FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Table of Contents

Section 1 Management

Section 2 Operations, Controls and Auditing

Section 3 Part 1 - Asset Management

Part 2 - Securities Transactions, Processing and Administration

Section 4 Compliance/Account Administration - Personal and Charitable Accounts

Section 5 Compliance/Account Administration Employee Benefit Accounts

Section 6 Account Administration Corporate Trust Accounts

Section 7 Compliance - Pooled Investment Vehicles

Section 8 Conflicts Of Interest, Self-Dealing and Contingent Liabilities

Section 9 Earnings, Volume Trends and Prospects

Section 10 Other Trust Matters

Section 11 FDIC:Registered Transfer Agent Examination Manual

Appendices

Appendix A Report of Examination Instructions - Not Available

Appendix B Examination aids

Appendix C Fiduciary Law excerpts or digests of applicable laws, regulations and principles

Appendix D Securities Law excerpts or digests of applicable laws, regulations and principles

Appendix E Employee benefit law, regulations, and opinions

Appendix F Corporate trust law excerpts or digests of applicable laws, regulations and principles

Appendix G Collective investment funds law, regulations and opinions

Appendix H Glossary

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Trust Examination Manual

Section 1 - Management

Table of Contents

This section of the Manual is organized into the following parts:

A. Introduction

B. Statement of principles of trust department management

C. Duties and responsibilities of directors

1. Supervisory Responsibilities

   a. Acceptance of New Accounts

   b. Approval of Closed Accounts

   c. Discretionary Distributions, Extraordinary Expenditures, and Other Matters

   d. Supervision of Investments

   e. Account Reviews

   f. Audit and Regulatory Reporting

   g. Retention of Legal Counsel

   h. Adequacy of Insurance Coverage

2. Organizational Structure

3. Committee Structure

   a. Trust Committee

   b. Management Committees

D. Management appraisal

1. Trust Officer Duties and Management Skills

2. Assessment Factors

3. Personnel, Staffing Levels, and Authority Lines

4. Personnel Policy

5. Management Succession

E. Risk management

F. Watch lists

G. Account review program

1. New Account Reviews
2. Scope of Annual Account Reviews
3. Frequency and Authority Level of Account Reviews
4. Content of Account Reviews
5. Records of Account Reviews
    a. Reviewing Authority Level
    b. Account Level

H. Trust policies

1. Other Trust Policies
2. Compliance with USA PATRIOT Act

I. Fee Concessions to insiders

J. Meeting with department management

K. Meeting with directors and committees

1. Disclosure of Ratings
2. Departments Assigned or Likely to be Assigned a Composite "1" or "2" Rating
3. Departments Assigned or Likely to be Assigned a Composite "3" Rating
4. Departments Assigned or Likely to be Assigned a Composite "4" or "5" Rating

A. Introduction

As a fiduciary, the bank's primary duty is the management and care of property for others. This responsibility requires the duty of loyalty, the duty to keep clear and accurate accounts, the duty to preserve and make productive trust property, as well as a myriad of other responsibilities. Refer to Section 4, Common Law duties. With these responsibilities comes risk, and management's ability to monitor and control these risks is of paramount importance. The Board of Directors and senior management must be able to identify, measure, monitor and control the risks inherent in fiduciary activities, and respond appropriately to changing business conditions. Increasingly, management is faced with operating or transaction, strategic, legal, compliance, credit, settlement, market, liquidity, and reputation risks. Appropriate internal policies, practices and controls should address these risks. The size and complexity of the trust department will dictate the depth of such policies.

Increasing competition from non-bank entities and the enactment of the Gramm-Leach-Bliley Act (GLBA) and USA PATRIOT Act will continue to bring changes to the fiduciary business. New affiliations with the mutual fund and insurance industries will increase business opportunities, but will also increase risk and potential conflicts of interest if not properly managed. The duty of loyalty must remain foremost in management's quest for new activities and affiliations.

B. Statement of Principles of Trust Department Management

The FDIC, in recognition of the necessity of establishing guidelines for the sound operation of a trust department, has issued a Statement of Principles of Trust Department Management (Statement) as revised and set forth below. Banks applying for the FDIC's consent to exercise trust powers must adopt the Statement before approval will be granted. In situations where a bank or trust department was not required to adopt the Statement pursuant to Part 303 of the FDIC Rules and Regulations, examiners should strongly recommend that the Board of Directors do so. Periodic or routine re-adoption of the Statement is not required. Examiners should make certain that trust management is operating the department in a manner consistent with the Statement, even when the Board has not adopted the Statement. Examiners must use judgment in ascertaining the conformance with these minimum standards. The Statement is general in scope and permits flexibility in implementation. However, examiners must determine whether the bank conforms to the spirit of the principles. Where deficiencies

are noted, trust management should be informed of the areas needing correction. Management's willingness to take corrective action should be reflected in the Report of Examination.

B.1. Statement

The minimum requirements to provide for sound banking practices in the operation of a trust department and to provide safeguards for the protection of depositors, fiduciary beneficiaries, creditors, stockholders, and the public, should include:

- Involvement by the Board of Directors in providing for the establishment and continuing operation of a trust department;
- Operation of the trust department separate and apart from every other department of the bank, with trust assets separated from other assets owned by the bank, and the assets of each trust account separated from the assets of every other trust account; and
- Maintenance of separate books and records for the trust department in sufficient detail to properly reflect all trust department activities.

The Board of Directors may act as the trust committee, and/or appoint additional committees and officers to administer the operations of the trust department. When delegating duties to subcommittees and/or officers, the Board and the trust committee continue to be responsible for the oversight of all trust activities. Sufficient reporting and monitoring procedures should be established to fulfill this responsibility.

The Board of Directors, by proper resolution included in its minutes, should:

1. Designate an officer, qualified and competent, to be responsible for and administer the activities of the trust department. In addition, the Board should define the officer's duties.

- Name a trust committee consisting of at least three directors to be responsible for and supervise the activities of the trust department. The committee should include, where possible, one or more directors who are not active officers of the bank.

  The trust committee should:

  a. Meet at least quarterly, and more frequently if necessary and prudent to fulfill its supervisory responsibilities;

  b. Approve and document the opening of all new trust department accounts; all purchases and sales of, and changes in, trust assets; and the closing of trust accounts;

  c. Provide for a comprehensive review of all new accounts for which the bank has investment responsibility promptly following acceptance;

  d. Provide for a review of each trust department account, including collective investment funds, at least once during each calendar year. Written policies should address the scope, frequency, and level of review (trust committee, subcommittee, or disinterested account officer) considering the department's fiduciary responsibilities, type and size of account, and other relevant factors.

     Generally, discretionary account reviews should cover administration of the account and suitability of the account's investments, and non-discretionary account reviews should address account administration;

  e. Keep comprehensive minutes of meetings held and actions taken; and

  f. Make periodic reports to the Board of its actions.

3. Provide comprehensive written policies which address all important areas of trust department activities.

Provide competent legal counsel to advise trust officers and the trust committee on legal matters pertaining to fiduciary activities.

- Provide for adequate internal controls including appropriate controls over trust assets.
- Provide for an adequate audit (by internal or external auditors or a combination thereof) of all fiduciary activities, annually. Trust committee minutes should record the findings of the audit, including actions taken as a result of the audit.

  If a bank adopts a continuous audit process instead of an annual audit process, the audit may be performed on an activity-by-activity basis, at intervals commensurate with the level of risk associated with that activity. Audit intervals must be supported and reassessed regularly to ensure appropriateness, given the current risk and volume of the activity.

- Receive reports from the trust committee and record actions taken in its minutes.
- Review the examination reports of the trust department by supervisory agencies and record actions taken in its minutes.

C. Duties and Responsibilities of Directors

The Board of Directors has the overall authority and responsibility for operating the trust department and administering fiduciary accounts. This administrative responsibility begins with the acceptance of an account and continues until the closing of the account. In discharging its authority, the Board of Directors may delegate duties and responsibilities to such committee(s), director(s), officer(s), employee(s), or legal counsel as it deems appropriate. However, the Board retains ultimate responsibility for delegated matters and must maintain the proper degree of control and supervision.

Only through its written records can the Board demonstrate that it has satisfactorily exercised its authority and responsibility. Consequently, the minutes of the Board should reflect discussions and decisions reached regarding significant trust related matters. Although the Board should review information regarding significant trust department activities, summaries of such information are acceptable. However, detailed reports or committee minutes should be available to the Board upon request.

The examiner may encounter instances where records of Board actions or information received are deficient or even completely lacking. In such situations, the examiner should inform the directors of the importance of correcting these deficiencies. The Report of Examination should outline the weaknesses and indicate management's response and planned corrective measures.

C.1. Supervisory Responsibilities

The Board of Directors is responsible for supervising and administering the activities of the trust department. The following are certain administrative responsibilities charged to the Board of Directors which may be delegated to duly appointed committees.

C.1.a. Acceptance of New Accounts

Formal acknowledgment of new accounts should be noted in Board or committee minutes. The Board has the authority to delegate approval of accounts to a junior committee. However, this practice should be used judiciously as the Board continues to remain responsible for all accounts accepted.

Management should delineate standards for the acceptance of new business to control potential risks. The standards should define criteria for accepting or declining new business, given management's administrative capabilities. The ability of the trust institution's staff, systems, and facilities to handle the proposed duties must be considered, when accepting new accounts. Other areas for consideration include, but are not limited to:

- Purpose of the account,
- Identity of principals and beneficiaries,
- Existence of, or potential for, conflicts of interest,

- Complexity of provisions,
- Composition and nature of assets,
- Existence of administrative problems, and
- Profitability.

Examiners should note that the acceptance of an unprofitable account should not be necessarily viewed as unfavorable. Unprofitable accounts may be accepted for a number of reasons including, but not limited to: other related accounts which, when viewed as a whole, are profitable; major commercial bank relationships; pro-bono appointments for charitable or other worthy causes, etc. Fee concessions for director, officer, and employee accounts may be acceptable, if offered on a non-discriminatory basis and under well-defined policies.

C.1.b. Approval of Closed Accounts

Closed accounts should be reviewed to determine if the responsibilities under the instrument have been properly discharged and account administration was in accordance with the department's policies and procedures. The improper administration of an account can potentially expose the bank to reputation risk and financial liability. A significant increase in the number of closed accounts may be indicative of other underlying operational or administrative issues. Formal acknowledgement of closed accounts should be noted in the Board or committee minutes, along with the reason the account was closed. Furthermore, trust department records must contain receipt for assets transferred from the successor trustee, administrator or beneficiaries.

C.1.c. Discretionary Distributions, Reallocation of Principal and Income, Extraordinary Expenditures, and Other Matters

The authority to grant discretionary distributions or reallocate principal and income (depending upon state law) is one of the most important powers vested in a fiduciary. The exercise of the power should be vested in the Board of Directors or a duly appointed committee (i.e., the trust committee or a subcommittee thereof) and approval or ratification of significant discretionary or reallocation actions should be noted in Board or committee minutes. Documentation of the approval of discretionary distributions or principal and income reallocations and denials should be retained in the individual account file to support ongoing administrative responsibilities. In the same manner, extraordinary expenditures should be approved by the Board or a delegated committee. The reasons for the expenditures and any communication with interested parties should be documented in the trust files.

The Uniform Principal and Income Act (UPIA) was most recently revised in 1997 to be consistent with the Prudent Investor Act, which looks to total return, rather than just interest or dividend income. As a result, investments may be made in products that do not provide a current income stream, but have considerable capital appreciation. Under the UPIA, specific assets and the uniform allocation is detailed. A copy of the UPIA is included in Appendix C and a listing of the more common assets and their related allocations between principal and income are included in Chapter 2.

The authority to grant discretionary distributions or reallocate principal and income are two of the most important powers vested in a fiduciary. The exercise of power should be vested in the Board of Directors or a duly appointed committee and approval or ratification of significant discretionary or reallocation actions should be noted in the Board or committee minutes. Documentation of the approval of discretionary distributions or principal and income reallocations, and denials should be retained in the individual account file to support on-going administrative responsibilities. In the same manner, extraordinary expenditures should be approved by the Board or a committee that reports directly to the Board. The reasons for the expenditures and any

communication with interested parties should be documented in the trust files.

C.1.d. Supervision of Investments

< To the extent the bank has investment discretion, management has several important responsibilities, including:

- Conservation of the value of the assets entrusted to its care of trust corpus;
- Optimization of income or growth in value consistent with prudent practices, the terms of the agreement, and the needs of the beneficiaries; and

The Board of Directors or its trust committee is responsible for the approval of all purchases and sales of assets, and for the retention or disposition of investments. However, in larger departments, senior management or the trust investment committee often reviews purchases and sales. The frequency (weekly or monthly) and method of review will vary depending upon management preferences, the volume of trades, and the trust accounting system utilized. Some departments may use an exception-based review process. Each review method provides management the opportunity to monitor compliance with internal policies and/or approved investment lists. Regardless of the method chosen, the review of purchases and sales is essential for a strong risk management program. Additional information on investments can be found in the Asset Management section. The suitability of assets held by each individual account should be incorporated into the account's annual investment review. Refer to the Account Review program for items to consider in an investment review.

C.1.e. Account Reviews

As discussed in the Statement, the trust committee should review each trust account initially upon acceptance and at least annually thereafter. Frequently, large trust departments delegate this responsibility to another committee or a disinterested trust officer. The annual review should incorporate an administrative review, and a review of investments, when the department exercises investment discretion. The scope of the annual review should be addressed in appropriate written policies which give consideration to the department's fiduciary responsibilities, the type and size of accounts, and other relevant factors. Refer to Account Review Program in this section.

C.1.f. Audit and Regulatory Reporting

The Board must ensure that appropriate internal and/or external audits of fiduciary activities are conducted. The adoption of a thorough audit program allows the Board to identify practices that contravene policies or violate fiduciary laws and regulations. It is essential for the Board or its designee to review the findings of the audit(s) and document the actions taken to respond to the findings. Additionally, the Board should review all examination reports by supervisory agencies and note corrective actions taken in the minutes. Refer to audits and accounting issues .

C.1.g. Retention of Legal Counsel

Management must effectively identify, measure, monitor, and control the legal risks inherent in the trust business. Therefore, informal or formal policies should be developed to assist management in the selection and retention of competent legal counsel, either in-house or external. Accounts considered for acceptance that involve pending or threatened litigation, complex or unusual documentation, or ambiguous language should be reviewed by counsel.

C.1.h. Adequacy of Insurance Coverage

An effective risk management program includes adequate insurance coverage. The Board has a responsibility to maintain sufficient coverage for the risks inherent in the fiduciary business. Furthermore, management must periodically review the policies for continued suitability. However, the Board and management should not rely on insurance coverage to compensate for

poor operational controls or the absence of proper oversight.

C.2. Organizational Structure

A Board resolution or the bank's bylaws should prescribe the structure and function of the trust department. Any workable system of organization of the trust department is acceptable, as long as it enables the directors, management and staff of the trust department to fulfill their respective responsibilities.

The Board of Directors may fulfill its fiduciary responsibilities by adopting an organizational plan that effectively accommodates the volume and type of fiduciary services offered, the competitive environment and future growth. The organizational plan should include effective communication processes that facilitate the exchange of all information necessary to inform all levels of trust department personnel of the institution's policies and directives, and allow senior management to verify that the trust department's operations comply with such policies and directives.

C.3. Committee Structure

Although the Board may elect to attend to all fiduciary matters, the handling of routine administrative and operational details is usually delegated to others. If the Board chooses to assign functions to a committee(s), all committee actions pertaining to the oversight of fiduciary functions should be recorded in minutes or similar records. Trust department committees should be structured to be flexible and workable. Functions and objectives should be clearly defined and effectively executed. Regular attendance and active participation by committee members are essential for effective oversight. Utilization of the committee process does not relieve the Board of its responsibilities for the actions taken by those groups.

C.3.a. Trust Committee

Normally, the Board of Directors does not directly supervise trust department activities. Depending on the size of the institution, the Board may establish a trust committee. In such cases, the committee should include at least three directors of the Board, and in institutions with outside directors, the committee should include at least one director who is not a bank officer. If the bank has no outside directors, the committee should not include any officers who participate significantly in the administration of the bank's fiduciary responsibilities. Examiners should assess trust committee independence and make recommendations where appropriate.

According to the Statement, the trust committee should meet at least quarterly. The trust committee should meet more frequently when necessary and prudent to fulfill its responsibilities.

C.3.b. Management Committees

Although not required, it is common practice to have management committees in both large and small departments. These committees typically review items requiring immediate attention or routine department activities. The two most frequently encountered committees are the trust administration committee and the trust investment committee. Larger departments may employ additional sub-committees (proxy, fee deviation, etc.) of the management committees. Management committees should maintain adequate minutes of meetings held and actions taken, which subsequently should be reviewed by the trust committee or its designee.

D. Management Appraisal

Examiners must assess management's ability to serve those fiduciary accounts presently under administration and those to which the bank has made a commitment. Although a primary measure of management's ability is the condition of the trust department and the quality of fiduciary services rendered, its potential to handle anticipated business is also significant, and therefore, examiners must evaluate the level of strategic planning by executive officers.

D.1. Trust Officer Duties and Management Skills

The Board of Directors should designate a qualified and competent officer to administer the activities of the trust department. In assessing competence, the qualifications of

management should be evaluated in relation to the duties assigned. Administrative duties of the trust officer include at a minimum, the following:

- Represent the institution in all fiduciary matters;
- Oversee administration of trust department accounts;
- Report all matters requiring its attention to the trust committee;
- Execute policies and instructions of the directors and the trust committee;
- Maintain adequate records such as entries, settlement sheets, and follow-up systems;
- Maintain adequate documentation to ensure all assets are properly safeguarded.

The senior trust officer/trust department manager may have limited knowledge of fiduciary matters, yet possess the managerial skills necessary to effectively guide the affairs of a particular trust department. In such cases, the examiner should emphasize the need for fiduciary expertise at middle management levels. The managerial skills of the senior trust officer/trust department manager should be evaluated in consideration of the following areas:

- Planning - A trust officer should establish a predetermined course of action. This includes setting both short-term and long-term objectives and establishing policies, procedures, and programs to reach these objectives.
- Organizing - A manager, along with the directorate, should establish an organizational structure designed to achieve the department's goals. The grouping of these activities, delegating of authority to perform these activities, and providing for coordination of relationships in the organizational structure should be analyzed.
- Staffing - Management should employ a sufficient number of qualified employees. This involves effectively recruiting, training, and retaining employees.
- Directing - Management should provide ongoing guidance and supervision of trust personnel to achieve the trust department's stated objectives.
- Controlling - Management should review, evaluate, and regulate the work in progress to ensure the activities meet established plans.

The examiner should analyze the type and depth of training offered to all trust personnel and evaluate the adequacy of the training program. Training may include in-house development programs, on-the-job training, correspondence courses, banking schools and seminars, training facilities of larger banks, and tuition aid programs.

The examiner should consider expertise available from sources outside the bank. Management may compensate for "in-house" weaknesses in such areas as investments, tax law, or accounting by employing outside professional services if permitted under state law. The examiner should determine whether management understands and can effectively evaluate the information and recommendations made by these services. Management should be able to use such services effectively. Before contracting with an outside servicer, a due diligence review of the counterparty and the contract should be performed. Refer to outside contracting for fiduciary services for additional information on due diligence reviews.

The competence of management should be questioned, if serious shortcomings or criticisms exist. When deficiencies are of short duration, middle management may often be responsible. However, senior management must be held responsible for any long-standing or widespread deficiencies. The examiner-in-charge must describe management deficiencies and make appropriate recommendations to correct them.

D.2. Assessment Factors

Examiners should look at the following factors when evaluating the competence and expertise of management, such as:

- Experience - What is the experience level of trust department management and does

this experience correspond to the individual duties and responsibilities assigned?

- Training - What kind of professional training, such as schools and seminars, is provided to management personnel, and has it been effective?
- Education - What is the level of academic achievement within the department and the relationship to managerial positions?
- Character - Are the personality, disposition, and reputation of trust department management consistent with the requirements imposed by their individual duties and responsibilities? Are there any other influences or factors that could cause a person's integrity, reliability, or ethics to be suspect?

In small trust departments, management must generally be well versed in all facets of the fiduciary services offered by the department. In moderate or larger departments, middle-level personnel may specialize (i.e., investment officers, account administrators, operations officers, taxation specialists, or new business development officers). Each should have a level of competence commensurate with the size and complexity of the department's activity.

D.3. Personnel, Staffing Levels, and Authority Lines

A plan of personnel organization should provide for continuity and include procedures for recruiting, training, and evaluating personnel. The staff should be adequate to handle the volume of work. Lines of authority, duties, and responsibilities should be clearly defined and effectively communicated to all personnel in order to promote the efficient, productive, and orderly execution of the department's functions. The lines of authority can be structured on a legal entity, business line, or functional basis. Reviewing lines of authority allows the examiner to assess the department's ability to identify, communicate and manage risks. An organizational chart is helpful as a starting point. The functional organizational structure should be designed to promote an orderly flow of the trust department's daily work and be sufficiently flexible to accommodate peak workloads without sacrificing efficiency or accuracy.

D.4. Personnel Policy

A personnel policy should cover the size of the trust department staff, qualifications of personnel, organizational structure, employee ethics, salary administration, and employee benefits. A code of ethical standards should deal with such matters as: acceptance of gratuities, gifts, favors, and bequests; acceptance of loans from fiduciaries, beneficiaries, customers, or agents; disposition of fees earned by employees for personal services rendered in the performance of fiduciary duties; employees accepting benefits for serving as co-fiduciary with the bank; employees exerting influence on fiduciary customers for personal gain; and employees maintaining confidentiality of the bank's fiduciary relationships.

D.5. Management Succession

The retention of qualified employees is essential in discharging the bank's fiduciary obligations. Undue reliance on one individual or several key individuals should be avoided where possible. The Board and management must ensure, through appropriate planning, that minimal disruption will occur should there be an unexpected departure of a key individual(s).

E. Risk Management

A formal risk management program should be established to identify and control fiduciary risk. An effective risk management program guards against liability that can result from lawsuits or poor administrative practices, and identifies those areas where there is potential for exposure. Strong internal controls, sound policies and practices, and appropriate management information systems provide the basis for an effective risk management program. The sophistication of the department's risk management program should be developed according to the complexity of its business products and services. Risk tolerance levels should be clearly set and monitored by both senior management and the Board of Directors. The program should be reviewed continuously and revised to capture current and anticipated business risks. At a minimum, an effective risk management program should:

- Establish the level of risk that management is willing to assume. Examiner emphasis should be placed on reviewing the planning process, policies related to the process, and underwriting

standards of accounts and new products.

- Identify the various risks associated with the institution's key products and services, as well as its operating environment. This includes an analysis of methods employed in determining fiduciary insurance coverage, loss reserves, and the impact of fiduciary risk on capital adequacy. Litigation concerns should also be analyzed.
- Implement adequate controls and monitoring systems. This includes establishing a system of checks and balances, reviewing audit coverage, the compliance management system, and the overall scope and reliability of existing management information systems.
- Supervise operations and the implementation of procedures when new accounts are obtained. Guidelines should provide information as to day-to-day management of fiduciary activities, operating systems, and internal controls.

Trust activities expose the bank to many of the same risks encountered in bank operations. Operating or transaction, strategic, legal, compliance, credit, settlement, market, liquidity, and reputational risks are found in varying degrees within many departments. While some risks may directly affect the department and the bank, others may be inherent in the products purchased or held in client accounts. Ultimately, if management is unable to identify and/or properly manage these risks, the bank's reputation may be damaged.

F. Watch Lists

A written watch list of accounts and assets meriting special attention provides a measure of control that can assist the department in limiting contingent liability and mitigating loss. To be effective, the watch list should be comprehensive, well documented, and periodically reviewed by the trust committee. Management actions, including decisions made, contacts with interested parties, and legal discussions should also be noted and documented in writing. The level of detail provided by the watch list and the depth of the follow-up procedures will vary with the size and complexity of the trust department. However, at a minimum, the watch list should:

- Identify trust accounts, groups of trust accounts, or assets that warrant the special attention of management; and
- Provide a summary of each account or asset identified, indicating the reason(s) why the particular account or asset merits special attention, and to the extent feasible, quantify the amount of risk.

Accounts or assets that involve pending or threatened litigation, customer complaints, waived fees, criticisms by regulatory authorities at prior examinations, large overdrafts, default or bankruptcy, or other situations may warrant inclusion on the department's watch list.

Finally, watch lists also serve as a valuable reference point for examiners, who can compare the findings of their own account review with the accounts identified by management as warranting special attention. This should assist examiners in assessing the adequacy of the risk management program. Finally, reliable watch lists can be used by examiners to determine the scope of account review.

G. Account Review Program

G.1. New Account Reviews

The initial review of new accounts for which the bank has investment responsibility should be conducted promptly following acceptance. Industry practice is to complete the review within 60-90 days of opening. The initial review should establish an investment program consistent with the needs and objectives of the account, and ensure that the synoptic record is complete and accurate.

G.2. Scope of Annual Account Reviews

The scope of the account review primarily depends on the department's fiduciary responsibilities and the type of account under review. An account review should generally cover the administration of the account (administrative review) and the suitability of the account's assets (investment review). Refer to Content of Account Reviews in this section for additional information on administrative and investment reviews. Departments that provide services to third parties, or who obtain services from third parties, should ensure that all affected accounts are reviewed by the appropriate party as outlined in the written agreements. The scope of an account review is dependent upon the nature of fiduciary

responsibilities and types of account, as outlined below.

- Collective Investment Funds - The review of collective investment funds should include both an administrative and an investment review. The administrative review should ensure that the operation of each collective investment fund complies with applicable laws, and regulations (e.g. OCC Regulation 9, SEC regulations, ERISA and DOL regulations, the Internal Revenue Code and IRS regulations, etc.) and standard industry practice. The investment review should ensure that investments are consistent with the stated investment purpose of each fund. Fund performance for each collective investment fund should also be included in the annual review.

- Discretionary Personal and Employee Benefit Accounts - In personal and employee benefit accounts where the institution has investment discretion, an account review generally should consist of both an administrative and investment review. The administrative review will differ according to the type and purpose of a given account.

- Nondiscretionary Personal Accounts - The account review should primarily focus on the appropriateness of account administration, which will differ according to the type and purpose of a given account. There may be no requirement or responsibility to review investments, but as in all nondiscretionary accounts, a corporate fiduciary may be held accountable for the actions of a co-fiduciary, due to bank's professional corporate trust status.

- Nondiscretionary ERISA Employee Benefit Accounts - Review of self-directed employee benefit accounts is normally limited to coverage of administrative matters. These will differ according to the type of responsibilities (such as participant record keeping, participant loan programs, etc.) administered by the bank. In these accounts, a cursory review of the investments is also in order to avoid flagrant violation of the insider and prohibited transaction provisions of ERISA. Trustees directed by named fiduciaries have liability to determine whether directions are proper, meaning that they are in accordance with the plan, and not contrary to ERISA and/or applicable regulations. See ERISA Section 403(a)(1). A corporate fiduciary is held to a higher standard because of its purported knowledge and expertise in fiduciary matters.

- Nondiscretionary non-ERISA Employee Benefit Accounts - These accounts are generally sponsored by church organizations or state, county, or municipal governments and their agencies. Only the administrative reviews, as covered above for nondiscretionary ERISA employee benefit accounts, need to be performed.

- Self-Directed IRAs and Keoghs - Self-directed IRA and Keogh accounts are considered trust accounts under Internal Revenue Code Section 408(h). Therefore, examiners should ensure that an administrative review is performed and that proper controls are in place to limit liability. For a discussion of the proper controls, refer to the Operations, Internal Controls and Auditing section regarding Self-Directed IRAs and Keoghs.

- Custodial Accounts - Although custodial accounts are not always considered fiduciary accounts (the classification depends on state law), administrative reviews should be performed on all custodial accounts. This also applies to custodial accounts for ERISA employee benefit plans. Management has the responsibility of ensuring that custodial relationships are being administered in accordance with signed agreements.

- Discretionary Corporate Bond Trusteeships - Bond indentures for corporate and municipal debt issues (bonds, debentures, notes, etc.) usually delineate how available funds are to be invested. Nonetheless, the bank may have discretion in selecting the actual investments. In such cases, the investments held for the account should be reviewed, as well as the administration of the account.

- Nondiscretionary Corporate Bond Trusteeships and Agencies - These accounts generally involve corporate and municipal debt issues, securities transfer agencies, paying agencies, etc. Since there are either no assets on hand or the bank has no discretion over their investment, only administrative reviews need to be conducted.

G.3. Frequency and Authority Level of Account Reviews

The Statement of Principles of Trust Department Management requires that all trust accounts be reviewed during each calendar year. The Board of Directors is responsible for conducting account reviews and outlining the frequency and authority level of account reviews in a departmental policy. The Board can establish an organizational structure of its choice, including the delegation of account reviews to subcommittees or disinterested account officers.

Certain accounts may warrant a more frequent review or a review at a higher level in the organization than other accounts. For example, those accounts where the bank has investment discretion may require a more frequent review than accounts where no investment discretion is exercised. The reviews should be conducted by a committee in order to obtain group experience and knowledge. In addition, accounts which should receive more frequent and senior-level reviews include accounts that: possess unique or unusual characteristics or circumstances, involve substantive complaints from grantors or beneficiaries, involve substantive or repeated criticism by regulatory authorities, involve pending litigation, or invest in complex and/or high risk investments.

In turn, certain accounts may be of a size or complexity that they can be, at the judgment of the Board, collectively reviewed. Collective review procedures would normally be performed on the smallest and least complex of trust department accounts. However, collective reviews may also include some larger, self-directed IRA or 401(k) employee benefit plans. In addition, de minimus accounts may qualify for "non-review" if Board approved procedures establish criteria for including or excluding these accounts from the non-review category. The examiner should ensure that collective and de minimus review procedures are reasonable.

Accounts where the bank does not have investment discretion, other than those discussed previously as deserving of a higher level of review, may, at the discretion of the Board, be reviewed by a disinterested account officer, that is, an officer who is not responsible for the account's administration.

Examiners should strongly encourage management to adopt account review procedures and should criticize failure to review accounts in accordance with the Statement of Principles of Trust Department Management or departmental policies in the Report of Examination.

G.4. Content of Account Reviews

A comprehensive account review includes both an administrative and an investment review. Management may choose to address both aspects in one review or perform two separate and distinct reviews. Both methods are acceptable as long as each review, by itself, is complete in nature. Whether performed separately or together, the reviewing authority (trust committee, subcommittee, or disinterested account officer) should perform the review in light of the governing instruments, applicable laws and regulations, fiduciary responsibilities, and needs of the beneficiaries.

No listing can appropriately denote every item which should be considered in an account review since the reviews vary based on the department's fiduciary responsibilities, type of account, assets held, and other circumstances. Nonetheless, the general areas noted below are illustrative of the areas that should receive coverage in either an administrative or investment account review.

Administrative Review

An administrative review may include, but is not limited to, the following items:

1. Governing instrument (trust, will, plan, indenture, etc.) - Is a copy on file?

- Synoptic record - Is the record complete, accurate, current, and reliable?
- Tickler system - Is the system up-to-date and accurate?
- Cash transactions - Are remittances, disbursements, and overdrafts posted correctly to income and principal? Is there any evidence of unusual cash flow activity, such as free riding? Is there any suspicion of money laundering? If so, has management

filed, or considered filing, a Suspicious Activity Report (SAR) as per FDIC Part 353.

- Securities transactions - Were appropriate approvals and authorizations obtained for non-discretionary and discretionary transactions? As applicable, were confirmations sent within the prescribed time frames? Did the confirmations or account statements contain the appropriate disclosure documentation? Refer to the full text of Part 344 of the FDIC Rules and Regulations for specifics.
- Own-bank and affiliate obligations - Are purchases properly authorized?
- Accountings and statements - Are they accurate and timely?
- Commissions and fees - Are they accurate, consistent with the established fee schedule, and being collected?
- Co-fiduciary approvals/denials - Are approvals/denials documented?
- Committee approvals/denials - Are approvals/denials documented?
- Internal policies and procedures - Is the account in compliance?
- Complaints - Are complaints by grantors, beneficiaries, plan administrators, etc. being reviewed? Have previous complaints been resolved?
- Criticisms - Is corrective action being taken with regard to criticisms noted by internal and/or external auditors and regulatory authorities?

Note: Examiners should be flexible in assessing the adequacy of the administrative review process. An evaluation of an institution's administrative review process should focus on the effectiveness of the process, rather than the manner in which the review process is conducted. While a formal review session approach (one in which those performing the administrative review meet formally at specific intervals to review the administration of some or all accounts) may work well in small and medium size trust departments, such an approach may be both impractical and inefficient in large departments that administer thousands of accounts. Such institutions may adopt administrative review methods that employ a "due diligence" approach to account review. In lieu of a "sit down and checklist" methodology, the "due diligence" approach uses a combination of internal audits, tickler systems, checks and balances and other procedures to verify that, over the course of the year, all accounts are properly administered. Examiners should not automatically criticize the absence of formal account review sessions, but instead should evaluate the effectiveness of the "due diligence" process in providing assurance that all accounts are administered properly. The "due diligence" process should promptly identify administrative deficiencies and promote the timely correction of identified weaknesses. The results of the administrative review process should be periodically reported to the Board, or a Board committee thereof, and senior management.

Investment Review

If the bank has discretion over the account's assets, sufficient information should be provided to the reviewing authority to enable it to make informed and intelligent decisions. At a minimum, information considered necessary to perform an investment review includes:

- Investment powers authorized by the trust instrument and/or governing law,
- Investment objective of the account (income, growth, etc.),
- Listing of account assets, reflecting cost and market values,
- Projected yields on individual assets,
- Projected income of the overall account, and
- Amount of principal and income cash on hand.

An investment review may include, but is not limited to, the following items:

1. Investment objectives - Are they consistent with the objectives of the trust? Are assets held consistent with the chosen investment objectives and/or asset allocation models?

- Diversification of discretionary investments - Is the account properly diversified consistent with either the Prudent Investor Act or Prudent Man Rule, as applicable?
- Concentrations - Are there any undue concentrations, either within a type of security, industry, or specific obligation?
- Own-bank or affiliate obligations - Is the purchase appropriate, yield adequate, and authorization documented?
- Investments in companies related to, or loans made to, bank insiders - Are there any conflict of interest or self-dealing concerns?
- Approved hold, buy, and sell lists - Is the account in compliance?
- Maturity of assets - Are there excess funds invested in short-term (lower yielding) investments? Is there adequate liquidity?
- Asset valuations - Are assets including real estate, limited partnerships, closely held businesses, real estate syndications, and derivatives valued accurately?
- Insurance coverage - Is it adequate?
- Environmental risk factors - Are there any environmental risk concerns?
- Complaints - Are complaints by grantors, beneficiaries, plan administrators, etc. being reviewed? Have previous complaints been resolved?
- Criticisms - Is corrective action being taken in regards to criticisms noted by internal and external auditors and regulatory authorities?

All of the items listed above will not necessarily be included in every trust department's account review program. Therefore, examiners must exercise discretion in assessing the adequacy of account reviews. An assessment should be made after giving consideration to the department's overall account review program, fiduciary responsibilities, committee minutes, file documentation, account officer expertise, and account sampling. Some trust departments may believe that completion of an investment review satisfies the account review requirement for discretionary accounts. Examiners should remind management that fulfilling account administrative duties (i.e., timely mailing of customer statements, income distributions, fee calculations, etc.) is also a fiduciary responsibility that should be reviewed to reduce exposure to liability.

If the account review program is materially deficient, the Report of Examination should contain criticisms of management . The examiner-in-charge should obtain management's response and plan for corrective action.

G.5. Records of Account Reviews

The bank should be able to satisfactorily demonstrate that account reviews are accomplished according to the standard set by the Statement of Principles of Trust Department Management and departmental policy. Normally, two types of records of account reviews are maintained: one at the reviewing authority level (i.e., trust committee, subcommittee, or disinterested account officer), and the other at the trust account level.

G.5.a Reviewing Authority Level

The purpose of a record at this level is to document the fact that the institution has accorded proper reviews of its trust department accounts. An appropriate record should be maintained at the reviewing authority level (committee or disinterested account officer) substantiating that a review was conducted. The record should list individual accounts reviewed and provide details of any decisions made concerning the accounts. Examiners should review management's methodology for conducting reviews and determine if adequate exception reporting has been implemented and is being monitored.

A summary report of these reviews should be submitted to the next highest committee (or subcommittee) level for ratification. Copies of the actual review documents or material(s) on which the review was conducted do not need to be routinely provided to the next highest committee, however, such documentation should be made available for review if requested.

G.5.b. Account Level

The purpose of a record at this level is to document the fact that the individual trust account received an appropriate review. A record of the review should appear in the individual account file, as it is management's duty to keep clear and accurate accounts. The actual review documents or materials on which the review was based should be kept at this level. Any noted exceptions to the governing instrument or department policies should be retained in the file along with sufficient documentation outlining corrective action. Objections, complaints, and lawsuits over trust accounts often occur years after a transaction occurs. The information provided in this record can be an important defense in explaining the rationale for actions taken in prior years. Account review information should be more easily assembled from this source than from information recorded in committee minutes .

H. Trust Policies

Directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the Board's goals, objectives, and risk limits into prudent operating standards. Compliance with internally developed policies and procedures is a fundamental element in a sound risk management program. When properly monitored and enforced by directors, well-developed policies, procedures, and controls promote operating efficiency, compliance with laws and fiduciary principles, and minimize losses.

In smaller banks, policies may be brief, yet adequately serve the needs of the department given the services offered and nature of accounts administered. In larger departments, however, or in those administering more complex accounts, policies will likely be more detailed. Nonetheless, the FDIC recommends that all policies be written. The Board should periodically review and revise the policies to ensure that they remain adequate for the bank's fiduciary activities. Depending upon the complexity of fiduciary operations, trust department policies typically, address the areas listed below.

Trust Department Policies

- Investment Policy
- Overdraft and Cash Balance Requirements
- Guidelines for Account Administration
- Fee Concessions
- Conflicts of Interest and Self-Dealing Policies
- Securities Trading
- Operations and Controls Guidelines
- Business Development Guidelines
- Selection and Retention of Legal Counsel
- Policy Exception Reporting and Approval Guidelines

In addition to trust specific policies, many banks incorporate fiduciary activities within broader bank policies. As appropriate, examiners should review bank policies that are applicable to the trust function or cover trust employees. Detailed below are some of the more common bank policies that may cover fiduciary activities.

Bank Policies

- Ethics/Code of Conduct including a Bribery Policy
- Personnel
- Bank Secrecy Act
- Customer Due Diligence
- Electronic Banking
- Privacy
- Electronic Funds Transfer

H.1. Other Trust Policies

Other trust policies may include, but are not necessarily limited to, brokerage placement policies; acceptance of accounts; acceptance of co-fiduciary appointments and division of compensation with co-fiduciaries; operations and administration; scope, frequency, and level of account reviews; loans to trust accounts; and proxy voting.

H.2. Compliance with USA PATRIOT Act

In October, 2001, Congress passed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, known as USA PATRIOT Act. The purpose of the Act is "To deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and for other purposes." The Act is far-reaching, and places numerous requirements on banks, including their trust departments. Banks must develop policies and procedures to ensure trust departments comply with provisions of the USA PATRIOT Act and other anti-money laundering (AML) regulations.

New provisions of the Bank Secrecy Act are intended to facilitate the prevention, detection, and prosecution of money laundering and the financing of terrorism. Financial institutions are required to implement a Customer Identification Program (CIP) and establish reasonable procedures to:

- Verify the identity of persons seeking to open an account.
- Maintain records of information used to establish the identities of customers.
- Determine whether any persons seeking to open an account appear on lists of known or suspected terrorists or terrorist organizations. As of the date of the most recent Trust Manual revision, there is no officially approved list of known or suspected terrorists or terrorist organizations.

Note: for purposes of the law, a customer includes all persons that open accounts. It does not include existing customers if bank management is satisfied of the identification of the account holder. Furthermore, a person includes a trust, but does not include the beneficiary of the trust.

The definition of an account specifically includes asset accounts, and accounts established to provide cash management, custodian, or trust services. However, the definition does not include accounts opened for the purpose of participating in employee benefit plans established under ERISA.

This is the minimum required identification information for the CIP when opening an account:

- Name
- TIN (tax identification number or social security number). There is a TIN exception for a business that has recently applied for, but has not received a TIN. The bank can open the account without the TIN for a reasonable time period; however, the bank must follow up to obtain the TIN.
- for individual - date of birth

- for individual - residence, if different, mailing address; or
- for corporations, partnerships, and trusts - principal place of business and, if different, mailing address.

In order to verify the identity of a person other than an individual opening an account, various documents could be used to show the existence of the entity, including articles of incorporation, government-issued business licenses, partnership agreements, or trust instruments.

Reliance on Other Financial Institutions

The CIP may include procedures specifying when a bank will rely on the performance by another financial institution, including an affiliate, of CIP procedures for customers with or opening accounts at the other institution. The PATRIOT Act states, "In order for a bank to rely on the other financial institution, such reliance must be reasonable under the circumstances, and the other financial institution must be subject to a rule implementing the anti-money laundering compliance program of 31 USC 5318(h) and be regulated by a Federal functional regulator. The other financial institution must enter into a contract requiring it to certify annually to the bank that it has implemented its anti-money laundering program and that it will perform (or its agent will perform) the specified requirements of the bank's CIP. The contract will provide a standard means for a bank to demonstrate the extent to which it is relying on another institution to perform its CIP, and that the institution has in fact agreed to perform those functions. If it is not clear from these documents, a bank must be able to otherwise demonstrate when it is relying on another institution to perform its CIP with respect to a particular customer."

Foreign Correspondent Accounts

Section 312 of the PATRIOT Act requires that "Each financial institution that establishes, maintains, administers, or manages a private banking account or a correspondent account in the United States for a non-United States person, including a foreign individual visiting the United States, or a representative of a non-United States person shall establish appropriate, specific, and, where necessary, enhanced, due diligence policies, procedures, and controls that are reasonably designed to detect and report instances of money laundering through these accounts." Additionally, enhanced due diligence procedures are required for correspondent accounts with foreign banks operating:

- under an offshore banking license; or
- under a banking license issued by a foreign country that has been designated as non-cooperative with international anti-money laundering principles by an intergovernmental group or organization of which the United States is a member, with which designation the United States representative to the group or organization concurs; or designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns.

The enhanced procedures include identifying the owners of any foreign bank not publicly traded and the nature and extent of the ownership interest of each owner, conducting enhanced scrutiny of such account to guard against money laundering and report any suspicious activity, and ascertaining whether the foreign banks provide correspondent accounts to other foreign banks, and, if so, the identity of those foreign banks and appropriate due diligence.

Private Banking

Enhanced procedures for private banking accounts include ascertaining the identity of the nominal and beneficial owners of, and the source of funds deposited into the account, and reporting any suspicious activity in the account. Additionally, an account maintained by, or on behalf of, a senior foreign political figure, his/her immediate family, or close associate must receive enhanced scrutiny to detect and report foreign transactions that may involve the proceeds of foreign corruption. Private banking accounts include those with assets exceeding $1 million which are assigned to an individual acting as an employee or agent of a financial institution and as a liaison between the financial institution and the direct or

beneficial owner of the account.

Mutual Funds

The USA PATRIOT Act also requires mutual fund management to adopt formal anti-money laundering programs which include at a minimum:

- The development of internal policies, procedures and controls;
- The designation of a compliance officer;
- An ongoing employee development program; and
- An independent audit function to test programs.

I. Fee Concessions to Insiders

It is a common fiduciary practice for management to grant fee discounts to fiduciary clients. Such discounts are usually offered as either fee concessions or compensating balance arrangements. The trust department's policy should clearly describe to whom and for what purpose discounts will be allowed, the types of services which may be involved, and the method by which the trust department may be compensated by the bank for such discounts.

If the practice is to charge reduced fees to directors, officers, employees, shareholders, or their interests, that practice should be in writing and approved by the Board. Fee concessions are acceptable provided:

- They are consistent with the marketing and profitability objectives;
- The trust department will operate at a profit after the fee concessions are granted;
- The fee concessions are awarded under a uniform and nondiscriminatory policy to all directors, officers, and employees of the bank; and
- The fee concession policy is approved by the Board of Directors.

Affiliate Accounts and Fees

ERISA establishes limitations on fees that may be assessed by the trust department against affiliated employee benefit accounts. Pursuant to ERISA, trust departments may be reimbursed only for specific costs associated with the employee benefit accounts and are limited to the extent that direct costs vary and are passed-through to the account in the form of fees.

Section 23B of the Federal Reserve Act prohibits the preferential waiver of fees for the benefit of an affiliate (and to the detriment of the bank/trust department). Section 23B targets fees that are negotiated or based on a fee schedule since such fees generate income or profit for the trust department. When these scheduled fees are reduced or waived for affiliated accounts, employee benefit or otherwise, an apparent violation of Section 23B may occur.

Note that ERISA establishes limits that trust departments may charge employee benefit accounts while Section 23B limits preferential treatment to affiliates. If a given trust department is assessing employee benefits accounts fees in accordance with the ERISA schedule, Section 23B will likely not apply as there is no preferential treatment to the employee benefit account, even if affiliated, since the trust department is only following proscribed law. However, when fees assessed are actually less than direct costs associated with the servicing of an affiliated employee benefit account, an apparent violation of Section 23B may exist.

J. Meeting With Department Management

Ongoing communication between the examination staff and trust department management is critical for effective supervision. Open communication ensures that examination requests are met and that disruptions to the department's normal business are minimized. Informal meetings should be held before and throughout the examination to discuss any significant changes since the last examination or any planned changes. Some of the items to discuss with management include:

- Policies

Organizational structure

- Operations
- Marketing strategies
- New products and services

At the conclusion of the examination, the examiner-in-charge should meet with the trust department manager and another senior level bank manager to discuss the examination findings. In addition to presenting the findings and recommendations, the examiner-in-charge should obtain management's response. No significant recommendations or criticisms should be presented in the report of examination that have not first been presented to management.

K. Meeting With Directors and Committees

Although review of trust committee minutes and supplemental reports should indicate the degree of involvement and interest of committee members in their assigned duties and responsibilities, it may not provide sufficient basis for analyzing committee effectiveness. Therefore, examiners may consider attending committee meetings held during the examination, not only to observe, but also to share examination findings and offer recommendations to the committee. The examiner may use this opportunity to discuss committee members' collective views on the department, its direction and potential.

At or near the conclusion of the examination a meeting with the Board of Directors, trust committee or other Board committee should be held. When it is concluded that a meeting with a Board committee rather than the full Board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of Board members who are not full time officers. Additionally, the committee chosen should be influential as to policy, meet regularly, and report to the entire Board.

The purpose of such Board or committee meetings is to acquaint directors and/or committee members with the condition of the trust department, present recommendations for correcting deficiencies or weaknesses, and seek the institution's commitment to correct the deficiencies. The examiner should note in the Report of Examination with whom the findings of the examination were discussed and the corrective commitments and/or reactions.

K.1.Disclosure of Ratings

At the conclusion of the examination, it is appropriate for the examiner to disclose to senior management and/or the Board of Directors the Uniform Interagency Trust Rating System (UITRS) component and composite ratings. Disclosure of the component and composite ratings encourages a more complete and open discussion of examination findings and recommendations, and therefore provides management with useful information to assist in making risk management procedures more effective. Examiners should clearly explain that the ratings are tentative and subject to final approval by the Regional Director.

K.2. Departments Assigned or Likely to be Assigned a Composite "1" or "2" Rating

I f the trust department is assigned or likely to be assigned a composite "1" or "2" rating under the UITRS, a meeting with the Board or a Board committee is not required.

K.3. Departments Assigned or Likely to be Assigned a Composite "3" Rating

If the trust department is assigned or likely to be assigned a composite "3" rating under the UITRS, the examiner-in-charge should meet with the Board of Directors or an appropriate committee during or subsequent to the examination. Regional Office representation is at the discretion of the Regional Director. Additional meetings or other contacts with the Board of Directors or appropriate Board committee may be scheduled at the discretion of the Regional Director or designee.

K.4. Departments Assigned or Likely to be Assigned a Composite "4" or "5" Rating

If the trust department is assigned or likely to be assigned a composite "4" or "5" rating under the UITRS, the examiner-in-charge should meet with the Board of Directors. In such instances, the Regional Office should be informed so that the Regional Director or a designee of the Regional Director can attend the meeting if necessary. Consultation with the Regional Office can take place during or subsequent to the examination. If the trust and commercial departments of the bank are examined concurrently, the meetings may be held

jointly. There should be close coordination between the examiners-in-charge of the commercial and trust examinations.

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Trust Examination Manual

Section 2 - Operations, Controls and Auditing

Table of Contents

The operations section of a trust department provides support to the administrative arm in much the same way as the operations division of a bank supports its other functions. As such, it is the focal point for all actions affecting customer accounts and the department itself. To be effective it must provide management with accurate and reliable systems for documentation, accounting and control. While the sophistication of the operational systems employed is likely to vary with the size and complexity of the department, the underlying principles involved are universal.

The trust function must have adequate facilities and equipment, as well as a sufficient number of knowledgeable, trained and experienced staff, to accomplish its tasks. Documentation substantiating appointments and actions taken throughout the life of an account must be obtained, maintained and preserved. Record keeping systems must provide a detailed picture of all funds and other assets under the control of the fiduciary from an account's inception to its closing. Procedures must be developed to process work in a uniform and orderly manner and a practical system of checks and balances must be developed to ensure the integrity of the work performed.

This section of the Manual is organized into the following parts:

A. Trust accounting

B. Property ownership

C. Principal and income

D. Carrying values

E. Accounting records

  1. General Ledger
  2. Asset Control Accounts
  3. Subsidiary Asset Controls
  4. Subsidiary Liability Controls

F. Trust records

  1. Administrative File
     a. Legal File
     b. Digest or Synopsis
     c. Correspondence File
     d. Investment Review File

e. Securities Transaction File

f. Tax File

2. Tickler System

3. Other Records

a. Securities Transaction Register

b. Vault Control Log

c. Broker Statements

G. Account documentation

1. Evidence of Appointment

2. Supporting Documentation

a. Trust Committee Minutes

b. Approvals

c. Indemnification

d. Accountings and Customers' Statements

e. Account Reviews

f. Receipt and Release

g. Other Documents

H. Internal Controls

1. Segregation of Duties

2. Vacation Policy

3. Reconcilements

4. Other Elements of Control

5. Fraudulent Acts

I. Nominees

J. Use of broker-dealers for securities safekeeping/securities investor protection corporation (SIPC)

K. Free riding and daylight overdrafts

L. Facilities

M. Information Technology

N. Business Continuity Planning

O. Self-directed IRA'S and keogh accounts

1. Direct Arrangements

2. Arrangements with Third Parties

P. Custodial holdings of government securities: compliance with government securities act of 1986

1. Background

2. Applicability

a. To broker-dealer activities

b. To government securities repurchase transactions

c. To custodial holdings of government securities for customers:

Q. Shareholder Communications Act of 1985

1. Background and Requirements

2. Applicability to Trust Accounts

R. State escheat laws

S. Audit and accounting issues

1. Audit Objectives

2. Audit Program

3. Audit Activities

4. Evaluation of the Audit Function

5. Statement on Accounting Standards (SAS #70)

6. FAS 87

A. Trust accounting

While general accounting principles apply to trust recordkeeping, significant differences exist between the accounting systems employed by the trust department and the commercial department. Trust departments are called upon to serve in various capacities. Aside from personal and employee benefit trusts, the department may serve as corporate trustee for bond issues or as a paying or escrow agent. Since each account must be treated as an individual entity, the accounting system adopted will be required to reflect individualized statements of holdings (or accountability), as well as aggregate controls for the department. The specialization required by this type of system, and the legal ramifications involved in handling fiduciary matters, necessitate the adoption of a completely separate set of books and records.

The fundamental principle behind general accounting theory is expressed in the equation:

Assets = Liabilities + Capital

This principle does not apply to trust accounting, since the fiduciary does not account for its own assets, but for the property of others. As such, the fundamental principle behind trust accounting is expressed as follows:

Assets = Accountability (or Liabilities)

In this equation, assets such as securities, deposits, or real property are liabilities for which the department is accountable, or liable, to others. Expressed differently, the assets of trust accounts are also the liabilities of the fiduciary. Normally, the only accounts holding cash or assets not owed to fiduciary customers are "house accounts," which may include undistributed profits and suspense items.

Note that the Call Report Instructions and Glossary describing accounting standards and practices, and generally accepted accounting principles, do not apply to trust accounting.

B. Property Ownership

The laws governing the ownership of property differ from state to state. Therefore, examiners need some basic knowledge of the property laws applicable within individual states. Trusts, in some form, are permissible in all states. A trust occurs when the ownership of property is separated as to title and equity. A trustee retains title to trust property (corpus or principal), but has no beneficial or equitable interest in

the property. A trust cannot exist when the legal owner, or party holding title, also holds the only beneficial interest in the property. Nevertheless, a fiduciary does not necessarily have to hold title to property, such as in a guardianship. Beneficiaries are divided into two classes: those holding a current interest in the property of a trust, and those holding a remainder (or future) interest. Since the first class of beneficiaries is entitled to the current return generated from the property, while the latter is entitled to the future value of the property at some specified future time, trustees must maintain separate records to account for, and distinguish between, income and principal.

In an agency capacity, ownership and, in general, title to the assets, does not pass to the fiduciary, but remains with the principal. The trust department's obligation is to act as the principal's agent and follow the instructions stipulated in an agency agreement.

C. Principal and Income Allocations

The trustee is under a duty to deal impartially (remain neutral) with beneficiaries, when there are at least two beneficiaries. This rule applies when the beneficiaries' interests are concurrent or successive. In personal fiduciary accounts, it is common for one set of beneficiaries to be entitled to the income ("income beneficiaries"), while a second set of beneficiaries is entitled to the principal ("remaindermen"). These classes of beneficiaries often have different, sometimes opposing, needs and interests. While serving both classes of beneficiaries can often prove difficult, the trustee must balance objectives and investments, so that one class of beneficiary is not favored over the other.

While account agreements may outline permissible investment products, the documents may not indicate treatment for allocations between principal and income. For those circumstances where principal and income are not defined, default allocations have been established under the Uniform Principal and Income Act, with most states adopting the 1931 and the 1962 Revised Uniform Principal and Income Act. The Act was again revised in 1997 to incorporate and be consistent with the concept of Prudent Investor Act (modern portfolio theory and total return) and allow for investment products not previously developed. A copy of the Act and commentary are provided in Appendix C Uniform Principal and Income Act of 1997. Nearly all states have adopted the Act in some form; however, examiners are reminded that states may modify "uniform" Acts during the legislative process. According to the National Conference of Commissioners on Uniform State Laws, the primary difference is the ability to delegate investment decisions. Consequently, the law of any state may depart in small or large measure from the "uniform" Act presented in this manual. The text of these and other uniform acts is also available at the Internet site of the National Conference of Commissioners of Uniform State Laws, http://www.nccusl.org .

Although distinguishing between "principal" and "income" appears relatively straightforward, there are many situations where it is much more complicated. The following list summarizes allocations for various issues:

- Discount Obligations - The entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition, unless the obligation, when acquired, has a maturity of less than one year.
- Capital Gains - Capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is considered to be income.
- Reinvested Dividends - If a trustee elects or continues a course of action to reinvest dividends in shares of stock of a distributing corporation or fund, the new shares would be principal. However, if the trustee makes a decision, for example, to make an investment without incurring brokerage fees, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.
- Mineral rights - 90 percent of oil and gas receipts are considered principal, while the remaining 10 percent are income.
- Timber, Christmas trees, and Plywood for Commercial Sale or Use - If the timber cut and removed does not exceed the growth rate of timber during the accounting periods in which a beneficiary has a mandatory income interest, then net receipts are allocated to income. Any amount removed in excess of the growth rate is considered principal. If the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, then net receipts may be allocated between income or principal. In determining net receipts to be allocated, a trustee should deduct and transfer to principal a reasonable amount for depletion.

- Liquidating Assets, Such As Leaseholds, Patents, Copyrights, And Royalty Rights - Property subject to depletion was revised to allocate 90 percent of the amounts received to principal and the remainder to income.

- Decedent's Estate Or Terminating Income Interest - An income beneficiary's estate will be entitled only to the net income actually received by a trust prior to the beneficiary's death and not the accrued income.

- Derivatives (such as interest rate swaps) and Options (not embedded) - If the department does not maintain separate accounting records for these transactions, then the trustee shall allocate to principal, receipts from and disbursements made in connection with such transactions. A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument that is income or principal under the Act. Only cash receipts and disbursements are included. Options include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of marketable stock that must be liquidated to pay estate taxes. The practice of selling call options on securities owned by the trust, if the terms of the option require delivery of securities, is also included in this definition. However, this does not apply if the consideration received or given for an option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

- Asset-Backed Securities, Including Real Estate Mortgages, Credit Card Receivables, and Auto Loans - If a trust receives a payment, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest and the balance to principal. If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period (defined as a calendar year or can be a 12-month period if selected by a fiduciary), the trustee shall allocate the payments to principal. If a payment is one in a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate 10 percent of the payments to income, and 90 percent to principal. An example of the final point is a busted PAC tranche, where the class protection has been eliminated.

- Inflation-Indexed Bonds - Any increase in principal due to inflation after issuance is principal upon redemption, if the bond matures more than one year after the trustee acquires it; if it matures within one year, all of the increase is considered income.

- Deferred Compensation, Annuities, and Similar Payments - If no part of a payment is characterized as interest, dividend, or equivalent, and all or part of the payment is required to be made, the trustee should allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. Payment is defined to include a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an IRA, and a pension, profit-sharing, stock-bonus, or stock-ownership plan. If no part of the payment is required to be made or the payment received is the entire amount to which the trust is entitled, the trustee shall allocate the entire payment to principal. A payment is not "required to be made" is defined as to the extent that it is made because the trustee exercises a right of withdrawal. To obtain an estate tax marital deduction for a trust, the trustee should allocate more to income to obtain the deduction.

- Disbursements From Income Are Based On Recurring Items That Are Not Specifically Tied "To An" Asset. For example, trustees' fees can be charged against either principal or income or both, while title insurance and real estate taxes must be assessed against principal.

- Generation-Skipping Transfer Taxes are payable from principal.

- Disbursements Made For Environmental Matters - Includes reclamation, environmental assessments, remedy and removal of environmental contamination, monitoring of remedial activities and the release of substances, preventing future release of substances, collecting amounts from persons liable or potentially liable, penalties imposed by law or regulation, and defending claims based on environmental matters. All environmental expenses are payable from principal, based on the assumption that the expenses will be extraordinary in nature. However, if the trustee is carrying on a business that uses or sells toxic substances, and cleanup costs would be a normal cost of doing business, then the expenses could be allocated to income.

- Income Tax Obligations Resulting From The Ownership Of Subchapter S Corporation Stock And

Interests In Partnerships - Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Distributions from corporations and partnerships that exceed 20 percent of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation.

- Income Tax Obligations Are Allocated Based On The Source. If the tax is based on receipts allocated to income, the tax is paid from income. If the tax is based on receipts allocated to principal, then the tax is paid from principal.
- The Power To Make Adjustments Between Principal And Income To Correct Inequities Caused By Tax Elections Or Peculiarities In The Way The Fiduciary Income Tax Rules Apply. This allows fiduciaries to make adjustments as necessary to re-allocate principal and income to make taxes equitable, based on prior tax elections. For example, individuals may elect to have taxes paid annually or at maturity on the income from savings bonds, although the income is not distributed, but added back to principal. In this situation, if the tax election was to pay taxes annually, the income beneficiary may be responsible for income tax on cash flows that the principal beneficiary may enjoy in the future.

When dealing with principal and income, however, examiners should be aware that the distinction between principal and income is not important for personal agency and employee benefit trusts. As previously stated, the trustee is under a duty to deal impartially with beneficiaries, when there are at least two beneficiaries. For agency or employee benefit accounts, there is one class of beneficiaries.

D. Carrying Values

Unlike commercial bank accounting, where assets and liabilities are carried at cost or book value, there is no generally accepted system for assigning carrying values to assets held by trust institutions. The examiner may find that the assignment of carrying values will vary not only from institution to institution, but also from one account to another within the same trust department. This makes a meaningful analysis of trust department statements of condition difficult, if not impossible, without knowing which valuation methods are used to prepare the statements. One or several of the following methods are generally used as asset carrying values in any given institution:

- Book or cost of the asset;
- Tax cost or date of death valuation when acquired from a decedent's estate;
- Par value, the face value of property; or
- Nominal value, assigning a nominal value to each item or interest of ownership in an asset, or miscellaneous items such as insurance policies and indentures. Stocks may also be carried at a nominal value for the number of shares held, particularly in custody or safekeeping accounts.

For Call Report, Schedule T purposes, trust assets should be reported at market value, where asset values can be determined by a market or trading, or by other sources, such as appraisals. Nominal values are permitted as described above.

E. Accounting Records

As mentioned earlier, the level of sophistication of trust departments varies from institution to institution. Records will also vary since, in addition to the differences relating to the size and character of the accounts administered, trust accounting systems are not standardized. However, the reporting requirements imposed on fiduciaries and the concepts involved remain the same. Therefore, the overall framework of each accounting system consists of the following:

E.1. General Ledger

The general ledger will comprise all control accounts of the department. It includes both customer and internal accounts used by the department to facilitate its operation. Many automated systems have subsidiary control records but do not have the traditional "general ledger". The examiner must exercise judgment in determining the sufficiency of the records encountered.

E.2. Asset Control Accounts

These accounts should reflect the total holdings of the major asset categories, such as stocks, bonds, or deposits.

E.3. Subsidiary Asset Controls

These accounts will reflect the total investments in specific issues of stocks, bonds, etc.

E.4. Subsidiary Liability Controls

These records will reflect the total of cash and investment holdings of each type of account administered. This category should be further subdivided to allow for transactions to be posted to individual accounts. The cash ledger should detail income and principal cash, and reflect transactions in chronological sequence. The investment ledger should reflect each asset held by a trust account. Purchases, sales, stock dividends and splits should be recorded in chronological order. The examiner must bear in mind that some indentures provide for the reinvestment of income cash, and that it is common practice to invest "income" until it is distributed. In these situations, it will be necessary to maintain separate ledgers to account for those assets consisting of "invested income".

F. Trust Records

In addition to maintaining a reliable system of accounting, a trust department needs other records to administer accounts in a timely and cost-effective manner. The design and control of these support records can mean the difference between a smoothly functioning department and one that may have to search through unorganized records when an administrative action needs to be taken. Moreover, departments with detailed and accurate records are less likely to be adversely affected by personnel turnover, errors in judgment, or contingent liabilities.

While some smaller, noncomplex trust departments may continue to maintain trust records manually, most institutions now maintain trust records electronically. Electronic recordkeeping systems are acceptable, provided that the institution has implemented adequate internal controls and procedures to ensure the integrity of trust department records. Two important records are the Administrative File and the Tickler System.

F.1. Administrative File

The administrative file consists of interrelated records, which, as a whole, represent the history of an account. The records of the administrative file may be contained in a single file or in several files within the department. These records consist of:

F.1.a. Legal File

Contains copies of all legal documents relevant to the account, including the document creating the account, such as a will, a trust agreement, or a court order.

F.1.b. Digest or Synopsis

Synoptic records provide a concise summary of the principal duties and provisions of the legal documents governing the account, and may also provide other important information, such as beneficiaries, remaindermen, remittance instructions, and reporting requirements. Synoptic records are especially valuable to trust department management and administrative officers. This document may be a paper document maintained in the account file or in an electronic format.

F.1.c. Correspondence File

Contains all correspondence related to the account.

F.1.d. Investment Review File

Contains asset reviews, which enable management to evaluate investment performance.

F.1.e. Securities Transaction File

Contains broker confirmations and other data related to changes in securities holdings during the life of the account.

F.1.f. Tax File

Contains tax-related documents and copies of tax returns filed for the account.

F.2. Tickler System

A tickler system is a chronologically arranged system of records, which reminds

department employees to collect income, distribute funds, calculate trust fees, etc. A tickler system can be maintained in electronic or paper format. Though simple in design and concept, the effective use of tickler systems can be critical for account administration.

F.3. Other Records

Other records which affect the operation of a department to a significant degree and which an examiner will find useful in the examination process are:

F.3.a. Securities Transaction Register

This record should list in chronological order all the securities transactions effected by the department. This record will most likely be in electronic format. The preparation and content of this document, as well as other records pertaining to securities transactions, are subject to Part 344 of the Corporation's Rules and Regulations.

F.3.b. Vault Control Log

This log is used to record the dates and identities of individuals who access the department's vault. Records should also be maintained indicating the items accessed and the reasons therefore.

F.3.c. Broker Statements

The statements reflect all transactions effected for the department by brokers. These statements should be reviewed carefully by the staff and reconciled to broker confirmations and the Securities Transaction Register.

G. Account Documentation

Documentation is as important as the administration itself, as fiduciaries must account for their actions to others. Challenges to account administration, resulting in complaints or litigation, may occur years after a particular transaction has occurred. The failure to maintain documentation that adequately supports the actions taken, including the rationale for such actions, may result in court-imposed surcharges or negotiated loss settlements. Examiners will encounter two basic types of documentation: documents evidencing the fiduciary's appointment and the creation of the account, and documents supporting the actions taken by the fiduciary during the term of the account.

G.1. Evidence of Appointment

In general, a fiduciary should refrain from taking any action until it receives proper evidence of appointment and an original or authenticated copy of the instrument creating the account. Valid evidences of appointment depend upon the type of appointment. In the most basic appointment, such as a personal agency, the department need only execute an agreement with its customer. The same is true for a living trust. In accounts operating under court jurisdiction, such as estates, trusts under will, and court-appointed guardianships, the fiduciary will need to obtain a court order of appointment in addition to the instrument creating the account. In estates where the executor has been named in the will, the court appointment is called Letters Testamentary. In estates where named executors cannot or do not accept the appointment, a court will appoint an administrator for the estate under Letters of Administration. Letters of Administration are also used to appoint an administrator where no valid will exists or where the will does not nominate an executor. Trustees named in a will serve under Letters of Trusteeship. Guardians serving under court appointment are issued Letters of Guardianship. In corporate appointments, the fiduciary should obtain a resolution for appointment, as well as a copy of the instrument it will be serving under. In accepting appointments to serve as successor to a prior trustee or executor, the fiduciary should obtain:

- Copies of the original court appointments (if applicable),
- An authenticated copy of the instrument it will serve under,
- An accounting of the estate, trust, or agency from inception to its appointment, and
- Any other documents substantiating its appointment, or indemnifying it against the actions of others.

G.2. Supporting Documentation

During the term of an appointment, numerous actions may be taken to serve the needs of the account and its beneficiaries. At times these actions involve nothing more than processing an address change for an income beneficiary. Others may involve actions

having serious consequences for the account, such as principal invasions or selling assets at a capital loss. A fiduciary must be able to support its actions by demonstrating it had the necessary legal authority and that it exercised sound judgment. The fiduciary's legal authority will be found in common law, statutory law, and the underlying indenture. The rationale for its actions may be more difficult to demonstrate; therefore, it is essential that the fiduciary be able to justify its actions, which requires adequate documentation. The types of documentation the fiduciary should maintain are:

G.2.a. Trust Committee Minutes

Deliberation and action over matters affecting the account.

G.2.b. Approvals

Written approvals of discretionary actions are sometimes required by indentures and, at other times, are merely prudent. Written approvals should always be sought from co-fiduciaries. When extraordinary actions affect individuals having a future interest in an account, the fiduciary should seek written approvals from all remaindermen.

G.2.c. Indemnification

Certain discretionary actions may involve controversial matters, such as purchasing own-bank or parent securities or performing duties not specified in trust indentures, but requested by others, such as co-fiduciaries or remaindermen. These actions require more formalized written approvals in the form of agreements or court rulings indemnifying the fiduciary against loss.

G.2.d. Accountings and Customers' Statements

These are required for court-appointed accounts, but may be prepared for other types of accounts. Essentially, the listing or statements reflect all account transactions occurring during a specific period of time. Either the court having jurisdiction, all interested parties, or both should approve accountings.

Customer statements should be provided in compliance with the governing agreement or at least annually. Most trust departments provide at least quarterly statements.

G.2.e. Account Reviews

Periodic reviews performed by the trust committee.

G.2.f. Receipt and Release

This is a formal document acknowledging the receipt of cash or assets. It is given by the recipient to the fiduciary, and releases the fiduciary from any further obligation with respect to a bequest or other distribution. This section applies to the physical transfer of assets and not to book-entry transfers.

G.2.g. Other Documents

There are numerous documents a fiduciary will obtain during the administration of an account. These might include property appraisals, lease agreements, broker confirmations, receipts for contracted work, or investment research. Each has its own significance, and depending on the nature of the appointment, may serve to support and indemnify fiduciary actions.

H. Internal Controls

H.1. Segregation of Duties

One of the most fundamental methods of internal control is the segregation of duties. One individual should not be capable of initiating, authorizing, executing, and subsequently reviewing a transaction for appropriateness. In a trust department, this concept begins by segregating administrative from operational functions and continues by segregating duties within the operating system itself.

Many FDIC-supervised trust departments are relatively small in size and the segregation of

duties is often not economically practical. In these cases, an institution should develop compensating controls. One compensating control easily employed by smaller institutions is the requirement that a second person be involved in executing a transaction. This can be implemented by having a second individual approve a transaction in writing. But it is effective only if the second person reviews the supporting documentation and understands the transaction being approved.

Management is responsible for assessing the specific requirements of the department and adopting an overall system of policies and procedures. Examiners should evaluate the adequacy of these policies and procedures, and determine compliance therewith.

H.2. Vacation Policy

Supervisory agencies and auditors have long recommended the practice whereby personnel are required to be continuously absent from their jobs or duties for a given amount of time and their duties assumed by another employee. During such an absence, the possibility of detecting irregularities is much greater, as the employee who is absent is unable to effectively control the situation. The FDIC has encouraged an uninterrupted absence of at least two weeks. However, compensating controls, such as the rotation of personnel among different jobs and duties, can constitute an acceptable alternative to a policy requiring a continuous two week absence.

H.3. Reconcilements

The reconcilement of deposit accounts, suspense accounts, and securities depository statements should be performed regularly by individuals who are independent of these functions, i.e. individuals who do not initiate, authorize or post such transactions to the recordkeeping system. It is acceptable to have personnel in the commercial department reconcile he aforementioned trust accounts to maintain the separation of duties.

H.4. Other Elements of Control

The organizational structure of a trust department is another component of overall control. Management must define functional lines of responsibility and establish an organizational framework along those lines. Work should flow in a logical manner. The organizational structure should take into account the need for checks and balances, as well as the need for an efficient, practical system. Control systems should be reviewed regularly and updated as necessary.

Examiners should consider the extent to which the Board and management have provided for the following:

- Adequate staffing to provide for efficient and timely processing and appropriate separation of duties;
- Compensating controls where limited staff precludes separation of duties;
- Clearly defined responsibilities, duties, and lines of authority;
- Prompt reporting and correction of internal control deficiencies;
- Adoption of a comprehensive operations manual, which is updated to reflect changes as needed.

Examiners should assess the effectiveness of the department's internal control practices in protecting and controlling trust assets. Controls may include the following:

- Trust assets are required to be separated from the assets owned by the institution;
- More than one employee should be present when assets are received;
- Written confirmations signed by beneficiaries or accountholders should be maintained for all items distributed;
- Assets held in the vault should be under dual control and verified periodically;
- The value of worthless assets should be determined and those assets maintained on the department's books at nominal value;
- Hold and return mail procedures should be established;
- Appropriate controls should be maintained over unissued checks (or pre-printed check paper), including the use of sequentially numbered documents;
- Signature controls should be established for the disbursement of trust funds.

Examiners should consider the extent to which the department's recordkeeping systems provide for accurate and reliable recordkeeping and reporting:

- Maintain records in sufficient detail to properly reflect all trust department activities;
- Report the assets of each trust account separately from the assets of other accounts;
- Account separately for principal and income according to the governing agreement, or if the document is silent, the state principal and income act;
- Process trust department transactions in a timely and accurate manner. This should include processing for securities income and maturity through automated systems; securities pricing and rating services; mutual fund and cash sweep transactions, and, corporate actions that affect securities holdings.

Other Internal Routine and Control Issues:

- Reconciliation of statements from securities depositories, brokerage accounts, internal accounts (suspense and own-bank), deposits at other institutions, mutual funds, and cash management services should be performed by a person independent of those preparing or authorizing entries or disbursements;
- Audit trails for all accounting transactions should be maintained;
- The effectiveness of internal controls should be assessed to ensure compliance with applicable laws and regulations;
- Vault control procedures should be established and include recording access to the vault and transferring of assets to/from the vault;
- All assets should be verified periodically;
- Daily proof of transactions (balancing and closing routines) should be performed;
- Administrators should review and sign transaction journals ;
- Management should provide for internal and/or external audits;
- Accounting records should be maintained on a current basis;
- Dual signatures should be required for checks above a specified amount;
- Documentation should be required for asset changes, cash distributions, and/or large overdrafts;
- Pre-numbered checks, in either manual or electronic format, should be used in sequential order;
- Records should be proofed by individuals not authorized to post them;
- Account reviews should be performed by individuals other than the administrator assigned to them;
- Investigation and resolution of stale accounting items and out-of-proof conditions should be made in a timely manner;
- Prompt investigation and reporting of suspicious transactions and activities, including the filing of suspicious activity reports, should be made;
- Separate control over checks returned undelivered should be established;
- Procedures for the reissuance of returned checks should be established;
- An adequate record retention policy should be established.

Examiners should realize that an effective system of internal controls designed to establish dual control, separation of duties, and the rotation of employees may be costly. Many trust departments are unprofitable measured by any standard, and trust officers may resist implementation of expensive control measures. Examiners need to exercise judgment in assessing a department's control systems. One or more basic points may have deficiencies, but the system may be strengthened by bolstering others. Often this is accomplished by reliance upon a strong audit, whether by an internal or external auditor.

H.5. Fraudulent Acts

While the discovery of fraudulent acts is not the primary objective of a trust examination, the examiner should be alert to a culture that permits such acts. The Board and senior management should establish a corporate culture that encourages ethical behavior, and that belief should be reflected in their own practices, as well as in the corporate policies and procedures. However, fraudulent acts occur, when there is a perception that management does not practice what it preaches or when management is unconcerned with deterrence. The Board and management can change this perception by appointing a member of senior management to oversee a fraud prevention program and that officer being accessible to and having open, two-way communication with staff. One of the most common methods of fraud detection is other employees telling a member of management

of activities witnessed.

However, deterrents are the major factor in fraud prevention. Strong internal controls and monitoring compliance with those controls is a major deterrent to fraud. Therefore, management should establish procedures for testing compliance with the department's policies and procedures, in addition to implementing a reasonably designed audit program. Employees are less likely to attempt to defraud an entity, when deterrents are visible to the employee.

The following are areas that are particularly susceptible to manipulation and abuse:

- Failure to record the receipt of assets when accounts are opened. The unwitnessed assembling of assets, particularly those of a decedent's estate, is a dangerous practice. In such cases, the detection of theft may be impossible since no record of a missing asset exists.
- Unauthorized and forged withdrawals of cash and securities from accounts. The absence of effective dual control makes such actions easy for the manipulator. One method is to transfer assets to an account under an embezzler's control. Once the assets are in this account, the individual is free to sell the assets for personal gain, use them in market speculation, or pledge them for personal loans.
- Diversion of stale outstanding checks, inactive trust deposits, and assets of dormant trust accounts for personal gain. A combination of independent and timely reconcilement procedures, together with the periodic tracing of transactions from initiation to conclusion can greatly reduce the likelihood of such diversions.
- Conversion of payments received on securities believed to be worthless. A trust department's policy guidelines on worthless securities should include procedures to be followed when determining an asset's worth. Requirements that all assets deemed worthless be reported to the trust auditor or an appropriate committee prior to being written off and the carrying of worthless assets at a nominal value either in the respective accounts or in controlled suspense accounts decrease the susceptibility to manipulation. This also supports a continuous audit trail of the asset from start to finish.
- Diversion of income on assets received in either irregular amounts or at irregular intervals. Such income is usually derived from royalties, oil wells, and the like. Income from all investments should be internally controlled and audited, with added attention given to those situations where investments fail to produce income. In this connection, several defalcations have occurred by the diversion of payments of interest and principal on debt obligations previously in default.
- Falsification of expenses and misapplication of trust commissions and fees. Expenses and recurring fees present possibilities for manipulation. The adopted policy should require that expenses be accompanied by appropriate documentation. The trust administrator should not have control or access to expense checks. Similarly, adequate internal safeguards should exist to assure the crediting of trust commissions and fees to the appropriate income accounts.
- Manipulation of payments received on rental properties, real estate, and real estate mortgages. The administration of these trust properties frequently involves handling cash payments received in the department by personal deposit or through the mails. Unless strong internal controls are in effect, defalcations through overlapping or withholding of payments could occur.
- Improper use of suspense accounts. Frequently, trust department suspense accounts are not governed by good internal control procedures, and unauthorized settlements or disbursements may easily occur.
- Improper securities trading practices:
    - Placing personal trades through bank accounts, thereby obtaining the advantage of the bank's volume discounts on commissions;
    - Purchasing or selling an issue of securities prior to executing bank or trust account trades which could be expected to change the price of the security, thereby obtaining a personal price advantage ("front-running");
    - Purchasing and selling the same securities issue on the same day, with the trader pocketing any price increases and assigning transactions to trust accounts in the event of any price decreases; and

- Buying or selling based on nonpublic material inside information, which might affect the price of securities, thereby enabling the trader to benefit personally from the transaction.

- Misuse of corporate bonds, notes, and stock certificates in the bank's possession as corporate trustee or agent under indenture. Inventories of unissued securities not under effective control could be stolen and used as collateral for loans. Securities remitted for payment or transfer not properly controlled could be used for the same purpose.

I. Nominees

Most trust departments register securities in a "nominee" name. Nominee registration simplifies the transfer of stocks and bonds, and facilitates the collection of dividends and interest. When a securities issuer pays interest or declares a dividend, the bank receives a single dividend or interest payment in the nominee name in which the security is registered. The department subsequently credits the accounts holding the particular security, typically using an automated report called a "dividend map." Without the use of nominee registration, separate dividend or interest payments would be received for each account holding the security.

Nearly all states provide by statute that securities may be registered in nominee form. Most governing trust instruments also authorize the use of nominee registrations. "Nominees" are legal partnerships comprising designated officers and/or employees of the bank. The bank's board of directors should approve the execution of the partnership agreement and, in most jurisdictions, register the partnership with the state.

Examiners should determine that the bank's nominee partnership agreements are reviewed periodically to ensure they are current, and include only current authorized officers and/or employees in the partnership agreement.

J. Use of Broker-Dealers For Securities Safekeeping/Securities Investor Protection Corporation (SIPC)

Financial institution letter FIL-38-2002 was issued on April 25, 2002, and discusses credit risks arising from securities held at broker-dealers and Securities Investor Protection Corporation (SIPC) coverage. A copy of the financial institution letter may be found in Appendix C. SIPC covers most types of securities, such as stock, bonds, and mutual funds. However SIPC does not protect against declines in market value. Also, SIPC does not provide protection for investment contracts that are not registered with the SEC.

Another coverage problem may occur when investors place cash or securities in the possession of non-SIPC members. The trust department may do business with a company that doesn't actually execute buy and sell orders, but instead uses another firm, known as a clearing firm, to process trades. Therefore, trust management should make sure that the brokerage firm and its clearing firm are both members of the SIPC.

In general, during a liquidation of a broker-dealer, SIPC will request the court to appoint a trustee which will (1) return property that is registered in a specific customer name, (2) pay those customers their pro rata share of "customer property", and (3) provide customers (other than banks and broker-dealers for their own accounts) SIPC advances up to the $500,000 limit. Customers not subject to SIPC protection, such as banks, will receive a pro rata distribution of "customer property." Therefore, banks and trust departments must be able to differentiate between bank-owned and bank customer-owned accounts and securities. Furthermore, trust department management should exercise due diligence when selecting broker-dealers and establishing a custodial relationship. Thereafter, relationships with broker-dealers selected should be periodically reviewed.

K. Free Riding and Daylight Overdrafts

"Free riding" occurs when customers buy and sell securities, usually on the same day, in amounts greatly exceeding the amount allowed under margin collateral requirements. The purchaser intends to pay for the purchased securities with proceeds from the sale of the same securities. The concept is similar to a check kiting scheme. Since funds are not made available by the purchaser prior to the purchase, it is a

means whereby a bank, typically through its trust department, may suffer losses. The Securities and Exchange Commission has investigated and brought enforcement against a number of firms or individuals for securities free riding.

Free riding often begins when a custodial account is opened with a trust department. The customer also establishes brokerage accounts through which the customer directs securities trades. The customer then advises the broker-dealer that payment for such trades will be made through the custodial account.

The customer attempts to profit from short-term changes in market prices of securities, without placing significant personal funds at risk. Free-riders, anticipating a near-term price increase, frequently place a buy order for securities with the intention of paying for the securities with the proceeds from the sale of the same securities.

Banks permitting such transactions without requiring adequate margin collateral face significant risks when customer accounts do not contain sufficient funds to cover purchase orders or enough securities to complete sell orders. These risks include: (1) enforcement actions for violation of the Federal Reserve Board's Regulation U (12 CFR 221) margin lending standards, or for aiding and abetting violations of Regulation X (12 CFR 224), or Regulation T (12 CFR 220); and (2) losses caused by the need to complete failed customer trades.

The Federal Reserve has also taken the position that intraday or "daylight overdrafts" relating to the purchase or sale of margin stock is considered an extension of credit subject to Regulation U. Violations of Regulation U may therefore be cited in situations where intraday overdrafts occur due to the purchase or sale of margin stock.

Policies and procedures for accepting custodial accounts and for clearing securities transactions should include measures to prevent free riding. Such policies and procedures should:

- Set standards for the acceptance of new custodial accounts, including customer background and credit information.
- Determine whether the new customer intends to use the account to obtain bank credit for transactions as if it were a margin account at a broker-dealer, and if so, ensure that a FR U-1 form is completed for compliance with Regulation U.
- Require identification of broker-dealers sending securities to, and receiving funds from, customer accounts, and establish systems to track accounts involving numerous broker-dealers;
- Disaffirm customer trades where acceptance would result in a violation of Regulation U; and
- Determine that each account has sufficient funds to cover any trade or, if margin credit is extended, that collateral requirements are met.

Financial Institutions Letter FIL 76-93 , dated November 4, 1993, provided material on this subject, and may be found in Appendix C. Also, the Federal Reserve Board issued a supervisory letter discussing the Federal Reserve's margin lending requirements as they apply to free riding (SR 93-13, dated March 16, 1993).

L. Facilities

A trust department must have sufficient space and the necessary equipment to accomplish its duties. It is desirable that the department be able to conduct its activities in a segregated, or at least clearly delineated, work space. The size and complexity of the assets under management and the department's prospects for future growth form much of the basis for determining premises and equipment needs. In reviewing this factor, examiners should consider the department's work flow, the appropriateness of safeguards over records, the presence of negotiable assets and the ability to maintain effective internal controls and segregation of duties.

M. Information Technology

Most trust departments use automated trust accounting systems, with processing performed either in-house or provided by a third-party servicer. A review of Information Technology should be performed by the Information Technology (IT) examiner, who will determine the risk profile type and procedures to be performed by completing the Technology Profile Script. The IT examiner will review the agreements and disaster recovery program for content at **each** IT examination. Therefore, communication between the trust and IT examiners is essential for coordinating the examination process and avoiding the duplication of work. Significant deficiencies would normally be fully presented in the IT examination report, with less detailed comments in the trust examination report.

However, the IT examination may not be performed during the same examination cycle as the trust examination. Also, banks which have trust subsidiaries may not have IT examinations of those subsidiaries. In either circumstance, the trust examiner should review the prior IT examination report for comments pertaining to trust technology, if available. Once onsite, the trust examiner should confirm that appropriate routine and controls are in place. The following are examples of appropriate routine and controls in an automated environment:

- System access should be password restricted and passwords should be changed frequently.
- Passwords should be set to a reasonable minimum number of characters, symbols, and numbers. However, words, proper names, or social security numbers should not be used as passwords.
- Access to records should be limited by the employees' position or duties.
- Automated records should be reconciled and any exceptions should be cleared in a timely manner.
- Suspense accounts should be monitored closely and the individual who reconciles and monitors suspense accounts and other automated records should not be the same person who enters the data.
- Exception reports should be reviewed by trust management.
- The GLBA workprogram should be completed for the trust department.

Trust examiners should be aware that Section 7(c)(2) of the Bank Service Corporation Act and FDIC Section 304.3(d) require that the FDIC Regional Office be notified of the existence of the servicing arrangement within 30 days of the contract or start of service (Form 6120/06: Notification of Performance of Bank Service, may be used). It may be possible for banks to submit this information over FDICconnect webpage.

Trust examiners should recommend that management obtain and review a copy of the third party servicer's independent audit, known as the Statement of Auditing Standards #70, or SAS 70 . This report should be reviewed by the trust, technology, and/or audit committees prior to entering into a servicing contract and periodically thereafter.

Electronic Banking

Electronic banking applications have increased in the trust area, although the level and sophistication of these applications vary widely. Informational websites which advertise trust and other bank services are the most basic. Transactional applications, which allow customers to make changes to 401(k) plans and obtain current portfolio valuations, are much more complex. While this aspect should be incorporated into the IT examination, trust examiners need to be aware of electronic banking applications and their potential risks. Primary examination guidance and information may be found in the FFIEC IT Examination Handbook and Electronic Banking Workprogram.

The trust examiner should notify the IT examiner when e-banking applications are more than basic. The following is an overview of strategic planning and goals, administrative controls, and information security program assessments.

The Board and senior management are responsible for developing the institution's e-banking business strategy, which should include the following:

- The rationale and strategy for offering e-banking services, including informational, transactional, or e-commerce support;
- A cost-benefit analysis, risk assessment, and due diligence process for evaluating e-banking processing alternatives, including third party providers;
- Goals and expectations that management can use to measure the e-banking strategy's effectiveness; and,
- Accountability for the development and maintenance of risk management policies and controls to manage e-banking risks and for the audit of e-banking activities.

The Board and senior management must provide effective oversight of third-party vendors providing e-banking services and support. Effective oversight requires that institutions ensure the following practices are in place:

- Effective due diligence in the selection of new service providers that considers financial condition, experience, expertise, technological compatibility, and customer satisfaction.
- Written contracts with specific provisions protecting the privacy and security of an institution's data,

the institution's ownership of data, the right to audit security and controls, and the ability to monitor the quality of service, limit the institution's potential liability for acts of the service provider, and terminate the contract;
- Appropriate processes to monitor vendor's ongoing performance, service quality, security controls, financial condition, and contract compliance; and
- Monitoring reports and expectations including incidence response and notification.

The Board and senior management should ensure that the information security program addresses these challenges and takes the appropriate actions:

- Ensure compliance with the "Guidelines Establishing Standards for Safeguarding Customer Information" pursuant to section 501(b) of the Gramm-Leach-Bliley Act of 1999 (GLBA).
- Ensure the institution has the appropriate security expertise for its e-banking platform.
- Implement security controls sufficient to manage the unique security risks confronting the institution. Control considerations should include the following:
    - On-going awareness of attack sources, scenarios, and techniques;
    - Up-to-date equipment inventories and network maps;
    - Rapid identification and mitigation of vulnerabilities;
    - Network access controls over external connections
    - Hardened systems with unnecessary or vulnerable services or files disabled or removed;
    - Use of intrusion detection tools and intrusion response procedures;
    - Physical security of all e-banking computer equipment and media; and
    - Baseline security settings and usage policies for employees accessing the e-banking system or communicating with customers.
    - Use verification procedures sufficient to adequately identify the individual asking to conduct business with the institution.
    - Use authentication methods sufficient to verify individuals are authorized to use the institution's systems based on the sensitivity of the data or connected systems.
    - Develop policies for notifying customers in the event of a security breach effecting their confidential information.
    - Monitor and independently test the effectiveness of the institutions security program.

N. Business Continuity Planning

As part of the Information Technology examination process, the entire bank, not just the Information Technology of the Commercial Department, should be reviewed. However, trust examiners need to be aware of the general concepts of business continuity planning.

Business continuity planning, also referred to as contingency planning, encompasses various aspects of the continuation of the trust business. In general, the planning process should incorporate establishing strategies for alternate facilities, employee work space, office equipment, files, etc. The goal is provide at least a minimal level of service to maintain business operations and retain customers. Therefore, the Board and senior management should establish policies, procedures, and responsibilities for the entire institution's continuity planning. The written plan should address administrative procedures, recovery items, list of contacts and locations for each aspect of the trust department's business profile. However, management should address the following:

- Backing up all software and data files not covered by the IT Department.
- Maintaining adequate supply of pre-printed forms and checks off-site
- Providing for duplicate corporate and notary seals to be stored at a secure, off-site location
- A plan to contact customers individually requires a list, which should include customer names, addresses, and phone numbers.
- A plan to contact customers via electronic means will require email addresses or use of the bank's website.

Disaster recovery is a subset of business continuity planning and is primarily concerned with recovering critical data and item processing, and communication networks. The three general types of disasters are the following:

- Natural - Weather-related, earthquakes, volcanic, wildfires
- Technical - Hardware or software failures or crashes, explosions, hazardous material spills, fire, nuclear power plant accidents, loss of electricity for extended periods of time

- Civil - Bomb threats, strikes, riots, criminal acts, sabotage, terrorism,

O. Self-Directed IRA'S and KEOGH Accounts

O.1. Directed Arrangements

Section 333.101(b) of the FDIC Rules and Regulations permits banks to offer self-directed IRA and Keogh accounts to customers without first obtaining FDIC consent to exercise trust powers. Although banks are permitted to offer these products without consent, the bank is considered as trustee of the accounts, whether or not the bank serves as custodian or trustee. The administration of IRA's and Keogh accounts must comply with the requirements of the Internal Revenue Code and applicable state laws.

When self-directed accounts are offered and booked as trust accounts, the accounts and related practices should be reviewed during trust examinations. Regional Director Memorandum 98-058, issued June 23, 1998, outlines trust accounts subject to the Interagency Statement of Policy on Nondeposit Investment Products. Those types of accounts and applicable sections are summarized as:

- Self-Directed IRA and KEOGH Plans - Three minimum disclosures from the Interagency Statement apply.
- Agency accounts where the customer has sole investment discretion - Interagency Statement applies in its entirety.

The three minimum disclosures are the following: (a) Not insured by the FDIC; (b) Not a deposit or other obligation of, or guaranteed by, the depository institution, and (c) Subject to investment risks, including possible loss of the principal amount invested.

If the accounts are not trust accounts, then practices should be reviewed as part of the Nondeposit Products review segment of the compliance examination. Examination responsibility is discussed in an Regional Director Memorandum 01-035 dated September 5, 2001. The memorandum can be located on the Intranet. Additional information and guidance are provided in the examination procedures for Nondeposit Products.

The following is a summary review of examination concerns in this area:

- Account Documentation - The bank must have sufficient documentation to adequately identify and support each account.
- Assets and Asset Valuations - Appropriate methodology to determine the market value of assets held in IRA and Keogh accounts should be used. The valuation of unique and specialized assets such as the securities of closely held businesses, mineral interests and limited partnerships is difficult and often requires special expertise. The assets of self-directed IRA and Keogh accounts should be segregated from the bank's own assets, whether kept in the bank's vault or at a correspondent bank.
- Accounting Records - These should be separate from the bank's own records, to properly reflect which assets belong to the bank's customers.
- Investment Advice - Investment advice must not be given to self-directed accounts.
- Illegal Investments - Although the customer directs the investments in a self-directed account, the bank has a duty (whether it is acting as trustee or custodian) to refuse to accept illegal directions, either as to the type of asset held or as to a prohibited transactions. For example, investments in Subchapter S Corporations are prohibited, as are investments in art, rugs, antiques, metals, gems, stamps, coins, or other items of tangible personal property specified by the IRS. (Note that certain coins, such as the American Gold and Silver Eagles, are permissible IRA investments.) While detailed analysis of each transaction is not required, the bank does have a duty to refuse to execute illegal transactions. Section 408(h) of the Internal Revenue Code treats custodians of these accounts as trustees for tax purposes. Consequently, the bank may incur liability for illegal acts within these accounts, even though the accounts are self-directed.
- Recordkeeping - All investment transactions for these types of accounts are subject to Part 344 of the FDIC Rules and Regulations.
- Audits/Independent Review - An audit or independent review should be performed for this activity. Coverage should include, at a minimum, a proof of records,

verification of assets, reconciliation of any deposit and suspense accounts, a review of the adequacy of internal controls, and compliance with law.

- Insurance - The blanket bond insurance carrier should be notified.
- Assets and Asset Valuations - Appropriate methodology to determine the market value of assets held in IRA and Keogh accounts should be used. The valuation of unique and specialized assets such as the securities of closely held businesses, mineral interests and limited partnerships is difficult and often requires special expertise. The assets of self-directed IRA and Keogh accounts should be segregated from the bank's own assets, whether kept in the bank's vault or at a correspondent bank.

O.2. Arrangements with Third Parties

The popularity of self-directed IRA and Keogh accounts has prompted nonbank financial service providers to offer these types of accounts. The bank may act as agent between the nonbank financial service provider and customers. When the bank or trust department acts as agent only (the account is not accounted for as a trust account or a commercial department account), these accounts will be reviewed by Compliance Examiners, who will assess compliance with the Interagency Statement of Policy governing the sale of Nondeposit Investment Products.

P. Custodial Holdings of Government Securities: Compliance With Government Securities Act of 1986

P.1. Background

As a result of several highly publicized failures of government securities brokers and dealers and other improper practices, Congress passed the Government Securities Act of 1986 (GSA). The stated purpose of the GSA and its implementing Treasury regulations is to enhance the protection of investors in government securities by establishing and enforcing appropriate financial responsibility and custodial standards. The GSA applies to (a) a bank which is a government securities broker or dealer, (b) any bank which retains custody of securities that are the subject of repurchase transactions with its customers (hold-in-custody repurchase transactions) and (c) any bank which holds government securities for its customer. A customer, by definition, includes the counterparty to a hold-in-custody repurchase transaction, but does not include a broker or dealer that is registered as, or that has filed notice of, its status as a government securities broker or dealer (§ 450.2(b)).

P.2. Applicability

On September 5, 2001, a Regional Director Memorandum was issued to transfer supervisory responsibility from DOS to DCA for Nondeposit Products, including insurance, retail sales of NDP, and Government Securities Act of 1986. Review of the applicability of and adherence to the Government Securities Act (GSA) should generally occur during compliance examinations. The primary exception to this transfer concerning GSA involves custodial holdings of government securities in a trust department. That specific activity should be reviewed during trust examinations.

Procedures for conducting such examinations are contained in Regional Director Memorandum 89-030, dated February 27, 1989. Treasury regulations implementing the GSA are contained under the Miscellaneous Statutes tab of the Prentice Hall service. In addition, several staff interpretations by the Department of Treasury are included in the Miscellaneous Statute tab of the FDIC Rules and Regulations.

P.2.a. With respect to broker-dealer activities

If the bank engages in broker-dealer activities related to government securities, a separate examination report for such activities is required. Pursuant to GSA Section 401.3(a)(2), the financial institution must conduct at least 500 government securities transactions, or does not have an arrangement with a registered dealer to effect transactions in order to be subject to this section.

P.2.b. With respect to government securities repurchase transactions

Government Securities are defined to include securities which are issued or

guaranteed by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors. The following is a list of securities that are considered to be government securities:

Commodity Credit Corporation

Export-Import Bank

Farm Credit Services including banks for cooperatives, intermediate credit banks, and land banks

Federal Home Loan Banks and Federal Home Loan Bank Board

Federal Home Loan Mortgage Corp.

Federal National Mortgage Association

Tennessee Valley Authority

U. S. Postal Service

Student Loan Marketing Association

Federal Housing Administration

General Services Administration

Government National Mortgage Association

Maritime Administration

Washington Metropolitan Area Transit Authority

Note: In general, if the title has the word "development" or "development bank," it is not considered a government security for this act.

- Where the bank is the seller of the securities, i.e., borrower of funds, and a trust account within the trust department of the same bank is the purchaser of the securities, counterparty, or creditor, a review of compliance with the GSA should generally occur at the trust examination. In such situations, the buying of repurchase agreements from the commercial side of the bank for trust accounts will generally be regarded as a conflict of interest (refer also to Section 3, Asset Administration). Where employee benefit plan monies are invested in own-bank repurchase agreements, Prohibited Transaction Exemption (PTE) 81-8 applies. PTEs are located in the Appendix E.

- Where an account administered by the trust department is the seller of the security (i.e., borrower of funds), trust examiners should review the administration as with any other account. In particular, the circumstances leading to the transaction and the borrowing (liability of the trust account to repurchase the security) should be evaluated. If the counterparty is the commercial department, consideration should be given as to whether a conflict of interest is present. However, where the repurchase agreement is between a trust account (i.e., the bank in its fiduciary capacity) and an unrelated non-bank counterparty, there is no need to review compliance with the GSA and implementing regulations since Section 403.5(d) pertains only to repurchase agreements between financial institutions (not financial institutions as fiduciaries) and counterparties.

P.2.c. With regard to custodial holdings of government securities for

customers:

- A complete exemption from the GSA Section 450 is provided for government securities held for customers by nonmember banks in a fiduciary capacity. Fiduciary capacity, as defined in Section 450.2(d), includes: trustee, executor, administrator, registrar, transfer agent, guardian, assignee, receiver, managing agent, and any other similar capacity involving the sole or shared exercise of discretion by a depository institution having fiduciary powers that is supervised by a Federal or State financial institution regulatory agency. This would normally exempt all activities traditionally conducted in a trust department.

- Where the bank is holding government securities for its customers (a typical custodial arrangement) the activity is usually conducted in conjunction with commercial bank customer services outside the trust department. However, in some instances this activity may be organized within the trust department. If so, trust examiners should ensure that the provisions of the GSA are followed. Examiners need to distinguish between the fiduciary capacities described above, custodial arrangements involving only the safekeeping of securities, and the performance of purely ministerial acts as directed by the principal, but where no sole or shared exercise of discretion exists. An exemption from Section 450 may also be available when customer securities are held in a custodial capacity, if the nonmember bank adopts policies and procedures that include all FDIC requirements applicable to government securities held in a fiduciary capacity. These are enumerated in the Regional Director Memorandum dated February 27, 1989, on the GSA, and set forth as follows:

    - The nonmember bank adopts policies and procedures that apply all the requirements of the FDIC that are applicable to government securities held in a fiduciary capacity (listed in the following section) to its custodial holdings, and

    - These custodial holdings are subject to examination by the FDIC for compliance with FDIC fiduciary requirements. (All insured nonmember banks would meet this requirement.)

    FDIC Fiduciary Requirements

    - State law regarding government securities held in a fiduciary capacity must be followed.

    - Government securities held in a fiduciary capacity must be segregated from the bank's securities. Where customer securities are held by a correspondent bank or outside depository, such securities must be segregated in a separate (separately identifiable) safekeeping account.

    - No liens, pledges, or any charges may be placed against government securities held in a fiduciary capacity unless permitted by written fiduciary contract or agreement. Customer government securities may not be sold under agreement to repurchase, or loaned to any party, unless specifically permitted by a written agreement that is signed by the customer. No sales under repurchase agreement or lending may be permitted unless customers are adequately compensated monetarily, under written agreement, nor

shall they be permitted unless the securities are adequately collateralized, preferably with securities of equal quality, marketability, maturity, and interest rate. Customer security interests in the collateral shall be perfected and held by the bank or an independent third party.

- Records must clearly describe the fiduciary capacity of the trustee and agreement with the customer.
- Records must clearly describe the government securities, the customer's interests, all movements of securities, and all transactions such as interest payments.
- A safekeeping receipt or confirmation must be provided to the customer.
- Adequate internal controls, such as separation of duties, rotation of duties, dual control or joint custody, must be in place.
- Adequate controls against external crime must be in place.
- An independent audit of assets and procedures must be conducted yearly. In addition, safekeeping accounts shall be reconciled by the bank at least monthly. Reconcilements shall be in written form and available for review by Corporation examiners.
- The fiduciary capacity must be adequately supervised.

Custodial Requirements

If a nonmember bank holds customer government securities in a custodial capacity, and it does not qualify for the Section 450 exemption described above, then the bank must comply with certain requirements (largely paralleling the exemption provisions) set forth in the regulation. Examiners should refer to the above-mentioned Regional Director memorandum and the Department of Treasury regulations for these requirements.

Q. Shareholder Communications Act of 1985

Q.1. Background and Requirements

The Shareholders Communications Act of 1985 applies to all entities exercising fiduciary powers. This includes trust departments holding securities in nominee name or otherwise on behalf of beneficial owners. The Act is implemented primarily by SEC Rule 14b-2. Essentially, the Rule stipulates that banks must comply with certain requirements to facilitate business communications between issuers of registered securities ("registrants") and the holders of those securities ("beneficial owners"). The requirements address:

- Responding to inquiries for lists of "beneficial owners,"
- Providing "beneficial owners" with proxy materials (or requesting voting instructions), and
- Providing "beneficial owners" with annual reports.

A beneficial owner is any person who has, or shares the power to vote pursuant to an agreement or otherwise, or directs the voting of, a security. [SEC Rule 14b-2(a)(2)]

While SEC Rule 14b-2 is the primary focus of this material, the Rule makes numerous cross references to other SEC regulations. SEC Rules 14a-1 and 14c-1 define relevant terms. Rules also designate when and how materials are to be provided by the securities issuer (SEC Rule 14a-13) and by broker-dealers (SEC Rule 14b-1). SEC Rule 14c-7

defines how materials are to be provided to investors. The text of these rules appears in Appendix D.

Q.2. Applicability to Trust Accounts

In general, all personal, employee benefit, and corporate trusts which have investments in registered stock are affected by these requirements.

- The requirements apply to all trust accounts opened December 29, 1986 or later.
- The requirements do not apply to any trust account opened on or before December 28, 1986 if either: (a) the bank has a written affirmative request from "beneficial owners" that information not be disclosed, or (b) the bank has made a "good faith effort" [as defined by SEC Rule 14b-2(b)(5)] to obtain from beneficial owners their consent to disclose such information.

R. State Escheat Laws

Escheat is defined as a reversion of property to the state in consequence of the lack of any individual qualified to inherit the property. For trust departments, the issue will generally arise concerning funds on deposit to pay unclaimed dividends, bond coupons not presented for payment, bonds not presented for payment and certain suspense accounts. Escheatment laws primarily involve deposits. However, banks acting as bond trustees, securities transfer agents, and paying agents must comply with state abandoned property laws for: (1) checks and securities certificates which are undeliverable, and (2) book-entry accounts for which the owner cannot be located. Escheat laws vary from one state to another. They will normally be found in state statutes under titles such as "unclaimed property" or "abandoned property". In some instances, one state may claim its escheat laws apply to dormant funds also claimed by another state.

The trust operations area should have procedures in place to ensure compliance with escheat laws. Examiners should familiarize themselves with applicable state escheat laws and be alert during examinations to stale items and other instances where escheat laws might be applicable. Relevant aspects of the escheat process are also discussed in Section 5 (Employee Benefit Accounts), and Section 6 (Corporate Trust Accounts) .

S. Audits and Accounting Issues

The FDIC Statement of Principles of Trust Department Management requires an audit of fiduciary activities (by internal or external auditors or a combination of the two) at least annually. The external audit function consists of agreed-upon procedures; therefore, an audit opinion is not rendered. Audit findings, including actions taken as a result of the audit, should be reported to the Audit Committee or the Board, and to the Trust Committee, recorded in the appropriate minutes.

The Statement allows institutions to conduct a continuous audit process on an activity-by-activity basis, at "intervals commensurate with the risk associated with that activity." Audit intervals must be appropriate and should be reassessed regularly to ensure appropriateness, given the current risk and volume of trust department activity.

Note: Trust department audits are not subject to Sarbanes-Oxley Act of 2002.

Note: Part 363 of FDIC's Rules and Regulations, Annual Independent Audits and Reporting Requirements, does not apply to trust departments. While portions of the pronouncement apply to bank auditing programs, the actual requirements apply only to the financial condition and related records, and not to off-book activities such as trust departments.

S.1. Audit Objectives

The objectives of trust audits are to determine the extent to which:

- Assets transferred to the department are properly recorded and controlled.
- Records are sufficient to permit an accurate accounting.
- Internal control procedures are adequate.
- Duties of the department, whether established by law or contract, are properly executed in a timely manner. Included among these responsibilities are investing trust assets, collecting income and principal, paying expenses, filing tax returns in

the appropriate location, and distributing income and principal.
- Proper fees have been collected and recorded in a timely fashion.

S.2. Audit Program

The most effective audit programs consist of full-time, continuous internal audit procedures, combined with agreed-upon procedures performed annually by an external auditor. Where both are used, the internal auditor tends to focus on control elements and recordkeeping. This allows the external auditor to evaluate fiduciary risk factors and perform sufficient testing to determine compliance with applicable laws, regulations, agreements, and internal policies. The trust department's size and complexity influence the extent to which the audit program has both internal and external components, as does State statutory requirements.

Every institution should develop a written audit program approved by the audit committee or Board. The audit program should be commensurate with the size and complexity of trust department activities. It should consider (a) the experience level of those required to implement it and (b) the frequency with which audit procedures are conducted. Vague references to the conduct of various phases of the audit should be avoided in favor of a step-by-step approach. In addition, management should be encouraged to consider coordinating or integrating internal audit procedures with those of external auditors. Careful planning can result in both better audits and increased efficiency.

In those departments where a continuous audit approach is used, different portions of the department may be under audit year round. Various areas or functions within the department are usually reviewed individually in separate audit activities. A continuous audit should cover all areas of the trust department within a three to five year time frame. Certain risk-based approaches to the continuous audit technique result in variable audit frequencies for particular activities - more frequently for higher risk areas, less often for functions of reduced risk. Management should be able to justify the assessment that particular areas present little risk to the department. Reports for the various phases, or functional components, of a continuous audit should be presented to the audit committee or Board of Directors in a timely manner.

S.3. Audit Activities

In reviewing the audit program, the examiner should find the following minimum functions being performed:

- Review of trust committee minutes
- Balance and proof of subsidiary ledgers to general controls
- Asset confirmations
- Spot-check and tracing of transactions for accuracy and validity
- Verification of commission and fee calculations
- Assessment of compliance with applicable regulations and the Statement of Principles of Trust Department Management
- Evaluation of internal routine and controls, and
- An administrative review of selected accounts comprising the following:
    - Trust agreements and court orders
    - Administrative actions (in compliance with above)
    - Income receipts and distributions
    - Principal invasions (including approvals) and trust department authority to invade
    - Asset composition and conformity with indenture, beneficiary needs,

and account investment objectives

- Consultation with, and approvals by, co-fiduciaries.

S.4. Evaluation of the Audit Function

The examiner's review of the audit process for the trust department should determine whether:

- All major activities are subject to audit,
- The scope of audit procedures is sufficient,
- Personnel involved in the audit function are sufficient in number and trust expertise to perform the prescribed duties,
- Audit personnel are sufficiently independent, both from operational responsibilities and management influences, to objectively execute their oversight role, and,
- Audit findings are accurately, completely, and promptly reported to management, from which appropriate response and follow-up action is required.

Audits of trust departments conducted by bank holding companies should be evaluated on their own merits and should be regarded as internal audits. Such audits can constitute an acceptable audit program, when the scope is suitable and the quality is satisfactory.

One source of audit information is the AICPA Audit and Accounting Guide, Banks and Savings Institutions, 1996. Chapter 17 of the book covers trust activities.

S.5. Statement on Accounting Standards

Statement on Auditing Standards Number 70 (SAS #70)

Overview

SAS #70, issued by the Auditing Standards Board, became effective after March 31, 1993, and provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization. Such organizations may include data service centers, trust departments, and custodians, which provide services for the department. The statement also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors.

SAS #70 also includes provisions of SAS #55, as amended by SAS #78, both concerning internal control, and SAS #94. The latter concerns the effect of Information Technology on the auditor's consideration of internal control in a financial statement audit.

Auditor

The audit may be conducted by either an auditor for the user organization (such as a trust department hiring an auditor) or by a service auditor for the benefit of the user auditors (an auditor hired by the servicer on behalf of the trust department(s) .) In the latter instance, the service auditor may perform procedures agreed-upon by the user organization and its auditor, or a group of user organizations and their auditors, and by the service organization and its auditor.

The service auditor's work should be performed in accordance with the general standards and with the relevant field work and reporting standards. Although the service auditor should be independent from the service organization, it is not necessary for the service auditor to be independent from each user organization. Furthermore, as the report may be intended for several different user auditors, a user auditor should determine that specific tests of controls in the service auditor's report are relevant to the user organization's financial statements.

When planning the audit, the auditor should obtain a sufficient understanding of the entity's internal controls. As part of that planning, knowledge about the design of relevant policies,

procedures, and records should be used to:

- Identify the types of potential misstatements
- Consider factors that affect the risk of material misstatement
- Design substantive tests

For the service auditor to express an opinion on whether the policies and procedures were suitably designed to achieve the specified control objectives, it is necessary that:

- The service organization identify and appropriately describe such control objectives and the relevant policies and procedures.
- The service auditor consider the linkage of the policies and procedures to the stated control objectives.
- The service auditor obtain sufficient evidence to reach an opinion.

The control objectives may be designated by the service organization or by outside parties such as regulatory authorities, a user group, or others. When the control objectives are not established by outside parties, the service auditor should be satisfied that the control objectives, as set forth by the service organization, are reasonable in the circumstances and consistent with the service organization's contractual obligations.

Types of Reports

The results of the audit will be included in a written report. The type of report may be agreed to by the service and user organizations, to permit a type of report that will be most suitable for the user organizations' needs. There are two general types of reports that may be issued:

- Reports on policies and procedures placed in operation ---

  A service auditor's report on a service organization's description of the policies and procedures that may be relevant to a user organization's internal control structure, on whether such policies and procedures were suitably designed to achieve specified control objectives, and on whether they had been in place in as of a specific date.

  This type of report may be useful in providing a user auditor with an understanding of the policies and procedures necessary to plan the audit and to design effective tests of controls and substantive tests at the user organization, but not intended to provide the user auditor with a basis for reducing his assessments of control risk below the maximum.

- Reports on policies and procedures placed in operation and tests of operating effectiveness ---

  A service auditor's report on a service organization's description of the policies and procedures that may be relevant to a user organization's internal control structure, on whether such policies and procedures were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the policies and procedures that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

  This report may be useful in providing the user auditor with an understanding of the policies and procedures necessary to plan the audit and may also provide the user auditor with a basis for reducing his assessments of control risk below the maximum.

Content of Service Auditor's Report

The service auditor's report should state whether the policies and procedures were suitably designed to achieve the specified control objectives. The report should not state whether they were suitably designed to achieve objectives beyond the specifically identified control

objectives.

A service auditor's report expressing an opinion on a description of policies and procedures placed in operation at a service organization should contain the following:

- A specific reference to the applications, services, products, or other aspects of the service organization covered.
- A description of the scope and nature of the service auditor's procedures.
- Identification of the party specifying the control objectives.
- An indication that the purpose of the service auditor's engagement was to obtain reasonable assurance about whether (1) the service organization's description presents fairly, in all material respects, the aspects of the service organization's policies and procedures that may be relevant to a user organization's internal control structure, (2) the policies and procedures were suitably designed to achieve specified control objectives, and (3) such policies and procedures had been placed in operation as of a specific date.
- A disclaimer of opinion on the operating effectiveness of the policies and procedures.
- The service auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's policies and procedure that had been placed in operation as of a specific date and whether, in the service auditor's opinion, the policies and procedures were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those policies and procedures were complied with satisfactorily.
- A statement of the inherent limitations of the potential effectiveness of policies and procedures at the service organization and of the risk of projecting to future periods any evaluation of the description.
- Identification of the parties for whom the report is intended.

S.6. FAS 87

FAS 87 discusses employer's accounting for defined benefit pensions and became effective for fiscal years beginning after December 15, 1986. This statement does not affect the assets or liabilities reported in the trust department, but in the commercial department. As a result, safety and soundness examiners may ask questions of the trust examiner concerning this statement. In very general terms, FAS 87 requires the use of one standardized method for measuring annual pension expenses and requires spreading the income effect over the employees' remaining service periods, with some exceptions. In addition, the employer must record a liability equal to the excess of the accumulated benefit obligation over plan asses for each plan that has such an excess. If questions concerning this statement arise, contact your accounting subject matter expert or regional office accountant.

Trust Examination Manual

Section 3 - Asset Management - Part I

Investment Principles, Policies and Products

Table of Contents

A. Trust Investment Principles

B. Suitability

C. Prudent Investments

D. Principal and Income

E. Trust Investment Policies

1. Investment Policy Components

2. Discretionary Asset Review Policies

F. Types of Investments

1. Cash Management

a. Money Market Funds

b. External Sweep Arrangements

c. Deposits

d. Overdrafts

2. Fixed Income Products

a. Corporate Debt Issues

b. Municipal Bond Issues

c. Collateralized Mortgage Obligations (CMO)/ Real Estate Investment Conduits (REMIC)

d. Asset-Backed Securities

e. Structured Notes

f. Trust Preferred Securities (TPS)

g. Church Bonds

3. Equity Securities

a. Financial Derivatives

b. Variable Annuities

c. Insurance Company Ratings

d. Exchange Traded Funds

e. Economically Targeted Investments

4. Mutual Funds

a. Investing in Proprietary Mutual Funds

b. Due Diligence Standards

c. Other Mutual Fund Considerations (Fees, Expenses, Taxes)

d. Receipt of 12b-1 Fees

1. Receipt of 12b-1 fees in ERISA Accounts

2. Receipt of 12b-1 fees in Personal and Non-ERISA Employee Benefit Accounts (EBs)

5. Hedge Funds

6. Notes and Mortgages

7. Real Estate

a. 1031 Exchanges

b. Environmental Liability

c. Land Trusts

d. Real Estate Investment Trusts (REITs)

e. Mineral Interests

8. Limited Partnerships

9. Family Limited Partnerships

10. Master Notes

11. Business Interests

12. Worthless Securities

13. Tangible Assets and "Collectibles"

14. Repurchase Agreements

15. Securities Lending

A. Trust Investment Principles

The management of property for others is one of the principal functions of a fiduciary. Fiduciaries administering personal or corporate accounts, either as trustee or agent, are guided by state statutes and the principles embodied in common law. For employee benefit accounts, ERISA, with its implementing Department of Labor (DOL) regulations and opinions, provides statutory and regulatory guidance.

The primary investment guidance given to fiduciaries is found in the terms of each account's governing instrument. There are major differences in the fiduciary's responsibilities under different types of accounts.

- When the fiduciary has discretion to select investments for an account, or makes recommendations for the selection of investments, the investments selected must both follow the terms of the governing instrument and be suitable investments given the needs of the beneficiaries or the purpose of the trust.
- When the trust department has no discretion in choosing investments (such as for self-directed or custodial accounts), the institution's sole responsibility is to follow the provisions of the governing account instrument.

Accounts subject to ERISA, diversification standards, parties in interest, and co-fiduciaries and investment managers are presented in Sections 404 through 406. Refer to specific sections of ERISA in Appendix E - Statute 404 through 406 and Section 5 of this Manual for further discussion.

B. Suitability

In enacting the Prudent Investor Act, states should have repealed legal list statutes, which specified permissible investments types. (However, guardianship and conservatorship accounts generally remain limited by specific state law.) In those states which adopted part or all of the Prudent Investor Act, investments must be chosen based on their suitability for each account's beneficiaries or, as appropriate, the customer. Although specific criteria for determining "suitability" does not exist, it is generally acknowledged, that the following items should be considered as they pertain to account beneficiaries:

- financial situation;
- current investment portfolio;
- need for income;
- tax status and bracket;
- investment objective; and
- risk tolerance.

C. Prudent Investments

T here are two fiduciary standards governing the prudence of the individual investments selected by a fiduciary: the Prudent Investor Act and the Prudent Man Rule. The Prudent Investor Act , which was adopted in 1990 by the American Law Institute's Third Restatement of the Law of Trusts ("Restatement of Trust 3d"), reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investment discretion. This approach allows fiduciaries to utilize modern portfolio theory to guide investment decisions and requires risk versus return analysis. Therefore, a fiduciary's performance is measured on the performance of the entire portfolio, rather than individual investments. As of May 2004, the Prudent Investor Act has been adopted in 41 States and the District of Columbia. Other states may have adopted parts of the Act, but not the entire Act. According to the National Conference of Commissioners on Uniform State Laws, the most common portion of the Act excluded by states concerns the delegation of investment decisions to qualified and supervised agents.

The Prudent Investor Act differs from the Prudent Man Rule in four major ways:

- A trust account's entire investment portfolio is considered when determining the prudence of an individual investment. Under the Prudent Investor Act standard, a fiduciary would not be held liable for individual investment losses, so long as the investment, at the time of acquisition, is consistent with the overall portfolio objectives of the account.
- Diversification is explicitly required as a duty for prudent fiduciary investing.
- No category or type of investment is deemed inherently imprudent. Instead, suitability to the trust account's purposes and beneficiaries' needs is considered the determinant. As a result, junior lien loans, investments in limited partnerships, derivatives, futures, and similar investment vehicles, are not per se considered imprudent. However, while the fiduciary is now permitted, even encouraged, to develop greater flexibility in overall portfolio management, speculation and outright risk taking is not sanctioned by the rule either, and they remain subject to criticism and possible liability.
- A fiduciary is permitted to delegate investment management and other functions to third parties.

A copy of the model Uniform Prudent Investor Act, together with explanatory notes, is included in Appendix C. A list of states adopting the Uniform Prudent Investor Act is also included. States, however, may and often do, modify uniform model laws when enacting legislation. For states that have adopted a version of the Prudent Investor Rule, this portfolio management approach supersedes the Prudent Man

Rule.

The Prudent Man Rule is based on common law, stemming from the 1830 Massachusetts court decision -- *Harvard College v. Armory*, 9 Pick. (26 Mass.)446, 461 (1830). The Prudent Man Rule directs trustees "to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. A copy of the Prudent Man Rule, also known as the Restatement of Trusts 2d, together with explanatory notes, is included in Appendix C.

Under the Prudent Man Rule, w hen the governing trust instrument or state law is silent concerning the types of investments permitted, the fiduciary is required to invest trust assets as a "prudent man" would invest his own property, keeping in mind: the needs of the beneficiaries, the need to preserve the estate (or corpus of the trust) and the amount and regularity of income. The application of these general principles depends on the type of account administered. This continues to be the prevailing statute in a small number of states.

The Prudent Man Rule requires that each investment be judged on its own merits. Thus, a fiduciary could be held liable for a loss in one investment, which when viewed in isolation may have been imprudent at the time it was acquired, but as a part of a total investment strategy, was a prudent investment in the context of the investment portfolio taken as a whole. Under the Prudent Man Rule, speculative or risky investments must be avoided. Certain types of investments, such as second mortgages or new business ventures, are viewed as intrinsically speculative, and, therefore, prohibited as fiduciary investments.

Since the Prudent Man Rule was last revised in 1959, numerous investment products have been introduced or have come into the mainstream. For example, in 1959, there were 155 mutual funds with nearly $16 billion in assets. By year-end 2000, mutual funds had grown to 10,725, with $6.9 trillion in assets (as reported by CDA/Wiesenberger). In addition, investors have become more sophisticated is more attuned to investments, since the last revision. As these two concepts converged, the Prudent Man Rule became less relevant.

Prudent Investments in Court-appointed Accounts

State statutes may outline specific permissible investments for certain types of accounts, such as guardianships f or minor children or incompetents. Under some state statutes, prudence is more narrowly defined for guardianship accounts, than under the Prudent Man Rule.

Trust departments can be appointed as a conservator for veterans . In general, prudent investments for veteran accounts are defined as an interest or dividend paying account at a Federally-insured institution, or in court-appointed cases, in securities issued or guaranteed by the United States. Under 38 CFR13.103, veteran benefits paid to legal custodians on behalf of a beneficiary may only be invested in U.S. savings bonds, pre-need burials trusts, or interest or dividend paying accounts, which are Federally insured. Department of Veterans Affairs benefits that are paid on behalf of an incompetent veteran to an institution via an institutional award payment arrangement may not be invested in any asset. Pursuant to 38 USC 501, Section 13.106 states that court-appointed fiduciaries must invest income or an estate derived from the Department of Veterans Affairs benefits only in legal investments which have safety, assured income, stability of principal, and ready convertibility for the requirements of the beneficiary and his or her dependents.

Prudent Investments in Employee Benefit Accounts

Employee benefit accounts subject to ERISA are governed by the prudence requirement of ERISA Section 404(a)(1)(B) , as well as by DOL Regulation 2550.404a-1 . Also see recap of ERISA prudence interpretations and opinions . In implementing ERISA requirements, the Labor Department has generally followed the Prudent Investor approach outlined above.

D. Principal and Income

As discussed more fully in Section 2 - Operations and Internal Controls, there may exist different classes of beneficiaries in a personal trust account that may only be entitled to a trust's principal, or income, but not both. In these situations, it is important that fiduciaries maintain accounting records that clearly distinguish assets as either principal or income.

Principal (corpus) consists of cash and other property transferred to the fiduciary. Income is the return derived from the investment of principal. Income must also be distinguished from capital gains, which are

not investment yields or returns on principal, but gains or appreciation of the value of the principal itself. Capital gains are added to the value of principal (capital losses reduce the value of principal), and inure to the benefit of principal beneficiaries. Depending on the terms of the trust, and a variety of other factors including the needs of the beneficiaries, income may be distributed as cash, or reinvested and held (for the benefit of income beneficiaries) as invested income. Unless clearly distinguished from other investments, invested income may appear to the observer to be principal. Consequently, it is imperative that fiduciary records distinguish between the two, as failure to do so could result in giving one set of beneficiaries funds that belong to another set of beneficiaries, creating a Contingent Liability. Separate records of principal and income are customary, and can be used for the preparation of accountings and tax returns. A further discussion of principal and income may be found in Principal and Income, located in Section 2.

E. Trust Investment Policies

The ultimate responsibility for establishing an overall investment policy remains with the board of directors or a trust committee appointed by the board. The basis of any investment policy should be sound fiduciary principles, including "prudence", the preservation of capital, diversification, and a rate of return commensurate with the level of risk assumed. The review of the department's investment policies and practices are of major importance in the trust examination.

Many trust departments have a separate trust investment committee which develops and administers investment policy, although smaller departments may utilize the board of directors or the trust committee for this purpose. The committee reviews and either approves or rejects recommendations made by a research division, an outside investment advisor, or the department's investment officer. Often the committee has the responsibility of reviewing individual account portfolios and determining whether assets are invested in compliance with the trust department's overall investment policy.

Accounts for which the department exercises investment discretion should receive an investment review in accordance with the Statement of Principles of Trust Department Management. An initial asset review should, in most cases, be conducted promptly following acceptance, and should establish an investment program for the account. Reviews should include securities and other types of assets received with the account. The initial review is of great importance, as the fiduciary may be required to act quickly to protect assets from loss or erosion of principal, or to take immediate action to protect tangible assets from creditors, insurable losses or physical damage. A fiduciary may have to compensate accounts that sustain investment losses due to the fiduciary's negligence such as a failure on the part of the fiduciary to act in a timely manner.

The department's overall investment policy should be flexible enough to accommodate the types of fiduciary appointments accepted. For example, individual trusts under will or agreement are usually established for the purpose of providing income to the income beneficiary and leaving principal (corpus) to the remainderman at the termination of the trust. By contrast, employee benefit trusts need to generate sufficient growth and income to provide the promised retirement benefits to participants and their beneficiaries. Conversely, investment management agency accounts normally desire capital growth rather than income.

When the governing instrument is silent, investment authority or directions default to state law, which must be followed. When the governing instrument's language concerning investments is unclear, court approval should be obtained.

E.1. Investment Policy Components

Investment policies should clearly set forth a framework for the selection, retention, review, and management of assets over which the department holds investment discretion. The policies should discuss the overall structure of the department's investment management responsibilities. They should provide for: appointing qualified officers to supervise daily investment activities; the monitoring of discretionary transactions, including the reporting of such transactions to the appropriate supervisory officers and committees; procedures for handling exceptions; and, formal procedures for reviewing and revising investment policies and practices. Depending on a department's size, complexity, and the types of appointments accepted, the following elements may also need to be addressed:

- Management's investment philosophy and standards of practice.
- A code of conduct for employees, officers, and directors who by their duties or supervisory roles have knowledge of, or access to: (1) discretionary investment

transactions; or (2) the department's approved list of securities, or changes to the approved list of securities. FDIC Part 344 requires that bank officers and employees who make investment recommendations or decisions for accounts of customers file a report with the bank on a quarterly basis.

- Investments and investment practices deemed appropriate, or inappropriate, with regard to the management of discretionary accounts.
- The nature and size of accounts the department is qualified to administer, and the minimum standards required for the acceptance of new accounts.
- Pre-acceptance review of the transferred assets for new accounts.
- The initial review of newly accepted accounts.
- Investment reviews of existing accounts.
- Procedures for documenting investment reviews.
- Whether the department will prepare its own research in-house, or purchase investment research from outside investment advisors.
- Guidelines governing the use of outside investment advisor r efer to Section 10.G.6) including:
    - Procedures for adopting and/or amending an approved list of investments recommended by outside advisors, if appropriate,
    - Procedures for diverging from outside advisor recommendations when appropriate, and
    - Procedures for monitoring purchases and sales to ensure compliance with the approved lists.
- Procedures for adopting and amending an approved list of equity investments based on in-house research, including:
    - Criteria for selecting the investments to be included on approved lists,
    - Criteria for monitoring the investments included on approved lists,
    - Description of the approval process for adding or deleting investments from approved lists, including specifying the person(s) having authority to make such additions or deletions, and
    - Monitoring purchases and sales to ensure compliance with the approved lists.
    - Procedures for making exceptions to the approved lists.
- Procedures for adopting and amending an approved list of mutual fund investments (inclusive of proprietary mutual funds, refer to subsection F.4.a, if appropriate) including:
    - Justification for the selection of a load fund over a no-load fund.
    - Criteria for the selection of the mutual funds to be included on approved lists,
    - Criteria for monitoring the mutual funds on the approved lists, and
    - Description of the approval process for adding or deleting mutual funds from the approved lists.
    - Criteria for diverging from the approved lists.
- Establishment of procedures for adopting and amending an approved list of obligors (corporate and municipal) of fixed income debt investments, if applicable, including:
    - Criteria for evaluating the credit risk of the obligors to be included on the approved lists,
    - Criteria for monitoring the credit risk of the obligors on the approved lists,
    - Description of the approval process for adding or deleting obligors from the approved lists, and
    - Monitoring purchases and sales to ensure compliance with the approved lists.
    - Criteria for making exceptions to the approved list.
- Guidelines for the development and use of asset allocation models, including:
    - Criteria or methodology for creating and modifying asset allocation models, and
    - Description of the process for supervisory review and approval of the models.
- Guidelines for the holding, purchasing, and managing of real property, including:
    - The evaluation of environmental risk, initially, and on an ongoing basis, and
    - Initial and periodic reappraisals/inspections of real property.
- Guidelines and procedures for holding closely held businesses, including:
    - Identification of conditions under which the department would administer such assets.
    - Criteria for contracting with a third party to run a closely-held business.
    - Methods and procedures for the initial and periodic evaluation of such assets
    - Whether the trust officer should serve on the board .

- Guidelines and procedures employed in the selection and use of money market mutual funds, including:
    - Periodic reviews of fund performance,
    - Methods for monitoring the use of and reliance on derivative products by such funds, and
    - Guidelines for the selection and use of funds paying 12b-1 fees, including: the appropriateness of such funds for each type of account administered, notification to customers of such fees, the solicitation of customer approvals when appropriate, and the routine disclosure to customers of such fees earned by investment of their accounts in such funds.
- Guidelines governing the use and monitoring of derivative investment products, as outlined in the FDIC Office of Capital Markets Examination Handbook and the FDIC Statement of Policy on Investment Securities and End-User Derivative Activities.
- Guidelines for the evaluation and management of assets deemed worthless.
- Guidelines and procedures for evaluating and monitoring exceptions, such as non-rated, or non-approved list, securities held in accounts. Refer to the following section.
- Guidelines and practices for securities lending. Refer to F.15.
- Guidelines and procedures governing loans from trust accounts (real estate, unsecured promissory notes, etc.).
- Guidelines and procedures regarding lending to, and permitted indebtedness of, managed accounts.
- Guidelines providing for the prompt investment of income and principal cash, unless the governing instrument, local law, or parties properly authorized to direct investments provide otherwise.

E.2. Discretionary Asset Review Policies

It is generally acknowledged that trust departments are liable, to varying degrees, for all assets held, whether or not they possess investment authority. It also follows that greater authority imparts greater risk. Trust departments which are otherwise well managed may sometimes lack appropriate policies with respect to periodic reviews of assets not contained on the approved list. Many departments hold at least some assets in discretionary accounts that were not acquired through the exercise of discretionary authority. These include directed purchases, assets acquired "in-kind," and assets acquired through distributions, corporate re-organizations or liquidations. This is especially true with respect to assets acquired as executor, trustee under will, successor to previous fiduciaries, and through guardianship or conservatorship appointments. The value of these assets may represent a significant percentage of the market value of an individual account.

Trust management should institute written policies which affirmatively address the routine evaluation of all discretionary assets (refer to subsection G, Account Review Program, of Section 1. This is true whether or not the assets were acquired by virtue of management's fiduciary authority. At least once during the calendar year, all assets held in discretionary accounts should be reviewed and evaluated in light of governing instruments and individual account circumstances. Departments that adopt a "passive" stance over assets received in-kind increase their exposure to fiduciary risk. Trust management may believe it can eliminate this risk by obtaining "direction letters." Although prudent and necessary, at best, this reduces, but cannot eliminate, fiduciary risk. The beneficiaries may change or may lack the legal capacity to release the fiduciary from liability, as in the case of minors or the unborn. Likewise, account circumstances change and economic factors vary over time, sometimes dramatically and with little or no advance warning.

Also, asset management policies should address the retention process for all discretionary holdings. Investment policies should address minimally acceptable sources for outside research. They should also outline the minimum acceptable standards for documenting and approving the retention of assets and provide guidance for the sale of underperforming assets. Trust departments may fail to include all discretionary assets in their annual review function, thereby increasing fiduciary risk. Trust departments that have adopted an "approved list" approach may be at increased risk if they do not review discretionary assets that are not on their approved list.

Trust departments may hold assets for which they cannot obtain reliable valuations. Such assets may include limited partnership interests, investments in closely held businesses, the

common stock of thinly traded or unlisted companies, partnership agreements, hedge funds, royalties, patents and copyrights, oil and mineral interests, etc. Asset pricing is an integral component of an annual portfolio analysis. It is also necessary for the preparation of estate tax returns (IRS Form 706), gift tax returns (IRS Form 709) and annual IRA account filings (refer to Section 5, F.1.) . It is a key factor in the proper calculation of account fees and commissions (department earnings). In these situations, and in situations where management does not have the resources to adequately evaluate certain types of assets, it should seek outside expertise. Management may not, however, be able to pass the cost of these outside services through to the account, particularly when the assets in question were purchased by the department under its discretionary authority. Consequently, examiners should review accounts for inappropriate charges in this context.

F. Types of Investments

Various investment vehicles are available for the investment of trust funds. The more common types of investments and some newer products are discussed below, along with applicable regulations, examination procedures and other related matters.

The Capital Markets Handbook defines products not outlined on the following pages and provides examination guidance. The Capital Markets Branch in the Washington Office can readily provide information concerning most investment products.

F.1. Cash Management

F.1.a. Money Market Funds

Various money market funds are offered for the short-term investment of idle cash. These funds are mutual funds and have differing portfolios depending on the particular fund. Investments in domestic or foreign certificates of deposits, repurchase agreements, commercial paper, and short-term U.S. Government or agency obligations are some of the more common portfolio components. Although the trustee may have full investment discretion, it should be satisfied that the investment of trust funds in money market funds is permissible under state statutes. When trustees do not have full discretion, sufficient authority should be sought in state statutes or court decisions, the language of the account's governing instrument, or by obtaining binding consents from all beneficiaries or written instructions from the parties authorized to direct investment selection, before utilizing these funds. In general, it would not be considered appropriate to permanently place funds in this type of investment vehicle, as money market funds are considered short-term investments.

Money market funds are registered under the Investment Company Act of 1940 and as such, are regulated by the Securities and Exchange Commission. Fund companies are required to provide a prospectus to the investor prior to purchase. The funds are required to have external audits. Prior to investing in a money market fund, the prospectus of the fund and portfolio composition should be reviewed to determine that the fund meets the objectives of the trust account. Thereafter, the fund should be reviewed periodically to ensure that the investment objectives continue to be met. In addition, there have been instances where money market funds have "broken the buck", referring to situations where the fund's net asset value falls below $1 per share. This issue has recently resurfaced and concerns may be found at in Appendix G, Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates . Therefore, various risks such as credit, liquidity, concentration, operational, and reputation risks should be assessed by trust department management. Examiners should determine that money market funds have been properly analyzed prior to investment and that the funds are periodically reviewed. Appropriate comments should be included in the Report of Examination if such funds have not been properly analyzed or if such investments are inappropriate for the accounts involved.

F.1.b. External Sweep Arrangements

Money market funds generally accrue interest daily and pay interest at the end of the month. Many trust departments now have services which automatically invest available cash exceeding predetermined dollar limits in a money market fund. These are commonly called "sweep" arrangements.

Fiduciaries are obligated to keep funds productive. Uninvested cash of discretionary appointments should be invested "temporarily" until "permanent" investments are chosen, or pending the implementation of an investment program or distribution to beneficiaries. Uninvested principal cash, including cash not awaiting immediate distribution or payment against a draft, are often "swept" at the close of each business day into some form of interest-bearing investment vehicle. Income cash should be treated in a similar manner. Current technology makes possible, and prudent fiduciary investment philosophies advocate, the full employment of all cash in some form of productive investment. Management's failure to invest cash when appropriate and practicable should be considered imprudent and a breach of fiduciary duty subject to criticism. In those cases where the fiduciary is responsible for the investment of cash, it is difficult for a fiduciary to justify permitting cash to remain idle when it is possible to make it productive. It would be unusual, given the current state of investor awareness, for customers to be indifferent to a fiduciary's intentional failure to invest large cash balances.

The investment of nondiscretionary cash is largely governed by the terms of the account agreement. There may be instances, however, when the account agreement lacks specific directions concerning how cash is to be invested and the customer has not provided any specific instructions. Examiners, in such cases, should be careful when "interpreting" a trust department's investment authority with respect to the investment of cash balances. In such cases, management should be encouraged to modify the governing account agreements in a manner to resolve any ambiguity concerning the department's responsibility to invest cash. In addition, faced with such uncertainty, the fiduciary should contact the account principal and request direction concerning the investment of the cash.

Examiners may encounter situations in which the trust department charges an additional fee ("sweep fee") for performing cash management services. The taking of such fees is customarily governed by state law and examiners should determine the permissibility of assessing additional fees under local statutes. If permissible under state law and not prohibited by the account agreement, the fee charged should be reasonable for the service performed. Additionally, the department should fully disclose the imposition of the fee to interested parties. The amount of fees charged relative to the sweep arrangement should be disclosed periodically in the account statements sent to customers. The charging of sweep fees in **ERISA accounts is not strictly prohibited.** Refer to Section 5, subsection H.7.f.(20). Sweep Fees for additional guidance for ERISA accounts.

F.1.c. Deposits

Deposits, whether time, savings, or demand, are another common form of investment. The deposits could be in another institution or in the commercial department of the bank under examination. Oftentimes, such investments provide the safety and liquidity needed by the account. However, given the availability of numerous other investment vehicles providing similar safety and liquidity, examiners should determine whether deposit holdings result from a lack of management initiative to seek other investment opportunities. Large holdings of non-interest bearing deposits should be scrutinized, since it is a fiduciary's duty to make trust assets productive. Discretionary deposits with the commercial bank should also be reviewed, given the conflict of interest and self-dealing aspects of such investments.

Some trust departments sweep cash to the commercial department's deposit accounts on an overnight basis, rather than sweep to an external investment vehicle. In those situations, bank management should have a strategic plan

for the activity. Within that plan, management should not view overnight trust funds as a long-term funding source for the commercial department. Management should have calculated the costs, including interest on deposits and the FDIC deposit insurance assessment. More importantly, trust management should be able to demonstrate that the customer is at least as well compensated, as he would have been with an external sweep, usually a money market fund. Care should also be taken to assure the deposit account is appropriated titled in the commercial department's records to insure pass-through deposit insurance coverage. Examiners should be aware that Section 24 of the FDI Act prohibits the pledging of bank securities to secure deposits of trust accounts. However, an irrevocable letter of credit issued by an agency of the U. S. Government or a surety bond, issued on behalf of the bank or trust department, is allowable under the regulation .

Refer to Section 8. E.3. Use of Own Bank or Affiliate Deposits, of this Manual for additional guidance in this area.

Federal deposit insurance coverage of trust account deposits is discussed in Section 10, subsection L. Deposit Insurance of Trust Funds

F.1.d. Overdrafts

Overdrafts occur for numerous reasons, including timing differences related to cash receipts and disbursements. Overdrafts should be short-term in nature, and rare in occurrence. The department should not be funding securities purchases with overdrafts. Such a practice reflects poor cash management of an account. Likewise, the failure of the department to properly plan for recurring or expected disbursements, resulting in a lack of liquid assets to fund disbursements, reflects poor cash management. These and similar events, if prevalent, should be criticized. The department should have a policy governing overdrafts. The policy should include review procedures, methods for curing overdrafts, and the action(s) that will be taken if an overdraft cannot be cured within a reasonable time period. Overdrafts outstanding for long periods of time should be treated as a loan to the account.

F.2. Fixed Income Products

In those states where the Prudent Investor Act has been adopted, the suitability of the entire portfolio should be reviewed as a whole, and individual investments are not considered inherently good or bad based solely on investment type or credit rating.

In states which operate under the Prudent Man Rule, investments are considered prudent or imprudent on an individual basis. Therefore, investments can be considered inherently prudent or imprudent based solely on investment type or credit rating.

The following is a brief overview of the more common investments and some newer products found in trust departments. For particular products and their risks not included on the following pages, examiners should refer to the Capital Markets Examination Handbook and the Manual of Examination Policies, used for safety and soundness examinations.

F.2.a. Corporate Debt Issues

Marketable debt securities (bonds, debentures, etc.) generally comprise a significant portion of a trust department's assets. The selection of acceptable debt instruments for discretionary accounts should be based on research performed in-house, acquired from outside sources, or a combination of the two. The department may also rely on ratings provided by the nationally recognized rating agencies. The rating bands for three of the rating services are outlined in this section. As seen in recent events, highly rated debt issues can decline into subinvestment quality rating bands or go into default. Therefore, management should monitor investments on an on-going basis to determine that the issue remains suitable for the account. As previously stated, the Prudent Investor Act does not preclude the investment in or continued holdings of subinvestment quality securities. However, speculation is inappropriate for trust accounts.

InterNotes are investment grade, medium-term notes, offered in minimum denominations of $1,000 to retail investors. InterNotes represent the debt of each respective issuer and are subject to credit and secondary market risk. The notes are offered via a prospectus and issues are sold at par value. Each week, new offerings from various corporations are made, and include issues with varying maturities, coupons, and interest payment schedules (monthly, quarterly, semi-annually.) InterNotes appear to have a shelf registration, meaning that the amount offered in the prospectus is registered once, and the issuer can offer amounts under that prospectus as needed.

An example of an InterNote may be the following:

- $6 billion issue from a corporation under a prospectus dated August 2002.
- Separate CUSIP numbers are assigned to specific terms, such as maturities, coupons, and call provisions, which represent amounts used under the registration.
- The offer as stated is valid for a week, and the minimum investment (denomination) and increments are $1,000.
- The products are rated by nationally recognized rating agencies and the ratings are posted on the InterNotes' website, along with other information concerning terms.
- Some InterNotes are based on floating rates, indexed to short-term rates.
- The products are directed at small, retail investors, in lieu of certificates of deposits and may be received in-kind.

F.2.b. Municipal Bond Issues

The department may invest in debt obligations issued for the benefit of local municipalities, school districts or other small governing authorities. Industrial revenue bonds may be issued for the benefit of corporate entities. Frequently, municipal bonds will be received in-kind rather than purchased by the department. The issues may or may not be rated. The lack of a rating may result from the expectation that the issue will be sold to a limited number of investors in the local community, or, the cost of acquiring a rating may be expensive in relation to the size of the issue. However, non-rated, does not necessarily equate with investment quality. Trust management should analyze prior to purchase and periodically thereafter to determine that the issuer is creditworthy. Management should establish policies and procedures including selection criteria and investment review procedures when non-rated investments are purchased for discretionary accounts.

Municipal bond issues may be appropriate for managing the customer's tax position, but normally the investment should not be placed in tax-deferred accounts, such as employee benefit accounts, as the accountholder does not gain any additional tax benefit from the exemption. Private activity bonds used for funding football stadiums, basketball arenas, etc., are subject to the Alternative Minimum Tax and may affect the customer's income tax liability. In either of these or other scenarios, management should determine and document the suitability for the accountholder.

CORPORATE & MUNICIPAL BOND RATINGS

Description	Moody's*	Standard & Poor's**	Fitch**
Highest quality, "gilt-edged"	AAA	AAA	AAA
High quality	Aa	AA	AA

Upper medium grade	A	A	A
Medium grade	Baa	BBB	BBB
Predominantly speculative	Ba	BB	BB
Speculative, low grade	B	B	B
Poor to default	Caa	CCC	CCC
Highest speculation	Ca	CC	CC
Lowest quality, no interest	C	C	C
In default, in arrears, questionable value		DDD DD D	DDD DD D

* Moody's uses numerical modifiers 1 (highest), 2 and 3 in the range Aa1 through Ca3.

** Standard & Poor's and Fitch may use + or - to modify some ratings.

F.2.c. Collateralized Mortgage Obligations (CMO)/ Real Estate Investment Conduits (REMIC)

CMOs are a mortgage derivative security consisting of several classes secured by mortgage pass-through securities or whole mortgage loans. Principal and interest payments from the underlying collateral are divided into separate payment streams that repay investors in the various classes at different rates. All collateralized mortgage obligations now issued are in Real Estate Mortgage Investment Conduit (REMIC) form. REMIC classes include sequential pay tranches, planned amortization classes (PAC), and targeted amortization classes (TAC). These tranches are generally more stable than some of the tranches outlined below.

The following tranches are generally more sensitive to changes in interest rates :

- Stripped Mortgage-Backed Securities - The separation of interest or principal cash flows from the underlying mortgage assets give I/Os and P/Os vastly different risk profiles. These products are highly sensitive to changes in interest rates.

- Interest-Only Stripped Mortgage-Backed Securities- A pure I/O consists entirely of a premium. The value of the I/O is the present value of the future interest payments based on the underlying collateral.

- Principal-Only Stripped Mortgage-Backed Securities- P/Os are generally sold at a discount, and the investor realizes a return on investment, as principal is returned at par and the discount is returned as income. (Refer to the Uniform Principal and Income Act for a discussion on determining income.)

- Inverse Floaters- The coupon varies inversely to an index. As the floating rate class of securities within the issue is larger than the

inverse floating rate tranche, leverage factors or multipliers are used to balance the inverse tranche with the floating rate tranches. Leverage factors or multipliers can magnify the effect of minor interest rate movements.

Prior to investing in any product, management should perform the appropriate due diligence. A copy of the prospectus and pre-purchase analysis should be retained in the trust files. Subsequent evaluations consisting of total return screens, stress tests, or volatility analyses performed by management should be retained for REMICs. This documentation should support the continued investment in the product.

The trust investment officer should have expertise in managing these instruments. Management should be fully aware of all derivative holdings and be able to explain how these instruments benefit the individual account. During account and investment reviews, management's knowledge of the products should be documented and the use in a particular account should be demonstrated through written comments or exhibits retained in file. Trust departments that cannot adequately demonstrate a reasonable level of knowledge of a derivative investment and its associated risks should be criticized.

For employee benefit accounts, an apparent violation of ERISA Section 404(a)(1)(B) (prudence), which can be found in Section 5.H.5.c r) should be cited. The basis for the apparent violation is detailed in the DOL advisory opinion letter issued to the OCC on March 21, 1996, entitled "Investments in Derivatives." Derivatives are defined in the letter as a financial instrument whose performance is derived in whole or in part from the performance of an underlying asset. Examples include futures, options, options on futures, forward contracts, swaps, structured notes, and collateralized mortgage obligations. In that letter, the DOL opined that the products are permissible. However, trust management is responsible for assessing the inherent risks of derivatives by "securing sufficient information to understand the investment prior to making the investment." The letter discusses the importance of performing stress simulations under normal and abnormal market conditions, the effect of volatility on the plan's portfolio, and the ability to properly analyze the investment. A copy of this letter is contained in Appendix E .

The trust policy should provide guidance, as to when investments in derivatives are appropriate and how investment risks will be managed. Parameters should be established for the dollar volume and interest rate risk that is acceptable for accounts, and formal monitoring and reporting mechanisms should be established. Furthermore, management should understand the types of risks involved in each derivative investment and should not rely solely on the statements of the selling broker, as an impartial analysis of such risks. A broker's job is to sell a product, and often the riskier the product being sold, the greater the broker's commission.

Potential risks associated with such derivative investments consist of the following:

- The investment is bought in a large block and several accounts hold the investment. An individual account's investment may not be liquid. For example, when an individual account needs to liquidate the asset, the question becomes how liquid is that individual account's investment. Also, is the holding in a saleable lot and at what price for a relatively small holding rather than a block transaction? Management may determine that the particular account's portion is not liquid and may sell the asset to another account. When inter-account transactions occur, self-dealing or conflicts of interest are a major concern. Also, management should have documentation supporting the transaction price. However, the pricing used may be matrix pricing, which is a

calculated price. While matrix pricing should be reliable under normal circumstances, the pricing does not incorporate every conceivable outside factor which may influence pricing.

- Trust accounting systems should provide for adequate, timely and accurate pricing of derivative investments. Many pricing services do not have sufficient capability in this area. In such cases, trust accounting systems often default to the purchase price or face value of the investment. As products return principal and income, the purchase price may greatly overstate to the value, if the trust accounting system does not accept paydowns. Each CMO tranche has a factor, indicating the amount outstanding as a percent of the original face amount. Normally, these factors are available on the payment of principal and interest ticket or for FNMA issued REMICs, on the agency's website. The Capital Markets Branch in the Washington Office can provide factors and other information regarding these and other products.

F.2.d. Asset-Backed Securities (ABS)

Asset-backed securities are debt instruments secured by installment loans or leases or revolving lines of credit. Common ABS collateral includes credit card receivables, automobile loans, automobile lease, mobile homes, and home equity loans. The ABS can be in the form of a pass-through or in a REMIC. Depending upon the structure, the investor either receives a pro rata share of the principal and interest payment or a structured payment.

F.2.e. Structured Notes

T hese are hybrid securities that combine fixed term, fixed or variable rate instruments, and derivative products. Structured notes are debt securities issued by corporations or government-sponsored enterprises, including the Federal Home Loan Bank, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. Most corporate structured notes are issued through shelf-registered medium-term note programs. The shelf-registration allows the issuer to issue up to $1billion in debt over a two year period, without re-registering with the SEC. Structured notes generally contain embedded options and have cash flows that are linked to the indices of various financial variables, such as interest rates, foreign exchange rates, commodity prices, prepayment rates, and other financial variables. Structured notes can be linked to different market sectors or interest rate scenarios, such as the shape of the yield curve, the relationship between two different yield curves, or foreign exchange rates.

F.2.f. Trust Preferred Securities (TPS)

Overview

Trust Preferred Securities originated in 1993, with industrial and utility companies being the primary issuers. Since then, both large and small bank holding companies have issued the hybrid investment product: The securities have characteristics that resemble both corporate debt and preferred stock. The debt-like characteristics include the tax deductibility of distributions, a fixed maturity date, a stated coupon or formula for the calculation of the coupon, and the ability of investors to accelerate claims against the company in the event of default. The securities rank behind both senior and subordinated debt in terms of repayment priority. The equity-like characteristics include resembling cumulative preferred stock, subordinating to other obligations, and representing a minority interest in a wholly-owned subsidiary. Currently, TPS issued by bank holding companies are limited to 25 percent of Tier 1 capital. All TPS have an interest deferral feature of up to 5 years. In general, TPS have a 30 year maturity, although TPS can be issued with a maturity of up to 50 years. The securities generally have a par value of $25 for retail investors, a $1,000 for institutional investor is the norm. A call provision of 5 or 10 years is common for the institutional class investor.

TPS Structure and Flow of Funds

Underlying Structure

First, the parent company establishes a wholly-owned special purpose subsidiary (a grantor trust), whose sole purpose is to issue the securities. The holding company then acquires all of the special purpose trust's common stock. Next, the trust issues preferred stock to the public, representing an undivided interest in the trust's assets. The holding company guarantees, on a subordinated basis, that the trust preferred securities holders will receive interest payments. The trust then lends the proceeds back to the parent company to purchase junior subordinated deferral debenture with identical terms. The interest that the trust receives from the funds lent to the parent company is used to pay the dividend on the trust preferred securities. In general, TPS are considered a variable interest entity and subject to FIN 46 - Special Purpose Entity accounting..

Common structures:

Monthly income preferred securities (MIPS)

Quarterly income preferred securities (QUIPS)

Pooled Trust Preferred Securitization -

I n a pooled trust preferred offering, an additional trust is added to the structure and is referred to as a business trust. The business trust issues securities to investors and uses the proceeds to purchase all of the trust preferred securities from the grantor trust, as described above. The trust preferred securities are then securitized, as the business trust is the sole investor of the securities. A pooled trust preferred security is a form of a collateralized debt obligation backed by various trust preferred securities. The pooling crosses geographical lines and therefore, limits concentration risk.

Eligible trust preferred securities are issued by bank or financial holding companies, whose subsidiaries' deposits are FDIC insured. The individual holding company must have assets of at least $200MM or deposits of $100MM. The entity must have been in operation for at least 5 years, and have a Tier 1 risk-based capital ratio of 10 percent or more.

Deferral Period

TPS can defer interest payments for 20 consecutive quarters, unless the deferral would extend beyond the stated maturity. While the deferral period is not considered a default, the reputation of the issuer is harmed. Further, while the interest may be deferred, it still must be paid. Therefore, the deferral period is also an accumulation period for interest. The issuer can enter into a deferral period, pay investors income due, and enter back into another deferral period. As long as there is a clean-up period, successive deferral periods are allowable.

Investment Considerations

TPS with fixed rate coupons and lives of 30 to 50 years are sensitive to interest-rate fluctuations. Coupons for these products are normally high in relation to market rates for long-term Treasury securities and generally yields are higher than those of corporate bonds or preferred stock issued by the same corporation. While the products contain call provisions, there is usually a lock-out period on the call.

An alternative to the fixed rate TPS is the floating rate TPS. The coupon for the floating rate issues may be based on a short-term rate, such as three-month LIBOR plus a spread. By reducing the interest-rate risk, these products have significantly less attractive coupons than the fixed rate products.

Trust preferred securities are rated by nationally recognized rating firms. For the pooled trust preferred issuance, only the senior notes and mezzanine notes are rated, with the senior notes carrying a higher rating. The income notes are not rated and are similar in concept to a residual.

Payments may be deferred for up to five years, but that action is not considered a default. However, TPS are not immune to default. For example, Enron issued TPS that have since defaulted. In the event of bankruptcy, the TPS are below all senior and subordinated debt, but above equity securities in priority.

While the previously mentioned deferral period may harm the issuer's reputation, from an investor's point of view, the deferral period can be significant, also. During the deferral period, the investor is liable for including the deferred income in gross income for federal income tax purposes, where it is considered original-issue discount. To collect the accrued but unpaid income, the investor must own the security on the date dividends are finally paid.

Employee Benefit Account Considerations

Investments in affiliated holding company trust preferred securities should be carefully reviewed. The transactions may be considered a "party in interest" under ERISA or a "disqualified person" within the meaning of Section 4975 of the Internal Revenue Code with respect to employee benefit plans and individual retirement accounts. The purchase of trust preferred securities by an employee benefit plan or IRA that is subject to the fiduciary responsibility provisions under ERISA or prohibited transaction provisions under Section 4975(e)(1) of the Internal Revenue Code may constitute a prohibited transaction. Prior to investing in trust preferred securities issued by the parent company, management should consult with legal counsel knowledgeable of ERISA and the Internal Revenue Code.

A prohibited transaction may occur when employee benefit accounts or IRAs are transferred from one institution to another. If the account held a TPS of the second holding company and transferred the asset into an account at a subsidiary of the second holding company, a prohibited transaction may occur.

F.2.g. Church Bonds

Church bonds are certificates of indebtedness issued by churches, and proceeds from the sale are used primarily to fund acquisition or expansion of the church property. Churches use the funding when conventional borrowing is not available; the bonds are secured by mortgages. In general, the bonds are held by members of a particular church. Maturities range from 6 months to 15 years, with interest paid or compounded every 6 months. The bonds are promoted as acceptable investments for Individual Retirement Accounts, although the ability to accurately value the bonds is questioned. Furthermore, the bonds most likely will not be rated, due to the nationally recognized rating agencies not analyzing this type of investment, nor are the churches willing to pay for a rating, especially when the rating may be less than investment quality.

F.3. Equity Securities

Marketable equity securities may comprise a significant portion of a trust department's assets. Equity investments selected for accounts where the trust department exercises investment discretion should be based on research that is either performed in-house, acquired from outside sources, or a combination of the two.

The department may also consider equity ratings assigned by rating agencies and services. In recent months, various financial service organizations, such as Charles Schwab, have established proprietary equity ratings, in addition to those established by the better known national rating agencies. While the rating scales used by either the rating agencies or the financial service organizations appear similar to the bond rating scales,

equity ratings do not have the same purpose as bond ratings. The stock rating represents the expected performance of the stock and/or its risk level, while a bond's rating is based on perceived creditworthiness. Therefore, a "C" rated equity may be considered as a hold, whereas a debt rated "C" is indicative of a security at or nearing default. Given the numerous entities issuing equity ratings, trust management should maintain a copy (paper or electronic) of the rating criteria and definitions used by the particular rating service.

The department may develop its own "approved list" based on in-house research; it may adopt the approved list of an outside investment research firm; or it may modify the "approved list" provided by an outside research firm. If the department uses in-house research or adopts its own version of an outside research firm's "approved list," there should be policies describing the criteria used to include investments on the "approved list," as well as procedures for reviewing such selections. Investments in equity securities should be suitable for the purpose and investment objectives of the account.

Restricted equity securities are not subject to registration under Federal securities laws. The securities certificates usually contain a "legend" stating that they are transferable only upon certain conditions, such as after a certain date or after "x" years. The securities must have been obtained in a transaction not involving a public offering. Normally a trust department acquires such securities in-kind rather than by purchase. To sell such securities, the trust department must comply with the requirements of SEC Rule 144, issued under the Securities Act of 1933 (refer to SEC regulations at 17 C.F.R. Section 230.144). For additional information, refer to Section 3.k.2. Restricted Equity Securities

F.3.a. Financial Derivatives

The following are the four types of Interest Rate Derivative Instruments: interest rate options; interest rate futures and forwards; interest rate swaps; and, interest rate caps, floors, and collars. These instruments are principally designed to transfer price, interest rate, and other market risks without involving the actual holding or conveyance of balance sheet assets or liabilities. Examiners are unlikely to find these types of instruments in a trust department unless the investment portfolio is exposed to some risk that can be mitigated by the use of one of these instruments. Some examples of how these vehicles could be used include: using foreign currency swaps to reduce foreign exchange risk, purchasing a call option to lock in the price of a security which the department expects to purchase in the future, purchasing a put option to establish a future selling price, and writing covered call options to enhance the yield of a portfolio.

Some trust departments use over-the-counter put and call options for accounts as a means of increasing trust account revenue. The writer of put and call options is paid a fee for selling these contracts. The purpose of using exchange traded options would be to take advantage of price fluctuations. Whether engaging in options transactions is legally permissible for trust accounts depends upon the terms of the agreement, and the applicable state law governing the investments permitted for specific types of accounts. Employee benefit trusts are governed by the prudent investment standards in Section 404(a)(1)(B) of ERISA and in DOL regulations at 20 C.F.R. Section 2550.404a-1 .

Many departments have restricted option writing activity to covered call options. However, it is recognized that under certain conditions, the writing of put options, within clearly defined policy parameters, may be an acceptable and appropriate investment strategy for some accounts. Prior to approving the utilization of options as an investment strategy, the board of directors, or an appropriately designated committee thereof, should ensure that adequate policies and procedures are established to measure, monitor and control the risks involved. The policies should: address the propriety of option writing for different types of fiduciary accounts; define the permissible option strategies that may be employed; define the dollar volume of options that may be written by individual accounts; establish procedures for reporting and approving such transactions; and prescribe control and record keeping practices. The policies should be reviewed on a regular basis, no less frequently than annually. The

trust department should also obtain an opinion from bank counsel as to the legality of these activities.

When a department writes a covered call option on stock held in its trust accounts, it sells to a third party the right (option) to purchase that stock (call) at a specified price until a specific date. Possession of the stock by the trust account makes the written option "covered."

Receipt of cash (fee) paid by the third party for the option provides an additional return on the stock if the market price remains the same, and cushions the potential loss if the market value declines. An element of risk is involved if the market value of the stock rises above the strike price, in which case the holder of the option will exercise the right to purchase the stock at the previously agreed upon price. In such instances, by granting of the option, the trust account foregoes any price appreciation over the strike price of the option. If the option contract is written and exercised on a bond, the trust account will receive the cash proceeds resulting from the sale, but reinvestment of these funds in a rising market will likely result in a reduced yield (income) to the account.

The following guidelines should be followed by examiners in reviewing investments in call options: (1) Sufficient authority must exist to make such investments. Such authority might consist of specific authority in the governing instrument, specific or express authority in applicable state law, the written and binding consent of all account beneficiaries, an order from a court of competent jurisdiction, or in those cases where the governing instruments and state law are silent, applicable Prudent Man or Prudent Investor Rules; (2) Such an investment must be prudent for each trust account involved, coupled with a determination that employment of an option writing strategy is consistent with the needs and investment objectives of the account; and (3) The trust department should have the necessary technical expertise to monitor and execute such transactions, which should be documented in accordance with approved policy by appropriate records, reviews and approvals.

F.3.b. Variable Annuities

Overview

The Securities and Exchange Commission (SEC) and National Association of Securities Dealers (NASD) regulate the sale of variable annuities, as the products are registered with the SEC as securities. The variable annuity is a contract between a purchaser and an insurance company, where the latter makes periodic payments to the purchaser beginning either immediately or at some future time. The purchase can be made by a single, lump-sum payment, or by multiple payments. All investments in variable annuities should be viewed as a long-term investment.

A range of investment options are offered, although investments in mutual funds are the most common. The underlying assets are generally invested in stocks, bonds, or money market funds. The rate of return varies with the investments selected. While the investment options may consist of mutual funds, variable annuities differ significantly from mutual funds, by the following:

- Variable annuities provide periodic payments and protect the owner from outliving his assets.
- The beneficiary is guaranteed a specified amount, if the purchaser dies before receiving payments.
- The income and gains are tax-deferred until withdrawn.
- When withdrawing funds, income is taxed at the ordinary rate, and not the lower capital gains rate.

Variable annuities should not be used in lieu of 401(k)s or other similar plans, as the contributions are not excluded from current income. Once a 401(k) or similar plan is funded to the legal maximum contribution, variable annuities may be an investment option. Generally, variable annuities should not be held in retirement accounts, such as 401(k) or IRA, as those accounts are already tax deferred. There is no additional advantage to owning tax deferred products in such accounts (this would be the same for municipal bonds.) However, examiners should determine if there are any other reasons to hold such products.

Phases

The product has two phases. The first phase is the accumulation phase. During that time, the purchaser allocates investments amongst various investment options. Just like a mutual fund, the investment selected will increase or decrease in value based on the fund's performance. During this phase, funds can be transferred between investment options, without a tax consequence. However, withdrawing funds during this time may result in "surrender charges." Withdrawals prior to age 59 ½ are also subject to a 10 percent federal tax penalty.

The second phase is the payout phase. The payout may be a lump-sum payment or multiple payments, usually monthly. The purchaser, not the insurance company, selects the number of payments under the multiple payment option. Some annuity contracts are structured as immediate annuities, which provide protection against market downturn, and, which, upon purchase, provide payments that are guaranteed for life. In this form, there is no accumulation. Since 2001, sales of the immediate annuities have experienced substantial growth, while variable annuities in general were on the decline. Several financial service providers have entered the immediate annuity market. Finally, the payout phase may be structured as a deferred annuity, where payments are delayed into the future.

Cost and Fee Structure

The cost and fee structure of variable annuities can be high. First, a surrender charge is assessed when funds are withdrawn (surrendered) prior to the end of a set period of time. This period may be as long as ten years. The sales charge is used to pay a commission to the representative who sold the product. Each year the surrender charge percent decreases. In addition, a mortality and expense risk charge is assessed annually. This charge covers the guaranteed death benefit, payout options that are guaranteed for life, or administrative charges. Administrative fees are charged to cover recordkeeping and other expenses. Other fees, known as underlying fund expenses, such as an initial sales load, transfer fees, and fees for stepped-up death benefits, may also be charged. Fees should be fully disclosed in the prospectus. The annual fees can reach two percent of the annuity's value.

Individuals can exchange their current variable annuity for a different variable annuity without paying tax on the income or gains under Section 1035 of the US Tax Code. While this allows a tax-free exchange, other fees such as surrender charges may still apply .

F.3.c. Insurance Company Ratings

The guarantee provided by the insurance company is only as good as the insurance company that offers the product. Insurance companies are rated by nationally recognized rating services, such as A. M. Best Company, Moody's Investor Service, Fitch Ratings, Standard & Poor's Insurance Rating Services, and Weiss Ratings. Each service provides ratings, but ratings from one rating service to another are not comparable, without knowing the rating agency's definitions. The following are the ratings and definitions from A. M. Best Company.

Definitions of Best's Ratings and Not Rated Categories (NR)

Secure Best's Ratings

A++ and A+ (Superior)
Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders.

A and A- (Excellent)
Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders.

B++ and B+ (Very Good)
Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.

Vulnerable Best's Ratings

B and B- (Fair)
Assigned to companies that have, in our opinion, a fair ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

C++ and C+ (Marginal)
Assigned to companies that have, in our opinion, a marginal ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

C and C- (Weak)
Assigned to companies that have, in our opinion, a weak ability to meet their current obligations to policyholders, but are financially very vulnerable to adverse changes in underwriting and economic conditions.

D (Poor)
Assigned to companies that, in our opinion, may not have an ability to meet their current obligations to policyholders and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.

E (Under Regulatory Supervision)
Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control or restraint, whereby they are no longer allowed to conduct normal ongoing insurance operations. This would include conservatorship or rehabilitation, but does not include liquidation. It may also be assigned to companies issued cease and desist orders by regulators outside their home state or country.

F (In Liquidation)
Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

S (Rating Suspended)
Assigned to rated companies that have experienced sudden and significant events affecting their balance sheet strength or operating performance whose rating implications cannot be evaluated due to a lack of timely or adequate information.

Not Rated Categories (NR)

NR-1 (Insufficient Data)
Assigned predominately to small companies for which A.M. Best does not have sufficient financial information required to assign rating opinions. The

information contained in these limited reports is obtained from the several sources, which include the individual companies, the National Association of Insurance Commissioners (NAIC) and other data providers. Data received from the NAIC, in some cases, is prior to the completion of the cross-checking and validation process.

NR-2 (Insufficient Size and/or Operating Experience)
Assigned to companies that do not meet A.M. Best's minimum size and/or operating experience requirements. To be eligible for a letter rating, a company must generally have a minimum of $2 million in policyholder's surplus to assure reasonable financial stability and have sufficient operating experience to adequately evaluate its financial performance, usually two to five years. General exceptions to these requirements include: companies that have financial or strategic affiliations with Best's rated companies; companies that have demonstrated long histories of financial performance; companies that have achieved significant market positions; and newly formed companies with experienced management that have acquired seasoned books of business and/or developed credible business plans.

NR-3 (Rating Procedure Inapplicable)
Assigned to companies that are not rated by A.M. Best, because our normal rating procedures do not apply due to a company's unique or unusual business features. This category includes companies that are in run-off with no active business writings, are effectively dormant, underwrite financial or mortgage guaranty insurance, or retain only a small portion of their gross premiums written. Exceptions to the assignment of the NR-3 category to run-off companies relate to those that commenced runoff plans in the current year or are inactive companies that have been structurally separated from active affiliates within group structures that pose potential credit, legal or market risks to the group's active companies.

NR-4 (Company Request)
Assigned to companies that were assigned a Best's Rating but request that their ratings not be published because the companies disagree with Best's rating conclusion. The NR-4 will be assigned at the request of the company following the dissemination by A.M. Best of the latest letter rating assignment.

NR-5 (Not Formally Followed)
Assigned to insurers that request not to be formally evaluated for the purposes of assigning a rating opinion. It is also assigned retroactively to the rating history of traditional U.S. insurers when they provide prior year(s) financial information to A.M. Best and receive a Best's Rating or another NR designation in more recent years. Finally, it is assigned currently to those companies that historically had been rated, but no longer provide financial information to A.M. Best because they have been liquidated, dissolved, or merged out of existence.

Rating Modifiers and Affiliation Codes
Under Review (u) Rating Modifiers are assigned to Best's Ratings to identify companies whose rating opinions are Under Review and may be subject to near-term change. Best's Public Data (pd) Rating Modifiers may be assigned to Health Maintenance Organizations (HMOs), Canadian, UK and other European insurers that do not subscribe to our interactive rating process. Best's Public Data Ratings reflect both qualitative and quantitative analysis using publicly available data and other public information. Syndicate (s) Rating Modifiers are assigned to syndicates operating at Lloyd's. Affiliation Codes are based on a Group (g), Pooling (p) or Reinsurance (r) affiliation with other insurers.

Rating Modifiers   Affiliation Codes

u - Under Review	g - Group
s - Syndicate	p - Pooled
pd - Public Data	r - Reinsured

For a complete definition of Best's Ratings, please refer to the Preface of Best's Insurance Reports or Best's Key Rating Guide. Best's Ratings reflect our independent opinion, but are not a warranty of a company's financial strength and ability to meet obligations to policyholders.

For the latest Best's Ratings, visit http://www.ambest.com

Financial Size Categories (FSC)

Assigned to all companies and reflects their size based on their capital, surplus and conditional reserve funds in millions of U.S. dollars, using the scale below.

To enhance the usefulness of our ratings, A.M. Best assigns each company a Financial Size Category (FSC). The FSC is designed to provide the subscriber with a convenient indicator of the size of a company in terms of its statutory surplus and related accounts. Many insurance buyers only want to consider buying insurance coverage from companies that they believe have sufficient financial capacity to provide the necessary policy limits to insure their risks. Although companies utilize reinsurance to reduce their net retention on the policy limits they underwrite, many buyers still feel more comfortable buying from companies perceived to have greater financial capacity.

FSC I	less	than	1
FSC II	1	to	2
FSC III	2	to	5
FSC IV	5	to	10
FSC V	10	to	25
FSC VI	25	to	50
FSC VII	50	to	100
FSC VIII	100	to	250
FSC IX	250	to	500
FSC X	500	to	750

FSC XI	750	to	1,000
FSC XII	1,000	to	1,250
FSC XIII	1,250	to	1,500
FSC XIV	1,500	to	2,000
FSC XV	greater	than	2,000

F.3.d. Exchange Traded Funds

An Exchange Traded Fund (ETF) is an index-linked portfolio of securities. ETF portfolios are purposely structured to replicate as nearly as possible the performance of a specific index. Precise replication is not possible due to expense factors in operating the trusts which hold the securities and other factors. This form of investing is sometimes referred to as "passive," since the portfolio of an EFT is not actively managed by any investment manager. Their composition is dictated by securities comprising the index itself, and they typically do not change unless the composition of the index changes. As with all investments, the inclusion of ETFs in any portfolio should conform with the requirements of local law, the governing instruments, the needs and requirements of both current beneficiaries and remainder interests, and the overall investment strategy and investment objectives of the particular accounts. Individual account records and trust management's investment records should document the basis for investing in an ETF, both initially, and on a continuing basis.

Most ETFs are structured as unit investment trusts and listed on the American Stock Exchange. ETFs can be purchased and sold like stocks. They are similar to mutual funds in that they consist of a diversified portfolio of stocks, but are dissimilar in that they are typically concentrated in a single industry, market, or based on some economic benchmark. Consequently, the performance of some ETFs may be more volatile than those which are based on broader indices. They are also dissimilar to mutual fund operated index funds in that they can be traded throughout the day. ETFs are traded on an exchange, and prices are available continuously throughout the trading day. Investors must also pay broker commissions on ETF purchases and sales. Most mutual funds can only be purchased and sold at the end of a trading day at the fund's Net Asset Value.

The more common of the Exchange Traded Funds are:

The NASDAQ-100 Index Tracking Stock (ticker symbol QQQ) is designed to track the performance of the 100 largest non-financial U.S. and non-U.S. companies listed on the National Market tier of NASDAQ. It was created March 10, 1999. NASDAQ-100 Index Tracking Stock Options are standardized put and call options on the underlying index. These options are also available for covered call writing.

The NASDAQ-100 Index Tracking Stock is structured as a regulated investment company trust. It is an index based unit investment trust and is sponsored by NASDAQ Investment Product Services, Inc., a wholly owned subsidiary of The NASDAQ Stock Market, Inc. ALPS Mutual Funds Services, Inc. is the Distributor of the trust. The Bank of New York is its Trustee.

The Standard & Poors Depositary Receipts (referred to as SPDRs, with a ticker symbol of SPY) is designed to track the performance of the Standard & Poors 500 Index. SPDRs are listed and traded on the American Stock Exchange. Trading began on January 29, 1993.

The Standard & Poors MidCap 400 Depositary Receipts (referred to as MidCap SPDRs, with a ticker symbol of MDY) is designed to track the performance of the Standard & Poors MidCap 400 Index. MidCap SPDRs are listed and traded on the American Stock Exchange. Trading began on May 4, 1995.

SPDRs and MidCap SPDRs are structured as regulated investment company trusts. They are index based unit investment trusts. PDR Services Corporation, a wholly owned subsidiary of the American Stock Exchange, sponsors these trusts. ALPS Mutual Funds Services, Inc. is the Distributor of the trusts. State Street Bank and Trust Company is Trustee of the SPDR trust, and The Bank of New York is Trustee of the MidCap SPDR trust.

Select Sector SPDRs are nine individual sector SPDR funds which comprise all of the companies in the Standard & Poors 500 Index. They are listed on the American Stock Exchange and began trading on December 22, 1998. Their trading symbols are:

XLB Basic Industries Sector XLF Financial Sector XLV Consumer Services Sector

XLI Industrial Sector XLP Consumer Staples Sector XLK Technology Sector

XLY Cyclicals/Transportation Sector XLU Utilities Sector XLE Energy Sector

Select SPDR Funds are structured as a regulated investment company trust. The funds are index based unit investment trusts. State Street Bank and Trust Company is Adviser, Administrator, and Custodian of the Select SPDR Trust. ALPS Mutual Funds Services, Inc. is its Distributor.

DIAMONDS (ticker symbol DIA) tracks the performance of the 30 stocks comprising the Dow Jones Industrial Average. The DIAMONDS trust is listed on the American Stock Exchange and began trading on January 20, 1998.

DIAMONDS is structured as a regulated investment company trust. It is an index based unit investment trust. Its Sponsor is PDR Services LLC, a Delaware limited liability company whose sole member is the American Stock Exchange, LLC. ALPS Mutual Funds Services, Inc. is the Distributor of the trust.

Most investors who purchase and sell ETFs do so in the secondary market. Purchasers of ETFs acquire an investment in a unit investment trust holding shares of the companies comprising a specific index. Initial units in the investment trust are generated by large or institutional investors through "creation units." These "creation units" consist of large blocks (generally 50,000 shares) of securities of the companies comprising the index. Each "creation unit" can only be created and redeemed in aggregates of these blocks of securities. Only investors who have executed a participating agreement with the trust's distributor and trustee, and who deposit the requisite number of shares of the securities making up the index, plus cash for accumulated dividends and transaction costs, are eligible to create "creation units." These investors act as arbitrageurs who trade "creation units," keep the trust's net asset value close to index target levels, and attempt to profit from differences between "creation unit" prices and index levels.

WEBS Index Fund, Inc . consists of funds trading on the American Stock Exchange. WEBS index funds consist of 17 country-specific stock portfolios structured to replicate as closely as possible the performance a specific

Morgan Stanley Capital International index. Trading began in March, 1996. The trading symbols are:

EWA Australia EWQ France EWJ Japan EWS Singapore EWO Austria EWG Germany

EWM Malaysia EWP Spain EWK Belgium EWH Hong Kong EWW Mexico EWD Sweden

EWC Canada EWI Italy EWN Netherlands EWL Switzerland EWU United Kingdom

WEBS Index Fund, Inc. is an investment company registered under the Investment Company Act of 1940 and is organized as a series fund. Barclays Global Fund Advisors is the investment manager of each WEBS Index series. Morgan Stanley Trust Company is the fund's global custodian. Portfolio securities are held by various sub-custodians throughout the world.

Most investors who purchase and sell WEBS do so in the secondary market. These index based funds hold shares of the companies comprising one of the 17 foreign equity securities sectors tracked by the Morgan Stanley Capital International indices. Initial units in the funds are generated by certain investors through "creation units." These "creation units" consist of a large number of shares of the companies comprising each WEBS sector. Only investors who deposit the requisite number of shares of the securities of the companies that make up a sector, plus cash for accumulated dividends and transaction costs, are eligible to create "creation units."

F.3.e. Economically Targeted Investments (referred to as ETIs or Social/Ethical Investing)

Social investing is an investment approach whereby the investor considers non-investment criteria in the investment decision making process. Normally, the investment manager desires to either promote or endorse a non-investment criterion, or attempts to avoid investing in companies with certain negative criteria. The screening process may deal with individual companies or entire countries or industries. A potential investment may be reviewed through multiple criteria to determine whether the non-investment goals can be achieved.

Social investing is known by any number of other terms. Sometimes it is referred to as ethical investing. The Labor Department's term is "Economically Targeted Investments", or ETIs.

Examples of such criteria are:

Positive Criteria	Negative Criteria
Energy producers	Oil companies or large users of energy
Environmentally friendly	Polluters
Food production	Tobacco firms
Unionized companies or industries	Non-unionized companies

Companies providing employees with certain types of desirable benefits (company-paid health benefits, non-contributing pension plans, day care facilities, etc.)	Companies with records of repeated labor strife, those with large amounts of unfunded pension liabilities, etc.
Health/pharmaceutical firms	Nuclear energy
Companies with high quality products	Companies whose products are shoddy, subject to forced recalls, lawsuits
US-owned companies, those which manufacture and/or sell products made locally or in certain countries	Companies which do business in countries engaging in human-rights abuses, or sell products made by forced-labor or prison inmates
Multiple-Family (or Low Cost) Housing	Luxury Hotels or Resorts

The concept behind ETI investing is that the investment manager can identify investments that meet the desirable attributes (or screen out the undesirable investments) without sacrificing investment quality or returns. This is often difficult. Companies that meet one or more desirable criteria may also contain negative criteria.

The social investing approach became fairly well-known in the early 1980's. There are now several mutual funds which have as their basic premise social investing. Results of social investing portfolios have been mixed to date. Refer to Section 5.H.5.c.(3) I for additional information on this form of investment philosophy with respect to ERISA accounts.

F.4. Mutual Funds

Mutual funds are open-end funds registered under the Investment Company Act of 1940 and regulated by the Securities and Exchange Commission. (A closed-end fund is often referred to as a mutual fund, but is an investment trust.) The mutual fund raises money from investors, and, in return, investors receive an equity position in the fund. The proceeds from the shareholders are invested in a group of assets. The primary benefit of investing in mutual funds is diversification. Funds offer choice, liquidity, and convenience, but for a fee and for a minimum investment. The price of a share of an open-end fund is determined by the net asset value (NAV), which is the total value of the securities owned divided by the number of shares outstanding. The NAV is the price at which you buy or sell shares when commissions and loads are not involved.

There are many types of mutual funds, but most are a variation on the following general types:

Bond Funds

U. S. Government and Agency issued bonds - These funds primarily invest in notes and bonds issued by the U. S. Treasury or Federal Government or Government Sponsored Agencies. Credit risk is not an issue, although returns are usually below those of other bond funds. These funds do have interest rate risk, especially those investing in long-term bonds.

Corporate bonds - Most corporate bond funds invest in highly rated bonds issued by corporations.

High-yield or junk bonds - These funds invest in the debt of corporations which are in weakened financial condition or in unproven small firms. The potential that any individual corporation will default is much higher compared to corporate bond funds, but due to a large number of bonds held, the fund does not have a concentration that would impact the overall fund.

Municipal bonds - These funds invest in tax-exempt bond issued by state, county, or municipal governments. The advantage of these funds is the income earned is exempt from Federal taxation and, in some instances, state and local taxation.

Trust management should consider the expense ratios based on the type of fund, the length of maturities, and yields. However, management should not be solely focused on the yield, but the composition of the fund. To boost yields, many funds invest in bonds other than those expected in the fund.

Stock funds

Value funds - These funds invest in stock, that the fund manager believes are undervalued based on their low price/earnings ratios or the value of the underlying assets. The large-cap versions look toward corporations whose stocks are selling at discounted prices, while small-cap fund managers look for stocks which have the potential to increase in value.

Growth Funds - The managers of these funds may have vastly different approaches to managing the funds. Some are rather conservative, while others are aggressive. In general, growth funds do not generate the highest returns in bull markets, but maintain their position better in a downturn. This type of fund generally focuses on appreciation rather than income.

Growth and income, Equity-Income, and Balanced Funds - These funds provide steady long-term growth while generating an income stream. All invest in dividend or income-producing securities, such as bonds or convertible securities. Growth and income funds normally have lower yields, as the funds are more focused on growth. Each fund maintains its NAV better during a downturn, but lag the market in a bull market. These funds are suitable for investors who are risk-averse or need a constant level of income.

Specialty or Sector Funds - These funds invest in particular market segments. By diversifying with the numerous stocks held in the funds, the investor reduces the risk of holding an individual stock, but still subject to the sector risk.

Before investing in any mutual fund, trust management should consider the expense ratios for the type of fund, the investment style and consistency therewith, risk profile, past performance, and, tax consequences for the account. To generate higher returns, some fund managers will make trades in fund assets, especially at year-end. If the asset is sold at a sizeable gain, that may affect the trust account's tax position.

F.4.a. Investing in Proprietary Mutual Funds

Banks and their holding companies have increasingly become more involved in sponsoring their own mutual funds, known as p roprietary mutual funds. Characteristically, the funds' names include the name of the institution. In general, trust department investment in proprietary mutual funds is permitted only when certain requirements are met. The applicable requirements depend on the type of trust account and whether the trust department holds investment discretion. As with all trust investing, the use of a proprietary mutual fund must be: (1) authorized by the governing instrument, (2) suitable for an account's investment objectives, and (3) authorized under state law.

Banks engage in a prohibited transaction in violation of ERISA Section 406 if they invest employee benefit accounts in proprietary mutual funds at their discretion. The prohibited transaction may be avoided, however, if the conditions of the Labor Department's ERISA Prohibited Transaction Class Exemption (PTE) 77-4 are followed. Refer to Section 5, H.7.f(11) Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised, for additional guidance for ERISA accounts.

Although investments in proprietary mutual funds are permissible, such investments pose conflict of interest and self-dealing issues. Therefore, these investments should also be reviewed with these concerns in mind. Refer to Section 8, Investment in Proprietary Mutual Funds for additional discussion of this topic.

Investments in proprietary mutual funds by nondiscretionary accounts are not restricted by the above requirements.

F.4.b. Due Diligence Standards

Prior to investing trust account assets in proprietary or affiliated mutual funds, or mutual funds which are advised by the bank or its affiliates, trust management should:

- Conduct and document a due diligence review of the legality of investing fiduciary accounts under Federal and state law.
- Establish written investment policies outlining acceptable standards for investments in such funds. These standards should be consistent with the minimum acceptable standards adopted by management for the investment of trust account assets in non-proprietary funds.
- Establish procedures for the periodic review, including the documentation thereof, of the fund's performance in comparison to indexes or other available funds. The analysis should employ performance criteria published by independent companies and include a comparison of mutual fund expense ratios.
- Establish an arms-length process for evaluating the prudence of investing trust accounts in proprietary or bank advised mutual funds rather than in non-proprietary alternative investments.

Minimum acceptable criteria for investment in mutual funds (whether proprietary, affiliated, advised, or non-proprietary) should be adopted by the Board of Directors. Acceptable performance criteria may include provisions addressing the following:

- An investment record with well-defined and discipline investment styles
- A comparison of the fund to peer group performance and peer group fees
- An investment performance which tracks the peer group; the peer group used should be adequately defined, since there are different performance measurements for the same class of funds. For example, the performance of a small-cap fund may be compared to the Russell 2000, the S & P Small Cap 600 index, or to the Morgan Stanley U. S. Small Cap 1750. Depending on which benchmark is used, the small cap fund performance may be above one benchmark and below another, since each were designed differently.
- An expense ratio which is consistent with the peer group

All funds appearing on the approved list should also be periodically reviewed for the following criteria:

- Investment performance
- Investment objective changes
- Investment drift
- Fund management
- Fund structure

The inclusion of any mutual fund in the trust department's investment mix should be documented by the trust investment, or similar, committee. The performance of proprietary, affiliated, or bank advised mutual funds should be reasonable in comparison to other available funds. If the proprietary funds' performance is significantly below benchmark indicators (poorly performing funds), management's decision to retain the investments should be reviewed regularly and supported by appropriate documentation. The Board of

Directors or a committee thereof, which reports to the Board of Directors, should review and approve the decision to retain poorly performing proprietary funds.

F.4.c. Other Mutual Fund Considerations

In addition to typical investment considerations, including the needs of beneficiaries, the account's investment objectives, and the potential for capital appreciation, etc., trust management should consider other investment criteria that are unique to mutual fund investing.

- Mutual Fund Fees

The fees associated with all mutual fund operations pose fiduciary concerns for both overall investment performance and potential conflict of interest, with respect to proprietary funds. Investment in proprietary mutual funds poses a conflict of interest, since investment in these funds is linked to increased bank fees and profitability through fund fees. Nevertheless, investment in any mutual fund imposes additional fees on trust accounts, unless trust management reduces trust fees for assets invested in mutual funds on a dollar for dollar basis. The resolution of these issues, and justification for passive investment management (mutual fund investing) vs. active investment management, should be articulated in trust policies and at the account level itself.

All mutual funds charge fees in one form or another. Mutual fund fees affect a shareholder's overall investment performance, because they are deducted from the investor's return. Some of the fees represent investment management fees, while others represent marketing expenses. Mutual funds are required to disclose fees in a standardized fee table, which is divided into two sections: (1) shareholder fees and (2) annual operating expenses. The table is required to be placed in the front of the fund prospectus. Transaction commissions are not included in the disclosed expense ratio, but can materially impact the investor.

According to http://www.fundexpenses.com for the year 2002, investors paid $35.2 billion in mutual fund fees. Of that amount, $9.2 billion or 26.1 percent represents 12b-1 fees; $6.1 billion or 17.3 percent represents administrative fees; and, $19.9 billion or 56.5 percent represents advisory/management fees.

- Shareholder Fees

Approximately 38 percent of all funds, excluding money market funds, are "no load" funds sold directly to the investor. The remaining 62 percent are sold through financial advisors, brokers, or insurance agents, who may have a vested interest in generating fee income for themselves. Shareholder fees may consist of purchase charges (front-end load fees), sales charges (back-end load fees), redemption fees, exchange fees, etc. Shareholder fees may also include "class" fees, depending on which "class" of shares the investor buys. For example, Class A shares may include front-end sales or "load" charges and may include 12b-1 fees, but at a lower rate than those of Class B and C shares. The front-end load potentially can be reduced or eliminated by breakpoint discounts, which are based on the size of the investment. The larger the investment, the lower the sale load. Class B shares may include an annual 12b-1 fee and/or deferred "back-end load" sales charges. Usually, contingent deferred sales charges decline each year the investor remains in the fund. Furthermore, most Class B shares convert into Class A shares after a certain number of years. At that point, the fund begins charging the same annual fund operating expenses as Class A shares. Class C shares may charge higher 12b-1 fees, but no front-end or back-end sales charges. Class C shares may be less expensive than either Class A or Class B shares, if the investment time horizon is short-term. However, if the investment is long-term, Class C shares can be more expensive. Purchasing different classes of

a mutual fund may be optional for the buyer, or dependent on the "class" the buyer falls into as defined by the mutual fund's plan of operation (such as institutional, individual, etc.).

In June 2003, the NASD censured a brokerage firm, suspended its chairman, and directed restitution be paid to customers for recommending the purchase of large positions in Class B shares, when the customers would have qualified for lower sales charges through the Class A shares.

Short-term redemption fees are assessed against those who move in and out of funds in under 90 days. These fees are intended to hinder those who attempt to time the market, resulting in increasing investor costs and decreasing returns. Short-term redemption fees can represent up to 2 percent of assets.

- Annual Operating Expenses

Annual operating expenses include all on-going fees paid by shareholders as long as they hold shares in the fund, including: investment management fees, 12b-1 fees, oversight fees paid to a fund's board of directors, custodial fees, transfer agent fees, and other administrative expenses. "Distribution expenses" up to 0.75 percent of a fund's net average assets per year may be paid in the form of 12b-1 fees. Even "no-load" mutual funds may pay up to (but no more than) 0.25 percent of average net assets each year in 12b-1 fees.

In general, the annual operating expenses increase with the funds risk profile. For example, funds consisting of investment-grade bonds or large or mid-size U. S. stocks will have lower expense than funds invested in small-cap stocks or foreign stocks. Index funds will have lower annual operating expense than managed funds. However, some managed funds fairly closely tract index funds, yet assess much higher fees. [The degree of mirroring the index funds is called "R-squared". Funds with an R-squared over 90 fairly closely track an index fund.]

- Other Considerations

During 2003 and 2004, mutual funds came under scrutiny for a variety of potential abuses, including hidden fees. The following are three major types of hidden fees that may be used by a mutual fund:

Directed Brokerage - Fund advisers direct brokerage commissions from fund portfolio securities transactions to selling brokers. A mutual fund company agrees to do a certain volume of trades with a brokerage firm, if that firm agrees to distribute the funds. In essence, the mutual fund company pays commissions to brokers to distribute the funds. This should have been accounted for in the 12b-1 fee, but may not be included. At the August 18, 2004, Commission meeting, the SEC unanimously agreed to end the practice of directed brokerage, as the arrangements create conflicts of interest, and potentially increase fees mutual fund investors pay.

Revenue Sharing - A mutual fund company pays brokers part of its own profits to push the funds, usually to smaller, non-institutional investors. Currently, this is not disclosed in the prospectus or by the broker.

Soft-Dollars Embedded in Commissions - A mutual fund company pays a brokerage firm, reportedly for research, but may also cover costs such as subscriptions to magazines, compute software and hardware, and attorney fees. The commissions are not included in the disclosed expense ratio (discussed below), but are deducted from the fund's assets. Commissions are higher, as significantly lower cost trades may be done on electronic trading exchanges. The research provided may be very little or useless, but can be maintained to justify their usage. As long as the mutual fund achieves "best execution," the practice is allowable.

- Mutual Fund Expense Ratio

A mutual fund's "expense ratio" is its total annual operating expenses as a percentage of the fund's assets. The expense ratio must be disclosed in the mutual fund prospectus. Although it is a good gauge of a mutual fund's ongoing fees, there is no link between high or low expense ratios and a mutual fund's performance. Consequently, neither trust management nor examiners should evaluate the "prudence" of investing in one mutual fund versus another upon a fund's expense ratio alone.

- Mutual Fund Tax Considerations

Mutual funds generally make both ordinary dividends and capital gains distributions each year. Ordinary dividends are reported as dividend income. Capital gains distributions are reported as capital gains, regardless of how long the investor owns shares in a mutual fund. Both dividend and capital gains distributions affect a fund's net asset value (NAV), which declines by the amount distributed. Despite any lower post-distribution NAV to the investor, the investor's investment basis remains unchanged. (NAV is the per share value of a mutual fund. It is equal to fund assets less liabilities, divided by the number of shares outstanding. The NAV calculation is a daily regulatory requirement.) Investors are also liable for any taxable capital gains on the sale of mutual fund shares. An investor's gain or loss on the sale of mutual fund shares is computed as the difference between a share's "cost basis" and its sales price.

Although mutual funds generally make capital gains distributions during the last calendar quarter, attempting to "time" purchases to avoid capital gains treatment, or capture a lower NAV after capital gains distributions, also subjects the investor to the uncertainties of market. Increases in a fund's NAV may be greater than the potential tax liability incurred by purchasing a fund before its capital gains distribution.

While the tax-efficiency of a mutual fund is not relevant to investors in tax-deferred accounts, the tax consequences may be significant to the investor in a taxable account. Effective April 16, 2001, the SEC adopted rules and amendments under the Securities Act of 1933 and the Investment Company Act of 1940 requiring the disclosure to investors of the effect of taxes on the performance of mutual funds. The rules and amendments require mutual funds to disclose in the prospectus after-tax returns based on standardized formulas comparable to the formula used to calculate before-tax average annual total returns. The standardized presentation requires after-tax returns for the 1-, 5-, and 10-year periods, and will accompany before-tax returns in fund prospectuses. The disclosure must be presented in two formats: (1) after taxes on fund distributions only and (2) after taxes on fund distributions and a redemption of fund shares. While the after-tax returns generally will not be required in fund advertisements and sales literature, any fund that either includes after-tax returns in these materials or include other performance information or that represents that the fund is managed to limit taxes, is required to include after-tax returns in the literature. Money market funds are exempt from this disclosure, as are fund shares used exclusively by defined contribution plans (i.e., qualified under Section 401(k), 403(b), 457 of the IRC) or similar arrangements (i.e., Section 817(d) of the IRC concerning variable contracts; entities that are not subject to the individual federal income tax , such as tax-exempt foundations, colleges, and corporations; or, a similar plan or arrangement for which an investor does not pay tax on the investment until sold.)

F.4.d. Mutual Funds: Receipt of 12b-1 Fees

SEC Rule 12b-1, promulgated under the Investment Company Act of 1940, permits mutual funds to adopt a plan which uses fund assets to finance, or promote, a fund's sales. The expenses associated with this plan are referred

to as "distribution costs." These costs may take the form of commission-like payments (termed "12b-1 fees") to organizations which generate a high volume of transactions in the mutual fund. Distribution activities include: advertising; the compensation of underwriters, dealers, and sales personnel; the printing and mailing of prospectuses to other than current shareholders; and the printing and mailing of sales literature. The rule is contained in 17 C.F.R. Section 270.12b-1(a)(2).

Approximately ⅔ of all funds assess 12b-1 fees, including some funds that are closed to new customers. According to an industry survey, approximately 63 percent of the fees go to brokers, while 32 percent covers administrative costs, and 5 percent is used for advertising. Another recent survey found that 19 percent of no-load funds charge 12b-1 fees, compared with 92 percent of load funds.

Whether a fiduciary may accept and retain 12b-1 fees for its own benefit depends upon the type of account, together with certain characteristics of the account, such as the fiduciary's investment authority, and the nature of customer disclosures. The following provides general guidance regarding the retention of 12b-1 fees for ERISA covered employee benefit accounts, non-ERISA employee benefit accounts, and personal accounts .

F.4.d.1. ERISA Accounts

Retention by an ERISA fiduciary of 12b-1 fees paid by mutual funds may be a form of a prohibited transaction, in violation of ERISA Section 406(b). Different treatment is appropriate for discretionary accounts, as opposed to nondiscretionary or custodial accounts. Refer to Section 5.H.7.f.13 Mutual Funds, Receipt of 12b-1 Fees for further guidance.

F.4.d.2. Personal and non-ERISA Employee Benefit Accounts (EBs)

Guidelines governing the receipt and retention of 12b-1 fees associated with the administration of personal and employee benefit accounts depend on the level of discretionary investment authority exercised by the fiduciary, together with the nature of the disclosures provided to the customer.

Discretionary Accounts

A standard fiduciary principle under state law and ERISA is that all decisions to place fiduciary assets in particular investments must be in the best interest of the trust beneficiaries. This fiduciary principle reflects the trustee's duty of loyalty under state law. All such investments must also be consistent with the provisions of an account's governing documents. An institution may fail to act in the best interests of its beneficiaries in certain situations in which it receives duplicate fees for identical investment management services from a trust account and from the mutual fund provider in which it invests on behalf of the trust account. As a result, an institution may face increased legal risk due to potential litigation on behalf of account beneficiaries claiming that the institution placed its interest ahead of the interest of beneficiaries.

In certain situations, the receipt by a fiduciary of 12b-1 fees from a mutual fund provider for distribution services regarding trust accounts may be a potential violation of state law or regulation. However, nearly every state legislature has now modified its laws to explicitly permit fiduciaries, under certain conditions, to accept such fees. The conditions imposed typically require investments to be prudent and permitted by the governing documents. The fees that the institution receives must also be

"reasonable".

Even when permitted by state law and the governing trust documents, institutions are still expected to identify measure and control the additional legal and compliance risk that such conflicts of interest present. In particular, institutions must continue to adhere to proper fiduciary standards when exercising investment discretion, including adequate documentation supporting the institution's decisions. Therefore, prior to entering into fee arrangements, senior management and the board, or a duly appointed committee thereof, should conduct and document an appropriate due diligence process. The due diligence process should include the following procedures (These procedures also are contained in Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation SR99-7, "Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest" , March 26, 1999.)

- Reasoned Legal Opinion - The institution should obtain a reasoned legal opinion of counsel that addresses the conflict of interest in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.
- Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
- Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as

appropriate.

Agency and Non-discretionary Accounts

Even in the case where the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, the institution should implement due diligence processes appropriate for the duties and responsibilities performed. Due diligence procedures should include a reasoned legal opinion in order to ensure compliance with applicable state and federal laws and regulations, as well as sound fiduciary principles. As part of the due diligence process, management and the board should establish adequate policies and procedures governing such fee arrangements for non-discretionary accounts. The institution, in addition, should document the "reasonableness" of the fees collected.

Except as noted in the following paragraph, a violation of general fiduciary duties resulting from the receipt of 12b-1 fees by a fiduciary from a mutual fund can be cured if the fiduciary rebates the 12b-1 fees back to the trust accounts that generated the transactions. Where the bank has retained 12b-1 fees without the authorizations or directions noted above, examiners should recommend that the fees be returned to the accounts that generated them. If there is a difference over the interpretation of state law, a general criticism of the matter should be presented together with a request for a legal opinion.

Financial institutions that operate proprietary mutual funds may attempt to resolve the conflict of interest and self-dealing concerns that result when a proprietary mutual fund collects 12b-1 fees from trust accounts that the institution administers in a discretionary capacity by rebating or waiving such fees for trust account shareholders. The proprietary fund, however, collects 12b-1 fees from non-trust account shareholders. The SEC has indicated that the waiving or rebating of 12b-1 fees for some shareholders, but not others, may violate the proprietary mutual fund's obligation to treat all shareholders impartially. See Southeastern Growth Fund, Inc.'s 1986 request for a No-action letter .

F.5. Hedge Funds

Product Overview

Although the term has not been formally defined, hedge funds refer to an entity that holds pools of securities or that does not register those securities under either the Securities Act of 1933 or the Investment Company Act of 1940.

The funds are exempt from the Investment Company Act due to the sales of the funds being limited to 100 or fewer investors. Also, the funds are only sold to highly sophisticated investors. To qualify for either exclusion, the funds must restrict the offerings, and by not selling to the general public. As a result, solicitation and advertising of hedge funds is prohibited. This includes advertising in written or verbal form, articles or other notices published in a newspaper or magazine, information on the Internet or via email, or at any meeting or seminar where the participants were invited by general solicitation or advertising.

Hedge funds may be sold to an unlimited number of "accredited investors." (In determining compliance with Rule 501(a) of Regulation D under the Securities Act of 1933, accredited investors are not included in the 35 limit.) To qualify as an accredited investor, the individual must have a minimum annual income of $200,000 ($300,000 when combined with spouse), or $1,000,000 in net worth. Most hedge funds require $5,000,000 in assets as a minimum. In order to avoid Investment Company Act registration, the fund may only be

sold to "qualified purchasers," which is a standard with significantly higher financial requirements than "accredited investors." Hedge fund investment advisors avoid registering under the Investment Advisors Act by relying on the de minimis exemption for registration, which is limited to 14 or fewer clients. Under SEC rules, each hedge fund counts as one client.

In recent years, hedge funds have grown significantly both by the number of hedge funds and the dollar amount invested in the funds. Much of the growth is associated with institutional investing by large plans, such as state teacher retirement plans, endowments, foundations, and other charitable organizations. Although the amount of media attention given to the funds gives the impression that hedge funds are a new investment product, the funds have actually been available for quite some time. The first hedge fund was established over 50 years ago.

Until recently, the funds actively avoided registration under the above Acts. Now, some hedge funds have registered under the Investment Company Act as closed-end investment companies, while others registered under the Securities Act of 1933. Registration makes the funds available to a larger number of potential investors, including trust and employee benefit accounts.

Hedge funds, whether registered or unregistered, invest in various financial instruments to achieve a positive return, and may take on speculative trading positions. Ironically, hedge funds may or may not engage in hedging or arbitrage activities. Some hedge funds adopt strategies similar to mutual funds, while others are extremely flexible in their approach. Hedge funds may or may not be as risky as other available investment options. However, hedge funds are constantly changing.

A substantial volume of hedge funds use leverage to increase an investment's value, without increasing the amount of funds invested. In many instances, the leverage factor is greater than 2:1. The ratio equals total absolute dollars invested divided by total dollars of equity. Therefore, leverage magnifies a position, so gains or losses are greater than they would otherwise have been without leverage. In addition, leverage may increase the risk of owning assets that are illiquid or those that are saleable, but at a price less than expected. In the end, leverage is only limited by margin or collateral requirements imposed by lenders and the willingness of lenders to provide credit to the funds.

Common traits of hedge funds

- The fee structure usually pays the adviser based upon a percentage applied to the fund's capital gains and appreciation.
- One or more brokers may be involved in providing trade clearance and settlement, financing, or custody services.
- The funds do not have specific time horizons, although the life may be shorter than other investment products.
- Investors cannot liquidate their assets during lock-up periods; redemption frequently allowed only quarterly.
- Hedge funds repurchase their own interests from investors on a limited, periodic basis.
- Fund managers provide potential investors with a private placement memorandum that discloses information about the investment strategies and operations.
- The funds may have the legal structure of a limited partnership, a limited liability company, or business trust. All three forms limit taxes and liability.
- If the fund is a limited partnership, the investment adviser normally serves as the general partner. If the fund is a limited liability company, the investment adviser normally serves as the managing member.
- Offshore hedge funds are originated outside of the United States, but are affiliated with United States-based funds.
- Hedge funds are not subject to any law or provision requiring financial statement audits.
- Fund advisers often invest heavily in their own fund.

Legal Structures

There are two different legal structures, depending on whether the funds are "Domestic"

or "Offshore." The manager of a domestic fund may also operate an affiliated offshore fund, either as a separate fund, or through a master fund, which is a non-US corporation. Domestic hedge funds typically do not have a board of directors or any comparable corporate body.

Offshore hedge funds are typically organized in countries considered tax havens. These funds attract investment by pension funds, as well as charities and foundations. While the fund may employ the same US entity to serve the offshore as well as domestic fund, most operational activities are performed at the offshore location. These funds generally have a board of directors. Offshore hedge funds may have over 100 investors, although Section 3(c)(1)of the Investment Company Act of 1940 limits investors to 100. The statute was interpreted to exclude non-US investors in determining the number of investors.

Supervision and Regulation
In general, the SEC does not examine or supervise hedge funds, as the funds can be exempt from the three SEC Acts previously described. While hedge fund regulations and supervision are under consideration, there is no definitive action in that direction at this time.

The most significant reason for establishing supervision, is the manner in which hedge funds are valued. There is no independent oversight of the valuation and performance results are not required to follow a standardized format and calculation. This may directly or indirectly affect the investor. First, the manner of presenting performance results may be inconsistent or inaccurate. With registered funds possibly investing in hedge funds, the net asset value of the mutual funds may be inaccurate and may result in violations for the registered mutual fund.

While the funds are not subject to supervision by the SEC, the funds are subject to the antifraud provisions of the federal securities laws. The identified frauds have been similar in nature to those fraudulent acts, such as misappropriation of assets or misrepresentation of performance, committed by other types of investment advisers. However, the frequency of outright theft, or misappropriation of investors' funds is greater.

ERISA Considerations An investment advisor to a hedge fund is a plan fiduciary, if it exercises discretionary authority over the management of plan assets. The hedge fund is considered a plan asset, when the plan's investment in a particular hedge fund is significant. This is defined to be more than 25 percent of the value of any class of equity interests in the hedge fund is held collectively by the employee benefit plan investors. Some hedge funds disclose in the private placement memorandum that a subscription may be denied, or a redemption may be forced, to maintain ownership at less than the 25 percent limitation. Once the ownership by an employee benefit plan exceeds 25 percent, the hedge fund is subject to regulation as an ERISA fiduciary. Conversely, some hedge funds accept regulation under ERISA to make their funds more attractive to investors.

Fund of Hedge Funds (FOHF)
Typically, FOHFs invest in 15 to 25 hedge funds to diversify the risks associated with an individual hedge fund. The minimum investment may be as low as $25,000. In concept, it is similar to a mutual fund investing in numerous stock or bond issues. FOHFs are generally not registered as investment companies under the Investment Company Act and use private placement to sell the funds. Some FOHFs are registered, but are not listed or traded on any exchange or NASDAQ.

On September 29, 2003, the SEC issued a paper entitled "Implications of the Growth of Hedge Funds." The paper provides a detailed explanation of the products, their usage, and the SEC's concerns that the product remains unregulated. To read this paper, go to www.sec.gov/news/studies/hedgefunds0903.pdf .

F.6. Notes and Mortgages

Notes and mortgages can be acquired in many ways, including: received in-kind, from the sale of real estate from a trust account in return for a mortgage, and the outright purchase

of notes and mortgages. There are three basic types of notes and mortgages: unsecured loans, loans secured by real estate, and loans secured by assets other than real estate.

The repayment of an unsecured note depends solely on the willingness and ability of the borrower to repay. Unsecured loans are, therefore, rarely seen in trust departments as they may be considered inappropriate.

Real estate loans are appropriate fiduciary investments for an account when the loans are secured. Prior to investing in loans, trust management should consider the liquidity needs of the account and how illiquid the loan may be. A trust department should not purchase loans or participations from the commercial department of the bank. Nevertheless, the trust department may participate in the origination of a loan, using the expertise of commercial loan officers to finalize the terms of the loan. Under the Prudent Man Rule, it is ordinarily improper to invest in second or junior mortgages unless the same account holds all senior mortgages. Although a sufficient margin of safety exists, a junior lienholder cannot control the foreclosure of collateral in the case of default.

Obtaining an appraisal is a common and prudent real estate lending practice. Examiners should be aware that the Corporation's appraisal regulation, Part 323 of FDIC's Rules and Regulations, does not generally apply to mortgages made by or to fiduciary accounts. Part 323 does apply, however, if an appraisal is required through the action of another law.

All mortgages should be held in some form of trust capacity unless otherwise permitted by the terms of the trust instrument or state statute. In addition, the mortgage should be accompanied by all the documentation necessary to establish the priority of the lien, an appraisal, and evidence of adequate insurance payable to the corporate fiduciary. The ratio of loan to appraised value should provide an adequate margin of collateral protection. Adequate credit information should be obtained to substantiate the borrower's ability to pay. Ticklers or checklists may be used by the bank to monitor payment of taxes, assessments, and insurance.

For notes secured by assets other than real estate, the bank should have a perfected security interest in the collateral. All states and the US Virgin Islands have adopted the requirements for secured transactions under Article 9 of the Uniform Commercial Code. For negotiable property, the key to security is physical possession. For physical property which is titled, such as automobiles and some machinery, filing is the key to perfecting security.

Procedures should be established to determine payment status and collect delinquent loans. Delinquencies should be reported on a regular basis to the board of directors, the trust committee, or another appropriate committee.

Notes and mortgages, like other investments, should be analyzed periodically to determine whether they should be retained. Collateral should be evaluated periodically to ensure it continues to exceed the balance due. Reappraisal reports should be obtained in limited circumstances, when it is in the best interest of the account. Also, if the security is real estate, it should be inspected periodically to ensure that it is being adequately maintained. Inspections should be standardized and documented. .

Privately negotiated loans between the trust department and a potential borrower, sometimes referred to as "private placements" are also potential trust department investments. Since the loan is privately negotiated, the instrument may be highly illiquid. Therefore, the highest degree of confidence should be placed on the financial strength of the borrower. Private placements, like other banking activities, should be subject to adequate safeguards and policy considerations. Special care should be exercised to ensure that self-serving practices or conflicts of interest are avoided. Policy constraints should prohibit placing private issues with funds the bank manages in a fiduciary capacity, especially when the issuer is a bank loan customer. A serious conflict of interest could result if the bank were to use or permit the use of proceeds from a placement to reduce criticized loans, or accommodate borrowers who are not creditworthy.

F.7. Real Estate

Real estate is generally acquired as a trust account asset as a result of the personal activities of the grantor or testator. Real estate holdings may include personal residences, residential income properties, commercial properties, unimproved lots, and acreage. The

real estate may be added to the trust as part of an overall estate plan, or left to a beneficiary under the will. In some instances, real estate may be added to trust accounts as an investment vehicle. However, in the absence of special circumstances or specific authority granted in the trust instrument, management should be cautious when investing trust funds in real estate. Under common law, the purchase of property for resale is not considered prudent unless specific provision has been made in the terms of the trust. The Prudent Investor Rule, however, does not consider such an investment inherently imprudent.

In considering the purchase or retention of real estate, management should first determine whether such investments are authorized in the governing instrument. Other factors to consider include: the types of accounts for which real estate may be appropriate; the current or planned use of the property; the geographic location; the size of the parcel and its future marketability; the risks involved in any planned construction or development of the property; the risks and liabilities from any potential environmental pollution or hazards; price comparisons with similar properties; the net yield from investing in the property; and the potential cash flow from and appreciation in the real estate investment.

Decisions to retain real estate should be governed by the requirements of the trust instrument. Appropriate consideration should be given to the current yield and the ease of marketability, if funds are needed to terminate the account or provide for principal withdrawals. Appropriate guidelines should also be in place for selling real estate, including appraisals by competent and impartial appraisers. It should be remembered that trustees have a duty of impartiality in dealing with beneficiaries and that capital gains generally accrue to remaindermen.

Investments in real property can sometimes be speculative in nature, especially when the assumption of risk and the hope of gain are much greater than the investment returns available from other investment vehicles. Real estate of all kinds is burdened with poor liquidity. Raw land generally bears an even higher degree of risk. Although long-term growth potential and possible tax benefits may be positive factors, the illiquid nature of real estate investments has limited their use to large or special purpose accounts (e.g., pension trusts).

The variety of real property investments requires different degrees of management knowledge and expertise. For example, farms are not managed in the same manner as a commercial income property. Every property held by the trust department should be reviewed at least annually, to determine whether the investment meets the needs and objectives of the account and its beneficiaries. When a property is received in kind, it should be physically inspected as soon as possible to determine its condition, verify leases and renters, and to ensure that adequate insurance is in force. In addition, the bank should have a program for reviewing the condition of the real estate through annual inspections, or through personal knowledge of the property obtained by bank personnel or agents, where inspections are not feasible. Each property should be evaluated periodically to ensure that adequate insurance is maintained, and to enable the department to decide whether the property should be retained or sold. The nature and estimated value of the property should be taken into consideration when deciding between an in-house or outside appraisal. For example, property of nominal value may not require an outside appraisal, whereas, a large shopping center would require an in-depth appraisal by a qualified appraiser. Appraisal review procedures should be established to evaluate the reasonableness of the overall conclusions and the assumptions employed by appraiser. At a minimum, most properties should have a current outside appraisal made prior to sale.

As noted under the previous section related to Notes and Mortgages, Part 323 of the FDIC's Rules and Regulations does not generally apply to real estate investments which are made by or for fiduciary accounts. The regulation would apply if an appraisal is required through the action of another law.

All parcels of real estate should appear on the books at some value, preferably market value, but the institution may, if reasonable, use historical cost or some other value. The bank should maintain appropriate documents for each parcel of real estate. Instruments, or copies of instruments, that should be on file are: deeds; mortgages (deeds of trust); liens and/or releases; owner's title policy or title opinion; leases; contract of sale and closing statements; receipted tax bills; fire and liability insurance policies; contracts for

improvements; and instruments conveying interests to the bank.

Procedures should be established to provide for the maintenance of adequate income and expense records covering the properties held. Ticklers or other methods should be used to monitor timely payment of insurance premiums, mortgages, and real estate taxes. Procedures should also be established to monitor payments and collect delinquent rent.

When property is managed by others, a management agency agreement should establish the agent's duties and responsibilities, the frequency of reporting, and the commission paid. Management contracts or leases of farms should include guidelines governing the authority for the sale of crops or livestock, the payment of operating expenses, basic repairs and maintenance of buildings, the fees charged by the bank, etc. In addition, procedures should be established for verifying the amount of farm commodities stored in elevators or warehouses.

F.7.a. 1031 Exchanges

This product is named for the Internal Revenue Code Section which authorizes the exchange of qualifying property and is commonly referred to as "Starker", "Exchange", or "Like-Kind Exchange." The most common examples of qualifying property are commercial, industrial, or residential investment property or heavy equipment or collectibles. Personal residences, partnership interests, and financial assets held for sale or resale are generally non-qualifying property, although exchanging one variable annuity product for another may qualify. A bank may serve in one of three capacities, but cannot serve in more than one capacity for any one transaction. The three capacities are lender, qualified intermediary (custodian), or property buyer/exchanger. The latter two may be found in trust department activities. When a trust department serves as a qualified intermediary, the trust department is responsible for holding the funds until the transaction is complete or the time limits expire. These accounts should be reflected as a non-managed personal agency account. From an asset viewpoint, these exchanges may be used for personal accounts, where there is a desire to exchange one form of income-producing property for another, without incurring a tax liability. For example, a personal account may hold farmland and exchange it for a strip-shopping center. The shopping center may provide a level of cashflow that the farmland does not provide. However, if the farm was sold outright, there may be a substantial tax liability to the beneficiary. The goal of these transactions is to shield the owner from incurring a large tax liability. Section 4, Personal and Charitable Trust Accounts provides a detailed explanation of the exchange itself.

F.7.b Environmental Liability

General

When a trust department account invests in real estate or operates a business, compliance with Federal and State environmental protection laws must be considered.

Resource Conservation and Recovery Act

Congress passed the Resource Conservation and Recovery Act (RCRA) in 1976 to complement laws governing other forms of pollution and environmental hazards. RCRA addresses solid waste disposal (superseding a 1965 Act which dealt with the issue) and encourages recycling and the use of alternative energy sources. The primary focus, however, is the control of hazardous waste disposal. Amendments added in 1984 regulate underground storage tanks (USTs, or LUSTs, if the tank was leaking).

In September 1995, the Environmental Protection Agency (EPA) issued regulations effective December 6, 1995, clarifying the liability of secured creditors holding as collateral properties with USTs. The EPA considered the question of trustee and fiduciary liability, as requested by commenters on the proposed regulation, but declined to include exemptions similar to those

provided secured creditors. The EPA concluded that the 1959 *Restatement of Trusts 2d* adequately addresses the issue of fiduciary liability and affords the trustee indemnification from the trust estate for the expenses properly incurred during the administration of the trust.

Comprehensive Environmental Response, Compensation and Liability Act of 1980

Congress enacted the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), as amended by the Superfund Amendments and Reauthorization Act of 1986, to govern the financial responsibility for cleaning up toxic waste. CERCLA is generally considered to be the primary environmental cleanup and liability law. The Environmental Protection Agency administers the Act and has issued numerous implementing regulations. Many states have also issued similar toxic waste cleanup regulations. CERCLA does not address liability for petroleum wastes. Petroleum wastes include the wastes generated by oil or gas production, refining, storage and retailing. However, there are other Federal and State laws which may apply to petroleum products.

In 1996, Congress amended CERCLA, under an amendment known as the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act (Asset Conservation Act). In short, under the amendment, a fiduciary's liability is limited to the assets held by that fiduciary in trust. However, this does not apply to the extent that a person is liable under the Act independently of the person's ownership of a facility as a fiduciary or actions taken in a fiduciary capacity. Also, if negligence of a fiduciary causes or contributes to the release or threatened release of hazardous substance, there is no limitation.

The Asset Conservation Act defines fiduciary as trustees; executors; administrators; custodians; guardians of estates or guardians ad litem; receivers, conservators, committee of estates of incapacitated persons, personal representatives, trustee (including successor trustees) under an indenture agreement; trust agreement; lease or similar financing agreement for debt securities or other forms of indebtedness as to which the trustee is not acting in the capacity of trustee, the lender or, representative in any other capacity that the administrator, after providing public notice, determines to be similar to the capacities previously described.

The Asset Conservation Act states that a fiduciary shall not be held liable for the following:

- Undertaking or directing another person to cleanup a site
- Terminating the fiduciary relationship
- Including in the terms of the fiduciary agreement a covenant, warranty, or other term or condition that relates to compliance with an environmental law, or monitoring, modifying or enforcing the terms or condition
- Monitoring or undertaking one or more inspections of the facility
- Providing financial or other advice or counseling to other parties to the fiduciary relationship, including the settler or beneficiary
- Restructuring, renegotiating, or otherwise altering the terms and conditions of the fiduciary relationship
- Administering, as fiduciary, a facility that was contaminated before the fiduciary relationship began; or
- Declining to take any of the above actions

This amendment was tested in the courts by Canadyne-Georgia Corporation. In 1996, the corporation sued a bank for its fiduciary capacity seeking damages for clean-up costs. After a lengthy legal process, in 2001, the district court held for the bank on the final issue.

Protections

Fiduciaries should have adequate written policies and procedures covering environmental risks and such policies should include:

- Pre-acceptance review of potential CERCLA and any state liability by identifying assets which could contain hazardous waste. If possible, the specific asset should not be accepted as part of the account. Potential accounts where the risks are too great or where the risks can not be managed properly should not be accepted;
- For existing accounts, a written evaluation of the potential environmental hazards for land and businesses held in trust accounts;
- Corrective action to clean up any hazardous wastes identified;
- Periodic inspection and appraisal practices should be amended to include coverage for hazardous and toxic wastes; and
- Required reporting to EPA and/or state pollution control agencies.

Trust counsel should review the department's policies to ensure that they provide adequate guidance for and oversight of the management of potential environmental risk.

F.7.c. Land Trusts

A land trust is a grantor-directed type of trust, where the title to real estate is held by the trustee on the customer's behalf, while all rights and benefits of ownership are retained by the grantor/beneficiary. The trustee only holds title to the property and has no responsibility for its care and maintenance. Several states recognize land trusts, including Illinois, Indiana, Florida, Virginia, North Dakota, and Arizona. In some states, the land trust is treated as personal property rather than real estate, during legal judgments. The benefits of a land trust are the following:

Elimination of probate expenses and delays

The ownership of the property is recorded in the trustee's name, and provides privacy to the actual owner.

Elimination of administrative difficulties related to multiple ownership and multiple beneficiaries.

Land trusts can be pledged as collateral.

Land trusts can be terminated at any time by either party.

While the trustees duties are extremely limited, there are several areas of potential exposure, including the following:

Forgeries - Internal policies should require the verification of signatures and identities.

Tax Bills - Internal procedures should include the prompt forwarding of special assessments, reassessments, delinquency and/or redemption notices.

Conflicts of Interest - The bank can be both a lender and a trustee for these transactions. Case law has generally permitted serving in two capacities, as long as the bank acts fairly and reasonably.

Litigation - The bank may become a party to lawsuits involving foreclosure proceedings, building code violations, IRS tax liens, and environmental liability issues. It appears that the more active and discretionary the trustees' powers are, the more likely the trustee is considered an "owner or operator" or "responsible party."

To mitigate these concerns, trust management should review title searches and other public records to determine if the person representing

ownership actually has ownership of the property and the current and prior uses of the property .

F.7.d. Real Estate Investment Trust (REIT)

Overview

The Real Estate Investment Trust Act of 1960 allows companies dedicated to owning and, in most cases, operating income-producing real estate to operate as a real estate investment trust. The REIT structure qualifies as a pass-through entity under IRC and is exempt from corporate taxes, as long as its activities are restricted to certain commercial and real estate activities. Most states also exempt REITs from state income taxes. The underlying real estate may be concentrated in a specific geographic region or in a certain type of property. Some REITs are more diversified and own property nationwide and/or in a wider variety of property types. The majority of the underlying real estate consists of retail, residential, and industrial/office. REITs provide current income, as they are required to pay out 90 percent of their income to investors. There is also the potential for long-term appreciation. The majority of REIT shares can be bought through brokers and can be purchased in small lots; the shares of REITs are traded on stock exchanges. The unsecured debt of a REIT is also rated by nationally recognized rating agencies. Some mutual funds invest entirely in REITs.

The three major types of REITs are described as follows:

Equity REIT - The vast majority of the REITs are Equity REITs, which invest in and owns properties through a corporation or trust that uses the invested funds to purchase and manage the properties. The rent from those properties is the income. Equity REITs are traded on major exchanges, which provide liquidity. The underlying property usually consists of commercial property, such as shopping centers and hotels. There is no minimum investment amount.

Mortgage REIT - These REITs loan funds to the owners of real estate (and obtain a mortgage), or invest in or purchase mortgages or mortgage-backed securities. Interest income on the mortgage loans serves as the source of income .

Hybrid REIT - This form is a combination of the above two forms. Therefore, both properties and mortgages are held.

In general, the evaluation of a REIT should include an assessment of those who manage the real estate held by the REIT; the perceived access to debt or equity financing sources; and the REIT's earnings potential. To determine the latter, the industry adopted the methodology of "Funds from Operations (FFO)" to address valuation problems and performance. FFO excludes the following from the net income figure: depreciation and amortization costs; gains and losses from extraordinary items; gains or losses from debt restructuring; and, gains or losses from sales of real estate. The allocable portions of funds from operations of unconsolidated joint ventures based on ownership interest are added back to net income under FFO. While this should be more accurate, the figure can be somewhat misleading in the analysis of older properties with high required maintenance expenditures .

Terms Associated with REITs

Payout Ratio - The ratio of a REIT's current annual dividend rate per share divided by its annual FFO per share.

REIT Purgatory - This is an unofficial industry term that means the REIT is shut-off from capital sources. This may occur due to reputation or growth. The most common reasons that a REIT is so designated are for providing misleading financial information; increasing leverage for growth, if the acquisitions would otherwise be unjustified under the REIT's strategy or portfolio composition; or taking actions that public companies would not

make. REIT Purgatory is reserved for companies that have long-term structural, systemic, or managerial problems.

Taxable Rent Subsidiary (TRS) - Created by the REIT Modernization Act of 1999, a TRS is a subsidiary of a REIT that provides services to the REIT's tenants and others and is required to pay Federal Income Tax, without disqualifying the tax-exempt status of the REIT. These are similar in concept to the affiliated relationships in mutual fund companies.

Umbrella Partnership REIT (UPREIT) - Generally, the partners of one or more existing partnerships and a newly formed REIT become partners in a new partnership termed the Operating Partnership. For their interest in the Operating Partnership (OP Units), the partners contribute the properties from existing partnerships and the REIT contributes the cash proceeds from its public offerings. The REIT typically is the general partner and majority owner of the Operating Partnership. Partners may sell their OP Units, usually in convertible format, for shares of the common stock of the REIT. When an OP Unit partner dies, the estate tax rules permit the beneficiaries to tender the Units for cash or REIT shares without paying income taxes.

F.7.e. Mineral Interests

Investments in natural resources such as oil, gas, and mineral interests, may be found in some trust departments. Such investments require special expertise. Policies for the management of these assets should be established. The authority for acquiring and/or retaining these assets should be evidenced either by specific language in the governing document, or by the consent of all interested parties. Holdings of this type should be reviewed regularly in terms of performance and appropriateness. Evidence of title, such as copies of deeds and title opinions should be maintained. Usually, title to land is a surface right and does not include mineral rights. Therefore, two or more different parties may have an interest in a parcel of real estate, with one having surface rights and the other mineral or subsurface rights. A review of the title should clearly show which interest is held. The status of the property, whether leased or unleased, and producing or nonproducing, should be determined by the trust management immediately upon accepting an account. When properties are placed in trust, the instrument conveying the property to the trustees should be recorded in the county or parish of the state in which the property is located. Copies of any leases should also be maintained. If working interests are involved, the trust department should have a copy of the operating agreement. If necessary, adequate property and liability insurance should be obtained. Proper bookkeeping and information systems should be established, including: ticklers covering delayed rentals on nonproducing interests, expiration of all leases and royalties, and income and expense records. Appropriate checks should be established to identify omitted or significant changes in regular lease income payments. In order to hold title to mineral interests in another state, the bank may have to qualify to do business as a fiduciary in that state, or arrange for the appointment of an ancillary trustee.

F.8 Limited Partnerships

Limited partnerships usually consist of a general partner, who manages the project, and limited partners, who invest funds in the project. The limited partners are not normally involved in the day-to-day management and usually cannot lose more than their capital contribution. Limited partners normally receive income, capital gains and tax benefits, while the general partner collects fees and a percentage of capital gains and income.

Public limited partnerships are sold through brokerage firms, typically for relatively small investments. Private limited partnerships are generally comprised of fewer than 35 limited partners, and require much more substantial investments than public limited partnerships. Both types of limited partnerships may have limited marketability. Limited partnerships may be difficult to value, which has led to the emergence of companies specializing in valuing limited partnership interests.

Limited partnerships are involved in real estate management and development, oil and gas exploration and recovery, and equipment leasing. They also finance movies and research and development projects. The limited partnership form of ownership is used extensively for venture capital and leveraged buyout funds. All types of investors participate in such investments.

In the early to mid-1980's, when real estate was booming and oil and gas prices were strong, $130 billion in limited partnerships were sold to an estimated 10 million investors. Tax laws initially allowed deductions of limited partnership losses from ordinary income, but this was eliminated by the Tax Reform Act of 1986.

One major advantage of limited partnerships is that they are excluded from corporate taxation by, as its name suggests, qualifying for taxation as a partnership. The principal disadvantages are that partnership tax accounting must be used and that the sponsor must provide a corporate general partner to hold 1 percent of the aggregate assets. General partners must make significant cash investments and they retain unlimited liability for the partnership's obligations.

Many limited partnerships have little or no market value. In 1995, one source estimated that fair market prices were only 20 percent to 60 percent of a partnership's net asset value. The same source concluded that of approximately 2,000 limited partnerships, only an estimated 300 traded with regularity -- and then only by independent dealers using their own clearinghouses for such transactions. These conditions do not contribute to high or competitive selling prices.

The proper valuation of such investments is especially important. Examiners should ascertain that the institution has the ability to obtain reasonably current fair market values for such investments and that customer statements reflect market values. The failure to properly value limited partnerships may lead to overcharging accounts if management or account fees are based on the market value of assets and, as noted in the following paragraphs, can cause difficulties for ERISA plans.

Limited partnership investments of employee benefit plans subject to ERISA must be reported by the plan administrator as a plan asset on the plan's Annual Report IRS Form 5500 found in Section 5. J. Form 5500 requires plan assets to be valued at a reasonable market value. If the bank acts as plan administrator, or is responsible for furnishing market values of plan assets to a plan administrator, it must have appropriate procedures for valuing limited partnerships. Since limited partnerships are not traded on a regular basis, it may be difficult for the plan administrator to arrive at a reasonable market value. Since many limited partnerships reportedly have little value, it is particularly important for plans to obtain accurate market values for these assets.

Formal annual appraisals are not required, but the plan administrator must be able to demonstrate that a reasonable approach was taken in valuing the asset. IRS Revenue Ruling 59-60 provides general guidance on valuing non-traded assets. It outlines the general factors that must be taken into consideration and requires a written report detailing the valuation. It indicates that the assets must be more than simply valued. The valuation should also reflect any "lack of control" or "lack of marketability." While the Revenue Ruling is specifically directed toward valuing estate assets, it is widely acknowledged as a general standard for valuing non-traded assets.

IRS Announcement 92-182, "Employee Plans Examination Guidelines," provides the following guidance in valuing limited partnership interests and applying I R S Revenue Ruling 59-60:

- "An accurate assessment of fair market value is essential to a plan's ability to comply with the requirements set forth in the [Internal Revenue] Code and in Title I of ERISA."
- "Plans must value their trust investments at least once a year, on a specified date, in accordance with a method consistently followed and uniformly applied."
- "Revenue Ruling 59-60 provides guidance for determining the value of plan assets. Although 59-60 provides methods for valuing shares of stock for closely-held corporations for estate and gift tax purposes, the factors may be used to determine

values of assets in qualified plans ..."
- "The detail of the plan's valuation should be examined in light of the plan assets involved. For example, the valuation should contain substantial detail if it values a limited partnership or a closely held corporation."

Under IRC Section 408)(i), IRA trustees/custodians are required to report the fair market value of assets to the IRS and IRA owners on an annual basis on Form 5498.

In an information letter dated February 24, 1993, the IRS provided guidance on how limited partnerships in IRA accounts should be treated. In addition to generally affirming the above points, it indicated that the IRA trustee "or issuer" is responsible for proper valuations, and that the trustee or issuer cannot waive, or be released or indemnified by the participant, from such valuation responsibility.

As a result, original cost or an amortized original cost would not normally be considered a reasonable valuation. Since most limited partnerships are not readily traded, the Net Asset Value (NAV) of each partnership unit may be available only on request of the general partner. Since the general partner may have a financial interest in the partnership, either as an investor or as a sponsor, the NAV obtained from the general partner should not automatically be considered the market value.

The plan administrator should attempt to evaluate the reasonableness of the NAV by, for instance, comparing it against other recent trades of the limited partnership's units, consulting a limited partnership valuation service or some equivalent approach.

F.9. Family Limited Partnerships (FLP) or Limited Liability Companies

FLP are a form of limited partnerships, formed to manage and control family property. All of the requirements for a limited liability partnership must be followed. In general, there are two types. One is the discounted technique, where assets are "discounted" in value, which ultimately reduces estate taxes. In order to receive this treatment, the principal must relinquish control, prohibit partners from withdrawing from the entity, and place severe limitations on transfers. Collectively, these restrictions allow the discounted limited partnerships to leverage wealth. The second form freezes the value of an individual's estate and shifts future appreciation to the next generation.

F.10. Master Notes

Master note arrangements, also known as "variable amount notes", are borrowing arrangements whereby trust accounts provide short-term cash to large companies. These types of investments may be operated in place of, or in addition to, a bank's Short Term Investment Fund. With the increased use of commercial paper and other sources of capital, this form of borrowing has lost much of its popularity.

The documentation of the borrowing arrangement includes the note evidencing the maximum amount of the loan, which may be on a demand basis or have a fixed maturity. Either the note or a separate loan agreement will detail the terms of the credit. The interest rate is usually adjusted monthly based on commercial paper rates. The note is payable to the bank or a nominee, and may be repaid by the borrower(s) in whole or in part at any time. The amount of the loan may fluctuate daily as increases or decreases are made in the participation. If an account acquires (increases) a participation, a buy order is executed; if the account withdraws (reduces) a participation, a sell order is executed. Buy and sell orders are combined at the end of the day, resulting in a net adjustment to the loan. This is communicated to the borrower on the following business day, and may be accepted or rejected. Interest, at an agreed upon rate, must be paid monthly on the daily amount of the loan outstanding during the preceding month.

A separate investment control is maintained for each master note. A participant record for each account should be maintained and appropriate accounting entries made by the bank each time the loan balance changes in order to ensure that participant records reconcile to the amount outstanding. Asset records for each participating account must reflect the investment in the master note.

Broad investment powers in the governing instrument are sufficient authority for such investments. However, investments by accounts for which the bank does not have full investment responsibility must have letters of direction from parties authorized to direct

each purchase or sale. Custodial and agency accounts may invest in master notes if the terms of the governing instrument permit.

All master notes should be issued by companies classified as "prime credits", i.e., an issuer rated in one of the two highest rating categories by at least two nationally recognized investment rating organizations. The bank should have full information on the capital, debt structure, and financial condition of the issuer, including: total amounts borrowed on master notes, total long and short-term borrowings, and the most current financial statement. Additionally, the bank should obtain quarterly certifications that the notes are: not subordinated to any other debt of the company, there is no litigation pending or threatened which would affect such notes, and the issuer is not in default on any of its outstanding obligations.

As a guideline, if the total amount of variable or master notes exceeds 10 percent of the market value of the assets held by the trust department, the examiner should question the prudence of such investments. A bank which has notes issued by any one company in excess of 5 percent of the market value of the department's total assets should be requested to justify the prudence of such investments. Where a note has both a demand and fixed term component, the examiner should comment upon the arrangement when the fixed term is in excess of 50 percent of the principal amount of the note. As with other types of investments, the bank should have appropriate written policies and procedures governing the use of master notes, including the maximum amount of funds to be extended, the submission of current financial information, periodic credit reviews of the borrower and the submission of corporate borrowing resolutions.

A conflict of interest may exist if the commercial department of the bank also has loans outstanding to the master note obligor.

F.11. Business Interests

The primary types of business interests encountered in a trust department are: (1) Stocks or other securities of closely held corporations, i.e., a corporate entity whose stock is not actively traded, (2) Partnership interests, either general or limited, (3) Sole proprietorships, and (4) Joint ventures. The management of business interests is often demanding, time consuming and requires expertise.

Family business interests can pose administrative problems to the trust department. One of the greatest problems in holding the securities of a closely-held business is the limited marketability due to concentrated ownership. This is particularly true if an accounts holds a minority interest. The illiquid nature of a minority interest, when combined with a lack of investment diversification, may cause concern. When the bank as fiduciary holds a minority business interest, it may attempt to identify other shareholders with whom it can jointly control or influence the management of the closely-held business. The surcharge potential is perhaps the most important concern with fiduciary appointments involving family business interests.

The purpose of reviewing the administration of closely-held business interests is to evaluate both the institution's expertise and its actual management of such business interests. Due to the relatively high surcharge potential, the bank should, prior to accepting such an appointment, thoroughly review all the potential risks and disadvantages associated with administering a closely-held business. If bank policy permits, it may be desirable for the fiduciary to represent the account by having a bank officer serve as an officer or director of the company. However, a directorship involves a certain degree of potential liability to the bank and the individual serving as a director. Therefore, consideration should be given to obtaining appropriate indemnity insurance to cover these situations.

Occasionally banks are appointed executor or administrator of an estate which includes a sole proprietorship or a partnership interest. As a general rule, such businesses terminate upon the death of the proprietor or partner, but it usually takes considerable time to settle outstanding business matters. The bank should work closely with estate counsel and others interested in the business, as conveyance of such business property is complicated and may be disruptive to the beneficiaries. It is important to determine that the bank has limited its liability in administering such property.

Conflicts of interest may be present when the bank is lending to the business. The bank should approach this area cautiously and seek outside financing sources first. Additionally, the bank should prohibit its personnel from acquiring an interest, financial or otherwise, in the company, other than representing the beneficiaries and the bank.

The examiner should review and evaluate the adequacy of the department policies governing the administration of business interests. The expertise of the bank in administering such interests should be evaluated through a review of board minutes, trust committee minutes, account files, and the qualifications of its personnel. Compliance with laws, governing instruments and standards of prudence should be determined, the possibility of conflicts of interest ascertained and the potential for liability to the bank assessed. Trust departments that actively manage business interests should be familiar with Federal Statutes that could impact the operation of the business. An example would be the Americans with Disabilities Act, which prohibits discrimination in private employment, transportation, telecommunications, and public accommodations.

Examiners should determine the extent to which the trust department monitors these investments. The department should periodically request financial information from the business, develop a method of evaluating the business' financial condition and document its findings. Additionally, these assets should be carried on the books of the trust department at some value that is supportable based on the available documentation.

F.12. Worthless Securities

On occasion, the trust department will receive securities which are or become worthless, particularly in estates and guardianship accounts. In determining if securities are indeed worthless, the department should obtain documentation, from the corporation commission or the secretary of state of the state in which the corporation that issued the security was chartered, evidencing that the corporation is no longer in business. Frequently, this documentation will state that the securities are worthless. Once such a determination has been made, the information should be presented to the trust committee with a request for approval to write-down the carrying value and identify the securities as worthless on the department's records.

Whenever possible, worthless securities should be returned to the trustor or distributed to the account beneficiary. Those securities remaining in the trust department's control can be listed among the account's assets, or carried in a house account with a reference to the account holding the asset. For control purposes, the department should continue to carry the securities on its records at a nominal value.

A complete list of worthless securities should be maintained and the securities kept in the trust securities vault under dual control. Periodically, the list should be reviewed to determine if any of the issues have become marketable, since they occasionally regain value. Protective measures are recommended to guard against neglect or misappropriation of any securities that regain value.

F.13. Tangible Assets and "Collectibles"

Tangible assets include works of art, antiques, stamps, coins and bullion, and diamonds and gemstones. Such assets often appeal to individuals who do not need current income from all their investments, and, therefore, can allocate a portion of their assets to tangibles in an effort to provide long-term capital gains with no current income tax consequences. Assets of this type are often viewed as an inflation hedge.

An examiner has several objectives in reviewing the management of tangibles. First, the examiner needs to determine that the department has adequate control over the assets and has made provisions for proper storage and adequate insurance. Management should attempt to verify ownership of the assets, as the grantor can't acquire good title to stolen property. Stolen artwork has resurfaced years later and has been returned to the rightful owner. However, discovery and demand for the return of stolen art must be made. The recovery period can extend well beyond the statute of limitations. In one case, the court ruled that the statute of limitations didn't begin until a museum demanded the item be returned. That was 30 years after discovery.

Rare stamps and coins should be authenticated by an expert (such as the Philatelic

Foundation of New York for stamps and the American Numismatic Association for coins). For diamonds and other gemstones a certificate should always be obtained. It is essential that such assets be maintained under dual control. Separate storage of tangible assets that might suffer significant damage, such as stamps, should be considered.

The purchase and retention of tangible assets should be permitted in the governing instruments. Appraisals should be obtained periodically. With some notable exceptions, tangible investments may be difficult to liquidate. A national auction market exists for investment grade stamps. Gemstones are usually sold by consignment through a major dealer. Some risks can be minimized by permitting such investments only in directed, i.e. non-discretionary, accounts, and by using reliable dealers and auction houses.

The Economic Recovery Tax Act of 1981 essentially eliminated the option of investing in tangibles for self-directed employee benefit accounts (IRA, Keogh, Pension and Profit Sharing) after December 31, 1981. Under the law, any funds of a self-directed retirement plan used to purchase tangible assets must be treated as a taxable distribution of the plan's assets to the participant(s). Refer to Section 5 for further discussion of this topic. However, if an independent trustee or qualified investment manager, vested with investment discretion, selects tangibles as an investment, the participants of the plan would not be similarly penalized.

F.14. Repurchase Agreements

A repurchase agreement is an acquisition of funds through the sale of securities, with a simultaneous agreement (commitment) by the seller to repurchase the securities at a later date. The owner of a U. S. Government or agency security transfers possession of the obligation for a percentage of its market value, but retains ownership and the inherent rights to receive the interest and principal of the obligation. At an agreed upon future date, the owner (seller) repurchases the obligation to repay the amount borrowed plus the agreed upon interest. A repurchase agreement, regardless of the terminology used, is a secured borrowing by which an owner (seller) leverages existing positions in securities by pledging these holdings against the repurchase liability.

Some trust departments engage in repurchase agreement transactions as a temporary investment vehicle for cash balances awaiting permanent investment or distribution. In this context, a trust account becomes the lender of funds to a financial institution or a broker/dealer. Although the trust account acquires an asset, it will generally be identified on the trust department's records as a repurchase agreement. Repurchase agreements are collateralized by U. S. Government or agency securities, bear a fixed or variable rate of interest, are payable at a fixed maturity (one day or longer) and may be subject to other terms and conditions.

Repurchase agreements bought from the bank's commercial department or from bank affiliates represent loans by trust account(s) to the fiduciary bank and involve a conflict of interest and self-dealing. The purchase of repurchase agreements from the bank's commercial department, affiliates of the bank or other organizations, where there exists an interest which might affect the best judgment of a fiduciary, should not be made unless specifically authorized either in the instrument creating the trust relationship, by court order, by local law or unless prior written approval is obtained from all interested parties. If appropriate authorization is contained in the instrument or local law, or obtained from a court or all interested parties, the examiner should review the investment in light of normal investment considerations, e.g., rate of return, diversification, adequacy of pledged securities (collateral margin), maturities, etc. The bank must pay a competitive rate of interest and the terms must be no less favorable than those granted to others purchasing the same types of repurchase agreement.

In those cases where such investments are not authorized, the examiner should fully discuss the matter with management, obtain a commitment to take corrective measures, and detail the situation in the Report of Examination.

The Department of Labor, in Prohibited Transaction Class Exemption 81-8 , dated January 23, 1981, "Short-Term Investments", allows employee benefit plans to acquire repurchase agreements with maturities of one year or less from parties-in-interest. However, the obligor financial institution or its affiliate(s) cannot hold discretionary authority

or control over the investment of assets of the plan purchasing its obligation. If the department has purchased own-bank or affiliate bank repurchase agreements for discretionary accounts, or directed employee benefit plans subject to ERISA prohibited transaction provisions without obtaining proper written direction, the examiner should fully discuss the matter with management and schedule the investment(s) as an apparent violation(s) of ERISA Section 406 (prohibited transactions with a party-in-interest) and/or ERISA Section 404 (fiduciary standards).

Repurchase agreements bought from other financial institutions or broker/dealers may be an acceptable short-term investment provided this type of investment is authorized by the governing instrument and/or state law, and is appropriate to the investment needs of an account's beneficiaries. Repurchase transactions represent a form of lending. Consequently, the considerations normally associated with granting secured credit should be made by the trust department. Repayment of repurchases by the selling institution or broker/dealer is a major consideration. The trust department should satisfy itself that the seller will be able to generate the funds necessary to repurchase the securities on the maturity date of the contract. In assessing the propriety of these transactions, the examiner must determine if the trust department has considered the ability of the seller to meet its commitment to repurchase on the prescribed date.

Because repurchase agreement transactions are considered a form of secured lending, the bank should have written policies governing their use as trust investments and a written agreement for each transaction outlining specific provisions pertaining to collateral margins. Acceptable margins, the percentage by which collateral securing the loan exceeds the credit, should be determined by considering the maturity and the volatility of the securities pledged, along with the maturity of the repurchase agreement. The collateral should be priced on a regular basis to assure maintenance of the required margin. Monies should not be lent until acceptable types of securities are delivered into the bank's custody or to an independent safekeeping agent designated by the bank. Trust department management should not make such investments without the account(s) acquiring a perfected security interest in the collateral securities. Registered securities should be endorsed in such a manner to ensure negotiability. In other respects, collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. The examiner should determine that proper procedures have been established for the control of collateral and the maintenance of collateral margins.

Other areas that should be addressed in policies governing repurchase transactions include: setting a maximum amount to be extended to a single firm by any one account and by all accounts in the aggregate; requiring borrowing firms to supply corporate borrowing authorizations; requiring the submission of current financial information; and obtaining periodic credit reviews of the borrowing entities.

Additional guidance is also provided in: the February 17, 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products (FIL-9-94) and the Government Securities Act of 1986. The FDIC adopted the FFIEC Supervisory Policy on Repurchase Agreements on February 10, 1998. This policy statement appears in Appendix C. The discussion of ERISA requirements is located in Section 5.H.7.f.16 Repurchase Agreements.

F.15. Securities Lending

A number of financial institutions and their trust departments are involved in securities lending activities in the capacity of either principal or agent. This is a fee-based service whereby the trust department lends customers' securities held in custodial, safekeeping, personal trust or employee benefit accounts. Collective investment funds and mutual funds whose investments are managed by the trust department may also engage in securities lending.

Securities lending primarily involves loans of large blocks of U.S. government and Federal agency securities held in corporate employee benefit plans. Corporate trust accounts, personal trust and agency accounts are involved to a lesser degree. The primary borrowers of securities are brokers and commercial banks. The primary reasons for borrowing securities are to cover securities fails (securities sold but not delivered), short sales, and option and arbitrage positions. On occasion, securities may be borrowed to meet pledging requirements. Securities lending is conducted through open-ended agreements which may

be terminated on short notice by either the lender or borrower. The objective of such lending is to increase a portfolio's yield by receiving fee-based income in addition to interest or dividends.

Securities loans are generally collateralized by U.S. government or Federal agency securities, cash or letters of credit. Each loan is initially collateralized at a predetermined margin. When the loan is terminated, the securities are returned to the lender and the collateral is returned to the borrower. Fees received are divided between the institution as lender/agent and the customer account that owns the securities.

While securities lending is similar to a repurchase agreement program, repurchase agreements have the following distinguishing characteristics:

- The sale and repurchase of U. S. Government or Federal agency securities,
- Cash is received by the seller and the party supplying the funds receives the collateral margin,
- The agreement is for a fixed period of time,
- The fee is negotiated and established for the transaction at the outset and no rebate is given to the borrower for interest earned on the cash collateral, and
- The confirmation received classifies the transaction as a repurchase agreement.

Traditionally, securities lending has been viewed as a low-risk activity which enhances a trust account's investment return. This has changed in more recent years, as a number of major losses have occurred due to securities lending activities. Previously, collateral was generally invested in very short-term investments. When interest rates were low, the returns on short-term investments were not attractive. To boost investment results further, high-grade but longer-term collateral was accepted. When interest rates suddenly rose, the value of this collateral dropped sharply.

To address those concerns, the FFIEC adopted a Supervisory Policy concerning Securities Lending in 1997. The Policy Statement includes the following guidelines for participation in a securities lending program.

- Develop and implement written policies, procedures, and a system of controls which enables the department to comply with applicable laws and regulations, and minimizes the potential risks associated with securities lending.
- Have a knowledgeable and experienced staff before engaging in any securities lending activity.
- Recordkeeping - Management should be able to readily determine which securities are lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account.
- Administrative procedures - All securities lent and all securities used as collateral must be marked to market daily.
- Credit analysis of the borrower - Securities lending activities involve risk of loss, normally from malfeasance or failure of the borrowing firm or institution. Therefore, the lender should approve transactions with the borrower in advance of lending securities. The review should include at a minimum: an analysis of the borrower's financial statements, management, and any other material evidence of the borrower's creditworthiness
- Credit and limit approvals should be based on a credit analysis of the borrower. This analysis should be performed by individuals who normally perform credit analyses of borrowers, not the individual responsible for the securities lending program.
- Credit and concentration limits - A credit line should be established for specific borrowers and should be based on the market value f the securities to be borrowed. This does not violate material inside information. . Lending concentrations with any one borrower should be avoided.
- Conduct a due diligence analysis and review of the borrower. Enter into a securities lending arrangement only pursuant to a written agreement delineating the duties and responsibilities of each participant. The agreement should specifically address: the types of and the minimum margins acceptable for collateral, procedures to maintain adequate margin levels, custody of collateral, procedures for the collection of dividend and interest payments on securities lent, and procedures in the event of default. If securities are used as collateral, the trust department should review

regulations for applicable requirements relating to the pledging, the perfection of the security interest, and the custody of the securities.
- Collateral management - Securities borrowers pledge and maintain collateral at least 100 percent of the value of the securities borrowed. However, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus any accrued interest for debt securities. Collateral must be maintained at the agreed upon margin. A daily "mark-to-market" or valuation procedures must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities. Securities should not be lent unless collateral has been received or will be received simultaneously with the loan.
- Cash as collateral - When cash is used, the lender is responsible for making it productive, by investing in repurchase agreements, master notes, shot-term investment fund, certificates of deposit, commercial paper or some other money market instrument. For fiduciaries lending securities, the governing customer agreement should outline how cash collateral is to be invested. Investing in own-bank deposits or repurchase agreements, or investments in the bank's parent company would be a conflict of interest, unless specifically authorized in writing by the owner of the lent securities.
- Letters of credit as collateral - Letters of credit are allowable as collateral for certain securities lending transactions.

Since trust departments are not investing for their own accounts, but rather for the beneficiaries of trust or agency accounts, any securities lending must also take into consideration:

- Authorization by the governing account instrument. Any discretionary management of the cash collateral should be subject to clearly delineated risk tolerance guidelines between the lending account and the trust institution.
- For accounts over which the bank exercises investment discretion, the decision to lend securities represents an investment decision. This decision should be subject to normal fiduciary standards of lending. The following considerations should be documented:
  - The appropriateness of the transaction with respect to account objectives and beneficiary needs;
  - Diversification;
  - The prudence of the investment.

The Department of Labor has issued two class exemptions which address securities lending programs for employee benefit plans covered by ERISA. Prohibited Transaction Exemption 81-6 (46 FR7527) issued January 23, 1981, supplemented by (52 FR 19754) issued May 19, 1987, and Prohibited Transaction Exemption 82-63 (47FR 14804) issued April 6, 1982, and corrected by 47 FR 16437 on April 16, 1982. The exemptions authorize transactions which might otherwise constitute prohibited transaction under ERISA. Prohibited exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be a "party in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions, neither the borrower nor an affiliate of the borrower can have discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities. Prohibited Transaction Exemption 82-63 permits a fiduciary to receive compensation for service rendered in connection with loans of plan assets that are securities.

Examiners should also refer to Section 5.H.7.f.17 Securities Lending for additional information and guidance with regard to ERISA account securities lending activities.

The FDIC adopted the FFIEC Supervisory Policy on Securities Lending on July 22, 1997. The policy statement is located in Appendix C.

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FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Section 3 - Asset Management - Part II

Securities Transactions, Processing, and Administration

Table of Contents

A. Brokerage Placement

1. Approved Broker Monitoring
2. Internet Trading

B. Securities Trading

C. Brokerage Selection Soft Dollars Basis- SEC § 28(e)(1)

D. Brokerage Selection on Deposit Basis - SEC § 28(e)(2)

E. Best Execution

F. Securities Settlement Practices

G. Securities Transfer Agent's Medallion Program (STAMP Program)

H. Shareholder Communications Act of 1985

I. Proxy Voting

J. FDIC Part 344: Record Keeping and Confirmation Requirements for Customer Securities Transactions

1. Exceptions to the Regulation
2. Record Keeping
3. Confirmations
4. Settlement of Securities Transactions
5. Written Policies and Procedures
6. Officer/Employee Reporting of Personal Investment Transactions

K. Compliance with SEC Requirements

1. Marketable Securities

a. Acquisition Statements for Registered Equity Securities - SEC 13(d) and SEC 13(g)

b. Reports of Equity Holdings - SEC 13F

c. Section 16 Statements for 10 percent or More Holders of Registered Stocks

2. Restricted Equity Securities - SEC Rule 144
3. Electronic Submission of Forms and Notices

A. Brokerage Placement

The Board of Director or trust committee should approve policies regarding the selection and retention of securities dealers. The FDIC Supervisory Statement Policy Statement on Investment Securities and End-User Derivative Activities considers the selection of dealers, investment bankers, and brokers particularly important in effectively managing risks. Trust management should have sufficient knowledge about the securities firm and the personnel with whom they are conducting business. At a minimum, trust management should consider the following before selecting a securities firm:

- The ability of the securities dealer, its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength, liquidity, and operating results;
- The dealer's general reputation for financial stability, and fair and honest dealings with customers;
- Information available from State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer, its affiliates or associated personnel;
- In those instances when an institution relies upon the advice of a dealer's sales representative, the background of the sales representative with whom the business will be conducted, in order to determine their experience and expertise.

A.1. Approved Broker Monitoring

The Board or a committee thereof should approve the list of securities dealers used by the department. At least annually, a committee, which should include representation by senior investment officers and traders, should review the brokers used and forward recommendations as to the continued use or termination of relationships based on the following criteria:

- Commission rates,
- Net cost or net realization from the trade,
- Promptness and certainty of execution,
- Experience and knowledge of the broker with a security, industry, or market,
- Access to a security's sources of supply,
- The broker's market making ability,
- Financial stability and reputation.

The quality and quantity of investment research furnished by outside firms and/or "soft dollar" arrangements should be evaluated collectively by the department's research analysts, senior investment officers, and traders. The recommendations as to the continued use of the research providers should be forwarded to the Board or trust committee. Based on the foregoing, the committee, or committees, reviewing broker and investment research providers should also forward recommendations on the allocation of broker and "soft dollar" commissions.

Limiting third-party brokerage services to a single broker significantly limits the Board's and management's ability to evaluate the quality of brokerage services. In such cases, the Board and management must be able to demonstrate that the institution has established adequate procedures for monitoring broker performance. The institution should also be able to document that, despite limiting brokerage to a single broker, the department is obtaining " best execution " for discretionary transactions.

A.2. Internet Trading

Internet or electronic("E") trading did not exist a decade ago and has grown to an estimated over 10 million on-line brokerage accounts by year-end 2000. Experience to date suggests that Internet trading has actually increased the historical risks associated with securities trading. The explosive growth of the Internet in general, and Internet trading in particular, has given rise to:

Fraudulent and unregistered on-line brokers;

Fraudulent investment schemes;

Fraudulent news stories; and

New methods of disseminating erroneous reports on altered "website banners" pirated from legitimate institutions.

Fraudulent Internet investment schemes attempt to entice investors into purchasing investments whose values are inflated or worthless. In addition to investment scams, some on-line investors may be susceptible to intrinsic on-line trading system weaknesses. These weaknesses include the following:

Technological failures brought on by overwhelming internet traffic on finite or outdated systems;

The inability to effect transactions quickly enough to avoid volatile fluctuations in highly sought after securities,

The volume of which may be fraudulently induced; failure to use "limit orders" to prevent the purchase of securities at prices inflated by market volatility;

Failure to understand the meaning of "best execution" broker practices;

Technological failures induced by the investor's own equipment; and

The failure to recognize that on-line "real-time" pricing can in actuality be 15 minutes old, or older, which increases the likelihood that "market order" transactions may be executed at prices vastly different than anticipated by the investor in a turbulent market.

Internet Trade Execution Misconceptions:

Trades executed on-line are not instantaneous. The transmission of a trade order over the internet merely sends an order to the broker. The broker must then send the trade order into the market for execution. This is essentially the same process which occurs when investors place orders by phone. However, on-line investors may be easily mislead into believing that they are executing an order at the "real time" price appearing on their computer screen (a price which may be stale). In a volatile market, on-line investors may end up with "market order" trades executed at prices vastly different than expected. The execution process may also be affected by heavy internet traffic, faulty equipment, a broker's inadequate hardware or a slow internet provider, telephone line failures, etc.

Broker Options in the Execution of Trades:

Exchange listed securities - a broker may send the order to the exchange floor, to another exchange (regional), or to a firm which "makes a market" for the security. Some regional exchanges and "market makers" pay brokers to place orders with them, which may increase the cost of the executed price. This is called "payment for order flow." The existence of market makers which pay for order flow may influence how a broker directs a trade, and ultimately, the execution price.

Over-the-Counter (OTC) market securities - a broker may send the order to a NASDAQ "market maker" which may also pay for order flow.

Limit Orders may be routed by the broker to an Electronic Communications Network (ECN) - which matches buy and sell orders at specified prices by computer.

In a process called "Internalization" - the broker may execute the trade out of the firm's own trading inventory position in the security.

Best Execution Options:

NASD Regulation 2320 requires brokers to seek the "best execution" which is reasonably available. In doing so, brokers evaluate all orders received from all customers in light of

conditions existing at the time they are received, and then determine which markets, market makers, or ECNs offer the most favorable terms of execution. Best execution factors include the speed and likelihood of execution, not simply the best price.

During highly volatile market conditions, where there exist large order imbalances or significant price fluctuations, firms which operate automated order execution systems are permitted to implement special procedures to preserve the continuous execution of orders, while reducing their own exposure to market risk. This may include switching from automated mode to manual execution mode and routing orders to other market makers. Some firms may provide partial executions, and place the balance of an order in a queue which is operated in a first-in, first-out, basis. These are only two methods available to a firm. Regulations require that any algorithm system used be fair, consistent and "reasonable."

Investor Directed Trades:

Investors retain greater "direction" of their executions by using "limit orders," and by (if permitted by their broker) directing the broker to transmit the trade to a particular exchange, market maker, or ECN. Some brokers charge additional fees for permitting investors to direct a trade to a particular exchange or market maker.

All investors are entitled to information concerning broker policies on order flow payments, internalization and algorithm procedures during volatile market conditions. On-line investors should be aware of these policies. This is of particular importance, as volatile markets, together with internal broker practices and technological factors beyond the internet investor's control, may significantly impact the execution price.

In 2000, North American Securities Administrators Association issued the following guidance to assist on-line investors:

- Prior to opening an on-line account, obtain complete information about the alternatives available for buying and selling securities, and how to obtain account information if the broker's website cannot be accessed.
- Recognize that the investor's computer is not directly linked to any market and that orders are not instantaneously executed when entered on the computer screen.
- Obtain information from the firm to substantiate advertised claims concerning the ease and speed of on-line trading.
- Obtain information from the firm about significant website outages, delays, and other interruptions to securities trading and account access.
- Before trading, obtain information about entering and canceling orders (market, limit, and stop loss), and the details and risks of margin accounts.
- Determine whether the computer is displaying delayed or real-time stock quotes, and when the information was last updated.
- Review the firm's privacy and website security policies, and whether the investor's name may be used for mailing lists or other promotional activities.
- Obtain clear information about sales commissions and fees, and any conditions which may apply to advertised discounts.
- Learn how to contact customer service representatives with on-line trading concerns.
- Contact state securities agencies to verify the registration and licensing status, and any disciplinary history of on-line firms and representatives; and file complaints when appropriate.

The joint state regulatory issuance also recommended the adoption of specific internet trading policies. Before engaging in on-line trading, trust management should adopt written internet trading policies, including, but not limited to:

- Requiring a due diligence investigation of internet brokers.
- Inquiring among peer trust departments about their experience with internet brokers, and obtaining other references.
- Performing a due diligence review of the reasons for using internet trading instead of regular brokerage accounts.
- Requiring Board of Director or trust committee authorization of internet trading practices. The Board or trust committee should review trust management's

documented justification for using internet brokers, including:
    - projected commission savings by trust customers, and
    - best execution protections.
- Requiring periodic reporting to the trust committee, or other operating committee, of usage of internet trading, including:
    - number and dollar volume of trades,
    - listing of trades which were executed at prices which were different than "real time" price on internet sites,
    - trades which were not executed,
    - problems with internet brokers,
    - delays in order transmission due to hardware problems,
    - slow internet transmissions,
    - discrepancies between trade orders and confirmations,
    - fails, etc.
- Performing the following oversight functions by the Board, trust committee, or other operating committee:
    - Periodic reviews of the quality and execution of internet trading,
    - Approval of the continued use of internet trading brokers,
    - Analysis of whether the use of internet brokers will result in increased research costs, if internet broker does not provide investment advice, and
    - Analysis of the quality and availability of investment research provided by internet brokers.
- Specific controls to limit internet trading risk.
- Prohibiting the use of internet for personal trading by employees.
- Prohibiting officers and employees from trading for accounts off the banking premises (or at home).
- Prohibiting after-hours trading if the department has not established specific controls governing after-hours trading.

These policies, and the suggestions issued by state securities regulators, are all equally applicable to broker selection and trading in general. Examiners should inquire into trust management's due diligence policies and safeguards, and assess whether sufficient measures have been taken to limit broker and securities trading risk. Additional affirmative measures may be taken to protect the institution and its customers by obtaining on-line broker information from the SEC and NASD. The SEC's Enforcement Division website is http://www.sec.gov/enforce.html , and may be used to obtain information about disciplinary actions against broker/dealers, lodge complaints, and reference SEC customer awareness information. The NASD's public disclosure website is at http://www.nasdr.com , and provides broker background information and other useful investor guidance. NASD's broker complaint website is linked via their homepage at http://www.nasdr.com

B. Securities Trading

Trust department investment policies and procedures should prohibit research analysts, traders and/or portfolio managers from trading for their own account through brokerage accounts maintained by the trust department. Examiners should verify that the trust department's accounts with brokerage firms are used only to effect transactions for trust accounts or approved outside clients. If the bank has not established policies or control procedures, the examiner should discuss the potential hazards with management, and recommend adoption of policies and procedures. The audit program should include procedures to detect misuse of brokerage accounts.

In general, borrowing for the purpose of investment is an improper activity for a trustee, except when purchasing improved real estate. The bank as fiduciary should not maintain a margin account with a broker unless specifically authorized by the terms of the governing instrument and directed by a party having appropriate authority.

Examiners should be alert for any involvement in speculative securities trading activities. Any speculative transaction ordinarily evidences contravention of "prudent man" doctrines.

Churning is a term for excessive trading in an account for the purpose of generating and maximizing broker commissions and can occur in both discretionary and nondiscretionary accounts. The practice is illegal and is among the most common claims made against stockbrokers, investment advisers, and financial planners. In determining whether churning has occurred, consideration should be given to the

following:

- the number and frequency of trades;
- the amount of "in-and-out" trading; the amount of commissions generated;
- the investor's objectives and level of business sophistication; and
- the degree of control the broker has over the account.

To be considered churning, the broker:

- must have either explicit (discretionary accounts) or implied control (non-discretionary accounts) over the account;
- trading must be excessive in relation to the customer's objectives; and,
- the broker must have acted with the intent to defraud or with behavior that was reckless.

The broker's lack of or poor judgment does not demonstrate intent to defraud or reckless behavior. Furthermore, accounts with investment objectives of growth or speculation are likely to have more frequent transactions than accounts with investment objectives of long-term growth or income. Therefore, what may appear to be churning in accounts should be reviewed in light of the investment objectives of each account.

For a more detailed discussion on broker selection, internet trading, and due diligence policies and practices, refer to A. Brokerage Placement .

C. Brokerage Selection on Basis of Soft Dollars - SEC § 28(e)(1)

Section 28(e) was added to the Securities Exchange Act of 1934 by the Securities Acts Amendments of 1975. This section provides "safe harbor" protection to the fiduciary exercising investment discretion, provided certain conditions are met. Under Section 28(e)(1), "No person . . . shall be deemed to have acted unlawfully or to have breached a fiduciary duty . . . solely by reason of his having caused the account to pay . . . an amount of commission . . . in excess of the amount of commission another . . . dealer would have charged . . . if such person determined in good faith that such amount of commission was reasonable in relation to the value of the brokerage and research services provided . . . in terms of either that particular transaction or his overall responsibilities with respect to the accounts as to which he exercises investment discretion." Section 28(e)(3) defines research and brokerage services. in order to qualify as research or brokerage services, the services provided must:

- Furnish advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in purchasing, or selling securities, and the availability of securities;
- Furnish analyses and reports concerning the issuer, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts; or,
- Effect securities transactions and perform functions incidental thereto, such as clearance, such as settlement and custody, or required in connection therewith by the SEC, or a self-regulatory organization.

Note that transactions in futures or for transactions done on a principal basis are not covered by the safe harbor.

Four requirements must generally be satisfied to obtain "safe harbor" protection under Section 28(e):

- The soft dollar goods and services must be provided by the broker-dealer effecting the securities transaction,
- The soft dollar goods and services must be provided to the party holding investment discretion over the account,
- The recipient of soft dollar goods and services must make a good faith determination that the commissions paid are reasonable in relation to the value of brokerage and research services provided, and
- The goods and services provided for the soft dollars must qualify as "brokerage and research" services.

Section 28(e) is a "safe harbor" which affords "protection." It is not a regulation, and, therefore, cannot in itself be violated. Any "violations" connected with transactions not afforded the protections under Section 28(e), would be of the antifraud provisions of federal securities laws. Also, while not specifically addressed within Section 28(e), there exists a general fiduciary duty to seek "best execution." Best execution implies the best net price to the customer, together with accuracy and speed of execution. It is

not intrinsically linked with, nor does it imply, the lowest brokerage commission.

Trust institutions which engage in soft- dollar trading are required to disclose the research products and services it obtains to the trust accounts paying soft-dollar commissions. In an inspection report on soft-dollar practices released September 22, 1998, the SEC stated that Section 28(e) "does not shield a person who exercises investment discretion from, violations of antifraud provisions of federal securities laws arising from churning an account, failing to obtain the best price or best execution, or failing to make required disclosure." Regarding full disclosure, the report provided, "Disclosure is required whether the product or service acquired by the adviser using soft dollars is inside or outside the safe harbor. Advisers are required to disclose, among other things, the products and services through soft dollar arrangements, regardless of whether the safe harbor applies." The SEC has directed advisers that they ".need not list individually each product, item of research, or service received, but rather .state the types of products, research, or services obtained with enough specificity so that clients can understand what is being obtained."

The SEC has also long taken the position that "mixed use items," or products and services that provide both research and non-research benefits (such as in-house computer networks used for other purposes in addition to research), should be allocated between soft dollars and hard-dollars. This requires institutions to allocate the costs associated with these products and to pay for the non-research portion with their own funds.

Refer to subsection E.2.a., located in Section 8 for additional discussion of this topic. Refer to Securities and Exchange Act of 1934 Release No. 34-23170, "Section 28(e) and Soft Dollars" , for a discussion of the scope of Section 28(e).

D. Broker Selection on Basis of Deposits - SEC § 28(e)(2)

The Justice Department has long viewed the allocation of brokerage business by banks based upon the volume of demand deposits maintained by a security dealer as reciprocity in violation of antitrust laws. Reciprocity means the use by a company of its power as the buyer of products or services to influence the sale of its own products or services.

Section 28(e)(2) of the Securities Exchange Act of 1934 states "A person exercising investment discretion . . . shall make such disclosure of his policies and practices with respect to commissions that will be paid . . . at such times and in such manner, as the appropriate regulatory agency, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors." Although the Corporation does not require the disclosure of brokerage policies and practices, examiners should review this area to determine whether the bank is complying with its fiduciary duties in the placement of brokerage business. Consequently, the type and amount of deposit relationships maintained by brokerage firms used by trust departments should be ascertained. Examiners should evaluate whether reciprocity (as opposed to the quality of execution, research, cost, or other ancillary services), may have played a role in the selection of brokers.

E. Best Execution

The SEC and the courts have stressed the duty to obtain best execution. The term is usually defined as seeking the most favorable terms for a customer transaction reasonably available under the circumstances. Best execution does not require that the lowest possible commission be obtained and the SEC has not adopted regulations that require a trade to be executed within a set period of time.

Trust management should consider various qualitative and quantitative factors when determining the quality of execution and should establish policy and procedures to evaluate and demonstrate that trades are made using the following criteria: The selection of broker/dealers should comply with the FDIC Supervisory Policy Statement on Investment Securities and End-User Derivative Activities. The points to consider in determining best execution should consist of research provided if any, best price, speed of execution, certainty of execution, access to initial public offerings, recordkeeping, and the commission rate or spread. These general criteria do not endorse or prohibit on-line transactions.

The SEC has brought enforcement proceedings against investment advisors and those actions have been centered in transactions involving soft dollars, cross trade, affiliated trades, and advisors' failure to disclose execution practices. Failure to use best execution procedures, may violate the antifraud provisions under securities law.

Trust investment officers can verify that a particular investment is registered with the SEC via the SEC's

EDGAR system. The NASD can provide information on brokers and dealers, such as disciplinary information. States have securities regulators that can provide information and accept complaints for various causes, including but not limited to poor or inappropriate execution, and broker/dealer licensing status, and fraud.

F. Securities Settlement Practices

Settlement occurs when the transaction is completed by the exchange of securities and money between the buyer and seller. On settlement date, the buyer receives the securities in either book-entry or definitive (physical) form, and a change in ownership is recorded.

The settlement period is the time between trade date and settlement date. Since 1995, most trades of U.S. government and federal agency securities settle the day after the trade date, which is known as next-day settlement. The standard for corporate debt and equities, American Depository Receipts (ADRs), and municipal securities has been three days. However, an initiative is underway to ultimately allow for straight-through processing (STP), in real-time with multiple currencies. In order for STP to occur, various actions must be implemented, and includes, but is not limited to the following:

International /Foreign Exchange -Implications to foreign investors trading U.S. issued securities

Legal and Regulatory - Rule changes to accommodate STP improvements

Payment Processing - Automated payment process

Physical Securities - Eliminate the movement of physical securities

Securities Lending - Implement the Automated Recall Management Systems (ARMS) to improve level of STP in the stock loan recall process

Real-time trade matching - For fixed income securities

The following is a more detailed explanation of current settlement practices based on the type of investment:

Transactions involving U. S. Treasury and Agency obligations are typically in book-entry form, rather than in physical certificate form. Book-entry is an electronic registration, transfer, and settlement system that enables the rapid and accurate registration and transfer of securities with concurrent cash settlement. Book-entry reduces handling costs and quickens transaction completion. U. S. Treasury and Agency book-entry securities are delivered and cleared over the Federal Reserve Wire System (Fedwire) on a delivery versus payment basis. Acceptance of the security automatically debits the payment amount from the buyer's account and credits it to the seller's account. The payment and securities involved are transferred over the Fedwire system. The Federal Reserve Bank of New York maintains the book-entry custody system. All depository banks are eligible to maintain book-entry accounts at their Federal Reserve District Bank, provided that they also maintain a funds account with that Federal Bank.

Mortgage securities settlement procedures are more complex than those for government, corporate, and municipal bonds. The Bond Market Association developed the Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities (hereinafter, "Uniform Practices") to establish industry standards for mortgage securities settlements. Since the Uniform Practices are updated frequently, trust management engaged in mortgage and asset-backed securities transactions should keep abreast of current settlement standards.

Corporate and municipal debt securities are available in book-entry and registered, definitive form. Book-entry corporate and municipal bonds settle through the Depository Trust Company (DTC).

Electronic trade processing and recordkeeping systems have improved the trade and settlement time and have reduced failed trades. However, failed trades may occur due to the following reasons

- The buyer rejects the delivery due to not being in good delivery form or the records of the buyer and seller not matching. The primary reason for this problem is a lack of communication.
- The buyer recognizes the trade, but it is in a different dollar amount.
- The buyer rejects the transaction due to incorrect maturity date, interest rate, or series.

If the receiving party accepts delivery (upon payment) and discovers that it was not a good delivery, then the buyer can correct the error by reclamation. In the reclamation process, the buyer returns the securities with an explanation to the seller (who has already received payment). The seller is obligated to return the payment, if the claim is valid. Either party may make a reclamation, if information is discovered after delivery, which, if known at the time of delivery, would have caused the delivery not to constitute good delivery. However, reclamation must be made within the stated time limitations established by the Bond Market Association.

If a trade has a settlement date between a record date and a payable date, delivery of the securities must be accompanied by a due bill. A due bill is a document delivered by a seller of a security to a buyer evidencing that any principal and interest or dividends received by the seller past the record date will be paid to the buyer by the seller upon submission of the due bill for redemption. The record date is the date for determining who will be paid principal, dividends or interest on an issue. Book-entry messages are considered acceptable due bill substitutes for securities transferred over Fedwire (Treasury), DTC (Corporates and Municipals), or PTC (GNMA). Due bills and book-entry messages cease to be valid after 60 days from their issue date. A trust department may experience considerable delays in attempting to recover payments without the use of a due bill, which result in the accumulation of significant principal and interest receivable accounts. If delivery and payment on a trade occur after a record date and on or after a payable date, delivery of the securities must be accompanied by a check for the principal, dividend or interest due.

G. Securities Transfer Agent's Medallion Program (STAMP Program)

The Securities and Exchange Commission created a universal signature guarantee program that consists of a stamp that serves as a signature by an eligible institution, such as a bank, brokerage, or trust company, that participates in the program. The purpose is to ensure that the person signing the certificate or irrevocable stock or bond power form is the owner or authorized agent. The program also standardizes the signature guarantee by assigning a standard format and numbering system. The latter identifies the financial institution. The stamp is an ink impression applied to a certificate that allows good delivery form. It is not the same as a notary, which attests to the authenticity of documents and contracts and signatures of testator and witnesses.

H. Shareholder Communications Act of 1985

This Act gives the SEC jurisdiction to regulate the proxy processing of all entities exercising fiduciary powers, including trust departments. The Act is implemented primarily by SEC Rule 14b-2 , which can be found in Appendix D. The purpose of this regulation is to ensure that beneficial owners of securities are provided proxy materials and other corporate communications within specified time periods. Refer to Operations and Internal Controls - Shareholder Communication Act for additional information and guidance.

I. Proxy Voting

As a function of equity ownership, a fiduciary has the duty to cast proxy votes for shares of stock held in a discretionary capacity. A policy should be developed which establishes the department's position with regard to voting on routine, as well as controversial, issues. The policy should also establish voting and recordkeeping procedures.

For **ESOP** investing in the employer securities that are **registered** with the SEC, participants must be given full voting rights for stock allocated to their accounts. In addition, the DOL has opined in a letter ruling dated September 28, 1995, that fiduciaries of ESOP in which participating employees are covered by a collective bargaining agreement must pass through decisions concerning tender offers or proxy voting to the plan's participants and vote as directed.

ESOPS maintained by employers whose securities are **not registered** with the SEC are required to pass through voting rights to participants with stock allocated to their accounts only for the following purposes: Corporate mergers or consolidations; recapitalizations, reclassifications, liquidations, dissolutions, or, the sale of substantially all assets. Furthermore, the plan may authorize the trustees to vote allocated stock based on a one vote per participant basis, rather than number of shares basis. IRC 409(e)

Employer stock held in a suspense account, i.e., not yet allocated to participants, may be voted by the trustee, in accordance with their duty to plan participants and beneficiaries.

J. FDIC Regulations

J.1. FDIC Part 344: Record Keeping and Confirmation Requirements for Customer Securities Transactions

The purpose of Part 344 is to ensure that customers for whom state nonmember banks effect securities transactions are provided adequate information concerning a transaction, and that banks maintain adequate records and controls with respect to securities transactions. This part is also designed to ensure that banks subject to this part maintain adequate records and controls with respect to the securities transactions they effect. The regulation **does not apply** to trust company subsidiaries of FDIC insured banks. The regulation parallels the securities recordkeeping regulations of the other Federal financial institution regulators (FRB Regulation H, and OCC 12 CFR 12, OTS 563). The requirements are nearly identical to those contained in those regulations. FDIC examiners conducting concurrent examinations with these regulators may rely on their findings with respect to customer securities recordkeeping and confirmation requirements.

Part 344 applies to transactions (business and consumer) made by the bank as a whole, and is not department specific. Therefore, to determine if exceptions may apply, **all transactions subject to the regulation should be totaled.** Transactions may include sweep transactions made from deposit customers in the Commercial Department to mutual funds, all nondeposit securities products and variable annuities bought or sold, and transactions made within the Trust Department, for example. Unless one of two general exceptions to the regulation apply, a bank executing securities transactions for customers is subject to all of the requirements of Part 344. The regulation, however, provides specific requirements for trust department accounts.

The term "security" includes stocks, bonds, mutual funds, repurchase agreements, variable annuities, and other investments outlined in the regulation in Section 344.3(m). The term **security does not include** a deposit or share account in a Federally or state insured depository institution; a loan participation; a letter of credit or other form of bank indebtedness incurred in the ordinary course of business; currency; any note, draft, bill of exchange, or bankers acceptance which has a **maturity at the time of issuance** of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited; units of a collective investment fund; interest in a variable amount (master) note of a borrower of prime credit; or U. S. Savings Bonds.

"Customer" as defined in Section 344.3(g) includes any person or account, including agency, trust, estate, guardianship, committee, or other fiduciary account for which a bank effects or participates in effecting the purchase or sale of securities. The term does not include a person or account having a direct contractual agreement with a fully disclosed broker/dealer, broker, dealer, dealer bank, or issuer of securities that are the subject of the transaction.

J .1.a. Exceptions to the Regulation

Low Activity Banks

Section 344.2(a)(1) provides that banks which, over the prior three calendar years, execute an average of fewer than 200 securities transactions per calendar year are exempt from the some of the recordkeeping requirements of 344.4(a)(2) through 344.4(a)(4) and the written policy and procedure requirements of 344.8(a)(1) through (3). All transactions in U.S. Government and agency securities, as defined in Section 344.3(i),are excluded when calculating the number of transactions. The recordkeeping requirements of Section 344.4 do not apply to banks effecting fewer than 500 government securities brokerage transactions per year. However, mutual fund, repurchase agreement, and variable annuity transactions are included when calculating the number of transactions.

High-Activity Banks

Banks which exceed the 200 securities transaction threshold are referred to as "high activity" banks in this material.

Transactions with a Broker/Dealer

Section 344.2(a)(5) exempts securities transactions from the requirements of

the regulation if those transactions were effected for a bank customer by a registered broker/dealer. This exemption also applies when the broker/dealer is a dual employee. The exemption is applicable as long as: (1) the broker/dealer is "fully disclosed" to the customer, and (2) the bank customer has a direct contractual agreement with the broker/dealer. The term "fully disclosed" means that the broker/dealer's name (and not the bank's) appears on account documents, confirmations, statements, etc.

J.1.b. Record Keeping

Section 344.2(b) requires that a bank executing securities transactions for its customers is responsible for maintaining, directly or indirectly, an effective system of records and controls to ensure safe and sound operations. The records and systems must clearly and accurately reflect the information required by Part 344, and provide an adequate basis for an audit.

Section 344.4 requires the maintenance of certain records. Two sets of records are required. The first set of requirements applies to **all** banks providing such services, while the second set applies only to "high activity" banks.

Mandatory Basic Records for All Banks

Pursuant to Section 344.4(a)(1), securities transaction records must be maintained for at least three years and be in a chronological order. The account or customer name for which the transaction was effected, a description of the securities, the purchase or sales price, trade date, and the name of the broker/dealer or other person the securities were purchased from or sold to should be maintained as. Otherwise, under Section 344.4(b), the regulation does not require either the use of specific forms or the creation of specific recordkeeping systems. The records may be maintained in hard copy, automated, or electronic format, but must be "easily retrievable, readily available for inspection and capable of being reproduced in a hard copy. A bank may contract with third party service providers, including broker/dealers, to maintain records required by this section. Thus, a bank subject to all of the recordkeeping requirements noted below may, if it chooses, maintain one computer system for all of the required information.

Pursuant to Section 344.4(a)(5), written notifications are required by Section 344.5 and 344.6. The notification may take the form of a broker/dealer's confirmation or a confirmation from the bank that includes specific items. Section 344.6(b) permits trust departments to elect an alternative notification procedures, when the department exercises investment discretion other than in an agency capacity, whereby the grantor, or if there is no such person, then the beneficiary, and gives or sends to such person written notification within a reasonable amount of time. A fee may be charged for providing this information. For agency accounts, where the trust department exercises investment discretion, the department will provide the customer with an itemized statement no less frequently than once every three months. The statement will specify the funds and securities in the custody or possession at the end of the period, and all debits, credits, and transactions in the customers' account during the period.

"High Activity" Recordkeeping

All banks exceeding the 200-securities transaction threshold must maintain the following in addition to the requirements for all banks previously outlined:

- For each customer, account records reflecting all purchases and sales of securities, and all receipts and disbursements of cash [Section 344.4(a)(2)];
- A separate memorandum (order ticket) for each order to purchase or sell securities (whether executed or canceled). The memorandum must include: (i) the account name(s), (ii) whether the transaction(s) was a market order, limit order, or subject to special instructions, (iii) the time the order was received by the person responsible for effecting the

transaction, (iv) the time the order was placed with the broker/dealer, or if there was no broker/dealer, the time the order was executed or canceled, (v) the price at which the order was executed, and (vi) the broker/dealer utilized [Section 344.4(a)(3)];
- A record of all broker/dealers selected by the bank, and the amount of commissions paid or allocated to each broker during the calendar year [Section 344.4(a)(4)].

Records Retention

Records required by Part 344 must be retained for at least three years after the date of the transaction. [Section 344.4(a)]

J.1.c. Confirmations

All trust departments must follow the minimum guidelines of Section 344.5 in complying with the confirmation requirements. However a trust department may, optionally, comply with Section 344.6 for all or some of its accounts. Section 344.6 is an alternative approach which provides an exemption from most of the confirmation requirements. Examiners should note that trust department accounts generally comply under Section 344.6. The following discusses the general requirements first, and then the exemptive provisions of Section 344.6.

General Provisions

The bank must provide customers with information (a confirmation) regarding securities transactions effected for their accounts by either of the following types of notification:

- A copy of the broker/dealer's confirmation and, if any remuneration is to be received by the bank, a statement of the source and amount of the remuneration (refer below for special remuneration provisions). If the confirmation is sent from the bank, it must be sent within one business day from the bank's receipt of the broker/dealer's confirmation. [Section 344.5(a)]; or
- A written notification (bank confirmation) disclosing specified items of information about the transaction. [Section 344.5(b)] The confirmation may be sent to the customer by mail, FAX, or electronically.

The bank may elect to have the broker/dealer send the confirmation directly to the customer with either of these options. [Section 344.5(a)(1)]

If the broker/dealer's confirmation is not sent to the customer, the bank must provide the following in its confirmation: (1) the name of the bank, (2) the name of the customer, (3) the capacity in which the bank is acting (as principal or agent - see below), (4) the date and time of execution (or the fact that the time of execution will be furnished within a reasonable time upon request), the identity, price, and number of shares of securities purchased/sold, (5) the source and amount of any remuneration received by any broker/dealer or by the bank in connection with the transaction, and (6) the name of broker/dealer used or the name of the person from whom the securities were purchased/sold. [Section 344.5(b)(1) through (7)] The regulation also requires specific disclosures for transactions in debt securities [Section 344.5(b)(8) through (12)]. These requirements generally parallel the contents of the confirmations that broker/dealers must provide customers under SEC Rule 10b-10.

If the bank is acting as a "principal," it is selling or buying the security to the customer, in effect setting the purchase or sale price internally. If the bank is acting as an "agent," it is acting only as an intermediary between its customer and a third party. Disclosure must be made to the customer as to which capacity the bank is acting in.

Special Remuneration Provisions

Normally, the customer pays the broker/dealer a commission, and sometimes

an additional bank fee, for executing a securities transaction. In addition to the direct commissions and fees paid by the customer, the bank may receive remuneration from outside sources, such as a broker/dealer or a mutual fund.

Under both of the general methods of complying with the confirmation requirements, the existence of any additional remuneration received (or to be received) by the bank from outside sources must be disclosed to the customer. [Section 344.5(b)(6)(i)] In general, the source and the amount of such remuneration must be disclosed. In three situations, however, the regulation provides an alternative approach:

- When a prior written agreement between the bank and the customer provides for different treatment;
- When the bank acts in a principal capacity for transactions involving government or municipal securities;
- When the transaction involves open end mutual funds (where the amount of the bank's remuneration may be based on the number and/or amount of transactions over a given period which has not yet expired), if the customer has been provided a current prospectus which discloses all current fees, loads, and expenses at or before completion of the transaction.

In these three instances, Section 344.5(b)(6)(ii) provides that a bank may elect not to disclose the source and amount, if the customer's confirmation indicates that the bank will furnish the information within a reasonable period after the customer's written request.

Exemptive Provisions for Confirmations in Section 344.6

Section 344.6 permits a different approach from the general confirmation rules above. The exemptive provisions basically provide that the trust customer may agree to waive the general confirmation provisions outlined above. This exemption differs according to the type of account.

- In discretionary fiduciary accounts (trusts, estates, guardianships, etc., but excluding collective investment funds), the customer may agree to the receipt of transaction information within a "reasonable" time frame other than that specified in the regulation. This alternative arrangement may be a part of the text of the trust agreement. The bank may charge a "reasonable" fee for furnishing such information. [Section 344.6(b)]

  In such discretionary fiduciary accounts, the "customer" is the person having the right to terminate the account. If no such person exists, anyone with a vested interest in the account is the "customer."
- In discretionary agency accounts, the bank must mail an itemized statement to the customer not less than once every three months. The statement must provide a detail of investments in the account, together with uninvested cash balance(s). It must also show all transactions during the statement period. [Section 344.6(c)]

  If the customer requests, the bank is required to provide written notification conforming with Section 344.5. In such instances, the confirmation must be provided "within a reasonable time." The bank may charge a "reasonable" fee for furnishing these confirmations.
  - The term "reasonable," when applied to the time to provide confirmations as above, has not been interpreted to date. It must be applied in light of: (i) any provisions of the instrument, (ii) state law and regulation (if any), and (iii) the facilities and capabilities of the fiduciary institution.
  - The term "reasonable," when applied to the fees which may be charged as above, has not been interpreted to date either. It must be applied in light of: (i) any provisions of the instrument, (ii) state law and regulation (if any), and (iii) the bank's pricing for equivalent statements, such as deposit or loan statements.

- In all nondiscretionary accounts (fiduciary and agency accounts, but excluding dividend reinvestment and similar periodic plans), the customer may opt to waive the confirmation.

  The agreement (or separate disclosure statement), however, must clearly indicate that the customer may receive a confirmation within regulatory time frames at no additional cost. [Section 344.6(a)] The waiver must be sufficiently prominent that the customer realizes what is being waived. It may be either a separate disclosure document or included in the body of the trust agreement. If included in the agreement, the waiver may not be buried in "boiler plate" text. The waiver should be positively affirmed by the customer with a separate signature or initials, or by having the customer check a box.
- In cash management sweep accounts, the bank must provide the customer a written statement for each month in which a purchase or sale of a security is effected in a customer's account. If no transactions occur in the account, a written statement must be provided to the customer at least quarterly. [Section 344.6(d)]
  - On December 22, 1998, the FDIC Legal Division issued an interpretation which provides that the monthly statement requirement in 344.6(d) for sweep accounts does not apply to sweeps performed for fiduciary and agency accounts in trust departments. The monthly statement requirement applies only to sweeps from retail deposit accounts of the commercial bank. However, if sweeps for the retail deposit accounts are routed through the trust department, the monthly statement requirement would apply. They would not be exempted merely because they were routed through the trust department.
  - Sweeps into repurchase agreements collateralized by government securities fall under U.S. Treasury Department regulations for government securities dealers, which require a daily confirmation [subject to the requirements of 17 CFR 403.5(d)] and do not permit the monthly/quarterly statement of Section 344.6(d).
- Collective investment funds may follow the same provisions as in OCC Regulation 9.18(b)(6). [Section 344.6(e)]
- Periodic plans (such as stock purchase or dividend reinvestment plans) must provide the customer written statements at least quarterly. The statement must detail the asset holdings of the account, charges and commissions paid by the customer, and all account transactions. The bank may charge a "reasonable" fee for providing this information. [Section 344.6(f)]
- Retail bank customers may not waive the receipt of confirmations or statements, even by written agreement.

J .1.d. Settlement of Securities Transactions

Except under limited circumstances described in Section 344.7, a bank should not effect or enter into a contract for the purchase or sale of a security that provides for the payment of funds and delivery of securities later than the third business day after the date of the contract unless agreed upon by the parties at the time of the transaction. This portion of the regulation parallels SEC Rule 15c6-1 which established three business days instead of five as the standard settlement time frame.

J.1.e. Written Policies and Procedures

Section 344.8 requires that a bank executing securities transactions for its customers establish certain specified written policies and procedures. Two levels of policies are provided for in the regulation. The first applies to any bank providing such services, while the second applies only to "high activity" banks.

Mandatory Written Policy

All banks executing securities transactions for their customers must establish written policies and procedures for the crossing of buy and sell orders on a fair and equitable basis where applicable and permitted under local law. [Section 344.8(a)(4)]

"High Activity" Bank Policies

Section 344.8(a)(1) through (3) requires that banks exceeding the 200-securities transaction threshold [Section 344.2(a)(1)] maintain written policies and procedures governing:

- The supervision of traders or others who transmit orders or execute transactions in securities for customers;
- The supervision of all officers and employees who process orders for notification or settlement purposes, or perform back office functions with respect to securities transactions; and
- Fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time.

J.1.f. Officer/Employee Reporting of Personal Investment Transactions

Section 344.9 requires bank officers and employees who make investment recommendations or decision for the accounts of customers, participate in such determination, or obtain information concerning which securities are being purchased, sold, or recommended must report to the bank within 10 business days after the end of the calendar quarter, all transactions in securities made by them or on their behalf, either at the bank or elsewhere in which they have a beneficial interest. The regulation does not require that the bank or trust department have written policy or procedures to ensure appropriate disclosure and only requires disclosure when transactions meeting the requirements are present. Similar policies and procedures are required for national banks (12 CFR 12) and state member banks [FRB Regulation H, Section 208.8(k)(5)(iv)].

Quarterly reports are required from bank officers and employees who make or participate in the making of investment recommendations or decisions for the accounts of customers, or who obtain information concerning which securities are being purchased or sold.

- Bank directors are not covered by this provision. However, bank directors who are also officers of the bank are required to file the reports, when applicable.
- Reports are required when transactions made by the covered officers and employees (or on their behalf) aggregate to more than $10,000 during the calendar quarter. All transactions in U.S. Government and agency securities [defined in Section 344.3(i)], and all mutual fund shares, are excluded when calculating the $10,000 threshold. The same securities are also excluded from the reporting requirement.
- Reports must be provided to the bank within 10 days after the end of each calendar quarter.
- Personal investment transaction reports are required whether or not the bank falls under the 200 securities transaction threshold exemptions of Section 344.2(a)(1).
- Reports are required only if transactions have occurred. There is no requirement for "no-activity" reports to be filed by covered officers and employees with the bank.

The regulation does not specify with whom the reports are to be filed, but positions appropriate to each bank's organizational structure, such as the internal auditor, ethics office, or corporate secretary would be appropriate. Whatever position is chosen, it must have sufficient authority to effect corrections.

The purpose of these reports is to provide the institution with a mechanism for

monitoring and identifying certain violations, conflicts of interest, self-dealing, violations of its own employee ethics code, and unethical actions. When properly monitored, the reports should aid in deterring and detecting the following personal investment transactions of covered bank investment insiders:

- fraudulent, deceptive and manipulative acts,
- improper use of material inside information, and
- other abusive practices.

The report should identify the individual who is filing the report, and identify and describe each transaction being reported. [Section 344.9(a)(3)] If the $10,000 per quarter transaction threshold for any covered individual is met, all transactions (other than those exempt from the reporting requirements) must be reported, not merely those in excess of $10,000 per quarter.

Reports must contain certain details of the transaction(s), including the date(s) of the transactions, the type of transaction (purchases, sales, etc.) and an identification of the securities purchased or sold. While not required by the regulation, certain additional information is helpful in describing the securities and the transaction(s). This information includes: (1) the number of shares or the principal dollar amount of each transaction, (2) the price at which the transaction was effected, and (3) the name of the broker, dealer, or bank with or through which the transaction was effected. The absence of this additional information, however, should neither be scheduled as a violation nor criticized.

While not covered by Part 344, the bank should review the reports filed and investigate any indications of potential violations, exceptions and unethical conduct. The following illustrate transactions that should be of concern to the bank:

- "front running" - A practice where an investment manager purchases securities for his/her own personal interest prior to an anticipated purchase of the same securities by the accounts for which he/she acts as investment manager. For example, the money manager may purchase securities for his/her personal account ahead of a purchase of the same securities by institutional accounts, since the purchase of a large block of securities could cause the price of the securities to increase.
- "insider trading" - transactions where an individual uses nonpublic material inside information (covered by the SEC's Rule 10b5-1), typically concerning the condition of a company or impending announcements (mergers, takeovers, profits/losses, new products, product recalls, etc.) which may materially affect the price of a company's stock, to benefit personally from investment transactions (refer also to Section 8. D. Material Public Information),
- "scalping" - trading for small gains over a short period of time, usually within a day. In some cases, this involves taking advantage of very narrow spreads in volatile markets. "Scalping" may be indicative of trading securities with advance knowledge of portfolio changes (particularly with respect to very large portfolios, usually the trust department's entire discretionary portfolio), or knowledge of material inside information.
- transactions with the institution's fiduciary accounts, and
- compliance with the provisions of the bank's code of ethics that restrict or otherwise require the reporting of securities trading by the bank's investment management staff for their personal benefit. Practices typically covered by an investment code of ethics include:
  - clearance in advance of personal trades;
  - delays of "x" period before buying or selling a security recently traded for discretionary trust accounts;
  - restrictions on short-term trading, such as requiring the holding

of a stock for a designated period of time before taking a profit, perhaps dependent on whether a security is held in discretionary trust portfolios or recent trades in such securities;
   - selling short or investing in options on stocks, bonds and commodities held in trust accounts;
   - prohibitions against purchases of initial public offerings (IPOs), which are often hard to get and may be easily "flipped" for a quick profit; and
   - improper placement of personal investment transactions through the institution's brokerage accounts.

Examiners should not only ascertain that the required policies exist and the reports are filed, but also that the reports are reviewed by an appropriate bank official and that adequate follow-up action is taken as warranted.

If a bank acts as investment advisor to a mutual fund, the bank must also comply with SEC Rule 17j-1, as promulgated under the Investment Company Act of 1940 [17 CFR Section 270.17j-1], in addition to Part 344. Rule 17j-1 generally requires the same quarterly disclosures as Part 344, except:

- All transactions must be reported; there is no $10,000 filing threshold;
- Directors are covered by the report, as they are considered "access persons" under the SEC rule; and
- The reports must be covered in the mutual fund's code of ethics . [Note that a model code of ethics has been prepared by the Investment Company Institute]

K . Compliance with SEC Requirements

Securities and transactions in securities are largely governed by Federal law. The following discussion addresses some important aspects of securities regulation which are relevant to trust departments. Special reports or notices may need to be filed in those accounts holding equity securities which are registered under Federal securities laws. These requirements may apply to the trust department as a whole, to individual trust accounts, and to individual transactions. Others apply to the selection of brokers, the placement of brokerage transactions, and mutual fund 12b-1 fees.

K .1. Marketable Securities

Section 12 of the Securities and Exchange Act of 1934 (Act) required that equity securities (common stock) issued by corporations with 500 or more shareholders and $1 million or more in assets be registered in order to be traded on a national securities exchange. The SEC's Rule 12g-1 (17 CFR 240.12g-1), which was issued subsequent to Section 12, increased the asset size threshold to $10 million in total assets.

FDIC Part 335 implements the law governing stock issued by FDIC-supervised banks. This regulation incorporates the SEC's asset size threshold of $10 million.

The following list recaps various requirements involving equity securities. A more extensive discussion of each requirement is included after the listing. When applicable, examiners should verify compliance with the requirements.

- If the bank controls more than 5 percent of a registered company's outstanding stock, it must file notices under Section 13 of the Securities Exchange Act of 1934. Refer to the discussion in K.1.a. below, under the caption 13D and 13G, Acquisition Statements for Registered Equity Securities.
- If the bank has discretion over $100 million or more in stocks and convertible bonds, it must file quarterly 13F reports under SEC regulations. Refer to the discussion under Quarterly SEC 13F Equity reports in K.1.b. below.
- If a "person" controls 10 percent or more of a registered company's outstanding stock, a filing under Section 16 of the Securities Exchange Act of 1934 may be required. Refer to K.1.c. below.
- SEC Rule 144 governs the sale of restricted securities. Refer to K .2 below.

NOTE : Examiners may search the SEC EDGAR database to determine whether a bank (or anyone or entity) has submitted any required filing with the SEC at the following internet

site: http://www.sec.gov/edgar/searchedgar/webusers.htm

K.1.a. Acquisition Statements for Registered Equity Securities - SEC 13(d) and SEC 13(g)

As with any investor, bank trust departments must file Acquisition Statements when required by Federal securities law. Acquisition statements are required only for equity securities and are required only under certain circumstances.

Section 13(d)(1) of the Securities Exchange Act of 1934 (Act) requires that persons holding a "beneficial ownership" in certain types of equity securities file a notice ("acquisition statement") with the SEC when such "beneficial ownership" exceeds 5 percent of the total outstanding shares of a covered equity security. Two types of notices are involved, more generally referred to as Schedules 13D and 13G under Federal securities law. Schedule 13G imposes similar, but less burdensome, requirements than Schedule 13D. Refer to the discussion of "beneficial ownership" below.

Purchasers of equity securities issued by entities (including national and state member banks, thrifts and bank holding companies) that are not FDIC-supervised state nonmember banks follow SEC requirements. SEC Rule 13d-1 (17 CFR 240.13d-1) implements Sections 13(d)(1) and 13(g)(1) of the Act regarding acquisition statements.

Purchasers of equity securities issued by nonmember banks and registered under Part 335 of FDIC's Rules and Regulations must follow requirements equivalent to those in Section 13 of the Act. FDIC Section 335.331 requires compliance with SEC Sections 13(d) and 13(e) of the Exchange Act. FDIC acquisition statements are the same as the acquisition statements required by the Securities Exchange Act of 1934.

Beneficial Ownership

For bank trust departments, "beneficial ownership" involves the department's total holdings of any covered equity security where the bank: (1) has investment discretion over more than 5 percent of the total outstanding shares, or (2) has voting authority over more than 5 percent of the total outstanding shares. Note: "beneficial ownership" is defined in SEC Rule 13d-3 [17 CFR 240.13d-3].

It is important to note that the 5 percent threshold may be exceeded by the bank in its fiduciary capacity if it possesses any vestige of discretionary investment power or voting power. Neither of these powers must actually be exercised by the fiduciary. In fact such powers could be delegated to another interested party. If the bank as fiduciary has the authority to exercise either of these powers and has such powers over an aggregate exceeding 5 percent of a registered equity security, it must file the acquisition statements.

From the above, it is clear that such conditions are not met by:
(1) nondiscretionary accounts where the bank has no voting authority or no investment authority, (2) custodial accounts, or (3) investment advisory accounts where the bank acts as custodian and does not manage the assets.

13D Acquisition Statements

13D filings are transaction-based reports that, typically, will not apply to trust departments. They are filed primarily when stock is being accumulated to obtain a controlling interest. Most trust department holdings are of a passive investment nature.

When a transaction occurs resulting in the control of a covered equity security in excess of the 5 percent beneficial ownership threshold, a 13D filing is required. Every time the beneficial ownership changes one percent or more, the change is considered a material change, and an amended 13D filing is required. A 13D Acquisition Statement must be filed within 10 days with:
(1) the issuer of the security by certified or registered mail, (2) each exchange where the security is traded, and (3) the SEC or the primary Federal bank

regulator for publicly held bank securities.

More than one 13D filing may be required.

Example:

> On July 1st, a trust department's beneficial ownership holdings of ABC Company's registered stock increases to greater than 5 percent of the outstanding stock. The 5 percent threshold has been exceeded and, therefore, a 13D filing is generally required.
>
> On September 15, the department's beneficial ownership holdings decrease by less than 1 percent, resulting in an assumed 5.5 percent position. Generally, no filing is required because no material change in ownership has occurred.
>
> On November 15th the department's holdings rise again, this time exceeding 8 percent of outstanding stock. An amendment to Schedule 13D is required because a material change of ownership of outstanding stock has occurred since its previous filing.

13G Abbreviated Statements

13G filings are year-end reports of equity security holdings that often apply to trust departments. If the securities are not held for the purpose of exercising control (or as part of a related transaction, such as a takeover), but rather are for passive investment purposes, a short-form Schedule 13G may be filed instead of the 13D. The same 5 percent threshold must be exceeded, but it is applied only as of the calendar year-end. A Schedule 13G must be filed by February 14 of the following calendar year-end with the same entities as a Schedule 13D.

If there is no change from one year end to the next, no new 13G filing is required. However, if there is any change from one year-end to the next, a new 13G filing would be required. If there is a change of agency (e.g., due to a change from FDIC-registered bank stock to SEC-registered holding company stock), a new 13G filing would be required, even if there had been no change in beneficial ownership from one year-end to the next.

K.1.b. Reports of Equity Holdings - SEC 13F

This report applies to institutional investors, including trust departments, that exercise investment discretion over $100 million or more of equity securities (or securities convertible into stock).

SEC Rule 13f-1 securities include equities "traded on a national securities exchange or quoted on the automated quotation system of a registered securities association" [e.g., NASDAQ - ed.]. The Rule also states that filers may rely on the most recent SEC-released list of all required 13F securities.

Reports are filed with the SEC using the format of SEC Form 13F, which is required by SEC Regulation 240.13f-1 (Rule 13f-1). A sample 13F form is shown in SEC Regulation 249.325.

For each security held, the report: identifies the issuer, gives the CUSIP Number, and shows the market value and number of shares held. The number of shares reported is then broken down into two categories: investment discretion and voting authority. Under each category, the number of shares is further divided into three categories: sole authority, shared authority, and "other" discretionary authority.

Both the SEC Rule and Section 13f-1 of the Securities Exchange Act of 1934 require that copies of reports covering banks be filed with the primary Federal banking regulator. Thus, state nonmember banks filing individually must provide the FDIC with a copy of their 13F reports, as must holding companies whose 13F reports include the securities holdings of state nonmember banks.

SEC Rule 13f-1 and a copy of a printed Form 13F are in the FDIC's Rules and Regulations service in Volume III under the Miscellaneous Statutes and Regulations tab. The SEC's Division of Investment Management has issued a publication "Frequently Asked Question About Form 13F", which can be accessed on the internet at http://www.sec.gov . O nce in the website, go to Divisions, Investment Management, Frequently Asked Questions about 13f. The website cannot be accessed directly.

K.1.c. Section 16 Statements for 10 percent or More Holders of Registered Stocks

» Not Applicable to Trust Departments «

Section 16(a) of the Securities Exchange Act of 1934 generally requires that certain filings be made with the SEC for "persons" that have 10 percent or more "beneficial ownership" in stocks that are registered under Federal securities laws. The Act is implemented by SEC Rule 16a-3.

In a no-action letter to CS Holding (January 16, 1992), however, the SEC indicated that bank trust departments will not be deemed to be beneficial owners "of securities held for the benefit of third parties or in customer or fiduciary accounts where such securities are held in the ordinary course of business without the purpose or effect of changing or influencing control of the issuer."

K.2. Restricted Equity Securities - SEC Rule 144

In general, as promulgated under Section 4 of the Securities Act of 1933, Rule 144 (SEC regulation 230.144) provides that in order for securities to be sold without a formal registration:

- the securities must have been beneficially owned for at least two years,
- the number of shares sold in any three-month period must not exceed the greater of 1 percent of the total outstanding securities of the same class, or the average weekly trading volume for the class of securities during the four-week period preceding the sale, and
- the securities must be sold either in a broker's transaction or in transactions directly with a market maker.

In addition, adequate information regarding the issuer must be available to the public and a Notice of Sale (Form 144) must be filed with the SEC. No report to the SEC is required if less than 500 shares are sold in any three-month period and the sales price does not exceed $10,000..

On February 20, 1997, the SEC issued Release No. 33-7390, which amended Rule 144 to reduce the holding periods for restricted securities (i.e., those securities issued in private placements under certain conditions) that are covered by Rule 144. Effective April 29, 1997:

- the holding period requirement applicable to the resale of limited amounts of such restricted securities by any person will be reduced from two years to one year, and
- the holding period applicable to the resale of unlimited amounts of restricted securities held by non-affiliates is reduced from three years to two years.

Regulation S provides both an issuer-distributor safe harbor (Rule 903) and a resale safe harbor (Rule 904) for offshore sales of securities. To qualify for either safe harbor, Regulation S requires that: (i) the offer or sale must be made in an "offshore transaction" and (ii) the offer or sale must not involve any "directed selling efforts" in the United States. "Offshore transaction" is defined in Rule 902(h)(1)(i) as those in which an offer is not made to a person in the United States, and (ii) either the buyer must be outside the United States (or the seller must reasonably believe that the buyer is) or the transaction is executed, for purposes of Rule 903, on or through a physical trading floor of an established foreign securities exchange, or for purposes of Rule 904, in, on or through the facilities of a "designated offshore securities market," which is either one of an enumerated list of foreign securities exchanges or one that meets a set of criteria set forth in Rule 902. "Directed selling efforts" is defined in Rule 902(c) to include those that are "undertaken for the

purpose of, or that could be reasonably expected to have the effect of, conditioning the market in the United States" for the related securities (e.g., widespread advertising).

K.3. Electronic Submission of Forms and Notices

Since 1999, many forms, notices, and reports filed under various securities laws and regulations must be filed electronically:

- Under SEC Regulation S-T (17 CFR 231.10 - .601) the SEC requires the electronic submission of all reports, statements, and schedules filed pursuant to:
  - Sections 12(b) and 12(g) of the Securities Exchange Act of 1934;
  - the Trust Indenture Act of 1939 (other than applications for exemptive relief filed pursuant to section 304 and section 310 of that Act);
  - Sections 13, 14, and 15(d) of the Securities Exchange Act of 1934;
  - Sections 8, 17, 20, 23(c), 24(e), 24(f), and 30 of the Investment Company Act of 1940; and
  - the Public Utility Act.

The rule also permits, but does not require, the electronic filing of Form 144, where the issuer of the securities is subject to 13 or 15(d) of the Exchange Act. Otherwise, Form 144 should be filed in paper format. However, some notices are required to be submitted in paper copy only, including, but not limited to: filings pursuant to Regulations A, D, and E; Form F6; and annual reports required by section 313 of the Trust Indenture Act of 1939.

- "Temporary Hardship Exemption" hardcopy filings are permitted under Regulation S-T (Rule 201), for unanticipated technical difficulties. "Continuing Hardship Exemption" hardcopy filings are also permitted under Regulation S-T (Rule 202), if the filings cannot be submitted electronically without "undue burden and expense."
- Under the revised reporting requirements of **17 CFR 249 . 325**, banks which electronically submit Form 13F may submit a copy of the form to their banking agencies either: (a) in hardcopy; or (b) electronically, if the agency is capable of receiving the filings in electronic format (the FDIC currently receives this form in hardcopy).

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Section 4 - Compliance/Account Administration - Personal and Charitable Accounts

Table of Contents

The services discussed below are commonly offered by the majority of trust departments and the duties described are typical. The duties associated with the various fiduciary capacities described vary from state to state. For this reason, they are described in general terms. In order to gain a more complete understanding of the scope of the duties and responsibilities of a given fiduciary capacity examiners should be familiar with applicable state statutes.

This section of the Manual is organized into the following parts:

A. General Overview

1. Policy Guidelines
2. Account Administration Considerations
3. Legal Considerations/Applicable Law and Regulations

B. Types of product lines

C. Types of accounts and fiduciary capacities

1. Court Supervised Accounts
   a. Estates
   b. Guardianships
2. Personal Trusts
   a. Trustee Under Will
   b. Trustee Under Agreement or by Declaration
   c. Trustee by Order of The Court
3. Charitable Trusts
   a. Internal Revenue Code Concepts
   b. Charitable Lead Trust
   c. Charitable Remainder Trusts
   d. Pooled Income Fund
   e. Charitable Contribution "Clifford Trusts" for Banks
4. Agencies

a. Custodian

b. Escrow Agent

c. Trustee for Land Trusts or Real Estate Trusts

d. "Qualified Intermediary" for 1031 Exchange or "Like Kind Property Exchange"

e. Investment Advisory Agent

f. Managing Agent

g. Farm Management Agent

h. Attorney-in-Fact Pursuant to an Executed Power of Attorney

i. Safekeeping Agent

D. Additional fiduciary capacities

1. Co-Fiduciaries

2. Successor Trusteeships

E. Asset Protection Trusts

A. General Overview

The proper and efficient administration of personal and charitable trust and agency accounts requires the establishment and implementation of policies and procedures, a system to monitor compliance therewith, and prompt correction of nonconformance.

The knowledge and expertise of management and operational staff; active involvement by the board of directors acting through a trust committee, and possibly through subcommittees; and adequate policies and effective procedures, coupled with systems for monitoring and ensuring compliance therewith; form the core of a risk management system designed to monitor, measure, and manage the various risks inherent in the administration of personal and charitable accounts.

Note: Unless specifically indicated otherwise, the term "personal trust" refers to court supervised accounts, personal trust accounts and personal agency accounts.

A.1. Policy Guidelines

The breath and depth found in an institution's policies and procedures depend upon the types, size, and complexity of accounts administered. Most policies, however, include the following elements:

- Account Acceptance Guidelines - Guidelines for the acceptance of accounts establishes limits on the type of fiduciary accounts that will be accepted. In establishing these guidelines, management should consider in establishing these guidelines are the level of expertise and experience available, either in-house or through third-party arrangements. It should also identify circumstances that may render the administration of an account overly complex or risky, such as unique or difficult-to-administer assets or ambiguous or complex terms in the governing document.

As such, an appropriate Account Acceptance Policy, coupled with an adequate pre-acceptance review process, is a fundamental element in an institution's risk management process. One of the most effective methods of limiting the risk inherent in fiduciary operations is to decline appointments for which the institution lacks appropriate

qualifications or that present heightened administration or compliance risks. For example, a policy may, within given limits, permit the acceptance of personal trust and investment agency accounts, but state that charitable trusts and insurance trusts should not be accepted. The policy may, however, provide for exception and establish a review process necessary to accept an appointment that would otherwise be contrary to policy. All such exceptions should be approved by the trust committee, or other duly appointed subcommittee thereof.

- Account Termination (or Closing) Guidelines - These guidelines ensure that upon terminating an account, the institution has adequately completed all of its administrative duties and responsibilities. The guidelines should identify all documentation required to close the account and include a process whereby account administration will be reviewed so that no outstanding administrative concerns remain unresolved. Often, an institution will develop checklists to ensure that all necessary items have been adequately addressed prior to closing the account. The lack of, or flawed, account closing procedures could result in future litigation.

- Fiduciary Appointments - These guidelines describe the types of fiduciary appointments (e.g. trusteeships, guardianships, successor trusteeships, co-fiduciary appointments, etc.) that an institution will accept. The guidelines may be included in account acceptance guidelines, if not addressed in a separate policy.

- Documentation Guidelines - These guidelines identify the documentation required to be maintained for each type of account accepted. For less complex accounts, the guidelines may briefly refer to administrative issues and approved checklists. Since a fiduciary must be able to demonstrate the appropriateness and prudence of its account administration, an institution's documentation guidelines must require the maintenance of original governing agreements, or working copies thereof, documentation evidencing fiduciary appointment, synoptic records, legal documents, etc.

- Account Review Guidelines - These guidelines communicate the Board's evaluation of the risk characteristics of various types of accounts by designating the depth and level of review. Accounts having a greater degree of complexity or risk may require an individual review performed at the trust committee level, whereas homogeneous accounts posing a relatively lower level of risk may be reviewed in groups at a lower management level. In any event, an institution's account review guidelines should ensure that each account is reviewed at least once during each calendar year. The FDIC's Statement of Policy of Trust Department Management requires an annual review for all accounts, even those that do not involve investment decisions.

A.2. Account Administration Considerations

It is the fundamental duty of a fiduciary to administer an account solely in the interest of the beneficiaries without permitting the interests of the trustee, or any third parties, to conflict in any manner. The duty of loyalty is of paramount importance, and is the cornerstone of all fiduciary appointments. The successful administration of an account must meet the needs of the beneficiaries in a safe and productive manner and equitably balance the interests of each beneficiary. This is true for any account administered. Therefore, a satisfactory account administration program ensures that accounts comply with applicable laws and the governing agreement. Such a program follows fundamental concepts of management and includes the following:

- Assignment of accounts to a specific officer. In larger departments two officers may be assigned: an administrative officer and an investment officer. This allows for the assignment of accountability for the various aspects of account administration.

- The intent of the testator, settlor, or principal must be clearly understood by the account officer(s). This ensures the identification and fulfillment of the purposes and objections of an account.

- Identification of any restrictive language, such as exculpatory language, provisions governing the invasion of principal, or spendthrift clauses.

- Adherence to the investment provisions, including restrictions, contained in the

governing agreement. This affords the income beneficiary and the remainderman or principal beneficiary, respectively, of an level of income or capital appreciation consistent with the intent of the creator of the trust.

A.3. Legal Considerations/Applicable Law and Regulations

Both common law and civil law (Federal, state and local statutes and regulations) govern trust activities. There are laws that apply to fiduciary activity in general, to specific fiduciary functions (trustee, conservator, guardian, agencies, etc.), and to the specific type of property under administration (securities, real estate, etc.)

A.3.a. Common Law/Fiduciary Principles

The body of common law is much more voluminous and detailed than civil law. Therefore, management should have at least a general familiarity with some of the more widely known common law authorities such as Scott, Bogert, and the Restatement of the Law of Trusts. Each of these sources provides insight into the general fiduciary principles that should be followed in the administration of personal and charitable trusts. The following are some of the more important duties of a trustee that originated out of common law:

- A trustee owes a duty of loyalty to administer trust affairs solely for the benefit of the beneficiaries. The thrust of this duty is to avoid conflicts of interest that would enrich or provide an advantage to the trust administrator at the expense of the beneficiary.

- A trustee must exercise the skill and prudence, as a person of ordinary prudence would exercise in managing his own property. Trust managers who represent themselves as having expertise will be held to that level of expertise.

- A trustee may not delegate the administration of the trust or the performance of acts that the trustee should personally perform. It should be noted that the trust agreement or state law may permit certain delegations. However, the determination of whether a delegation is appropriate is contingent upon whether the act requires professional skills or abilities not possessed by the trustee. For example, trustees can employ accountants, attorneys, and other professionals, when those qualifications or abilities are lacking in the trust department. Furthermore, a breach of trust for not delegating duties may occur when certain qualifications are necessary, but are not possessed or obtained through other sources. Refer to the Prudent Man Rule in Appendix C for additional information.

- A trustee must keep and render accurate accounts. The accountings should reflect receipts and disbursements, gains and losses on investments, and other transactions affecting the account. Such records are also necessary for completion of tax returns. Usually, the state law requirements apply to testamentary trusts or court-appointments and call for accountings to the court at specific intervals. If the trustee fails to keep accurate records, the court may take actions, up to and including removal of the trustee. Also, a beneficiary may request an account statement from the trustee, as deemed necessary. Most trust departments provide at least quarterly statements to accountholders, but not beneficiaries.

- The trustee must provide information to the beneficiary that will protect his rights or that would be viewed as important by the beneficiary.

- A trustee has a duty to keep trust property separate from his own property and should not commingle trust property with that of other trust accounts. Trust property should be clearly earmarked. The purpose behind this duty is to provide an audit trail, to prevent the trust's assets from being attached by the trustee's creditors, and to prevent fraudulent use. This duty does not preclude a trust manager

from using mutual funds or other pooled investment vehicles.

- A trustee must take title to all titled or certificated assets and secure documents representing intangible assets upon becoming trustee.
- A trustee must make the trust productive and must invest the trust assets for income or increase in market value. Uninvested cash (other than held for distribution or reinvestment) held for periods of time, may be evidence of negligence by the trustee.
- A trustee must comply with all provisions of the trust instrument, including those regarding distributions to or for beneficiaries. The trustee must exercise care to ensure that distributions are made in an accurate and timely manner.
- A trustee must deal impartially with beneficiaries. An equitable balance must be made between the income beneficiaries and principal beneficiaries (remaindermen).
- The trustee must work with persons holding power and control, such as state courts, local taxing authorities, property managers, etc. One task related to this duty is the voting of proxies.
- A trustee has an obligation to work with and exercise skill in communicating with co-trustees. A co-trustee must be especially wary of acting unilaterally, or conversely, being indifferent toward the actions of the other trustee.
- A trustee has a duty to defend against claims involving trust assets or the validity of the trust. It is imperative that fiduciaries have access to legal advice as questions arise and whenever a claim is made.
- The trustee must preserve and protect the property of the trust. In practice, this means obtaining and maintaining insurance, ensuring that deeds, mortgages and titles are properly recorded, and depositing funds within the FDIC deposit insurance limitations. Trustees must maintain buildings, vehicles, and equipment in good condition to prevent deterioration.

Examiners should not cite "violations" of common law (equity). Noncompliance with certain principles of equity would normally be treated as another criticism with reference to "generally accepted trust practices", rather than a statutory violation. Noncompliance with common law may involve a substantial exposure to liability and loss.

Trust companies will attempt to limit exposure to liability and loss by inserting **exculpatory clauses** into the trust instrument. These clauses usually seek to limit liability to severe breaches of trust, such as negligence, bad faith, or willful misconduct, and not for every failure to use ordinary skill and ability. The courts have afforded fiduciaries only limited protection from lawsuits against fiduciaries employing these clauses. Since a trustee purports to have specialized fiduciary skills, courts do not appreciate a defense claiming only ordinary care and skill was utilized. Additionally, the fact that the trustee often demands the insertion of this clause could be construed as conflicting with the fiduciary's duty of loyalty to his client. Clauses which limit losses resulting from a co-trustee's own actions or property under his control, exclusive of the other co-trustee, usually have similar limited effectiveness.

Civil courts have provided several remedies for failure of fiduciaries to properly exercise their obligations. These remedies include setting aside inappropriate transactions, enjoining a disloyal act, monetary damages, forfeiture of fees or interest or nullifying a sale and ordering a re-sale of property. Courts have removed trustees where there were egregious instances of improper administration of trust agreements. Examples of circumstances where a trust could be found liable follow:

In the event of an improper transaction, such as a sale of assets from a trustee to a trust, or an inter-account transaction, a beneficiary will often be given a choice of either affirming the transaction, setting aside the sale, or taking the profit resulting from the sale. It is the burden of the trustee to prove that any transaction is fair to all parties.

The failure to adequately defend the trust from attack could result in financial liability. Such attacks may derive from creditors seeking to attach the assets of the trust, a lawsuit challenging the validity of the trust, or attempts to prematurely terminate the trust. Fiduciaries have been found liable for failure to appeal a court case where the trust was held liable. Expenses from a successful court challenge can be paid from the trust; frequently, an unsuccessful challenge can be defended using trust assets if the defense was encouraged by the beneficiary.

A failure by a trustee to act promptly and competently in receiving and maintaining trust assets could result in whatever loss ensues. For example, failure to ensure trust property could result in the trust being held liable in the event of storm damage or theft. Additionally, unwarranted delays by a successor trustee in obtaining financial assets could result in liability if these assets declined in value during the delays.

Co-mingling the assets of the trust with the assets of the trustee or another trust could result in significant liability. Should a trustee be unable to trace the source of assets, the trustee may be held liable for damages or a court may conclude that all the co-mingled assets are those of the trust.

The failure to make trust assets productive also produces liability exposure. A trustee that does not promptly invest cash, that deposits funds in excess of FDIC insurance coverage, or that does not make necessary changes in investments received, could cause significant liability.

Examiners are not expected to render a legal opinion as to equity matters involved in the administration of personal trusts. However, the examiner should discuss the facts of an apparent violation of a common law principle or of the trust instrument itself, and extend contingent liabilities as necessary. In complex and significant matters, the bank's legal counsel may provide a legal opinion concerning the matter.

A.3.b. Federal Statutes

The administration of personal trusts, including charitable trusts, is subject to federal statutes. A fiduciary is subject to Federal laws in the same manner as any individual or business owning or dealing with property. The violation of Federal statute is typically described in the report of examination. Examples of Federal laws and regulations with which a fiduciary must comply include: Federal securities laws; consumer protection laws; the Federal Reserve Act and implementing regulations; fair credit laws; U.S. Treasury regulations; the Internal Revenue Code, etc. Violations may result from the activities of a trustee or other fiduciary or apply by reason of the type of property held and/or administered by the fiduciary.

A.3.c. State Statutes

State financial or banking codes include laws governing banks, trust companies, and similar institutions. A growing number of states have adopted various uniform statutes that apply directly or indirectly to the conduct of trust activities. States adopting uniform statutes often modify them. Therefore, management should be familiar with the text of their respective state law. Below are some of the more common uniform codes.

- Uniform Prudent Investor Act - The Uniform Prudent Investor Act establishes "modern portfolio theory" as the standard for the management of trust assets, rather than focusing on the prudence of individual investments, as is the case with the Prudent Man Rule.

Uniform Prudent Investor Act permits the delegation of investment and management functions, subject to safeguards. The text of the Uniform Prudent Investor Act and comments is found in Appendix C.

- Uniform Trust Code - The act comprises a comprehensive codification of trust law. However, many states have modified major portions relating to the rule of perpetuities, and asset protection trusts. See Asset Protection Trusts in this chapter.

- Uniform Probate Code - The act simplifies and clarifies the law concerning the affairs of decedents, missing persons, protected persons, minors, and incapacitated persons. The code is designed to promote a speedy and efficient system for liquidating the estate of a decedent and distributing estate assets to the designated heirs, facilitating the use and enforcing certain trusts, and providing a uniform law among various jurisdictions.

- Uniform Principal and Income Act (UPIA) - The UPIA provides guidance to fiduciaries regarding the allocation of assets between principal and income. This allocation is very important when the trustee must consider the interests of both an income beneficiary and a remainderman in administrating a trust or estate. The UPIA is a default statute that only operates when the governing instrument is silent. The UPIA provides guidance to the fiduciary when the settlor grants discretion to the trustee or when the trust agreement is silent as to the allocation. Therefore, a settlor may direct the allocation of principal and income in any manner in a revocable trust. The UPIA was originally written in 1931 and was revised in 1962. Another revision, endorsed by the American Bar Association, was drafted in 1997. It is now being recommended for enactment in all states. The recent revision has two main purposes. First, a general revision was necessary to bring the act up to date. Second, the rules for allocating income and principal was updated to address the principles of modern portfolio theory. The 1997 UPIA amends existing rules (it expands the definition of receipts from an entity, provides for uniform treatment of corporate distributions and when an investment in an entity is liquidated, and modifies the treatment of receipts from the exploitation of natural resources, etc.) and establishes rules for asset types (derivatives, asset-based securities, etc.) not mentioned in the prior UPIA. A copy of the 1962 UPIA and 1997 UPIA are found in Appendix C. Please refer to the discussion in Section 3.

- Uniform Fraudulent Transfer Act (UFTA) - The UFTA is designed to prevent fraudulent transfers which occur when a debtor intends to hinder, delay, or defraud a creditor, or transfers proceeds under certain conditions to another person without receiving reasonable equivalent value in return. Included within the law are the "Badges of Fraud", which aid in determining whether the debtor had actual intent to defraud. See www.FraudulentTransfers.com.

- Uniform Gifts to Minors Act (UGMA) - The UGMA allows an adult to contribute to a custodial account in a minor's name without having to establish a trust or name a legal guardian for the transfer of property to a minor.

- Uniform Simultaneous Death Act (USDA) - The purpose of the USDA is to establish priority of death in the case of simultaneous deaths. The priority affects the distribution of a decedent's assets.

The text of these and other uniform acts is also available at the Internet site of the National Conference of Commissioners of Uniform State Laws http://www.nccusl.org/nccusl/DesktopDefault.aspx

State laws that apply to classes of property also are relevant. For example,

real property held as an asset of a trust or estate would be subject to state real property laws, while some states have intangible taxes on monetary assets.

B. Types of Product Lines

The volume and type of personal trust accounts can be segregated into three broad product lines; trusts, estates (including guardianships), and agencies. An important distinction is made between those accounts for which the institution has investment discretion, and those for which it does not. The relationships may be further categorized by the specific capacity in which the institution serves, the purpose of a particular type of account, and/or other unique features of an account. Personal trust accounts can also be segregated into those accounts subject to supervision by a court and those that are not.

C. Types of Accounts and Fiduciary Capacities

C.1. Court Supervised Accounts

The administration of estates and guardianships is supervised by an appropriate court, referred to in various jurisdictions as probate, chancery, or surrogate court. Judicial supervision is intended to protect the interests of minors, incompetents, unknowns, and the deceased. The court formally appoints the fiduciary (even though perhaps "nominated" by the will), and reviews and approves all acts of the fiduciary. The fiduciary typically must periodically provide the court with "accountings" of the fiduciary's activities in administering the account.

C.1.a. Estates

In an estate, the trust department, as either executor or administrator, is responsible for a decedent's assets from the time of formal appointment by an appropriate court until the estate's final settlement is approved by the court. A fiduciary is not responsible for events prior to its appointment. However, once appointed, the trust department, as executor or administrator, is responsible for protecting the estate's assets, and is held responsible for neglectful or delayed administration. All acts in the administration of an estate are reported to, and subject to approval by, an appropriate court. The department's duties and responsibilities are dictated by the decedent's will and by state and common law.

The primary duties of an executor, or administrator cum testamento annexo (c.t.a.), include the following:

- assembling of decedent's assets;
- preparation of an inventory of all assets of the deceased;
- taking control or custody of such assets;
- orderly conversion of certain assets "in kind";
- payment of administration costs, taxes (including Federal estate and/or state inheritance taxes), and all other legal claims against the estate;
- distribution of the net estate in accordance with the terms of the will; and
- filing of a final accounting with the court of competent jurisdiction, if required.

Probate procedures may also require interim accountings, but this varies between states. The duties of an administrator are essentially the same as for an executor or administrator c.t.a., but are dependent upon the intestacy laws of individual states.

Generally, the trust department will act in one of the following capacities:

C.1.a.(1). Executor

An executor, whether an individual or an institution, is nominated in a will by

the maker (testator) to settle an estate and to perform in any other manner described in the will. Before a bank acts as executor, it must have the will accepted by a court of competent jurisdiction as the valid and final will of the deceased. The court will then issue written authority to serve as executor, often termed Letters Testamentary.

C.1.a.(2). Administrator

An administrator is appointed by the court to settle the estate of a person who died leaving no valid will. Without a will, the administrator must carry out its functions solely in accordance with state intestacy laws. Written authority, often termed Letters of Administration, must be received from the court to serve as administrator of an estate.

C.1.a.(3). Administrator cum testamento annexo (c.t.a.)

The court appoints an administrator c.t.a. (i.e., with the will annexed) when there is no executor named in the will, or when the executor named is unable or unwilling to serve. As with an executor, the will must be accepted by a court of competent jurisdiction, and the administrator c.t.a. must receive written authorization to settle the estate. Settlement of the estate is made in accordance with the terms of the will. When an executor or an administrator c.t.a. dies or is removed before completing the settlement of the estate, the substitute fiduciary is known as an administrator c.t.a., d.b.n. (de bonis non) (i.e., administrator with the will annexed for assets not yet distributed).

C.1.a.(4). Ancillary Administrator

Ancillary administration may be necessary if an estate contains property in a state or jurisdiction (foreign country) other than the decedent's domicile at the time of death. The ancillary administrator represents the estate on all matters within the alternate jurisdiction. Typically, performance in this capacity involves the handling of real property when an estate contains property in another state.

C.1.b. Guardianships

A guardian is an individual or institution appointed by a court to care for the property and/or the person (referred to as the "Ward") of a minor, an incompetent, a spendthrift, or other incapacitated person. The powers and responsibilities of the guardian are governed by the provisions of state statutes and court decisions. Investment limitations are often delineated by statute and any exceptions require court approval. The guardian's duties may be limited to the property (guardian of the estate), the person (guardian of the person), or both (guardian). Banks generally will serve only in the capacity of guardian of the estate and many states prohibit a bank from serving as the guardian of a person.

Under a guardianship, the ward is the beneficial owner of property. A guardian is an agent of the court and has no legal or equitable title to the ward's property. The guardian of a minor receives, holds and manages the property, renders accountings to the court and makes a final settlement with the minor when he becomes of age. A guardian for an incompetent or absentee performs the above duties as long as the incompetency or absenteeism lasts. Such words as committee, conservator, curator and tutor are used in various states to describe particular types of guardianships.

Obligations of a guardian include:

- Protect and preserve the assets;
- Submit an inventory and appraisal to the court;
- Retain or reinvest assets as advised by the court, or as permitted under state law;
- Use income and principal to meet the needs of the ward; and

Submit accountings (usually annually) to the court.

C.2. Personal Trusts

A trust is a fiduciary relationship by which legal title to property is held by one person or corporation for the benefit of another. In trust relationships, the trustee has the responsibility of ownership and holds legal title to the trust property, while the beneficiary enjoys the benefit of ownership and holds equitable title.

Personal trusts can be broadly classified as either testamentary (also known as trust under will), or living (also known as inter vivos or trust under agreement). Trusts can further be classified as revocable or irrevocable. In a revocable trust, the settlor retains the right to change or terminate the trust at any time and does not relinquish control over the assets held in a revocable trust. Therefore, under Federal estate tax law, those assets are considered owned by the grantor. Furthermore, the revocable trust is not a public record, and assets transferred to beneficiaries via a revocable trust remain a private transaction. For irrevocable trusts, the trust cannot be modified or revoked by the settlor; however, the instrument may provide that a designated person can modify or terminate the trust. The settlor of an irrevocable trust relinquishes control over the assets and is, therefore, those assets are not subject to estate taxes. An irrevocable trust may be amended or revoked under specific circumstances. For example, one state supreme court held that a person who is both a settlor and sole beneficiary of an inter vivos trust may revoke the trust when the agreement specifically provides that the trust is irrevocable. As with the revocable trust, assets transferred to beneficiaries remain a private transaction. Under common law, if the instrument is silent regarding revocation, the trust is assumed to be irrevocable.

Fiduciary powers and duties should be clearly defined in the trust agreement. A lack of definition may cause uncertainty, impair investment performance, and prevent the trustee from taking actions in the best interests of the beneficiaries. In the absence of clearly defined provisions, state statutes also contain a list of the trustee's powers and duties. The general responsibilities of the trustee include:

- Preservation of the assets composing the trust;
- Management of assets to provide income;
- Distribution of income to designated beneficiaries;
- Accounting for all actions; and
- Dealing with interested parties.

The administration of personal trust accounts is primarily controlled by the terms of the governing instrument. State statutes and common law technically govern only when the instrument is silent or the provisions violate public policy. Refer to the discussion of Account Administration Considerations.

The fiduciary capacity under which personal trusts are administered is generally that of trustee under will, trustee under agreement, trustee by declaration, or in some circumstances, trustee by order of the court.

C.2.a. Trustee Under Will

A trust under will (testamentary trust) is created when the decedent's will bequeaths property to be held in trust for the benefit of a person, corporation, or charitable organization. The trustee receives the property from the executor or administrator and administers the assets for the beneficiaries. A probate court usually has jurisdiction over a testamentary trust. When the will is probated, the trust included in the will becomes a public record. Frequently, the bank may first serve as executor (or administrator c.t.a.), and then follow as trustee if the will establishes a trust, and the court permits by necessary appointment.

Common types of testamentary trusts used by modern estate planners include: the marital deduction trust and non-marital (a.k.a. bypass trust, credit shelter, or exemption-equivalent) trust. These two are frequently used in conjunction with one another, and are sometimes referred to as "a-b" trusts.

Another is the QTIP (Qualified Terminable Interest Property) trust. Testamentary "support", "education", and "health and welfare" trusts for spouses, children, and grandchildren, are also common. Other types of trusts may also be encountered. In each instance, the successful administration, and supervisory review of such administration, requires an understanding of the objectives of the trust, as well as the specific language of the trust instrument.

C.2.b. Trustee Under Agreement or by Declaration

A trust under agreement (living or inter vivos trust) comes into existence when the creator of the trust enters into an agreement or contract with the trustee setting out the terms of the trust. A trust by declaration is created upon declaration by one person to be trustee of property for the benefit of someone else. The trustee's duties are set out in the agreement or declaration and may include a wide range of responsibilities. The creator may have reserved the right to amend or terminate the agreement, in which instance the trust is considered either partially or fully revocable. Irrevocable forms of agreement are also used and may have certain tax advantages.

The desire of individuals to obtain favorable tax treatment under Federal income tax laws has led to the creation of various types of special purpose irrevocable trusts. Examples of such trusts include "Clifford Trusts," "Crummey Trusts", and various gift-related estate tax reduction trusts (RPM Trusts, Grantor Retained Income Trusts, Grantor Retained Annuity Trusts, and Grantor Retained Unitrusts)." To properly administer such trusts, trustees must have a comprehensive knowledge of the applicable Federal income tax laws, since a failure to satisfy all the requirements of the Federal tax code could cause a trust to lose the favorable income tax treatment for which the trust was created.

Other types of living trusts are Medicaid trusts, family incentive trusts, and insurance trusts. Such trusts have a unique or limited purpose. The successful administration of such trusts requires an understanding of the each trust's unique objectives, including the specific provisions contained in the trust instrument, and the laws and regulations governing such trusts.

C.2.c. Trustee by Order of The Court

A court of competent jurisdiction may appoint a bank as trustee to receive property in trust and administer it for the benefit of the person(s) designated. In some states, the capacity is known as a guardianship or conservatorship rather than trusteeship. Often, the court appoints the trustee for a special purpose arising from litigation. In divorce proceedings or real property disputes, the court may appoint a trustee to care for disputed property and account to beneficiaries pending settlement. The trustee in this instance may have full or only directed authority over the management of the disputed property.

C.3. Charitable Trusts

A charitable trust may be established by will or agreement for religious, educational, cultural or community-welfare purposes. It is normally exempt from Federal income tax if it meets the requirements of the Internal Revenue Code. In many states, the rights of the charitable beneficiary are enforced by that state's attorney general. Some charitable trusts may last forever, while duration of other trusts is limited by the rule against perpetuities, which differs in important respects from state to state. The purposes of charitable trusts depend upon the intent of the trustors, but tax planning will usually be important.

The following sections provide an overview of the Internal Revenue Code as it applies to charitable trusts and of the potential adverse consequences of failing to comply with the requirements of the Code. The discussion is general in nature and primarily focuses on "nonexempt" activity.

C.3.a. Internal Revenue Code

The administration of charitable trusts is governed to a significant extent by the

provisions of the Internal Revenue Code (IRC). These rules and regulations are quite extensive and complex and it is essential that the trustee have a good working knowledge of the applicable provisions of the Code and the requirements for maintaining a charitable trust's favorable tax treatment. The failure to maintain the favorable tax status may result in unfavorable tax consequences to individual donors and the charitable organization itself. In such cases, the trustee may be subject to losses as a result of legal actions and court surcharges. The miscalculation of payments and distributions may also result in surcharges and other liabilities.

The first step in the management process for charitable trusts is determining whether a charitable organization and the trust created for its benefit are classified as "exempt" or "nonexempt".

a. Organizations are granted tax-exempt status under Section 501(a) of the IRC. Though there are many types of exempt organizations, the most common are found in Section 501(c)(3). These are nonprofit organizations operated exclusively for charitable or educational purposes. Exempt organizations are then further categorized by the Tax Reform Act of 1969, which introduced the concept of a "private foundation". The act differentiates between two groups: public charities and private foundations. The restrictions and requirements imposed upon private foundations to qualify favorable tax treatment are numerous and complex.

   Additional information is available from the Department of Treasury, Internal Revenue Service, Publication 557, "Tax-Exempt Status of Your Organization." Publication 557 can be found on the IRS web site www.irs.gov

b. Nonexempt organizations are those that do not qualify for tax-exempt status. However, they involve certain charitable purposes for which a contributor is allowed a deduction. Nonexempt activity is governed by section 4947(a)(2) of the Internal Revenue Code. There are two categories of nonexempt trust. The first are trusts that devote all of their "unexpired interests" to charitable purposes. The second are trusts where the unexpired interests are devoted to both charitable and non-charitable purposes. These are also known as "split-interest" trusts. There are three types of split-interest trusts: Charitable Lead, Charitable Remainder, and Pooled Fund trusts. The split-interest trusts are more fully discussed in the following sections.

C.3.b. Charitable Lead Trust

A charitable lead trust is a trust for a fixed term of years wherein a charity is the beneficiary of an annual annuity or unitrust payment, with the remainder interest belonging to a noncharitable beneficiary. It is designed to provide income payments to at least one qualified charitable organization. The fixed term may be measured by a fixed number of years, the lives of one or more individuals, or a combination of the two. If the life of an individual option is chosen, the individual must be alive at the origination of the trust. After the expiration of the fixed term, trust assets are paid to the grantor or one or more of the noncharitable beneficiaries named in the trust agreement.

As previously noted, the trust may be designed as either an "annuity trust" or a "unitrust".

In an **annuity trust**, a trust is formed where a fixed amount is paid not less often than annually. The fixed amount (the annuity) may be stated as a fixed percentage of the initial net fair market value of the trust assets, as a fixed sum, or an amount determined by a formula stated in the trust agreement. The annuity may be changed during the term of the trust; however, there are specific criteria that must be met. In the event that trust income is insufficient to meet the annual annuity payment, the corpus of the trust may be invaded.

In a **unitrust**, a trust is formed where a fixed percentage of the net fair market value of its assets, valued at least annually, is distributed, not less often than annually. The net fair market value of the trust assets may be determined under a number of methods, provided the methodology and timing used are consistent. The determination may be made on any one date during the taxable year, or may be made by taking an average of the valuations made on more than one date during the taxable year. If the trust agreement is silent, the trustee may select the method and date.

Other key features of unitrusts include the following:

- Charitable organizations are described in IRC Section 170(c)
- No minimum or maximum payout annuity or payout rate
- No five-percent probability test
- No maximum term for the trust unless required by state law
- Additional contributions allowed (Note: Adding additional monies to an annuity trust will not increase the income paid out.)

C.3.c. Charitable Remainder Trusts

A charitable remainder trust is an irrevocable trust that provides for a specified distribution, at least annually, to one or more beneficiaries, at least one of whom is not a charity. The term of the trust is not to exceed the lesser of 20 years or the life or lives of the individual beneficiary(ies). If the beneficiary is an individual, he must be living at the time the trust is created. The irrevocable remainder interest is held for the benefit of, or paid over to, one or more qualified charities. The specified distribution must be either a sum certain (annuity) or a fixed percentage (unitrust).

A Charitable Remainder Annuity Trust (CRAT) provides a sum certain that is paid out, not be less than 5 percent nor more than 50 percent of the initial net fair market value of the property placed in the trust. The annuity amount may be a percentage of the initial fair market value or an amount fixed in the trust agreement. Neither the percentage nor the fixed payment may can be changed, regardless of fluctuations of portfolio value. Therefore, additional contributions are prohibited. [Authority under IRC 664(d)(1)]

A Charitable Remainder Unitrust (CRUT) provides for the payment to a noncharitable beneficiary, of a fixed percentage, not less than 5 percent nor more than 50 percent of the net fair value of its assets, valued annually. The fair market value of the trust assets may be determined on any one date during the taxable year of the trust, or by taking an average of the valuations made on more than one date during the taxable year. The valuation method must be applied consistently, although the annual payment from a unitrust will vary, depending upon the value of trust assets. There are a number of payout options: standard, income, net income, make-up, and flip. Each option presents unique payout considerations that the trustee must be familiar with to ensure that proper distributions are made. Additional contributions are permitted. [Authority under IRC 664(d)(2)]

Charitable remainder trusts may be constructed with many variations, and require a good understanding of the Internal Revenue Code. Other important considerations for this type of trust include:

- Charitable contributions are defined in IRC Section 170(c).
- To qualify as a charitable remainder trust, the trust must meet all of the requirements set forth in IRC Section 664. Note, the IRS no longer issues determination letters stating that a charitable remainder trust qualifies for a charitable income, gift, or estate tax deduction. The IRS does provide sample documents to provide guidance.

- There is a requirement called the "10 Percent Minimum Present Value", or prequalification floor. In 1998, the law was revised to require that the present value of the charitable remainder interest be at least 10 percent of the net fair market value of the property transferred into the trust on the date of transfer. If a trust fails this test, there are additional rules to provide relief.
- The transfer of trust principal and excess income to the charitable remainderman prior to the termination of the trust is permitted within certain limitations.

C.3.d. Pooled Income Fund

A pooled income fund is a trust established by a charity to receive donated property and to provide the donors with income for life. The pooled fund maintains an investment portfolio and provides the donor a rate of return on the donated property. The donor receives income, gift, or estate tax deductions. Trust departments may be appointed to act as an administrator or investment manager for pooled income funds. Refer to Section 7, Subsection N.4, Bank Managed "Pooled Income Funds" Organized by Outside Entities for additional information.

C.3.e. Charitable Contribution "Clifford Trusts" for Banks

This special purpose account combines charitable features with the customary Clifford Trust, a form of personal trust created for a period exceeding 10 years. The grantor of such a trust transfers assets irrevocably in trust (i.e., for the duration of the trust) and, the income is not taxable to the grantor during the term of the trust. It is important to note that the income may, or may not, be used for charitable purposes. The Tax Reform Act of 1986 eliminated the 10-year or Clifford trusts exception from grantor-trust taxation rules, thereby eliminating the establishment of such trusts. Some older trusts may still exist.

A bank itself may have established a Clifford Trust, primarily for income tax purposes. Under the Internal Revenue Code, a corporation is restricted to a maximum percentage of its taxable income that may be deducted as a charitable contribution. By employing the trust vehicle, a bank may increase its charitable contributions beyond the percentage limitation without subjecting the excess amount contributed to taxation. The trust is funded with bank assets, usually cash or prime quality securities, and all of the income is distributed to charities, with the principal reverting to the bank upon termination of the trust. One or more of the bank's directors and/or officers may be appointed as individual trustee(s). In such cases, the bank does not need trust powers. However, if the bank has a trust department it would be preferable for that department to be named as trustee.

The trust instrument should: provide a statement of the purpose and objectives of the trust; specifically prohibit "insider" transactions, self-dealing and conflicts of interest; provide for disclosure of the trust's operations to the FDIC and State banking authority; and require periodic (at least annual) accountings to the board of directors. The trust instrument should not include any authority to borrow funds or permit trust assets to be mortgaged, pledged or otherwise encumbered.

A bank's current and projected liquidity, its future earnings and the adequacy of its capital are impacted by a Clifford Trust arrangement. In light of these considerations, it seems reasonable to expect a bank to be able to project that a Clifford Trust will not seriously impact its capital, liquidity, and earnings during the term of the trust.

C.4. Agencies

An agency relationship is created by an agreement under which the trust department is appointed to act as agent for the property belonging to the principal. Many banks use standardized language in agency agreements. The use of such agreements eases account administration by standardizing the institution's fiduciary duties, which also limits the

potential risks that can result from complex, non-standard agency contracts. There are two basic distinctions between an agency relationship and a trust relationship:

- Ordinarily, agents do not hold legal title to property, while trustees hold legal title for the benefit of account beneficiaries. (Agency assets are now registered in the name of the bank, or its nominee, more frequently as this expedites trading and the transfer of ownership when assets are sold.)
- An agency is usually revocable at the option of the principal, and is automatically terminated at the death of the principal (account assets must then be turned over to the executor of the estate or to a court appointed administrator). Trusts, on the other hand, may be irrevocable, and continue long after the death of the settlor and/or the original beneficiary(ies).

An example of some of the duties performed under an agency agreement include accepting possession of the principal's assets, collecting and distributing income, and buying and selling investments, either at the department's discretion or as directed by the principal. A trust department acting as an agent should always operate under a written agreement, with the agent's authority and duties clearly defined by the terms of the agreement. Some of the most common agency capacities in which a trust department may serve include:

C.4.a. Custodian

In a Custodianship, the trust department has only the duties of safekeeping property and performing ministerial acts, as directed by the principal. As a rule, investment management or advisory duties are not exercised. For example, in the exercise of custodial duties involving securities, the bank may be required to collect income and principal; notify the principal of defaults, called securities, stock rights for purchase; and execute instructions to buy and sell securities.

C.4.b. Escrow Agent

In this capacity, a bank has the responsibility of holding the assets and other documents delivered into its custody until the conditions for their release to a third party have been fulfilled according to the terms of the escrow agreement. Added responsibilities include ensuring that the conditions specified in the escrow agreement have been fully satisfied before assets and other documents are delivered to the third party. The bank is liable for its actions not only to the principal, but also to the third party. The bank as escrow agent should: assume no liability under the terms of the agreement; perform in accordance with the duties and obligations set forth in the escrow agreement; and not arbitrate in the case of disputes or disagreements between the principal and the third parties to the escrow agreement.

C.4.c. Trustee for Land Trusts or Real Estate Trusts

A land trust may be used for privacy purposes, for estate planning purposes, or to facilitate borrowing arrangements. The bank as trustee acts solely as the holder of the legal title to the property. Typically, the beneficiary(ies) retains the power of direction and control over the trust property. In some cases, however, the trust document may indicate that another party (not the bank) has the power to direct the trust. This is a unique type of fiduciary relationship that is not allowed in every state. Illinois is the state in which land trusts are most prevalent.

The administration of this type of trust, if allowed, is addressed in state statute. Typical documentation includes:

- Land Trust Agreement - This is a document that identifies the property(ies) held in trust, the individuals or entity that holds a beneficial interest in the trust, the manner in which the benefit is held (tenets in common, joint tenet, etc.), the successor beneficiary, and the individual(s) or entity with power of direction. There should be no responsibilities assigned to the trustee other than that of holding title to the property and recordkeeping.

- Deed of Trust - This is a document that conveys property into and out of the trust and is sometimes referred to as a "deed in trust". This document evidences legal title to the parcel of land and the change in ownership. State law dictates whether the deed must be recorded.
- IRS filing (Notice of Fiduciary Relationship) - This is required at the time a property is deeded into or out of the trust.
- Legal Notices - As the trustee is the holder of legal title, it will receive all legal notices pertaining to the property. The notices should be forwarded for further action to the party or parties identified in the agreement. If the notice requires disclosure of the names of the beneficial owner(s), the trustee will be guided by state statute for direction.
- Written Letters of Direction - These are instructions to convey a property into or out of a trust. They also inform the trustee if the property is to be encumbered with a mortgage or with the assignment of a beneficial interest, and so on. The direction is to be signed by the individual or entity identified in the trust agreement.

To appropriately administer this type of account, management must understand applicable state law and IRS statutes. Good recordkeeping procedures require the documentation of all actions taken with regard to the property in the trust. Since the trustee assumes minimal liability from holding title to the property and has no duty to maintain the property or to defend claims against it, management may view the administration of land trusts as a low risk activity. This is not, however, the only risk factor to be considered. The level of risk also depends upon the type of property held and the beneficiary. The lowest risk is typically associated with an owner occupied single family residential property. Administering this type of property in a land trust requires only limited recordkeeping, basic documentation, and limited monitoring. A higher level of risk accompanies the holding of commercial property (income producing properties, land development, raw land) and/or beneficiaries who are not individuals (e.g., partnerships and corporations, etc). The higher risk results from the volume of transactions associated with commercial property, along with the specialized documentation required. For example, administering a land trust holding a parcel of land under development by a corporation represents a higher level of risk to the trustee. The additional risk results from multiple conveyances of the property, changes in legal descriptions (as the parcel is subdivided), and changes in encumbrance. The type of beneficiary requires specialized documentation to allow the trustee to clearly identify which individuals are the beneficial owners.

C.4.d. "Qualified Intermediary" for 1031 Exchange or "Like Kind Property Exchange"

In this capacity, the bank serves as a specialized custodian identified by the IRS as a "qualified intermediary." This is an agency relationship governed by IRC Section 1031 (26CFR1.1031(k)-1). The agreement governing this relationship is commonly referred to as "Starker", "Exchange" or "1031 Exchange" trust. The client typically uses this type of account as a method of deferring income tax on the exchange of business-use property, but it may also be used to structure a tax-free exchange. Essentially, it permits property used in a trade or business or held for investment ("relinquished property") to be exchanged solely for like-kind property ("replacement property") which will be used in a trade or business or held for investment. Like-kind exchange does not mean 100 acres of farmland for 100 acres of farmland. A transaction may, for example, be structured to exchange farmland for apartment buildings. Items transferred in this manner may include real estate (as mentioned in the explanation of like-kind), heavy equipment, or collectibles. The exchange is usually a three-way transaction that is facilitated by an intermediary, referred to as a "qualified intermediary". There are five types of exchanges: delayed/deferred, simultaneous, reverse, improvement, and

clearing house.

The typical sequence of events for a simple deferred exchange is described as follows:

- Sale - The seller sells the "relinquished" property.

- Establishment of Agency Relationship - At the close of a sale, the proceeds go to a "qualified intermediary". The funds are held in a "qualified escrow account" or "qualified trust" - essentially an account for the benefit of the seller. The relationship must be set forth in a written agreement that includes language expressly limiting the seller's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalents held in the account prior to the consummation of the entire transaction. The "qualified intermediary" may not have a fiduciary relationship with the seller. This means that the "qualified intermediary" cannot give legal or tax advice. The "qualified intermediary" must return the funds held on deposit, with any accrued interest, to the seller if any of the timing restrictions can not be met.

- The "qualified intermediary, whose duties are set forth in the Exchange Agreement, must acquire the "relinquished property" from the seller, transfer the "relinquished property" (to the buyer), acquire the "replacement property", and transfer the "replacement property to the seller (who is now the buyer).

- Identification Period - The seller identifies replacement property(ies) within 45 days of the closing of the sale of the "relinquished" property. The property does not have to be purchased or under a contract to purchase in 45 days, it simply must be identified. The written notification must designate the property as "replacement" property and be signed by the seller. Identification must be unambiguous, e.g., for real estate the legal description or legal address. The written notification must be delivered to the "qualified intermediary" by midnight of the 45th day following the close of the sale of the "relinquished" property.

- Exchange Period - The seller (now the buyer) closes on the replacement property within 180 days of the sale of the "relinquished" property. The funds are wired from the account to the closing agent.

A "reverse exchange" occurs when the replacement property is closed before the relinquished property is sold. The IRS allows a bank to be a "qualified intermediary" to take title to the property and hold it until the relinquished property is sold. As long as the length of the holding period is 180 days or less, then the exchange should be allowed by the IRS.

These are complex transactions that must meet specific IRC requirements. As demonstrated by the example, the agency agreement is specially tailored, and the bank's primary duty is to document the chain of events required to qualify for the favorable tax treatment afforded by the IRC. This documentation is essential if the IRS audits the seller. To effectively supervise this type of arrangement, management must have a fundamental knowledge of IRS requirements, maintain sufficient documentation to prove the chain of events, and have a method of monitoring all the triggering events (ticklers for notification purposes and the triggering of a tax event). This topic is also discussed in the Asset Management section of the manual. Link

C.4.e. Investment Advisory Agent

As Investment Advisory Agent, the bank may exercise a number of duties, with

the primary duty being to offer investment recommendations to the principal. Other responsibilities may include: execution of security transactions; collection and disbursement of funds; and other custodial duties. Generally, written approval of the principal is needed for investment transactions or the disbursement of funds and/or assets.

C.4.f. Managing Agent

In a Managing Agency, the bank normally has the same duties as an investment advisory agent, with the additional authority to make investment selections and execute transactions without the written consent of the principal. Managing agency agreements are general in nature, and sometimes grant agents significant discretionary authority. While a managing agency may appear similar to a trust relationship, basic differences in the transfer of title and revocability, as previously discussed, remain. However, an exception may exist in certain conventional managing agency accounts, whereby the agreement may provide for assets to be registered in nominee form, to facilitate trading activities. The agency relationship terminates upon the revocation by either party or at the death of the principal.

C.4.g. Farm Management Agent

Farm management agency account relationships are utilized for a number of reasons. Agricultural assets are unique and require a particular expertise to maximize income potential and enhance value. Whether the assets are held in a trust, or in an agency capacity, the fiduciary must exercise the requisite level of care. Some farms may be managed as an account investment alternative, assuming farmland returns compare favorably to other investments. An account beneficiary may be interested in retaining ownership and operating a family farm. An absentee owner or a retired farmer may contract for farm management because they no longer may be able to manage the farm themselves.

Banks offering farm management services must address the following areas: the establishment of a written agreement clearly delineating the responsibilities of the bank (as an agent or other capacity) and the principals; the appointment of a farm operator or manager responsible for actual day to day operation of the farm; the execution of a lease governing the operation of the farm; and the monitoring of the farm operator's performance in order to identify and correct problems with farm operations. Each of these is discussed below.

1. Establishment of Farm Management Agreements

    a. The governing agreement should delineate the bank's responsibility for operating, leasing, retaining, deeding, or selling the farm; making crop planting and marketing decisions; entering into borrowing arrangements; making major capital improvements; and selecting and dismissing tenants.

    b. The agreement should include any provisions whereby the bank must obtain the approval of other parties to the agreement for matters cited in the preceding paragraph.

2. Appointment of a Farm Operator or Manager

    a. Leases with tenant farmers should be current and of an appropriate duration in order to facilitate the removal of poor tenants or the alteration of lease terms.

    b. If an outside agent is used to manage farmland, they should be carefully selected, adequately bonded, and should submit reports of their activities to the institution.

    c. Obtaining financial statements from the farm operator may

also be appropriate to ensure their capacity to perform under the lease terms.

3. Lease Arrangements

The types and terms of leases vary in each account, but one type of lease arrangement may be more prevalent in a given geographic area. Account officers should periodically determine which arrangement maximizes the return for beneficiaries relative to the level of the risk appropriate for the account. Leases are usually written for one year, but typically a farm operator's tenure is considerably longer, providing the tenant continues to perform satisfactorily. The more prevalent types of lease arrangements are summarized below.

a. Cash rent lease. Under this arrangement, the farm operator pays a predetermined sum of cash rent for the use of the farm in a given year. A portion of the rent is usually paid in the Spring, with the balance of the rent paid in the Fall. The farm operator retains all of the crop production, receives the government crop production subsidies, provides all labor and equipment, and pays all of the cost for seed, fertilizer, chemicals, etc. The land owner contributes the land and buildings and typically pays the real estate taxes, insurance and maintenance expenses. Cash rental arrangements are becoming increasingly popular because the arrangement provides a predetermined annual return to the trust that is not subject to the significant risks of crop production and market price variations. Cash rental rates are also readily comparable and can allow competitive bidding by potential farm operators.

b. Bushel rent lease. The bushel rent lease is very similar to cash rent; however, the rent is paid in the form of a specified number of bushels of grain, in lieu of cash, delivered to a local market. The farm operator and land owner pay the same respective expenses as mentioned in the cash lease arrangement. This rental arrangement results in a moderate increase in income volatility compared to the cash rent lease. The return is not subject to production risk; however, the return is subject to changes in grain market prices.

c. Net share lease. Under the net share lease arrangement, the land owner's rent is a predetermined percentage of the crop produced. Depending on the geographic location and the crop produced, the arrangement may require 25 to 35 percent of the crop. The farm operator and land owner pay the same respective expenses as mentioned in the cash lease arrangement. This rental arrangement results in a moderate increase in income volatility compared to the bushel rent lease. The return is subject to both production risk and to changes in grain market prices.

d. Crop share lease. The 50/50 crop share lease has historically been the most prevalent farming arrangement for good quality farms in the Corn Belt. The farm operator provides all labor and equipment, pays 50 percent of all of the cost for seed, fertilizer, chemicals, etc., retains 50 percent of all of the crop production, and receives 50 percent of the government crop production subsidies. The land owner

contributes the land and buildings, pays the real estate taxes, insurance and maintenance expenses, pays 50 percent of all of the cost for seed, fertilizer, chemicals, etc., retains 50 percent of all of the crop production, and receives 50 percent of the government crop production subsidies. This rental arrangement results in a moderate increase in income volatility compared to the net share lease. The return is subject to an increased share of both production risk and to changes in grain market prices.

e. Custom farming operation. Under this arrangement, the land owner pays 100 percent of the crop production costs, real estate taxes, insurance and maintenance expenses, retains 100 percent of all of the crop production, and receives 100 percent of the government crop production subsidies. The land owner pays the farm operator specified "custom fees" to provide labor and equipment to perform the planting, harvesting, etc. This rental arrangement has the potential for a greater overall return but results in a higher level of income volatility. The return is subject to all of the crop production risk, along with the change in grain market prices.

f. Direct farming operation. Under this arrangement, the land owner owns all of the farm equipment and pays all of the necessary operating expenses, including labor. A resident manager is paid by the farm operation, and the land owner receives 100 percent of all crop proceeds. The return is subject to the risks described in the custom farming operation; however, the arrangement has the added risk of equipment ownership verses the elimination of "custom fees."

4. Monitor the account and the farm operator's performance.

a. A record of farm income and expense should be available for the property under management.

b. Evidence that taxes have been paid should be maintained.

c. Evidence that proper **insurance** is in force should be maintained. Three types of insurance should usually be required: fire and extended coverage on buildings and improvements, public liability, and multi-peril crop insurance. Some farm operators may only carry crop hail insurance. Hail insurance is a private (and often expensive) insurance program that insures only crop losses related to hail. Multi-peril crop insurance is a very widely utilized government farm income insurance program. Government subsidies make multi-peril insurance an affordable income management tool. Multi-peril insures crop yields and, depending on the policy provisions selected, crop revenues. Multi-peril protects the landowner and/or the tenant's crop revenue from all types of perils that could adversely impact yields, including wind, hail, disease, frost, drought, insects, weeds, and flooding. Multi-peril crop insurance is strongly warranted in crop share and custom farming arrangements, i.e. arrangements where crop yield is the deciding factor on the return realized from the farmland investment. Crop yield coverage levels vary from 50 percent to 85 percent of a normal crop yield. The higher coverage levels are available at higher premiums. The farm management agent must determine what level of crop and income risk protection is appropriate for a given account.

d. On-site farm visits are essential. The type of lease

arrangement dictates the frequency and nature of on-site visits. In a custom farming or crop share lease arrangement, two or more visits may be warranted during the planting/growing/harvesting season to monitor the quality of the tenant and crop conditions due to the weather, disease, insects, weeds, etc. A cash rental lease arrangement may require only an annual visit to monitor maintenance of the soil and any facilities. Detailed records of visitations should include the date, purpose, persons contacted, observations made, and any facts or opinions that were developed.

e. Cash flow projections are considered a good management tool and are often essential to obtain credit. Annual crop plans should be on hand. USDA yield averages for the area may provide a benchmark performance measurement.

f. Farm management agents marketing grain should maintain records of prices obtained and document decisions regarding grain sales.

g. A record should be maintained showing the quantity and storage location of harvested crops (on the farm or stored in elevators or warehouses). When not on the farm, detailed storage receipts should be on hand.

h. Soil maps should be retained to assist in determine soil quality, soil erodibility, and whether drainage might be a problem. Soil tests should be performed every few years because soil fertility may be subject to depletion over time. Lease arrangements, supported by periodic farm inspections and soil testing, should be designed to ensure the farm operator's practices maintain soil fertility.

5. Other problems

a. Inadequate Performance. A bank may encounter problems where the farm is not achieving adequate returns or there are conditions that limit the value of the farm. Lease arrangements may be outdated and no longer provide the risk/return appropriate for the managed account.

b. Environmental Concerns. The farm management agent should have policies and procedures to identify potentially adverse environmental conditions such as fuel storage tanks, improper disposal of pesticide containers, dump sites, or other hazardous conditions. Such conditions may require that an environmental specialist or engineer review the situation and, if necessary, supervise proper cleanup. Environmental monitoring safeguards the value of the asset and reduces the farm management agent's potential exposure to liability.

c. Conservation Concerns. Problems can arise involving compliance with governmental conservation programs. "Swamp buster" is intended to prevent the drainage of wetlands. "Sodbuster" is intended to protect the farming of highly redouble lands (HEL). "Conservation Compliance" provisions require an acceptable conservation plan on highly erodible soils to prevent soil erosion. Compliance with conservation programs by farming operations is important because compliance usually is a prerequisite to receiving related government income support. Financial incentives such as the Wetland Reserve Program (WRP) and the Environmental Conservation Acreage Reserve Program

(CRP) may be attractive alternatives for enhancing the value of environmentally sensitive cropland.

d. Livestock. The complexities of properly monitoring, growing, and marketing livestock or operating livestock enterprise investments within a trust arrangement could result in relatively high risk to the account. Livestock arrangements are highly unusual and should require a high level of expertise and monitoring.

e. Conflicts of Interest. Banks sometimes obtain a discount for seed purchases by buying seed in large quantity or by being a "district dealer" for seed companies. District dealer status should be approved by a committee. These discounts present potential conflicts of interest in the form of side commissions, paid either to a farm manager personally or to a bank for being a district dealer; or from a bank retaining a portion of the bulk discount obtained. A bank, however, might be entitled to a small portion of such a discount in return for the bank's efforts in negotiating the discount, if most of the discount were passed on to the farm. In addition, a conflict of interest may arise if the bank as farm management agent enters into a lease arrangement with a farm operator that is also a borrower from the commercial side of the bank. Policies should adequately address the conflict of interest to ensure the farm lease arrangement is not adversely impacted.

C.4.h. Attorney-in-Fact Pursuant to an Executed Power of Attorney

A bank becomes Attorney-in-Fact when it receives a formally executed written power of attorney. There are various types of powers of attorney: general, special power, heath care, "durable", and "springing." Each of these is defined in Appendix H, under power of attorney. The durable and springing aspects may be added to any type of power of attorney.

To limit fiduciary risk, a trust department that accepts an appointment as attorney-in-fact should only do so under a special power of attorney. A specialized power of attorney can be tailored to limit the attorney-in-fact's responsibilities to those found in a revocable personal trust agreement. A general power of attorney provides too broad a range of powers and the health care power of attorney addresses issues not traditionally administered by bank fiduciaries. A general power of attorney grants authority to the bank to do anything as attorney-in-fact which the principal could legally do, including: the voting of stock; signing or endorsing checks; signing proxies; collecting debts; conveying real estate; transferring personal property; or performing similar services. Principal is the term used to identify the person who executes the power of attorney.

The principal may wish to use a power of attorney to manage his personal financial affairs, as it is traditionally an inexpensive means to have another party take care of principal's affairs when the principal is incapacitated or otherwise unable to care for his financial affaires. It is generally less costly than a revocable trust and provides more management options than an investment management account. Note, in order for the power of attorney to be effective in the event of the principal's incapacitation, it must be a "durable" or "springing" power of attorney. Appointing an Attorney-in-Fact is typically less costly and easier to acquire, than a court appointed conservatorship.

Regardless of the type of power of attorney accepted, the trust department must act in the principal's best interest, keep accurate records, keep the principal's property separate and distinct from that of all other accounts, and avoid conflicts of interest. Management must be aware of any state statutes governing this type of fiduciary appointment. For example, in some states, to

effect real estate transactions the power-of-attorney must be recorded within a particular jurisdiction, such as a county. In some states the power-of-attorney must be notarized before becoming effective, and in some states the Attorney-in-Fact must appear before a public official and state under oath that he intends to give the power (knowing full well of its consequences).

C.4.i. Safekeeping Agent

A bank performs safekeeping duties when it limits itself to the safekeeping and delivery of property (to the principal or others as the principal may direct), with no ministerial duties required. The safekeeping division of the trust department should maintain adequate records and controls, together with suitable physical security. Articles left for safekeeping should not be commingled with bank assets, but should be properly identified and adequately insured.

D. Additional Fiduciary Capacities

D.1. Co-Fiduciaries

In each of the aforementioned trust capacities, the bank, in accordance with the governing instrument or appointment, may be required to share the administration of an account with another fiduciary, referred to as a co-fiduciary. Examples of co-fiduciary arrangements include the following:

- A court may appoint a co-guardian to provide for special expertise over investments, or more commonly, may appoint a separate Guardian of the Person (Ward), while the bank serves as the Guardian of the Property.
- A co-fiduciary relationship may be requested by the testator of a will, or the settlor of a trust, to provide for special expertise over investments, or to be assured that certain family interests are considered when the account is being administered.

It is not uncommon for a family member to be appointed co-trustee with a financial institution. A co-fiduciary may also be one or more individuals, or another bank or trust company. If the co-fiduciary is an individual, the bank is commonly referred to as the corporate fiduciary. Regardless of the term used, each fiduciary has a responsibility to participate in the administration of the account.

It is generally held under common law that co-fiduciaries act in unison. It is the duty of each co-fiduciary to use reasonable care to prevent other co-fiduciaries from committing a breach of trust, and if a breach occurs, to compel the responsible party to correct it. Co-fiduciaries can be held responsible for a breach of trust committed by co-fiduciaries if, by neglect or willful misconduct of its own, it fails to protect the account from the other co-fiduciary's breach of trust. Further, while a fiduciary is ordinarily liable only for its own actions, a corporate fiduciary is often held to a higher standard of care than an individual co-fiduciary. As a result, a corporate fiduciary may be held liable if it does not compel a co-fiduciary(ies) to initiate corrective action to cure a breach of trust.

As a matter of sound policy, and to protect against possible liability, management should ensure the following:

- Documentation of Co-Fiduciary Actions - Management should maintain documented approvals from co-fiduciaries for all investment transactions and all other discretionary actions made during an account's administration. Approvals should be in written form and retained as permanent file documentation.

- Physical Control of Account Assets - It is generally undesirable for an individual (i.e. non-corporate) co-fiduciary to maintain physical possession or control over account assets. When this occurs, management should evaluate the controls over the assets in the custody of co-fiduciaries, as well as any bonding requirements applicable to the individual fiduciary.

- Joint Responsibility for Administration - Management should not delegate excessive authority over investments or other matters to the individual co-fiduciary. Examples of excessive delegation include purchasing assets requested by the non-corporate co-fiduciary without proper research or making a discretionary distribution requested by the non-corporate co-fiduciary without first substantiating that the distribution meets the needs of the beneficiary and/or the purpose of the account.

- Appropriate Response to a Disinterested or Uncooperative Co-Fiduciary - Situations may be encountered where a co-fiduciary has become disinterested or uncooperative and is not performing properly. Ideally, the bank, as corporate fiduciary, should try to avoid such situations through pre-acceptance review of the account. Failing that, special efforts may be needed to obtain the co-fiduciary's cooperation or, ultimately the bank may have to seek relief through a court.

D.2. Successor Trusteeships

The bank may be requested or appointed to serve as successor trustee in the event the originally appointed trustee is removed, unable, or unwilling to continue in office. Often, potential successor trustees are specifically designated in the trust document. Accepting an appointment as a successor trustee can entail additional risk to the bank. Although a successor trustee is generally not liable for acts of prior trustees, it can be held liable for actions of predecessor trustees if: (1) the successor trustee knows, or should know, of a breach of trust, or any other situation injurious to the account, and (2) it fails to take action to compel its predecessor(s) to remedy the situation.

Before acceptance, the bank should perform a due diligence review of an account's prior administration and require the prior trustee to furnish a complete accounting of its administration leading up to the time the successor is formally appointed. If the review discloses acts of improper administration, the successor trustee should either: (1) refuse to accept the appointment, or (2) take immediate steps to protect the account by asserting liability against its predecessor(s). The bank may also request appropriate releases from the court and/or all beneficiaries to further protect itself from the assumption of liability arising from the administration of prior trustees. The bank should maintain written documentation of both the performance of a due diligence review and any measures that were taken to protect both the account and the bank from potential liability arising from the actions of prior fiduciaries.

Even if the due diligence review does not disclose improper administration by the previous fiduciary, the bank should consider other factors prior to accepting the trust, such as:

- Does the beneficiary of the trust have unrealistic expectations regarding the rate of return on investments or level of service that can be provided?
- Is the language of the trust document overly complex or contradictory?
- Are the assets managed by the successor trustee unusual or beyond the expertise of the trust officers?
- Are fees sufficient in relation to the degree of difficulty in management of the trust?
- Is the trust subject to the laws of other states and, if so, is the trust department capable of complying with all required regulations?

A will or trust instrument may include an exculpatory clause, which relieves, or attempts to relieve, a fiduciary from liability for breach of trust. However, a fiduciary is not always fully protected by an exculpatory provision, and such provisions do not protect fiduciaries from breach of trust or actions which are illegal. Some states have passed statutes affording protection to the successor fiduciary from acts of its predecessor(s).

E. Asset Protection Trusts

In most instances, trusts are created to preserve and protect assets for beneficiaries. The most prominent attacks against assets come from the following sources:

- Contract creditors including personal debt contracted for a variety of reasons.
- Tort creditors resulting from court or other legal judgments.
- Regulatory liability imposed by government to achieve social goals. One of the most common sources of regulatory liability is the cost of cleaning up environmentally damaged property.
- Divorce claims.
- Disabled beneficiaries. Often many clients will create trusts for an immediate family member, with the purpose of avoiding having the trust assets included in determining eligibility for Medicaid or public assistance.

Assets afforded Creditor Protection

Certain assets are exempt or partially exempt from creditors under either federal of state law. Many states allow an individual or married couple to retain a certain amount of equity in their residence. ERISA and many state laws protect qualified retirement plans from creditors. Some states also protect cash value of life insurance and annuities from creditors.

In *In Re Rousey* 347 F.3d 689 (8th Cir. 2003), the debtors voluntarily filed for relief under Chapter 7 of the Bankruptcy Code. Included in their assets were two IRA's, which were funded as roll-overs from their previous employer's pension plans. No additional funds were added to the accounts. The U. S. Court of Appeals for the Eighth Circuit ruled that IRA's were not exempt under 11 U.S.C. §522(d)(10)(E), affirming the decision of the Bankruptcy Appellate Panel. The court found that IRA's should not be exempted from a person's bankruptcy estate and pointed out that Congress could easily change the law if it wanted to protect IRA's. Furthermore, the Eighth Circuit held that because the Rousey's could withdraw money, the IRA's were similar to savings accounts. The debtors appealed. The U.S. Supreme Court is scheduled to hear the case in the Fall 2004 term. See *In Re Rousey* 347 F.3d 689 (8th Cir. 2003), cert granted, 72 U.S.L.W. 3740 (U.S. June 7, 2004) (No. 03-1407)

Other methods established to protect assets against creditors include:

- Limited Partnerships. Under this type of partnership agreement, a limited partner's exposure for the debts of the partnership is limited to the investment in the partnership, and the creditor cannot attack the personal assets of the limited partner.
- Limited Liability Companies (LLC). The LLC limits the liability similar to other corporations, but allows flow-through treatment of taxable income or loss.

In general, a beneficiary's creditors cannot reach trust assets if a trust is created in good faith by an individual other than the beneficiary. Under the English "Statute of Elizabeth", which is embodied in the Second Trust Restatement, if a person created a trust for his own benefit, his creditors could reach the trust assets. Both Offshore Protection Trusts and Domestic Protection Trusts have been designed to overcome this traditional precept.

Offshore Protection Trusts

Offshore protection trusts established in several jurisdictions purport to offer considerable protection against creditor claims. A key feature that generally differs from trusts established in the United States is that a settlor is permitted to create a spendthrift trust for the settlor's own benefit. With a few exceptions, laws in the states require someone other that a beneficiary to create the trust.

Offshore trusts are difficult for creditors to attack for several reasons, including:

- Simply because it's a foreign trust may deter creditors.
- Legal costs may be high. Several jurisdictions do not allow contingency fees or require deposits to commence a proceeding.
- Some jurisdictions do not recognize foreign judgments, forcing the creditor to obtain judgments in both the United States and the foreign jurisdiction.

- A foreign jurisdiction may offer anonymity with respect to wealth.

The effectiveness of the ability of the offshore trust to protect assets from creditors is often dependent upon the amount of control retained by the settlor. Generally, the more control that is retained by the settlor, the less protection is provided by the trust against creditors.

Additional provisions frequently found in offshore protection trust designed to increase protection against potential creditors include:

- Ability of Foreign Trustees or Other Fiduciary to Change Situs of Trust Assets. The trust can be given power to change the situs of the trust assets to another jurisdiction if an action against the trust is threatened in the original jurisdiction. This can increase the costs of and time consumed by the creditor.

- Letter of Wishes. The settlor can provide nonbinding written guidelines to the trustee, covering the settlor's intent regarding investment of assets and distributions.

- Duress Clause. This clause directs a trustee to ignore direction of a U. S. trustee, if such direction is given under duress, including court compulsion.

- No Benefits Term. The trust might include a provision that provides for a term in which the beneficiaries are persons other than the settlor. The term could correspond with the limitations period applicable to claims of creditors in the foreign jurisdiction governing the trust.

- Restrictions on Beneficial Interests. The trust can provide that the settlor is only one of several permissible beneficiaries with the trustee having the power to choose among them or remove one or more. This trust can also provide upon the occurrence of certain events, the settlor's beneficial interest in the trust may either be terminated or held in abeyance for a specific period of time.

Offshore trusts have not proved impenetrable from state or Federal court actions; in fact, court decisions have order repatriation of assets to U. S. jurisdictions. Courts are generally unkind if evidence indicates a fraudulent transfer or attempts to avoid payment of alimony or child support. Creditors can often force bankruptcy or make it very difficult for a beneficiary to obtain the use of the assets of an offshore protection trust.

Domestic Protection Trusts

Domestic Protection Trusts (also known as Dynasty Trusts) are attempts by several states to provide spendthrift protection for trusts in which the settlor is the beneficiary (self-settled trusts), similar to offshore protection trusts. States that have adopted Domestic Protections Trusts include Nevada, Rhode Island, Delaware, and Alaska, and other states are considering adopting similar measures. Two effects of a discretionary self-settled trust are:

- Any gift made by the settlor to the trust in which the settlor retains an interest causes the trust to be incomplete for federal gift tax purposes.

- The settlor's interest in the trust will continue to be part of the settlor's gross estate for federal estate tax purposes.

Several states permit exceptions of Domestic Protection Trusts which allow creditors to reach the trust assets of self-settled trusts include:

- Creditors can reach the assets if the transfer of assets into the trust was intended to hinder, delay or defraud creditors, that is, it was a fraudulent conveyance.

- The claim resulted from an agreement or a court order for child support, or at the time of the transfer of assets, the settlor was delinquent in child support payments. Some states also include court orders arising out of divorce decrees.

- The administration of the trust must take place in the state where the trust was created.

During 2003, the State of Alaska modified its trust statutes allowing substantial protection for beneficiaries from creditors desiring to attach assets of self-settled trusts. Major provisions

of the statute include the following:

- The statute provides protection for the trust assets against claims for spousal support, alimony, child support, providers of necessities, and claims for tort liability. Note, however, that a settlor cannot be delinquent in a child support obligation when the trust is settled.
- The statute prohibits an order or attachment against the beneficiary's assets held in trust.
- A non-resident beneficiary is now allowed to act as co-trustee with distribution authority without compromising creditor protection.
- Claimants of pre-existent creditors must demonstrate evidence that a specific claim was made prior to assets being transferred to the trust or file an action within four years of an asset transfer asserting a specific cause of action based on an act of omission prior to the transfer, such as negligence. Most other states have unlimited statutes of limitations for actions that occurred prior to the asset transfer.
- The definition of a "fraudulent conveyance" has been modified, hampering the ability of a creditor to assert that an asset transfer was fraudulent. The phrase "hinder or delay" has been removed from the statute, so now a claim of fraud must prove that the transfer was intended to defraud a creditor. The higher standard in the new statute will make it significantly more difficult for a creditor to attach the assets of the trust.

Should other states follow the example of Alaska and loosen the restrictions on self-settled trusts, the effects could be far-reaching and substantially inhibit creditors and other claimants from reaching the assets of these trusts.

While self-settled trusts reduce the ability of creditors to attach trust assets, several limitations restrict their ability to protect trust assets. Some of these limitations include:

- Since states cannot exempt themselves from Federal law, the state cannot hinder the IRS, a Federal court, or some other Federal body from reaching the trust assets.
- The effectiveness is usually limited to the state where the trust is administered. Since a state cannot impose its regulations upon assets located in other states, the trusts can provide only limited ability to protect assets located in other states, even if these assets are administered by the trusts.
- States are required to recognize the judgments of other states, so judgments ordered in one state can be enforced in the state where the trust is administered, despite the terms of the trust.
- While an offshore protection trust can maintain some degree of confidentiality and secrecy, a domestic protection trust is subject to subpoena or discovery either through Federal courts or the regulations of another state.
- Most states will allow claims that originated prior to the transfer of assets. Claimants usually are unable to transfer assets into dynasty trusts after claims have been presented.

Signs of Fraudulent Transfer of Assets

Trust Department managers must be wary of trusts being used for fraudulent transfers. Most states have adopted legislation similar to the Uniform Fraudulent Transfer Act which defines several factors, called *Badges of Fraud,* which are indicators that the transfer of assets to a trust may be fraudulent. These factors are:

1. the transfer or obligation was to an insider;
2. the debtor retained possession or control of the property transferred;
3. the transfer or obligation was concealed;
4. before the transfer was made or obligation was incurred, the debtor had been sued or

threatened with suit;

5. the transfer was of substantially all the debtor's assets;
6. the debtor absconded;
7. the debtor removed or concealed assets;
8. the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred;
9. the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred;
10. the transfer occurred shortly before or shortly after a substantial debt was incurred; and
11. the debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

Rule Against Perpetuities

In order to compete with states with liberal trust laws, many states have recently passed regulations abolishing or severely modifying the "rule against perpetuities." The "rule against perpetuities" is the rule originating in common law that prohibits the grant of an estate unless the future interest granting that estate vests within 21 years after the death of someone alive when the interest was created. In other words, the estate must distribute assets no later than 21 years after the death of someone now living.

The original purpose of the rule was to strike a compromise between allowing an owner of assets to exercise his will over his assets at death and, on the other hand, tying up assets in such a way and for an indeterminate time so as to prevent the workings of a free market.

Estate planners have created innovative methods of using trusts in states that have abolished the above rule. In one instance a trust was created in order to perpetuate and grow a business. This was accomplished through the use of a defective trust, so income taxes were paid outside the trust, allowing the trust and the business to continue to grow for future generations.

Examination review of trusts designed to protect assets should insure that the transfer of assets was not fraudulent and did not violate any state regulation, including the "rule against perpetuities". Furthermore, most states have passed a version of the Uniform Fraudulent Transfers Act, designed to ensure transfers are not made into trusts to avoid an immediate claim by creditors, or avoid child support or alimony.

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FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Section 5- Compliance/Account

Administration - Employee Benefit Accounts

Table of Contents

A. Introduction

B. Scope of Bank Activity

C. Types of Benefits

D. Types of Plans

1. Defined Benefit Plans

   a. Defined Benefit Pension Plans

   b. Cash Balance Plans

2. Defined Contribution Plans

   a. Profit Sharing Plans

   b. Money Purchase Pension Plans

   c. Target Benefit Plans

   d. Stock Bonus Plans

   e. Employee Stock Ownership Plans (ESOPs)

      (1). ESOPs, In General

      (2). Leveraged ESOPs

      (3). Advantages and Disadvantages of an ESOP

   f. Thrift and Savings Plans

   g. Welfare Benefit Plans

3. Abandoned Plans

4. Health Savings Accounts (HSAs)

E. Self-Employed Retirement (KEOGH or HR-10) PLANS

F. Individual Retirement Accounts (IRAs)

1. Operating/Filing Requirements

2. Types of IRAs

3. Bank Trustee and Custodial Responsibilities

a. Self-Directed Custodial IRAs - Own Bank Deposits

b. Self-Directed Custodial IRAs - Non Bank Deposits

4. Special Examination Application

G. Savings Incentive Match Plan for Employees (SIMPLE)

H. Compliance With the Employee Retirement Income Security Act of 1974 (ERISA)

1. Introduction

2. Accounts Covered/Not Covered by ERISA - ERISA Section 401

3. Establishment of Plan - ERISA Section 402

4. Trustee Requirements - ERISA Section 403

5. Fiduciary Responsibilities - ERISA Section 404

a. Fiduciary Defined

b. Requirements

c. Special Examination Applications of Fiduciary Responsibility Provisions

(1). Contributions, In-Kind

(2). Derivatives

(3). Economically Targeted Investments (ETIs or Social investing)

(4). ESOP Plans - Employer Securities Investments - Prudence

(5). ESOP Plans - Employer Securities Investments - Valuation

(6). Individual Account (Section 404(c)) Plans

(7). Loans - Documentation

(8). Own-Bank/Holding Company Stock Investments

(9). Proxy Voting and Corporate Governance

(10). Directed Trustees

6. Co-Fiduciary Liability - ERISA Section 405

a. Allocation and Delegation of Fiduciary Responsibility

b. Directed Accounts

7. Prohibited Transactions - ERISA Section 406

a. Introduction

b. ERISA Insiders - Party in Interest Defined

c. Prohibited Transactions With Parties in Interest

d. Prohibited Transactions With Fiduciaries

e. Prohibited Transaction Liabilities of Non-Fiduciary Parties In Interest

f. Special Examination Applications of Prohibited Transaction Provisions

(1). Brokers Executing Securities Transactions

(2). Contributions, In-Kind

(3). Float Management

(4). Foreign Exchange

(5). Loans to Common Borrowers - General

(6). Loans to Common Borrowers - Lending Limits

(7). Loans - Takeout Financing

(8). Loans - Own-Bank Origination and Servicing

(9). Mortgages (Residential), Investment in

(10). Mutual Funds, Conversion from Collective Investment Funds (CIFs)

(11). Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised

(12). Investment of Own Bank Employee Benefit Plans In Proprietary Mutual Funds

(13). Mutual Funds, Receipt of 12b-1 Fees

(14). Overdrafts and Interest-Free Loans

(15). Qualified Professional Asset Managers (QPAMs) - Transactions With Investment Managers

(16). Repurchase Agreements

(17). Securities Lending

(18). Securities Issued - Proceeds Used to Reduce Debt at a Party in Interest

(19). Soft Dollars

(20). Sweep Fees

(21). Relaease of Claims and Extensions of Credit in Connection with Litigation

8. Investment in Employer Securities and Real Property - ERISA Section 407 and 408(e)

a. Qualifying Employer Securities

b. Qualifying Employer Real Property

c. Statutory Limitations

(1). Defined Benefit Plans

(2). Individual Account Plans

d. Acquisition of Employer Securities and/or Real Property

e. Fiduciary Standards

9. Exemptions From Prohibited Transactions

a. Exemptions and Opinions

(1). Class and Individual Exemptions

(2). Advisory Opinions

b. Ancillary Services Statutory Exemption

c. Receipt of Services by IRAs and Keogh Plans Exemption

d. Collective Investment Funds (CIFs) Statutory Exemption

e. Deposits, Interest-Bearing Statutory Exemption

f. Employee Stock Ownership Plans (ESOPs) - Loans to Plans Statutory Exemption

g. Loans to Plan Participants Statutory Exemption

(1). ERISA Requirements for Loans to Plan Participants

(2). Plan Authorization and Conditions for Loans to Plan Participants

(3). IRS Statutory and Regulatory Requirements for Loans to Plan Participants

(4). Consumer Protection Laws and Loans to Plan Participants

h. Investment Advice

(1) Responsibilities of Plan Sponsors

(2) Prior DOL Guidance

i. Block Trades

j. Alternative Execution Systems

k. Service Providers

l. Foreign Exchange Transactions

m. Cross-Trading

n. Inadvertent Prohibited Transactions

10. Exculpatory and Indemnification Provisions

11. Fiduciary Liability Insurance

12. Bonding Requirements

I. Disclosures to employees and Beneficiaries

1. Summary Plan Description

2. Summary Annual Report

J. Reporting to government agencies

1. Annual Return/Report of Employee Benefit Plan (Form 5500)

2. Pension Benefit Guarantee Corp (PBGC) Annual Premium Filing (Form PBGC-1)

K. Bank sponsored employee benefit plans

1. ERISA Applicability

2. Trust Powers

3. Unfunded Vested Liability

4. Capital Treatment for ESOPs

5. Fees - Permissibility vs. Prohibited Transactions

6. Assignment or Alienation of Plan Benefits

7. In-Kind Contributions

L. Compliance with state laws

1. Escheat Provisions

2. Special Treatment for Multiple Employer Welfare Arrangements (MEWAs)

M. Compliance with the internal revenue code

N. Referrals of ERISA Violations to the Department Of Labor (DOL)

O. Account Documentation and IRS Determination Letters

1. Account Documentation in General

2. IRS Letter of Determination

P. Voluntary Correction Programs

Q. Catch-up Contributions

R. Pension Protection Act of 2006

A. Introduction

The field of employee benefits is one which applies to banks with or without trust departments. Employee benefit plans are vehicles for which the benefits promised by an employer are funded, administered, and provided to eligible employees or members. Individual Retirement Accounts (IRAs) established by individuals under certain provisions of the tax laws are also covered in this section.

Employee benefit plans represent a diverse field. Plans vary according to the types of benefits provided, the manner in which plan assets are administered, and the manner in which benefit amounts are provided to the employees/participants and their beneficiaries. Every bank offers various types of employee benefits to its employees and their beneficiaries. As such, portions of the material in this section of the manual are relevant to every bank supervised by the FDIC.

Bank trust departments may manage the bank's own employee benefit plan(s) for its own employees. The trust department may perform the same services for the bank's parent holding company and affiliates. In addition, the trust department may service employee benefit plans sponsored by outside corporations, unions, individuals, and government entities.

B. Scope of Bank Activity

A bank may serve in various capacities with respect to employee benefit plans. For example, a bank may be appointed trustee or co-trustee for a plan, or may accept an appointment as agent, custodian, depository, or recordkeeper for a plan, or fulfill a combination of these duties. In addition to the duties described above, a bank may also perform administrative functions for a plan. The duties of the bank with respect to an employee benefit account depend upon the governing plan documents and the written documents, including trust and agency agreements, between the bank and the sponsor of the employee benefit plan.

While banks provide various trust and agency services to employee benefit plans sponsored by non-affiliated corporations, unions, government entities and individuals, they often provide such services for own-bank or affiliated institution plans. Since a bank is not required to obtain trust powers in order to serve as trustee for its own-bank plans, many banks without trust departments will also be subject to ERISA and Department of Labor regulations. Therefore, the material covered in this section will be applicable to banks that do not operate a trust or fiduciary services department.

Moreover, banks often serve as trustee or custodian for retirement benefit plans established by individuals. The most common type of retirement plan established by individuals is the Individual Retirement Account (IRA). While retirement plans established by individuals are not subject to ERISA or Department of Labor regulations, they are, due to their tax-advantaged status, subject to various sections of the Internal Revenue Code and regulation by the Internal Revenue Service. This section also covers IRA's and other individual retirement plans, along with the applicable Internal Revenue Code and IRS regulations governing such plans.

C. Types of Benefits

One way of describing various types of employee benefit plans is to reference the types of benefits the plan provides. In general, there are two types of benefits: retirement and welfare.

Retirement plan benefits generally arise when an employee is qualified to retire, and often provide benefits to the employee's spouse and dependents. Some retirement plans involve the deferral of income for periods extending to the termination of employment, or beyond. Such plans usually cover key members of management. Retirement plans involve a number of different types of plans and funding arrangements. Although trust departments are generally more active in the retirement benefits field, examiners need to be aware of the general requirements for welfare benefit plans as well.

The term welfare benefits is used to describe non-retirement benefits. Welfare benefits may involve health and life insurance, scholarships and education assistance, day care centers, apprentice programs, prepaid legal services, vacation and sick-leave programs, and all other non-retirement benefits.

D. Types of Plans

A second, and more common way of generically describing various types of employee benefit plans involves the method used to determine how assets are contributed to the plan. In this regard, there are two main types of pension plans: defined benefit and defined contribution plans.

Most plans operated by private employers are offered, at least in part, because contributions to the plan are tax deductible to the plan sponsor. In order to be tax deductible, an employee benefit pension plan must meet certain minimum standards and have certain provisions required by the Internal Revenue Service (IRS). As the tax laws and regulations tend to change often, the specific requirements, eligibility,

conditions, and thresholds also are subject to change.

Types of Employee Benefit Pension Plans					
Plan Type	**Benefit Basis**	**Examples of Plans**	**Risk Born By**	**Assets Available for Benefits**	**Admin Cost**
Defined Benefit	Formula - (based on Salary & Longevity)	Pensions	Sponsor	All Plan Assets	HEAVY
	Cash Balance (based on "Pay Credit" and "Interest credit")	Pensions	Sponsor	Participant's Vested Account Balance	Less costly than traditional defined benefit plan
Defined Contribution	Employee (+ Employer) Contributions	Profit- Sharing ESOP 401(k) 403(b) SEP-IRA Pensions	Employee	Participant's Own Portion of Plan	Much Less
	Investment Choices				
	Investment Results				

D.1. Defined Benefit Plans

A defined benefit plan is one which establishes a formula to define what the participant (employee) is entitled to receive. The formula is usually based on longevity and/or income. Most traditional pension plans use this approach, which often provides greater benefits the longer the employee stays with the plan sponsor. Employees/participants are entitled to the percentage of the benefits established under the plan. This entitlement is termed "vesting."

D.1.a. Defined Benefit Pension Plans

In this approach, the *benefit* payment is defined. The participant is entitled to whatever amount the formula results in, and has a claim against all of the plan's assets for payment of the vested benefit. The plan sponsor (employer or union) is responsible for ensuring that sufficient assets are in the plan to pay those defined benefits. The most common type of defined benefit plan is the traditional pension plan.

Pension plan benefits are generally paid out in the form of a life annuity beginning at the participant's normal retirement date. Other methods of paying benefits are installment payments and lump sum distributions, with options sometimes given to the participant. The Pension Benefit Guarantee Corporation (PBGC) insures the benefits of private defined benefit plans to the extent provided in Title IV of ERISA.

In private plans, it is common for retirement benefits payable under the pension plan to be set in conjunction with Social Security benefits. Benefits calculated in this manner are said to be *integrated* with Social Security retirement benefits. IRS regulations governing the integration of Social Security benefits are complex and designed to prevent discrimination in favor of highly paid employees.

Defined benefit plans are more expensive to administer and operate than defined contribution plans. Defined benefit plans involve projecting a host of variables to estimate the amount of benefits payable upon retirement and the amount of assets that must be contributed today to fund those benefits in the future. Actuaries are required to perform the projections. Due to the extra costs involved, defined benefit plans have become less popular, with many defined benefit plans terminated and replaced by defined contribution plans.

D.1.b. Cash Balance Plans

Another form of defined benefit plan is the "cash balance" plan. Cash balance plans are similar to traditional defined benefit pension plans in that: (a) they guarantee a specific benefit upon retirement which is not dependent upon the plan's investment performance; (b) retirement benefits are payable as an annuity with surviving spouse protection; (c) employers must follow minimum funding policies under ERISA, and (d) basic plan benefits are guaranteed by the PBGC up to limits set by law.

In recent years, this type of plan has become increasingly popular. Most of these plans have emerged as conversions from overfunded traditional defined benefit pension plans. Following conversion, plan assets remain intact. And employers cannot remove overfunded assets unless the plan has been terminated and full benefits under the terminated plan have been funded. Despite this protection, some conversions by high profile employers have attracted media attention. The focus of much of the attention, and controversy, surrounds diminished benefits for employees with long years of service. Unless employers take explicit steps to protect older employees with long company service, conversions from traditional pension plans (whose benefits are largely determined by years of service and final average pay) into cash balance plans, may impact these employees negatively.

Cash balance plans differ from traditional defined benefit plans in that they define benefits in terms of a stated "account balance," as opposed to a specific monthly benefit for life under traditional defined benefit pension plans. In this form of plan, employers credit a participant's account each year with a "pay credit" (typically based on a percentage of compensation) plus an "interest credit" (either a fixed rate, or a rate which is linked to an index, such as the one year treasury bill rate). When a participant retires under a cash balance plan, he or she is entitled to the balance of his or her vested benefit (similar to a defined contribution plan), which may be taken as an annuity or in a lump sum. This is opposed to retirements under traditional defined benefit pension plans, where retirees are entitled to lifetime monthly annuities based upon years of service and pay.

A transition device, called "wearaway," is sometimes offered to employees with long service when traditional defined benefit pension plans are converted to cash balance plans. Wearaway provides employees the option of receiving the greater of their frozen benefit under the phased out pension plan formula, or their total benefit under the cash balance formula. Employees near early retirement age may accrue little or nothing for a prolonged period under a cash balance plan until the phased out plan benefit is *worn away*. This is because the value of the traditional pension plan benefit may be far greater than future accruals under the cash balance plan. Furthermore, beginning balances under the cash balance plan may be set lower than the present value of the phased out plan's accrued benefit. This serves to worsen the wearaway effect. Some employers temper the adverse conversion impact on long service employees by: (a) "grandfathering" them under the older plan's benefit formula, (b) providing higher "pay credits," (c) setting their opening balances higher, or (d) permitting employees to choose between benefit formulas under the old or new plans.

Employer accruals under a typical cash balance plan remain relatively level,

increasing only slightly toward the end of an employee's career. Employer accruals under a traditional defined benefit pension plan begin relatively low, but increase sharply as an employee approaches retirement. This tends to make cash balance plans less costly to fund and operate than traditional defined benefit pension plans. Unlike traditional pension plans, cash balance plans also typically eliminate early retirement options but permit participants to receive retirement benefits in a lump sum, which can be rolled over into an IRA or another employer's plan.

D.2. Defined Contribution Plans

A defined contribution plan is one which establishes a formula defining how much the plan sponsor will contribute to the plan. The formula may be based on the sponsor's profitability, on the amount of the participant's earnings, or on any number of other factors or combinations. In some plans, the sponsor determines the amount of contribution on a discretionary basis.

Profit sharing, employee stock ownership, thrift 401(k) and 403(b), Simplified Employee Pension (SEP)-IRA, Salary Reduction SEP (SARSEP), Savings Incentive Match Plan for Employees (SIMPLE), and other types of commonly encountered plans use the defined contribution approach. As with defined benefit plans, plan participants are entitled to their vested percentage of the benefits, as established under the plan.

In this approach, the *contribution* is defined; the benefit payment is not. The benefit amount is dependent on both the amount contributed and the success of the investment results. Under this approach, the participant is entitled only to the amount in his or her account, based on the varying amounts contributed and the investment return. The participant has a claim only on the assets of his or her account in the plan; there is no claim against all of the plan assets belonging to other plan participants. The PBGC does not insure the benefits of defined contribution plans.

In general, there are five basic types of plans or formulas for defined contribution plans: profit sharing, money purchase pension, target benefit, stock bonus, and employee stock ownership.

D.2.a. Profit Sharing Plans

A profit sharing plan is a qualified defined contribution plan which is also an Individual account plan. These plans are subject to ERISA. Plan assets are often invested wholly in the employer's stock. ERISA diversification requirements are not generally violated so long as the plan or trust instrument allows no more than 10% of the plan's assets to be invested in employer securities, except as provided in Section 407(a) of ERISA. Such plans are believed to foster productivity on the part of employees, who will own part of the company.

There are two types of profit sharing plans: current or deferred plans. In a current profit sharing plan, profits are paid directly to employees in cash, check, or stock as soon as profits are determined. Deferred profit sharing plans are more common. Deferred profit sharing plans are defined contribution plans operating under a written plan and qualified under the Internal Revenue Code (IRC) where the employer provides retirement benefits.

The employer's contribution to the plan each year can be either purely discretionary (nothing at all, if the employer wishes) or based on some type of predefined formula. If a formula is used, it typically relates the contribution to the employer's profits. The term profit sharing plan implies that an employer must have profits before any contributions are made to the plan. However, this requirement was eliminated under the Tax Reform Act of 1986. Contributions to profit sharing plans are not required to be based on an employer's profits according to Section 401(a)(27)(A) of the IRC.

The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants. In addition, the plan must provide a predetermined formula for distributing the fund accumulated under the plan after a fixed number of years; attainment of a stated age; or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

Generally, contributions are allocated to participants in proportion to their compensation with subsequent allocations reflecting future contributions adjusted by the investment experience of the plan. Plan benefits consist of the amount accumulated in each participant's account including: (1) employer contributions, (2) forfeitures from other employee's accounts, and (3) interest and capital gains. Many plans permit participants to borrow against their vested interest in the plan.

D.2.b. Money Purchase Pension Plans

A Money Purchase Pension Plan (MPPP) is a defined contribution plan which is also an Individual account plan. Employer contributions are usually determined based upon a percentage of compensation for specific Individuals. As with the profit sharing plan, benefits for each participant are derived from the amounts contributed to each Individual account. Unlike a profit sharing plan, forfeitures are not added to participants' accounts but are used to reduce the employer's contributions.

Money purchase pension plans differ from profit sharing plans in a number of ways:

- MPPPs must state a definite formula or approach for employer contributions; contributions may not be determined annually by the employer;
- MPPPs are subject to minimum funding requirements of the IRC;
- MPPPs must provide for a life annuity as a distribution option;
- MPPPs have different deduction limitations under the IRC than profit sharing plans; and
- MPPPs distributions are not permitted before retirement age, death, disability, or termination of either the plan or employment.

D.2.c. Target Benefit Plans

Target benefit plans are intended to provide a target benefit to each participant upon retirement. Employer contributions to each participant's account are established through a defined benefit formula. The amount of the contribution is determined by an actuary. The plan does not guarantee that the target benefit will be paid at retirement; its only obligation is to pay whatever can be provided by the amount in the participant's account depending on the actual investment results achieved by the fund. A life annuity must be one distribution option for the employee.

Target benefit plans are hybrids of a money purchase plan and a defined benefit plan. Target benefit plans are Individual account plans because contributions are allocated to each participant's Individual account.

D.2.d. Stock Bonus Plans

Stock bonus plans are identical to profit sharing plans and are usually established to permit employees to share in the ownership of the business and/or to reward meritorious service. Contributions, as with profit sharing plans, are not necessarily based upon profits and the benefits are distributable in cash or stock of the employer.

Generally, the plan must allow the participant to demand that the benefit be distributed in employer securities. If employer stock is not traded on an established market, the employee must have the right to require the employer to repurchase the stock under a fair market value formula.

D.2.e. Employee Stock Ownership Plans (ESOPs)

The information presented under this section will apply to both ESOPs sponsored by the bank for its own employees, and ESOPs found in the bank's trust department which are sponsored by different employers. In addition to the material presented under this heading, examiners should also refer to the following:
(1) ESOP Plans - Employer Securities Investments - Prudence; (2) ESOP Plans - Employer Securities Investments - Valuation; and (3) ESOPs Loans to Plans - Section 408 Statutory Exemption. The pertinent areas related to ESOPs are noted below:

- ESOPs, In General
- Leveraged ESOPs
- Advantages and Disadvantages of ESOPs

D.2.e.(1). ESOPs, In General

An ESOP is an Individual account plan that is either a qualified stock bonus plan or a combination qualified stock bonus and qualified money purchase plan. ESOPs provide separate accounts for each participant. Benefits are based solely on amounts contributed to each Individual account including attributable income, expenses, gains and losses, and allocated forfeitures of other participants' accounts. ESOPs are defined in Section 407(d)(6) of ERISA, Department of Labor (DOL) ERISA Regulation 2550.407d-6, and Section 4975(e)(7) of the IRC. See Appendix E.

Congress has provided a number of tax incentives to encourage the formation and continuation of ESOPs. ESOPs operate primarily under IRS requirements but are also subject to certain ERISA provisions. Since tax incentives impact government revenues, the rules under which ESOPs operate are subject to change by Congress and implementing IRS regulations. Some ESOPs which reflect various statutory or regulatory approaches have special names: Tax Reform Act Stock Ownership Plans (TRASOPs), Payroll-deduction Stock Ownership Plans (PAYSOPs), etc.

Most ESOPs invest solely in the employer's stock. Since many companies are either closely-held or have a very limited market for their stock, valuing the stock can prove problematic and provide opportunities for abuse. The value of the employer's stock greatly impacts the employee's eventual benefits.

In reviewing the administration of an ESOP's investments, the examiner must be cognizant of the following facts pertaining to ESOPs. ESOPs:

- *Are not* exempt from ERISA's prudence and exclusive benefit rules; but
- *Are* exempt from ERISA's diversification rule; and
- *May be* exempt from prohibited transactions (purchases and sales of employer securities from the employer and/or parties in interest) *if* certain conditions are met. In general, refer to ERISA Section 408(e) and DOL

ERISA Regulation 2550.408e. See Appendix E. Three main conditions for exemption require:

- Not more than adequate consideration may be paid by the plan (see Definitions, ERISA 3(18);
- No direct or indirect commissions may be paid; and
- The investment meets the prudence requirement of Section 404(a) of ERISA.

As tax-qualified plans, ESOPs must follow applicable IRS requirements, in addition to ERISA provisions. Except as otherwise indicated below, IRS Regulation 54.4975-11 (see Appendix E) establishes most of the following operational requirements for ESOPs. An ESOP must:

- Be formally designated as an ESOP in the plan document.

- Be designed to invest primarily in qualifying employer securities. For leveraged ESOPs, investments are restricted to the employer's common stock or convertible preferred stock; stock rights, warrants, and options are not considered in the definition. For non-leveraged ESOPs, the definition also includes marketable bonds, debentures, notes, and similar marketable debt instruments of the employer.

  The types of qualifying employer securities are covered by IRS Regulation 54.4975-12. DOL ERISA Regulation 2550.407d-5 defines the term qualifying. See Appendix E.

- Value employer securities in accordance with both IRS and ERISA requirements. The valuations affect purchases and sales of employer securities, market-value reporting on the Annual Report (Form 5500), allocations to participants' accounts, and distributions to participants.

  ERISA Section 408(e)(1) and DOL ERISA Regulation 2550.408e require that transactions for employer securities involve no more than adequate consideration. This term is defined in ERISA Section 3(18).

  Section (d)(5) of IRS Regulation 54.4975-11 requires certain steps when valuing employer securities by an ESOP. For securities traded on securities exchanges, the quoted prices may be used. If the stock is publicly traded, no appraisal is necessary. But if it is traded infrequently, an appraisal may still be needed. In general, employer securities which are not readily tradable on an established securities market must be valued by an independent appraiser.

  - Valuations must be made in good faith and based on all relevant factors:
    - In any transaction between the ESOP and a disqualified person, the value of the securities must be determined *as of the date of the transaction.* In such transactions,

an independent appraisal, by itself, does not automatically equal good faith.

  - For all other transactions, values must be determined as of the most recent valuation date under the plan. In such transactions, an independent appraisal will generally be deemed to be a good faith determination of value.

- Include a put option. IRC Section 401(a)(23) also states that, to be qualified, a stock bonus plan must include a put option for securities that are not publicly traded.

  With a put option, an employee who is entitled to a distribution from an ESOP has the option of requiring the employer to repurchase employer securities from the employee's Individual account in the plan. If the securities are not readily tradable on an established market, the securities must be valued at a reasonable fair market value. Through this arrangement, the employee receives a cash distribution instead of an in-kind distribution of illiquid securities.

- Include a suspense account for which assets are added to and maintained.

In addition, an ESOP must (1) pass voting rights through to participants for those shares allocated to Individual accounts according to Security and Exchange Commission (SEC) Regulation 240.14c-7 and (2) meet stringent nondiscrimination tests as to employee participation according to IRS regulations.

ESOPs can acquire assets through: (1) an outright gift of cash or newly issued common stock to the plan, (2) a thrift arrangement under which employees contribute money (PAYSOPs), (3) a profit-sharing arrangement where the employer's annual contribution is a percentage of profits, or (4) a money purchase arrangement where a percentage of compensation is contributed each year irrespective of profits. Most ESOPs; however, obtain initial funding through loans and are termed *leveraged* ESOPs. Loans to ESOP plans must comply with IRS and Labor Department requirements. Refer to the Leveraged ESOPs caption below.

D.2.e.(2). Leveraged ESOPs

Since a majority of ESOPs are leveraged, the examiner needs to understand the concept of a leverage ESOP and the conditions that apply. A corporation creates an ESOP, alone or in addition to (sometimes referred to as piggyback) another qualified retirement plan. The ESOP applies for a loan. The lender is usually an independent third party, but it could be anyone, including a party in interest such as the plan sponsor or the bank.

A number of conditions apply to such loans when the loan is with or guaranteed by a party in interest. The ESOP loan should be primarily for the benefit of participants and beneficiaries. Demand loans are not permitted and the loan

must be payable over a set period. Terms of the loan must be, at the time it is made, at least as favorable to the ESOP as those of a comparable loan negotiated at an arm's-length basis by independent parties. No more than a reasonable rate of interest may be charged. While the loan may be unsecured, most ESOP loans are secured. If collateral is given by the plan to a party in interest, it may consist only of qualifying employer securities.

Leveraged financing may operate in two different ways. In the first way, the company gives the lender a written guaranty promising that the ESOP will repay the loan and that, each year, the employer will contribute to the ESOP sufficient funds to permit the ESOP to make its annual repayment of the loan. In the second way, the company borrows money from a bank and lends the money to the ESOP under terms identical to those negotiated between the company and the bank (mirror loan). After one of the financing options is chosen, the ESOP takes the loan proceeds and purchases qualifying employer securities at a reasonable price. Purchases must meet the conditions of ERISA Section 408(e) to avoid violating prohibited transaction rules.

Company contributions to the ESOP, which are tax-deductible under IRC Section 404, are used to pay off the loan. The employer's entire plan contribution (used to pay back the loan) is deductible within the limits of the IRC. If the employer borrowed the money directly, only the interest paid on the loan, and not repayment of the principal, would be deductible. The payments release a proportionate amount of securities from the loan's collateral. The securities, which were held in a suspense account by the plan, can be allocated among the plan participants as portions of the loan are paid off.

D.2.e.(3). Advantages and Disadvantages of an ESOP

There are a number of factors that influence the decision to sponsor an ESOP. Many of the considerations are tax-oriented. The plan sponsor, participating employees, and other parties all derive various advantages and disadvantages from the operation of an ESOP.

Employer Considerations

The employer's advantages include the fact that ESOPs are believed to foster productivity on the part of employees who will own part of the company. An ESOP may also provide a means of raising capital internally without resorting to outside financing, which may be more expensive. If leverage for the ESOP is necessary, the lender may offer a lower interest rate to the plan since interest received on the loan may be non-taxable to the lender (see Lenders to ESOPs). In addition, an ESOP may be used to convert a public company to a private one or to resist an unwanted takeover. An ESOP used for such a purpose is subject to, among other things, the fiduciary responsibility and prohibited transaction provisions of Title I of ERISA, Protection of Employee Benefit Rights

Operating an ESOP also offers the employer a number of tax advantages. Tax deductions are available for stock or cash contributions to the plan, cash dividends paid to plan participants, and dividends used to repay the loan. Particularly noteworthy is that the employer's entire plan contribution (used

to pay back the loan) is deductible within IRC Section 404 limits.

Disadvantages for the employer involve the dilution of ownership and/or control, and the difficulties and costs inherent in arriving at recurring fair market valuations for thinly-traded securities.

Employee Considerations

The primary consideration for most employees is that contributions made by the employer and accumulated earnings are tax-deferred. In addition, taxes on stock appreciation, when the stock is distributed, may be deferred by rolling the distribution over into an Individual Retirement Account (IRA). The fact that ESOPs offer employees a stake in the employer corporation through stock ownership has meant, in some situations, that employees have been able to save their jobs by purchasing a company or production facility which was scheduled for closure.

One significant disadvantage is that the employee bears all investment risk. In addition, the employee's investment is concentrated in one company's stock performance and valuations for the employer stock may be difficult to achieve. If the outlook for the employer's industry or for the employer itself is poor, the employee's retirement benefits may be threatened. Ownership of marginal or poorly managed companies, or those in declining industries, is of little value to employees and no foundation for careful retirement planning. As with any defined contribution plan, the employee's benefits are not insured by the PBGC.

When employees own stock in the employer, they exercise a certain amount of control over the employer. However, their influence may be limited as most ESOPs do not own a majority of the company's stock. Only shares allocated to Individual accounts have voting rights. And, the allocation of stock to Individual employees' accounts is a slow process in leveraged ESOPs. Voting rights are fully passed through only in publicly traded companies; in non publicly traded companies, only certain issues are voted on by participants. In a number of instances where an ESOP was formed to permit employees to purchase a facility from the employer, the employees owned a majority of the stock but management controlled voting authority. In effect, the employees may have little or no say in how the company they own is managed or operated.

To qualify for tax credit under IRC Section 409, ESOPs are required to pass the following voting rights on to Individual accounts holding allocated shares. IRC Section 409(e)(2) requires plans holding registered employer securities to permit plan participants to direct the plan on how to vote allocated securities. Where plans hold non-registered securities, IRC Sections 409(e)(3) and (5) require plans to permit plan participants to direct the plan on how to vote allocated securities with respect to corporate matters, such as: mergers, consolidations, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a business, or similar transactions. IRC Section 409(e) is located in Appendix E.

Lenders to ESOPs

Tax laws provide incentives for lenders to grant loans to ESOPs. Under IRC Section 133, 50% of the interest the lender earns from an ESOP loan is non-taxable income when certain conditions are met:

- The ESOP owns at least 50% of each class of the outstanding stock of the corporation issuing the stock (or 50% of all outstanding stock) immediately after the acquisition (there are some limited additional provisions for isolated situations);
- The term of the loan isn't for more than 15 years; and
- The participants can direct the plan how to vote the shares allocated to their Individual accounts and acquired with the exempt loan.

These loans carry normal credit risk to the lender; plan sponsors in weak financial condition may involve more than normal credit risk. If the employer is unable to make its contributions to the ESOP, the plan will be unable to repay the lender. If the lender exercises its rights as a secured lender (the employer stock collateral pledged by the ESOP and the employer guarantee), it may wind up owning and operating the company.

Company Shareholder Considerations
Generally, if an ESOP exists, shareholders of the employer have a ready market for their stock. In addition, if a shareholder sells his or her employer stock to the ESOP, any unrealized gain may be deferred. The shareholder may elect not to recognize the gain on the sale of stock to the ESOP if qualified replacement property is purchased within the replacement period. Refer to IRC Section 1042 regarding the Sales of Stock to Employee Stock Ownership Plans or Certain Cooperatives.

D.2.f. Thrift and Savings Plans

A thrift or savings plan is a defined contribution plan which is also a type of Individual account plan. These plans are employer sponsored and employee participation is normally voluntary. The plans permit the employee to make contributions, usually established as a percentage of pay. Employers normally make matching or partially matching contributions.

In many thrift and savings plans, employees can direct their plan assets into several pre-selected investment vehicles. Many corporate plans include employer stock as one of the investment options for these plans. An advantage to a plan where the employee decides how to invest funds in his or her plan account is that there is a reduced fiduciary liability for both the plan sponsor and any bank trustee. Self-directed thrift plans must generally comply with the requirements of DOL ERISA Regulation 2550.404c-1. This is discussed further in subsection H.5.c.(6), Individual Account (Section 404(c)) Plans.

Most thrift and savings plans are tax-qualified. Section 401(k) of the IRC, which originally was added in 1978, permits employers to establish tax-qualified cash or deferred profit sharing or stock bonus plans. Under such plans, taxes on amounts contributed by both the employer and the employee, as well as accumulated earnings are deferred. With a salary reduction-type arrangement, the employees receive less current cash income and pay correspondingly lower Federal income taxes. Essentially, what a salary reduction plan accomplishes is to permit employees to provide for their own retirement with pre-tax dollars, rather than after-tax dollars.

To qualify for the mentioned tax benefits, the IRS requires the plan document to cover a number of specific areas. Among these are nondiscrimination in eligibility for the plan, and provisions to assure that executives and highly-paid employees do not receive preferential treatment. Vesting, withdrawals, participant loans, distribution of benefits, and other requirements must be met. The IRS rules governing these matters are complex and are primarily a concern for the plan sponsor, not a bank fiduciary.

D.2.g. Welfare Benefit Plans

The more common types of employee welfare benefit plans and the related benefits include:

- *Health Plans* which provide for hospital expenses, diagnostic X-ray and laboratory fees, surgical and medical fees, medicine and drugs, major medical insurance, accidental death and dismemberment, and life insurance benefits. Such plans may also provide for dental care, visual care, psychiatric care, and preventive medical examinations.
- *Disability Plans* which normally provide benefits during periods of inability to work because of physical incapacity from illness or injury.
- *Vacation and Holiday Plans* which provide cash benefits to cover time off for vacation purposes.
- *Apprenticeship, Educational, and Similar Plans* which provide funds for retraining Individuals in the event of termination of a job in a particular industry, provide an opportunity to expand skills to improve job performance, or take on new responsibilities within or outside of the company.
- *Multiple Employer Welfare Arrangements (MEWAs)* which permit a pooling of employer contributions to purchase health insurance for their employees at favorable rates. Problems can arise because some suppliers offer attractively priced but unfunded "insurance-like" products without complying with state insurance laws. These suppliers claim their products are employee benefit "plans" and are, therefore, preempted from state insurance laws by ERISA. In doing so, they attempt to avoid state regulation and insurance reserve requirements. The following rules apply: (1) when a MEWA is covered by ERISA and fully insured (which rarely happens), state insurance laws may apply to the extent they provide specified levels of reserves and contributions to pay future benefits; (2) when a MEWA is covered by ERISA and not fully insured, any state insurance law "not inconsistent" with ERISA may also apply; (3) when a MEWA is not covered by ERISA, no preemption can be claimed. Refer to subsection L, Compliance with State Laws for additional comment on state law and MEWAs. [The term MEWA is defined for purposes of Title I of ERISA in Section 3(40)(A); section 514(b)(6) of ERISA addresses the issue of presumption with respect to MEWAs.]

Most single employer welfare plans are either insured plans or unfunded plans. The insured plans typically provide medical and/or life insurance. The unfunded benefit plans most common for single employers are vacation and sick leave plans. The establishment of a single trust, to which contributions are made and from which benefits are paid, normally involves multiple employer plans. Occasionally larger corporations may provide medical and life benefits on a self-insured basis. In these instances, a trust to which annual contributions are made may be established.

Since welfare benefits are normally included in group insurance programs, an examiner will infrequently encounter a trust department acting as trustee of a welfare benefit plan. However, trusteed welfare benefit plans are subject to the various provisions of ERISA in the same manner as pension benefit

plans. Thus, when encountered in trust departments there must be a plan and trust document which defines the manner of contribution, provides the basis for payment of benefits, and describes the manner in which such plan funds are to be invested.

D.3. Abandonned Plans

The Abandoned Plan Program facilitates the termination of, and distribution of benefits from, individual account pension plans that have been abandoned by their sponsoring employers. The program was established pursuant to three final regulations and a related class exemption and is administered by Employee Benefits Security Administration national and regional offices.

Significant business events, such as bankruptcies, mergers, acquisitions, and other similar transactions affecting the status of an employer, too often result in employers, particularly small employers, abandoning their individual account pension plans (e.g., 401(k) plans). When this happens, custodians such as banks, insurers, mutual fund companies, etc. are left holding the assets of these abandoned plans but do not have the authority to terminate such plans and make benefit distributions – even in response to participant demands. In these situations, participants and beneficiaries have great difficulty accessing the benefits they have earned. In response, the Labor Department's Employee Benefits Security Administration (EBSA) has developed rules to facilitate a voluntary, safe and efficient process for winding up the affairs of abandoned individual account plans so that benefit distributions are made to participants and beneficiaries. Information about the program is available under the Abandoned Plan Program section of EBSA's Web site at www.dol.gov/ebsa.

Overview of Regulations

The regulations, 29 CFR Parts 2550 and 2578, establish standards for determining when a plan is abandoned, simplified procedures for winding up the plan and distributing benefits to participants and beneficiaries, and provide guidance on who may initiate and carry out the winding-up process.

Plan Abandonment

A plan generally will be considered abandoned if no contributions to or distributions from the plan have been made for a period of at least 12 consecutive months and, following reasonable efforts to locate the plan sponsor, it is determined that the sponsor no longer exists, cannot be located, or is unable to maintain the plan.

Determinations of Abandonment

Only a qualified termination administrator (QTA) may determine whether a plan is abandoned under the regulations. To be a QTA, an entity must hold the plan's assets and be eligible as a trustee or issuer of an individual retirement plan under the Internal Revenue Code (e.g., bank, trust company, mutual fund family, or insurance company).

Termination and Winding-Up Process

The regulations establish specific procedures that QTAs must follow, including:

- Notifying EBSA prior to, and after, terminating and winding up a plan.
- Locating and updating plan records.
- Calculating benefits payable to participants and beneficiaries.
- Notifying participants and beneficiaries of the termination, their rights and options.
- Distributing benefits to participants and beneficiaries.
- Filing a summary terminal report.

A QTA is not required to amend a plan to accommodate the termination.

The regulations include model notices that the QTA may use.

Distribution Safe Harbor for Missing Participants

The regulations establish a fiduciary safe harbor for distributions from terminating individual account plans (whether or not abandoned) on behalf of missing participants.

In most cases, the account of a missing participant will be transferred directly to an individual retirement plan. In some cases, accounts of $1,000 or less may be distributed to a bank account or state unclaimed property fund on behalf of the missing participant.

Fiduciary Liability

QTAs that follow the regulations will be considered generally to have satisfied the prudence requirements of ERISA with respect to winding-up activities.

A QTA does not have an obligation to conduct an inquiry or review to determine whether or what breaches of fiduciary responsibility may have occurred with respect to a plan prior to becoming the QTA for such plan.

A QTA is not required to collect delinquent contributions on behalf of the plan, provided that the QTA informs EBSA of known delinquencies.

Since more than one entity may be holding assets of a plan, the regulations provide a safe harbor for other asset custodians who cooperate with the QTA.

Annual Reporting Relief

The regulations provide annual reporting relief, under which QTAs are not responsible for filing a Form 5500 Annual Report on behalf of an abandoned plan, either in the terminating year or any previous plan years; but the QTA must complete and file a summary terminal report at the end of the winding-up process.

Instructions on how to file the terminal report will be available under the Abandoned Plan Program section of EBSA's Web site at www.dol.gov/ebsa.

Class Exemption

Accompanying the regulations is a class exemption, PTE 2006-06 (116KB PDF file - PDF Help), that provides conditional relief from ERISA's prohibited transaction restrictions.

The exemption would cover transactions where the QTA selects and pays itself:

- For services rendered prior to becoming a QTA.
- To provide services in connection with terminating and winding up an abandoned plan.
- For distributions from abandoned plans to IRAs or other accounts maintained by the QTA resulting from a participant's failure to provide direction.

D.4. Health Savings Accounts (HSAs)

Health Savings Accounts (HSAs) were created on December 8, 2003 under Title XII of the Medicare Prescription Drug, Improvement and Modernization Act of 2003," (MPDIMA of 2003) and updated under Title III of the Tax Relief and Health Care Act of 2006 (TRHCA of 2006).

In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish an HSA. However, individuals who may be claimed as a dependent on another person's tax return are not eligible to open an HSA. HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Where the establishment of an HSA is voluntary on the part of an employee, and the employer does not influence or limit the investment or use of HSA funds, the HSA does not constitute "employee welfare benefit plans" for purposes of Title I of ERISA . Individuals may make tax deductible contributions to the HSA even if they do not itemize deductions; the individual's employer can make contributions that are not taxed to either the employer or the employee; and, employers sponsoring cafeteria plans can allow employees to contribute untaxed salary through salary reduction. Individuals age 55 and older are also allowed to make additional catch-up contributions to their HSAs. Furthermore, certain credits on behalf of the individual by plan sponsors are permissible and not viewed as a prohibited transaction under ERISA or the Code. Amounts contributed to an HSA belong to the account holder and are portable. Earnings on HSAs are not taxable, and can grow tax-free through investment earnings. Unlike amounts in Flexible Spending Arrangements that are forfeited if not used by the end of the year, unused funds remain available for use in later years. Distributions from an HSA for qualified medical expenses are not includible in gross income. However, distributions from an HSA which are not used for qualified medical expenses are includible in gross income and subject to an additional 10 percent tax. The additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of 65. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions cannot be made to an HSA.

A high deductible health plan is a health plan that, for 2007, has a deductible that is at least $1,100 for self-only coverage or $2,200 for family coverage and that has an out-of-pocket expense limit that is no more than $5,500 in the case of self-only coverage, and $11,000 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan is not a high deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance. A plan does not fail to be a high deductible health plan by reason of failing to have a deductible for preventive care.

Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary of Treasury may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization.

Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Health flexible spending arrangement ("FSAs") and health reimbursement arrangements ("HRAs") are health plans that constitute other coverage under the HSA rules. An individual who is covered by a high deductible health plan and a health FSA, or HRA, is generally not eligible to make contributions to an HSA. An individual is eligible to make contributions to an HSA if the

health FSA or HRA is: (1) a limited purpose health FSA or HRA; (2) a suspended HRA; (3) a post-deductible health FSA or HRA; or (4) a retirement HRA.

Tax Treatment of and Limits on Contributions

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. In the case of an employee, contributions to an HSA may be made by both the individual and the individual's employer. All contributions are aggregated for purposes of the maximum annual contribution limit. Contributions to Archer MSAs (medical savings accounts for self-employed individuals and employees of small employers with 50 or fewer employees) reduce the annual contribution limit for HSAs. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) (for 2007) $2,850 for self-only coverage and $5,650 for family coverage. The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of individuals and covered spouses who are age 55 or older, the HSA annual contribution limit is increased by catch-up contributions of $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter. As in determining the general annual contribution limit, the increase in the annual contribution limit for individuals who have attained age 55 is also determined on a monthly basis. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare. In the case of individuals who are married and either spouse has family coverage, both spouses are treated as having only the family coverage with the lowest annual deductible. The annual contribution limit (without regard to the catch-up contribution amounts) is divided equally between the spouses unless they agree on a different division (after reduction for amounts paid from any Archer MSA of the spouses). An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. The excise tax generally is equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA. Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

Comparable Contributions

Section 306 of the TRHCA of 2006 requires employers to make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

Taxation of Distributions

Distributions from an HSA for "qualified medical expenses" of the individual and his or her spouse or dependents are excludable from gross income. Qualified medical expenses include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State

law, or (4) health insurance premiums for Medicare, other than premiums for Medigap policies. Qualified health insurance premiums include Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income also are subject to an additional 10 percent tax unless made after death, disability, or the individual attains the age of 65.

Health Flexible Spending Arrangements and Health Reimbursement Arrangements

Arrangements commonly used by employers to reimburse medical expenses of their employees include health flexible spending arrangements ("FSAs") and health reimbursement accounts ("HRAs"). Health FSAs are typically funded on a salary reduction basis. If the health FSA meets certain requirements, the compensation that is forgone is not includible in gross income and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement is referred to as the "use-it-or lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts available from a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one half months immediately following the end of the plan year during which unused amounts may be used. An individual participating in a health FSA that allows reimbursements during a grace period is generally not eligible to make contributions to the HSA until the first month following the end of the grace period even if the individual's health FSA has no unused benefits as of the end of the prior plan year. HRAs operate in a manner similar to health FSAs, in that they are an employer maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or lose-it rule does not apply. Rather, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA. Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

Rollovers from Health FSAs and HRAs into HSAs for a Limited Time

Section 302 of the TRHCA of 2006 permits certain amounts in a health FSA or HRA to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006 or (2) the balance in the health FSA or HRA as of the date of the distribution. Amounts contributed to an HSA under this section are excludable from gross income for tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. Contributions must be made directly to the HSA before January 1, 2012. The rollover is limited to one distribution with respect to each health FSA or HRA of the individual. This provision was designed to assist individuals in transferring from another type of health plan to a high deductible health plan. If an individual for whom a contribution is made under the provision does not remain an eligible individual during the "testing period," the amount of the contribution is includible in gross income of the individual. An exception

applies if the employee ceases to be an eligible individual by reason of death or disability. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10 percent additional tax applies to the amount includible. A modified comparability rule applies with respect to contributions under the provision. If the employer makes available to any employee the ability to make contributions to the HSA from distributions from a health FSA or HRA under this section, all employees who are covered under a high deductible plan of the employer must be allowed to make such distributions and contributions. The IRS issued guidance regarding rollovers from FSAs and HRAs into HSAs. See Internal Revenue Service Notice 2007-22.

Certain FSA Coverage Treated as Disregarded Coverage

Section 302 of the TRHCA of 2006 provides that, for taxable years beginning after December 31, 2006, coverage under a health flexible spending arrangement ("FSA") during the period immediately following the end of a plan year during which unused benefits may be paid or reimbursed to plan participants for qualified expenses is disregarded coverage. Such coverage is disregarded if (1) the balance in the health FSA at the end of the plan year is zero, or (2) the entire remaining balance in the health FSA at the end of the plan year is contributed to an HSA.

Repeal of Annual Plan Deductible Limitation on HSA Contribution Limitation

Section 303 of the TRHCA of 2006 modifies the limit on the annual deductible contributions that can be made to an HSA. The maximum deductible contribution is not limited to the annual deductible under the high deductible health plan. The maximum aggregate annual contribution that can be made to an HSA in 2007 is $2,850 for self-only coverage and $5,650 family coverage.

Indexing of Cost of Living Adjustments

Section 304 of the TRHCA of 2006 provides that for adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year will be determined as of the close of the 12-month period ending on March 31 of the calendar year for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (contribution limits and high-deductible health plan requirements).

Contribution for Months Preceding Month that Taxpayer is an Eligible Individual

Section 305 of the TRHCA of 2006 allows individuals who become covered under a high deductible plan in a month other than January to make the full deductible HSA contribution for the year. An individual who is an eligible individual during the last month of a taxable year is treated as having been an eligible individual during every month during the taxable year for purposes of computing the amount that may be contributed to the HSA for the year. For the months preceding the last month of the taxable year that the individual is treated as an eligible individual solely by reason of this section, the individual is treated as having been enrolled in the same high deductible health plan in which the individual was enrolled during the last month of the taxable year. If an individual makes contributions permitted by section 305 but does not remain an eligible individual during the "testing period," the contributions preceding the month in which the individual was an eligible individual are includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability.

The "testing period" is the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax applies to the amount in question.

Employer Comparable Contribution Requirements for Contributions Made to Nonhighly Compensated Employees

Section 306 of the TRHCA of 2006 provides an exception to the comparable contribution requirements which allows employers to make larger HSA contributions for nonhighly compensated employees than for highly compensated employees. Highly compensated employees are defined as under section 414(q) and include any employee who was (1) a five-percent owner at any time during the year or the preceding year; or (2) for the preceding year, (A) had compensation from the employer in excess of $100,000 (for 2007) and (B) if elected by the employer, was in the group consisting of the top 20 percent of employees when ranked based on compensation. The comparable contribution rules continue to apply to the contributions made to nonhighly compensated employees so that the employer must make available comparable contributions on behalf of all nonhighly compensated employees with comparable coverage during the same period.

Rollovers from IRAs into HSAs

Section 307 the TRHCA of 2006 permits a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement (“IRA”). The contribution must be made in a direct trustee-to-trustee transfer. Amounts distributed from an IRA under this section are not includible in income, and are not subject to the 10 percent tax on early distributions. The amount that can be distributed from the IRA and contributed to an HSA is limited to the maximum deductible contribution to the HSA computed on the basis of the type of coverage under the high deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the year of the contribution from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA. Only one distribution and contribution may be made during the lifetime of the individual. However, if a distribution and contribution are made during a month in which an individual has self-only coverage as of the first day of the month, an additional distribution and contribution may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions. If the individual does not remain an eligible individual during the "testing period," the amount of the distribution and contribution is includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax applies to the amount in question. Section 307 does not apply to simplified employee pensions (“SEPs”) or to SIMPLE retirement accounts. The IRS issued guidance on this matter in the form of a Service Notice on March 5, 2007.

DOL Guidance Regarding HSAs

The DOL has issued gudiance on several issues concerning HSA and the application of ERISA and the Internal Revenue Code to HSAs. In 2004, the DOL issued Field Assistance Bulletin 2004-01 which addressed the application of ERISA to HSAs established in connection with employment. DOL expanded on this guidance by issuing Q&As in Field Assistance Bulletin 2006-02. In addition, in 2004, DOL issued Advisory Opinion 2004-09A, which

addresses the application of the prohibited transaction provision of IRC Section 4975 to certain contributions to HSAs.

E. Self-Employed Retirement (KEOGH or HR-10) Plans

Self-employed Individuals are permitted to establish tax-qualified pension and profit sharing plans for themselves and their employees. A self-employed Individual is a sole proprietor or partner who works in his or her unincorporated business. Such arrangements are normally designated as Keogh or HR-10 plans, trusts, or accounts. Sometimes Keogh accounts are termed Self-Employed Retirement Plans (SERPs). Keogh plans are generally comparable to corporate-sponsored defined contribution plans that are Individual account plans.

There are specific provisions in the IRC covering Keogh accounts. Only self-employed Individuals may deduct contributions to a Keogh plan. Participants may be permitted to make nondeductible contributions to a plan in addition to employer contributions. Even though these employee contributions may not be deductible, the earnings on them and the contributions by the employer are tax deferred until the Individual begins retirement withdrawals. Retirement withdrawals may commence upon attainment of age 59 1/2 but must commence by the end of the calendar year in which the Individual attains age 70 1/2. The owner-employee may contribute up to 25% of the first $150,000 of earned income or $30,000, whichever is less. In addition, the IRC requires that contributions, in the same percentage of compensation as for the owner-employer, be made on behalf of common law employees with three or more years of service. Plan participants rarely direct their own investments.

In self-employed retirement plans, the *contribution* is defined but the benefit payment is not. Benefits are subject to both the amount contributed and the success of the investment results. Under this approach, the participant is entitled only to the amount in his or her account, based on the varying amounts contributed and the investment return. The participant has a claim only on the assets of his or her account in the plan; there is no claim against all of the plan assets belonging to other plan participants. The PBGC does not insure the benefits of defined contribution plans. IRS Publication 560, Retirement Plans for the Self-Employed, provides more detailed information on both defined benefit and defined contribution Keogh plans.

A bank may serve as a trustee or custodian for Keogh or HR-10 plans. As trustee, the bank's responsibilities may range from ministerial functions to the exercise of broad discretionary duties. As custodian, responsibilities are essentially ministerial in nature. In either case, the bank's responsibilities will be governed by the instrument and ERISA.

- Keogh accounts which cover only the owner-employer, and no other employees, are subject to compliance with the prohibited transaction provisions of ERISA Section 406 and the parallel IRC Section 4975 (refer to subsection H.7, Prohibited Transactions - ERISA Section 406).
- Keogh accounts which cover both the owner-employer and other employees are subject to ERISA Sections 404 and 406, covering fiduciary responsibility and prohibited transactions (refer to subsection H.7, Prohibited Transactions - ERISA Section 406).
- IRC Section 408(m) indicates that if self-directed and Individual account plans invest in collectibles, the investment will be treated as a distribution. Collectibles include: stamps, coins, artwork, gems, antiques, etc. An exception is made for U.S. American Eagle gold coins, which are permissible investments (refer to Appendix E)

A bank may accept non-deposit self-directed Keogh custodial accounts without trust powers under Section 333.101(b) of the FDIC's Rules and Regulations, if the appropriate state authority also permits such accounts to be accepted without trust powers. Despite the fact that trust powers are not needed, banks accepting such accounts must implement appropriate controls. Refer to Section 2, subsection O, Self-Directed IRAs and Keogh Accounts.

Examiners should also be aware that Keogh accounts may not normally be invested in Collective Investment Funds (CIFs) without violating Federal securities laws. There are a few approaches where collective investments are possible, but with many restrictions. Refer to Section 7, subsection D.1, Keogh Account Usage Of Collective Investment Funds. Under certain conditions, banks may offer beneficiaries of Keogh accounts reduced or no cost banking services, refer to Section 5, subsection H.9.c, Receipt of Services by IRAs and Keogh Plans.

F. Individual Retirement Accounts (IRAs)

As tax laws change, the types of IRA and the conditions affecting their availability and operation change. An IRA is a personal savings plan that offers a person tax advantages to set aside money for retirement. Two advantages for the individual include that they may be able to deduct contributions to the IRA in whole or in part, and generally, earnings and gains are not taxed until retirement distributions commence. Tax qualification for IRAs is achieved pursuant to IRC Section 408.

In 2003 and 2004, an individual may contribute the lesser of $3,000 ($3,500 if the individual reached age 50 before 2004) or taxable compensation into an IRA. An individual and a non-working spouse (a one-income couple) are limited to $6,000 per year in contributions ($3,000 each to a Traditional IRA and a Spousal IRA). This limit increases to $6.500 if one individual reached age 50 before 2004, or $7,000 if both reached 50 before 2004. The amount contributed is deductible on the Individual's tax return. IRA contributions must end in the year the participant turns 70 1/2. (Note: Traditional IRAs are IRAs which are neither Roth IRAs nor SIMPLE IRAs.)

IRA deductibility for Federal income tax purposes is limited based on income tax filing status, the amount of earned income, and/or coverage of the participant or spouse by an employer-sponsored retirement plan(s). Even if Individuals cannot take a full deduction because of one of the limitations described above, they may still contribute up to the maximum amount permitted in the current year (refer to IRS Publication 590 for detailed information pertaining to IRA contributory and deductibility limits, these limits are subject to change). Retirement withdrawals may commence upon attainment of age 59 1/2, but must commence by the end of the calendar year in which the Individual attains age 70 1/2.

Under certain conditions, banks may offer beneficiaries of IRAs reduced or no cost banking services, refer to subsection H.9.c. Receipt of Services by IRAs and Keogh Plans.

IRS Publication 590, Individual Retirement Arrangements provides further information on IRAs.

F.1. Operating/Filing Requirements

The IRS requires all IRAs to operate under either one of two versions of IRS Form 5305, or under a written agreement which incorporates the provisions of either of the versions of this form. The two forms are identical except for the interchangeability of the terms trust and custodian throughout the forms. As custodian, responsibilities are essentially ministerial in nature.

The examiner should note:

- Under IRC Section 408(h) - bank custodians of IRAs are considered trustees, hence fiduciaries.

- Under IRC Section 408(i) - IRA trustees are required to report contributions, distributions, and other matters required by regulation (including the fair market value of assets) to the IRS and the IRA owner on an annual basis. As the value of some types of assets, such as limited partnerships, is not easily ascertainable, the administration of some IRA accounts can be problematic.

  In a 2-24-93 letter to Partnership Valuations, Inc., Annapolis, Maryland, the IRS indicated that trustees of IRAs were responsible for ensuring that IRA assets are properly valued on an annual basis, including assets which are "hard to value". It also stated that IRA trustees could not evade evaluation responsibility by having the IRA owner sign a release, indemnification or other instrument. The IRS indicated that IRA contributions, distributions, and valuations should be reported on IRS Form 5498 (Individual Retirement Arrangement Information) to satisfy annual reporting requirements. A copy of the 2-23-93 IRS Interpretive Letter EP:R:9 - Valuation of IRA Assets to Partnership Valuations, Inc. is located in Appendix E. IRS Revenue Ruling 59-60 - Valuation of Non-Traded Assets, in Appendix E also provides general guidance on valuing non-traded assets.

F.2. Types of IRAs

In addition to IRAs for Individuals, a number of different variations now exist and are highlighted below:

- *Rollover IRAs* enable an employee to transfer, tax-free, lump-sum distributions from a previous employer's tax-deferred retirement plan to a new IRA. Rollovers may also be used to transfer funds from one IRA account to another IRA account. The transfer permits the employee to continue tax-deferred earnings.

  When a lump-sum distribution from an employee benefit plan is "rolled" into an IRA, the entire distribution from the previous plan must be transferred to one or more rollover IRAs. In addition, if the funds being transferred originate from either a lump-sum distribution or represent the movement from an existing IRA account to a new IRA account, the transfer must be done directly from the previous plan or IRA to the rollover IRA. If the transfer is done by a check to the employee, the employee must:

  - Pay 20% of the total amount to the government for Federal income taxes, which is withheld from the initial disbursement;
  - Furnish the 20% that was withheld in order to avoid tax consequences since the entire amount of the initial distribution must be rolled into the new rollover IRA; and
  - Place the total amount of funds into the rollover IRA by the 60th day after the day the distribution is received.

- *Individual Retirement Annuity* is an IRA which is established by purchasing an annuity contract or an endowment contract from a life insurance company. The annuity must be issued to the IRA owner, and either the owner or their surviving beneficiaries may receive benefits from the IRA. The entire interest in the contract must be nonforfeitable, it must provide that the owner cannot transfer any portion of it to any person other than the issuer, it must (for contracts issued after 11-6-78) have flexible premiums to permit annuities to change as the owner's compensation changes, it must limit annual contributions to the maximum amount permitted under Traditional IRAs discussed above, and provide for refunded premiums to pay for future premiums or to buy additional benefits before the end of the calendar year after the year the refund is received, and it must begin distributions by April 1 of the year the owner reaches age 70 1/2. IRS Publication 590, Individual Retirement Arrangements, provides further basic information on IRAs.

- *Individual Retirement Bonds* are IRAs which were funded through the purchase of Individual retirement bonds issued by the Federal government. The program was suspended after 4-30-82. It had the following characteristics: the bonds paid interest only until they were cashed in by the owner; no interest was paid on the bonds after the owner reached 70 1/2 years of age; upon the owner's death, the bonds stopped paying interest at the earlier of 5 years after the date of death or the date on which the owner would have reached age 70 1/2; and the bonds could not be sold, discounted, or used as collateral or security. IRS Publication 590, Individual Retirement Arrangements, provides further basic information on IRAs.

- *Simplified Employee Pension (SEP)-IRA* is a pension plan where the employer establishes an IRA account for the benefit of each covered employee. Employer contributions are excluded from an employee's income. In any year where the employer's contribution is less than the normal IRA maximum for Individuals (refer to Traditional IRAs above), the employee may contribute the difference. SEP-IRAs are much simpler and involve less administrative cost for the employer than do other types of retirement plans. I RS Publication 560, Retirement Plans for the Self-Employed, provides information on SEP-IRA plans.

  The Economic Growth and Tax Relief Reconciliation Act of 2001amended Sections 402 and 414 of the Internal Revenue Code, enabling individuals age 50 and over to make elective retirement plan deferrals (catch-up contributions) to 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEP), Section 403(b) arrangements, and Section 457 governmental plans effective for plan years beginning after December 31, 2001. Refer to Section Q. Catch-Up Contributions for additional details.

- *Salary Reduction Simplified Employee Pension Plan (SARSEP)* is a type of defined

contribution employee benefit plan established under the Tax Reform Act (TRA) of 1986. SARSEPs are sometimes referred to as elective deferral arrangements or as salary reduction arrangements. SARSEPs operate with pretax employee contributions, thus reducing the employee's income tax liability.

New SARSEPs could be adopted by employers through December 31, 1996. Beginning January 1, 1997, SARSEPs were replaced by Savings Incentive Match Plans for Employees (SIMPLEs), and no new SARSEPs may be established. SARSEPs adopted prior to 1997 can be continued with additional contributions made to them.

SARSEPs were available to employers with 25 or fewer employees, and with at least 50% of eligible employees participating in the plan. Employees contribute a percentage of their salary, thus reducing current income and current income taxes. Income and capital gains earned by SARSEPs are tax-deferred. The annual limit on salary contributions to a SARSEP is limited ($9,500 in 1996), with the limit indexed. In top heavy plans, the amount contributed for the highly compensated employees cannot be more than 125% of the average percentage of pay contributed by all non-highly-compensated employees.

IRS Publication 560, Retirement Plans for the Self-Employed, also provides information on SARSEP plans.

- *Inherited Individual Retirement Accounts* are subject to special rules. The IRA is included in the estate of the decedent who owned it. Unless the inheriting beneficiary is the decedent's surviving spouse, the beneficiary cannot treat the IRA as their own. Only the surviving spouse can elect to: make contributions to the IRA, including rollover contributions; rollover the inherited IRA into another IRA; and to delay receipt of distributions until (the surviving spouse reaches) age 70 1/2. All other inheriting beneficiaries must take distributions from the IRA, which is dependent upon the IRA owner's election at the time the IRA was opened and minimum distribution requirements. IRS Publication 590*, Individual Retirement Arrangements*, provides further basic information on IRAs.
- *Roth Individual Retirement Accounts* were introduced in 1998. Except for some special rules which apply only to Roth IRAs, these Individual retirement accounts are subject to the same IRS rules as are traditional IRAs. IRS Publication 590, *Individual Retirement Accounts*, extensively discusses all types of IRAs, and it should be used as general guidance when reviewing IRAs. Some of the basic Roth IRA rules follow:

    1. A Roth IRA must be initially designated as a Roth IRA *when it is established*. Neither SEP-IRAs nor SIMPLE IRAs may be designated or operated as Roth IRAs.

    2. Contributions to Roth IRAs are not tax deductible and are not reported on the individual's tax return:

        a. Roth IRA contribution limit:

        If contributions are made only to Roth IRAs, the contribution limit for 2003 for individuals under age 50 is generally the lesser of:

        - $3,000 ($3,500 if the individual is 50 or older in 2003), or
        - An individual's taxable compensation for the year.
        - These $3,000 and $3,500 amounts do not increase in 2004.

b. Contributions to both traditional and Roth IRAs for same year:

If contributions are made to both a Roth IRA and a traditional IRA, the contribution limit for 2003 is the lesser of:

- $3,000 ($3,500 if the individual is 50 or older in 2003) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- An individual's taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

If an individual's modified adjusted gross income is above a certain amount, contribution limits may be reduced and must be computed. IRS Publication 590*,* Individual Retirement Arrangements, details how to calculate the reduced contribution limits.

c. An individual can contribute to a Spousal Roth IRA, provided:

- The contributions satisfy the Spousal IRA limit (same as Traditional IRA Spousal Limit above),
- A joint tax return is filed for the year, and
- The couple's modified adjusted gross income is less than $160,000.

3. Contributions to Roth IRAs may continue even after the owner has reached 70 ½ years of age, there is no age limit for contributions.

4. A contribution to one type of IRA may be "recharacterized" as a contribution to a different IRA, but it must be performed in a trustee-to-trustee transfer.

5. Roth IRAs are not subject to any minimum distribution, and account balances can be left in the IRA as long as the owner lives.

6. Traditional IRAs, SEP-IRAs, and SIMPLE IRAs can be converted to Roth IRAs if the owner has a "modified adjusted gross income" of not more than $100,000 and (if married) files a joint return. Except for the one year waiting period, most rollover rules for traditional IRAs apply.

7. A Traditional IRA may be converted to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rolloversapply to these rollovers. However, the 1-year waiting period does not apply. Although the conversion of a Traditional IRA is considered a rollover for Roth IRA purposes, it is treated as a taxable distribution from the Traditional IRA.

8. Individuals who convert traditional IRAs to Roth IRAs, but who are ineligible to do so, are subject to a taxable distribution for the amount of the conversion, plus any additional taxes on early withdrawals. A Roth IRA conversion may be "re-characterized" by converting it back to a traditional IRA prior to the owner's tax return due date, including extensions.

9. For tax years 1998 and 1999, IRA owners were permitted to convert

an amount from a traditional IRA to a Roth IRA, transfer that amount back in a "re-characterization," and then reconvert it back to a Roth IRA in a "re-conversion." After 1999, owners cannot convert and reconvert an amount during the same taxable year.

10. Qualified distributions from Roth IRAs are not taxable, if they are made after a 5 year period beginning with the first taxable year for which a contribution was made, *and* the distribution is:

    a. Made on or after the date the owner reaches age 59 ½,

    b. Made because of the owner's disability,

    c. At the owner's death, made to a beneficiary or the to the owner's estate, or

    d. One that meets the traditional IRA "First" home requirements, up to a lifetime limit of $10,000.

11. Distributions of regular contributions are not taxable.

12. If the owner of a Roth IRA dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her required "beginning date" (by April 1 of the year following the year in which the owner reaches age 70 ½).

13. Beneficiaries:

    a. Generally, upon the death of the owner, the entire interest in the Roth IRA must be distributed to a beneficiary by the end of the fifth year of the owner's death, unless the interest is payable to a designated beneficiary over his or her life expectancy.
    b. A beneficiary of a Roth IRA may *aggregate an inherited Roth IRA with another Roth IRA*, if: (i) either the beneficiary inherited the other Roth IRA from the decedent, or was the spouse of the decedent, (ii) the beneficiary is the sole beneficiary of the Roth IRA, and (iii) the beneficiary elects to treat it as his or her own IRA.
    c. If the sole beneficiary of a Roth IRA is the spouse, he or she can either delay distributions until the decedent would have reached age 70 ½ , or treat the IRA as his or her own.

14. Excess contributions are subject to a 6% excise tax.

15. Early withdrawals are subject to a 10% premature distribution tax in addition to other applicable taxes.

- Abusive Roth IRA Transactions - The Treasury Department issued Notice 2004-8 identifying and prohibiting certain abusive Roth IRA contribution transactions. The notice was effective on the date of issuance, December 31, 2003. The transactions in question are used to avoid Roth IRA contribution limitations and, in some instances, taxation as income or capital gains. These and similar types of transactions subject the IRA to possible d isqualification and/or excise tax as prohibited transactions under the IRS Code.

- Deemed IRAs (Traditional IRA and/or Roth contributions to an individual retirement account within a qualified employer plan). The Economic Growth and Tax Relief

Reconciliation Act of 2001 added IRC Section 408(q), creating "deemed IRAs" for plan years after 2002. Contributions to deemed IRAs may only be made on a voluntary basis by the employee and are not deductible from income. These contributions do not affect the dollar amount of employer based contributions under a qualified plan. Deemed IRAs must be maintained in a separate account or annuity under the plan, and are subject to IRA rules, not qualified plan rules. However, the plan may commingle deemed IRA assets with qualified employer plan assets for investment purposes. The IRS issued Revenue Procedure 2003-13 outlining amendment guidance for existing qualified employer plans. The revenue procedure also provides sample plan amendment language which allows qualified plans to include deemed IRAs. For Deemed IRA purposes, the IRS has ruled that qualified employer plans include Section 401(a) defined benefit and defined contribution plans, Section 401(k) plans, Section 403(a) annuity plans and 403(b) plans, and Section 457 deferred compensation plans. They do not, however, include Savings Incentive Match Plans for Employees of Small Employers (SIMPLE) IRAs. Procedures for amending qualified employer plans are also provided in IRS Bulletin 2003-4.

- Group Trust Participation by Roth and Deemed IRAs - IRS Revenue Ruling 2004-67 extends the ability to participate in group trust investments described in Revenue Ruling 81-100 to Roth individual retirement accounts described in § 408A and deemed individual retirement accounts described in § 408(q). (Note: investing IRAs in common or collective funds is prohibited under Federal securities laws, refer to IRS Revenue Ruling 81-100 in Section 7.)
- Coverdell Education Savings Accounts (ESAs) - referred to as Education IRAs until July 26, 2001 - are not Individual Retirement Accounts or retirement arrangements of any kind. They are trust or custodial accounts established for the purpose of paying "qualified higher education expenses" (tuition, fees, books, supplies, equipment, and "contributions to a qualified state tuition program") of a designated beneficiary at an "eligible educational institution" (either an eligible postsecondary school - any college, university, vocational school, or other post secondary educational institution qualified to participate in student aid programs by the U.S. Department of Education; or an eligible elementary or secondary school - any public, private, or religious school that provides elementary or secondary education - kindergarten through grade 12 - as determined under state law.)

  Earnings on investments grow tax free until distributed. Upon distribution, if the withdrawals are less than the beneficiary's qualified higher education expenses, the withdrawals are tax free. Any portion of a withdrawal which is greater than the beneficiary's educational expenses is taxable to the beneficiary. Taxable distributions are subject to a 10% tax in addition to other applicable income taxes.

  To be treated as an ESA, the account must be designated as such when it is established. Any Individual, including the designated beneficiary, can contribute to an ESA if the individual's modified adjusted gross income for the year is less than $110,000 ($220,000 for individuals filing joint returns). Contributions are not tax deductible. There is no limit on the number of ESAs which can be established for the same beneficiary, and there are no limits to the number of beneficiaries a contributor may contribute towards in the same year. However, total contributions for the *same beneficiary* in any tax year cannot exceed $2,000. Contribution limits are gradually reduced if a contributor's modified adjusted gross income is between $95,000 and $110,000 (between $190,000 and $220,000 if filing a joint return). Excess contributions are subject to a 6% excise tax. No contributions may be made to an ESA in any tax year in which the beneficiary receives a contribution toward a "qualified state tuition program."

  Education IRA Account requirements:

1. The trustee or custodian must be a bank or an entity approved by the IRS.

2. The document must provide that the trustee or the custodian can only accept a contribution that:

    a. is in cash,
    b. is made before the beneficiary reaches age 18 (no contributions can be made to an ESA after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary (not defined as of 2004), and
    c. would not result in total contributions for the tax year (not including rollover contributions) being more than $2,000.

3. Money in the account cannot be invested in life insurance contracts.
4. Money in the account cannot be combined with other property except in a "common trust fund or common investment fund." *(Note: investing IRAs in common or collective funds is prohibited under Federal securities laws, refer to* IRS Revenue Ruling 81-100 in Section 7.*)*
5. Generally, the balance in the account must be distributed within 30 days after the beneficiary reaches age 30, or the death of the beneficiary. Assets distributed upon the death of a beneficiary must either be made to the beneficiary's estate, or to a beneficiary named by the designated beneficiary. However, distribution is not required if the Education IRA is transferred to a surviving spouse or other family member under age 30.

   IRS Publication 970,Tax Benefits for Education provides information on Education IRAs.

F.3. Bank Trustee and Custodial Responsibilities

As trustee, the bank's responsibilities may range from ministerial functions to the exercise of broad discretionary duties. In most instances, IRAs found in trust departments are subject to the investment direction of the Individual or possibly an investment advisor. However, the trust department may be given full discretion in the investment selection process. As custodian, responsibilities are essentially ministerial in nature. The examiner should note that IRC Section 408(h) considers bank custodians of IRAs to be trustees, hence fiduciaries (refer to Appendix E).

Whether acting as trustee or custodian, the bank's responsibilities and duties will be controlled by provisions of the instrument under which the relationship is established. Examiners should perform a careful review of this instrument in order to ascertain the degree of responsibility assumed by the bank and conformity with the duties imposed upon the institution under the agreement.

F.3.a. Self-Directed Custodial IRAs - Own Bank Deposits

The majority of IRAs serviced by banks are handled in the commercial department in a custodial capacity. These accounts are restricted to investments in own bank deposits. Unless state law provides to the contrary, trust powers for such accounts are not required, even if the account document indicates the bank is a trustee.

F.3.b. Self-Directed Custodial IRAs - Non Bank Deposits

A bank may accept non-deposit self-directed custodial IRAs without trust powers under Section 333.101(b) of the FDIC's Rules and Regulations, if the appropriate state authority also permits such accounts to be accepted without trust powers. Despite the fact that trust powers are not needed, banks which accept such accounts must implement appropriate controls. Refer to Section 2, subsection O, Self-Directed IRAs and Keogh Accounts for additional information.

F.4. Special Examination Application

There are several provisions involving IRA accounts which examiners should be aware of:

- According to Advisory Opinion 93-33A issued by the PWBA Office of Regulations

and Interpretations of the US Department of Labor on December 16, 1993, pursuant to Regulation 2510.3-2(d), the DOL does not have jurisdiction over IRAs which are not part of an employer sponsored pension plan falling under Title I of ERISA. Nevertheless, under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the DOL was given the authority to issue interpretations of section 4975 of the Internal Revenue Code (with certain exceptions, including sections 4975(a), (b), (c)(3), (d)(3), (e)(1), and (e)(7)) involving prohibited transactions of that section of the Code. Accordingly, employer sponsored IRAs are subject to ERISA and fall under DOL jurisdiction. Traditional or individual non-employer-sponsored/non-employer-contributed IRAs are not subject to ERISA and fall under the supervision of the Secretary of the Treasury. They are, however, subject to DOL interpretations of section 4975 of the Code with regard to prohibited transactions under that section of the Code. (Refer also to subsection H.7, Prohibited Transaction - ERISA Section 406)

Several IRA-specific interpretations have been issued by the Labor Department, which has authority over ERISA and also to interpret IRC Section 4975. All of the Advisory Opinions (AOs) noted below deal with self-directed transactions.

- AOs 88-9 and 88-28 deal with investment in the fiduciary bank's stock (or that of its holding company). These AOs include guidance on purchases of treasury stock and stock issued in an Initial Public Offering (IPO).

- AO 88-18 deals with a loan from the IRA to a company where the grantor/customer has a substantial interest. Under the circumstances described, DOL concludes that a prohibited use of plan assets for the benefit of a disqualified person under Section 4975(c)(1)(D) or an act of self-dealing under Section 4975(c)(1)(E) is likely to result if the customer directs the IRA to lend funds to the company.

- AO 89-3 deals with the investment of IRA assets in the stock of the company which employs the grantor/customer. In this case, the stock was purchased directly from the employer company. Under the circumstances described, particularly that the employer had no involvement with the establishment or maintenance of the IRAs, the employer company is not a disqualified person under Section 4975(e)(2); therefore, no prohibited transaction under Section 4975(c)(1)(D) exists. The AO cautions that a prohibited transaction may occur under other provisions of Section 4975.

- SEP-IRAs are subject to ERISA Sections 404 and 406, covering fiduciary responsibility and prohibited transactions.

- IRS Forms 5305 (the governing IRA document) prohibit the Individual sponsoring an IRA from borrowing from the account or from pledging the account as collateral for a loan.

  IRS Regulation 1.408-4 regarding the Treatment of Distributions from IRAs states that if the Individual establishing the account uses, directly or indirectly, any portion of the IRA as security for a loan, the amount used as collateral will be deemed a distribution for that tax year [IRS Regulations 1.408-1(c)(4) and 1.408-4(d)(2)]. The regulation requires the issuing of a W2-P to the borrower and to the IRS to report the distribution. If the distribution occurs prior to the Individual reaching age 59½, a premature distribution would take place, involving an IRS penalty equal to 10% of the pledged amount under IRS Regulation 1.408-1(c)(6).

- Section 408(m) of the IRC indicates that if an IRA invests in collectibles, the investment will be treated as a distribution. Collectibles include: stamps, coins, artwork, gems, antiques, etc. Both Section 408(m) and DOL Prohibited Transaction

Class Exemption (PTE) 91-55 provide an exception for U.S. American Eagle gold coins, which are permissible investments.

- Group Trust/Collective Investment Funds - Examiners should be aware that IRAs of all types may not invest in OCC Regulation 9.18 Collective Investment Funds (CIFs) without violating Federal securities laws. A number of lawsuits have resulted from IRAs being placed in CIFs, and there is one instance of the SEC taking enforcement action against an FDIC-supervised bank for having done so. There are a few approaches where IRAs may be collectively invested, with many restrictions. The investments are usually confined to mutual funds, but never to Regulation 9.18 CIFs. (Refer to IRS Revenue Ruling 81-100 in Section 7

G. Savings Incentive Match Plan for Employees (SIMPLE)

Savings Incentive Match Plans for Employees (SIMPLEs) plans are defined contribution employee benefit plans which replaced SARSEP plans effective January 1, 1997 . SIMPLE plans permit small employers and their employees to make salary reduction contributions toward a simplified retirement arrangement. Employers may establish a SIMPLE IRA plan: (a) if they had 100 or fewer employees who received $5,000 or more in compensation in the preceding year; and (b) they do not maintain another qualified plan, unless the other plan is for collective bargaining employees. These plans must be maintained on a calendar year basis, and may be established as either:

- part of a 401(k) plan (SIMPLE 401(k)), or by
- using SIMPLE IRAs (SIMPLE IRA plan).

Employer matching contributions - employers are required to match each employee's salary reduction contributions on a dollar for dollar basis up to 3% of the employee's compensation. This requirement does not apply if employers make non elective contributions.

Non elective contributions - employers may choose to make non-elective contributions of 2% of compensation on behalf of each eligible employee who will earn at least $5,000 (or a lower employer designated amount) in the current calendar year. Employers opting for this contributory method must make non elective contributions whether or not employees elect to make their own salary reduction contributions.

Employees earning at least $5,000 during any 2 years preceding the current calendar year, and who are reasonably expected to do so in the current calendar year, are eligible to participate in a SIMPLE plan. Employees may elect to contribute up to $8,000 for 2003 (increasing $1,000 each tax year until it reaches $10,000 in 2005). Salary reduction contributions under a SIMPLE IRA plan count toward the overall annual salary exclusion limit ($12,000 for 2003) when employees participate in other employer plans with elective salary reductions or deferred compensation. Participants who are age 50 or over at the end of the calendar year may make catch-up contributions. The catch-up contribution limit for 2003 is $1,000; it increases by $500 each year until it reaches $2,500 in 2006. The limit is subject to cost-of-living increases thereafter.

The Economic Growth and Tax Relief Reconciliation Act of 2001amended Sections 402 and 414 of the Internal Revenue Code, enabling individuals age 50 and over to make elective retirement plan deferrals (catch-up contributions) to 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEP), Section 403(b) arrangements, and Section 457 governmental plans effective for plan years beginning after December 31, 2001. Refer to Section Q. Catch-Up Contributions for additional details.

IRS Publication 560, Retirement Plans for the Self-Employed provides information on SIMPLE plans.

H. Compliance with the Employee Retirement Income Security Act of 1974 (ERISA)

ERISA is a very complicated law and the employee benefit area is constantly being impacted by changes in Federal tax laws. In addition, the Labor Department issues various regulations, interpretations, and opinions in response to changes in the industry and the need to clarify various requirements of ERISA. As a result, the material in this part is grouped according to the various requirements of ERISA.

Before reviewing the entire ERISA section of this manual, the examiner should initially review four parts of this section which may highlight plans, accounts, and/or circumstances, which in general, ERISA does

not apply. The four sections include: (1) Accounts Covered/Not Covered by ERISA; (2) Fiduciaries Defined; (3) Exemptions from Prohibited Transactions; and (4) Compliance with State Laws.

H.1. Introduction

The primary objective of ERISA is to protect the rights and interests of participants and their beneficiaries in the various plans and accounts described above. Plans and accounts which fall under ERISA are required to: contain certain data, be properly administered in an arm's-length manner, make disclosures to employees and beneficiaries, and comply with government reporting requirements.

Two government agencies are primarily responsible for administration and enforcement of ERISA. DOL is responsible for interpreting and enforcing fiduciary provisions of ERISA and also interprets those sections of the IRC dealing with fiduciary requirements for employee benefit plans. The IRS is responsible for IRAs, Keogh accounts that cover only the Individual/employer, and various tax-related provisions of the IRC.

ERISA also established the Pension Benefit Guaranty Corporation (PBGC), which insures participants' and beneficiaries' vested interests in defined benefit pension plans to a maximum monthly benefit as specified in Title IV of ERISA. PBGC also acts as trustee and receiver for pension plans voluntarily terminated by their sponsors, or involuntarily terminated because of the failure of the sponsor for financial or other reasons. All private defined benefit pension plans meeting certain requirements must, under ERISA, make required annual premium payments to the PBGC.

Important Notice
Material in this section, dealing with ERISA, makes reference to various sections and interpretations of ERISA. Appendix E provides information covering four general types of reference material: • ERISA Law and Internal Revenue Code Sections. • Summaries of ERISA Regulations, Opinions, and Court Decisions, by ERISA Section. • Implementing Labor and IRS Regulations. • Interpretive Opinions, Technical Bulletins, Exemptions, etc.

H.2. Accounts Covered/Not Covered by ERISA - ERISA Section 401

ERISA basically covers the administration and operation of all kinds of employee benefit plans. This includes pension plans, profit-sharing plans, 401(k) plans, ESOPs, IRAs, and Keogh Plans (HR-10 Accounts). Banks which sponsor these for their own employees or offer them to bank customers must comply with ERISA. Bank trust departments which administer the bank's own plan or the plans of others must also comply with ERISA. As a result, ERISA applies to all plans sponsored by banks and their holding companies, and will apply to most employee benefit plans the examiner will encounter in trust departments.

Described below are three frequently encountered employee benefit plans which are not subject to ERISA. ERISA does not apply to:

- *Government plans*. These include plans sponsored by Federal, State, and local government instrumentalities (Nonqualified deferred compensation plans offered by government agencies may also be referred to as 457 plans). As a result, plans for county or city employees, fire and police forces, economic development authorities, etc. are excluded from ERISA requirements. In 1986, a tax-deferred savings plan was established for Federal employees pursuant to the Federal Employees' Retirement System Act of 1986.

Church plans. Plans sponsored by religious (church) organizations and their affiliated organizations.

- *Excess benefit plans that are unfunded.* In general, these plans cover a select group of highly compensated employees and provide benefits in addition to those provided under a tax-qualified plan. Excess benefit plans are funded solely out of the general assets of the employer. These plans are not tax-qualified nor protected in a trust from creditors of the plan sponsor. The reason these plans are not tax-qualified is that benefits provided under the plan are in excess of those permitted for tax-exemption under the IRC and coverage under the plan is limited to highly paid employees. (Examiner note: there is nothing illegitimate or inappropriate about this type of plan if established and administered properly.)

The above list is not all inclusive and the examiner should refer to ERISA Section 4(b) for a complete listing. The types of employee benefit plans that are exempt from ERISA are generally subject to State statutes.

H.3. Establishment of Plan - ERISA Section 402

Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan. Every employee benefit plan shall:

- Name a Plan Administrator;
- Provide a procedure for establishing and carrying out a funding policy;
- Describe any procedures for the allocation of responsibilities for the operation and administration of the plan;
- Provide a procedure for amending such plan, and for identifying the persons with authority to amend the plan; and
- Specify the basis on which payments are made to and from the plan.

Examiners should note that the plan sponsor is generally responsible for ensuring that the plan meets the requirements of ERISA Section 402.

H.4. Trustee Requirements - ERISA Section 403

Section 403 of ERISA requires that all assets of employee benefit plans must be held in trust by one or more trustees. There is no requirement that a bank or other corporate fiduciary be used. Individuals may serve as plan trustees under ERISA.

Trusteed plans are those most frequently encountered and a trust agreement, as distinguished from the governing plan, establishes the trustee's duties and responsibilities. Principal among these, the trustee holds title to and takes possession of account assets. The trustee is also responsible for safekeeping and asset management, to the extent this is not delegated to others. Other typical trust agreement provisions relate to irrevocability and non-diversion of trust assets, as well as investment powers of the trustee, payment of legal and other fees, periodic reports by the trustee, records and accounts to be maintained, payment of benefits, and the rights and duties of a trustee in case of amendments to or termination of the plan.

H.5. Fiduciary Responsibilities - ERISA Section 404

ERISA codifies traditional fiduciary responsibilities into a single nationwide standard. The primary section of the ERISA which deals with fiduciary responsibilities is Section 404. The standards enunciated by Section 404 amount to an itemization of how a fiduciary *should* act.

H.5.a. Fiduciary Defined

For the most part, the definition of a fiduciary under ERISA is a functional definition. Therefore, a person is a fiduciary to the extent he:

- Exercises any discretionary authority or discretionary control respecting management of such plan, or exercises any authority or control respecting

management or disposition of its assets;

- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or

- Possesses any discretionary authority or discretionary responsibility in the administration of such plan.

See Section 3(21)(A) of ERISA.

Certain entities with respect to a plan are automatically fiduciaries: trustees, named fiduciaries, plan administrators and investment managers. This includes the management of the plan sponsor. For a bank's own employee benefit plan, this would typically mean the bank's board of directors, senior management, and any plan committee. Employees (if any) of a plan who exercise discretionary authority or responsibility in the administration of a plan become fiduciaries with respect to such plan. In addition, banks sometimes provide plan administration services, especially for the bank's own plan, and, as a result, are fiduciaries with respect to such plans.

Every qualified plan must have at least one named fiduciary person designated as the one responsible for operating the plan. This person may be the trustee, the plan administrator, the employer/plan sponsor, or the investment advisor. Fiduciaries generally do not include accountants, attorneys, insurance agents, insurance companies, consultants, or actuaries unless they exercise control over the plan in some fashion.

The examiner should remember that DOL has ruled that a bank serving solely as custodian is not a fiduciary according to Advisory Opinion 77-45.

H.5.b. Requirements

Exclusive Benefit - ERISA Section 404(a)(1)(A): The overall thrust of ERISA is that the plan must be operated solely for participants and beneficiaries of the plan. Section 404(a)(1)(A) expands on this underlying theme by stating that the plan must be operated for the exclusive purpose of providing benefits and defraying reasonable administration expenses. Any violations of ERISA's self-dealing or conflict of interest provisions (Section 406 prohibited transactions) would also normally involve a violation of Section 404 addressing the exclusive benefit provisions.

Prudent Man Rule - ERISA Section 404(a)(1)(B): This section of ERISA requires that fiduciaries act prudently. Prudence is normally associated with asset management, but this section also applies to all of a fiduciary's duties for a plan. ERISA Section 404(a)(1)(B) states that fiduciaries must manage the plan:

> With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.

The wording of the prudence requirement under ERISA includes an implication that a trust department may be held to a higher standard of prudence than Individual fiduciaries. The text of ERISA refers to a fiduciary acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims. A fiduciary which holds itself out as having a certain expertise (such as a trust department marketing and charging fees for its services and expertise) is to be held to a higher standard of prudence than merely a prudent Individual.

Section 404(a)(1)(B) of ERISA discusses investment duties of the fiduciary which somewhat mirror the Prudent Investor approach. This approach differs from the traditional Prudent Man Rule in two major aspects:

- No category of investment is deemed inherently imprudent by its very nature.

- Prudence is evaluated by looking at the entire investment portfolio. The Prudent Man Rule approach looks at Individual investments, ignoring all investments with gains and focusing only on those with losses.

Prudence is generally viewed by evaluating the decision-making process, not necessarily the results. Therefore, investment decisions tend to be viewed as of the date of the transactions, not on the basis of what happened after an investment was made. Also see related discussions of the Prudent Man Rule and the Uniform Prudent Investor Act in Section 3 - Asset Management and in Appendix C - Fiduciary Law.

Examiners should be aware that a plan's exemptions under Sections 407 and 408 from prohibited transactions under Section 406 of ERISA, do not release the fiduciary's duty under Section 404 regarding prudence. The fact that a bank has plan and statutory authority to invest up to x percent of its assets in employer securities does not mean it can make an investment if, to do so, would be imprudent. This is true even if the only investment that can be made under the plan is restricted to employer securities.

Appropriate Consideration of Investment Decisions - DOL ERISA Regulation 2550.404a-1(b): The Labor Department has provided guidance on the actions a fiduciary must take in order to demonstrate it was prudent. DOL ERISA Regulation 2550.404a-1(b) addressing Investment Duties provides the fiduciary must exercise appropriate consideration when making investment decisions including:

- Determining that the investment or investment course of action is reasonably designed as part of the portfolio (or the portion of the plan's portfolio for which the fiduciary has investment duties) to further the purposes of the plan, taking into account the risk of loss and the opportunity for gain associated with the investment or investment course of action; and

- Considering the portfolio's or portion of the portfolio's: (1) diversification, (2) liquidity and current return relative to plan cash flow and needs, and (3) projected return relative to plan funding requirements.

The regulation points out that contemplation of an investment decision must include the above considerations, but that it is not necessarily limited to only the itemized points. The regulation does not explicitly state that the appropriate consideration must be in writing; however, documentation is the only logical way a bank could demonstrate prudent actions at a later date. Examiners, therefore, should expect to see reasonable written documentation of investment decisions for ERISA plans, although failure to have appropriate documentation is not a violation. Examiners should remember that a bank is not responsible for reviewing the prudence of investment decisions made by outside investment managers to whom investment responsibility has been properly delegated by the plan administrator or other authorized party.

Diversification of Investments - Section 404(a)(1)(C): Section 404(a)(1)(C) of ERISA requires that plan investments be diversified in order to minimize the risk of large losses. Prior DOL rulings indicate an appropriate benchmark of one-third (33%) of the total portfolio of assets should be used in evaluating whether an investment is diversified. The 25% banking statutory standard to determine concentrations of credit does not apply to ERISA accounts.

While ERISA requires that plan assets be diversified, and failure to do so is a violation, there are a number of specific instances where the diversification standard does not apply, including the following:

- Individual account plans where the participant directs his or her own investments. See the discussion on Section 404(c) plans.

- Insured bank, thrift, and credit union deposits which comply with the statutory exemptive provisions of ERISA Section 408(b)(4) and DOL ERISA Regulation 2550.408b-4.

- Bank, thrift, and credit union deposits which are in excess of the amounts covered by Federal insurance, if the institution's assets are diversified, and if the transaction also complies with the statutory exemptive provisions of ERISA Section 408(b)(4) and DOL ERISA Regulation 2550.408b-4. Also refer to DOL Advisory Opinion 77-46 in Appendix E.

- Mutual funds, collective investment funds, Real Estate Investment Trusts (REITs), and annuities, as these investments are not considered single investments. Refer to DOL Advisory Opinions 75-93, 80-13, 78-30, and 75-79, respectively.

Adherence to Plan Document - ERISA Section 404(a)(1)(D): Section 402(a)(1) of ERISA requires that every employee benefit plan shall be governed by a written plan instrument. Failure to follow this governing plan document is normally a violation of ERISA Section 404(a)(1)(D).

If the trustee's actions comply with the plan or trust agreement but would violate ERISA, the plan or agreement may not be followed. In such instances, ERISA takes precedence over the governing documents.

Indicia of Ownership of Plan Assets - ERISA Section 404(b): In order to facilitate oversight and enforcement by appropriate agencies, ERISA Section 404(b) requires that documents evidencing ownership of plan assets must be maintained within the jurisdiction of United States (U.S.) courts. These documents (securities, certificates, etc.) are termed indicia of ownership. A number of specific exceptions to holding plan assets which are foreign securities outside the U.S. are outlined primarily in DOL ERISA Regulation 2550.404b-1 and, under certain circumstances, the accompanying Preamble. Listed below are some of the exceptions provided by the regulation. Each of the exceptions is subject to specific conditions.

- American Depository Receipts (ADRs). ADRs that enable a person to demand delivery of a foreign security constitutes the indicia of ownership of the foreign security. This exception is specifically noted in the Preamble to DOL ERISA Regulation 2550.404b-1.

- Assets that are under the management and control of a U.S. regulated bank, insurance company, or investment adviser, which is organized under the laws of a State or of the U.S. In addition, the plan fiduciary's principal place of business must be in the U.S. and certain minimum financial conditions must be satisfied.

- Foreign securities which are in the physical possession of, or in transit to, a U.S.-based bank or registered broker or dealer and certain other conditions are met.

- Contributions made on behalf of plan participants who are Canadian citizens or residents may be maintained in Canada if required by Canadian tax or other laws.

- Foreign Currency maintained outside the U.S. solely as an incident to the purchase, sale, or maintenance of securities by a U.S. plan.

- Assets which are maintained by a registered broker or dealer in SEC-designated satisfactory control locations if certain other conditions are met. The SEC regulation covering designation of satisfactory control locations is Rule 15c3-3 [17 C.F.R. 240.15c3-3].

The DOL's indicia of ownership rules also address any securities (other than those issued by Individuals) the principal trading market for which is outside the jurisdiction of the U.S. District courts. SEC Rule 17f-5(c) provides fiduciary standards for Eligible Foreign Custodians. These standards concern whether: (1) the Eligible Foreign Custodian has the requisite financial strength to provide reasonable care for the foreign

assets, (2) the Custodian has adequate reputation and standing, and (3) the mutual fund will have jurisdiction over and be able to enforce judgments against the Custodian.

The FDIC has been advised that an **eligible foreign custodian** as defined in SEC Rule 17f-5 of the Investment Company Act of 1940 [**17 C.F.R. 270.17f-5**], may fulfill the requirements of a satisfactory control location. An eligible foreign custodian under the revised rule is any one of the following:

> An entity that is incorporated or organized under the laws of a country other than the United States ***and*** which is a Qualified Foreign Bank ***or*** which is a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company.

Under the revised rule: (1) A Qualified Foreign Bank is a bank or trust company, organized under the laws of a country other than the United States, and which is regulated by that country's government or an agency of the country's government. (2) U.S. Bank is: (i) a national bank; (ii) a Federal Reserve member bank; (iii) a state chartered bank or trust company which is supervised by state or federal authority; or (iv) a receiver, conservator, or other liquidating agent of any of these institutions. (3) Foreign Assets consist of investments for which the primary market is outside the United States, and any cash and cash equivalents reasonably necessary to effect transactions in those investments.

H.5.c. Special Examination Applications of Fiduciary Responsibility Provisions

A number of areas not specifically covered in the ERISA statute are particularly relevant to banks and trust departments. Many areas are noted because of frequent inquiries by examiners and bankers, while other areas have been subject to criticism in examination reports. The special application of a number of issues regarding ERISA plans are commented on below, grouped alphabetically by topic.

Topic	Section
(1) Contributions, In-Kind	H.5.c.(1)
(2) Derivatives	H.5.c.(2)
(3) Economically Targeted Investments (ETIs) (Social/Ethical Investing) Section 3, F.3.e and	H.5.c.(3)
(4) ESOP Plans - Employer Securities Investments - Prudence	H.5.c.(4)
(5) ESOP Plans - Employer Securities Investments - Valuation	H.5.c.(5)
(6) Individual Account (Section 404(c)) Plans	H.5.c.(6)
(7) Loans - Documentation	H.5.c.(7)
(8) Own-Bank/Holding Company Stock Investments	H.5.c.(8)
(9) Proxy Voting and Corporate Governance	H.5.c.(9)
(10) Directed Trustees	H.5.c.(10)

H.5.c.(1). Contributions, In-Kind

Instead of making a cash contribution to an employee benefit plan, some plan sponsors have attempted to make a contribution of non-cash assets, usually termed an in-kind contribution. DOL Interpretive Bulletin 94-3 explains that it is a prohibited transaction for the sponsor to make in-kind contributions in satisfaction of an obligation to contribute to defined benefit plans and certain defined contribution and welfare benefit plans. Refer to subsection H.7.f.(2), Contributions, In-Kind for additional information regarding in-kind contributions and the associated prohibited transaction under ERISA Section 406.

Independent of the application of the prohibited transaction provision, Interpretive Bulletin 94-3 also states that a fiduciary has a duty to review in-kind contributions when such contributions are permissible. The bulletin indicates that automatic acceptance of an in-kind contribution

may violate ERISA Sections 404(a)(1)(A) addressing the exclusive benefit rule, 404(a)(1)(B) addressing the Prudent Investor Rule, and/or 404(a)(1)(C) regarding the lack of diversification. If accepting an in-kind contribution results in ERISA violations of 404(a)(1)(A), (B), and/or (C); the fiduciaries of the plan would be liable for any losses resulting from such a breach of fiduciary responsibility, even if the contribution in-kind does not constitute a prohibited transaction under ERISA Section 406.

H.5.c.(2). Derivatives

Derivative investments are not automatically contrary to ERISA's provisions. It should, however, be considered imprudent and an apparent violation of ERISA Section 404(a)(1)(B) if an employee benefit plan invests in derivatives without: (1) understanding the investment vehicle, (2) realizing that the investment involves derivatives, either directly or through a pooled investment vehicle which uses derivatives; (3) adequately evaluating the market, legal, credit and operational risks associated with investments in derivatives; (4) obtaining timely and accurate market prices for investments in derivatives; and (5) adequately monitoring investments in derivatives. For a further discussion of derivatives, associated risks, and considerations in evaluating prudence, refer to subsection F.2.C of Section 3 of this Manual. In addition, refer to the Labor Department letter issued to the Office of the Comptroller of the Currency regarding Investments in Derivatives dated March 21, 1996 (refer to Appendix E).

One of the problems associated with derivatives is the inability to properly price and value the investment, both at acquisition and during the period that the investment is held. Often, derivatives are overvalued at book value, rather than the lower market value. Failure to value such investments at a fair market value for employee benefit plans may have two further consequences on:

- Fees - If the plan's fees are based on its asset size, as is common, the overvaluation of derivatives will cause the plan to pay unwarranted fees.

- Reports - The overvaluation of the derivatives will normally result in a parallel failure to accurately report the plan in regulatory filings, particularly the Form 5500 annual report. In such cases, an appropriate violation for inaccurate reporting should be cited.

H.5.c.(3). Economically Targeted Investments (ETIs or Social investing)

Social investing is an investment approach whereby the investor attempts to inject non-investment criteria into the investment process. Normally, the investment manager desires to either promote or endorse a non-investment criteria or attempts to criticize or avoid certain criteria (for example, promotes environmentally friendly firms and avoids tobacco firms). The screening process may deal with Individual companies, or entire countries and industries. Many times, a potential investment is reviewed through multiple filters or screens to determine whether the non-investment goals can be met.

In 1994, the Labor Department issued Interpretive Bulletin 94-1 dealing with ETIs. The bulletin indicates that an ETI philosophy is not, in and of itself, imprudent. The Interpretive Bulletin states that ETIs are subject to the same standards as any other plan investment in that the investment must be: (1) prudent, (2) authorized by the plan, and (3) considered in light of other available investment alternatives. In accordance with the standard of care (Section 227) and duty of loyalty (Section 170) in the

Prudent Investor Rule, an ETI would not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk, or if the ETI is riskier than alternative available investments with commensurate rates of return. Refer to Section 3 of this Manual for additional comment.

H.5.c.(4). ESOP Plans - Employer Securities Investments - Prudence

Some ESOPs are sponsored by companies which are encountering difficulties (for example, banks with low capital) or are in declining industries. While the ESOP plan document may restrict plan investments to employer stock, the prudence of such an investment may be open to question. This is especially true if the employer eventually fails, the plan's employer stock become worthless, and hindsight is used.

A number of court challenges have been brought against bank trustees who followed the plan document and continued purchasing employer stock, even as the employer trended toward eventual failure. The actual failure of the employer is not necessarily required for a challenge -- merely the loss of a major portion of the stock's value. The fact that the trustee followed the plan document which authorized no other investment vehicle, has not always been a sufficient defense for the trustee. In addition, the price paid by the plan for the employer stock may be called into question.

Court decisions have reportedly differed, in some cases deciding for the trustee and in other cases deciding for the plan participants. A sampling of court cases appears in Appendix E. The court decisions provide guidance for how such investment transactions may be evaluated. When an ESOP invests in employer securities, the examiner should:

1. Determine if the trustee (bank, directors, officers, plan committee, etc.) is following the plan document(s) [Reference: Statewide Bancorp ESOP court case.

2. Determine if the plan requires investment in the employer securities or if the language is permissive.

   If the plan requires investment in employer securities, the trustee must comply unless "compliance would be impossible or illegal" or a court approves a deviation.

   If investment language is permissive, prudence is required in the acquisition and retention of the securities. A fiduciary is presumed to have complied with ERISA unless the facts and circumstances would defeat or substantially impair the plan's purpose. If trustees are also directors of officers of the employer (likely in own-bank plans), they must show that they acted impartially in investigating available investment alternatives -- particularly if the employer is experiencing financial difficulty.

   In evaluating a fiduciary's prudence when an ESOP's investment language is permissive, the examiner should evaluate the reasonableness of the fiduciary's actions based on whether the action:

   - Complies with the provisions of the plan;

   - Complies with the goals of the plan; and

   - Conflicts with the substantive or procedural requirements of ERISA, or the regulations thereunder.

[References: U.S. Supreme Court Case, Firestone Tire and Rubber Co. v. Bruch, 489 U.S. 101 (1989); and Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995).]

3. Evaluate, based on the facts presented, if the trustee administered its investment responsibilities prudently in either continuing or discontinuing the purchase of the employer stock.

In those situations where the value of the securities and/or the financial stability of the employer is declining, and in the examiner's judgment the trustee is acting imprudently, the examiner should criticize the administration of the account and cite the apparent violation(s) of the applicable ERISA section(s) [primarily ERISA Section 404(a)(1)(B)].

H.5.c.(5). ESOP Plans - Employer Securities Investments - Valuation

Many of the ESOPs that FDIC examiners will encounter are sponsored by small banks and small companies in small towns. The stock of such entities is typically closely held and not listed or traded on securities exchanges or NASDAQ. Brokers usually do not make a market for the stock and it is thinly traded in the local area. The question of fair and proper valuation of such stock is critical to any ESOP plan.

The valuation of employer stock is covered in both IRS and DOL regulations applicable to ESOPs. The standard established in DOL regulations requires that no more than adequate compensation may be paid. IRS regulations expand on this somewhat by providing that an independent appraiser must be used to establish a fair price. The IRS stresses that the mere presence of a written appraisal does not necessarily mean that the appraisal arrived at a fair valuation. Refer to subsection D.2.e., Employee Stock Ownership Plans (ESOPs) regarding valuing employer securities in accordance with both IRS and ERISA requirements.

Both the DOL and IRS indicate that no one method of valuation is acceptable or unacceptable in every situation. Examiners must use judgment in assessing if adequate consideration for the transaction was provided. In general; however, book value by itself is not considered a sufficient independent basis for valuation.

Despite the guidelines above, a number of abuses or potential abuses have occurred in ESOPs, including those sponsored by banks and bank holding companies. The abuses often involve insiders of the employer, who set unrealistically high values for the employer stock. In some instances, the inflated prices help maintain a market for the employer's stock. In other cases, the insiders sell their stock to the ESOP at the inflated price. The FDIC has referred a number of these plans to the Labor Department for apparent ERISA violations involving the pricing of the employer securities.

Failure to value employer securities at a fair market value for the plan itself will normally result in an apparent violation of ERISA 404(a)(1)(B). In addition, failure to value employer securities at fair market value will result in a parallel failure to accurately report the plan assets in regulatory filings, particularly the Form 5500 annual report. In such cases, ERISA Section 103(b)(3)(A) should be cited for inaccurate reporting (refer to DOL ERISA Regulation 2520.103-1(a)(1) and -1(b)(2)(i) for additional guidance).

H.5.c.(6). Individual Account (Section 404(c)) Plans

Section 404(c) of ERISA provides limited relief from certain fiduciary responsibilities and duties for plans which permit participants to self-direct

their plan investments. Plans such as 401(k) and 403(b) are Individual account plans. Under Section 404(c), plan participants who direct their own investments are not considered to be fiduciaries, provided that the conditions set forth in DOL Regulations under Section 404(c) are met.

Plan sponsors can limit their fiduciary liability if the plan operates in conformance with DOL ERISA Regulation 2550.404c-1. Compliance with the regulation is optional, but if a plan does not comply with the regulation, the relief provided by Section 404(c) is not available. The regulation is generally for transactions beginning with the first day of the second plan year beginning on or after October 13, 1992. Transactions occurring before that date are subject only to the general requirements of Section 404(c) of ERISA, without regard to the specifics of regulation.

Compliance with the regulation generally imposes requirements on the plan, not the participants. The Individual account plan must permit participants with the ability to:

- Choose from a broad range of investment alternatives. At least three investment alternatives must be provided, each of which is diversified and has materially different risk and return characteristics [see 2550.404c-1(b)(3)(i)(B)].

  In practice, the three alternatives will generally consist of the following types of investment vehicles: (1) a no-risk investment [for example, money market mutual fund, Short-Term Investment Fund (STIF), or Guaranteed Investment Contract (GIC)]; (2) a stock investment; and (3) a fixed-income investment. Employer stock may be a choice but special requirements apply to this investment.

- Give investment instructions with a frequency appropriate to the market volatility of the investment alternatives. Plan participants must be able to make changes to at least three of the investment vehicles not less than once a quarter [see 2550.404c-1(b)(2)(ii)(C)(1)].

  If an investment vehicle permits investment changes more often than quarterly, the participant must have the ability to immediately roll the proceeds into another plan investment vehicle that is a low risk, liquid investment choice [see 2550.404c-1(b)(2)(ii)(C)(2)]. Special provisions are given for investments in stock of the employer/sponsor.

- Diversify investments within and among investment alternatives. [refer to DOL regulation 2550.404c-1(b)(3)(i)(C)].

- Obtain sufficient information to make informed investment decisions. This involves specific disclosures about the plan itself, as well as each authorized investment alternative within the plan with respect to participants or beneficiaries of a plan.

  [see 2550.404c-1(b)(2)(i)(B)(1) and (2)].

  The Labor Department has released special guidance on this requirement to provide investment information and education to plan participants [see Interpretive Bulletin 96-1]. Examiners should be aware that this guidance applies primarily to plan sponsors, not to bank trustees who service outside accounts. It will; however, apply to banks and bank holding companies who sponsor Individual account plans for their own employees. The bulletin will also apply in those instances where banks provide such investment information and/or education to outside plan sponsors.

Special provisions are given for investments in stock of the employer/sponsor [see 2550.404c-1(b)(2)(ii)(C)(3)].

Under Section 404(c) of ERISA and the implementing regulation, the plan sponsor and fiduciaries have no obligation to provide investment advice to plan participants and beneficiaries. However, the plan sponsor and fiduciaries do have an obligation (see requirements above) to provide sufficient information on which the participants can make informed and intelligent decisions.

H.5.c.(7). Loans - Documentation

The FDIC has made a number of ERISA referrals to the Labor Department regarding loans made by plans where the loans lacked key or common documentation. Examiners applied normal underwriting or documentation standards that examiners would expect to find if the loan had been made by the bank itself. Granting of loans in the absence of such key documentation was cited as an apparent violation of the ERISA prudence standards. Examples of the documentation deficiencies reported include nonexistent corporate borrowing authority, missing financial information, unsupported repayment capacity, and inadequate lien filings.

For each referral, Labor Department investigators determined that either such documentation deficiencies did not represent a violation of ERISA, or the matter did not qualify for further investigation. As a result, examiners should not cite apparent violations of ERISA Section 404(a)(1)(B) regarding prudence for such documentation exceptions.

H.5.c.(8). Own-Bank/Holding Company Stock Investments

One common inquiry from examiners involves discretionary investments of an outside account's assets in the stock of the fiduciary bank or its holding company. In a 1980 letter to the OCC, the Labor Department stated that a discretionary investment in own-bank or own-holding company stock was an imprudent act. DOL commented that such a discretionary investment burdens our imagination to envision a situation in which a trustee with investment discretion could make an objective decision, solely on the basis of the prudence standard, regarding the purchase or sale of its own stock.

In a number of situations DOL has indicated that self-directed or non-discretionary purchases, sales, and retention of own-bank and own-holding company stock are permitted. Specific guidance was given for self-directed IRA purchases and initial public offerings of savings bank stock upon conversion from a mutual to a stock institution [see DOL Advisory Opinions 88-9, 88-28, and 92-23 in Appendix E].

H.5.c.(9). Proxy Voting and Corporate Governance

In Interpretive Bulletin 94-2, the Labor Department has stated that the voting of proxies is a fiduciary responsibility under the prudence requirements of ERISA. Trustees have the duty to execute proxies unless they receive proper instructions from the named fiduciary. The absence of explicit proxy voting instructions in a plan document or trust agreement does not relieve the fiduciary of the duty to vote the proxies. If the investment management responsibility has been properly delegated to an investment manager by a named fiduciary, the investment manager has authority to execute proxies unless the right to vote proxies (in whole or in part) has been reserved by the plan to the trustee or named fiduciary. The fiduciary is responsible not only for voting all proxies which it receives, but also for ensuring that it receives all proxies to which a plan

is entitled. Records must be kept of proxy voting.

The fiduciary duties of prudence and loyalty to participants and beneficiaries require trustees and investment managers to vote on every proposal that might affect the value of a plan's investment. In voting proxies, the fiduciary may consider only those factors that affect the value of a plan's investment. The impact on the plan participants and beneficiaries of the subject being voted upon may not be considered. This is especially relevant in cases of leveraged buyouts or unfriendly takeovers, where the jobs of the participants may be in jeopardy.

The Labor Department has also stated that an activist stance in shareholder rights is not automatically imprudent. A plan may undertake activities intended to monitor or influence the management of corporations in which the plan owns stock. Circumstances where this may occur are in closely-held companies, or stock intended to be held as a long-term investment. Actions might be undertaken for such concerns as mergers and acquisitions, capitalization and debt levels, executive compensation, and long-term business plans.

H.5.c.(10). Directed Trustees

While a plan trustee is always a fiduciary under ERISA 3(21), not all trustees have the same level of control or authority over the management of a plan's assets. A directed trustee is a plan trustee who is, by the terms of the plan, subject to the direction of a named fiduciary who is not a trustee. Section 403(a) of ERISA recognizes that such trustees have limited authority and discretion, and, therefore, limits the fiduciary liability of directed trustees provided that the directions being carried out for named fiduciaries are proper, in accordance with the terms of the plan, and not contrary to ERISA. On December 17, 2004, DOL issued Field Assistance Bulletin 2004-03, Fiduciary Responsibilities Of Directed Trustees, which provides, in the context of publicly traded securities, guidance regarding the fiduciary duties of directed trustees and factors to be considered in determining whether the directions of a named fiduciary are "proper." See FAB 2004-03 for a complete discussion.

H.6. Co-Fiduciary Liability - ERISA Section 405

ERISA Section 405(a) provides that, in general, a fiduciary is liable for the actions of another fiduciary that breaches fiduciary responsibilities if it:

- Participates knowingly in an act or omission of the other fiduciary.
- Undertakes knowingly to conceal an act or omission of the other fiduciary.
- Enables the other fiduciary to breach its duties by a failure to comply with Section 404(a)(1) [Prudence] in the administration of its specific fiduciary responsibilities.
- Possesses knowledge of a breach by the other fiduciary and does not make reasonable efforts under the circumstances to remedy the act.

Examiners must be careful in citing violations of this section as a fiduciary is not automatically liable for the misconduct of a co-fiduciary. The fiduciary is required to know that: (1) a co-fiduciary exists, (2) the other fiduciary participated in the act in question, and (3) the action was a breach of fiduciary duty.

Fiduciaries with limited required duties (for example, when fiduciary responsibilities are properly allocated or delegated), do not insulate themselves from breaches in other areas by other plan fiduciaries. On one hand, a fiduciary may become liable if it merely knows of a breach of fiduciary duty by another fiduciary and does nothing to remedy the problem. On the other hand, failing to adequately monitor the conduct of another fiduciary may be an imprudent act and cause co-fiduciary

liability to be incurred.

One of the remedies often proposed by a fiduciary who learns of a co-fiduciary's misconduct is to offer resignation of the fiduciary appointment, thereby attempting to insulate itself from the co-fiduciary's misconduct. However, mere resignation by the fiduciary as a protest against the breach is not sufficient. Action must be taken to rectify the breach of fiduciary responsibilities.

A successor trustee is not responsible for breaches of fiduciary responsibilities by predecessor trustees. However, it cannot ignore any misconduct by a previous trustee. The successor trustee has a duty to correct prior improper investments upon assuming responsibilities.

H.6.a. Allocation and Delegation of Fiduciary Responsibility

Each plan document must designate a named fiduciary as defined in Section 402(a)(2) of ERISA. While this is often a plan committee, it may also be Individuals identified by name or position. The named fiduciary is primarily responsible for managing the plan and for selecting and monitoring any outside trustees, investment managers, and other fiduciaries.

The allocation of responsibilities usually requires specific authorization in the plan document. If properly implemented, allocation procedures can protect named fiduciaries. In addition, proper allocation procedures may permit one fiduciary to insulate itself from the actions of another fiduciary, despite the co-fiduciary liability provisions of ERISA Section 405. Refer to ERISA Section 405(c)(2).

Sections 402, 403, and 405 of ERISA contain various overlapping provisions dealing with the allocation and delegation of duties and responsibilities among fiduciaries. Two significant provisions note that a named fiduciary:

- May allocate either trustee responsibilities (authority and discretion to manage and control plan assets) and/or non-trustee responsibilities (fiduciary duties that do not involve asset management) to entities, groups, Individuals, etc., other than those referenced in the plan document as named fiduciaries.

- May not allocate *trustee* responsibilities (non-trustee fiduciary responsibilities are permissible) among themselves, as named fiduciaries are jointly and severally liable for such responsibilities.

Trustee responsibilities normally lie with the named fiduciary. However, if the plan states a non-trustee named fiduciary may appoint outside trustees:

- The named fiduciaries are insulated from the actions of the outside trustee. But, the named fiduciaries must monitor the outside trustee's actions.

- The outside trustee is obligated to follow the proper directions of the named fiduciary. Proper directions are those which follow the plan document and do not violate ERISA. [References: ERISA Sections 402(c)(3), 403(a)(1), and 405(c)(3)]

ERISA also permits the named fiduciary to delegate authority to one or more qualified investment managers. A qualified investment manager is: (1) a bank, (2) an investment manager registered with the SEC under the Investment Advisors Act of 1940, or (3) an insurance company which is qualified under the laws of more than one state to perform services, and which has acknowledged in writing its fiduciary status with the plan. If responsibilities are delegated to a qualified investment manager:

- Named fiduciaries are insulated from the actions of the investment manager as long as:

    - The investment manager was prudently chosen and retained.

    - The investment manager does not violate the fiduciary responsibilities of ERISA Section 404(a)(1).

    - The named fiduciary monitors the performance of the investment manager. This may occur by formal periodic review, day-to-day contact and evaluation, or other appropriate means.

- Trustees are not responsible for the actions of a properly-appointed investment manager, even when the trustee is subject to direction from the investment manager.

  [References: ERISA Sections 3(38), 402(c)(3), 403(a)(1), 403(a)(2), and 405(c)(2)(A)(iii)]

Where the plan permits, named fiduciaries may allocate responsibility for non-trustee fiduciary responsibilities among themselves. If the named fiduciary delegates non-trustee responsibilities, they are not liable for such other person(s) who carry out these responsibilities, provided that:

- The plan's provisions regarding establishment, implementation, and continuation of the allocation are appropriate and properly followed.

- The non-trustee fiduciary is prudently chosen and retained.

  [References: ERISA Sections 403(a)(2), 405(c)(1)(A), 405(c)(1)(B), 405(c)(2), and 405(c)(3)]

H.6.b. Directed Accounts

One aspect of employee benefit account administration that merits special examiner attention relates to directed accounts. ERISA provides statutory protection from liability for trustees who follow the directions of an investment manager as defined in Section 3(38), or of a plan participant, who is properly authorized in the plan instrument(s) to instruct the trustee in the investment of plan funds.

For example, many plans permit the sponsor (employer) or the plan administrative body (Individual, plan committee, etc.) to appoint investment managers who are authorized to direct the trustee in the selection of trust investments. Where a duly qualified investment manager has been appointed, Section 405(c) of ERISA affords the trustee substantive protections in following the investment manager's directions.

Some plans include provisions authorizing each plan participant, at his or her election, to direct investment of funds allocated to their account. In these cases Section 404(c) affords protection to plan fiduciaries, including the trustee, if the conditions set forth in DOL Regulation 2550.404c-1 are met. However, it is not uncommon for the plan document(s) to permit the employer, plan administrator, or plan administrative committee to instruct the trustee to retain or dispose of specific trust assets at their option. Other plans specifically require that the employer or the plan administrative body direct all investments. Thus, examiners will frequently find it necessary to determine whether investment selection by an outside party is merely allowed, or is required by terms of the plan and trust instruments.

The trustee should insist that all directions received from a participant, investment manager, employer, or plan administrative body relative to investment purchases or sales be in writing, whether or not the plan/trust instruments require such documentation. Where the plan documents require that investment instructions, or any other instructions, from outside parties to the trustee be in writing, a trustee's failure to obtain such documentation would constitute a violation of Section 404(a)(1)(D) of ERISA.

As a result of the statutory protections afforded directed trustees under ERISA, many trust managers have taken the position that as long as they faithfully follow the instructions of an outside party who is duly authorized to select investments, the bank is fully protected. This is not the situation in all instances. Where the trustee follows

instructions of an outside fiduciary which violate the prohibited transaction provisions of Section 406, or the limitation provision relative to holdings of employer securities or real property of Section 407 of ERISA, the trustee would be equally liable with the co-fiduciary. In instances where the employer or plan administrative body instructing the trustee failed to: (1) adhere to the prudence standards prescribed in Section 404(a)(1)(B), (2) diversify plan investments as required by Section 404(a)(1)(C), or (3) act in accord with the documents and instruments governing the plan as prescribed by Section 404(a)(1)(D) of ERISA, the trustee would be exposed to liability as a co-fiduciary under Section 405 of ERISA in accepting and acting upon such instructions.

H.7. Prohibited Transactions - ERISA Section 406

H.7.a. Introduction

ERISA prohibits a fiduciary of an employee benefit plan from causing the plan to engage in certain transactions with a "party in interest". Generally, all transactions with parties in interest are prohibited, even if done on an arm's length basis. Certain transactions with parties in interest are exempted from the prohibition, either by statute or by an administrative exemption granted by the U.S. Department of Labor (DOL).

ERISA Section 406, the primary section dealing with prohibited transactions, is divided into two parts. The first part prohibits fiduciaries of plans from causing the plan to engage in transactions with parties in interest. The second part sets forth additional prohibitions on transactions between a plan and a fiduciary of the plan. ERISA Section 407 contains special provisions covering securities and real estate of the employer sponsoring the plan. ERISA Section 408 provides the statutory exemptions for certain prohibited transactions and authorizes the issuance of administrative exemptions by the DOL. All three of these sections are very pertinent to bank trust departments and own-bank plans. Examiners need to be aware of provisions that may appear in more than one section of the law, as well as covered in various exemptions.

A prohibited transaction violation usually generates a corresponding violation of the fiduciary responsibility provisions (exclusive benefit and/or prudence rules) of ERISA Section 404. In drafting Report of Examination comments, the examiner should bear in mind that the prohibited transaction violation is generally deemed to be the more concrete and significant of the two sets of violations.

Examiners should note that there is a parallel set of violations involving Section 4975 of the IRC for most types of prohibited transactions. While IRC Section 4975 is similar to the provisions of ERISA regarding prohibited transactions, the two are not identical. Where applicable, both sets of violations should be cited. Refer to subsection M , Compliance with the Internal Revenue Code for coverage of these provisions. Where possible, a cross reference to IRC Section 4975 is given.

H.7.b. ERISA Insiders - Party in Interest Defined

Section 3(14) of ERISA provides a definition of a party in interest. Definitions applicable to bank insiders from banking laws and regulations do not apply. Reference is made to the text of ERISA definitions and the summary of interpretations for a more complete description.

In general, a party in interest will include the following:

- The plan sponsor and its directors and officers.

- Fiduciaries, legal counsel, and employees of the plan. Fiduciaries include plan administrators, investment managers and trustees of the plan.

- Service providers and their directors, officers, and employees.

Certain subsidiaries, affiliates, and controlling shareholders of parties in interest are themselves considered parties in interest, as well as relatives of certain parties in interest. Section 3(15) defines the term relative as a spouse, ancestor, lineal descendant, or spouse of a lineal descendant [also see IRC 4975(e)(2)].

A bank normally serves in one or more of the primary party in interest positions. For own-bank plans, the bank is the plan sponsor and therefore a fiduciary, and also may also be a service provider. For outside plans, the bank may serve as fiduciary and service provider. Examiners should note that a bank serving as a mere custodian is generally not a fiduciary (As explained in subsection H.7.c., the definition of fiduciary is a functional one.), but is a party in interest under ERISA.

The chart below is a summary of the major party in interest provisions. For each of the primary party in interest positions, the chart indicates if the organization/Individuals, directors and officers, owners, and affiliates are considered to be a party in interest. Reference is made to the appropriate section(s) of ERISA. For further details, consult the definition of a party in interest and ERISA Section 3(14) in Appendix E [Also see IRC 4975(e)(2)].

ERISA INSIDERS (Party in Interest)								
							50+ % Affiliates	
		Organizations or Individuals	Directors Officers	50+ % Owners	10+ % Owners	Relatives	Organizations	DOE & 10%+ Owners
Type of Insider	Sections	3(21)(A)	3(14)(H)	3(14)(E)	3(14)(H) and 3(14)(I)	3(14)(F) and 3(15)	3(14)(G)	3(14)(H) and 3(14)(I)
Fiduciaries	3(14)(A)	X	X			X	X	X
Plan Sponsor	3(14)(C)	X	X	X	X	X	X	
Employee Unions	3(14)(D)	X	X	X	X		X	
Service Providers	3(14)(B)	X	X		X	X	X	X
Owners include: Corporations, Partnerships, Joint Ventures, Trusts, and Estates								

H.7.c. Prohibited Transactions With Parties in Interest

Section 406(a) of ERISA prohibits a fiduciary from causing an ERISA plan to engage in five general types of transactions between the plan and parties in interest, if the fiduciary knows or should know that the transaction constitutes a direct or indirect:

- Selling, exchanging, or leasing of any property [see Section 406(a)(1)(A) and IRC 4975(c)(1)(A)].

- Lending of money or other extensions of credit [see Section 406(a)(1)(B) and IRC 4975(c)(1)(B)]. Exceptions exist for own-bank deposits, overdrafts, repurchase agreements, securities lending, and loans to plan participants. See Special Examination Applications below.

- Furnishing goods, services, or facilities [see Section 406(a)(1)(C) and IRC 4975(c)(1)(C)]. Much of this prohibition is negated by the ancillary service exemptions in Section 408.

- Transferring of plan assets to a party in interest, or use of plan assets by (or for the benefit of) a party in interest [see Section 406(a)(1)(D) and IRC 4975(c)(1)(D)].

- Acquiring or holding of sponsor employer securities or employer real property. Special exemptions are included in Section 407, with different provisions for different types of plans [see Section 406(a)(1)(E)]. There is no parallel IRC provision, but see subsection H.5.c.(5) for special IRC rules for ESOPs.

Transactions are prohibited even when done on an arm's-length basis. ERISA Section 408 and related DOL Regulation 2550.408 contain a number of statutory exemptions for transactions covered by Section 406. In addition, the DOL has issued a number of official interpretations and class exemptions for transactions covered by Section 406.

H.7.d. Prohibited Transactions With Fiduciaries

Section 406(b) of ERISA prohibits three general types of self-dealing transactions between ERISA plans and fiduciaries, even if done on an arm's-length basis. The fiduciary is prohibited from:

- Dealing with a plan's assets in its own interest or for its own benefit [see ERISA Section 406(b)(1) and IRC Section 4975(c)(1)(E)].

- In any transaction involving the plan, acting on behalf of a party whose interests are adverse to the interests of the plan, its participants or beneficiaries [see ERISA Section 406(b)(2)][no parallel IRC provision].

- Receiving any consideration for itself from any party dealing with the plan in connection with a transaction involving assets of the plan [see ERISA Section 406(b)(3) and IRC Section 4975(c)(1)(F)].

As is the case with Section 406(a), there are statutory exemptions, as well as DOL interpretations and transaction class exemptions, that cover certain transactions covered by Section 406(b).

H.7.e. Prohibited Transaction Liabilities of Non-Fiduciary Parties In Interest

As explained above, ERISA Section 406 prohibits fiduciaries from causing a plan to engage in a prohibited transaction. In *Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, No. 99-579, 120 S.Ct. 2180, (June 12, 2000), the U.S. Supreme Court held that non-fiduciary parties in interest who participate in prohibited transactions also may be held liable under ERISA.

Salomon Smith Barney, Inc. (Salomon) provided broker-dealer services to the Ameritech Pension Trust (APT). Salomon acted on a non-discretionary basis, subject to the direction of APT's investment manager. Solomon accordingly was considered a party in interest, but not a fiduciary, of APT. APT's trustee, Harris Trust and Savings Bank, sued Salomon when certain motel interests sold by Salomon to APT were discovered to be nearly worthless. Solomon had provided financing for two motel chains and, in exchange, received a percentage of the net cash flow generated by the motels and a share of any increase in the property value. Solomon sold these interests to APT. Both motels went bankrupt shortly after being sold to APT.

The action was brought under ERISA Section 502(a)(3), which authorizes civil actions to obtain "appropriate equitable relief" to redress violations of ERISA, and sought rescission of the transaction, restitution and disgorgement of profits. Salomon moved for summary judgment, noting that ERISA Section 406 applies only to fiduciaries, and asserting that "absent a substantive provision of ERISA expressly imposing a duty upon a non-fiduciary party in interest, the non-fiduciary party may not be held liable under ERISA Section 502(a)(3)."

The Supreme Court rejected Salomon's position. It stated that ERISA Section 502(a)(3) "itself imposes certain duties, and therefore . . . liability under that provision does not depend on whether ERISA's substantive provisions impose a specific duty on the party being sued." Actions under ERISA Section 502(a)(3), the Supreme Court found, are not limited to specific defendants, but are limited by the requirement that relief sought be "appropriate equitable relief."

Utilizing a similar analysis, several other courts have found that entities that are neither parties in interest nor fiduciaries may be sued under ERISA Section 502(a)(3) for participation in a prohibited transaction. See *LeBlanc v. Cahill*, 153 F.3d 134 (4th Cir. 1998); *Reich v. Compton*, 57 F.3d 270 (3d Cir. 1995).

H.7.f. Special Examination Applications of Prohibited Transaction Provisions

A number of areas not specifically covered in the ERISA statute are particularly relevant to banks and trust departments. Many of the topics have been the subject of inquiries by examiners and bankers and subject to criticism in examination reports. In some cases, banks have been subject to Labor Department lawsuits or investigations, plan or beneficiary reimbursements, and/or penalty payments. The topics most relevant to examiners are noted below and grouped alphabetically by topic.

Topic	Section
Brokers Executing Securities Transactions	H.7.f.(1)
Contributions, In-Kind	H.7.f.(2)
Float Management	H.7.f.(3)
Foreign Exchange	H.7.f.(4)
Loans to Common Borrowers - General	H.7.f.(5)
Loans to Common Borrowers - Lending Limits	H.7.f.(6)
Loans - Takeout Financing	H.7.f.(7)
Loans - Own-Bank Origination and Servicing	H.7.f.(8)
Mortgages (Residential), Investment in	H.7.f.(9)
Mutual Funds, Conversion from Collective Investment Funds	H.7.f.(10)
Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised	H.7.f.(11)
Investment of Own Bank EB Funds in Proprietary Mutual Funds	H.7.f.(12)
Mutual Funds, Receipt of 12b-1 Fees	H.7.f.(13)
Overdrafts	H.7.f.(14)
Qualified Professional Asset Managers - Transactions With Investment Managers	H.7.f.(15)
Repurchase Agreements	H.7.f.(16)
Securities Lending	H.7.f.(17)
Securities Issued - Proceeds Used to Reduce Debt at a Party in Interest	H.7.f.(18)
Soft Dollars	H.7.f.(19)
Sweep Fees	H.7.f.(20)

H.7.f.(1). Brokers Executing Securities Transactions

Prohibited Transaction Class Exemption (PTE) 86-128 is designed more for securities brokers who execute transactions for ERISA plans than it is for banks and trust departments. However, there are several portions which are very applicable to trust departments. In general, PTE 86-128 permits fiduciaries to execute securities transactions for ERISA accounts. The PTE states to what extent the fiduciaries may charge and retain commissions on the transactions.

PTE 86-128 is based on the ancillary services statutory exemption of ERISA Section 408(b)(2). The PTE provides relief only from the prohibited transaction provisions of ERISA Section 406(b), which involves plan transactions with a fiduciary. Direct and indirect sales (or other underlying transactions) under ERISA Section 406(a) between an ERISA plan and a party in interest are not covered.

There are a number of other exclusions from the PTE that are relevant to trust departments. Custodians, non-discretionary trustees, and trustees of self-directed plans are excluded from the general definition of trustee. In addition, it explicitly does not exempt churning of account assets, inter-trust transactions where the bank has discretion on both sides of a transaction, and transactions of IRAs.

PTE 86-128 deals with securities transactions which occur in several different scenarios:

- Non-Profit Basis - Under the PTE, any fiduciary (including trustees, plan administrators, and plan sponsors) may execute securities transactions for Individual ERISA plans if *all* profits earned in connection with the transaction are credited back to the plan. This is termed a recapture. Both direct and reasonable indirect costs (including overhead) of executing the transaction may be retained. The nonprofit approach would apply to both discretionary and non-discretionary trust department accounts.

- Profit Fees Charged - The PTE permits broker-dealers to execute securities transactions for ERISA accounts and charge commissions to make a profit. Ordinarily, a broker providing services to an ERISA plan is a party in interest, and the plan is prohibited from having any transactions with such an insider.

  This portion of the PTE covers fiduciaries who are *not* trustees, plan administrators, and plan sponsors. As such, it would cover bank-affiliated securities brokers, custodians, non-discretionary trustees, and trustees of self-directed plans.

- Collective Investment Funds (CIFs) - For CIFs with ERISA accounts, the recapture method is authorized. Alternatively, commissions from CIF transactions may be retained if:

  - The employer-bank's ERISA plan(s) amounts to no more than 20% of the CIF, *and*

  - The total commissions from all CIFs containing the employer-bank's ERISA plan(s) amount to no more than 5% of all brokerage commissions received by the bank during the calendar year.

  These provisions seem primarily aimed at preventing abuses by the bank of its own-bank ERISA plan(s) invested in the bank's CIFs. The conditions are intended to prevent undue commissions from being paid by the bank's plan(s) to a bank-affiliated broker through the medium of the CIF transactions.

- Inter-Account Transactions - These transactions (agency cross transactions), where the buyer and seller of a security use the same broker, are permitted, if certain conditions are met. Inter-trust account transactions, where the bank has discretion over both accounts, are not included in this part of the PTE.

PTE 86-128 also sets conditions for Individual plans pertaining to: (1) Information, (2) Non-discretionary Status, (3) Authorization, (4) Disclosure and Approval, (5) Confirmations, and (6) Summary Reports. Refer to the PTE 86-128 for further details.

H.7.f.(2). Contributions, In-Kind

Instead of making a cash contribution to an employee benefit plan, some plan sponsors have attempted to make a contribution of non-cash assets, usually termed an in-kind contribution. Based on a Supreme Court case, the Labor Department released Interpretive Bulletin 94-3, which indicates that a prohibited transaction exists when the plan sponsor makes such a contribution to defined benefit and certain defined contribution and welfare benefit plans.

An in-kind contribution to a defined *benefit* plan by a plan sponsor constitutes a prohibited transaction in violation of ERISA Section 406(a)(1)(A) and a violation of IRC Section 4975(c)(1)(A). The transaction constitutes a prohibited transaction because such a contribution would be credited to the plan's funding standard account. Such an in-kind contribution is considered a prohibited transaction even if the value of the contribution exceeds the funding obligation for the plan year, as it

would be credited against future funding obligations.

An in-kind contribution to a *defined contribution plan* or a *welfare plan* is considered a prohibited transaction if it reduces an obligation of the plan sponsor to make a contribution measured in terms of cash amounts. As an example, the Interpretive Bulletin states that an in-kind contribution to a profit sharing plan, the terms of which require the employer to make annual contributions of a specified percentage of profits, would be considered a prohibited transaction, even if the terms of the plan permit an in-kind contribution. On the other hand, an in-kind contribution to a plan which is funded solely at the employer's discretion would not constitute a prohibited transaction.

Interpretive Bulletin 94-3 also provides details about a fiduciary's duty to review in-kind contributions. This is covered in the material for Section 404 of ERISA dealing with fiduciary responsibilities in subsection H.5.c.(1). Contributions, In-Kind.

H.7.f.(3). Float Management

When employee benefit funds are distributed from a trust account, funds are transferred from the trust account to a general Demand Deposit Account (DDA) for the trust department. This DDA is normally with the commercial side of the bank. Until the checks are returned and paid, the bank earns the float from the demand deposit balance.

In Advisory Opinion 93-24A and a follow-up interpretation to the American Bankers Association, DOL indicates that a violation of ERISA Section 406(b)(1), and possibly 406(b)(3), may occur. The DOL asserted that this would be the case regardless of whether the funds are technically considered plan assets after they were transferred from the trust. On November 5, 2002, the DOL issued Field Assistance Bulletin 2002-3, Disclosure and other Obligations Relating to “Float, ” in which DOL discusses the factors that a fiduciary must consider in assessing the reasonableness of an agreement wherein a service provider retains float and the disclosure requirements for service providers under such an arrangement.

The statutory ancillary services exemption of ERISA 408(b)(6) does not include the float earned by the fiduciary bank from a DDA to the extent that it is reasonably possible to earn a return on such funds. Retention of float would be permissible; however, if it was a part of the trust department's overall compensation from the plan and if appropriate disclosures regarding the use of float were provided to the plan.

H.7.f.(4). Foreign Exchange

The Pension Protection Act of 2006 added a statutory exemption for foreign exchange transactions. See Section H.9.I for details concerning the exemption contained in
ERISA Section 408(b)(18). Prior to the enactment of the statutory exemption, DOL issued several PTEs covering certain foreign exchange transactions.

Prohibited Transaction Class Exemption 94-20 (PTE 94-20) permits banks and broker-dealers to effect foreign currency exchanges and foreign currency options transactions for employee benefit plans for which the banks or broker-dealers are parties in interest. To qualify for PTE 94-20, the transactions may be performed only for non-discretionary accounts or upon the direction of an independent fiduciary. In addition, the terms of the transaction must be the same afforded on an arm's-length basis, written policies must be maintained, written confirmations (with specified contents) must be provided, and appropriate records retained for six years. PTE 94-20 is effective for transactions incurred on June 18, 1991, and later. Provisions are also included for transactions prior to that date. The full text of PTE 94-20 can be found in Appendix E.

Under the Labor Department's Prohibited Transaction Class Exemption 98-54 (PTE 98-54), [located in Appendix E], the following foreign exchange transactions between employee benefit plans and banks or broker-dealers (which are trustees, custodians, fiduciaries or other parties in interest with respect to the plans), are permitted pursuant to standing instructions:

1. conversions of interest, dividends or other securities distributions into U.S. dollars, or into other currencies, in an amount equivalent to no more than $300,000 U.S. dollars. **Note:** As stated in footnote 4 of PTE 98-54, although the Department of Labor believes that the $300,000 threshold is appropriate for large plans that purchase and sell foreign securities, the Department notes that such dollar limitations may not be appropriate for smaller plans (e.g., plans with aggregate plan assets of less than $50 million), and

2. the purchase or sale of foreign currencies in an amount equivalent to no more than $300,000 U.S. dollars, in connection with the purchase or sale of foreign securities.

The exemption contains both retroactive conditions for transactions prior to January 12, 1999, and prospective conditions for transactions occurring after that date. Prospective conditions include the following: (1) arm's-length terms; (2) no discretionary authority or control or investment advice by the bank or broker-dealer with respect to the plan assets involved in the transaction; (3) deadlines for trades following the receipt of good funds, and daily establishment of an exchange rate for the trades; (4) advance written authorization by an independent fiduciary; (5) written policies and procedures for handling foreign exchange transactions for plans; (6) written confirmations; (7) compliance with certain recordkeeping procedures.

H.7.f.(5). Loans to Common Borrowers - General

In a number of banks, examiners have found that employee benefit plans sponsored or administered by the bank have invested plan assets in loans to the same borrowers as the bank itself. This would appear to violate ERISA Section 406(b)(2) in that the plan's interests are, directly or indirectly, in conflict with the bank's interests as lender to the same party.

Examiners should review the performance and credit quality of such loans, applying normal loan examination standards. Where loans are delinquent, appropriate comments should be made and the examiner should also review the procedures used to monitor loan performance. Examiners should also sample the status of loans made by the commercial loan department to the same borrowers. When both loans are delinquent, examiners should provide details of both sets of loans and also review adequacy of procedures to protect the plan's interests. In several instances, examiners have noted favoritism given to the loans made by the bank over those made by the plan.

Examiners should be aware that, like any investment, loans of this nature may represent a violation of the diversification and prudence requirements of ERISA Section 404(a)(1). The bank must also be able to demonstrate that it exercised the appropriate consideration of DOL ERISA Regulation 2550.404a-1 regarding investment duties for investing plan assets in a loan where the plan's interests conflict with that of the bank.

H.7.f.(6). Loans to Common Borrowers - Lending Limits

FDIC examiners have encountered a number of instances where a bank used an employee benefit plan to circumvent state legal lending limits. When the amount of a loan (or credit line) exceeds the bank's legal lending limit, either a separate loan is made by an employee benefit plan or the employee benefit plan participates in the bank's loan. This is clearly a conflict of interest and self-dealing, irrespective of the credit quality of the borrower.

The primary ERISA violation in such cases is Section 406(b)(1) in that the transaction would primarily have taken place to enable the bank to make the loan or keep a customer relationship, which would otherwise have violated state law. Section 404(a)(1)(A), which requires that the plan be operated exclusively for the benefit of plan participants and beneficiaries, would coexist with the Section 406(b)(1) violation. The bank is also likely to be in violation of ERISA Section 406(b)(2). The bank's interests as a lender to the same borrower as the plan would, directly or indirectly, be in conflict with the interests of the plan.

Examiners should be aware that, like any investment, loans of this nature may represent a violation of the diversification and prudence requirements of ERISA Section 404(a)(1). The bank must also be able to demonstrate that it exercised the appropriate consideration of DOL ERISA Regulation 2550.404a-1(b)(2) regarding investment duties for investing plan assets in a loan where the plan's interests conflict with that of the bank.

H.7.f.(7). Loans - Takeout Financing

In a number of instances, a bank has granted construction loans in conjunction with ERISA employee benefit plans. The bank will provide the short-term construction loan and the employee benefit plan will fund the long-term financing for the same construction project. This type of arrangement is a prohibited transaction in violation of ERISA Section 406(b)(1) and 406(b)(2) because the plan is providing the financing to pay off the bank's loan. In addition, the construction loan was most likely granted with the knowledge that the ERISA plan would provide the permanent financing.

H.7.f.(8). Loans - Own-Bank Origination and Servicing

Employee benefit plans may invest in loans if authorized by plan documents. A trust department may utilize the experience and facilities of the bank's loan department to originate and service loans for employee benefit accounts. Such arrangements are not prohibited transactions so long as the bank either charges no fee or charges no more than its direct costs of performing these services for the plan. Indirect costs may not be charged to the plan.

When the bank acts as a loan originator, great care must be taken to ensure that all of the loan documents are either (1) in the plan's name, or (2) in the name of the bank as trustee or agent of the plan. If the loan documents are in the bank's name, there is a presumption that the loan was made by the bank and sold to the plan, which would be a prohibited transaction in violation of ERISA Section 406(a)(1).

When the bank acts as a loan originator and the borrower pays certain fees to obtain the loan (such as a loan origination fee), all of these fees must flow back to the plan, and not be retained by the bank. If the bank retained such fees, it would be a prohibited transaction in violation of ERISA Section 406(b)(3).

H.7.f.(9). Mortgages (Residential), Investment in

Prohibited Transaction Class Exemption (PTE) 82-87 (as amended by PTE 88-59), permits employee benefit plans to participate in transactions related to residential mortgage financing, including commitments for the provision of mortgage financing, receipt of commitment fees, the making or purchase of loans or participation interests, and the sale, exchange or transfer prior to the maturity date of mortgage loans or participations in mortgage loans. The PTE applies to mortgage loans on single or multiple residential dwelling units, such as detached houses, townhouses, and condominiums.

The exemption is necessary in the case of plans that engage in mortgage financing transactions with parties in interest. The exemption provides relief only from ERISA Section 406(a), and not ERISA Section 406(b).

General conditions exist for relief under the PTE, including

- mortgage loans acquired must be "recognized mortgage loans" or participation interests in such loans. "Recognized mortgage loans" are defined as either residential mortgages eligible for purchase by FNMA, GNMA, FHLMC, or Federal Housing Administration insured GNMA tandem project residential mortgage loans.

- loans must be made for the purchase of a residential dwelling unit(s).

- mortgage loans must be originated by an independent established mortgage lender.

- the price paid or received by the plan must be at least as favorable as available in a similar transaction involving unrelated parties.

- certain Individuals may not be fiduciaries with respect to the plan's decision to engage in the transaction, including developers and builders of the units, lenders, and existing owners of the mortgage or participation interests.

- the decision to engage in the mortgage financing transaction must be made by an independent qualified real estate manager. This is a financial institution or business organization that advises institutional investors in similar investments and which acknowledges in writing that it will make relevant decisions in the capacity as a fiduciary.

- the plan must maintain records for the duration of any loan made pursuant to the exemption sufficient to demonstrate compliance with the exemption.

The PTE also contains specific conditions applicable to commitments to purchase either a mortgage loan or a participation interest, and for the purchase of participation interests.

H.7.f.(10). Mutual Funds, Conversion from Collective Investment Funds (CIFs)

In a 1994 letter to the OCC's trust examination section (see Appendix E), the Labor Department indicated that a transaction involving a CIF used by ERISA accounts which converted into a proprietary mutual fund would represent a prohibited transaction under ERISA Sections 406(a) and 406(b). The opinion letter specifically notes that PTE 77-4 [located in Appendix E] covers the acquisition and sale of mutual funds for cash, but it does not provide relief for conversion transactions. The Labor Department took the position that a prohibited transaction occurs because the bank, as an ERISA plan fiduciary, is involved in the following:

- Transferring plan assets to itself (by imposition of mutual fund fees) in violation of ERISA Section 406(a)(1)(D).

  ERISA applies because, as either investment advisor or custodian of a mutual fund, the bank (or an affiliate) gains financially through increased fee income. Fee income is increased by investing ERISA plan assets in an investment vehicle where the bank/affiliate's investment advisor or custodian fees are dependent on the amount of assets invested in the mutual fund.

- Dealing with itself (or an affiliate) on both sides of the conversion transaction, in violation of ERISA Sections:
  - 406(b)(1), dealing with itself, which constitutes self-dealing;
  - 406(b)(2), by serving on both sides of the transaction; and/or
  - 406(b)(3), by receiving fees based on the transaction.

In 1997, the Labor Department issued Prohibited Transaction Exemption 97-41 (PTE 97-41) [which is located in Appendix E], providing relief from the prohibitions of ERISA Sections 406(a), 406(b)(1) and 406(b)(2) for conversions of CIFs into mutual funds, and the investment of employee benefit plans in the converted funds. Note that no exemption is provided from the prohibition of ERISA Section 406(b)(3). PTE 97-41 permits employee benefit plans to: (a) purchase shares of a mutual fund advised by a bank or investment adviser which is also a fiduciary to the plan, (b) in exchange for assets transferred in-kind from the CIF, (c) when the plan's assets are completely withdrawn from the CIF. These transactions are also subject to in-kind asset transfer requirements of SEC Rule 17(a)-7, issued under the Investment Company Act of 1940 [17 C.F.R. 270.17(a)-7]. PTE 97-41 is retroactive from October 1, 1988.

PTE 97-41 requirements for the in-kind transfer of plan assets and purchase of mutual fund shares are virtually identical for retroactive exemptions of previous transactions (occurring between October 1, 1988 and August 8, 1997), and later transactions. In both cases, the transfer and purchase must be in connection with a complete withdrawal of an employee benefit plan's assets from a CIF. Conversions occurring after August 8, 1997 must meet the following conditions:

- No sales commissions or other fees are paid by the employee benefit plan in connection with the purchase of mutual fund shares.
- All transferred assets are securities for which market quotations are readily available, or cash.
- The transferred assets constitute the employee benefit plan's pro rata portion of all assets that were held by the CIF immediately prior to the transfer.
- The employee benefit plan receives mutual fund shares that have a total net asset value equal to the value of the plan's transferred assets on the date of the transfer, in accordance with SEC Rule 17a-7.
- An independent fiduciary with respect to the employee benefit plan receives advance written notice of the in-kind transfer and purchase of assets, and full written disclosure of information concerning the mutual funds, including:
    - A current prospectus for each mutual fund to which the CIF assets may be transferred;
    - Fees to be paid by an employee benefit plan and the mutual funds to the Bank or Plan Adviser;
    - Reasons why the Bank or Plan Adviser considers the transfer and purchase to be appropriate for the employee benefit plan;
    - Limitations with respect to plan assets which may be invested in shares of the mutual funds, and, if so, the nature of such limitations;
    - The identity of all securities to be valued in accordance with SEC Rule 17a-7(b)(4); and
    - The identity of fixed-income securities to be allocated on the basis of each employee benefit plan's pro rata share of the aggregate value of such securities.
- An independent fiduciary must give prior written approval for each purchase of mutual fund shares in exchange for the employee benefit plan's assets transferred from the CIF.
- An independent fiduciary of each employee benefit plan is provided, in writing:

    - Within 30 days of purchase--(i) The identity of each transferred security that was valued in accordance with Rule 17a-7(b)(4); (ii) The current market price, as of the date of the in-kind transfer, of each such security; and (iii) The identity of each pricing service or market-maker consulted in determining the current market price of such securities.
    - Within 105 days following each purchase--(i) The number of CIF units held by the plan immediately *before* the in-kind transfer, the related per unit value, and the total dollar amount of such CIF units; and (ii) The number of shares in the mutual funds held by the plan immediately *following* the purchase, the related per share net asset value, and the total dollar amount of such shares.
- With respect to each of the mutual funds which an employee benefit plan continues to hold shares acquired in connection with the in-kind transfer, the Bank or Plan Adviser must provide the independent fiduciary--(i) A prospectus of such fund annually; and (ii) Upon request, a description of all fees paid by the fund to the Bank or Plan Adviser.
- The combined total of all plan fees received by the Bank or Plan Adviser must not be in excess of "reasonable compensation" within the meaning of section 408(b)(2) of the Act.
- All dealings in connection with the in-kind transfer and purchase between the employee benefit plan and a mutual fund must be on a basis no less favorable to the employee benefit plan than dealings between the mutual fund and other shareholders.

As noted above, the PTE does not provide relief for prohibited transactions in violation of ERISA Section 406(b)(3). However, the PTE provides that a transaction that complies with the exemption is deemed to satisfy certain conditions under PTE 77-4 (which does provide such relief), and therefore may qualify under that exemption if the additional conditions are met. PTE 77-4 provides relief for ERISA Section 406(a) and 406(b), including 406(b)(3). Accordingly, a bank that complies with PTE 97-41 may receive investment management and advisory fees with respect to the plan's assets invested in the fund if it complies with the additional requirements of PTE 77-4.

Another type of CIF conversion, involving liquidation-to-cash of a CIF's assets, with simultaneous rollover of the cash proceeds into a mutual fund, is *not* considered an ERISA prohibited transaction. Further, employee benefit CIFs are permitted by the IRS to convert into a mutual fund using the liquidation-to-cash method without being subject to capital gains taxes.

Examiners should consider conversions of ERISA CIFs into proprietary mutual funds which fall outside the requirements of PTE 97-41, or the liquidation-to-cash method, to be a prohibited transaction.

A bank electing to convert a CIF through an in-kind transfer of assets which does not meet the conditions of PTE 97-41 may seek an Individual prohibited transaction exemption from the DOL. See e.g., Allfirst Bank, 64 FR 57129; Pacific Income Advisors, 63 FR 60408; Society National Bank, 61 FR 44081. [See 29 C.F.R. 2570.30 -.52 Individual and Class Prohibited Transaction Exemption Requests, which replaced ERISA Procedure 75-1, for information about the requirements for requesting exemptions.]

The DOL staff has indicated its primary concerns involve (i) the proper valuation of the CIF and mutual fund assets, and (ii) various fees and commissions which may be levied, together with the disclosure.

Some bank counsel have suggested that PTE 84-24 regarding Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance and Investment Companies, and Investment Company Principal Underwriters, may provide an alternative approach to PTE 77-4. The Labor Department staff has verbally indicated that this is an unsatisfactory approach.

H.7.f.(11). Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised

A bank that exercises its discretionary authority to cause an employee benefit plan to invest in the bank's proprietary mutual funds or in mutual funds advised by a bank's trust department would be engaging in a prohibited transaction under ERISA Sections 406(b)(1) and 406(b)(3). The bank (and its holding company or an affiliate) receives a management fee from the mutual fund based on the amount of assets advised. The placement of plan assets in the mutual fund thus generates direct or indirect compensation for the bank and represents a conflict of interest prohibited by ERISA Section 406(b).

Prohibited Transaction Class Exemption 77-4 (PTE 77-4) permits employee benefit plans to invest in mutual funds which are proprietary to or advised by a bank that is a fiduciary to such plans. If certain requirements are satisfied, PTE 77-4 exempts fiduciaries from the prohibitions of ERISA Sections 406(a) and 406(b). In general, PTE 77-4 applies differently to discretionary and non-discretionary accounts as follows:

- Applicability to Discretionary ERISA Accounts
  - An independent fiduciary must approve purchases and sales of the proprietary mutual fund for the account. The approval must be:
    - Indicated in writing prior to each Individual purchase or sale of the fund,
    - Indicated in writing prior to the commencement of a specified purchase program, or
    - Set forth in the plan documents or in the investment management agreement between the plan and the fiduciary/investment advisor.
  - No sales commission load is paid in connection with the purchase.
  - No redemption fee is paid, unless the fee is:
    - Paid only to the mutual fund, and
    - Disclosed in the prospectus both at the time of the purchase and at the time of the sale.
  - No investment management/advisory fee is paid to the mutual fund for the entire period of the investment, subject to specific limitations.
  - The independent fiduciary receives mutual fund prospectuses, written disclosures of investment advisory and other fees charged, notification of any fee changes, and analyses of the advantages of the affiliated arrangement.
- Applicability to Non-Discretionary ERISA Accounts

  PTE 77-4 also applies to non-discretionary transactions. Only the three conditions above involving fees would apply in all cases. The final condition above covering prospectuses would be satisfied if the party making investment decisions receives the specified information noted above.

PTE 77-4 was released in 1977 and was not intended specifically for bank-related or bank-affiliated mutual fund investments. The PTE was intended for mutual funds operated by insurance companies and securities brokers. Nonetheless, it is the primary guidance available at this time to evaluate similar arrangements in banks and trust companies.

The Labor Department has released two Advisory Opinions (AO) applying PTE 77-4 to banking-related situations. AO 93-13A provides guidance on how PTE 77-4 applies to affiliated mutual funds and AO 93-26A provides guidance on how the PTE applies to the use of affiliated mutual funds by IRA and Keogh accounts.

H.7.f.(12). Investment of Own Bank Employee Benefit Plans In Proprietary Mutual Funds

As discussed in the Collective Investment Fund Conversion section above, the Labor Department's Prohibited Transaction Exemption 97-41 (PTE 97-41), [located in Appendix E], provides relief from ERISA Section 406 violations for conversions of CIFs into mutual funds, and the investment of employee benefit plans in the converted funds. However, it does not provide a specific exemption for the investment of a bank's own employee benefit plans in mutual funds which are sponsored, advised, or underwritten by the fiduciary bank, or any of its affiliates.

Prohibited Transaction Exemption 77-3 (PTE 77-3), [located in Appendix E] provides relief from ERISA Sections 406 and 407(a) for transactions involving the purchase or sale of shares of registered open-end investment companies by plans covering employees of the mutual fund, its investment advisor, its principal underwriter and affiliates of such entities.

The exemption is conditioned on the following:

- the plan may not pay plan-level advisory fees to an investment advisor, principal underwriter or affiliated person.

- the plan may not pay a redemption fee in connection with the sale by the plan to the mutual fund of shares unless the redemption fee is paid only to the mutual fund and the existence of the fee is disclosed.

- the plan may not pay a sales commission in connection with the purchase or sale of shares.

- all dealings between the plan, the mutual fund, the investment advisor or principal underwriter and any affiliate must be on a basis no less favorable to the plan than dealings with other shareholders of the fund.

PTE 77-3 was not initially intended to cover banks. Nonetheless, it, together with Department of Labor Advisory Opinion 98-06A (AO 98-06A), [located in Appendix E], applies to bank sponsored plans. The AO 98-06A addresses investment in kind by own-bank plans in funds advised by the bank. The AO provides that relief is available not only for cash purchases of mutual fund shares, but also for transactions involving the exchange of securities held on behalf of a plan for shares of the mutual fund. The AO further provides that PTE 77-3 requires the same methodology as PTE 97-41 for valuing the assets of the plan and determining the number of shares of the fund received by the plan. The AO clarifies that PTE 77-3 would not provide relief for a prohibited transaction arising in connection with terminating a CIF, permitting certain plans to withdraw from a CIF that is not terminating, or transferring any plan assets held by a CIF.

The July 30, 1998 opinion, issued in response to an inquiry by Federated Investors, provides the following cautionary notes:

- "...a plan fiduciary considering the in-kind acquisition of shares of a mutual fund advised by the bank in exchange for assets of the bank's in-house

plan must insure that the fiduciary's or the bank's interest in attracting and retaining investors in the mutual fund does not conflict with the interests of the plan or its participants and beneficiaries in the selection of appropriate investment vehicles."

- "If the decision by the plan fiduciary to enter into the transaction is not "solely in the interest" of the plan's participants and beneficiaries, e.g., if the decision is motivated by the intent to generate seed money that facilitates the marketing of the mutual fund, then the plan fiduciary would be liable for any loss resulting from such breach of fiduciary responsibility, even if the acquisition of mutual fund shares was exempt by reason of PTE 77-3."

At least two companies, New York Life Insurance Company and First Union Corporation, have been sued for breach of fiduciary duty by in-house plan participants in connection with the investment of in-house plans in proprietary mutual funds.

H.7.f.(13). Mutual Funds, Receipt of 12b-1 Fees

Under SEC Rule 12b-1, mutual funds are permitted to pay, from the assets of the mutual fund itself, certain distribution costs. These payments may take the form of commission-like payments to organizations which generate large numbers of transactions in the mutual fund. Not all mutual funds have 12b-1 arrangements.

ERISA Section 406(b)(3) prohibits a fiduciary bank from receiving any direct or indirect compensation for itself from a plan's investment in a mutual fund, including the receipt of 12b-1 fees. In addition, a bank with discretionary authority to invest in a mutual fund which pays the bank a 12b-1 fee would violate ERISA Section 406(b)(1) because it is involved in a conflict of interest. The Department of Labor has issued several advisory opinions clarifying the circumstances in which receipt of 12b-1 fees constitutes a violation of ERISA Sections 406(b)(1) and (3).

The Department of Labor issued Advisory Opinion 93-13A on the receipt by a fiduciary of 12b-1 fees from mutual funds involving bank proprietary mutual funds. In Footnote 4 to AO 93-13A, the DOL was unable to conclude that PTE 77-4 would be available for plan purchases and sales of mutual fund shares if a 12b-1 fee is paid to the fiduciary or its affiliate. This means that the purchase of a proprietary mutual fund would be a prohibited transaction if a 12b-1 fee was paid to a fiduciary or affiliate.

The Department of Labor has also issued Advisory Opinions involving discretionary and non-discretionary accounts which invest in mutual funds which pay 12b-1 fees to fiduciaries. These opinions are discussed below. DOL Advisory Opinion 97-15A to Frost National Bank, commonly referred to as Frost and Advisory Opinion 97-16A to the Aetna Life Insurance and Annuity Company, commonly referred to as Aetna appear in Appendix E. The Department of Labor also issued an interpretive letter to the American Bankers Association on 8-20-97, summarizing the issues addressed by these advisory opinions.

An analysis of ERISA and corresponding exemptions and interpretations, leads to two potential interpretations, one for discretionary accounts and the other for self-directed and non-discretionary accounts:

- Discretionary Accounts - As a general rule, ERISA Section 406(b)(3) prohibits a fiduciary from using the control, authority, or responsibilty that makes it a fiduciary, to cause such fiduciary to receive any direct or indirect compensation for itself from a plan transaction, including the receipt of 12b-1 fees. A bank with discretionary authority to invest in a mutual fund which pays the bank a 12b-1 fee would appear to violate ERISA Section 406(b)(1) because it is involved in a conflict of interest that causes itself to receive additional compensation.

Advisory Opinion letter AO 97-15A - Frost National Bank:

- The general prohibition with respect to discretionary authority was tempered in AO 97-15A to Frost National Bank on 5-22-97. The DOL indicated that advising plan assets invested in mutual funds which pay additional fees to the advising fiduciary would generally violate the prohibitions of Sections 406(b)(1) and (b)(3). The DOL indicated, however, that a fiduciary would not violate these sections by receiving 12b-1 fees from a mutual fund if the fiduciary used the fees to offset, on a dollar-for-dollar basis, a plan's obligation to pay the fiduciary for its services.

- The DOL further stated that fiduciaries which do not advise or exercise authority or control to cause a plan to invest in a mutual fund, would not violate these sections merely by the receipt of a fee or other compensation from a mutual fund in connection with a plan's investment. See AO 2003-09A, ABN AMRO Trust Services Company. It cautioned, however, that if a fiduciary retains authority to delete or substitute mutual funds which it makes available to plans, the fiduciary in fact may, depending upon the circumstances, exercise discretionary authority or control to cause the payment of fees to itself. If the fees were used to offset the plan's liability to the trustee, however, the fiduciary would not violate Sections 406(b)(1) and (b)(3).

- Finally, DOL's Frost opinion noted that with respect to the standards of fiduciary conduct stated in ERISA Section 404(a)(1), the plan fiduciary must assure that the compensation paid directly or indirectly by the plan to its administrator is reasonable, taking into account the trustee services provided to the plan in addition to any other fees or compensation received by the plan administrator in connection with the investment of plan assets. DOL emphasized that the responsible plan fiduciaries must obtain sufficient information regarding any fees or other compensation that the plan administrator receives with respect to the plan's investments in each mutual fund to make an informed decision as to whether the plan administrator's compensation for services is no more than reasonable. In addition, DOL required that plan fiduciaries monitor the actions taken by the plan administrator in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied.

- **Self-Directed and Non-Discretionary Accounts -** It is possible that DOL may exempt such transactions if the use of the mutual funds generating the 12b-1 fees is specifically authorized in the plan and if a fiduciary's receipt of the 12b-1 fees is disclosed in the mutual fund's prospectus and by the plan.

Advisory Opinion letter AO 97-16A - Aetna Life Insurance and Annuity Company:

- While the DOL has not adopted a Prohibited Transaction Exemption on this matter, it did release AO 97-16A on 5-22-97 to the Aetna Life Insurance and Annuity Company. The opinion addresses the acceptance of fees by non-discretionary administrative and record keeping service providers.

- In application, the letter indicated the mere receipt of a fee or other compensation from a mutual fund in connection with a plan's investment would not in and of itself violate section 406(b)(1) or (b)(3) if a service provider did not advise or otherwise exercise authority or control to cause a plan to invest in a mutual fund.

- In a cautionary note, the DOL stated that service providers retaining authority to delete or substitute mutual funds made available to plans might, depending upon the circumstances, be deemed to exercise discretionary authority or control to cause the payment of fees to themselves. Once again, the DOL took the position that if the fees were used to offset the plan's liability to the trustee, the fiduciary would not violate Sections 406(b)(1) and (b)(3)

  Consequently, examiners should not cite the receipt of 12b-1 fees by self-directed or non-discretionary accounts as an ERISA violation or recommend them for referral to the Department of Labor.

  Advisory Opinion letter AO 2003-09A - ABN AMRO Trust Services Company :

- A trustee that provides bundled services to plans, but not investment discretion, may keep 12b-1 fees from affiliated mutual funds as long as a fiduciary, who is independent of the trustee and it's affiliates, elects to include the particular fund as one of the allowed investment elections.

- If the trustee, however, provides investment advice within the meaning of regulation 29 CFR 2510.3-21(c), the trustee will cause a violation of 406(b)(1) .

Except as noted in the following paragraph, a violation of general fiduciary duties (ERISA Section 406(b)(3)) resulting from the receipt of 12b-1 fees by a fiduciary from a mutual fund can be cured if the fiduciary rebates the 12b-1 fees back to the trust accounts that generated the transactions. Where the bank has retained 12b-1 fees without the authorizations or directions noted above, examiners should recommend that the fees be returned to the accounts that generated them.

Financial institutions that operate proprietary mutual funds may attempt to resolve the ERISA conflict of interest and self-dealing concerns that result when a proprietary mutual fund collects 12b-1 fees from trust accounts that the institution administers in a discretionary capacity by rebating or waiving such fees for trust account shareholders. The proprietary fund, however, collects 12b-1 fees from non-trust account shareholders. The SEC has indicated that the waiving or rebating of 12b-1 fees for some shareholders, but not others, may violate the proprietary mutual fund's obligation to treat all shareholders impartially. See 1986 no-action letter to Southeastern Growth Fund, Inc. If the bank is using this no-action letter as a defense for not rebating the 12b-1 fees, a general criticism of the matter should be presented in the examination report together with a request for a legal opinion. Furthermore, acceptance of 12b-1 fees on discretionary employee benefit accounts invested in such funds would violate ERISA Section 406(b)(3) as noted above.

H.7.f.(14). Overdrafts and Interest-Free Loans

An overdraft in an ERISA plan's deposit account may be a transaction prohibited by ERISA Section 406(a)(1)(B), as overdrafts represent the lending of funds from a depository institution to an ERISA plan. The depository institution is a party in interest either because it is a fiduciary (own-bank deposits) or a provider of services to the plan.

The Department of Labor has recognized that most overdrafts are of a temporary nature and not abusive. Overdrafts may occur as the result of securities transactions or check clearings. As a result, the DOL provided relief in Prohibited Transaction Class Exemption 80-26 (PTE 80-26) [located in Appendix E] from the prohibitions of ERISA Sections 406(a)(1)(B), 406(a)(1)(D) and 406(b)(2), for interest free loans and other extensions of credit from parties in interest to

employee benefit plans. The PTE is effective January 1, 1975. The exemption covers loans or other extensions of credit used for the payment of ordinary operating expenses of the plan, or for a period of no more than three days for a purpose incidental to the ordinary operation of the plan.

The exemption requires the following:

- no interest or other fee may be charged to the plan and no discount for payment in cash is relinquished by the plan.
- the loan or extension of credit must be unsecured.
- the loan or extension of credit may not be made, directly or indirectly, by an employee benefit plan.

The Department of Labor also issued PTE 2000-14, as a temporary amendment to PTE 80-26 (both of which are located in Appendix E). The purpose of the temporary amendment was to permit parties in interest to make interest free loans to plans, enabling them to continue to operate in the event they experienced an inability to liquidate or access assets, or to access data caused by Y2K problems. The amendment was effective from November 1, 1999 until December 31, 2000. Loans extended under this exemption were to be repaid no later than December 31, 2000.

In addition to the guidance discussed above, the Department of Labor issued an advisory opinion on February 10, 2003, that discusses the provision of overdraft protection services in connection with securities and other financial market transactions. In AO 2003-02A, the Department of Labor opined that, under certain circumstances, the extension of an overdraft to a plan in connection with the settlement of a securities or other financial market transaction would satisfy the requirements for the exemptions provided in ERISA Sections 408(b)(2) and 408(b)(6).

H.7.f.(15). Qualified Professional Asset Managers (QPAMs) - Transactions With Investment Managers

PTE 84-14 (80KB PDF file - PDF Help) permits various parties in interest with respect to employee benefit plans to engage in transactions with investment funds in which plans are invested if the investment fund is managed by a "qualified professional asset manager" (QPAM). Investment funds are accounts subject to the discretionary authority of the QPAM, including accounts maintained by an insurance company and trusts maintained by a bank. PTE 84-14, therefore would apply to certain transactions between a bank with discretionary investment authority over an ERISA plan and parties in interest for such a plan, provided the bank meets the definition of a QPAM given below. The exemption permits banks and other parties in interest to avoid costly ERISA compliance reviews for investment transactions under consideration. PTE 84-14 became effective December 21, 1982.

A bank that has the power to manage, acquire or dispose of the assets of a plan qualifies as a QPAM if it has equity capital in excess of $1,000,000 as of the last day of its most recent fiscal year, and acknowledges in writing that it is a fiduciary with respect to each plan that has retained it as a QPAM. Savings and loan associations, insurance companies, and investment advisors that meet certain qualifying conditions may also be QPAMs. With respect to bank trust departments, Individual ERISA plans and Collective Investment Funds would usually satisfy the definition of an investment fund.

The exemption deals with different types of scenarios and, depending on the type of scenario, provides relief from Section 406(a) prohibited transactions with parties in interest, Sections 406(b)(1) and (2) prohibited transactions with fiduciaries, and Section 407(a) restrictions on investments in employer real estate. No relief is

provided by the PTE from ERISA Section 406(b)(3), involving a fiduciary earning fees or profiting from the transactions it places. In addition, the exemption specifically excludes securities lending (PTE 81-06) [refer to subsection H.7.e.(17), Securities Lending], investments in residential mortgages (PTE 82-87) [refer to subsection H.7.e.(9), Mortgages (Residential), Investment In], and investments in mortgage pools (PTE 83-1).

The QPAM PTE (80KB PDF file - PDF Help) provides a safe harbor for a number of situations which may occur after a particular transaction first occurs. For instance, a loan may be made to an outside person or organization who later becomes a party in interest [relief provided]. In another situation, a plan purchases an office building from an unrelated party, but among the building's tenants is an office of an affiliate of a plan sponsor [relief provided if percentage tests met]. In another instance, a bank QPAM hires an outside investment manager for its expertise with a particular type of asset, with the bank retaining a potential veto power over transactions [no relief provided]. The Preamble for the PTE gives more than 20 examples of when, how, and if the PTE applies.

If certain general conditions of the PTE 84-14 are satisfied, many types of transactions are exempted if other specific conditions are satisfied.

- General Conditions - Although PTE 84-14 addresses seven general conditions, two of the most important conditions are noted below.
  - The plan in question, when combined with the assets of other plans established or maintained by the same employer or by the same employee organization, does not represent more than 20% of *all* discretionary assets managed by the QPAM for the client at the time of the transaction (not just employee benefit accounts).

  - At the time of a transaction, the party in interest (or its affiliate) did not possess, and during the immediately preceding year did not exercise the authority to:
    - Appoint or terminate the QPAM as a plan asset manager, or
    - Negotiate a management agreement for a plan with the QPAM. This includes renewals or modifications to existing agreements.

- Transactions With Employers - A QPAM may have the following types of transactions with employers or with any person who is a party in interest by virtue of a relationship with an employer whose ERISA plans are invested in the investment fund:
  - Selling, leasing, or servicing of goods, or the furnishing of services to an investment fund managed by a QPAM by a party in interest if the transaction meets five requirements:
    - The transaction must be necessary for the administration or management of the investment fund;
    - The transaction takes place in the ordinary course of business engaged in by the party in interest with the public;
    - Effective as of August 23, 2005, the revenue received from the investment fund by a party in interest does not exceed 1% of the party in interest's gross annual receipts; and
    - The requirements of Sections I(c) through I(g) of the General Exemption are satisfied.

  - Leasing commercial or office space by an investment fund managed by a QPAM to a party in interest with respect to a plan having an interest in the investment fund if the transaction meets six requirements:
    - No more than 10% of the investment fund's assets are invested in the employer's securities and real estate;
    - No commissions or fees are paid by the investment fund to the QPAM or employer (or their affiliates);

- The space leased must be adaptable to more than one use;
- The leased space must represent no more than 15% of the building; and
- For a plan that is not an individual account plan, the aggregate fair market value of employer real estate and employer securities held by the investment funds of the QPAM does not exceed 10% of the fair market value of the assets of the plan held those investment funds; and
- The requirements of Sections I(c) through I(g) of the General Exemption are satisfied.

- Leases to the QPAM - This section permits the investment fund to lease to the bank various office or commercial space in which the investment fund has invested, if the following general requirements are satisfied:
  - No commissions or fees are paid by the investment fund to the QPAM-bank or its affiliates;
  - The space leased is adaptable to more than one use;
  - The leased space is not more than the greater of 7,500 square feet or 1% of the building; and
  - The transaction takes place on an arm's length basis.

- Transactions Involving Places of Public Accommodation - Effective as of August 23, 2005, the restrictions of Sections 406(a)(1)(A) through (E) and 406(b)(1) and (2), along with the corresponding taxes imposed by Code Section 4975(a) and (b) do not apply to the furnishing of services and facilities (and goods incidental thereto) by a place of public accommodation owned by an investment fund managed by a QPAM to a party in interest if the services and facilities (and incidential goods) are furnished on a comparable basis to the general public.

On August 23, 2005, the Department of Labor's Employee Benefits Security Administration adopted amendments to PTE 84-14 (80KB PDF file - PDF Help). The amendments provide for the following:

- Eliminates the "one year look-back rule" where the exemption was not available if a party in interest had exercised the power to appoint the QPAM within one year preceding a transaction;
- Clarifies that the power to appoint the QPAM provision of the PTE applies only with respect to the assets involved in a transaction, as opposed to a plan's other assets;
- Makes the exemption available to a party in interest investing in a commingled investment fund, notwithstanding that the party in interest has the authority to redeem or acquire units of the fund on behalf of the plan, if the plan's interest in the fund represents less than 10% of the investment fund's total assets;
- Amends the definition of affiliate as it applies to sections I(a) and Part II, to delete those partnerships in which the person has less than a 10% interest, and to only include highly compensated employees as defined in IRC 4975(e)(2)(H);
- Amends the determination of when a party in interest is related to a QPAM to those instances where:
  - The QPAM or the party in interest owns a 10% or greater interest in the other entity; or
  - A person controlling, or controlled, by the QPAM or the party in interest owns a 20% interest in the other entity; or
  - A person controlling, or controlled, by the QPAM or the party in interest owns less than a 20% interest in the other entity, but nevertheless exercises control over the management or policies of the other party by reason of its ownership interest.
- States that determinations of whether the QPAM is "related" to a party in interest for the purposes of Section I(d) may be made as of the last day of

the most recent calendar quarter;
- States that shares held in a fiduciary capacity need not be considered in applying percentage limitations;
- Raises the threshold for client assets from $50 million to $85 million for registered investment advisors (RIAs) to meet the definition of QPAM. Client assets are determined as of the last day of the RIA's fiscal year. Similarly, the minimum shareholders' and partners' equity for RIAs was increased from $750,000 to $1 million;
- Requires that a QPAM must be independent of an employer with respect to a plan whose assets are managed by the QPAM, i.e. an employer cannot be a QPAM for its own plan(s).

H.7.f.(16). Repurchase Agreements

Since a repurchase agreement is generally considered to represent a loan, a repurchase agreement between a party in interest and the fiduciary bank would normally be a prohibited transaction under ERISA Section 406(a)(1)(B). The DOL issued Prohibited Transaction Class Exemption 81-8 (PTE 81-8) (as amended 50 FR 14043, April 9, 1985) which provides relief from the restrictions of ERISA Section 406(a)(1)(B). Repurchase Agreements are also discussed in subsection F.14. of Section 3, Asset Management. The FDIC adopted the FFIEC Supervisory Policy on Repurchase Agreements of Depository Institutions with Securities Brokers and Others on November 12, 1985. The policy statement is located in Appendix C.

PTE 81-8 addresses a number of short-term investments including repurchase agreements. The restrictions of ERISA Section 406(a)(1)(A), (B), and (D) do not apply to the investment of employee benefit plan assets which involves the acquisition, holding, sale, exchange or redemption by or on behalf of the plan of banker's acceptances, commercial paper, repurchase agreements, certificates of deposit and, as of 1985, securities of certain banks.

Conditions applicable to repurchase agreements in which the seller of the underlying securities is a bank, broker-dealer, or a dealer who makes primary markets in securities of the United States or any agency thereof or in bankers acceptances include:

- the repurchase agreement must be embodied in a written agreement the terms of which are at least as favorable to the plan as an arm's-length transaction between unrelated parties.

- the plan must receive interest at a rate no less than in a comparable transaction with an unrelated party

- the repurchase agreement must have a duration of one year or less.

- the plan must receive securities, banker's acceptances, commercial paper or certificates of deposit with a market value of not less than 100 percent of the purchase price paid by the plan.

- upon expiration of the repurchase agreement and the return of the securities or other instrument to the bank, the seller must transfer to the plan an amount equal to the purchase price plus appropriate interest.

- neither the seller nor an affiliate may have discretionary authority with respect to the plan assets invested in the transaction, or may render investment advice with respect to those assets.

- the underlying securities or other instruments must be of a type that could be acquired by the plan without violating the restrictions of the prohibited transaction rules and such securities may not be not restricted securities

within the meaning of Rule 144 of the Securities Act of 1933.

- certain measures must be agreed to such that, during the term of the agreement, the plan always holds securities or other instruments with a market value equal to the purchase price paid by the plan.

- the seller must furnish the plan with specified financial statements.

H.7.f.(17). Securities Lending

The lending of securities from employee benefit plans is a fairly common practice. When the lending is fully collateralized, there is little risk and the plan earns additional income from the lending of the securities. Generally, this activity takes place with the fiduciary bank, a securities broker, and/or one of their affiliates providing services to the plan. In such cases, a prohibited transaction in violation of ERISA Section 406(a) would exist because the fiduciary bank and/or service providers are considered parties in interest by definition. Securities lending is also discussed in subsection F.15 of Section 3, Asset Management. The FDIC adopted the FFIEC Supervisory Policy on Securities Lending on July 22, 1997. The policy statement is located in Appendix C.

Prohibited Transaction Class Exemption 81-6 (PTE 81-6) (as amended 52 FR 18754, May 19, 1987) permits securities lending with parties in interest if certain conditions are satisfied. In addition, Prohibited Transaction Class Exemption 82-63 (PTE 82-63) permits the fiduciary bank to charge a reasonable fee for securities lending services. A fiduciary bank may instead use the statutory exemption under Section 408(b)(6) of ERISA to receive a fee for these services.

PTE 81-6 provides relief from ERISA Sections 406(a)(1)(A) - (D). Conditions include:

- neither the borrower nor an affiliate has discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice with respect to those assets;
- the plan must receive as collateral either cash, securities issued by the U.S. Government, or its agencies or instrumentalities, or irrevocable bank letters of credit;
- collateral must be provided equal to 100 percent of the market value of the securities lent, and if on any day the market value of the collateral is less than 100 percent of the market value of the securities lent, the borrower must deliver additional collateral such that the total collateral equals 100 percent of the market value of the securities lent;
- the borrower must provide the plan with certain financial statements prior to the loan;
- the loan must be made pursuant to a written loan agreement with arm's length terms;
- the plan must receive reasonable fees for the loan of the securities, or the opportunity to invest cash collateral, and also must retain all income from the securities that were lent under certain circumstances, rebates to the borrower are permitted;
- the plan must be able to be terminate the loan at any time, at which time the borrower shall deliver to the plan certificates for such securities or the plan may apply the collateral to the purchase of equivalent securities.

H.7.f.(18). Securities Issued - Proceeds Used to Reduce Debt at a Party in Interest

If a fiduciary uses its discretionary authority to cause an employee benefit plan to purchase securities, the proceeds of which will be used to repay a debt owed by the issuer to a party in interest or a plan fiduciary that is a bank or a bank affiliate, such a transaction would violate ERISA Section 406(a). Violations of ERISA Sections 406(b)(1) and (2) are also possible.

Prohibited Transaction Class Exemption 80-83 (PTE 80-83) permits the purchase of such securities in several different situations. Generally, the price paid by the plan for such securities may not be greater than the offering price described in an effective registration statement under the Securities Act of 1933 or an offering circular required under applicable federal law, and the plan must comply with certain recordkeeping procedures. In addition, when a fiduciary bank's loan is to be repaid with the proceeds of a securities issue, the PTE includes the following additional requirements that must be satisfied:

- with some exceptions, the securities generally must be purchased prior to the end of the first full business day after the securities are offered to the public;
- the securities must be offered by the issuer pursuant to an underwriting agreement under which the underwriters have generally committed to purchasing all of the securities being offered;
- the issuer must have been in continuous operation for at least three years;
- the amount of securities purchased by the plan may not exceed three percent of the total offering;
- the price to be paid by the plan may not exceed three percent of the fair market value of the plan's assets which are subject to the management and control of such fiduciary;
- the total amount of securities in any single offering purchased by the fiduciary of the plan, combined with all other securities purchased by the fiduciary on behalf of all other employee benefit plans may not exceed 10 percent of the offering.

H.7.f.(19). Soft Dollars

The term soft dollars refers to the practice whereby the investment manager of a discretionary account pays more than the absolute minimum commission in placing securities transactions with a broker. In return, the investment manager receives research services paid for by the excess commissions. Section 28(e) of the Securities Exchange Act of 1934 permits this practice and authorizes a safe harbor if bona fide research services are provided. In addition to the statutory provision of Section 28(e), the SEC has issued additional guidance governing "soft dollar" arrangements. See Securities Exchange Act Release No. 34-23170 and Release No. 34-54165 (217KB PDF file - PDF Help)

For discretionary accounts, Technical Bulletin 86-1, indicates that soft dollar transactions which meet the safe harbor of Section 28(e) do not represent a prohibited transaction under ERISA. However, those that do not fall within the safe harbor would represent a violation of ERISA Sections 406(a)(1)(D), 406(b)(1), and 406(b)(3).

For non-discretionary accounts, the safe harbor is not available. A non-discretionary account cannot justify paying higher brokerage commissions in order to receive investment research which won't benefit the account. The same violations would apply as noted in the preceding paragraph, in such instances.

H.7.f.(20). Sweep Fees

Banks acting as trustees or investment managers to employee benefit plans may agree to provide "sweep services" to such plans. Sweep services involve investing excess uninvested cash of a plan in either a deposit account or other short-term investment vehicle. Depending on how the arrangement is structured, provision of sweep services may involve one or more prohibited transactions under ERISA Section 406. In some cases, the statutory exemptions of ERISA Section 408 may provide a safe harbor.

The primary guidance regarding sweep fees is contained in two DOL opinions, AO 88-2A and AO 86-FRB, the Plotkin Letter. The two overriding variables applicable to sweep fees are whether fees are earned by the bank from the transaction and whether the bank has discretion to make the sweep transaction.

The key is whether the bank is exercising its fiduciary authority or control to cause a plan to pay an additional fee. The examiner needs to identify the variables present at the bank under examination.

The general rule is that a bank which has authority to decide when a sweep transaction should be performed *and* which levies a separate fee for this service, is in violation of ERISA Sections 406(b)(1), (2) and (3). Section 406(b)(1) [Also see IRC 4975(c)(1)(E)] is applicable because the bank is exercising its discretionary authority to cause the plan to pay an extra fee. Section 406(b)(2) is applicable because the bank is charging a fee for the sweep transaction which is adverse to the interest of the plan or the plan's participants or beneficiaries. Section 406(b)(3) [Also see IRC 4975(c)(1)(F)] is applicable because the extra fee is being paid to the bank. Mere authorization by an independent fiduciary does not preempt a violation.

Whether a bank may provide sweep services involves a number of interrelated areas. Four primary areas or questions to consider include the following: (1) Are any extra fees charged for sweep services? (2) Does the bank have discretion over the plan's investments? (3) What is the bank's discretion over *when* sweeps will occur and *how much* will be swept? and (4) What type of investment vehicle is used?

For all types of ERISA accounts, the bank may:

- Provide sweep services if no fee is charged [Plotkin Letter].
- Provide investment services, including sweep services, under a single fee arrangement which is calculated as a percentage of the market value of the total assets under management [Plotkin Letter].
- Charge direct expenses properly and actually incurred in the performance of such services [Plotkin Letter].
- Provide sweep services where a for-profit fee is charged, if a fiduciary independent of the bank (such as the plan sponsor, plan administrator, or outside investment manager) [See AO 88-2]:
    - Authorizes either Individual sweep transactions or authorizes a standard procedure as to when and how sweeps will occur;
    - Is provided adequate disclosures of pertinent matters such as the fees, sweep intervals, and sweep levels;
    - Authorizes the investment vehicle(s);
    - Is permitted to terminate the sweep arrangement at any time without penalty; and
    - Receives notice from the bank, not less than 30 days prior, of any change in sweep fees.

    The independent fiduciary must be provided with sufficient information so that it can adequately exercise its responsibility to monitor the sweep arrangement [AO 88-2].

    For-profit fees may be based on a percentage of the income paid by the sweep investment vehicle [Plotkin Letter] or on a percentage of the amount swept.

  Normally, uninvested cash is swept to high-quality and highly liquid money market investment vehicles. Examples of these vehicles include the following (list is not all-inclusive):

    - Own-bank and other-institution deposits.
    - Trust collective investment funds (such as a Short-Term Investment Fund).

- Mutual funds which are:
  - Independent of the bank or its parent,
  - Bank or holding company related mutual funds (such as proprietary funds - refer to subsection H.7.f.(11). Mutual Funds, Investment in Proprietary (Own Bank or Affiliated) and Advised), and
  - Advised by the bank's investment advisor (refer to subsection H.7.f.(11). Mutual Funds, Investment in Proprietary (Own Bank or Affiliated) and Advised).
- Repurchase agreements (refer to subsection H.7.f.(16). Repurchase Agreements).
- Commercial paper (refer to PTE 81-8).

Even with this guidance; however, trust department management may contend that sweep fees are permissible. One type of defense which may be raised by management involves the statutory exemptions under ERISA Section 408. These exemptions are addressed in the Plotkin letter. Sections 408(b)(4) Deposits and 408(b)(8) Collective Investment Funds provide authority to utilize own-bank investment vehicles, but do not preempt sweep fee violations of Section 406(b) (see the conditions listed for the use of those section 408 exemption categories in Section 408(b)(4)(A) and (B) and 408(b)(8)(A) and (C)). The same can be said for the ancillary services provisions of Sections 408(b)(2) and (6), particularly with investment vehicles such as repurchase agreements and commercial paper. In addition, the Plotkin letter discusses the applicability of the statutory exemptions under Section 408(b)(6) regarding ancillary services and under Section 408(b)(8) regarding collective trust funds for sweep service arrangements maintained by a bank.

H.7.f.(21). Release of Claims and Extensions of Credit in Connection with Litigation

On December 31, 2003, the Department of Labor issued PTE 2003-39 (72KB PDF file - PDF Help), "Release of Claims and Extensions of Credit in Connection with Litigation." The exemption provides relief from Sections 406(a)(1)(A), (B), and (D) of ERISA, and the taxes imposed by Sections 4975(c)(1)(A), (B), and (D) of the Internal Revenue Code for the following transactions:

- The release by the plan, or a plan fiduciary, of a legal or equitable claim against a party in interest in exchange for consideration, given by, or on behalf of, a party in interest to the plan in partial or complete settlement of the plan's or the fiduciary's claim; or
- An extension of credit by a plan to a party in interest in connection with a settlement where the party in interest agrees to repay, over time, an amount owed to the plan for the settlement of a legal or equitable claim.

The exemption is subject to the following conditions:

- There must be a genuine controversy involving the plan. A genuine controversy is deemed to exist when a court has certified a case as a class-action;
- The fiduciary that authorizes the settlement has no relationship to, or interest in, any of the parties involved in the litigation, other than the plan, that might affect the exercise of such fiduciary's best judgment;
- The settlement is reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of the claims foregone;
- The terms and conditions of the transaction are no less favorable to the plan

than comparable arms-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances;
- The transaction is not part of an agreement, arrangement, or understanding designed to benefit a party in interest;
- Any extension of credit by the plan to a party in interest in connection with the settlement is on terms that are reasonable, taking into consideration the creditworthiness of the party in interest and the time value of money; and
- The transaction does not involve matters covered by PTE 76-1, which relates to delinquent employer contributions to multiemployer and multiple employer collectively bargained plans.

In addition to the conditions above, transactions entered into after January 30, 2004 are subject to several additional conditions:

- Where the litigation has not been certified as a class action, an attorney(s) of the plan, having no relationship to any of the parties other than the plan, determines that there is a genuine controversy involving the plan;
- All terms of the settlement are specifically described in a written settlement agreement or consent decree;
- Assets other than cash may be received by the plan from a party in interest in connection with the settlement only if:
  - Necessary to rescind a transaction that is the subject of the litigation; or
  - Such assets are securities having a generally recognized market, per ERISA 3(18)(A), and which can be objectively valued. A settlement wil not, however, fail to meet this requirement solely because it involves the contribution of additional qualifying employer securities in settlement of a dispute involving such qualifying employer securities.
- To the extent that assets other than cash are received by the plan for the release of claims, such assets must be specifically described in the written settlement and valued at their fair market value in accordance with Section 5 of the VFC. The valuation methodology, including the appropriate date, must be set forth in the written settlement agreement;
- Nothing precludes the exemption from applying to a settlement that includes a written agreement to:
  - Make future contributions;
  - Adopt amendments to the plan; or
  - Provide additional employee benefits
- The fiduciary acting on behalf of the plan acknowledges in writing that it is a fiduciary with respect to the settlement of the litigation on behalf of the plan.

Finally, the PTE requires the maintenance and retention of certain records demonstrating compliance with the conditions of the PTE for a period six years.

H.8. Investment in Employer Securities and Real Property - ERISA Section 407 and 408(e)

When Congress considered various provisions for ERISA, it reviewed employee benefit plan losses and abuses. Congress found that a number of plans incurred major losses because they had placed large amounts of their assets in employer securities and/or real property. However, Congress also realized that some investment in employer securities and real property could be beneficial when not done to excess.

In general, ERISA Section 407(a)(2) provides that no employee benefit plan may invest more than 10% of its assets, valued at market at the time of the transaction, in employer securities and real property. In determining the 10% maximum, both employer securities and employer real property are added together. Since certain types of employee benefit plans are designed to invest *exclusively* in employer securities (ESOPs, etc.), certain exceptions to the general limitations were included in the law.

An important exception to the 10% limitation is embodied in ERISA Section 407(b)(1). This section provides that the *10% limitation does not apply to eligible Individual plans* (generally, defined contribution plans) as defined in ERISA Section 407(d)(3). Therefore, the *10% limitation usually only applies to defined benefit plans.*

For any investment in employer securities or real property, ERISA Section 407 establishes three tests. The securities and/or real property must be: (1) *qualifying*, (2) within statutory limits which differ according to the type of plan, and (3) meet certain fiduciary standards of ERISA Section 404. The acquisition or sale of such securities and/or real property must also meet the conditions of ERISA Section 408(e). Acquiring, holding, or selling employer securities and/or real estate which do not qualify as such, exceed the limitations of Section 407, or do not meet the conditions of Section 408(e) result in a violation of ERISA Section 406(a)(1)(E) and/or Section 406(a)(2).

Examiners should also take special note that there is a parallel set of violations involving Section 4975 of the IRC for most types of prohibited transactions. Both sets of violations should be cited whenever applicable. Refer to subsection M, Compliance with the Internal Revenue Code for coverage of these provisions.

H.8.a. Qualifying Employer Securities

ERISA Section 407(d)(5) defines the term qualifying employer security to include stock and other marketable obligations of the employer. In addition, Section 407(d)(1) provides that securities issued by affiliates of the employer are also included in the term "employer security." The term affiliate is itself defined in Section 407(d)(7). The IRS definition for the term qualifying employer security" is found in IRS Regulation 54.4975-12.

For employer stock held in plans, *other than eligible Individual account plans*, ERISA Section 407(f) imposes the following percentage limitations *(which should not be confused with the maximum 10% limitation of employee benefit plan assets discussed under H.8 above):*

1. no more than 25% of the aggregate amount of the same class of stock (issued and outstanding at the time of acquisition) is held by the plan, and

2. at least 50% of that amount is held by persons independent of the issuer.

However, ERISA Section 407(f) also provided temporary exemptive relief from the limitations until 1-1-93, provided: (1) the stock was held since 12-17-87, or (2) the stock was acquired after 12-17-87 (under a contract legally binding as of 12-17-87) and was continuously held following its acquisition.

ERISA Section 407(e) defines marketable obligations to include debt obligations (bonds, debentures, and notes), certificates, or other evidence of indebtedness. The same section requires that the debt obligations must be acquired for no more than the value which is established independent of the issuer and meets one of the market price categories listed in ERISA Section 407(e)(i)(A), (B), or (C). The acquisition of debentures convertible into stock is deemed to be the acquisition of a debenture, not stock.

H.8.b. Qualifying Employer Real Property

ERISA Section 407(d)(2) states that employer real property includes land and buildings (and related personal property) leased to an employer or to an affiliate of the employer. Section 407(d)(4)(C) permits all of the property to be leased to the employer or its affiliate. The term affiliate is defined in Section 407(d)(7).

Real property must satisfy three requirements to be considered *qualifying* employer real property:

- There must be at least two pieces of real property. A single parcel of land, or a single building or lease can never be considered qualifying [ERISA Section 407(d)(4)(A)].

- The real property (consisting of at least two parcels) must be geographically dispersed. This is decided on a fact and circumstance basis [ERISA Section 407(d)(4)(A)].

Each piece of real property and its improvements, must be adaptable to more than one use. This is also decided on a fact and circumstance basis [ERISA Section 407(d)(4)(B)].

DOL ERISA Regulation 2550.407a-1 refers to applicable requirements in ERISA Sections 406 and 407 concerning the acquisition and holding of employer securities and employer real property.

H.8.c. Statutory Limitations

H.8.c.(1). Defined Benefit Plans

Defined benefit plans and most money purchase plans may invest no more than 10% of their assets, in aggregate, in employer securities and employer real property. Total plan assets are calculated net of plan debt (including any debt to acquire the securities or real property). [See DOL ERISA Regulation 2550.407a-2(c)]

H.8.c.(2). Individual Account Plans

The statutory limit of 10 percent does not apply to "eligible Individual account plans." Eligible Individual account plans are profit-sharing and employee stock ownership plans (ESOPs), as well as stock bonus, thrift and savings plans, that explicitly provide for the acquisition and holding of qualifying employer securities or qualifying employer real property. [See ERISA Section 407(d)(3)(A)] Generally, these plans are intended to invest wholly or largely in employer securities. Section 407(d)(3)(B) requires that such plans must *explicitly authorize* the holding of employer securities and/or real property in excess of the Section 407(d)(3)(A) 10% general limitation.

Plans offering participant-directed investments (such as 401(k) and 403(b) plans) may provide for investment in employer securities, so long as certain requirements are observed [see DOL ERISA Regulation 2550.404c-1 and subsection H.5.c.(6). Individual Account (Section 404(c)) Plans]. The regulation contains specific requirements when employer securities are offered as an investment alternative to participants. Generally, fiduciaries are provided with limited relief from ERISA fiduciary responsibility liability if plans meet certain conditions and participants direct their own investments [see 2550.404c-1(d)(2)].

H.8.d. Acquisition of Employer Securities and/or Real Property

ERISA Section 408(e) and DOL Regulation 2550.408e indicate that the acquisition or sale of employer securities and/or real property must be for adequate consideration and that the plan may pay no fee or commission. Adequate consideration refers to the price paid for the securities and/or real property. For a parallel discussion, refer to the discussion of valuing employer securities for ESOP plans in subsection H.5.c.(5). ESOP Plans - Employer Securities Investments - Valuation.

The 10% limitation is viewed at the time of the acquisition; subsequent upward movements in market prices do not create violations. DOL ERISA Regulation 2550.407a-2(b) indicates that acquisitions include contributions to the plan, outright purchases, exchanges of assets, or foreclosures of collateral for a defaulted loan. The exercise of warrants resulting in the acquisition of an employer's common stock is considered a transaction subject to Section 407; however, employer stock acquired as a result of a stock dividend or stock split should *not* be included when determining whether the 10% maximum has been breached.

H.8.e. Fiduciary Standards

Even if all of the above conditions are met, a fiduciary making decisions to invest in

employer securities/real property must ensure that the exclusive benefit and prudence rules of ERISA Section 404(a)(1) are met. Refer to a parallel discussion of the prudence of ESOP investments in employer securities in subsection H.5.c.(5), ESOP Plans - Employer Securities Investments - Valuation.

H.9. Exemptions From Prohibited Transactions - ERISA Section 408

Certain exemptions from the prohibited transaction provisions are included in Section 408 of ERISA. A number of these statutory exemptions are discussed below. Failure to comply with the various conditions of these statutory exemptions means that the transaction is a prohibited transaction in violation of ERISA Section 406.

Examiners should note that there is a parallel set of prohibitions in Section 4975 of the Internal Revenue Code for most types of prohibited transactions described in ERISA Section 406. IRC Section 4975(d), however, contains a number of exemptions from the prohibited transactions detailed in Section 4975. Although similar, ERISA Section 406 and IRC Section 4975 are not identical.

In addition to violations of ERISA Section 406, examiners should also cite violations of IRC Section 4975 if applicable. Refer to subsection M, Compliance with the Internal Revenue Code for coverage of these provisions.

H.9.a. Exemptions and Opinions

H.9.a.(1). Class and Individual Exemptions

ERISA Section 408(a) authorizes the DOL to issue both class and Individual exemptions. These exemptions are in addition to the exemptions provided by ERISA Section 408 . While class exemptions are applicable to any party that meets the conditions, Individual exemptions provide relief only for the party(ies) requesting the exemption. The DOL has issued more than 35 class exemptions and hundreds of Individual exemptions. A number of the Prohibited Transaction Exemptions most relevant to banks and trust departments are cited throughout this manual and appear in Appendix E.

Before an exemption may be granted, ERISA requires that the DOL find that the exemption is:

- administratively feasible;
- in the interests of the plan and its participants and beneficiaries;
- protective of the rights of plan participants and beneficiaries.

A bank requesting an exemption from the DOL must supply the information required by DOL ERISA Regulation 2570.30 - .52. Regulation 2570.30 - .52 replaced ERISA Procedure 75-1, which is cited in many of the rulings dated prior to 1990. A publication, *Exemption Procedures Under Federal Pension Law*, explains how to obtain ERISA exemptions and is available from the Division of Public Affairs, Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington D.C. 20210; phone (202) 219-8921; web site: www.dol.gov.

H.9.a.(2). Advisory Opinions

The DOL also is authorized to answer inquiries regarding ERISA-related matters in the form of information letters and advisory opinions. A bank submitting such an inquiry must supply the information outlined in ERISA Procedure 76-1.

H.9.b. Ancillary Services Statutory Exemption

ERISA Section 406(a)(1)(C) prohibits a party in interest from providing services to an employee benefit plan. Congress provided two statutory exemptions, ERISA Sections 408(b)(2) for necessary services, and 408(b)(6), for what are termed "ancillary services" by banks and financial institutions. No exemptions, however, are provided from the fiduciary responsibility or co-fiduciary liability sections of ERISA Sections 404 and 405,

respectively.

ERISA Section 408(b)(2) [see also IRC Section 4975(d)(2)] permits a plan to receive office space, or legal, accounting or other services from a party in interest. The office space or service must be necessary for the establishment or operation of the plan; it must be furnished under a contract or arrangement which is reasonable; and no more than reasonable compensation may be paid by the plan [see DOL ERISA Regulations 2550.408b-2 for important guidance on the scope of this exemption]. The exemption provides relief only from the prohibitions of ERISA Section 406(a), and not from Section 406(b).

ERISA Section 408(b)(6) permits fiduciary banks to receive reasonable compensation for the provision of ancillary services, provided the bank has adopted internal safeguards to ensure that the provision of such services is consistent with sound banking and financial practices, and provided that specific guidelines are adopted addressing the extent to which the services will be provided. Examples of services that could be provided include securities lending, loan origination and servicing, EDP services and use of own-bank demand deposits. Section 408(b)(6) provides an exemption from ERISA Sections 406(a) as well as 406(b)(1) and 406(b)(2) (but not ERISA Section 406(b)(3)); therefore, it may provide an exemption in cases that would not be covered by ERISA Section 408(b)(2) [see DOL ERISA Regulation 2550.408b-6; see also DOL ERISA Regulation 2550.408c-2.

Refer to ERISA Section 408(b)(4) and related DOL Regulation 2550.408(b)(4) concerning exemptions governing the use of own-bank interest-bearing deposits, PTE 81-6 and PTE 82-63 concerning requirements governing securities lending and AO 92-24A addressing float management (a component of reasonable compensation) for demand deposits.

H.9.c. Receipt of Services by IRAs and Keogh Plans Exemption

The DOL's Prohibited Transaction Class Exemption 93-33 (PTE 93-33) permits banks to provide certain banking services at reduced or no cost to Individuals for whose benefit IRAs or Keogh plans are established, and their family members. PTE 93-33 provides relief from ERISA Section 406(a)(1)(D) and 406(b), and from the sanctions resulting from application of IRC Section 4975, including the loss of exemption of an IRA. PTE 93-33 amended and superseded Prohibited Transaction Class Exemption 93-2.

The exemption allows banks to take deposit balances of IRAs and Keoghs into account when determining eligibility for reduced fees for services. While the term "services" is not defined, the services must be of the type the bank could offer consistent with applicable federal and state banking law, and must be provided by the bank or an affiliate in the ordinary course of the bank's business to customers who qualify for reduced or no cost banking services but who do not maintain IRAs or Keoghs with the bank. Services may include incidental products of a *de minimis* value provided by third parties.

Other conditions of the exemption include:

- for the purpose of determining eligibility to receive services at reduced or no cost, the deposit balance required by the bank for the IRA or Keogh must be equal to the lowest balance required for any other type of account which qualifies for the reduced or no cost services.

- the rate of return on the IRA or Keogh plan must be no less favorable than the rate of return on an identical investment that could have been made by a customer of the bank who does not receive reduced or low cost services.

PTE 93-33 was amended on April 21, 1994 to permit banks to include securities investments (except investments offered solely to IRAs and Keoghs) in determining eligibility for reduced fees.

The DOL more recently issued Prohibited Transaction Class Exemption 97-11 (PTE 97-11) which provides a similar exemption to broker dealers.

H.9.d. Collective Investment Funds (CIFs) Statutory Exemption

The investment of employee benefit plans in a CIF operated by a party in interest of the plan is a prohibited transaction. ERISA Section 408(b)(8) [see also IRC Section 4975(d)(8)] provides a statutory exemption for any transaction between a plan and a bank's CIF, if the investment is a sale or purchase of an interest in the fund, specifically authorized in the governing plan or by an independent fiduciary, and if the bank receives no more than reasonable compensation. Section 408(b)(8) provides relief from ERISA Sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2).

The DOL has issued a class exemption, Prohibited Transaction Class Exemption 91-38 (PTE 91-38) which provides relief from ERISA Sections 406(a), 406(b)(2) and 407(a) for (i) transactions between parties in interest with respect to a plan, and a CIF that is maintained by the bank and in which an employee benefit plan is invested, and (ii) acquisitions of employer securities or employer real property by the CIF, provided that the party in interest is not the bank that maintains the CIF or any other CIF maintained by the bank or an affiliate. The transaction must meet one of the following criteria:

- The plan, along with all other employee benefit plans maintained by the same employer, may not hold more than 10 percent of the total of all interests in the CIF. (For transactions occurring between October 23, 1980 and June 30, 1990, the plans could not hold more than 5 percent of the total of all interests); or
- The CIF is a specialized fund that invests substantially all of its assets in short-term obligations (one year or less).

The PTE requires that the terms of the transaction be not less favorable than terms generally available in an arm's length transaction between unrelated parties and that the bank adhere to certain recordkeeping procedures.

The PTE covers other transactions under additional conditions:

- transactions between employers participating in a multiple employer plan and CIFs;
- acquisitions, sales, or holding of employer securities and employer real property by CIFs that do not meet the conditions of the general exemption;
- certain transactions with persons who are parties in interest with respect to a plan solely by virtue of being providers of services;
- the furnishing of certain goods to or leasing of real property by a CIF from a party in interest of a plan participating in the CIF;
- provision of services to a CIF in which a plan has an interest by the bank maintaining the CIF in connection with the management of real property owned by the CIF;
- provision of services, facilities and any goods incidental to such services and facilities by a place of public accommodation owned by a bank sponsored CIF to a party in interest with respect to a plan which has an interest in the CIF;
- excess holding of qualifying employer securities or qualifying employer real property (other than through a CIF).

Refer to Section 7, Collective Investment Funds for a general discussion of Collective Investment Funds.

H.9.e. Deposits, Interest-Bearing Statutory Exemption

ERISA Section 408(b)(4) provides a statutory exemption for the investment of plan assets in bank deposits which bear a reasonable interest rate, where the bank is a fiduciary or other party in interest of the plan. The exemption provides relief from ERISA Sections 406(a)(1), 406(b)(1) and 406(b)(2) but not from ERISA Section 406(b)(3).

The exemption may be utilized with respect to own-bank plans, or, for other plans if the transaction is authorized by the plan or an independent fiduciary. Own-bank deposits, when used as investments for plans covering a bank's employees must bear a reasonable rate of interest.

Investment in own-bank interest-bearing deposits by outside plans must satisfy the following requirements [also see IRC 4975(d)(4)(B)]:

- Use of the deposits must be expressly authorized by the plan or an independent fiduciary.
- The deposits must bear a reasonable rate of interest.
- The express authorization must identify the bank by name. [See Labor Regulation 2550.408b-4]

H.9.f. Employee Stock Ownership Plans (ESOPs) - Loans to Plans Statutory Exemption

Bank examiners may encounter ESOPs sponsored by a bank or its holding company, or ESOPs sponsored by outside organizations for which the bank serves as trustee or plan administrator. In most ESOPs, the purchase of employer securities is financed through loans guaranteed by one or more parties in interest, known as "leveraging." Leveraged ESOPs involve the potential for abuse due to the possible involvement of insiders and the stock's potential lack of marketability. Moreover, the guarantee of a loan to an ESOP by a party in interest is a prohibited transaction.

ERISA Section 408(b)(3) [see also IRC Section 4975(d)(3)] provides an exemption from the prohibited transaction provisions of ERISA Sections 406(a), 406(b)(1) and 406(b)(2) for loans to an ESOP that are guaranteed by a party in interest [see also DOL ERISA Regulation 2550.408b-3] and loans which are issued by a bank that is a party in interest.

The exemption requires a loan to a plan to be:

- primarily for the benefit of the participants and beneficiaries of the plan (see DOL ERISA Regulation 2550.408b-3(c) for the tests to determine whether a loan is made primarily for the benefit of the participants and beneficiaries [also see IRC Section 4975(d)(3)(A)]); and
- charged a reasonable interest rate (see DOL ERISA Regulation 2550.408b-3(g)).

When an ESOP purchases employer securities with the proceeds of a loan from an insider or a party in interest, the price paid for the securities must be a fair market price established by persons who are not parties in interest. An independent appraisal is often required by IRS Regulations. *This is an area where abuse of ESOPs has often been noted*. When an ESOP purchases employer securities at prices in excess of their fair market value, the question arises whether the transaction was primarily for the benefit of the participants and beneficiaries of the plan. Refer to the discussion in subsection H.5.c.(5). ESOP Plans - Employer Securities Investments - Valuation.

A loan that is exempt under Section 408(b)(3) must be non-recourse against the plan, and the plan may pledge as collateral only qualifying employer securities (as defined under ERISA Section 407) acquired with the proceeds of the exempt loan or pledged as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan.

ESOPs are further described in subsection D.2.e., Employee Stock Ownership Plans (ESOPs).

H.9.g. Loans to Plan Participants Statutory Exemption

Most employee benefit retirement plans (pension, profit-sharing, 401(k), etc.) permit the plan to make loans to its own plan participants. Four sets of overlapping conditions, all of which must be complied with, must be satisfied when a plan engages in this type of activity. The four conditions are:

1. ERISA statutory and regulatory requirements,
2. Plan authorization and conditions,
3. IRS statutory and regulatory requirements, and
4. Consumer protection laws.

Under the terms of some trust or agency agreements, a bank may neither be responsible for administering participant loan programs, nor for participant loan record keeping. Often, the plan administrator is responsible for participant loan programs. In situations where a bank is the plan's trustee, but: (1) it is not responsible under the terms of its appointment for administering a participant loan program, and (2) it does not have access to loan documentation, or other information which would reasonably permit it to determine that either the program or the participant loans are in compliance with applicable IRS regulations, it should not be cited for violations pertaining to the operation of the participant loan program.

H.9.g.(1). ERISA Requirements for Loans to Plan Participants

Section 408(b)(1) of ERISA permits loans to plan participants, even though participants are parties in interest and may also be fiduciaries of the plan. Loans must meet four requirements including the following:

- Originated in accordance with specific plan provisions [see Section 408(b)(1)(C) and IRC 4975(d)(1)(C)]. Labor Department Regulation 2550.408b-1(d)(2) requires that certain features of the participant loan program be included in the plan document or other official documents of the plan (such as the Summary Plan Description). Required features of a participant loan program include:
    - Identification of loan program administrator(s);
    - Procedures for loan applications;
    - Basis for loan approvals or denials;
    - Limits (if any) on amounts/types of loans;
    - Determination of what constitutes a reasonable rate of interest;"
    - Types of acceptable collateral; and
    - Events constituting default, and steps that will be taken in the event of default.
      Examiner Note:
        - A defaulted loan is taxable in the year of default. A 1099-R must be issued (to the borrower and the IRS) to report the distribution. Refer to IRS requirements dealing with when default occurs (refer to subsection H.9.g.(3). IRS Statutory and Regulatory Requirements for Loans to Plan Participants).
        - If defaulted loans are present, check the IRS/DOL Annual Return/Report (Form 5500) for the plan

  This section of the DOL regulation was effective for participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989.

- Available to participants and beneficiaries on a reasonably equivalent basis [refer to Section 408(b)(1)(A) and (B), and IRC 4975(d)(1)(A) and (B)]. Department of Labor ERISA Regulation 2550.408b-1(b)

and (c) states that loans must be available on a non-discriminatory basis to all eligible plan participants and beneficiaries, regardless of race, color, religion, age, sex, or national origin. In addition, the minimum loan amount set in the plan document may not exceed $1,000. The plan can set a maximum dollar amount and/or a maximum percentage of a participant's vested interest in the plan which may be borrowed.

- Charge a reasonable rate of interest [see Section 408(b)(1)(D) and IRC 4975(d)(1)(D)]. Reasonable is explained in DOL ERISA Regulation 2550.408b-1(e) as a rate commensurate to the rates charged by persons lending money for loans under similar circumstances.

- Provide adequate security or collateral [see Section 408(b)(1)(E) and IRC 4975(d)(1)(E)]. If a loan is secured by a participant's vested interest in a plan, the maximum loan amount is based on 50% of the vested interest. Anything in excess requires additional collateral. See DOL ERISA Regulation 2550.408b-1(f).

Labor Department Regulation 2550.408b-1 addressing Loans to Plan Participants and Beneficiaries, explains the meaning and implementation of the statutory provisions. Except as noted in the plan provisions above, the regulation was effective for loans granted or renewed beginning October 19, 1989.

H.9.g.(2). Plan Authorization and Conditions for Loans to Plan Participants

As noted above, ERISA Section 408(b)(1)(C) permits ERISA plans to make loans to plan participants and beneficiaries only if authorized by the plan document or some other related official document. Granting loans that do not comply with the plan's conditions would result in a violation of ERISA Section 404(a)(1)(D).

H.9.g.(3). IRS Statutory and Regulatory Requirements for Loans to Plan Participants

A loan made by an ERISA plan is considered taxable income (distribution) to the plan participant unless it meets a number of IRS provisions. In addition, if a participant or beneficiary assigns or pledges any portion of his or her interest in a plan as security for a loan, the portion of the Individual's interest assigned or pledged is treated as a distribution from the plan to the Individual, refer to IRS Regulation 401(a)-13. If any taxable distributions occur, the plan participants must receive a year-end Form W2-P and appropriate notification must be provided to the IRS and state tax authority.

The IRS participant loan requirements are governed by Section 72(p) of the Internal Revenue Code. Section 72(p) was added in 1982 and its provisions have been amended numerous times since the establishment of this section. Two different standards apply to participant loans:

- Loans used to *acquire* the principal residence of the participant must be repaid by normal retirement age, as defined by the plan [see IRC Section 72(p)(2)(B)].
  Previous tax law provisions permitted these loans to be used to acquire, build, or substantially renovate the principal residence of the participant or dependent family member. However, these provisions were revoked in 1986.

- For all other loans dated August 13, 1982, or later, there are specific limitations on the term, maturity, renewals, repayment, principal

amounts, and amounts of any new loans. Failure to comply with the following requirements results in the loan being treated as a taxable distribution.

- The loan agreement must provide that the term not exceed five years.
- Principal of the loan must be repaid in not less than quarterly installments [see IRC Section 72(p)(2)(C)].
- Extensions, renewals, and rollovers are prohibited. A taxable distribution results if these transactions occur.
- The maximum amount eligible for a tax-free loan is based on the participant's vested interest in the plan:

Participant's Vested Interest	**Tax-Free Loan Limit**
$ 10,000 or less	Full Vested Amount
$ 10,000 - Under $ 20,000	$ 10,000
$ 20,000 - Under $ 100,000	50% of Vested Amount
$ 100,000 and more	$ 50,000

- The maximum amount of any new loan is reduced by the excess (if any) of the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date on which the new loan was made over the outstanding balance of loans from the plan on the date the loan was made. The effect is to reduce the $50,000 maximum limit for a participant loan by the amount paid on any outstanding loan during the one-year period immediately preceding the making of the new loan.

Default occurs at the time of failure to make the payments. The employee benefit plan may permit a grace period which can be no longer than the last day of the calendar quarter following the calendar quarter in which the missed payment was due. If default occurs:

- The amount of the deemed distribution is the entire outstanding balance of the loan at the time of such failure to make payments.
- The participant will be taxed on the amount of the deemed distribution, unless the participant's account includes after-tax contributions, in which case all or a part may not be taxable.
- The 10% premature distribution tax will apply to the amount of the deemed distribution if the participant has not reached age 59 1/2.
- A Form 1099R needs to be issued to the participant and the IRS (and, if applicable, to the state tax department).

The Internal Revenue Service amended Section 72(p) effective July 31, 2000, by adding Section 72(p)-1. This new section provides question and answer guidance, together with examples, on how participant loans which are deemed distributions are to be accounted for by employee benefit plans. Section 72(p)-1 appears in Appendix E.

The IRC also requires spousal consent when a participant's accrued benefit is used to secure a participant loan from the plan. **IRC Section 417(a)(4)** prohibits the use of accrued benefits to secure participant loans unless: (1) written spousal consent is obtained within 90 days preceding the date on which the loan is to be secured, and (2) the plan provides for spousal consent. IRC Section 417 appears in Appendix E.

H.9.g.(4). Consumer Protection Laws and Loans to Plan Participants

Participant loans are viewed as consumer credit: credit extended for personal, family or household purposes. Since participant loans are consumer loans, consumer protection laws apply to participant loans originated by an employee benefit plan's participant loan program in the same manner as they apply to a corporate fiduciary's own consumer loans. Although less frequently the case, Individual trust accounts originating loans may meet the definition of a creditor for consumer protection purposes. In such cases, the loans extended by Individual trust accounts must also satisfy the requirements of applicable consumer protection laws. Business purpose loans, on the other hand, are generally exempted from the requirements of consumer protection laws.

Trust examiners are not expected to have the technical expertise to conduct consumer compliance reviews, nor are they expected to conduct consumer compliance examinations while performing a trust examination. Trust examiners may review previous Compliance Examination reports, as well as internal/external audit reports, to ascertain whether the institution has demonstrated adequate compliance with consumer protection laws and regulations. Where deemed necessary, trust examiners may discuss the advisability of performing a consumer compliance examination with field supervisors.

H.9.h. Provision of Investment Advice to Participants and Beneficiaries

The Pension Protection Act added new sections 408(b)(14) and 408(g) to ERISA. The new sections provide relief for any transaction in connection with the provision of investment advice to a participant directed individual account. The relief covers the advice itself; the acquisition, sale, or holding of a security or other property in connection with the advice; and the receipt, direct or indirect, of fees or other compensation by the fiduciary or an affiliate in connection with the advice.

In order to qualify for the statutory exemption in 408(b)(14) the provision of investment advice must comply with the requirements detailed in Section 408(g). Section 408(g) requires that the investment advice be provided by a "fiduciary adviser" under an "eligible investment advice arrangement." An "eligible investment advice arrangement" is defined as a nondiscretionary investment advisory arrangement where either:

- Direct or indirect compensation received by the fiduciary advisor does not vary depending on the nature of the advice, i.e. a flat or level fee arrangement; or
- Advice is provided exclusively on the basis of a computer model

meeting certain specified requirements.

The DOL in Field Assistance Bulletin (FAB) 2007-01 stated that the level fee requirement applies only to the fiduciary adviser, and not to an affiliate of the fiduciary adviser, unless the affiliate is also a fiduciary adviser to the plan.

A "fiduciary adviser" is a:

- A bank or similar institution, but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or state banking authorities;
- A registered investment adviser;
- An insurance company qualifed to do business under the laws of a State;
- A registered broker-dealer;
- Affiliates of the above; and
- An employee, agent, or registered representative of the above.

When an individual acts as an employee, agent, or registered representative of an entity that provides investment advice - both the individual and the entity are considered fiduciary advisers. See FAB 2007-01.

In addition the following general requirements apply:

- The fiduciary adviser must provide appropriate disclosures, including those required by Federal securities laws;
- Any sale, acquisition, or holding must be at the sole direction of the recipient of the advice;
- Compensation received by the fiduciary adviser or an affiliate must be reasonable; and
- Terms must be at least as favorable as in an arm's-length transaction.

If a computer model is used, the model must:

- Apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- Take into account relevant information about the participant, such as age, life expectancy, risk tolerance, assets, sources or income, etc;
- Use prescribed objective criteria to provide advice to participants;
- Not be biased in favor of investments offered by the fiduciary adviser or its affiliates; and
- Take into account all the investment options under the plan and may not be inappropriately weighted towards any investment option

An "eligible investment expert" must certify that the computer model meets the specific requirements prior to the first use and at the time of each material modification of the model. The DOL may establish qualifications for an "eligible investment expert."

The "eligible investment advice arrangement" must be audited annually by an independent auditor. The independent auditor must:

- Have appropriate technical training or experience and proficiency;
- Must represent in writing that he/she has the required training and expertise; and
- Issue a written report of its findings to each fiduciary that has authorized participation in the arrangement.

Section 408(g)(6) requires the following disclosures:

- The role of any party that has a material affiliation or contractuaul relationship with the financial adviser in the development of the investment advice program or in the selection of investment options available under the plan;
- Past performance and historical rates of return of the investment options available;
- All fees or other compensation, including payments by third-parties, that the fiduciary adviser or its affiliates will receive;
- Any material affiliation or contractual relationship of the fiduciary adviser or its affiliates in any security or other property;
- When and how any participant information will be used;
- Types of services provided by the fiduciary adviser in connection with the provision of investment advice; and
- The participant may arrange separately for the provision of advice by another adviser that has no material affiliation with, and receives no fees or other compensation in connections with, a security or other property

Disclosures must be clear and conspicuous and calculated to be understood by the average plan participant. The DOL and the SEC will develop a model disclosure form. Fiduciary advisers are required to:

- Ensure that all disclosure materials are accurate;
- Provide disclosure to recipients of advice at no charge, at least annually; and
- Provide disclosures to recipients of any material changes to the disclosures at no charge and at a time reasonably contemporaneous with such changes.

Fiduciary advisers must keep for a period of at least six years the records necessary to determine whether they have complied with the requirements for the exemption. If, however, the records are lost or destroyed due to circumstances beyond their control, a prohibited transaction will not be deemed to have occurred solely on account of the records having been lost or destroyed.

H.9.h.1. Responsibilies of Plan Sponsors

Plan sponsors and other authorizing fiduciaries have a fiduciary responsibility for the prudent selection and periodic review of a fiduciary adviser. Plan sponsors and other authorizing fiduciaries, however, are not responsible for monitoring the specific investment advice of a fiduciary adviser. The Pension Protection Act does provide limited relief from fiduciary liability for plan sponsors entering into an "eligible investment advice arrangement" if 1) the terms of the arrangement require the fiduciary adviser to comply with the requirements of ERISA Section 408(b)(14) and 2) the fiduciary adviser acknowledges acting as a plan fiduciary.

On February 2, 2007, the DOL issued Field Assistance Bulletin (FAB) 2007-01 in which DOL provided guidance regarding processes and criteria for selecting and monitoring an investment adviser. In FAB 2007-01 the DOL opined that the selection of an investment adviser should be based on an objective process designed to obtain the information necessary to assess the qualifications of the adviser, the quality of services, and the reasonableness of fees. The process must avoid self-dealing, conflicts of interest, and other improper influence. Selection criteria should include:

  - Experience and qualifications, including required registrations

and licenses;
- Willingness of an adviser to assume fiduciary status; and
- Extent to which advice will be based upon generally accepted investment theories

Monitoring criteria should include the periodic review of:

- Changes in the information made to select the adviser;
- Compliance with contractual provisions;
- Utilization of investment advice in comparison with its cost; and
- Participant comments and complaints

Note that while plan sponsors and authorizing fiduciaries are not normally required to monitor the specific investment advice given by the fiduciary adviser, they may have to review specific advice in response to comments or complaints by plan participants.

H.9.h.2 Prior DOL Guidance Concerning the Provision of Investment Advice

In FAB 2007-01, the DOL reiterated that prior guidance regarding the provision of investment advice remains valid. Prior guidance issued by DOL includes Interpretive Bulletin 96-1 and Advisory Opinion 2001-09A, the SunAmerica Letter. In addition, certain guidance relating to the receipt of fees by fiduciaries would be applicable to situations where a fiduciary adviser receives fees. For example, the Frost and Country Bank advisory opinions, AO97-15A and AO2005-10A, respectively, apply to the receipt of fees by fiduciary advisers. Therefore, plan sponsors could opt to provide investment advice or education under prior DOL exemptions or guidance.

H.9.i. Block Trades

The Pension Protection Act added new Section 408(b)(15) to ERISA, which provides an exemption for block trades of stock between a plan and a non-fiduciary party in interest. Section 408(b)(15) defines a block trade as any trade of at least 10,000 shares or with a market value of at least $200,000 which will be allocated across two or more unrelated client accounts of a fiduciary. The interest of a plan, or grourp of plans sponsored by the same employer, can not be greater than 10% of the aggregate size of the block trade. The terms of the transaction must be at least as favorable to the plan as in an arm's-length transaction. The compensation associated with a block trade can not exceed the compensation associated with an arm's-length transaction with an unrelated party.

H.9.j. Alternate Execution Systems

The Pension Protection Act added new Section 408(b)(16) to ERISA which provides an exemption for any transaction involving the purchase or sale of securities, or other property, between a plan and a party in interest if the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue if certain requirements are satisfied.

The execution system must be subject to regulation by the applicable regulatory agency or by a foreign regulatory agency. The

execution system must either:

- Be designed to match purchases and sales at the best price available through the system in accordance with SEC rules or those of another relevant government authority; or
- Neither the execution system nor the parties to the transaction may take into account the identity of the parties in the execution of trades.

The price and compensation associated with the purchase or sale cannot be greater than in an arm's-length transaction with an unrelated party. If the party in interest has an ownership interest in the system, advance authorization by the plan sponsor or other independent fiduciary is required. A plan fiduciary must be provided with 30 days prior notice before using the system.

H.9.k. Service Providers and Their Affiliates

The Pension Protection Act added Section 408(b)(17) to ERISA. Section 408(b)(17) provides an exemption for the transactions described in Section 406(a)(1)(A), (B), and (D), (e.g. the sale, exchange, or leasing of property; the lending of money or other extension of credit; or the transfer of plan assets to, or use by or for the benefit of a party in interest), if the transactions are between the plan and a non-fiduciary party in interest that provides services to a plan or is related to a service provider to a plan. Such transactions are exempt only if the plan receives no less, or pays no more, than adequate consideration.

Adequate consideration means:

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

> (I) the price of the security prevailing on a national securities exchange which is registered under Section 6 of the Securities Exchange Act of 1934, taking into account factors such as the size of the transaction and marketability of the security, or
>
> (II) if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of the party in interest, taking into account factors such as the size of the transaction and marketability of the security, and

(ii) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary.

H.9.l. Foreign Exchange Transactions

The Pension Protection Act added Section 408(b)(18) to ERISA. Section 408(b)(18) exempts any foreign exchange transaction between a bank or a broker-dealer (or an affiliate of either) and a plan for which the bank or broker-dealer is a trustee, custodian, fiduciary, or other party in interest if the following requirements are satisfied:

- The bank or broker-dealer does not have investment discretion or provide investment advice with respect to the transaction;
- The transaction is in connection with the purchase, holding, or sale of securities or other investment assets, i.e. it can not be a stand-alone transaction;
- The terms are no less favorable than an arm's-length transaction between unrelated parties; and
- The exchange rate cannot deviate by more than 3% from interbank bid and ask rates for transactions of comparable size and maturity, as displayed by an independent service that reports exchange rates.

H.9.m. Cross-Trading

The Pension Protection Act added Section 408(b)(19) to ERISA. Section 408(b)(19) provides an exemption from ERISA Sections 406(a)(1)(A) and 406(b)(2) for transactions involving the purchase or sale of a security between a plan and any other account managed by the same investment manager if the following requirements are satisfied:

- The transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
- The transaction is effected at the independent current market price of the security (within the meaning of SEC Rule 270.17a-7(b));
- No brokerage commission, fee (except for customary transfer fees, which are disclosed), or other remuneration is paid in connection with the transaction;
- Cross-trading must be authorized in advance by a plan fiduciary other than the investment manager and the plan fiduciary must receive disclosures detailing the conditions under which cross-trades will occur. The authorization and disclosures must be in writing in a document separate the other written agreements between the parties. In addition, the investment manager must provide authorizing plan fiduciaries a copy of the investment manager's written policies and procedures governing cross-trading;
- Each plan participating in the transaction has assets of at least $100 million. If the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust must have assets of at least $100 million;
- The investment manager provides to the plan fiduciary who authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during the quarter, including the following information, as applicable: (i) the identity of each security bought or sold; (ii) the number of shares or units traded; (iii) the parties involved in the cross-trade; and (iv) trade price and the method used to establish the trade price
- The investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;
- The investment manager has adopted, and cross- trades are effected in accordance with, written cross- trading policies and procedures that are fair and equitable to all accounts participating in the cross- trading program, and that include a

description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and
- The investment manager has designated an individual responsible for periodically reviewing such purchases and sales to ensure compliance with the investment manager's written policies and procedures, and following the review, the responsible individual must issue an annual written report no later than 90 days following the period to which it relates and signed under penalty of perjury to the plan fiduciary who authorized cross trading describing the steps performed during the course of the review, the level of compliance, and any specific instances of non- compliance. The written report must also indicate to the authorizing fiduciary that the plan has the right to terminate its participation in the cross-trading program at any time.

On February 9, 2007, the Department of Labor issued Interim Final Rule 2550.408b-19, which describes the general requirements for and the content of an investment manager's written cross-trading policies and procedures. The interim final rule requires that cross-trading policies:

- Must be fair and equitable to all accounts and reasonably designed to ensure compliance with Section 408(b)(14);
- Clear and concise and written so as to be understood by the average plan fiduciary; and
- Sufficiently detailed so as to facilitate the periodic review of the cross-trading program by the compliance officer.

The interim rule specifically requires that cross-trading policies include:

- A description for determining whether a cross-trade benefits the parties to the transaction;
- A description of how the investment manager will determine that cross-trades are effected at the "independent market price ";
- A description of how the investment manager will ensure compliance with the $100 million minimum asset size requirement;
- A description of how the investment manager will mitigate potential conflicts of interests involving the parties to a cross-trade;
- A requirement that the investment manager allocate cross-trades among accounts in an objective and equitable manner, including a description of allocation methods and how they are chosen;
- The identity of the compliance officer, including a description of the compliance officer's qualifications; and
- A description of the scope of the review to be conducted by the compliance officer.

H.9.n. Inadvertent Prohibited Transactions

The Pension Protection Act added Section 408(b)(20) to ERISA. Section 408(b)(20) provides limited exemptive relief for transactions with parties in interest that are corrected within 14 days of discovery, or when date when the transaction should have reasonably been discovered, if:

- The transaction is the acquisition, holding, or disposition of securities or commodities;
- The transaction is not a transaction between a plan and plan sponsor that involves employer securities or employer real estate; and

- The fiduciary or other party in interest did not know, nor reasonably should have known, that the transaction was prohibited.

Under Section 408(b)(20) means :

- To undo the transaction to the extent possible and in any case to make good to the plan or affected account and losses from the transaction; and
- To restore to the plan or affected account any profits made through the use of assets of the plan.

H.10. Exculpatory and Indemnification Provisions - ERISA Section 410(a)

An exculpatory clause is a provision in a plan document or trust instrument that attempts to exculpate, or excuse, persons from certain actions. Sometimes these are called an immunity provision. These clauses may attempt to relieve trustees from liabilities from certain described actions and permit a trustee to adhere to a lesser standard than otherwise required by applicable law.

Section 410(a) of ERISA states that any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty ... shall be void as against public policy. The only exception is to recognize that fiduciaries may allocate and delegate responsibilities under ERISA Section 405 (refer to subsection H.6, Co-Fiduciary Liability - ERISA Section 405).

An indemnification agreement is one where one person or organization agrees to protect another against loss. In Interpretive Bulletin 75-4, the Labor Department permits indemnification agreements which leave the fiduciary fully responsible and liable for its actions, but allows another party to satisfy any liability incurred by the fiduciary in the same manner as fiduciary liability insurance (see below). The plan itself may not provide this indemnification; if it does, it is as ineffective as an exculpatory clause.

H.11. Fiduciary Liability Insurance - ERISA Section 410(b)

Section 410(b) of ERISA permits, but does not require, fiduciaries to be covered by fiduciary liability insurance. This type of coverage would protect the plan against errors or omissions of fiduciaries. The insurance may be purchased by the plan, out of plan assets, or by other interested parties. Coverage might be for the fiduciary or the plan sponsor/employer.

If the plan purchases the insurance coverage, the policy must be payable to the plan. The policy must also provide that the insurance company may take recourse (seek reimbursement) against the fiduciaries in the event of a breach of fiduciary liability. If the plan purchases the coverage, a party in interest (such as a fiduciary) may not be the beneficiary of the policy. If the insurance is purchased by a party other than the plan, the recourse provision is not required.

Individual fiduciaries may also purchase fiduciary liability insurance which would protect them against personal fiduciary liability. Such protection is often purchased by banks to protect their directors, officers, and employees. Reference is made to the insurance coverage in Section 10 of this Manual.

H.12. Bonding Requirements - ERISA Section 412

Section 412(a) of ERISA requires that, in general, each fiduciary or other person who is responsible for plan assets must be bonded. Bonding protects the plan against fraud or dishonesty. Corporate fiduciaries with $1,000,000 or more in capital are exempted from these provisions. Section 611(b) of the Pension Protection Act of 2006 added an exemption for broker/dealers registered under the Securities Exchange Act of 1934 and subject to the fidelity bonding requirement of a self-regulatory organization. As a result, the bonding requirements effectively apply to bank directors and officers who serve as individual fiduciaries. The amount of the bond is 10% of the assets handled, with a minimum of $1,000 and a maximum of $500,000. If, however, a plan holds employer securities, then the maximum bond is $1,000,000. See Section 622(a) of the Pension Protection Act of 2006. However, if a plan holds Administrators, officers, and employees

of unfunded plans are exempt from the bonding requirements.

The bond may have no deductible and must name the plan as the insured party. A pledge of assets, even if U.S. Government securities, is not an acceptable substitute for the bonding coverage. Bankers blanket bond policies normally do not provide this fiduciary bonding coverage. There is no requirement for errors and omissions insurance.

I. Disclosures to Employees and Beneficiaries

In enacting ERISA in 1974, Congress found that there was a dearth of information available to the average plan participant. In most cases, participants had no legal right to such information. As a result, ERISA requires several participant disclosures to inform participants of their rights and obligations under a plan. Two of the most common are described below.

A table located in subsection J.2. provides an overview of the major ERISA reporting and disclosure requirements.

I.1. Summary Plan Description

Section 102(a)(1) of ERISA governs the Summary Plan Description (SPD). This is a plain-language summary of the plan. The SPD is provided to all plan participants and is required to be sufficiently accurate so as to inform participants of their rights and duties under the plan. The SPD must be written in a manner calculated to be understood by that plan's average plan participant. If a substantial portion of the plan participants speak a language other than English, the SPD must contain a prominent notice in that other language stating how to obtain assistance.

SPDs must be prepared for all pension and welfare plans covered by Title I of ERISA. The requirement applies to plans with fewer than 100 participants, as well as to large plans. Preparation and distribution of the SPD is normally the responsibility of the plan administrator, not the bank fiduciary. Only in the event that the bank is responsible for preparing, distributing, or filing the SPD does it need to have copies of the disclosures. Nonetheless, if the bank has a copy, it may provide a good summary of the plan's various provisions.

While there is no specified format for the SPD, the requirements for the content of the SPD, explained in Department of Labor Regulation 2520.102-3, have as their objective supplying the plan participant with a full picture of how the plan operates and whom to contact with questions or complaints. In general, the SPD should include:

- Plan Identification. This includes the name and address of the sponsor, the plan's tax identification number (EIN), and the type of plan.
- Plan Administrator/Trustee. This identifies (name, address, telephone) the person(s) or organization operating the plan for the plan sponsor, as well as the plan's trustee(s).
- Plan Information. Eligibility qualifications to join the plan must be provided, as well as a description of circumstances that would lead to disqualification, ineligibility, forfeiture, loss, or suspension of benefits.
- Pension Benefit Guaranty Corporation (PBGC) Coverage. A statement must indicate whether plan benefits are guaranteed by PBGC and, if not, why not.
- Participant Rights. A statement must be included in the SPD which indicates which rights a participant or beneficiary has under ERISA and the plan. DOL regulations provide a model statement which may be used.
- Benefit Claims. A procedure for claiming benefits must be included in the SPD.

In general, plan participants must be provided an SPD at least once every five years. If no changes are made to a plan, an SPD must be distributed at least every ten years. If major changes to a plan are made, a summary of the changes or an updated SPD must be distributed

within seven months after the end of the plan's fiscal year in which changes occur. Changes need not be sent to retirees and their beneficiaries if the changes do not affect them.

The summary plan description was also previously filed with the Labor Department under Section 104(a) of ERISA four months after the plan became subject to the Act. Whenever material changes were made in the plan, a summary of the changes, or an updated SPD, was filed with the Labor Department within seven months after the end of the (plan's) fiscal year in which the changes occurred.

Effective August 5, 1997, with the passage of the Taxpayer Relief Act of 1997, plan administrators were no longer required to file SPDs, summary material modifications (SMMs) or updated SPDs with the Labor Department. Under the new law, plan administrators must furnish copies of SPDs and other plan documents to the department upon request. In addition, new civil penalties of up to $100 per day (not to exceed $1,000 per request) may be assessed against administrators who fail to furnish the requested information to the department within 30 days.

I.2. Summary Annual Report

Section 104(b) of ERISA requires each plan to furnish a Summary Annual Report (SAR) to its participants *and* beneficiaries. The SAR is intended to provide interested parties with a concise summary of the plan's financial position and operating results. The requirement applies to plans with fewer than 100 participants, as well as to large plans.

DOL has issued two report formats, one for pension plans and another for welfare benefit plans. See Labor Regulation 2520.104b-10. Both contain basic plan descriptions and explain how the plan is funded, but the plan administrator may omit any part of the model SAR that doesn't apply to a particular plan.

For non-insurance funded plans, the model pension SAR provides for a valuation of plan assets at the beginning and end of the plan year, amounts of administrative expenses and benefit disbursements, and information about transactions with parties in interest. The model welfare benefit SAR provides information about relevant insurance policies and, if assets are invested outside insurance funding vehicles, financial information similar to that in the pension SAR. Both contain a notice that the participant is entitled to more details, and how to obtain the additional information.

SARs must be distributed to applicable participants two months after the Annual Report (Form 5500) is filed. The Form 5500 is normally filed seven months after the plan's fiscal year-end, so SARs are due to be distributed nine months after the plan year-end. Any extension in filing Form 5500 automatically extends the distribution date for the SPD. SARs are not filed with the government.

J. REPORTING TO GOVERNMENT AGENCIES

Under Title I of the Employee Retirement Income Security Act (ERISA), Title IV of ERISA, and the Internal Revenue Code, pension and other employee benefit plans are generally required to file returns/reports annually concerning, among other things, a plan's financial condition and operations. Many of these reporting requirements are satisfied by filing the IRS/DOL/PBGC Form 5500. Private pension plans must also file a reports with the PBGC. The two reports most often encountered by examiners are summarized below. For a summary of ERISA reporting requirements refer to subsection J.2.

J.1. Annual Return/Report of Employee Benefit Plan (Form 5500)

Section 103(a)(1)(A) of ERISA requires an annual report to be prepared for each ERISA plan. ERISA Section 104(a)(1) requires the annual report to be filed with the government. The annual report is a combined IRS-DOL-PBGC filing using the Form 5500. Although Form 5500 is an IRS form, it is not a tax form and the information disclosed on Form 5500 is public information. Information on Individual Form 5500 filings can be obtained from the freeERISA web site: http://www.freeERISA.com. Registration is required to use the site, which is available without charge. Users can access Form 5500 filings either by providing the filer's name or the filer's Employee Identification Number (EIN).

Not every employee benefit account file sampled will contain a Form 5500, since it is the

administrator and sponsor of an employee benefit plan who are required to report. However, the bank as trustee may be responsible for the preparation and filing of the report. In such cases, a copy of the form should be retained in the trustee's files and available for review by examiners. Although the examiner's responsibilities do not include validating the accuracy of Form 5500, examiners should criticize the account if transactions that took place during the year are not reflected on the Form 5500, or if such transactions are not reported accurately. Limited penalties may be applicable for false statements of fact or knowingly concealing information. See DOL ERISA Regulation 2520.103-1(a)(1) and -1(b)(2)(i), and ERISA Section 103(b)(3).

Form 5500, along with instructions for its preparation, is available on the Internet at: www.dol.gov/ebsa/5500main.html

Form 5500: This is the annual report form that pension benefit plans, welfare benefit plans, Direct Filing Entities (DFEs) and fringe benefit plans must file. The Form 5500, Annual Return/Report for Employee Benefit Plans was substantially revised for the 1999 reporting year. Beginning with the 1999 reporting year, one Form 5500 will be used for all filers. Prior to 1999, there were several alternative Form 5500s, such as the 5500-C and 5500-R. For the 1999 filing year and thereafter, Form 5500 consists of a relatively simple main form containing basic identifying information and a checklist that guides filers to more detailed schedules that must be filed according to the filer's specific type of plan. Form 5500 contains **12** Individual schedules. Each schedule focuses on a particular subject area and/or filing requirement. Filers must complete only those schedules applicable to the filer's specific type of plan. Refer to the Profile of Form 5500 Components table for a summary of the type of information collected for each schedule and a description of the changes made to each schedule.

The revised Form 5500 was structured to streamline annual reporting requirements for plans using simple tax qualification structures and financial operations. Generally, welfare plans will complete fewer items than pension plans, and small plans (those with fewer than 100 participants) will complete fewer items than large plans. (Note: In determining whether a plan has 100 or more participants at the beginning of its plan year, *all* participants in the plan are counted, not just vested participants.)

Many plans with only one participant can continue to file Form 5500EZ.

Who Must File: Generally, unless exempted, a return/report must be filed every year for every pension benefit plan, welfare benefit plan, fringe benefit plan, and Direct Filing Entity (see below).

Pension benefit plans required to file include both defined benefit plans and defined contribution plans. A return/report is due whether or not the plan is qualified and even if benefits no longer accrue, contributions were not made this plan year, or contributions are no longer made. The following are among the pension benefit plans for which a return/report must be filed:

- Profit-sharing, stock bonus, money purchase, 401(k) plans, etc.
- Annuity arrangements under Code section 403(b)(1)
- Custodial accounts established under Code section 403(b)(7) for regulated investment company stock.
- Individual retirement accounts (IRAs) established by an employer under Code section 408(c).
- Pension benefit plans maintained outside the United States primarily for nonresident aliens if the employer who maintains the plan is:
    1. a domestic employer, or
    2. a foreign employer with income derived from sources within the United States if contributions to the plan are deducted on its U.S. income tax return.
- Church pension plans electing coverage under Code section 410(d).
- Pension benefit plans that cover residents of Puerto Rico, the U.S. Virgin Islands, Guam, Wake Island, or American Samoa.
- Plans that satisfy the Actual Deferral Percentage requirements of Code section 401(k)(3)(A)(ii) by adopting the SIMPLE provisions of section 401(k)(11).

The following pension benefit plans are **not** required to file Form 5500:

- An unfunded excess benefit plan.
- An annuity or custody account arrangement under Code section 403(b)(1) or (7) not established or maintained by an employer as described in 29 CFR 2510.3-2(f).
- A Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) that involves SIMPLE IRAs under Code section 408(p).
- A simplified employee pension (SEP) or a salary reduction SEP described in Code section 408(k) that conforms to the alternative method of compliance in 29 CFR 2520.104-48 or 2520.104-49.
- A church plan not electing coverage under Code section 410(d).
- A pension plan that is a qualified foreign plan within the meaning of Code section 404A(e) that does not qualify for the treatment provided in Code section 402(e)(5).
- An unfunded pension plan for a select group of management or highly compensated employees that meets the requirements of 29 CFR 2520.104-23, including timely filing of a registration statement with the DOL.
- An unfunded dues financed pension plan that meets the alternative method of compliance provided by 29 CFR 2520.104-27.
- An Individual retirement account or annuity not considered a pension plan under 29 CFR 2510.3-2(d).
- A governmental plan.

Welfare benefit plans provide benefits such as medical, dental, life insurance, apprenticeship and training, scholarship funds, severance pay, disability, etc. All welfare benefit plans covered by ERISA, except the following, are required to file Form 5500:

- A welfare benefit plan that covered fewer than 100 participants as of the beginning of the plan year and is unfunded, fully insured, or a combination of insured and unfunded.
- A welfare benefit plan that is maintained outside the United States primarily for persons substantially all of whom are nonresident aliens.
- A governmental plan.
- An unfunded or insured welfare plan for a select group of management or highly compensated employees which meets the requirements of 29 CFR 2520.104-24.
- An employee benefit plan maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws.
- A welfare benefit plan that participates in a group insurance arrangement that files a Form 5500 on behalf of the welfare benefit plan as specified in 29 CFR 2520.103-2.
- An apprenticeship or training plan meeting all of the conditions specified in 29 CFR 2520.104-22.
- An unfunded dues financed welfare benefit plan exempted by 29 CFR 2520.104-26.
- A church plan under ERISA section 3(33).
- A welfare benefit plan solely for:
    1. an Individual or an Individual and his or her spouse, who wholly owns a trade or business, whether incorporated or unincorporated; or
    2. partners or the partners and the partners' spouses in a partnership.

Plans must file Form 5500 by the last day of the 7th calendar month after the end of the plan year (not to exceed 12 months in length).

Direct Filing Entities (DFEs)

The term direct filing entity includes common/collective trusts (CCTs), pooled separate accounts (PSAs), group insurance arrangements (GIAs), master trust investment accounts (MTIAs) and 103-12 investment entities (103-12 IEs) for which a form 5500 is properly filed. Only one Form 5500 should be filed for each DFE year for all plans participating in the DFE. The DFE Form 5500, including all required schedules and attachments, must report information for the DFE year (not to exceed 12 months in length) that ends with or within the participating plan's year. The DFE Form 5500 filing is an integral part of the annual report of each participating plan and the plan administrator may be subject to penalties for failing to file a complete annual report unless both the DFE Form 5500 and the plan's Form 5500 are properly filed.

For reporting purposes, common/collective trust (CCT) and pooled separate account (PSA) are, respectively: (1) a trust maintained by a bank, trust company, or similar institution or (2) an

account maintained by an insurance carrier, which are regulated, supervised, and subject to periodic examination by a state or Federal agency in the case of a CCT, or by a state agency in the case of a PSA, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations.

A master trust investment account (usually referred to as a master trust) is a trust for which a regulated financial institution serves as trustee or custodian (regardless of whether such institution exercises discretionary authority or control with respect to the management of assets held in trust), and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. The assets of a master trust are considered for reporting purposes to be held in one or more investment accounts (MTIAs). An MTIA may consist of a pool of assets or a single asset. Each pool of assets held in a master trust must be treated as a separate MTIA if each plan that has an interest in the pool has the same fractional interest in each asset in the pool as its fractional interest in the pool, and if each such plan may not dispose of its interest in any asset in the pool without disposing of its interest in the pool. A master trust may also contain assets that are not held in such a pool. Each such asset must be treated as a separate MTIA..

DOL Regulation 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than an MTIA, CCT, or PSA), whose underlying assets include plan assets within the meaning of 29 CFR 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans. Such an entity that correctly files a Form 5500 constitutes a 103-12 Investment Entity (103-12 IE).

A group insurance arrangement (GIA), for reporting purposes, provides benefits to the employees of two or more unaffiliated employers (not in connection with a multiemployer plan or a collectively-bargained multi-employer plan), fully insures one or more welfare plans of each participating employer, uses a trust or other entity as the holder of the insurance contracts, and uses a trust as the conduit for payment of premiums to the insurance company.

Schedule D, DFE/Participating Plan Information, is a new schedule added to Form 5500 to standardize the format of DFE reporting requirements. DOL's goal is to ensure adequate reporting of the approximately $2 trillion in plan assets held in PSAs, CCTs, MTIAs and 103-12 IEs.

DFEs, other than GIAs, must file Form 5500 no later than 9 ½ months after the end of the DFE year. A Form 5500 filed for a DFE must report information for the DFE year (not to exceed 12 months in length) that ends with or within the participating plans year. GIAs must file by the last day of the 7th calendar month after the end of the plan year (not to exceed 12 months in length) that began in 1999. A 1999 Transition Rule permits DFEs with a fiscal year ending in 1999 to file 1999 DFE Form 5500s on or before October 16, 2000. Under a separate 1999 Transition Rule, the new requirements that large plans report their percentage interests in the assets of CCTs and PSAs on their Schedule H if the CCT or PSA chooses not to file as a DFE was deferred until returns/reports for plan years beginning in 2000.

Filing Requirements

The Form 5500 schedules that a plan must file are generally determined by the type of plan, pension, welfare, DFE or Fringe Benefit, and, for pension and welfare plans, whether it is a small or a large plan (i.e. whether the plan has fewer than 100 participants). The Quick Reference Chart summarizes which schedules are required for each type of plan. Three schedules that examiners should be aware of are detailed below.

Schedule A: Insurance Information - This schedule must be attached if any benefits under a defined benefit, defined contribution, or welfare benefit plan are provided by an insurance company, insurance service, or other similar organization. This includes investments with insurance companies such as Guaranteed Investment Contracts (GICs).

Schedule B: Actuarial Information - The employer or plan administrator of a defined benefit plan that is subject to minimum funding standards (see IRC Section 412 and Part 3 Title I of ERISA) must file this attachment. An enrolled actuary must sign Schedule B. See Income Tax

Regulation Section 301.6059-1(d) for qualifications of an enrolled actuary. The form summarizes the actuarial assumptions used to calculate the participant's defined benefit.

Schedule B includes the amount of a defined benefit plan's unfunded vested liability; the number of plan participants; transactions with insiders; and limited partnership valuations, as well as similarly difficult to value assets.

For the bank's own employee pension plans, the unfunded vested liability represents a contingent liability of the bank. See Bank Sponsored Employee Benefit Plans in subsection K.3, Unfunded Vested Liability regarding the examination treatment of unfunded vested pension liabilities.

Schedule C: Service Provider and Trustee Information - All persons receiving, directly or indirectly, $5,000 or more in compensation for all services rendered to the plan during the plan year must be described on this attachment. Examples of service providers include, but are not limited to: accountants, lawyers, brokers, custodians, trustees, and actuaries.

Form 5500EZ: In general, this form is intended for one participant pension plans.

Profile Of Form 5500 Components
Source: In Brief: 1999 Form 5500, U.S. Department of Labor - PWBA

Form Component	Type of Information Collection	Description
Form 5500	Overview information on type of annual return/report, type of plan, and schedules attached.	Basic information identifying the filer with checklist for attached schedules
Schedule A	Information on contracts with insurance companies for plans and certain DFEs	Revised by adding questions to collect better data on type and value of insurance contracts
Schedule B	Actuarial information on defined benefit pension plans.	Minor revisions to update for 1999 requirements.
Schedule C	Information on service providers for large plans and certain DFEs .	Limited to 40 highest paid service providers, eliminated list of trustees, and limited termination notice to accountants and enrolled actuaries.
Schedule D	Information on participation in certain pooled investment/insurance arrangements (CCTs , PSAs , MTIAs , 103-12 IEs and GIAs).	New standardized form for reporting information about Direct Filing Entities (DFEs) and participating plans.
Schedule E	Information on ESOP plans.	No material revisions.
Schedule G	Information on nonexempt transactions and loans, leases and fixed income investments in default/uncollectible for large plans and certain DFEs .	Streamlining current schedules of loans, leases, fixed income obligations in default/uncollectible and nonexempt transactions. (Note: Schedules of assets and reportable (5%) transactions are required to be filed, but not on computer scannable forms.)
Schedule H	Financial statements and related information for large plans and DFEs .	New schedule streamlining large plan financial questions on current Form 5500 and consolidating them into a

		separate schedule.
Schedule I	Financial statements and related information for small plans.	New schedule streamlining small plan financial questions on current Form 5500-C/R and consolidating them into a separate schedule.
Schedule P	Tax exempt pension trust filers to start IRS statue of limitations.	No material revisions.
Schedule R	Information on pension plans including plan distributions and funding requirements.	New schedule revising pension plan questions on current Form 5500 and Form 5500-C/R and consolidating them into a single schedule.
Schedule T	Information on pension plan tax qualification requirements.	New schedule revising tax qualification questions on current Form 5500 and Form 5500-C/R and consolidating them into a separate schedule that can be filed in accordance with the 3-year testing cycle under Rev. Proc. 93-42.
Schedule SSA	Information required by Social Security Administration for pension plans on separated participants with rights to future benefits.	No material revisions.

Quick reference chart For Filing the new form 5500[1]

	Large Pension Plan	**Small Pension Plan**	**Large Welfare Plan**	**Small Welfare Plan**	**DFE[2]**
Schedule A (Insurance Information)	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.[5]	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.	Must complete if MTIA, 103-12 IE or GIA has insurance contracts.
Schedule B (Actuarial Information)	Must complete if defined benefit plan and subject to minimum funding standards.	Must complete if defined benefit plan and subject to minimum funding standards.	Not required.	Not required.	Not required.
Schedule C (Service Provider Information)	Must complete if service provider was paid $5,000 or more and/or an accountant	Not required.	Must complete if service provider was paid $5,000 or more and/or an accountant	Not required.	MTIAs, GIAs and 103-12 IEs must complete Part I if service provider was paid $5,000 or

	or actuary was terminated.		or actuary was terminated.		more. GIAs and 103-12 IEs must complete Part II if accountant was terminated.
Schedule D (DFE/Participating Plan Information)	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	All DFEs must complete Part II, and DFEs that invest in CCT, PSA, or 103-12 IE must also complete Part I.
Schedule E (ESOP Information)	Must complete if ESOP.	Must complete if ESOP.	Not required.	Not required.	Not required.
Schedule G (Financial Schedules)	Must complete if Schedule H, lines 4b, 4c, or 4d are Yes.[3,5]	Not required.	Must complete if Schedule H, lines 4b, 4c, or 4d are Yes.[3,4]	Not required.	MTIAs, GIAs and 103-12 IEs must complete if Schedule H, lines 4b, 4c, or 4d are Yes.[3]
Schedule H (Large Plan and DFE Financial Information)	Must complete.[5]	Not required.	Must complete.[4]	Not required.	All DFEs must complete Parts I, II & III, MTIAs, 103-12 IEs, and GIAs must also complete Part IV.
Schedule I (Small Plan Financial Information)	Not required.	Must complete.	Not required.	Must complete.[4]	Not required.
Schedule P (Annual Return of Fiduciary)	Must file to start running of statute of limitations under Code section 6501(a).[5]	Must file to start running of statute of limitations under Code section 6501(a).	Not required.	Not required.	Not required.
Schedule R (Retirement Plan Information)	Must complete unless plan is neither a defined benefit plan	Must complete unless plan is neither a defined benefit plan	Not required.	Not required.	Not required.

	nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year.[5]	nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year.			
Schedule SSA (Statement Identifying Separated Participants With Deferred Vested Benefits)	Must complete if plan had separated participants with deferred vested benefits to report.[5]	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.	Not required.
Schedule T (Qualified Pension Plan Information)	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year.[5]	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year.	Not required.	Not required.	Not required.
Accountant's Report	Must attach.[5]	Not required.	Must attach.[4]	Not required.	Must attach for a GIA or 103-12 IE.

[1] Source: In Brief: 1999 Form 5500, U.S. Department of Labor - PWBA. This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions and regulations for complete information.

[2] DFE (Direct Filing Entity) includes: bank common and collective trusts (CCTs) and insurance company pooled separate accounts (PSAs) (29 CFR 2520.103-3 and 103-4) that choose to file information on behalf of their participating plans; master trust investment accounts (MTIAs) (29 CFR 2520.103-1(e); investment entities filing under 29 CFR 2520.103-12 (103-12 IEs); and group insurance arrangements (GIAs) filing under 29 CFR 2520.103-2 and 104-43.

[3] Schedules of assets and reportable (5%) transactions also must be filed with the Form 5500 if Schedule H, lines 4i or 4j are Yes, but use of scannable form not required.

[4] Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR 2520.104-20 are exempt from filing an annual report. Such a plan with 100 or more participants must file an annual report, but is exempt under 29 CFR 2520.104-44 from the accountant's report requirement and completing Schedule H, but MUST complete Schedule G, Part III, to report any nonexempt transactions.

[5] Not required for certain plans eligible for limited pension plan reporting.

J.2. Pension Benefit Guarantee Corp (PBGC) Annual Premium Filing (Form PBGC-1)

The Pension Benefit Guaranty Corporation (PBGC) was established as a federal corporation under The Employee Retirement Income Security Act of 1974. The PBGC is responsible for

providing pension benefits to participants and beneficiaries of covered plans when plan sponsors can no longer fund the plan, generally in the case of bankruptcy. The agency insures only private-sector defined benefit plans. Public sector and religious organization pension plans are not covered; neither does the agency insure defined contribution plans of any kind. As of December 2006, the PBGC was the guarantor of pension benefits for more than 44 million American active workers and retirees participating in more than 30,000 private-sector defined benefit pension plans. The two major categories of plans covered by the agency are single-employer and multi-employer pension plans. Multi-employer plans are generally collectively bargained/union plans which are funded by one or more companies in a common industry. As of September 30, 2006, the single-employer program accounted for virtually all of the PBGC's deficit. It held total assets in these plans of $61 billion, and was responsible for a present value of future benefits estimate of $80 billion. PBGC's liabilities are not backed by the full faith and credit of the federal government, nor does it receive any funds from tax revenues. Rather, the PBGC is self-funding, deriving its revenue from premiums on covered plans paid by plan sponsors, assets acquired from terminated plans, recoveries from terminated sponsors, and earnings from invested assets.

Under the single-employer program, PBGC pays monthly retirement benefits up to a guaranteed maximum. The guaranteed maximum payment for a single life annuity in plans terminating in 2007 is: $4,125.00 a month at age 65, $3,258.75 a month at age 62, and $1,856.251 a month at age 55. Benefit increases and new benefits are only partially covered if plan amendments covering the increases were adopted less than five years as of the date a plan terminated. Under the multiemployer Program, the agency provides financial assistance in the form of loans to plans facing insolvency. As a requirement for financial assistance, plans must discontinue benefits in excess of the PBGC's guaranteed level.

Annual Premium Filing (Form PBGC-1)

Form PBGC-1: This form is filed on an annual basis by all defined benefit plans and is not dependent on the size of the plan. Large plans, plans with 500 or more participants, must file an estimated flat premium form.

Form 1-ES: This form discloses the number of participants and the estimated amount of premium payment due the PBGC. If an employer wants to terminate the plan, the PBGC must be notified in advance and must approve any distributions of plan assets to participants. PBGC forms are available on the Internet through PBGC's home page at http://www.pbgc.gov/

ERISA Reporting & Disclosure

ERISA Reporting & Disclosure							
	Sent To	**Defined Benefit Pension**		**Defined Contribution Retirement (P/S - 401(k) - ESOP)**		**Welfare Benefit**	
Participants (#)		100 +	< 100	100 +	< 100	100 +	< 100
Recurring Requirements							
PBGC-1 (Premium Pmt)	PBGC	7 months after plan fiscal year-end	Same	N/A	N/A	N/A	N/A
Summary Annual Report (SAR)	Participants	9 months after plan fiscal year-end	Same	Same	Same	Same	Same
Annual Report (Forms 5500)	IRS	7 months after plan fiscal year-end (9 ½	Same	Same	Same	Same	Same

		months for DFEs other than GIAs					
Exception Reports							
Reportable Event Notice	PBGC	For some, file notice within 30 days of occurring; for other, report on Form 5500	Same	N/A	N/A	N/A	N/A
Termination Intent Notice	PBGC	10 Days Before Proposed Termination	Same	N/A	N/A	N/A	N/A

K. Bank Sponsored Employee Benefit Plans

K.1. ERISA Applicability

The following summary gives the major provisions of ERISA applicable to banks sponsoring pension or profit-sharing plans for their own employees. Review of these major points should enable the examiner to determine whether a bank is in substantial compliance with ERISA. Some of the summary points represent a consolidation of many sections but, where practicable, citations are given indicating which sections of ERISA may be applicable.

Form of Plan

Employee pension benefit plans are to be in writing [ERISA Section 402(a)(1)] and, with certain exceptions, must meet ERISA's minimum participation and vesting standards. [See also ERISA Section 402(b), refer to subsection H.3, Establishment of Plan - ERISA Section 402].

Operation of Plan

1. At least one trustee must be appointed to operate the plan [ERISA Section 403(a), refer to subsection H.4, Trustee Requirements - ERISA Section 403]. The trustee need not be a bank. Usually, directors, officers, or employees of the plan sponsor (employer) are named as Individual trustees.

   In general, ERISA requires that all assets of employee benefit plans be held in trust. Exemptions exist for fully insured plans and regulations provide that welfare plans under which benefits are paid directly from the general assets of the employer (unfunded plans) are exempt from the trust requirements. Insured plans are those where the funding agency is an insurance company. Contributions are paid to the insurer which in turn pays all benefits to eligible participants based upon instructions from the plan's retirement or administrative committee. These plans range from fully guaranteed retirement benefits to immediate participation guarantee contracts in which the basic guarantee is limited to providing lifetime annuities for those employees who have actually retired.

2. A trust agreement detailing the responsibilities and duties of the trustee should be in writing [ERISA Section 403(a)]. The trust agreement may be included with the plan as an all-inclusive document, but normally this is not the case. Trust agreements are not necessary if the plan's assets are solely insurance policies or annuity contracts issued by insurance companies [ERISA Section 403(b)].

3. The plan must be operated solely in the interests of the plan participants and beneficiaries. In practice, this means that the plan must operate according to the plan

documents and fiduciary principles, with diversified investments made prudently [ERISA Section 404, refer to subsection H.5.b., Requirements]. ERISA prohibits transactions involving conflicts of interest (ERISA Section 406(a)) and self-dealing (ERISA Section 406(b)). Refer to subsection H.7., Prohibited Transactions - ERISA Section 406.

K.2. Trust Powers

If a bank sponsors an employee benefit plan for its own employees, it may name Individuals as trustees. This is commonly done in smaller institutions, where one or more directors and/or officers are named as Individual trustees. Where the bank itself is named as trustee for its own employee benefit plan (and does not serve in any fiduciary capacity for any other institution, parent company, affiliate, or Individual), it is not required to have trust powers unless trust powers are required by state law for such purposes. In such cases the FDIC does not view the bank as operating a trust department, and does not require the bank to apply for Corporation consent to serve as its own trustee. These plans are typically reviewed at safety and soundness examinations, and no trust report is prepared. Any apparent violations of ERISA are scheduled in the safety and soundness report. Referrals of violations (if any) to the Department of Labor are prepared according to instructions found in Appendix A. Refer to subsection B. of Section 10 of this Manual for further discussion of situations which may require FDIC consent to exercise trust powers under Part 333 of FDIC's Rules and Regulations.

K.3. Unfunded Vested Liability

For the bank's own employee defined benefit pension plans, the unfunded vested liability represents a contingent liability of the bank. The unfunded vested liability figure from Form 5500 Schedule B should be noted on the optional own-bank employee benefit account page in the Trust examination report. If the bank contemplates terminating its pension plan or if the bank itself is in such a position that it may be closed, the amount of the unfunded vested liability should be shown as a contingent liability in the trust examination report and carried forward to any concurrent safety and soundness examination report.

K.4. Capital Treatment for ESOPs

In issue number 89-10, the Emerging Issues Task Force (EITF) of the Financial Standards Accounting Board (FASB) reached a consensus that ESOP debt should be reflected on the plan sponsor's balance sheet if the ESOP has no other sources of funds except contributions from the sponsor, dividends on the sponsor's stock, or proceeds from sales of the stock with which to service the debt.

When a bank sponsors a leveraged ESOP which invests in bank stock, there is no immediate increase in regulatory capital for the bank. While the number of shares issued has increased because of the purchase by the ESOP, this increase is offset by the corresponding liability incurred by the bank in guaranteeing the ESOP loan. As the loan is paid down, a commensurate decrease in the ESOP-guarantee liability occurs, providing an increase in bank capital.

The FASB EITF indicated that the consensus reached in issue number 89-10 did not address the push down of ESOP debt to a subsidiary's balance sheet in the situation where the participants are employees of the subsidiary. Security Exchange Commission (SEC) Staff Accounting Bulletin Topic 5.J provides that holding company debt should be pushed down to a subsidiary if the subsidiary will: (1) assume the holding company's debt, (2) retire all or part of the holding company's debt with the proceeds from a debt or equity offering, or (3) guarantee or pledge its assets as collateral for the holding company's debt.

When a bank sponsors a leveraged ESOP which invests in the stock of its own holding company, a case-by-case determination must be made as to the proper Report of Condition treatment of the impact on the bank's capital. A number of issues are involved, including whether the bank or the holding company guarantees the ESOP's debt, sources of funds to repay the debt, etc.

K.5. Fees - Permissibility vs. Prohibited Transactions

Banks are permitted to charge servicing fees to their own plans and to plans administered on

behalf of their holding company. Labor Department Advisory Opinion 79-49 provides that the provision of services by a fiduciary to its own employee benefit plans is not a prohibited transaction under ERISA Section 406(a) . This falls under the service provider exemption of ERISA Section 408(b)(2) . However, this exemption applies only if the fiduciary does not charge the plan a fee in excess of its direct expenses. If a fee in excess of direct expenses is charged, the transaction would violate ERISA.

Under Section 23B of the Federal Reserve Act, a holding company must be charged for services performed on its behalf by an affiliated bank (unless the bank would also, in good faith, waive fees for comparable transactions with nonaffiliated plans). Therefore, banks acting as custodian, trustee, or any other fiduciary capacity for employee benefit plans sponsored by their holding company, should charge the holding company for performing these services**.**

Banks which service holding company plans, or their own plans, should be guided by the ERISA requirement that servicing fees may not exceed their direct servicing expenses. The Labor Department has previously taken the position that banks which charge their own plan fees which exceed their "direct expenses," are in violation of ERISA Sections 406(b)(1) **and** 404(a)(1)(B) , **and** DOL Regulation 2550.408b-2(e)(1) . Banks which do so are also subject to a penalty under ERISA Section 502(1) , which is equal to 20 percent of any amount recoverable for the violation or breach of duty. Banks should also be aware that the DOL has taken the position that charging fees which are charged other trust customers is not considered a reimbursement of expenses. This is predicated on the concept that fees are formulated on a cost plus profit basis.

In reviewing own bank and holding company plans, examiners should determine whether management: (1) is aware of these requirements, and (2) can reasonably demonstrate that fees charged the plans are no more than "direct expenses." Also refer to a 1995 FDIC Legal Opinion on this matter located in Appendix C.

K.6. Assignment or Alienation of Plan Benefits

Examiners may encounter instances (either in trust department accounts, the bank's own employee benefit plan, or on the commercial side of the bank) where a participant has assigned their plan benefits as collateral for a loan. According to ERISA Section 206(d)(1) and IRC Section 401(a)(13), a plan will not be considered a qualified trust unless it provides that benefits under the plan may not be assigned or alienated. If a plan is disqualified, it may be required to forfeit favorable tax treatment. In addition, if a commercial lender originates a loan accepting an assignment of an employee benefit account, the lender may have difficulty securing the collateral if the borrower defaults.

There are three exceptions to the general rule prohibiting assignment and alienation of plan benefits. The three exceptions are discussed below.

- A plan may provide that once a participant begins receiving benefits under the plan, the participant may assign or alienate the right to future benefit payments if the assignment or alienation:
  - Is voluntary and revocable,
  - Does not in aggregate exceed 10% of any benefit payment, and
  - Is not for the purpose of defraying plan administration costs.

- A plan may provide for loans from the plan to a participant or a beneficiary to be secured by the participant's accrued nonforfeitable benefit provided that certain circumstances are met.

- A plan will not fail to satisfy the requirements of Section 401(a)(13) if payments are made to an alternate payee under a Qualified Domestic Relations Order (QDRO).

K.7. In-Kind Contributions

DOL Interpretive Bulletin 94-3 indicates that a prohibited transaction exists when the plan sponsor makes "in-kind" contributions to defined benefit plans and certain defined contribution and welfare benefit plans. Exceptions are noted for certain defined contribution and welfare benefit plans if the contribution would not reduce a present or future obligation of the plan sponsor to make cash contributions. Refer to subsections H.5.c.(1), Contributions, In-Kind and

H.7.f.(5), Loans to Common Borrowers - General.

L. Compliance with state laws

Section 514(a) of ERISA explicitly provides that, with certain exceptions, state laws dealing with employee benefit plans subject to ERISA are superseded by ERISA. From a practical standpoint, this means that only ERISA statutory, regulatory, and interpretive statements on a given issue apply to plans subject to ERISA. Even where FDIC requirements or state laws or regulations provide for a stricter standard, they do not apply to ERISA plans. ERISA further states in Section 514(b), that nothing shall be construed to exempt or relieve any person (or bank) from any law of any state which regulates insurance, banking, or securities. Refer to AO 94-41 for further discussion.

L.1. Escheat Provisions

When the plan document specifies the disposition of undeliverable benefits, those procedures control the trustee's actions. However, most plans will not address escheat guidelines. Thus, DOL concludes that ERISA preempts state escheat laws to the extent they apply to employee benefit plan payments when escheating is not addressed in state banking laws. In states where escheating is not addressed in state banking law, and the bank (as trustee or plan sponsor) remits unclaimed property to the state, an apparent violation of ERISA Section 404(a) would exist. Section 404(a) requires the trustee to hold and conserve plan assets for the exclusive purpose of providing benefits and defraying reasonable plan expenses. In states where escheat provisions are addressed in state banking law, examiners should not cite an apparent ERISA violation. However, the examiner should ensure that the bank is in compliance with state escheat laws. Refer to AO 94-41.

L.2. Special Treatment for Multiple Employer Welfare Arrangements (MEWAs)

The term Multiple Employee Welfare Arrangement (MEWA) is defined in Section 3(40)(A) of ERISA. A special provision exists for MEWA plans which are fully insured. In 1983, Congress added Section 514(b)(6) to ERISA to explicitly disclose that State insurance regulations apply to fully insured MEWA plans. Fully insured MEWA plans and unfunded MEWA plans are relatively rare (refer to subsection D.2.g., Welfare benefit Plans for further details).

M. Compliance with the Internal Revenue Code

A prohibited transaction cited under ERISA Section 406 represents, in almost every instance, a parallel violation of Section 4975 of the Internal Revenue Code (IRC). Whenever examiners cite a violation of ERISA Section 406, the corresponding violation of IRC Section 4975 should also be noted. The result is that a prohibited transaction under ERISA creates tax penalties levied by the IRS.

There are some differences between ERISA and IRC provisions. Different terminology is used, such as the party in interest of ERISA is a disqualified person in IRC. The two definitions can differ in unusual situations. As a result, examiners should note that a few ERISA prohibited transactions may not result in tax penalties under IRC Section 4975. Section 4975 of IRC, titled Tax on Prohibited Transactions appears in Appendix E.

N. Referrals of ERISA Violations to the Department of Labor (DOL)

In 1980, the federal financial institution agencies entered into an agreement with the DOL to refer violations of ERISA, meeting certain specific criteria, to that agency. The Labor Department in turn is obligated by law to refer certain matters to the Internal Revenue Service. A copy of the 1980 Interagency Agreement is located in Appendix E. The referral agreement covers only apparent violations cited in FDIC examination reports. Apparent violations cited in State examination reports are not forwarded by the FDIC to the Labor Department.

In compliance with the interagency agreement, the Corporation may forward the following types of apparent violations to the Labor Department:

- Where the federal financial institution does not serve as plan administrator or plan sponsor, as those terms are defined in ERISA Section 3(16), possible violations of:
    - Title I, Part 4, Section 404, relating to fiduciary duties (including transactions directed by named fiduciaries or qualified investment managers), except where the transaction amounts, individually or in combination with other questionable transactions, constitute less than $100,000;
    - Title I, Part 4, Sections 406 and 407(a), relating to prohibited transactions, except where the

threat of loss to the plan participants is de minimis;
  - Title I, Part 4, Section 411, relating to prohibition against certain persons holding certain positions;
  - Title I, Part 4, Section 412, relating to the bonding requirements as applicable to the financial institution itself.

- Where the financial institution, in respect to a plan, also serves as plan administrator or plan sponsor, the agencies shall provide written notification of possible violations of the ERISA sections listed above, plus written notification of possible violations of Title I, Part 1 of ERISA relating to reporting and disclosure.

Examiners may cite ERISA violations of a bank's own employee benefit plan(s) in the safety and soundness examination report if the bank does not operate a trust department. Employee benefit plans operated by the bank are subject to review and examination by FDIC examiners. A substantial number of ERISA violations referred to the Labor Department come from other than trust examination reports.

A separate page in the trust examination report, ERISA Employee Benefit Account - Recommendation for Referral to Labor Department, is used to provide relevant information about the employee benefit plan(s) affected and to facilitate the referral of the violation(s) to the Labor Department. This page should also be used if ERISA violations warranting referral are scheduled in the safety and soundness examination report. This separate page, when used, is either submitted as part of the Confidential Section of the examination report, or submitted separately to the Regional Office along with the report of examination. Instructions for completing the ERISA referral schedule can be found in Appendix A.

O. Account Documentation and IRS Determination Letters

O.1. Account Documentation in General

As with other types of trusts and agencies serviced by the trust department, corporate sponsored employee benefit accounts should be fully documented. At a minimum, the department should have on file properly executed copies of the:

- Governing plan document together with all subsequent amendments.

- Trust instrument or agency agreement, if separate from the plan document, together with all subsequent amendments.

  Even if the department services accounts only in an agency capacity, such as a custodian, it is still desirable that copies of the governing plan document and agency agreement be on file. Retaining such documentation enables bank personnel to assure that responsibilities are executed in accordance with plan or agreement provisions.

- Certified resolution(s) of the sponsoring firm's board of directors adopting the plan, trust agreement, and subsequent amendments to either.

- Documents evidencing the appointment of other parties authorized, in accord with plan provisions, to direct the trustee to:
  - Make benefit payments (normally, the plan administrator), and/or

  - Select trust investments (normally, an outside investment manager) [see ERISA Section 405].

- Internal Revenue Service determination letter if the:
  - Bank is acting as plan administrator, or

  - Account is invested in a CIF restricted to employee benefit accounts operating under Revenue Ruling 81-100.

O.2. IRS Letter of Determination

If requested, the IRS will review a plan and make a determination as to whether it meets the various standards to make it eligible for tax deductions. The opinion letter issued by the IRS is called a Letter of Determination. While there is no requirement imposed by ERISA or the IRS to

obtain a Letter of Determination, it is prudent for the plan sponsor to do so. Failure to obtain a letter, however, is not a violation.

Letters of Determination are usually obtained for new plans and for amendments to existing plans. Each amendment to an existing plan does not normally trigger a request for a new Letter of Determination. A number of minor changes will occur before a new Letter of Determination is required. On the other hand, if a major change occurs, the plan sponsor will often seek a new Letter from the IRS.

A sample Determination Letter appears in Appendix E. For further information, consult IRS Publication 794. Relevant information from this publication appears in Appendix E.

P. Voluntary Correction Programs

Employee Benefit Plan Voluntary Correction Programs

The Internal Revenue Service, US Department of Labor, and Pension Benefit Guaranty Corporation have adopted voluntary correction programs which permit employee benefit plan sponsors and other plan officials to correct certain categories of errors and misfilings with either no, or reduced, penalties, while preserving the plan's tax qualification.

1. **Internal Revenue Service**
   The IRS retirement plan correction program (Employee Plans Compliance Resolution System, covered under Revenue Procedure 2003-44), helps employer sponsors protect participant benefits and keep their plans within the requirements of the Internal Revenue Code. This revenue procedure combined and revised a series of previous IRS remedial programs for correcting plan qualification defects. The program covers qualified retirement plans, Section 403(b) arrangements, SEPs, and SIMPLE IRAs, for a variety of plan qualification failures and violations, including: operational failures, for failure to comply with terms of plan documents; plan document failures, in which retirement plan provisions violate IRS qualification requirements; demographic failures, in which IRS nondiscrimination requirements are not met in the plan document; and the diversion or misuse of plan assets.

   - **Self Correction Program**
     Under the Self Correction Program certain plan errors can be corrected without IRS involvement. No notification of IRS is required, no fees or penalties are assessed, and the plan and its participants retain tax benefits.

   - **Voluntary Correction Program**
     The Voluntary Correction Program may be used for plan errors which not eligible for self correction. Errors are corrected and the tax benefits of the plan are preserved for plan participants with IRS assistance.

   - **IRS Plan Audits**
     Errors corrected under either the Self Correction or Voluntary Correction programsare not treated as errors when the IRS audits these plans. For other errors found during IRS examinations, the **Audit Closing Agreement Program** permits their correction and tax benefit preservation at fees which are lower than would be incurred if the plan had not a participated in the Voluntary Correction Programs.

2. **U.S. Department of Labor**
   The Employee Benefits Security Administration has two voluntary self-correction programs for plan administrators who need help in meeting ERISA requirements: the Delinquent Filer Voluntary Compliance Program promotes, through the assessment of reduced civil penalties, plan administrator compliance with annual reporting obligations under Title I of the Employee Retirement Income Security Act of 1974; theVoluntary Fiduciary Compliance Program allows plan participants and beneficiaries and certain other persons engaging prohibited transactions under the Employee Retirement Income Security Act of 1974 to self correct the violations, and avoid potential civil actions by the DOL.

   - **Delinquent Filer Voluntary Compliance Program**
     The Delinquent Filer Voluntary Compliance Program assists plan administrators who have filed Form 5500 late, or not filed it at all, to comply with the filing requirements and pay reduced civil penalties. The IRS has agreed to provide penalty relief under the Code for delinquent Form 5500 Annual Returns/Reports filed for Title I plans where

the conditions of this program have been satisfied.

- **Voluntary Fiduciary Correction Program**
  The Voluntary Fiduciary Correction Program (PTE 2002-51 and PTE 2002-51 Amendment) affords plan sponsors and officials the opportunity to self-correct 15 specific transactions, involving delinquent participant contributions and other violations, prohibited under ERISA. The DOL also relieves these individuals from the payment of excise taxes associated with the transactions covered under the class exemption.

3. **Pension Benefit Guaranty Corporation**
PBGC provides incentives to self-correct late filings, or other errors involving missed premium deadlines and underpaid premiums.

- **Underpaid Premium Correction Program**
  Voluntarily self-corrected underpayments made before PBGC sends a notice of premium delinquency or a premium audit, reduces the monthly penalty rate by 80 percent (from 5 percent to 1 percent of the unpaid premium). Premium penalties may be waived for reasonable cause or in other appropriate circumstances.

- **Participant Notice Voluntary Correction Program**
  Missed or improperly prepared reports or notices are assessed lower penalties where the failure is quickly corrected or involves a small plan. Information penalties are waived for reasonable cause or in other appropriate circumstances. Self correction is considered a mitigating factor for plans participating in this program.

Q. Catch-up Contributions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended IRC Sections 402 and 414, creating a new category of elective retirement plan contributions, referred to as "catch-up" contributions. It also added IRC Section 414(v) which, effective for plan years beginning after December 31, 2001, permits individuals age 50 or older to make additional pre-tax salary deferrals ("catch up" contributions) to certain eligible plans: 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEPs), Section 403(b) arrangements, and Section 457 governmental plans. Eligible plans must be amended to permit catch-up contributions. Final regulations implementing "catch-up" contribution rules were issued under IRS Revenue Bulletin 2003-37 .

Catch-up contributions are elective retirement plan salary deferrals which would otherwise exceed plan imposed limitations. Catch-up contributions are also exempted from certain IRC statutory limits (IRC 401(a)(30), 401(k)(11), 402(h), 402A(c)(2), 403(b), 404(h), 408(k), 408(p), 415, and 457). Employers are not required to match catch-up contributions, and may incorporate plan language explicitly omitting catch-up contributions from existing employer-matching salary deferral programs. The IRC also does not require employers to provide for catch-up contributions in any of its plans. However, if an employer permits catch-up contributions in any one of its eligible plans, it must "universally" permit them in each of the eligible plans it sponsors. This "universality" provision ensures employers may not favor one category of employee vs. another (non-union vs. unionized, etc.). A temporary exclusion for collectively bargained plans is permitted, but only until the expiration of existing union agreements. Thereafter, all plans must be treated "universally." Although plan participants may elect to make "catch-up" contributions to a multiple number of eligible employer sponsored plans, the aggregate of their catch-up deferrals may not exceed annual statutory limits.

Under the IRC, deferrals are not considered "catch-up" contributions until the end of the plan's year. This is so because it cannot be determined until the end of a plan year whether or not the elective deferral will exceed plan limits. Further, although the catch-up limit is applied on a calendar year basis, the implementing regulations provide guidance on how the contributions may be calculated for retirement plans operating on a fiscal year basis.

Catch-up limits for all eligible plans except SIMPLE 401(k) and IRA plans:

Tax Year	Catch-up Limit*
2002	

	$1,000
2003	$2,000
2004	$3,000
2005	$4,000
2006	$5,000

Catch-up limits for SIMPLE 401(k) and IRA plans:

Tax Year	Catch-up Limit*
2002	$500
2003	$1,000
2004	$1,500
2005	$2,000
2006	$2,500

*For taxable years beginning after 2006, catch-up limits will be adjusted for inflation in increments of $500.

Trust Examination Manual

Section 6- Account Administration Corporate Trust Accounts

Table of Contents

A. Introduction

B. Types of accounts

1. Corporate Trustee
   a. General
   b. Indenture
   c. Duties of Trustee
2. Stock Transfer Agent
3. Stock Registrar
4. Bond Registrar (Transfer Agent for Registered Bonds)
5. Mutual Fund Transfer Agent
6. Registered Transfer Agents
7. Fiscal or Paying Agent
8. Dividend Reinvestment
9. Other Corporate Agencies
10. Asset-backed/Securitized Debt Issues
11. Municipal Trustee Issues
    a. Secondary Market Disclosures for Municipal Issues
    b. Defeasement Activities With Municipal Bonds
12. Global Custody
    a. Subcustodians
13. Trust Preferred Securities - Trustees

C. Account administration and controls

1. Pre-Acceptance Reviews
2. Appointment Documentation
3. Conflicts of Interest

4. Environmental Liability
5. Administration and Controls
    a. General
    b. Operational Issues
    c. Bond Trusteeships
    d. Default Administration
    e. Corporate Agencies

D. Complinace with the trust indenture act of 1939
1. General
2. Applicability
3. Compliance
    a. Trustee Appointment Requirements
    b. Conflicts of Interest
    c. Trustee Administration of Issue
    d. Administrative Filings With Trustee by Issuer
    e. Actions in the Event of Default

E. Other compliance
1. Lost, Stolen and Counterfeit Securities
    a. Registration
    b. Reporting
    c. Inquiries
2. State Escheat Laws
    a. Legal Background
    b. Escheatment Litigation
3. Other Laws and Regulations

A. Introduction

Corporate trust and agencies are accounts where the bank serves as trustee, agent, or global custodian. Corporate trust and agency services normally concern services performed in connection with the issuance, redemption, transfer, or recordkeeping for debt or equity securities.

Trustee under a bond indenture or trustee for an issue of trust preferred securities are typically the only trust relationships administered by a corporate trust department. For example, under a bond indenture, one trustee is appointed for a given bond issue, but several agents or co-agents may provide various related services to the same issue. It is not uncommon for a single indenture to name both the trustee for the issue and the related corporate agents, such as a paying agent for the issue.

The most common corporate agency activities include stock or bond transfer agent, registrar for stock or bond issues, paying agent for bond interest or stock dividends, dividend reinvestment agent, and escrow

agent.

Unlike personal and employee benefit accounts, where the interest of the beneficiary is the primary concern, banks serving in a corporate trust capacity serve two different constituencies. On the one hand, the issue of the security covered under the indenture hires the indenture trustee and pays the trustee's fees. The indenture trustee and other agents owe the issuer of the security effective and efficient administration of the duties assigned under the indenture. On the other hand, a fundamental duty of the indenture trustee is to monitor the issuer's compliance with the terms of the indenture and to take all necessary actions to protect the interests of the bondholders. In fact, the principal reason for appointing a trustee under a bond indenture is for the protection of those purchasing the securities issued under the indenture.

B. Types of Accounts

B.1. Corporate Trustee

B.1.a. General

Departments that serve as corporate trustee assume the greatest amount of responsibility and potential risk among the various types of corporate trust and agency accounts discussed in this chapter. The responsibilities of the trustee may include some or all of the following: the issuance of bonds, the maintenance of bondholder records, transfer of recorded ownership, the payment of principal and interest, and payment of remaining principal at maturity.

The issuer could be a corporation, state, municipality, quasi-public authority, school, church, or any incorporated organization, which chooses to finance its needs through the issuance of bonds. Bonds may also be distinguished by whether they are secured or unsecured. Examples of secured bonds include mortgage bonds, secured notes and equipment trust certificates. More complex types of issues are securitized or asset-backed securities which are discussed in the section Asset-backed/Securitized Debt Issues. Unsecured bonds are called debentures. Some bond issues are subject to the Trust Indenture Act of 1939 (amended by the Trust Indenture Reform Act of 1990) and others are not. Refer to Sub-section D, Compliance with the Trust Indenture Act of 1939 for additional information on the Trust Indenture Act.

Bonds issued may be sold to the general public, a limited investor group, or a single investor such as an insurance company or governmental agency. Bonds are now typically issued in registered, as opposed to bearer, form. They come in a wide variety of other distinguishing features, such as single or serial maturities; fixed or floating rates of interest; call provisions; convertibility into other types of securities; and sinking fund provisions for payment of principal.

B.1.b. Indenture

The document creating the corporate trust is called a trust indenture, a trust agreement, an indenture, or simply an agreement. The indenture defines the:

- Purpose(s) and/or nature of the debt to be created,
- Nature and description of the bonds to be issued,
- Parameters of administration during the life of the bonds,
- Nature, method, and place of repayment of principal and interest,
- Relationship between the corporation (borrower or obligor), the bank (trustee and/or agent) and lender(s) (bondholder(s)),
- Duties of the respective parties to the indenture,
- Description of the collateral (if any),
- Events of default,
- Actions to be taken in the event of default.

Indentures tend o be of uniform construction and design, but may be tailored to include unique provisions. Associated with the indenture is the instrument

that perfects a lien on collateral, if any, securing the bonds. These instruments are called the trust mortgage, deed of trust, collateral trust, equipment trust, etc., depending on the type of collateral.

B.1.c. Duties of Trustee

The primary duty of the trustee under the indenture is to perform the duties specified by the indenture. These normally include the following:

- Arranging for the printing and issuance of the bonds,
- Maintaining required records, accounts and documentation,
- Paying principal and interest,
- Holding beneficial title to collateral (if any),
- Safeguarding and appraising collateral (if any),
- Investing idle cash (if permitted or directed under the indenture),
- Ensuring the issue is in compliance with legal requirements,
- Monitoring for events of default under the indenture during the life of the bonds,
- Protecting the interests of bondholders in the event of a default.

B.2. Stock Transfer Agent

Transfer agents usually perform three functions. First, they issue stock certificates, which constitute an increase in shares outstanding (e.g., original issues, stock dividends and splits, etc.). Second, they maintain records identifying the owners of the shares of stock, how many shares are owned, and which certificates are owned. Third, they cancel and reissue certificates to reflect changes in ownership.

In connection with the latter, certificates and accompanying documents are checked for authenticity and appropriateness; canceled; and replaced by new certificates. The transfer agent sends both the canceled certificates and the newly issued certificates to the registrar for verification. This involves only an in-house transmittal when the institution acts both as transfer agent and registrar. After registration, the newly issued certificates are sent to the registered owners or their representatives and appropriate disposition (destruction, return of canceled certificates to the issuer, or cancellation and retention in a safeguarded area) is made of the canceled certificates.

Refer also to the discussion on registered transfer agents.

B.3. Stock Registrar

A stock registrar performs the critical duty of guarding against the over- or under-issuance of a security, sometimes referred to as a record difference, out-of-proof or out-of-balance condition. In addition to checking original issues, the registrar checks each transfer made by the transfer agent: to ensure the genuineness of the certificates presented for transfer; to make certain that the old certificates have been canceled; and to ensure that the number of shares represented by the new certificates does not exceed the number of shares represented by the old (canceled) certificates. In the case of bonds, the indenture trustee normally performs this function. New York Stock Exchange rules permit one institution to act as both transfer agent and registrar for listed securities other than its own.

Much less frequently, banks may be appointed solely as the outside registrar of a stock issue, without the more typical dual appointment as transfer agent and registrar.

Refer also to the discussion on registered transfer agents.

B.4. Bond Registrar (Transfer Agent for Registered Bonds)

I n the case of bonds, the bond registrar usually performs the duties of both transfer agent and registrar. usually, the indenture trustee performs the function of bond registrar. On rare occasions, however, there may be a separate bond registrar for an issue.

At one time, corporate, government bonds, and other debt securities were issued primarily in bearer form. Unlike stock issues, which were in registered form, the issuer did not know who held the bonds. The bondholder "clipped" interest coupons attached to the bond and sent them to the trustee or paying agent as interest became due. Eventually, the bond itself matured or was called prior to maturity, and was sent to the trustee for payment.

Today, however, most bond issues are registered for both principal and interest. Under Section 149 of the Internal Revenue Code, in order to qualify for the Federal tax exemption for interest with respect to state, county, and municipal bonds, such bonds must be in registered form. A transfer agent is, therefore, needed to maintain records of ownership. Since bond issues often have a 20 or 30 year maturity, some bearer bonds, (and associated coupons) may still be encountered by examiners.

For bond issues, the entity that performs transfer agent services is termed the bond registrar. A bond registrar performs all of the functions of the stock transfer agent and the stock registrar.

While unusual, banks are sometimes appointed solely as registrar of a bond issue, without the associated bond trustee duties.

Also refer to the discussion of registered transfer agents.

B.5. Mutual Fund Transfer Agent

A mutual fund transfer agent performs the functions of both the stock *transfer agent* and stock registrar. It maintains ownership records, transfers shares, and ensures the number of shares is kept in balance. A mutual fund's transfer agent is identified in the mutual fund's prospectus.

Two characteristics of mutual fund transfer operations are very different from stock or bond transfers. Mutual funds normally do not issue certificates to evidence ownership. Instead, entries on the books of the mutual fund or its transfer agent identify the owners and record the number of shares owned. In addition, open-end mutual funds do not have a limit on the number of shares issued and outstanding. Therefore, the "registrar function" faces a situation where the total number of shares outstanding is constantly changing (increasing or decreasing, depending upon the volume of purchases or redemptions).

Despite the general statements in the above paragraph, there are exceptions to both. Some mutual funds allow the issuance of share certificates on special request, such as when a customer wants to pledge fund shares as collateral for a loan. While most mutual funds are open-end, with no set number of shares issued and outstanding, "closed-end" mutual funds do have such limits. There are, however, fewer closed-end mutual funds than open-end funds.

Every mutual fund transfer agent must be a registered transfer agent. In addition, operations of mutual funds are subject to the Investment Company Act of 1940.

B.6. Registered Transfer Agents

Some institutions transfer securities, which are either listed on a national stock exchange or, more commonly, are registered under Federal securities laws. Section 17A of the Securities and Exchange Act of 1934 and Part 341 of the FDIC Rules and Regulations, require FDIC-supervised institutions that transfer these types of securities (including securities of a parent company or an affiliate) to register with the Corporation as a transfer agent. State nonmember banks serving solely as transfer agent for their own registered stock must also register as a transfer agent, whether or not the bank exercises trust powers and regardless of which department performs the transfer function. Registration as a transfer agent is also required when the institution is merely named as transfer agent for these securities, but has contracted with a third-party organization to actually perform all of the transfer processing and recordkeeping, a situation referred to as a private label arrangement.

As part of the registration process, each institution must obtain a FINS (Financial Industry Numbering System) Number from the Depository Trust Company in New York City. The FINS Number is a standardized numbering system used to identify each institutional party (banks, broker-dealers, transfer agents, etc.) to a securities transaction.

As of November 30, 2003, 92 FDIC-supervised institutions were registered as transfer agents. The FDIC utilizes a separate examination report for registered transfer agents and the Registered Transfer Agent Examination Report of Examination is completed for all such banks.

Examiners should note that, if a bank is a registered transfer agent, all bond and stock issues (regardless of which department of the bank transfers the securities) must b processed according to the SEC's operational regulations for registered transfer agents. This includes municipal and industrial revenue/development bond issues (which are not subject to securities registration and, were it not for the bank's registration as a transfer agent, would not otherwise be subject to securities transfer regulations).

Stocks must be registered under Federal securities laws, if they meet one of the following two criteria:

- As of January 1, 1998, equity securities must be registered under Section 12(g) of the Securities and Exchange Act of 1934 and SEC regulation 17 C.F.R. Section 240.12g when an issuer has (i) $10 million or more in total assets and (ii) more than 500 shareholders. Refer to 12 C.F.R. Part 335 of the FDIC Rules and Regulations.
- Prior to January 1, 1998, the applicable exemption threshold governing the registration of equity securities is (i) less than $1 million in total assets and (ii) 500 or fewer shareholders.

Less frequently, examiners will encounter corporate bond issues listed on a national securities exchange or mutual funds where the bank has been named a transfer agent. These also require registration as a transfer agent.

B.7. Fiscal or Paying Agent

As the fiscal agent for a corporation or a municipality, an institution makes interest payments on coupon bonds (often referred to as bearer bonds) as the coupons are presented; redeems maturing bonds; or prepares and mails interest checks for registered bonds, or dividend checks for stock issues. A fiscal agent may also be called a dividend disbursing agent, coupon and bond paying agent, or some similar name indicative of its duties.

B.8. Dividend Reinvestment

Some corporations offer their stockholders the option of participating in dividend reinvestment programs, wherein dividends are automatically applied to the purchase of additional shares of the corporation's stock, either on the open market or directly from the corporation. On the dividend payment date, dividend payments are transferred by the dividend disbursing agent to the dividend reinvestment agent (often the same institution) who purchases shares of the corporation's stock. It may also be possible for stockholders to purchase additional shares through their dividend reinvestment agent. The dividend reinvestment agent usually holds the shares purchased until the participating stockholder requests physical delivery.

B.9. Other Corporate Agencies

An institution may also serve s an escrow agent or depository in connection with: defaults, mergers, consolidations, reorganizations, initial public offerings, tender offers, or other transactions requiring that securities or funds be deposited with a responsible third-party. The depository may also receive and record the claims of creditors.

Banks are often appointed as:

- Conversion agent (where debt securities are "converted" into equity securities),
- Exchange agent (involving exchange of one class of securities for another, or exchange of bearer bonds for registered bonds),
- Subscription agent (usually involving an invitation to equity security holders to subscribe to a new issuance of additional debt or equity), and
- Authenticating agent (commonly used when the indenture trustee is not located in a major money market city -- the bond registrar is also able to exercise limited authority to authenticate bonds on exchange or transfer).

Lesser-known services are offered to corporations in connection with the voluntary or involuntary liquidation of business enterprises. A business concern, which finds itself in

financial difficulties but is not insolvent, may turn over its assets to a trust institution as assignee for the benefit of creditors. A business in financial difficulties, which can not reschedule its payments owed to creditors, may have a court appointed receiver operate the business until such time as the assets can be liquidated or it becomes evident that bankruptcy can be averted. The duty of a trustee in bankruptcy is to realize as much cash as possible from the sale of the assets of a bankrupt business and, under the supervision of the court, to apply the amount realized to the claims of creditors. Few institutions accept trusteeships in bankruptcy because of the undesirable and unprofitable nature of this type of business.

B.10. Asset-backed/Securitized Debt Issues

In recent years, it has become more common for debt securities to be secured by various types of self-liquidating collateral. These asset-backed or securitized debt issues may be secured by a variety of assets, including commercial loans, second mortgage loans, automobile loans, and credit card receivables. The trustee must ensure that the collateral, a pool of loans for example, is properly serviced, payments are properly allocated to principal and interest, and delinquencies are identified and resolved. Accepting such responsibilities is a major undertaking involving considerable potential risk. The pre-acceptance review of such appointments is crucial: to identify the quality of the loans involved; to ensure the bank's ability to monitor the loans and servicer; to evaluate the complexity of the deal structure; and, if necessary, to arrange for back-up services.

Servicing of the loan pool cannot be delayed. There have been instances where major problems have arisen when the loan servicer went out of business or was otherwise unable to properly service the underlying loans. In such cases, the bank trustee must promptly ensure continued servicing, which may involve considerable unanticipated, and perhaps unreimbursed, costs.

The trustee is responsible for ensuring that adequate backup arrangements exist to handle such a situation if it should arise. The trustee itself can arrange to be the backup servicer, or it can use a third party servicer. Considerations for selecting a backup data processing and/or loan servicer are similar to those used to select other third party data processing servicers.

Either a "hot site" or a "cold site" can serve as backup. A "hot site" is dedicated exclusively to servicing the collateral; no other work is performed. The advantage is instant availability. Maintaining such a site, however, which may never be used, is extremely expensive. A "cold site" performs other work (such as the bank's own data processing center). Costs are much lower, but a cold site's capacity to service additional loans must be assured.

In each case, the trustee must ensure that the backup servicer:

- Has hardware and software compatible with that used by the original servicer; and
- Has adequate capacity to continue with its own work as well as service the loan portfolio.

As in any data processing servicing arrangement, a written contract should be in place. Further guidance on considerations in selecting a data processing servicer is contained in the Serviced Institution Control Guidelines chapter of the *FFIEC IT Examination Handbook.*

B.11. Municipal Trustee Issues

B.11.a. Secondary Market Disclosures for Municipal Issues

In 1995, the SEC Rule 15c2-12 [17 CFR 240.15c2-12] significantly changed the requirements governing the public disclosure and availability of financial information related to issuers of municipal debt securities. The rule was designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with the underwriting of municipal securities by brokers, municipal securities dealers, and "participating underwriters". With some limited exemptions, it applies to the underwriting of municipal securities with an aggregate principal amount of $1,000,000 or more. The disclosure and financial requirements of "participating underwriters" are contained in Section 15c-2-12(b). A "participating underwriter" is prohibited from purchasing or

selling municipal securities in connection with an offering, unless there is a written agreement or contract for the benefit of holders of these securities to provide directly, or "indirectly through an indenture trustee or a designated agent" required information. [Section 15c2-12(b)(5)]. Therefore, as indenture trustee for a municipal issue, a bank may be responsible for providing the required financial information, if the indenture trustee has entered into a contract to provide the required information for an issuer or underwriter.

The required information that must be provided to each nationally recognized municipal securities information repository (NRMSIR), and to the appropriate state information depository, if an, includes the following:

(1) annual financial information for each obligated person for whom this information is presented in the final official statement issued in conjunction with the underwriting of the issue.

(2) notice of any of the following events with respect to securities in the offering, if material:

- principal and interest delinquencies
- non-payment related defaults
- unscheduled draws on debt service reserves reflecting financial difficulties
- substitution of credit or liquidity providers, or their failure to perform
- adverse tax opinions or events affecting the tax-exempt status of the security
- modifications of the rights of security holders
- bond calls
- defeasances
- release, substitution, or sale of property securing repayment of the securities
- rating changes

(3) notice of the failure of any person required to provide annual financial information by the date specified in the written agreement or contract in a timely manner

Notification to the Municipal Securities Rulemaking Board may be substituted for the requirements to notify the NRMSIR's for items (2) and (3) above.

In addition, SEC Rule 15c2-12(b)(5)(i) requires the written contract for the benefit of holders of securities to indicate those to whom annual financial information and notices of material events will be provided. The written contract also must cover the following: (1) the type of financial information and operating data to be provided annually; (2) the accounting principles used to complete the financial statements, including any requirement for audited statements; (3) the date on which annual financial information will be provided and to whom.

The NRMSIR's, are private information vendors. As of June 21, 2004, there were four NRMSIR's and three state information depositories. The NRMSIR's were the following: Bloomberg

Municipal Repositories, DPC Data, Inc., FT Interactive Data and Standard & Poor's Securities Evaluations, Inc.. The State Information Depositories (SID's) have been established for Texas, Michigan, and Ohio, are In addition, the Municipal Securities Rule Board (MSRB) also operates the Municipal Securities Information Library and Continuing Disclosure Information systems, which provide similar information.

For those concerned with disclosure obligations for municipal securities, the "preliminary note" to SEC Rule 15-c2-12 refers the reader to the following: Securities Act Release No. 7049 and Securities Exchange Act Release No. 33741, FR-42 (March 9, 1994). SEC Rule 15-c2-12 replaces the voluntary industry standards promulgated by the American Bankers Association's Corporate Trust Committee, which were known as Disclosure Guidelines for Corporate Trustees.

B.11.b. Defeasement Activities With Municipal Bonds

A defeasement is a type of municipal debt financing which enables the issuing government entity to reduce the amount of interest it pays on outstanding bonds. For example, an entity that has outstanding bonds carrying high interest rates issues new debt at a lower (current) rate. The proceeds are used to buy State and Local Government Series U.S. Treasury securities (SLGS), which pay enough interest to pay the interest on the old outstanding bonds. SLGS are offered for sale to issuers of state and local government tax-exempt debt to assist in complying with yield restrictions or arbitrage rebate provisions of the Internal Revenue Code. The SLGS program was established in 1972 and approximately eight percent of municipal securities are subject to advance refunding, according to the July 1, 2004, "Report on Transactions in Municipal Securities" by the SEC. The securities can be sold, but typically mature when the old bonds reach their call date, providing a steady source of funds to retire the old debt. This process allows municipalities to pay less on a current basis. SLGS cannot be transferred by sale, exchange, assignment, pledge or otherwise.

Defeasement financings are *also referred to as arbitrage bonds*. The use of arbitrage for new bond issues was limited by the Tax Reform Act of 1986. Under the Act, annual calculations must be made of all earnings to report income in excess of allowable yields. Earnings of impermissible arbitrage must be placed in a rebate fund for payment to the IRS every five years. Failure to comply can cause an otherwise tax-exempt municipal bond issue to become taxable retroactively to the date of issuance

Although compliance with the requirements for defeasement financing under the Tax Reform Act of 1986 is generally the responsibility of the issuer, the trustee is often responsible for establishing and maintaining the rebate fund. While other parties should make the rebate calculations, the trustee is responsible for ensuring that the proper actions are taken to protect the interests of the bondholders.

B.12. Global Custody

Global custody refers to the cross-border safeguarding, settlement, servicing, and reporting of investor securities on a worldwide basis. This line of business has experienced significant growth over the last 20 years as a result of the continuing expansion of the international flow of capital and investment. The customers of global custody services are holders of large

pools of investment assets, mainly securities. These customers include institutional investors, insurance companies, public entities, mutual funds, banks and trust organizations.

The main services provided by global custodians are:

- The safekeeping of cash and securities
- The settlement of securities trades
- The servicing of securities held in custody

Accurate and timely reconciliation of customer cash and securities positions is essential to maintaining control over customer assets. Effective reconciliation procedures and timely follow-up of open items are essential for the proper management of safekeeping services.

Securities trades are normally processed through a broker, who in turn, notifies the global custodian of the details of a trade. The settlement process is more complicated than the normal process in the United States due to international variances.

Servicing of securities in global custody involves the following functions: (1) collection of income; (2) monitoring and processing corporate actions; (3) proxy voting; (4) processing tax reclamations; (5) foreign currency exchange; (6) cash management; and (7) international securities lending. The first three functions are similar to those performed in domestic custody accounts. The last four functions involve other risks due to the additional aspects of international income tax collections, which may vary, and the risks associated with currency fluctuations.

B.12.a. Subcustodians

Subcustodians often are used by the global custodian to provide local securities safekeeping services, to act as local settlement agents and to provide related services in local overseas markets. Subcustodians provide the local operational, regulatory and legal expertise applicable to their particular region. Due to the key role of subcustodians in the global custody business, effective management of the subcustodian network is essential for successful management of global custody.

The selection and oversight of subcustodians is crucial to a well-managed global custody operation. Before selecting a subcustodian, the global custodian should perform a due diligence review of the credit-worthiness and operational and informational systems capabilities of the subcustodians available in a given regional market. In addition to a rigorous initial screening of subcustodians, the global custodian should monitor the performance and credit quality of each of its subcustodians on an ongoing basis including periodic on-site visits to the subcustodian. The use of technology and telecommunications is also a very important element of an effective subcustodian network. Building a technological bridge between the clients, their global custodian, and the subcustodian network is a key component of a prudently managed global custody program.

B.13. Trust Preferred Securities - Trustees

Trust preferred securities represent preferred stock issued by a trust, usually a Delaware statutory trust, created for the sole purpose of investing the proceeds from the sale of preferred stock and common stock in a subordinated bond or debenture. The trust created is a subsidiary that

invests in the subordinated debt of the trust's parent company. The parent will purchase the common stock issued by the trust, usually representing at least 3% of the trust. The only asset of the trust is the subordinated bond or debenture from the parent and the only income received is the interest payments received on the subordinated debt, which is used to pay dividends on the preferred stock issued by the trust.

Under the Trust Indenture Act of 1939, the sale of subordinated debt in conjunction with the issuance of preferred securities requires the appointment of an indenture trustee. The duties of the indenture trustee for the subordinated debt do not differ from the duties of other indenture trustees. The trust formed to issue the preferred and common stock usually requires a Delaware trustee, in the case of a Delaware trust, and the appointment of a property trustee. The property trustee is the holder of record, for the benefit of the holders of the preferred securities, of the subordinated debt. In the event of default, the property trustee, whose duties are essentially those of an indenture trustee, acts to protect the interests of the holders of the preferred stock. A property trustee is required to exercise the care, skill of a prudent person. In addition, the trust agreement provides that the property trustee is a trustee for the purposes of the Trust Indenture Act.

The parent normally will issue a guarantee for the benefit of those holding the preferred securities. There will be a preferred security guarantee trustee, usually the same as the indenture trustee, to enforce the guarantee if necessary. The parent's guarantee, however, is unsecured and subordinated to other creditors with respect to existing and future senior debt. In contrast to many bond indentures that contain restrictions on the issuance of senior debt or requirements to maintain minimum liquidity levels, the indenture governing the issuance of preferred stock and the related trust agreement contain no or very few restrictions on the parent company's financial activities.

C. Account Administration and Controls

The administration of corporate trusteeships and agencies generally requires fewer discretionary decisions and actions than do personal or employee benefit trust accounts. However, they do require a higher level of documentation, automated services, and an in-depth knowledge of securities, security-related laws, industry practices, etc. Duties and actions are specified in the indenture and the corporate trustee/agent is limited to the provisions of the indenture. It assumes or performs additional duties and functions at its own risk.

As in all areas of fiduciary administration, the bank should have adequate written policies and procedures governing account acceptance conflicts of interest, internal operations, auditing, and profitability.

C.1. Pre-Acceptance Reviews

One of the most important aspects of good corporate trust administration occurs before accounts are accepted. This is the decision-making process of whether or not to accept a corporate trusteeship or agency account. Many financings are driven by timing considerations, often the result of perceived market windows or regulatory deadlines. Nonetheless, the due diligence review must not be neglected. Factors to be considered include:

- the financial strength of the obligor, both currently and anticipated over the life of the bond issue;
- the size and character of the issue;
- the integrity of the issuer;
- the existence of, and potential for, conflicts of interest;
- the environmental liability potential;
- the capacity and capability of the corporate trust department to perform its duties and fulfill all responsibilities based on a thorough analysis of the requirements of the indenture;
- the probability of profitable administration to the department. In regard to profitability,

the "cash float" of principal, interest, or dividends held as bank deposits was often an integral consideration in past fee structures. With greater emphasis on cash management, this is less of a factor today; and

- operational considerations, such as the capability of the information systems to properly handle the administrative requirements of an issue.

C.2. Appointment Documentation

Complete documentation for each trust indenture is of utmost importance. In this regard, a listing of documentation items is included on the Corporate Trust Line Sheet, included in Appendix B - Examination Aids. In general, banks should not accept accounts without obtaining the necessary appointment documentation.

Some of the same types of documentation required for a commercial loan should be maintained in conjunction with the administration of a corporate trust, for example, a corporate resolution authorizing the debt, in this case a security. In corporate trust appointments, the absence of required documentation may seem inconsequential, but could have a major impact at a later date.

Appointment documentation is governed by the type of appointment being accepted (bond trustee, transfer agent, paying agent, etc.), the characteristics of the securities issue (bonds, stocks, convertible securities, etc.), and the issuing organization (corporations, local government agency, state government agency, etc). Some issuers are from regulated industries, such as banking, broadcasting, utilities, or communications, where regulators may impose other requirements.

C.3. Conflicts of Interest

The trustee must also exercise prudent judgment and avoid potential conflicts of interest that might prevent it from acting under the duty of loyalty. For issues subject to the Trust Indenture Act of 1939, prohibited conflicts must be identified in the indenture. Section 310(b) of the Trust Indenture Act (15 U.S.C. Section 77jjj(b)) establishes procedures for the disqualification of an indenture trustee in instances involving conflicts of interest. Section 311 of the Act (15 U.S.C. Section 77kkk) addresses situations in which the indenture trustee is a creditor of the issuer of the securities. For securities not subject to the Trust Indenture Act, the existence of conflicts of interest is an equally important consideration. Indenture trustees have been held liable for losses suffered by bondholders in cases where it was determined that the indenture trustee acted in a way that placed its own interest ahead of that of the bondholders.

A bank should avoid accepting an appointment as indenture trustee for a securities issue of a corporation with which it also has a creditor relationship. In such cases, when an obligor defaults under an indenture where a bank is both a creditor and the indenture trustee, doubts may arise concerning whether the bank placed its own interests (by attempting to improve the bank's credit position or chances of repayment) ahead of its responsibility to protect the interests of all bondholders. Similarly, when a bank acts as trustee for more than one debt issue (or more than one debt tranche) of an issuer, questions about the indenture trustee's impartiality may also arise.

Conflicts of interest are permissible for issues subject to the Trust Indenture Act of 1939, provided the issue is not in default. Once default occurs, however, unless a "curing" of the default occurs within the 90 day period set in Section 310(b) of the Trust Indenture Act, the trustee is required to resign. Refer to subsection D - Compliance with the Trust Indenture Act of 1939 for a more detailed discussion of conflicts of interest.

Generally, conflicts of interest place the bank in a position of increased risk, especially when a default occurs. Therefore, potential and actual conflicts of interest should be identified and resolved prior to acceptance, and monitored for the length of time the security remains outstanding. Some banks make prior arrangements to resign in favor of another trustee in the event of default. Often, the successor trustee requires indemnification for the original trustee's acts.

C.4. Environmental Liability

Trust departments that serve as trustee for bond issues secured by real estate should have policies addressing the environmental risks related to real estate. These policies should

cover the types of environmental audits and other procedures to be followed in order to ascertain whether any proposed real estate collateral for corporate trust issues is contaminated. Prior to beginning the foreclosure process on real estate, a determination should be made, through an environmental audit or otherwise, that the property subject to foreclosure is free of environmental contamination. Failure to take reasonable precautions before taking title to potentially contaminated real estate could subject the trustee to considerable liability. Refer to subsection F.7.b in Section 3, Environmental Liability, for more information about environmental risk.

C.5. Administration and Controls

C.5.a. General

The bank's corporate trust department is frequently operated separately from the personal trust department, often maintaining separate books and records. The corporate trust function may be located in a different area than the rest of the trust department. It is not uncommon for personal and employee benefit accounts to use one data processing system, while corporate trust activities use another. Examiners should review the organization, including recordkeeping systems, of corporate trust services during the pre-examination planning process.

C.5.b. Operational Issues

While appropriate processes, procedures and controls differ somewhat between bond trusteeships and corporate agency appointments, the following operational considerations apply to most appointments

Tickler Systems

Corporate trust administration, in the absence of default, involves various administrative and operational duties that are periodic and time sensitive, such as monitoring compliance with bond covenants, paying interest and principal, and administering funds and collateral. Ticklers, whether manual or automated, should be set up for all periodic events to ensure that all administrative and compliance responsibilities are completed within required timeframes. The tickler system should identify items that are past due, such as the failure to pay interest and principle, the failure to obtain annual certificates of compliance, failure to obtain insurance certificates, etc. Such events may, depending upon the terms of the indenture, call for acceleration of the payments due, and should be closely by senior management. Senior management is responsible for determining how the trustee should proceed in instances of delinquent compliance with bond covenants.

Unissued and Cancelled Securities Certificates

Appropriate inventory controls should be placed on supplies of blank certificates. The supply of blank certificates should be limited to the quantity needed, to be issued as part of the original distribution of the securities or as replacement certificates for loss, missing or stolen securities. Access to the certificates should be limited to appropriate personnel. A listing of the certificate numbers should be kept and periodically reconciled to the certificates held in inventory. Any breaks in inventory should be reported and investigated.

The trustee should also have appropriate controls over cancelled securities certificates. The fraudulent use of cancelled securities certificates presents significant problems and potential cost to investors, creditors and broker-dealers. Securities certificates that have not been properly cancelled can be used to defraud the public and financial institutions. Stolen certificates that were not properly cancelled have been subsequently sold to investors and used as collateral for loans. Pursuant to SEC Rule 17AD-19, written procedures for the cancellation, storage, transportation, destruction, or other disposition of certificates should provide for the following:

- Controlling access to any cancelled certificate facility
- Physically marking certificates with the word "cancelled" in a clear and

conspicuous manner, unless the transfer agent's procedures require the certificate to be destroyed within 3 business days of cancellation. Tiny perforations that do not **deface** the certificates are not consistent with the rule.

- Maintaining a secure storage area for cancelled certificates
- Maintaining a retrievable database of all of its cancelled, destroyed, or otherwise disposed of certificates. The information required to be maintained includes the CUSIP number, certificate number, denomination, registration, issue date, and cancellation date.
- Requiring that the physical transportation of cancelled certificates be conducted in a secure manner and that a record of the certificate transported be maintained. When cancelled certificates are transported, the trustee should receive notice that the certificates were delivered. In the case of non-delivery, the trustee should investigate the circumstances regarding the non-delivery. If the non-delivery is not resolved, the certificates transported should be reported to the Securities Information Center (SIC) as lost, missing, or stolen securities, as required by SEC Rule 17f-1, which is applicable to all banks (not just trust departments) that accept or handle certificates.
- Requiring that authorized personnel of the transfer agent, supervise, witness and document the destruction of certificates.

When performing the bond registrar function, the trustee, or outside registrar if one has been appointed, should ensure that proper controls are in place to prevent physical under- or over-issuances of securities. A trustee, or outside registrar, responsible for a physical over-issuance of securities, may be required to buy-in the excess securities issued. If the bank is a registered transfer agent, the registrar function must comply with the SEC operational requirements of 17 C.F.R. Section 240.17Ad.

Administration of Funds

Most corporate rust appointments, whether as trustee under a bond indenture or under a corporate agency agreement, involve the disbursement of funds for principal, interest, or dividends. In addition, the corporate trustee or agent may have to administering various related funds, such as sinking and reserve funds. Banks should have processes and procedures for independently validating the accuracy of funds held for interest, principal and other disbursements. Procedures should provide for the validation of principal, interest and dividend payments for outstanding, as well as called or matured issues. In large departments, such validation normally would be accomplished by separating the administrative function from the operational function. The administrative review should act as a check on operations, by verifying the accounting records relating to an issue. In smaller departments the audit function can validate the accounting records relating to corporate trust appointments. Out-of-balance issues should be identified, reported to management, and receive prompt attention until resolved.

For all issues, records should accurately indicate the amount of principal, interest and dividend payments that are due and have not been paid. Funds held for the payment of interest or dividends (payable on different coupon or dividend dates) should be segregated Payments may be segregated by establishing separate control accounts for each payment, increases control over funds held for distribution and facilitates the reconciliation and escheatment of unclaimed funds. The maintenance of separate payment accounts prevents for interest and dividends also prevents payment errors.

Reconcilements

Examiners should review the trust department's reconciliation procedures. Disbursement accounts should be reconciled after each payment date. The standard bond printout, listing the current principal outstanding, outstanding bonds that are due but not presented, and the amount of cash on hand held for mature but not presented bonds, should be periodically reconciled to the departments operational records. Principal outstanding can be validated by

comparing the department's automated records with the issue's legal documents. The trustee's records can also be compared to the obligor's records. The obligor of an issue also tracks the principal amount outstanding and few obligors will transfer funds to the trustee in excess of what the issuer owes for interest or principal.

Escheatment

Controls over returned mail should ensure that returned interest, dividend and principal payments are properly accounted for and protected from theft, misuse or misapplication. Unless allowed by state law, issuers are not entitled to a return of unclaimed interest and dividend payments. Instead, unclaimed funds are subject to state escheat and unclaimed property laws. Without appropriate processes and procedures to govern the administration and disbursement of funds, corporate trustees and agents face the risk of violating state escheat and unclaimed property laws. Without proper accounting controls, escheatable funds can not be identified and may be misused to cover unrelated operational losses or reported as miscellaneous income. Refer to subsection E2.b - Escheatment Litigation for a discussion of cases involving the failure to escheat funds to the proper authorities.

C.5.c. Bond Trusteeships

When an institution is appointed bond trustee, it normally also serves as bond registrar (transfer agent) and paying agent. Refer to the material under those captions, as well as to material under the Corporate Agencies caption that follows this material.

Proper administration of the underlying collateral is vital, including the identification and control of environmental risk where real property is concerned. Extreme care must be taken by the trustee regarding the timing of collateral foreclosure so that the interests of all parties to the indenture are fairly served. A trustee's failure to appropriately protect the interests of bondholders before, and subsequent, to default, can result in liability and loss to the trustee. Proper maintenance of the collateral, including periodic verification or continuance of Uniform Commercial Code (UCC) filings, is required. The trustee should ensure that the initial filings were in the appropriate jurisdiction and should verify that a continuance is filed, if under UCC Article 9. Should the trustee prematurely foreclose on collateral, the obligor may incur liability. If foreclosure is inordinately delayed, bondholder interests may suffer severe loss of value.

Many bond trusteeships involve the maintenance of separate funds, used for sinking funds, construction, building maintenance, etc. The assets of these funds are invested according to the provisions of the bond indenture. The bank trustee usually has little or no discretion in such investments. Proper separation of the various funds, investment of their assets, and administration of these funds are essential.

The trustee must not only provide reports and recordkeeping for the issuer, but also must protect the interests of the bondholders. The reporting of distributions, and interest and dividend payments, to both tax authorities and security holders is also required of the trustee. These responsibilities are important since the trustee can be held liable if the bonds default and subsequent loss is attributable to the trustee's negligence. The acts of omission as well as commission by the trustee are critical in the event of default.

Many bond issues are complex and impose numerous duties on the indenture trustee. For instance, credit enhancements such as letters of credit and municipal bond insurance may have their own requirements which the trustee must monitor. The risks of managing such issues must be adequately addressed by the bank and reviewed by the examiner. For example, letters of credit may be issued for a 10-year period covering a bond with a 30-year maturity. The indenture may provide for mandatory early redemption, if no

letter of credit covers the issue, or if the creditworthiness of the letter of credit issuer drops below a certain quality. The trustee must monitor the status of the letter of credit and its issuer to ensure compliance with the indenture.

In recent years, bond issues have become more complex. Moreover, interest rates, for instance, may be indexed to other indices. Derivative securities have also become common. These increasingly complex securities present new types of risks to bond trustees, who must know their responsibilities and have adequate policies and procedures in place to manage the risks.

C.5.d. Default Administration

In the case of a default, the indenture trustee is responsible for protecting the interests of the bondholders. There are two types of default: technical and substantive.

Technical default occurs when the issuer does not comply with specific covenants in the agreement. However, the failure to comply, in and of itself, does not cause nonperformance. Examples of technical default include failure to: provide periodic financial statements, provide audited financial statements, demonstrate compliance with specific provisions of the indenture, etc. However, the manner in which the indenture trustee responds is important. Unlike many large corporate issuers that have sophisticated compliance systems to ensure that bond covenant requirements are satisfied, smaller, less sophisticated issues may often fall into technical default. In such cases the trustee must act in a timely manner to bring the issuer back into compliance wit the bond covenants. The trustee should promptly inform the issuer of the noncompliance and give the issuer a deadline for curing the technical default, for example 30 to 90 days, or more if circumstances make a longer deadline reasonable. In the event that the issuer fails to cure the technical default by the deadline given, the trustee should notify the issuer that a default will be declared if the issuer does not cure the technical default by a certain date, for example within 30 days. If the issuer still has not cured the technical default by the given deadline, the trustee should declare a default and consult the bondholders to determine whether to waive the default or accelerate the payment of principal. Trustees that fail to act in an appropriate and timely manner when technical defaults occur risk being held liable for inaction or negligence, in the event of a subsequent substantive default

In contrast to technical defaults, substantive events of default include the failure to make required interest, principal or sinking fund payments; the bankruptcy or insolvency of the obligor; or a cross default on other obligations, such as loans or other bonds. The trustee should take timely and appropriate actions to ensure that bondholders realize the maximum amount of repayment of principal and interest due. Failure on the part of the trustee to act on the bondholder's behalf, could result in bondholder claims that the trustee, through negligence, caused monetary losses and seek reimbursement of those losses.

In administering defaulted bonds, the trustee should employ legal counsel and request bondholder involvement. Bondholders should be promptly informed of substantive default events. The trustee should communicate with any bondholder committee nominated by all the bondholders and seek direction from the that committee. Within reason, when principal is at risk, trustees should defer to the bondholders of the defaulted issue. Any modification in the bond indenture and other governing documents should not be made without the consent of bondholders. A decision to waive the default should be made by the bondholders.

The trustee must act quickly to secure any collateral, if the defaulted issue is secured. Securing the collateral, however, might entail complications if the collateral is a business or some other facility requiring professional management or contaminated real estate. The trustee is not required to

seek all remedies or pay out of its own funds the expenses related to those remedies. In most cases, the trustee should obtain an indemnification agreement from the bondholders before pursuing certain remedies, along with a commitment that it will be reimbursed for expenses incurred.

C.5.e. Corporate Agencies

The administration of corporate agencies does not involve discretionary actions, but does require accurate recordkeeping, prompt posting of accounting records, timely reporting, and a staff thoroughly trained in related laws, regulations, and standard industry practices. The performance of agencies requires technical expertise, open communication between interested parties, and an efficient operating system. As in all other aspects of fiduciary operations, the corporate agency function should be fully covered by written policies approved by the trust committee and board of directors.

Unlike the long-term relationships of bond trusteeships, corporate agency accounts are often moved to another institution: if the bank does not perform to the expectations of the securities issuer, if the bank's performance results in investor complaints to the issuer, or if the bank does not offer the full range of services expected by the issuer. The importance of pre-acceptance reviews is just as valid for corporate agencies as it is for bond trusteeships.

When the bank is serving as a paying agent, the obligor deposits the necessary funds with the bank, which prepares and issues checks in payment of the interest, dividends or bonds. When bonds are fully registered, an interest check is sent to the holder of record. In the case of coupon bonds, the coupons must be presented for payment. Coupons are received in several ways, but normally flow through the banking system and the related clearinghouse process.

Many stock transfer appointments also involve the administration of dividend reinvestment plans and/or stock purchase plans. The proper administration of the funds received, accurate recordkeeping, the prompt execution of orders, and the issuance of accurate investor statements are all important operational imperatives. Section 344.6(f) of the FDIC Rules and Regulations requires that periodic plans (such as stock purchase plans or dividend reinvestment plans) provide the customer not less than once every three months a written statement showing: (1) the funds and securities in the custody or possession of the bank, (2) all service charges and commissions paid by the customer in connection with a transaction, and (3) all other debits and credits of the customer's account involved in the transaction. If the customer requests it, the bank must provide the information listed in Section 344.5 of the FDIC's regulations, except in those cases where the customer does not remunerate the broker/dealer.

As with bond trusteeships, the bank must not only provide reports to the obligor, but also must provide investors with periodic statements and provide tax authorities and security holders with reports of interest and dividend payments.

D. Compliance with the Trust Indenture Act of 1939

D.1. General

Certain bond issues, and their administration, must comply with the Trust Indenture Act of 1939 (TIA) [15 USC 77aaa - bbbb], as amended. Only bonds issued by corporations are potentially subject to the TIA; municipal bond issues (including industrial development and industrial revenue issues) are not covered. Bonds issued by banks are exempt from the TIA. All Trust Preferred Securities are subject to the TIA.

The TIA requires the use of an independent trustee in connection with the public offering of debt securities. The TIA generally provides that debt securities may be issued only pursuant to a trust indenture governing the responsibility and liability of the trustee.

The Trust Indenture Reform Act of 1990 [PL 101-550 Title IV, 104 Stat. 2721] simplified the information required in an indenture. It also eliminated the automatic disqualification of banks as indenture trustee when the bank has director interlocks with the issuer, or has served as underwriter for the issuer. The 1990 law requires the trustee to resign in circumstances when an issuer defaults and the trustee is a lender to the issuer.

The full text of the Trust Indenture Act and implementing SEC regulations appear in Appendix F of this Manual. Some regulatory filings must be submitted electronically. Refer to subsection K.3. Electronic Submission of Forms and Notices, located in Section 3.

D.2. Applicability

Exemptions for various types of securities are contained in Section 304. In addition, certain SEC rules issued provide further guidance concerning the exemptions in Section 304. Two important exemptions are:

- non-indenture securities totaling less than $5,000,000, when issued within a consecutive twelve-month period (TIA Section 304 (a)(8) and 17 CFR 260.4a-1 of SEC Rules)
- securities that have been or will be issued under an indenture which limits the aggregate principal outstanding at any one time to $10,000,000; the exemption is limited to securities issued within a 36-month period by the same issuer (TIA Section 304 (a)(9) and 17 CFR 260.4a-3 of SEC Rules)

The exemptions described above are *aggregate* exemptions. For example, an issue of $10 million or less would have to be qualified with the SEC if, under the indenture, additional bonds aggregating more than $10 million may be issued for public distribution. TIA Sections 304(a) through (e), as well as the SEC Rules noted above, may be found in Appendix F.

D.3. Compliance

The TIA imposes stringent duties on the issuer and the trustee of indenture securities. The requirements for registration and exemption under the Act are provided by Section 305, as well as implementing regulations.

The TIA generally requires that the indenture include certain provisions. For example, the issue must be administered according to its indenture. Specific provisions regarding conflicts of interest are detailed in Section 310. An annual report to bondholder is required by Section 313. Actions required in the event of default are covered by Section 315.

Other important areas covered in the TIA include: (1) the appointment of the bond trustee, (2) conflicts of interest, (3) the administration of the issue, and (4) actions in the event of default. These are briefly summarized below.

D.3.a. Trustee Appointment Requirements

- There must be one or more trustees, at least one of whom shall be a corporation appropriately organized and subject to Federal or State supervision or examination. [§ 310(a)(1)]
- The trustee must have at all times a combined capital and surplus of not less than $150,000. [§ 310(a)(2)]

D.3.b. Conflicts of Interest

- The indenture must provide that, in the case of a event of default, if a conflicts of interest exists, the trustee must eliminate the conflict of interest within 90 days or resign. If the trustee fails to comply, it must (within 10 days after the expiration of the 90-day period) transmit notice of such failure to the bondholders. [§ 310(b)(i) and (ii)]
- Section 310(b) specifies in detail prohibited relationships between the trustee and either an obligor or an underwriter, if:
    1. it acts as trustee under more than one *indenture* (not issue) of the same obligor (with some exceptions) [§ 310(b)(1)];
    2. it, or any of its directors, or executive officers, is:

- an underwriter for the obligor with respect to the indenture securities [§ 310(b)(2)];
- a director, officer, partner, employee, appointee, or representative of the obligor, or an underwriter for the obligor with respect to the indenture securities (with exceptions) [§ 310(b)(4)];

3. it directly or indirectly controls, or is directly or indirectly controlled by, or is under direct or indirect common control with, an underwriter for the obligor with respect to the indenture securities [§ 310(b)(3)];
4. more than certain specified percentages of the trustee's voting securities are beneficially owned by the obligors, underwriters, and their respective officials [§ 310(b)(5)];
5. an issue is in default and the trustee is the beneficial owner of, or holds as collateral security, more than specified percentages -

    - of the security in default [§ 310(b)(6)], or
    - of certain categories of the issuer's securities [§ 310(b) (7)], or

6. an issue is in default and the trustee holds, in specified fiduciary capacities, 25 percent or more of the outstanding securities [described in item (5) above] [§ 310(b)(9)]; or
7. the bank-trustee is, or becomes, a creditor of the obligor (with exceptions) [§ 310(b)(10)]

- If the trustee is (or becomes) a creditor of the obligor within three months prior to default, it must set aside any repayment received during this period, or after default, in a special account to be divided pro rata between the trustee bank and the bondholders (with some exceptions) [§ 311]

D.3.c. Trustee Administration of Issue

- Bondholder annual reports. If certain events have occurred (primarily involving the debt issue, but also including changes in the conflicts of interest described above), the trustee must send a report to the bondholders at intervals of not more than 12 months. If no changes have occurred, no report is required [§ 313(a)]
- Bondholder periodic reports. If: (1) changes have occurred in the bond issue's collateral, or (2) the trustee claims large reimbursable advances, a report must be sent to bondholders within 90 days of such occurrence [§ 313(b)]

D.3.d. Administrative Filings With Trustee by Issuer

- The obligor must file with the trustee: (1) an annual certification as to compliance with the indenture, (2) copies of annual reports, and (3) other information and documents. These must also be filed with the SEC [§ 314(a)(1), (2), and (4)]. The content of the various reports is specified by Sections 314(b) through (e).
- The obligor must provide the trustee with lists (names and addresses) of the bondholders, and the trustee must maintain such lists [§ 312(a)]. The trustee must provide such lists to any three or more bondholders upon written request [§ 312(b)].

D.3.e. Actions in the Event of Default

The indenture must contain provisions setting out the duties and responsibilities of the trustee prior to, in case of, and after, default [§ 315].

E. Other Compliance

Laws and regulations in the corporate trust area are technical and require a high level of knowledge and training. In addition to the Trust Indenture Act of 1939, other laws and regulations exist that are supplemented by standard industry practices and the specific rules established by the various stock exchanges on which the securities are listed.

E.1. Lost, Stolen and Counterfeit Securities

E.1.a. Registration

Pursuant to SEC Rule 17f-1 [17 CFR 240.17f-1], a central database for the collection and dissemination of information about lost, stolen, and counterfeit securities has been established. In general, all insured banks and every registered transfer agent must register with the Securities Information Center (SIC) as either a direct or indirect inquirer. The rule also imposes certain reporting and inquiry requirements.

E.1.b. Reporting

Pursuant to SEC Rule 17f-1, banks and registered transfer agents must report to the SIC instances of missing, lost, stolen, or counterfeit securities. Securities certificates that are subsequently recovered must also be reported. The rule does not include securities that have been escheated, called for redemption, subject to litigation, or when the issuer is in bankruptcy. Bond coupons are also not considered securities certificates for this rule. Reports are required for all corporate securities having a CUSIP number, municipal securities, and bearer U.S. Government securities. Reports must be confirmed in writing on SEC Form X-17F-1A.

In the corporate trust function, the most likely application of this reporting requirement is when the bank, in its bond or stock transfer function:

- Is notified by a security holder of lost or stolen securities certificates. This occurs when the security holder requests a replacement certificate. Normally, the transfer agent creates an internal "stop transfer" order and issues a replacement certificate. The security holder is usually required to furnish an indemnification bond as a part of this process. The indemnification bond protects the bank in the event a lost or stolen certificate received in good faith is presented for transfer later and the bank is required to honor the certificate by purchasing replacement securities in the open market.
- During the securities transfer process, the transfer agent identifies:
  - counterfeit certificates, or
  - valid certificates previously reported as lost or stolen, or
  - valid certificates listed as paid or canceled on the transfer agent's books.
- The bank determines that securities certificates are missing from the bank's blank certificate inventory.

It is important to note that the rule was amended in 2004 and clarifies that the rule covers the life span of a certificate, from the time it is printed to the time destroyed.

The bank should file a report with SIC in each of these situations. Under Section 353.3(d)(2) of the FDIC Rules and Regulations, the filing of suspicious activity reports is not required for lost, missing, counterfeit or stolen securities, if the bank files a report as required by the reporting requirements of 17 CFR 240.17f-1.

E.1.c. Inquiries

Banks are required to make routine inquiries of the SIC by the end of the fifth business day after a certificate comes into its "possession or keeping". Furthermore, inquiries must be made of the SIC before the certificate is sold, used as collateral, or sent to another reporting institution. Normally, the inquiry requirement does not apply to the corporate trust function. There are

provisions in the Rule governing situations where certificates are received from sources other than customers. Refer to SEC Rule 17f-1(d)(1), which appears under the Miscellaneous Statutes and Regulations tab in Volume III of FDIC's loose-leaf regulations service.

E.2. State Escheat Laws

While escheatment laws primarily involve deposits, banks acting as bond trustee, securities transfer agent, and paying agent must comply with state abandoned property laws for checks and securities certificates which are undeliverable, as well as for book-entry accounts for which the owner cannot be located. Funds on deposit to pay unclaimed dividends, bond coupons not presented for payment, bonds not presented for payment, as well as funds in suspense accounts, may be subject to state escheat laws. However, institutions should establish and implement adequate procedures to ensure compliance with the applicable law.

Administratively, each state has its own dormancy period. Over the years, these have tended to become shorter. In addition, every state establishes rules as to where abandoned property must be sent. States also set their own publication and notification requirements, have their own individual forms to be completed, and set their own dates for transmitting escheated funds. Due to the different administrative and legal requirements of each state, it has been difficult both for bank personnel and for examiners to verify compliance with escheat laws

E.2.a. Legal Background

Escheat laws vary from state to state and may not exist in some states. One state may claim that its escheat laws apply to dormant funds which are concurrently claimed by another state. One state might clam the property based on the location of the trustee/transfer agent bank (or broker/dealer), while another state might claim the same property based on the physical or legal headquarters of the issuing organization. Yet another state might issue rules based on the stock exchange where the security was traded. It was possible for several states to claim the same funds. Bank trustees and transfer agents were often faced with conflicting claims.

In *Delaware v. New York*, 113 S. Ct. 1550 (1993), the U.S. Supreme Court resolved the differences among state laws concerning the right to receive unclaimed securities distributions. In that decision, the Court provided the following rules for resolving such disputes:

- We therefore resolve disputes among States over the right to escheat intangible personal property in the following three steps. First, we must determine the precise debtor-creditor relationship as defined by the law that creates the property at issue. Second, because the property interest in any debt belongs to the creditor rather than the debtor, the primary rule gives the first opportunity to escheat to the state of "the creditor's last known address as shown by the debtor's books and records." Finally, if the primary rule fails because the debtor's records disclose no address for a creditor or because the creditor's last known address is in a state whose laws do not provide for escheat, the secondary rule awards the right to escheat to the state in which the debtor is incorporated. 113 S. Ct. at 1556
- For purposes of the second rule under the *Delaware v. New York* standard, the Court held that "intermediaries" such as banks or securities firms who hold unclaimed securities distributions in their own name on behalf of the beneficial owners of such distributions are the relevant "debtors" with respect to the application of state law. In reaching this conclusion, the Court stated:

  From an issuer's perspective, the only creditors are registered shareholders, those whose names appear on the issuer's records. Issuers cannot be considered debtors once they pay dividends, interest, or other distributions to record owners; payment to a record owner discharges all of an issuer's

obligations. 113 S. Ct. at 1559.

E.2.b. Escheatment Litigation

Two high profile lawsuits occurred during the latter part of the 1990's and resulted in significant media and regulatory attention being placed on the escheatment practices of corporate trust departments. In 1995, a former officer in the corporate trust department of the Bank of America, San Francisco, California, filed a lawsuit against the bank. The state of California, the city and county of San Francisco and 300 local governments later joined the suit in 1997. The plaintiffs claimed that between 1977 and 1995, the bank or its predecessor, Security Pacific, mismanaged the proceeds of several bond issues for which it was serving as paying agent. The bank was accused of escheating insufficient amounts of unclaimed funds, charging excessive fees on bond trust accounts and destroying or losing critical records. Other allegations included claims that the bank mishandled payments for bonds that had been called so that it could maximize the earnings realized on the float of such funds and that it made unauthorized investments in order to generate higher fees. The case was settled out of court for $187 million.

The second lawsuit began when New York State auditors discovered in 1994 that the amount of unclaimed funds at Bankers Trust Corporation, New York, New York, had declined significantly from the prior year. Auditors became suspicious when bank employees thwarted their attempts to obtain records explaining the reduction in the amount of unclaimed funds o the bank's books. The FBI, the Manhattan U.S. Attorney's office and the Federal Reserve took over the investigation in November 1998. According to newspaper reports, three former executives were indicted on various Federal charges that they systematically diverted $19.1 million of unclaimed customer's funds to the bank's own accounts. The funds were used to bolster the department's financial results, cover budget shortfalls, and even pay for the office Christmas party. The bank settled with Federal and New York State authorities in March 1999 by paying $63.5 million in fines and returning the $19.1 million in unclaimed funds that it acknowledged diverting to revenue.

E.3. Other Laws and Regulations

There are various other laws, regulations, rules and practices that affect the administration of accounts in a corporate trust department, such as bankruptcy laws, the rules and regulations of the various securities exchanges where securities are listed, Municipal Securities Dealer Regulations (refer to the Corporation's handbook covering municipal securities dealer activities) and the standardized operating procedures within the securities industry.

Trust Examination Manual

Section 7- Compliance- Pooled Investment Vehicles

Table of Contents

A. Introduction to pooled investments

B. Common and collective funds (CIF's)

1. General Information on CIF's
2. Common Trust Fund and Employee Benefit Collective Fund
3. Importance of Tax-Exempt Status
4. Importance of Securities Law exemptions
5. "Bona Fide Fiduciary" Rule
6. OCC Regulation 9.18 Requirements
7. Basic Terms and Accounting Concepts
8. Benefits and Limitations of CIF's to Fund Participants and To The Bank
9. Typical Fund Categories

C. CIF tax-exempt status - IRC section 584 and IRS revenue ruling 81-100

1. Internal Revenue Code Section 584
2. IRS Revenue Ruling 81-100

D. Registration under securities acts

1. Securities Act of 1933
2. Investment Company Act of 1940

E . OCC regulation 9.18

1. Section 9.18 Applicability to State Nonmember Banks
2. 1997 Revision of Section 9.18
3. Section 9.18(a)(1)
4. Section 9.18(a)(2)
5. Section 9.18(b)(1) The Written Plan
6. Section 9.18(b)(2) Fund Management
7. Section 9.18(b)(4) Valuation
8. Section 9.18(b)(5) Admission and Withdrawal

9. Section 9.18(b)(6)(i) Annual Audit
10. Section 9.18(b)(6)(ii) Financial Report
11. Section 9.18(b)(7) Advertising of Collective Investment Funds
12. Section 9.18(b)(8) Self-Dealing and Conflicts of Interest
13. Section 9.18(b)(9) Management Fees
14. Section 9.18(b)(10) Expenses
15. Section 9.18(b)(11) and (12) Prohibition Against Certificates / Good Faith Mistakes
16. Section 9.18(c) Other Collective Investments

F. Investment management issues
1. Use of Outside Investment Advisors
2. Specialty CIF's

G. ERISA implications on CIF operations
1. ERISA 408(b)(8) Exemption
2. DOL PTE 91-38 Exemption

H. Other participant limitations
1. Charitable Trusts Usage of Collective Investment Funds
2. Keogh Account Usage of Collective Investment Funds
3. Government Plan Usage of Collective Investment Funds

I. Investing in CIF's of other institutions
1. Affiliated Institutions
2. Non-Affiliated Institutions

J. CIF's investing in CIF's within the same department

K. Proprietary mutual funds
1. Considerations When Engaging in Mutual Fund Activity
2. Structure of Bank Financial Activities Under the Gramm-Leach-Bliley Act of 1999
3. Investment Company Act of 1940

L. Conversion of CIF's to mutual funds
1. General Overview
2. Tax Considerations
3. Supervisory Concerns
4. ERISA Considerations

M. Mutual fund and CIF merger rules
1. SEC Rule 17a-8

N. Other pooled investment vehicles
1. Master Deposit Accounts

2. Wrap Accounts, Also Known as Asset Allocation Programs
3. Private Equity Fund of Funds
4. Bank Managed "Pooled Income Funds" Organized by Outside Organizations
5. Regulation D Exempted Securities Offerings

O. Bank as investment adviser to CIF's and mutual funds

1. Interagency Policy Statement

P. Overview of federal laws

1. Federal Securities Law
   a. Securities Act of 1933 (1933 Act)
   b. SEC Rule 180 (Sophisticated Investor Rule) under the 1933 Act
   c. Regulation D under the 1933 Act
   d. Securities and Exchange Act of 1934
   e. Investment Company Act of 1940
   f. Investment Advisors Act of 1940
2. Federal Banking Law
   a. Banking Act of 1933
   b. Title 12 C.F.R. 9.18
3. Federal Tax Law
   a. Internal Revenue Code (IRC)
4. State Statutes

A. Introduction to Pooled Investments

Pooled investment vehicles include common trust funds and employee benefit collective funds (both generically referred to as collective investment funds); proprietary mutual funds and other pooled investments. Because of their similarities, reference to collective investment funds (CIF's) within this manual will refer to both common trust funds and employee benefit collective funds, unless otherwise noted. Unlike CIF's, proprietary mutual funds are SEC registered securities that can be distributed to a wider variety of investors. Other pooled investments refers to less common or emerging account types such as master deposit accounts and private equity funds.

All pooled investment vehicles are designed to facilitate investment by combining fiduciary funds of various trust department accounts. Although the operation of CIF's runs counter to the accepted common law duty of the trustee not to commingle trust funds, legislation has been passed in every state authorizing banks to establish and administer CIF's.

The administration of pooled investment vehicles must follow principles of prudent management; comply with applicable laws, regulations, and regulatory opinions; and maintain proper documentation, recordkeeping, and accounting. For each type of pooled investment vehicle, proper management entails compliance with specific aspects of the laws and implementing regulations promulgated by Internal Revenue, Securities and Exchange Commission, Office of the Comptroller of the Currency (OCC), Department of Labor (DOL), and ERISA . Any apparent violations of applicable laws and regulations expose the institution to a substantial risk of loss, due to the cost of corrective action including possible regulatory sanctions and penalties. Inadequate management of pooled investment vehicles could also harm the trust clients and create potential liabilities to the trust department and the bank.

As with individual trust accounts, bank management and the trust committee are required by the Statement of Principles of Trust Department Management to provide adequate oversight of pooled investments. At a minimum, management and the trust committee should document the performance of an annual administrative and investment review - including assuring that the funds are administered in accordance with governing law.

B. Common and Collective Funds (CIF's)

B.1 General Information on CIF's

A CIF is a trust fund maintained by a bank exclusively for the collective investment of assets from several trust accounts administered by a trust department. They are not available to the general investing public. CIF's are sometimes operated on a multiple-bank basis within a bank holding company. In such cases, the largest trust department in the holding company typically makes its CIF's available to fiduciary accounts in smaller, affiliated trust departments (where permitted by the trust instrument, terms of the account, and local law).

Before a particular account purchases a participation in a CIF, it must be determined that the account's governing agreement permits CIF's and that the particular CIF is a suitable investment for the account. The trust committee, or alternatively designated individual or committee, should direct the account's participation in a common trust fund.

B.2. Common Trust Fund and Employee Benefit Collective Fund

CIF's are divided into two general categories depending on the types of trust accounts qualified to invest in the CIF and the source of their federal tax-exemption.

Common Trust Fund

A common trust fund is a fund that is typically held by personal trust accounts. As these funds obtain exemption from Federal tax under IRC Section 584, they are also referred to as "IRC 584 funds". Additionally, common trust funds are operated under OCC Regulation 9.18(a)(1). For this reason, these funds are many times also referred to as "(a)(1)" funds.

Employee benefit trust accounts are not permitted to be commingled with personal trust accounts in a common trust fund. However, a common trust fund may apply the tax- exemption afforded by IRC Section 584 to the collective investment of employee benefit trust accounts only. This is permissible only as long as all of the accounts invested in the common trust fund are employee benefit trust accounts. In this case, no employee benefit agency accounts or personal trust accounts may be invested in the common trust fund. Due to these restrictions, this application of IRC 584 is rare.

The collective investment of charitable trust accounts is discussed in Subsection H.1, Charitable Trust Usage Of Collective Investment Funds.

Employee Benefit Collective Investment Fund

When not used generically, the term collective investment fund is normally applied to funds established for the collective investment of employee benefit trust and agency accounts, as permitted under OCC Regulation 9.18(a)(2). Consequently, employee benefit collective investment funds are sometimes referred to as "(a)(2) funds". These funds generally obtain exemption from Federal tax under IRS Revenue Ruling 81-100, and are also referred to as "RR 81-100 funds".

Under IRC Section 584, no agency accounts, including employee benefit agency accounts, are allowed. Therefore, RR 81-100 is the method employed by most banks operating employee benefit collective investment funds.

Note that operating a CIF for the purpose of managing employee benefit accounts is subject to ERISA "party-in-interest" concerns - prohibited

transactions. The Department of Labor (DOL) has issued two class exemptions to address this issue. Refer to Subsection G - ERISA Considerations for information.

B.3. Importance of Tax-Exempt Status

If the CIF is operated in conformance with applicable rules and regulations, the CIF qualifies for Federal income tax-exemption. CIF's draw their tax-exempt status from either Section 584 of the Internal Revenue Code or IRS Revenue Ruling (RR) 81-100. Each source of exemption imposes different requirements on the fund, and it is essential that examiners understand the requirements of each and their differences; and how they impact the operations of a given fund.

A bank may request a written opinion from the IRS on whether its CIF qualifies for tax-exempt treatment under the Internal Revenue Code. As in the case of employee benefit plans, there is no IRS requirement that banks apply for a determination of the tax-exempt status of CIF's. However, obtaining this opinion provides assurance that the CIF was drafted in compliance with Federal tax laws, and that it qualifies for tax-exempt treatment.

If a CIF was later found not to qualify for tax-exempt treatment, all CIF capital gains and ordinary income might become subject to taxation. With respect to personal trust accounts, taxation might occur both at the CIF level and again at the participant level (double taxation). Employee benefit accounts would only experience taxation at the CIF level, since the participating employee benefit plans are themselves exempt from taxation. The loss of favorable tax treatment could cause the bank to incur a liability to the participants in a collective investment fund, whose proportional interests in the fund are directly impacted by any loss in value due to the loss of a fund's tax-exempt status.

IRC Section 584 and RR 81-100 are discussed in Subsection C - CIF Tax-Exempt Status - IRC Section 584 and IRS Revenue Ruling 81-100.

B.4. Importance of Securities Law Exemptions

CIF's are exempt from securities registration and regulation as a security and as a mutual fund only when operated in compliance with specific exemptions under Federal securities laws. Funds operated without the benefit of these exemptions must register under the Securities Act of 1933, and operate as mutual funds, under the Investment Company Act of 1940. With the repeal of Section 20 of the Banking Act of 1933, banks now have more flexibility in underwriting and operating mutual funds. The increased flexibility comes from the Gramm-Leach-Bliley Act of 1999, which is explained in Subsection K - Proprietary Mutual Funds. To understand the nuances of the exemption one must ensure that the concept of "bona fide fiduciary" as interpreted by the SEC is followed. Subsection D - Registration under Securities Acts provides more information.

B.5. "Bona Fide Fiduciary" Rule

CIF's are established by banks to facilitate the administration of accounts held under "bona fide fiduciary" appointments (as defined under Federal securities laws). CIF's operating rules strictly limit fund participation to "bona fide fiduciary" appointments, and employee benefit trust and agency accounts. A bank's CIF investment expertise cannot be offered either to personal agency accounts or to non-trust department customers.

"Bona fide fiduciary" appointments have been interpreted by the SEC under Federal securities laws to be limited to the traditional "personal trust" appointments of: trustee, executor, administrator, guardian, and Custodian under a Uniform Gift to Minors Act. The SEC holds that the exercise of trust powers must involve duties beyond those that are merely incidental to money management. Examples of accounts involving such incidental money management include investment agency relationships, IRA accounts, and mini-trusts. The absence of a genuine underlying fiduciary purpose has consistently been interpreted, by the SEC, as falling outside the confines of a trust relationship. Further, the staff of the SEC has repeatedly ruled that so called mini-trusts established under standardized, revocable, or minimum asset level contracts, constitute little more than investment management agency accounts (refer to the SEC interpretive letter in Appendix

G). Therefore, these types of accounts are not permitted to participate in a bank collective investment fund.

The sole exception to the "bona fide fiduciary" rule applies to CIF's operated for employee benefit accounts. In these situations (discussed later in this section) banks are permitted to invest funds held as trustee or agent in CIF's.

B.6. OCC Regulation 9.18 Requirements

OCC Regulation Section 9.18 provides the regulatory requirements for the operation of common and collective investment funds. Refer to Subsection E - OCC Regulation 9.18 and Appendix G for further information. Although not an FDIC regulation, state nonmember banks operating CIF's granted tax-exempt status pursuant to IRC Section 584, must comply with Regulation 9.18, because Section 584 requires compliance with this regulation. Compliance with Regulation 9.18 is not required for funds operated by FDIC regulated state nonmember banks which do not rely on IRC 584 for tax-exemption (typically employee benefit collective investment funds receiving tax-exemption under RR 81-100). However, State Law and general standards of practice make OCC Regulation 9.18 or other similar guidelines applicable to RR 81-100 funds as well. Many states have promulgated laws regarding CIF's. Due primarily to the need to comply with Federal securities and tax laws, State laws are generally similar to Regulation 9.18.

OCC Regulation 9.18 covers the written plan, fund management including use of outside adviser, fund valuation, admission and withdrawal, audit and financial reports, and self-dealing/ conflicts of interest among other things.

B.7. Basic Terms and Accounting Concepts

- Plan - The governing instrument of a fund. This is in effect a trust agreement, and is often entitled a declaration of trust or a group trust.
- Units - Units represent investments in a CIF and, like shares of a mutual fund, units represent a proportional ownership interest in all the investments held by the fund.
- Participants - Individual accounts investing in the fund are called participants.
- Valuation Date - The CIF valuation date is set by the Plan. It can vary from daily to quarterly, but it cannot be less frequently than quarterly (for CIF's maintained for personal trust accounts). Participants may only gain admission to (purchase units) and withdrawal (sell units) from a CIF on or before a CIF's valuation date.
- Principal value of a unit - This is the amount a participant pays or receives when investing in or selling a unit of a CIF. The principal value of a unit is determined by dividing the total number of CIF units into the CIF's total market value on a valuation date.
- Income value of a unit - This is the amount of income accrued by each unit during a valuation period. Methods used for calculating both the principal value and income value of each unit must be outlined in each CIF's plan.
- Fund and Participant Accounting Systems - Trust departments operating CIF's must operate two parallel accounting systems for each CIF. First, each CIF portfolio must have an adequate "fund accounting system" operated on an accrual method of accounting, reflecting the CIF's securities transactions and income earned. Secondly, all participants in each CIF must have a "participant accounting system" to reflect each participant's holdings in the CIF, (including: the number of units bought and sold, original cost per unit, all capital gains and losses per unit, balance of units held, income earned and distributed per unit, etc.).

B.8. Benefits and Limitations of CIF's To Fund Participants and To The Bank

Benefits of CIF's to participants and bank include:

- CIF's offer the advantage of investment diversification, which is often difficult to

achieve when investing small amounts of fiduciary funds individually.

- Smaller accounts benefit because they are able to regularly invest in CIF units that typically do not require large outlays of cash. This improves the diversification of their account and reduces uninvested cash balances.
- Given the size of the transactions, it is more efficient for the trustee to make and supervise investments for CIF's.
- CIF's allow management to concentrate investment decision-making and research efforts by permitting it to manage fewer, but larger, portfolios.
- CIF securities transaction costs and brokerage commissions are reduced, since larger purchases and sales can be effected more economically. Also, to the extent a participant invests in a CIF, securities commissions are eliminated, because no fees or charges may be assessed on the purchase or sale of CIF units under OCC Regulation 9.18.

Limitations of CIF's for the participants include:

- Adverse tax consequences can arise when unrealized capital gains are allowed to accumulate in the fund. New participants become subject to the taxable treatment of unrealized gains when they enter the fund. All capital gains are passed through for tax purposes to the participants in a fund during the taxable period in which the gains are realized. The pass-through applies to new participants, whether or not they experience any appreciation in their units.
- Participating accounts are faced with reduced liquidity. Since participants may only withdraw from a fund as of a valuation date, this could be as infrequent as monthly or quarterly, participants may experience liquidity problems arising from the inability to sell CIF units.
- The inability to divest of CIF units except at valuation dates may inadvertently "lock in" all participants during a period of falling prices. The longer the interval between valuation dates, the greater the potential impact on all participants.

Limitations of CIF's for the bank include:

- Most of the costs involved in establishing a common trust fund must be borne by the bank, including legal fees for drafting the original agreement and any subsequent modifications, and any reorganization expenses.
- Banks also experience greater pressure on fund performance, as the CIF's performance results are easily compared with performance attained by various industry benchmarks or outside mutual funds with similar investment objectives.

B.9. Typical Fund Categories

CIF's must be maintained by the type of qualifying accounts (personal trust accounts vs. employee benefit trust and agency accounts), as well as for the fund objective, such as fixed income or equity. The following are the more common types of CIF's which may be found in a trust department:

- Equity Fund - These funds usually consist primarily, or wholly, of common stocks. They are designed to achieve market appreciation while producing some current income.
- Diversified or Balanced Fund - Typically, such funds have a balance of equity and fixed income securities providing asset diversification by asset type. Such funds seek capital appreciation with a regular stream of income.
- Fixed Income Fund - Portfolios of these funds are composed predominately, or wholly, of bonds, preferred stocks, mortgages, and other assets from which the income return is fixed.

- Municipal Bond or Tax-Exempt Bond Fund - These CIF's are comprised of state and municipal obligations which provide income exempt from both Federal and State taxes for residents of the state issuing the securities.

- Real Estate Investment Fund - Portfolios of these funds are invested primarily in real estate.

- Mortgage Fund - These funds consist predominately of mortgages.

- Short Term Investment Fund (STIF) - These funds are CIF equivalents to a money market mutual fund. They are established for the temporary investment of trust cash. Their primary objective is to provide high liquidity and a continuous stream of income at current rates of return. OCC Regulation 9.18(b)(4), "Valuation" in subsection E.7, contains specific requirements for proper STIF administration.

- Covered Call Option Fund - These funds permit the writing of covered call options. Refer to subsection F.2. Specialty CIF's for information on OCC guidance.

- Foreign Securities Investment Fund - These CIF's are primarily composed of foreign securities. They may consist predominately of equities or fixed income investments, or may be structured as balanced funds. Subsection F.2. Specialty CIF's contains information on OCC regulatory requirements, including interpretations regarding the use of Foreign Securities Investment Funds by ERISA accounts.

- Index Fund - These funds are invested in securities tied to a particular securities index, such as Standard & Poor's, the New York Stock Exchange Index, or the Dow Jones Industrials. Refer to subsection F.2. Specialty CIF's for investment related information in operating this type of fund.

- Guaranteed Investment Contract ("GIC") Fund - These CIF's are primarily, or fully, invested in GIC's, which are usually issued by insurance companies. Refer to subsection F.2.e. for investment information and GIC valuation requirements.

C. CIF Tax-Exempt Status - IRC Section 584 and IRS Revenue Ruling 81-100

Each CIF is considered a separate tax entity, having its own tax identification number and administrative requirements. To maintain its tax-exempt status, CIF's must be operated in conformity with IRS regulations. The primary IRS regulations granting CIF's tax-exempt status are Internal Revenue Code Section 584 and IRS Revenue Ruling 81-100, described separately below. Each imposes different requirements that significantly affect both the CIF's operation and which accounts are allowed to invest in the CIF. Nondeposit trust companies are permitted to operate common trust funds under IRC Section 581. Additional information on IRC Section 581 is located in Appendix G.

C.1. Internal Revenue Code Section 584

IRC Section 584 primarily pertains to the operation of common trust funds for personal accounts (personal trusts, estates, guardianships, and accounts created under a Uniform Gifts to Minor Act). There are four key points to consider when reviewing a fund granted tax-exempt status under Section 584:

1. IRC Section 584 provides that any common trust fund that obtains its tax-exempt status from this section of the Code must comply with OCC Regulation 9.18.

2. Therefore, FDIC-supervised banks operating common trust funds drawing tax-exemption from Section 584 must comply with OCC Regulation 9.18.

3. There are no state or local laws exempting state banks from compliance with this provision, as compliance is mandatory to achieve CIF tax-exemption under Section 584.

4. Personal agency accounts and IRAs may not participate in ANY common trust fund, due to restrictions contained in Federal securities laws.

Failure to comply with IRC Section 584 requirements jeopardizes the tax-exempt treatment afforded common trust funds. Therefore, any loss of the fund's tax favored treatment could expose the bank to liability. Tax liability could occur at the fund level and the participant

level. The latter would occur due to regulatory sanctions and penalties and/or pending participant actions, such as lawsuits. The fund participants' proportional interest in the fund are directly impacted by any loss in the fund's value. The bank may be responsible for absorbing the tax consequences incurred by participants.

There are forms that must be filed annually with the IRS. U.S. Treasury Regulation Section 1.6032.1 and IRC Section 6032 require banks operating common trust funds to file annual informational returns with the IRS for each fund established under IRC Section 584. The IRS has not developed a specific form for this purpose. However, Schedule K-1 of Form 1065 (Partner's Share of Income, Credits, Deductions) is typically used to satisfy the reporting requirement. The return must include, for each fund participant: the name; the address; and the proportional share of taxable income or losses, and capital gains or losses. This informational return is required, regardless of the taxable income earned during the reporting period. The aforementioned Treasury regulation requires banks to file a full copy of the common trust fund's declaration of trust at least once with the return. If the plan is amended, the bank must resubmit the plan and its amendments with the informational return.

As noted in the earlier discussion of common trust funds, banks may in some instances rely on the tax- exempt treatment afforded by IRC Section 584 when establishing funds exclusively for employee benefit trusts and certain other tax-exempt fiduciary accounts administered in the capacity of trustee. If an IRC 584 fund is established for employee benefit trusts, the fund would be required to comply with OCC Regulation 9.18, and employee benefit trusts could not be commingled with personal trust accounts in common trust fund. Reasons for this distinction relate to SEC decisions regarding securities registration.

IRC Section 584 appears in its entirety in Appendix G. Also, Subsection P.3 - Federal Tax Laws contains additional information on IRC Section 584.

C.2. IRS Revenue Ruling 81-100

IRS Revenue Ruling 81-100 applies to the collective investment of employee benefit trust and agency accounts. The qualifying accounts are from employee benefit plans which obtain their tax-exempt status from Section 401 of the Internal Revenue Code. RR 81-100 also technically permits IRA accounts which obtain their tax-exempt status from Section 408 of the Internal Revenue Code.

Under Federal securities laws, bank CIF's must qualify for exemption from securities registration and exemption from investment company registration (i.e., registration as a mutual fund). Therefore, **IRA accounts should not be allowed to participate in any CIF**. Examiners should note the differences in purpose between IRC and SEC regulations and opinions. Federal tax laws do permit IRAs to be invested in collective investment funds, see IRC Sections 408(a)(5) and 408(e)(6). Due to the SEC's restrictive interpretation of: (1) an "exempted security" under Section 3(a)(2) of the Securities Act of 1933, and (2) "investment company" (mutual fund) exemptions under Sections 3(c)(1), (3), and (11) of the Investment Company Act of 1940, IRAs are effectively barred from CIF's and, for all practical purposes, may only be collectively invested in mutual funds operated under the Investment Company Act of 1940. Therefore, examiners should review collective investment funds that allow the investment of funds held by IRA accounts, determine if the bank is complying with securities law, and cite apparent violations where applicable. Refer to Subsection D - Registration Under Securities Acts and the December 6, 1994, SEC ORDER on The Commercial Bank of Salem, Oregon in Appendix G for additional details.

Some banks have used exemptions afforded under Regulation D of the Securities Act of 1933 to collectively invest otherwise non-permissible accounts, such as IRAs, without registration. Regulation D places restrictions on the number and sophistication of investors. Refer to Subsection N.5. Regulation D Exempted Securities Offerings for details.

For all practical purposes, only employee benefit accounts whose tax-exemptions derive from IRC Section 401 may invest in RR 81-100 funds. These funds are typically established in a form identical to that outlined by OCC Regulation 9.18(a)(2), even though

compliance with OCC regulations is not mandatory. Therefore, no violation should be cited unless local law requires state nonmember banks to comply with 9.18(a)(2). OCC Regulation 9.18, however, generally addresses items considered as standard industry practice and, therefore, serves as a guide to the prudent operation of employee benefit CIF's. The operation of such funds under OCC guidelines, or guidelines substantially similar, should be recommended. Refer to Subsection E - Regulation 9.18 for more information.

RR 81-100 requires that**:**

1. Participating employee benefit plans adopt the "group trust" as a part of the plan ("group trust" refers to the collective investment fund declaration of trust discussed in Subsection P.3 - Federal Tax Laws);

2. "Group trusts" prohibit collective investment fund assets from being diverted to any purpose other than the exclusive benefit of participating plan beneficiaries;

3. "Group trusts" prohibit the assignment of any collective investment fund assets by any of the participating plans; and

4. "Group trusts" must be established and maintained as domestic U.S. trusts.

Failure to comply with RR 81-100 jeopardizes a collective investment fund's tax-exempt status. The loss of favorable tax treatment could cause the bank to incur a liability to the participants in a collective investment fund, whose proportional interests in the fund are directly impacted by any loss in value due to the loss of a fund's tax-exempt status.

No informational returns are required for employee benefit collective investment funds operated in accordance with RR 81-100, and that derive their tax-exemption under IRC Section 501(a). However, Department of Labor regulations define collective investment funds used for the collective investment and reinvestment of funds contributed to an employee benefit plan as Direct Filing Entities (DFE). DFE's are required to file reports with the Department of Labor. Refer to Section 5.J.1 of this manual for more information concerning Department of Labor reporting requirements.

Revenue Ruling 81-100 is reprinted in its entirety in Appendix G. Also, Subsection P.3 - Federal Tax Laws contains additional information on RR 81-100.

D. Registration Under Securities Acts

CIF's maintained by banks are generally exempt from the requirements of the Securities Act of 1933 (1933 Act) and the Investment Company Act of 1940 (1940 Act). However, if a bank does not strictly meet the exemption requirements, the bank would be required to register the CIF as a security under the 1933 Act and as an investment company (mutual fund) under the 1940 Act. Banks generally seek to avoid registration of their CIF's, due to the additional regulatory requirements imposed with registration.

The following items explain the exemption rules and how banks may violate the acts depending on which types of participant accounts are allowed or if different account types are commingled.

D.1. Securities Act of 1933 (1933 Act)

The 1933 Act provides for the registration of securities sold in interstate commerce to the investing public and requires issuers of such securities to make full and fair disclosure in connection with the offering of such securities.

Exemptions under the 1933 Act:

Section 3(a)(2) of the 1933 Act exempts from the registration requirements and other provisions of the act:

- Any interest or participation in any common trust fund or other similar fund that is excluded from the definition of the term "investment company" under Section 3(c)(3) of the Investment Company Act of 1940. This generally exempts any CIF maintained by a bank for the collective investment and reinvestment of assets contributed by the bank in its capacity as trustee, executor, administrator, or guardian.

- Any interest or participation in a single or collective trust fund maintained by a bank for stock bonus, pension, or profit sharing plans which meet the requirements for qualification under Section 401 of the Internal Revenue Code of 1954.
- Any interest or participation in a single or collective trust fund maintained by a bank for a governmental plan as defined in section 414(d) of the Internal Revenue Code of 1954 within certain described parameters.

Implications of Admitting Certain Participants Into a CIF - 1933 Act:

- IRAs: Funds permitting participation by IRAs would not be exempt under Section 3(a)(2), because IRAs qualify under Section 408 of the Internal Revenue Code. The participation of IRAs in a CIF would therefore trigger securities registration requirements under the 1933 Act. If the CIF was not registered, the participation of IRA accounts would constitute an apparent violation of the 1933 Act. See further discussion of IRAs below under Investment Company Act of 1940 subheading.
- Keogh Plans: The exemption provisions of 3(a)(2) do not cover CIF's that allow participation by some or all employees who are categorized under 401(c)(1) of the Internal Revenue Code pertaining to Keogh plans (HR-10 Plans). Keogh plans may not normally be invested in CIF's without the CIF having to register under Federal securities laws. However, a small number of specialized Keogh accounts may qualify for a limited exemption and therefore be able to invest in a bank CIF. To qualify, the plan accounts and plan sponsor must comply with a narrowly defined intrastate exemption or SEC Rule 180 "Sophisticated Investor Rule". Refer to Section H.2. Keogh Account Usage of Collective Investment Funds for details.
- Government Plans: Various governmental organizations' plans receive their tax-exempt status from different Internal Revenue Code sections (such as IRC 401, 403, 457, and other sources). Plan participation in employee benefit CIF's is generally permissible without causing the bank's CIF to have to register under the 1933 Act. However there are instances where examiners should inquire further about the respective plan's qualifications. This includes state and local government entities which may obtain their plan's tax-exempt status from other sources and may not meet other 1933 Act standards. Refer to information in Section H.3 Government Plan Usage of Collective Investment Funds to ensure that CIF registration under the 1933 Act is not required.
- Traditional Agency Accounts: Banks may never collectively invest a traditional investment management agency account in a CIF. See Subsection B.2 Common Trust Fund and Subsection E.3. Regulation 9.18(a)(1) for further explanation. However, agency accounts are permitted to invest in mutual funds that are registered under the 1933 Act.
- Employee Benefit Agency Accounts: Employee benefit agency accounts are permitted in Regulation 9.18(a)(2), "RR 81-100" CIF's. See Subsection B.2. Employee Benefit Collective Investment Fund for additional information.
- Regulation D Exemption: Although difficult to apply, some banks have used exemptions afforded under Regulation D to collectively invest in otherwise non-permissible accounts, such as IRAs, without registration. Regulation D places restrictions on the number and sophistication of investors. Refer to Subsection N.5. Regulation D Exempted Securities Offerings for details.

D.2. Investment Company Act of 1940 (1940 Act)

The Investment Company Act of 1940 (1940 Act) provides for the registration and regulation of investment companies. Under the 1940 Act, an investment company is an issuer, which holds itself out as being primarily engaged in the business of investing, reinvesting, or trading in securities. In assessing the extent to which the provisions of the 1940 Act may have applicability to the trust activities of banks, reference should be made

to the following exemptions contained in the 1940 Act.

Exemptions under the 1940 Act:

- Section 3(c)(3) of the 1940 Act does not apply to "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."
- Section 3(c)(11) of the 1940 Act exempts from the definition of an investment company: " employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1986 or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts or governmental plans ".

Implications of Admitting Certain Participants Into a CIF - 1940 Act:

- IRAs: The bank CIF exclusion under the 1940 Act does not include IRAs, which fall under Section 408 of the Internal Revenue Code. Due to the SEC's restrictive interpretation of an exempted security under Section 3(a)(2) of the Securities Act of 1933, and investment company exemptions under Sections 3(c)(1), (3), and (11) of the 1940 Act; IRAs are effectively barred from CIF's and, for all practical purposes, may only be collectively invested in registered mutual funds operated under the 1940 Act. Therefore, examiners should question any CIF that allows the investment of funds held by IRA accounts and must determine if the bank is violating both the 1933 Act and 1940 Act. Refer to the December 6, 1994, SEC ORDER on The Commercial Bank of Salem, Oregon in Appendix G for additional particulars.
- Commingling of employee benefit and personal accounts: The SEC has interpreted the phrase "common trust fund" as applying only to those accounts administered by banks in their traditional capacity as trustee, executor, administrator or guardian for individuals. Therefore, the commingling of both employee benefit and personal accounts fails to qualify under the 3(c)(3) exemption because employee benefit plans are by definition not personal trust accounts. Furthermore, the commingling of both employee benefit and personal trust accounts fails to qualify under the 3(c)(11) exemption because personal trust accounts are not covered by Section 401 of the Internal Revenue Code.

  Examiners should ensure that employee benefit and personal accounts are not invested in the same CIF, due to the registration requirements that would result. Failure to qualify under the above exemptions due to the commingling of personal and employee benefit accounts in a CIF subjects the CIF to registration and regulation as a mutual fund (investment company) under the 1940 Act.

  The SEC has taken the position that employee benefit accounts administered in the capacity of trustee may not be commingled in common trust funds established for personal trust accounts. The SEC has consistently made a distinction between personal trusts and employee benefit trusts under securities laws. Consequently, it is irrelevant that both OCC Regulation 9.18 and IRC Section 584 appear to permit accounts administered in the capacity of trustee to be commingled without reference to the type of accounts being invested (personal vs. employee benefit plan). These accounts are not permitted to be commingled in a CIF.

  In the November 1, 1991, No-Action Letter to Santa Barbara Bank and Trust found in Appendix G, the SEC replied to an inquiry concerning Federal securities law restrictions against commingling assets of employee benefit plans, IRAs, and personal trust accounts. The SEC stated that this would require registration of a CIF as a mutual fund under the 1940 Act, and that interests in the CIF would then have to be registered as securities under the Securities Act of 1933.

Appendix D provides additional information on the A pplicability of Federal Securities Law to Banks and Bank Sponsored Securities Activities , including three separate sections on collective trust funds.

E. OCC Regulation 9.18

The complete text of OCC Regulation 9 - Section 9.18, regarding the operation of collective investment funds, can be found in Appendix G. The following is a synopsis of significant parts of Section 9.18.

E.1. Section 9.18 Applicability to State Nonmember Banks

State nonmember banks need to comply with Section 9.18 for funds granted tax-exempt status pursuant to IRC Section 584. Funds granted tax-exempt status pursuant to Revenue Ruling 81-100 , such as employee benefit CIF's, are generally not subject to Section 9.18 requirements**.** However, state law often requires that all CIF's comply with Section 9.18 or comply with a similarly written state provisions. Even where not required by law, the standards set forth in Section 9.18 should be followed by state nonmember banks as industry best-practices for all funds.

E.2. 1997 Revision of Section 9.18

The OCC revised its national bank fiduciary regulations in 1997. At the time, several OCC fiduciary precedents and trust interpretive letters had been issued under the prior version of the regulation. The OCC opined that the precedents and interpretations in these interpretation letters have become industry practice or simply articulate sound fiduciary principals.

At the same time, the OCC opined that whether a CIF plan needs to be amended to accommodate the changes in the revised regulation, depends upon the language in the existing plan. If the language specifically states the requirements of the old regulation, management should continue to operate the plan in compliance with the original plan - unless the plan is amended. If the plan's language merely makes general reference to 12 CFR 9.18, an amendment may not be necessary. However, banks operating short-term investment funds should amend their plans to reflect the new valuation provision in the revised regulation. Any amendment should be approved by the bank's board or its designee. Expenses incurred in amending a plan are considered the cost of establishing or organizing a CIF, and, therefore, may not be charged to the fund (Section 9.18(b)(10)). Refer to Appendix G for OCC Bulletin 97-22 (Excerpts) for further information regarding the implementation of the revised Section 9.18 to pre-existing CIF's.

E.3. Section 9.18(a)(1)

Section 9.18(a)(1) provides that banks may operate a fund maintained exclusively for the collective investment of monies contributed by the bank in its capacity as trustee. Section 9.18(a)(1) funds are commonly referred to as common trust funds and are defined in Subsection B.2. Common Trust Fund. In the administration of funds created pursuant to Section 9.18(a)(1), bank procedures should provide that no units of participation may be held by an agency account.

The 1997 revision to Section 9.18(a)(1) eliminated the 10% limit on a participant's interest in a common trust fund, and the 10% limit on investment of a common trust fund in the obligations of one issuer. The revised regulation also eliminated the requirement that a bank maintain, in cash and readily marketable assets, a percentage of common trust fund assets as necessary to provide for the liquidity needs of the common trust funds.

E.4. Section 9.18(a)(2)

Section 9.18(a)(2) states the general permissibility of banks to operate a fund consisting solely of assets of retirement, profit sharing, stock bonus, or other trusts that are exempt from Federal income tax. Section 9.18(a)(2) funds are often referred to as Collective Investment Funds (as previously described in Subsection B.2.). In the administration of funds created pursuant to Section 9.18(a)(2), bank procedures should not allow participation by any trust accounts which are subject to Federal income tax.

E.5. Section 9.18(b)(1) The Written Plan

A CIF must be established and maintained in accordance with a written plan. The plan may cover multiple funds. The plan must be approved by resolution of the bank's board of directors or a committee authorized by the board. (Although not required by 9.18, it is

recommended that legal counsel examine the plan.) A copy of the plan must be made available to any person for inspection at the main office of the bank during banking hours.

Section 9.18(b)(1) sets forth the required minimum content of the written plan establishing a CIF:

i. Investment powers and policies with respect to the fund,

ii. Allocation of income, profits, and losses,

iii. Fees and expenses that will be charged to the fund and to participating accounts,

iv. Terms and conditions governing the admission and withdrawal of participating accounts,

v. Audits of participating accounts,

vi. Basis and method of valuing assets in the fund,

vii. Expected frequency for income distribution to participating accounts,

viii. Minimum frequency for valuation of fund assets,

ix. Amount of time following a valuation date during which the valuation must be made,

x. Bases upon which the bank may terminate the fund, and

xi. Any other matters necessary to define clearly the rights of participating accounts.

Items (iii) and (vii) are 1997 additions to Section 9.18. Plans that were approved and in operation prior to the 1997 revisions (unless the plan is amended) are not required to maintain such provisions. .

E.6. Section 9.18(b)(2) Fund Management

Under Section 9.18(b)(2), a bank administering a CIF shall have exclusive management thereof, except as a prudent person might delegate responsibilities to others. The ability of management to delegate certain responsibilities to others under the prudent person standard was added in 1997. Management, however, is responsible for conducting a due diligence review prior to delegation, having board or designee approval of the delegation, ensuring an written agreement sets forth duties and responsibilities, and closely monitoring the activities and performance of the third party. In OCC Bulletin 97-22, the OCC recommended that a bank review, with their attorney, the securities laws and tax implications prior to any delegation of investment responsibility. Delegating investment advise is discussed in Subsection F.1 - Use of Outside Investment Advisers.

E.7. Section 9.18(b)(4) Valuation

Section 9.18(b)(4) requires that the fund be valued at least once every three months. Funds must be valued at market value or, if such valuation is not readily ascertainable, at a fair value determined by the trustee.

The current regulation grants a valuation frequency exception for 9.18(a)(2) funds (retirement, pension, profit sharing, stock bonus, or other trusts exempt from Federal taxation) that invest primarily in real estate or other assets that are not readily marketable. For these types of funds, the bank is only required to determine the value of the fund's assets at least once each year. **Note***:* Section 9.18(b)(4), "Valuation", is currently being revised to provide increased flexibility when valuing assets that are illiquid, difficult to value, or not readily marketable. The anticipated change will allow these assets to be valued once per year within all funds (without the existing restrictions on fund type). The valuation of the fund's readily marketable assets will still be required to be valued at least once every three months. Refer to www.occ.treas.gov for most current regulatory information on this issue.

There are specific valuation guidelines for Short-term Investment Funds (STIF's). The assets of a STIF may be valued at cost (as opposed to fair market value), if the STIF maintains a dollar weighted average portfolio maturity of 90 days or less, the bank uses straight line accrual between the cost and anticipated principal receipt on maturity, and the

bank holds fund's assets until maturity under usual circumstances [Section 9.18(b)(4)(ii)(B)]. Revisions to Section 9.18 made substantial changes with respect to the operation of STIF's. One significant change is the elimination of the requirement that a STIF invest at least 80% of the STIF's assets in instruments payable on demand or that have a maturity date not exceeding 91 days from date of purchase. The revised regulation also eliminated the requirement that at least 20% of the fund's assets must be cash, demand obligations, and assets that will mature at the fund's next business day.

E.8. Section 9.18(b)(5) Admission and Withdrawal Under Section 9.18(b)(5), participants should be admitted to or withdrawn from a fund only on the basis of the valuation described in Section 9.18(b)(4), and on such valuation date. The admission or withdrawal must be under prior request or notice on or before the valuation date. The bank may require notice of up to one year for withdrawals from funds with assets that are not readily marketable. No admission or withdrawal request or notice can be canceled or countermanded after the valuation date. Distributions to withdrawing participants may be made in cash, ratably in kind, a combination of cash and ratably in kind, or in any other manner consistent with the applicable state law.

In OCC Interpretive Letters #920 and #936, the OCC stated that while Section 9.18(b)(4) addresses the frequency of valuing a CIF, that requirement does not mandate a similar frequency for admissions and withdrawals. The confusion, the OCC writes, results from the fact that the regulation provides that admissions and withdrawals may only be on the basis of the valuation. The Interpretive Letters are located in Appendix G.

E.9. Section 9.18(b)(6)(i) Annual Audit

Section 9.18(b)(6)(i) requires that each CIF be audited at least once during each 12-month period by auditors responsible only to the bank's board of directors. [If permitted by state law, Section 9.18(b)(10) permits the plan to pay reasonable expenses incurred to operate the fund. The regulation does not define reasonable or specify which expenses may be paid. The OCC had interpreted the prior regulation to permit the recapture of the audit costs associated with independent outside auditors, but not internal audit costs.]

There are no regulatory requirements as to the scope of the audit. Therefore, as long as the audit appears reasonably complete, examiners should express no objection. As mentioned previously, CIF's that obtain tax-exempt status under RR 81-100 are not necessarily subject to Section 9.18 requirements except if required to do so under state law or regulation. Nonetheless, audits are strongly recommended by the Corporation, and examiners should criticize any CIF that is not audited annually. When OCC Regulation 9.18 sets specific requirements, a reasonable equivalent should be in place for a CIF subject to RR 81-100.

Both internal and external audits are acceptable, if the audit scope is adequate. Items typically addressed in a CIF audit:

- Sufficient tests to permit the auditor to provide an opinion on financial data required by OCC Regulation 9.18(b)(6)(ii).
- Confirmation or verification of the fund's assets, together with a reconciliation of pending transactions.
- Reconciliation of any cash positions in deposit or money-market funds.
- General compliance with OCC Regulation 9.18, especially as to: advertising restrictions [Section 9.18(b)(7)] and prohibited transactions regarding self-dealing and conflicts of interest [Section 9.18(b)(8) and Section 9.12(b)].
- General compliance with any applicable state laws or regulations.
- Conformance with the plan document, particularly as to: limitations on the types of eligible participants and limitations on permissible investments.
- Review of any transactions with bank insiders or investments in their related interests.
- Review of any fees paid by the CIF to the bank, its insiders, and their related

interests.

- A test to ensure that income receivable from investments is posted to the CIF, and that proper accruals are used in distributing net income.

E.10. Section 9.18(b)(6)(ii) Financial Report

Section 9.18(b)(6)(ii) requires each CIF to issue an annual report that is intended both for the bank and the beneficiaries of participating accounts. At least once during each 12 month period, a financial report of the fund based on the audit (Section 9.18(b)(6)(i) above) must either be furnished, or made available, at no charge to each person who would receive an accounting from each participating trust account. It may also be provided to prospective customers.

The financial report must contain a list of investments at both cost and current market value, a summary of investment changes for the period reflecting purchases (with costs) and sales (with profit or loss), income and disbursements since the last report, and notation of any investments in default. The report may not contain predictions of future fund performance, but may include historical performance data.

Additionally, Part 344 of the FDIC Rules and Regulations - Recordkeeping and Confirmation Requirements For Securities Transactions requires an annual financial report for all CIF's (even RR 81-100 Employee Benefit CIF's). Part 344.6(e) states that for collective investment fund accounts: " The bank shall at least annually give or send to the customer a copy of a financial report of the fund, or provide notice that a copy of such report is available and will be furnished upon request to each person to whom a regular periodic accounting would ordinarily be rendered with respect to each participating account. This report shall be based upon an audit made by independent public accountants or internal auditors responsible only to the board of directors of the bank."

E.11. Section 9.18(b)(7) Advertising of Collective Investment Funds

Advertising of common trust funds established for personal trust accounts (9.18(a)(1) funds) is prohibited under OCC Section 9.18(b)(7), except in connection with the advertisement of general fiduciary services. The advertising restrictions of this section do not apply to employee benefit collective investment funds (9.18(a)(2) funds) typically organized under RR 81-100. Be advised that advertising of any collective investment fund may jeopardize its exemption from securities laws, thereby requiring registration.

E.12. Section 9.18(b)(8) Self-Dealing and Conflicts of Interest

Section 9.18(b)(8) requires banks administering CIF's to comply with Self-Dealing and Conflicts of Interest requirements. The following is a summary of CIF self-dealing and conflict of interest rules (with links to the specific Regulation 9 sections):

- The bank may not have an interest in the CIF, except in its fiduciary capacity. (This includes a prohibition on any creditor relationship between the bank and the fund or its participants. This section has been interpreted to extend to overdrafts.) [9.18(b)(8)(i)]

- The bank may not make a loan on the security of the participant's interest in the fund. [9.18(b)(8)(ii)]

- The bank may not lend, sell, or otherwise transfer assets of a fiduciary account to the bank, insiders, or affiliates. [9.12(b) as referenced by Section 9.18(b)(8)]

- Defaulted investment exception: A bank may purchase a defaulted fixed income investment from a fund for its own account. If it does so, the purchase price must be at the greater of: market value, or cost plus accrued unpaid interest. [9.18(b)(8)(iii)]

- No fund assets may be invested in the bank's stock or obligations. [Section 9.12(a) as referenced by Section 9.18(b)(8)]

See entire text of Section 9.18(b)(8) and Section 9.12 in Appendix G for further information.

Own-Bank Deposits in a Short-Term Investment Fund (STIF): OCC Interpretive Letter

#969 states that a bank may use own-bank deposits for fiduciary assets awaiting investment or distribution collectively in a STIF administered by the bank. However, the activities must comply with conditions set forth in the letter and Section 9.10 and Section 9.12 of the regulation. The activity must be "lawfully authorized by the instrument creating the relationship, or by court order or by local law". Refer to Interpretive Letter #969 in Appendix G for further information.

Underperforming CIF's: In addition to the specific conflicts of interest principles addressed in Section 9.18, banks confront other conflicts of interest in the administration of CIF's. One of the most difficult is management's continued use of a CIF that consistently underperforms general market indices. The costs of establishing and maintaining CIF's, together with marketing or public relations, and potential litigation considerations, may influence management's decision to continue to invest customer assets in CIF's. Sound fiduciary investment practice, on the other hand, might require that account assets invested in an underperforming CIF be sold and investments made in more productive investment vehicles. CIF performance must be evaluated in the same manner as other investments. CIF performance should be compared with mutual fund performance indices and overall market indices (S&P 500, Dow Jones Industrials, etc.). Examiners should not recommend either the continuation or termination of a particular fund. However, management's failure to routinely evaluate and document fund performance should be criticized. Funds that have underperformed general market indices should receive management's (including the board of directors) close scrutiny, and be covered by a strategic plan to improve performance.

E.13. Section 9.18(b)(9) Management Fees

Section 9.18(b)(9) permits a bank administering a CIF to charge a reasonable fund management fee only if the fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the bank maintains the fund. The amount of the fee must be commensurate with value of legitimate services of tangible benefit.

Through various interpretive letters, the OCC has provided some clarification to Section 9.18(b)(9) regarding what constitutes reasonable fees commensurate with the value of services provided. OCC Interpretive Letter #829, responds to a bank inquiry regarding applying different management fees to common participants commensurate with the amount and type of participant services provided. Interpretive Letter #829 addressed charging different fees to various 401(k) employee benefit plans participating in the bank's CIF's based on the complexity of the 401(k) plans' administrative characteristics.

E.14. Section 9.18(b)(10) Expenses

Section 9.18(b)(10) permits a bank administering a CIF to charge reasonable expenses incurred in operating the CIF, to the extent not prohibited by applicable state law. The section specifies that the bank shall absorb the expenses of establishing or reorganizing a CIF.

OCC Interpretive Letter #919, located in Appendix G, provides guidance for permissible expense recovery from participants in model-driven funds and index funds. Model-driven funds are collective investment funds that seek to outperform a specified index or benchmark based on a pre-determined investment strategy. The Interpretive Letter indicated that model-driven funds may charge participants the cost of entering or exiting a fund just as index funds do, provided the fund's governing document authorizes such changes.

E.15. Section 9.18(b)(11) and (12) Prohibition Against Certificates / Good Faith Mistakes

Sections of 9.18(b)(11) and 9.18(b)(12) prohibit issuing certificates or documents representing an interest in the CIF and provide an opportunity for bank's to promptly correct good faith mistakes, respectively.

E.16. Section 9.18(c) Other Collective Investments

Section 9.18(c) prescribes other permissible instances when banks may collectively invest assets that it holds as fiduciary. Under certain circumstances, 9.18(c) address

commingling single loans or obligations, variable amount notes (vans), mini-funds, trust funds of corporations and closely-related settlors, and other, special exemption funds subject to OCC approval.

F. Investment Management Issues

F.1. Use of Outside Investment Advisors

OCC Regulation 9.18(b)(2) requires that the bank hold exclusive management over collective investment funds, except as a prudent person might delegate responsibilities to others. However, if management delegates investment responsibility, as allowed under the 1997 revised OCC regulation, the CIF may lose its exemption from Federal securities law (Section 3(a)(2) of the 1933 Act) and exemption from Federal taxation (IRC 584, for common trust funds).

The OCC has stated that management may delegate investment responsibility so long as it is done prudently. Per the OCC, this includes conducting a due diligence review of the investment advisor prior to delegation and closely monitoring the investment advisor's performance after delegation. The Board or its designee should approve the delegation and ensure that an agreement outlining each party's duties and responsibilities is in place. Management should review the securities law and tax law implications of the delegation with legal counsel prior to the delegation of investment management responsibilities.

F.1.a. CIF's Tax-Exempt Under IRC 584 (Subject to OCC Regulation 9.18)

In the past, the OCC has permitted the use of outside investment advisors if:

1. such delegation is proper under governing law or if the surrender of control and management results in strict liability of the trustee for the acts of its delegate,
2. the arrangement is governed by a written agreement,
3. the adviser can perform only the functions the bank could perform,
4. the CIF is subject to the jurisdiction of the OCC (no definition of OCC jurisdiction over state nonmember bank CIF's has been rendered),
5. the trustee bank establishes specific investment guidelines to be followed by the investment advisor,
6. the trustee bank frequently reviews the investment advisor's activities, and
7. the trustee bank can terminate the contractual relationship at will.

F.1.b. CIF Tax-Exempt by Revenue Ruling 81-100

There is no explicit coverage of outside investment advisors for CIF's that are tax-exempt subject to RR 81-100. Examiners should look first to ERISA, as these funds are restricted to tax-qualified employee benefit plans, and then to OCC precedents. State law or regulations may also contain applicable guidance.

ERISA concepts:

- In general, ERISA would appear to permit the use of a **non-affiliated** investment advisor, so long as the fees were reasonable.
- ERISA Section 406(b)(3), however, appears to **prohibit** the use of an **affiliated** investment advisor for a fee in connection with a transaction involving the assets of the plan. If the affiliated investment advisor charged **no fee, no violation would occur**.
- Prohibited Transaction Class Exemptions (PTE's) 80-51 & 91-38 (located in Appendix E) do not address the use of investment advisors for RR 81-100 funds.

OCC precedent:

- In the past, the OCC has issued approval for the use of an outside investment advisor for an employee benefit CIF consisting primarily of a diversified portfolio of guaranteed investment contracts (GIC's). The approval was conditioned upon a number of items.

- Each participating account, either in its governing instrument or in a separate authorization agreement, specifically authorized the investment in the fund, the employment of the advisor (outside investment advisor) by the trustee of the unrelated fund, and the amount of fees to be paid to the advisor for the GIC Fund.

- Approval of this arrangement also required that any investment advisor fee charged to the fund be listed as a separate line item on participating account statements, and in the annual financial statement of the fund.

F.2. Specialty CIF's

The following subsections provide information for several types of special investment funds. (This is not meant to be an all-inclusive list).

F.2.a. Short-Term Investment Fund (STIF)

STIF's are the CIF equivalents to a money market mutual fund, typically used for the temporary investment of trust cash. Their primary objective is to provide high liquidity and a continuous stream of income at current rates of return. Refer to OCC Regulation 9.18(b)(4) discussion in Subsection E.7 for STIF valuation and management rules.

F.2.b. Covered Call Option Fund

The OCC requires that each participating account provide specific investment authority regarding use of the bank's covered call option fund. However if the fund was established under Revenue Ruling 81-100, the incorporation may be by reference. The fund should also provide a specific method for valuing options.

F.2.c. Foreign Securities Investment Fund

The OCC requires that each participating account contain specific authority to invest in the bank's Foreign Security Investment Funds, unless the funds are established under Revenue Ruling 81-100, which requires incorporation by reference. In prior statements, the OCC also indicated that where custody of the securities is maintained outside the jurisdiction of the District Court of the United States, the requirements of Section 404(b)(I) of ERISA must be met (i.e., no fiduciary may maintain the "indicia of ownership" of any assets of the plan outside of the jurisdiction of District Courts of the United States). If the securities are not held in foreign branches of U.S. chartered banks, the bonding requirements of ERISA 412 must also be met.

F.2.d. Index Collective Investment Fund

The assets of such funds are structured to replicate the performance of a recognized financial index, e.g., the S&P 500. The OCC indicates that the index funds may not include own-bank securities or securities of an affiliated holding company, even though the securities of such companies may be included in the financial index.

F.2.e. Guaranteed Investment Contract (GIC) Fund

GIC funds are comprised primarily of guaranteed investment contracts issued by insurance companies, as well as equivalent bank products (refer to the Glossary Section of this manual). Since GIC's are perceived to be guaranteed, they are extremely popular with 401(k) plans and their participants, as they appear to provide a no-risk investment. The only guaranteed portion of a GIC, however, is its interest rate and other contractual provisions. Repayment of the principal is dependent on the

financial condition of the GIC's issuer. The failure of several large insurance companies (which issued GIC's), made it clear that there is credit risk in GIC's. In addition, the value of any fixed-rate investment product is affected by changes in prevailing interest rates.

OCC Regulation 9.18(b)(4) requires that CIF investments be valued at a reasonable fair market value. If a market value is not readily ascertainable, the investments should be valued at fair value determined in good faith by the trustee. Determining a fair value for GIC's is difficult because these investments are not actively traded on a secondary market or exchange, and do not have quoted market values. The OCC, however, has stated that the unsupported use of the contract price or book value does not meet the requirements of Regulation 9.18. In the December 21, 1995, letter to the law firm of Mayer, Brown & Platt, the OCC gave permission to value GIC's at contract/face value **if** (1) only defined contribution plan assets are in the CIF, **and** (2) the CIF's assets consist solely of: "benefit responsive" GIC's, short-term government securities, and money market instruments. This position follows an approach taken by AICPA Statement of Position ("SOP") #94-4. Examiners should closely review the valuation methodology employed for any GIC or similar investment vehicles used in CIF's.

G. ERISA Considerations

ERISA Section 406 prohibited transaction rules are applicable when employee benefit plan assets are invested in CIF's. In addition, DOL advisory opinion states that investment of plan assets in a CIF maintained by a bank trustee causes the assets of the CIF to be treated as assets of the plan. ERISA 408(b)(8) and PTE 91-38 (discussed below) provide exemptions for certain ordinary activities and transactions.

G.1. ERISA 408(b)(8) Exemption

ERISA Section 408(b)(8) provides an exemption from the prohibitions outlined in ERISA Section 406 for any transaction between an employee benefit plan or its participating accounts and the bank CIF if:

- the transaction is a sale or purchase of an interest in the fund,
- the bank or trust company receives not more than reasonable compensation, and
- the transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company or affiliate thereof) who has authority to control and manage the assets of the plan.

G.2. DOL PTE 91-38 Exemption

Transactions between a bank CIF that holds plan assets and plan related parties (such as the bank or an affiliate) are subject to ERISA Section 406 prohibitions and Internal Revenue Code 4975; but Department of Labor (DOL) PTE 91-38 provides an exemption under certain conditions.

In PTE 91-38, the DOL grants a class exemption for bank-maintained CIF's, in which employee benefit plans have an interest, to engage in certain transactions with plan-related parties provided specified conditions are met. For example; to qualify for the exemption under PTE 91-38, the plan must hold less than a 5 to 10% interest in the total assets of the CIF.

The proper application of PTE 91-38 precludes a violation of ERISA 406(a), transactions between plan and party in interest. However, if the CIF enters into a transaction with the bank or affiliate insider, there would be a violation of ERISA 406(b)(1), transactions between plan and fiduciary (and thereby triggering a violation of IRC 4975 tax on prohibited transactions). There is no exemption from this section of ERISA. For example, if the CIF purchased loans from the bank, the CIF would be in violation of 406(b)(1) and could possibly be in violation of 406(a) if the conditions for relying on PTE 91-38 were not met.

H. Other Participant Account Limitations

H.1. Charitable Trusts usage of Collective Investment Funds

Banks are appointed to manage charitable trusts established by associations which qualify as tax-exempt charitable organizations under IRC Section 501(a), and Charitable Remainder Trusts created by individuals under IRC Section 664. This is slightly different from bank managed "pooled income funds" organized by outside organizations (discussed separately under section N.4).

Issues to be considered when contemplating the collective investment of charitable accounts:

- Collective investment of charitable trusts must be confined to CIF's whose tax-exempt status is derived from IRC Section 584. IRC Section 584 permits the collective investment of funds held by a bank in the capacity of trustee for an individual, and in the capacity of trustee for employee benefit accounts. Charitable trusts fall outside the scope of RR 81-100which are limited to participation in CIF's for employee benefit plans administered by banks in the capacities of both trust or agency.

- Charitable accounts for which a bank acts as "agent" may not be invested in collective funds of any type**.** Remember it is impermissible under Federal securities laws to collectively invest personal agency accounts.

- Collective investment of charitable trusts must comply with OCC Regulation 9.18. The Internal Revenue Code, by virtue of IRC Section 584, requires CIF's obtaining tax-exempt status under that section of the Code to comply with OCC Regulation 9.18.

- In the past, the OCC opined that charitable trusts may be collectively invested with other fiduciary accounts in CIF's operated in accordance with either Section 9.18(a)(1) or Section 9.18(a)(2). The CIF operated for the collective investment of charitable trusts must conform to IRC Section 584 requirements. This includes Section 9.18(a)(2) CIF's, which are normally operated in accordance with RR 81-100. As a practical matter, Section 9.18(a)(2) CIF's are confined to employee benefit plans and operated in accordance RR 81-100. It would therefore be unusual for charitable trusts to be invested in a Section 9.18(a)(2) CIF.

- The OCC also ruled, pursuant to Section 9.18(c)(5), that it was permissible to collectively invest funds in a CIF consisting solely of charitable trusts without the need to comply with all of the requirements contained in Section 9.18(b). This interpretation would not extend, however, to CIF's whose participation included charitable trusts along with personal trusts, executorships, guardianships, etc., because the collective investment of these personal trusts would have to comply with OCC Regulation 9.18 in its entirety.

Under the revised OCC Regulation 9.18, banks establishing CIF's for charitable trusts and relying on Section 9.18 (c)(5) for exemption from the provisions of 9.18(b) must submit a written plan to the OCC. The content of the written plan is enumerated in the text of Regulation 9.18(c)(5). The OCC has opined that state nonmember banks operating charitable collective funds are also required to submit the fund's plan to the OCC to qualify for special exemption under 9.18(c)(5).

H.2. Keogh Accounts Usage of Collective Investment Funds

Keogh plans, also referred to as HR-10 plans, are self-employed retirement plans that are qualified under IRC Section 401(c)(1). As with IRA accounts, owing to a narrow interpretation of the Securities Act of 1933 (Act) by the SEC, Keogh plans may not normally be invested in CIF's without the CIF having to register under Federal securities laws.

It is possible, nevertheless, through the careful application of either: (1) Section 3(a)(11) of the Securities Act of 1933 - Intrastate Exemption, or (2) SEC Rule 180-Sophisticated Investor Exemption, to invest Keogh plans in CIF's without registering either the Keogh plans, or the CIF's, as securities under Section 5 of the Act.

H.2.a. Intrastate Exemption for Keogh Accounts

CIF's seeking Section 3(a)(2)(C)(ii) exemption from registration, must also comply with the requirements of Section 3(a)(11) ("intrastate exemption" requiring all fund participants to reside in the same state as the fund's issuer).

- Section 3(a)(11) of the Act provides an intrastate exemption from registration for any security which is offered and sold only to residents within a single state, and where the securities issuer is also a resident, and doing business, within the same state.
- For the intrastate exemption to be available: (a) all commingled fund participants (including all beneficiaries of the Keogh plans) and (b) the bank operating the CIF, must be intrastate.

While the foregoing suggests that Keoghs may be commingled with other employee benefit plan accounts, this is not the case. The commingling of intrastate Keogh plans with interstate employee benefit plans precludes the Section 3(a)(11) registration exemption for the Keogh plans. On January 15, 1981, the SEC's Division of Corporation Finance opined that intrastate Keogh plans may be commingled with other types of interstate employee benefit plans (pension, profit sharing, etc.) without the interests of the non-Keogh plans having to be registered under the Act. However, the Keogh plans themselves would have to be registered unless specifically exempted by statute, or by Commission rule, or order. (SEC Release No. 33-6281, 17 C.F.R. 231.6281)

Examples of SEC interpretations of the exemptions afforded by Sections 3(a)(2) and 3(a)(11) of the Act include:

1. In National Bank of Fairfax, the bank wanted to invest Keogh accounts of both resident and nonresident employers. The National Bank of Fairfax Self-Employed Retirement Plan and Trust would only have been available to self-employed individuals and their employees. The Plan provided two methods for investing Keogh accounts under its single "umbrella" plan:

    a. If an employer was a resident of Virginia, its plan would be collectively invested in the CIF. This method would comport with the exemption requirements of Section 3(a)(11).

    b. If an employer was not a resident of Virginia, the CIF required funds relating to the non-resident plan to be segregated into a separate trust account. The separate trust account would be operated under the same terms and conditions as the accounts maintained for Virginia residents. In doing so, the bank sought to apply the registration exemption afforded by Section 3(a)(2).

    In response to the bank's inquiry, the SEC denied the issuance of a No-Action Letter, stating that it was not the intent of Section 3(a)(2) to provide specific exemptions for Keogh plans and, therefore, the Section 3(a)(2) exemption would not be available for the creation of separate trust accounts for nonresident accounts. The National Bank of Fairfax's December 29, 1976, request for No-Action letter and the SEC's response appears in Appendix G.

2. The Citizens and Southern National Bank of Georgia also requested a No-Action letter from the SEC to permit application of Section 3(a)(2) and 3(a)(11) registration exemptions for the commingling of two employee benefit collective investment funds maintained by the bank.

   a. The C&S Pooled Profit Sharing and Pension Trust held only employee benefit accounts, exclusive of Keogh accounts. These accounts were sponsored by both Georgia and non-Georgia employers.

   b. The Commingled Retirement Trust Fund held funds of Keogh plans of Georgia residents.

   The bank sought the SEC's approval to commingle these two funds without registration based on SEC Release 33-6281.

   The SEC replied that Release 33-6281 was intended to permit commingling without the corporate plans losing their registration exemption under SEC Section 3(a)(2). However, the exemption granted the Keogh accounts under Section 3(a)(11) would be lost if the two funds were combined, requiring the interests of the Keogh plans to be registered. The Citizens and Southern National Bank of Georgia, September 25, 1981, request for a No-Action letter and the SEC's response are included in Appendix G.

H.2.b. "Sophisticated Investor Rule" Exemption for Keogh accounts

SEC Rule 180 (17CFR Section 230.180) provides what is often termed the "sophisticated investor rule" exemption. Details on this exemption are discussed in the overview of securities laws Section P.1.b. SEC Rule 180 (Sophisticated Investor Rule) and in Appendix G, 17 C.F.R. Section 230.180 "Sophisticated Investor Rule".

H.3. Government Plan Usage of Collective Investment Funds

Government employee benefit plans as defined in the Internal Revenue Code include plans of the government of the United States, the government of any state or political subdivision, or plans of any agency or instrumentality thereof. Many of these plans qualify for tax-exemption under IRC Sections 401, 403, or 457. However, not all government plans are qualified under these sections of the Code. Due to the fact that some state and local plans cannot meet all the qualifications for tax-exemption, particularly vesting requirements as embodied in Section 401, the Code was amended to provide special tax treatment for such plans by adding Section 414(d). Further, under some local law restrictions, it is not permissible for some government plans to be established under formal trust arrangements.

Securities registration and investment company exemptions for bank CIF's used to collectively invest government plans are contained in: Section 3(a)(2)(C) of the Securities Act of 1933, Section 3(a)(12)(C)(iii) of the Securities and Exchange Act of 1934, and Sections 3(c)(11)(A) and (B) of the Investment Company Act of 1940. Therefore, ample securities law exemptions exist for the collective investment of government plans. SEC No-Action Letters, including those covering government plan participation in CIF's, are located in Appendix G.

Regardless of the form of tax qualification used, and regardless of the presence or absence of a formalized trust agreement, government plans may be collectively invested by banks consistent with the requirements of OCC Regulation 9.18(a)(2) and Revenue Ruling 81-100. Government plans may be invested in CIF's together with corporate-sponsored employee benefit plans, or in CIF's confined to government plans. Those plans not established under trusts must, however, be held: (a) under some form of fiduciary arrangement and (b) in the custody of the organization authorized under local law.

It should be noted that some governmental plans do not obtain an exemption from Federal income taxation. Instead, they rely on an "exclusion" from taxation allowed through the

concept of "intergovernmental constitutional immunity". If a governmental plan has not obtained tax-exempt status by meeting the requirements of the Internal Revenue Code, evidence must exist that the plan is appropriately relying on the exclusion from taxes allowed though "intergovernmental constitutional immunity."

The following SEC No-Action Letters permit the inclusion of government plans (including IRC Section 457 qualified plans of state and local government employees) with corporate employee benefit plans without triggering registration under: the Securities Act of 1933, the Securities Exchange Act of 1934, or the Investment Company Act of 1940 : The Provident Bank (1991), The Idaho First National Bank (1988), and Fidelity Management Trust Company (1989), all located in Appendix G.

I. Investing in CIF's of other institutions

I.1. Affiliated Institutions

When permitted in the governing instrument and allowed by state law, banks may invest funds of fiduciary accounts in affiliate bank CIF's. The OCC has permitted such investments in the past. The SEC has also addressed this issue in a 1989 No-Action Letter to Old Kent Financial Corporation (located in Appendix G). In that No-Action Letter, the SEC permitted banks under the holding company of Old Kent Financial Corporation to use the common and collective funds of other affiliated banks under the holding company.

When banks invest fiduciary funds in affiliate institution CIF's, examiners should ensure that:

1. the CIF plan of operation or governing document authorizes use of the CIF by accounts of affiliated banks,
2. the board of the affiliated bank has authorized the use of the originating bank's plan,
3. the affiliated bank maintains documentation for all admission and withdrawal decisions for each fiduciary account invested in the originating bank's fund,
4. the originating bank is notified on or before the fund valuation date, and the appropriate committee of the originating bank approves all affiliate bank admissions and withdrawals in compliance with 12 C.F.R. 9.18(b)(5), and
5. the originating bank furnishes the annual financial report, or notice of its availability, to each fiduciary account invested in its CIF's).

I.2. Non-Affiliated Institutions

Examiners may also encounter situations where banks wish to invest fiduciary funds in CIF's of non-affiliated banks. In the past, the OCC permitted employee benefit CIF's (Section 9.18(a)(2) funds) maintained by a trustee in accordance with RR 81-100 to be invested in a CIF maintained by an unrelated trustee. However, the OCC staff indicated that personal trust CIF's (Section 9.18(a)(1) funds) deriving tax- exemptions pursuant to IRC 584 cannot accept participations from non-affiliated institutions.

Although the OCC has permitted the investment of fiduciary funds in non-affiliated institution CIF's, the SEC declined to issue a No-Action Letter to Northern Trust Corporation on this same issue. Northern Trust Corporation had been seeking permission for non-affiliated CIF's to invest in CIF's operated by Northern Trust Company (a subsidiary bank). Northern Trust Corporation had previously applied for and obtained OCC approval to conduct this activity. However, the SEC did not concur that the activity would be permissible without registering the Northern Trust CIF's as securities. The 1989 SEC No-Action letters to Northern Trust Corporation (Northern Trust I and Northern Trust II) are located in Appendix G.

Consequently, even where permissible under local law and the governing document, banks should not invest customer funds in non-affiliated bank CIF's or accept investments from non-affiliated bank CIF's. Banks wishing to do so should be advised to first seek an SEC No-Action ruling on the proposed activity. Failure to obtain such a ruling could result in an SEC enforcement action, fines, and losses to the participating accounts, which would

inevitably be borne by the bank.

J. CIF's investing in CIF's within the same department

The OCC has permitted CIF's to be invested in other CIF's operated by the same department. Investing equity or fixed income fund cash awaiting permanent investment in a short term investment fund (STIF) would be a practical use of this provision. This is not the only application, and there is no limitation on which funds can take advantage of the provision.

K. Proprietary Mutual Funds

K.1. Considerations When Engaging in Mutual Fund Activity

There are numerous regulatory and costly administrative burdens associated with the operation of a proprietary mutual fund. The operation of a mutual fund requires knowledge of SEC and IRC rules and regulations. Furthermore, banks have the added burden of complying with applicable banking laws. Strong management oversight is required. Since a large volume of activity is required to effectively operate a fund and there is the potential for the receipt of lucrative fees, banks operating proprietary mutual funds must address a number of potentially abusive conflicts of interest.

Examples of the general considerations involved in operating a mutual fund:

- Mutual funds must be registered with the SEC, as both a security under the Securities Act of 1933, and as a mutual fund (mutual funds are investment companies under Federal securities laws) under the Investment Company Act of 1940.
- To operate on a tax-exempt basis and pass all income and capital gains through to investors, mutual funds must also comply with various tax laws, including Subchapter M of the Internal Revenue Code.
- The mutual fund would be organized under a trust and the bank (or related organization) would be trustee.
- State law would govern the establishment of trust.
- To be economically viable, a mutual fund must obtain a critical mass of assets to realize the necessary economies of scale.
- To profitably offer such products, the mutual fund sponsors must be compensated through a sufficient volume of business (generally portfolio size rather than number of investors).

Banks may act in a number of capacities for any mutual fund, including: custodian, transfer agent, and, investment adviser or investment manager. Each of these activities has its own unique risks and may expose the bank to different conflicts of interest. Also, the Gramm-Leach-Bliley Act (GLBA) of 1999 permits banks to engage in previously prohibited securities related activities, such as underwriting. A greater range of potential activities also increases the potential for conflicts of interest.

Refer to Appendix D discussion of Applicability of Federal Securities Laws to Banks and Bank Sponsored Securities Activities for specific requirements that would be applicable to proprietary mutual fund activities. Specific subsections include Bank as Investment Advisor, Bank as Investment Company, and Collective Trust Funds. Non-bank subsidiaries must, however, register with the SEC, if they engage in any of these activities.

State law may require registration as a custodian, investment advisor, or any other securities activities. FDIC regulated banks acting as mutual fund transfer agents must register and comply with Part 341 of the FDIC's Rules and Regulations.

K.2. Structure of Bank Financial Activities Under the Gramm-Leach-Bliley Act of 1999 (GLBA)

Effective March 12, 2000, the GLBA repealed Section 20 of the Banking Act of 1933. Banks may now underwrite and distribute proprietary and third-party mutual funds. This activity must be done through one of the following entities:

- Financial Holding Company (FHC). A FHC may engage in any activity and may acquire and retain shares of any company engaged in any activity that is determined by the Federal Reserve Board to be "financial in nature" or "incidental" to such financial activity. Or, a FHC may engage in an activity that is complementary to a financial activity and does not pose a substantial risk to the soundness of the financial institution. Activities that are financial in nature include providing financial, investment and economic advisory services, including advising an investment company. It also includes underwriting, dealing in, or making a market in securities (Section 4(k)(4) of the Bank Holding Company Act of 1956).

  A FHC that acquires any company or commences any of the above activities shall provide to the Federal Reserve Board written notice describing the activity conducted by the FHC. Notice must be provided not later than 30 calendar days after commencing the activity.

  A "bank holding company" is also allowed to engage in the "expanded financial activities" of a FHC. However, there are minimum capital, management, and community reinvestment standards that must be met. Also, this requires pre-notification to the Federal Reserve Board. Specific details are found in Section 4(l) of the Bank Holding Company Act. The entire Bank Holding Company Act text is located in the FDIC's Laws, Regulations and Related Acts.

- Financial Subsidiary. The activities that may be conducted by a subsidiary of a national bank have also been revised. A national bank may control a "financial subsidiary", or hold an interest in one, only if the subsidiary engages in activities that are financial in nature or incidental to a financial activity. Activities that are financial in nature include those described in the FHC subheading, above.

The GLBA added Section 46 to the Federal Deposit Insurance Act (FDI Act) to govern financial subsidiaries of state banks. Under the final rule, the FDIC adopted a streamlined certification process for insured state nonmember banks to follow before they may conduct activities as principal through a financial subsidiary. State nonmember banks self-certify that they meet the requirements for carrying out these activities. The self-certification process allows banks to conduct the new activities immediately. There is be no delay for administrative approval or review, although the FDIC continues to evaluate these activities as part of the normal supervisory process.

To commence financial subsidiary activities under Section 46(a), the insured state nonmember bank must certify that it is well-managed; that it and all of its insured depository institution affiliates are well-capitalized; and that the insured state nonmember bank is in compliance with the capital deduction requirement. In addition, an insured state nonmember bank may not commence any new activity under Section 46(a), or directly or indirectly acquire control of a company engaged in any such activity, if the bank or any of its insured depository institution affiliates received a rating of less than satisfactory in its most recent CRA examination. Any insured state nonmember bank controlling or holding an interest in a financial subsidiary also must comply with Sections 23A and 23B of the Federal Reserve Act, as amended by the GLBA and meet the financial and operational safeguards required by Section 5136A(d) of the Revised Statutes of the United States (12 U.S.C. 24a(d)), unless otherwise determined by the FDIC.

If the financial subsidiary of the insured state nonmember bank engages in the public sale, distribution or underwriting of stocks, bonds, debentures, notes, or other securities activity of a type permissible for a national bank solely through a financial subsidiary, the state nonmember bank and the financial subsidiary must comply with certain provisions requiring the separation of the financial subsidiary from the bank. These provisions require that the financial subsidiary be physically separate and distinct in its operations from the operations of the bank; that the financial subsidiary conduct its securities business pursuant to independent policies and procedures designed to inform customers and prospective customers of the financial subsidiary that the financial subsidiary is a separate organization from the insured state nonmember bank and that the insured state nonmember bank is not responsible for and does not guarantee the obligations of the financial subsidiary. In addition, the bank must adopt policies and procedures, including

appropriate limits on exposure, to govern its participation in financing transactions underwritten by its financial subsidiary. Further, the bank may not express an opinion on the value or the advisability of the purchase or sale of securities underwritten or dealt in by its financial subsidiary, unless the bank notifies the customer that the entity underwriting, making a market, distributing or dealing in the securities is a financial subsidiary of the bank.

The mutual fund, as a registered investment company under the Investment Company Act of 1940, would be under the supervision of the SEC. The SEC is required to share its supervisory findings with Federal banking agencies, upon request, and does not limit the FDIC's examining authority of affiliates as outline in Section 10(b)(4) of the Federal Deposit Insurance Act.

K.3. Investment Company Act of 1940

The Investment Company Act of 1940 (1940 Act) governs the activities of companies principally engaged in the business of investing, reinvesting, and trading securities, and whose own securities are held by the public. Mutual funds and other registered investment companies are subject to SEC operational regulations designed to protect the interests of investors and the public. The Act prohibits such companies from changing the nature of their business, or their investment policies, without the approval of their shareholders.

Among the most significant sections of the Investment Company Act of 1940 are the following:

- Section 9 bars persons convicted of securities fraud within the past 10 years from serving as officers or directors;
- Section 10 prevents underwriters, investment bankers or brokers from constituting more than a minority of such companies' board of directors;
- Section 13 prohibits such companies from changing the nature of their business or their investment policies without the approval of holders of a majority of their voting securities;
- Section 15 requires that management contracts (and material changes thereto) be approved by a majority of the holders of outstanding voting securities of such registered company;
- Section 17 prohibits transactions between such registered companies and their directors, officers, affiliated companies, principal underwriters, and promoters, except where the SEC grants an exemption based on a finding of the fairness of such transactions and no overreaching by the parties. It also identifies a bank as one of the acceptable custodians for a registered investment company. The GLBA amended Section 17(a) to allow loans from affiliates to mutual funds (effective May 12, 2001). The amendment is especially important to banks offering proprietary mutual funds. The original Section 17(a) prohibited affiliates from selling, purchasing, or borrowing money or property from mutual funds, but did not cover loans from affiliates to mutual funds. In addition, the SEC interpreted Section 18(f) of the 1940 Act to prohibit mutual funds from borrowing money except from a bank. The borrowing limit is one-third of the assets of the fund. Under the current regulations this could pose potential problems for banks offering proprietary mutual funds. The GLBA amended Section 17(f), custody of securities, to allow for a bank or its affiliates to serve as a custodian for proprietary mutual funds (registered investment companies).
- Section 18 prohibits registered "closed-end" investment companies from issuing senior securities, except under conditions and terms specified in that Section; and
- Section 20 prohibits "circular ownership" of such investment companies and "cross-ownership" of their securities under the terms listed in Section 20(c).
- Included among other provisions of the Investment Company Act are sections involving sales and repurchases of securities issued by investment companies (Section 22), periodic payment plans (Section 27), and face-amount certificate

companies (Section 28). Also, the GLBA allows a bank or its affiliate to serve as a custodian for a proprietary "unit investment trust" (Section 26).

L. Conversion of CIF's to Mutual Funds

L.1. General Overview

Competitive pressures and changing securities laws contribute to banks converting CIF's into proprietary mutual funds. The banking industry has long taken the position that mutual funds offer greater advantages to both the bank and trust beneficiaries. But there are also risks, such as abusive conflicts of interest and increased reputational risk.

- One of the **incentives for converting** a CIF to a proprietary mutual fund is purely financial. There is a lucrative array of fees available under a mutual fund arrangement that is not available from bank sponsored CIF's. However, the desire for increased revenue must not take precedence over the fiduciary responsibility of the bank. Such a conflict must be resolved in favor of the account beneficiaries. If the desire for financial reward is dominant, the conflict could become abusive.
- One of the **potential disadvantages** to a bank is the public availability of the proprietary mutual fund's performance - a factor not generally confronted with CIF's. If a proprietary mutual fund performs poorly over an extended period of time, the bank's reputation may be harmed, especially if the poor performance continues without appropriate corrective action.

Conversions of existing CIF's to mutual funds typically take one of two forms. In both cases, the CIF terminates activity and is replaced by the mutual fund operation. The first type involves the liquidation-to-cash of a CIF's assets, with a simultaneous rollover of the cash proceeds into a mutual fund. The second type involves a one-time "in-kind" transfer of assets at market value from a CIF to a mutual fund.

Mutual funds may be sponsored by a non-bank affiliate of a state nonmember bank. However, they are currently predominantly sponsored by a non-affiliated third party institution (including mutual fund companies and brokerage houses). In either case, the bank usually provides investment advisory, custodial, transfer agent, and other fee related services to the fund.

L.2. Tax Considerations of Conversion

L.2.a. Common Trust Fund Conversions

Prior to 1996, the conversion of common trust funds established for personal trust accounts was treated as a taxable transaction under the IRC. Years of lobbying Congress to enable a tax-free "in-kind" transfer were finally successful in August 1996, when IRC Section 584 was amended by Section 1805 of the "Small Business Job Protection Act of 1996". This legislation added new paragraph IRC Section 584(h), which permits tax-free conversions of Personal Trust CIF's (A-1 Funds). The conversion can be into one or more mutual funds. The basis of the mutual fund shares distributed to participant trusts must be equal to the basis of the common trust fund interests exchanged. In the event that the conversion involves more than one mutual fund, the basis of the common trust fund interests exchanged should be allocated proportionately to the mutual fund shares received. The amendment was effective for transfers after December 31, 1995.

This amendment makes the conversion tax-free for Federal taxation purposes only. Therefore, there may be remaining state income tax consequences. There are also accounting and other tax issues related to the rebating of fees, the amortization of bond premiums, and capital gain distributions, to name a few, that must be considered in conjunction with the conversion decision.

A copy of the 1996 amendment to IRC Section 584 is located in Appendix G.

L.2.b. Collective Investment Fund Conversion

Conversions of collective investment funds maintained for employee benefit accounts subject to ERISA do not face the same tax problems as those faced by common trust funds. Tax relief is granted because, although conversion is a taxable event, the participants can only be tax-exempt entities and, therefore, no tax liability is incurred.

L.3. Supervisory Concerns of Conversion

The board of directors should specifically authorize or ratify the conversion of a CIF to a mutual fund. The advice of qualified legal counsel experienced in securities laws and fiduciary matters should be obtained to ensure that the conversion complies with all applicable laws and fiduciary obligations. The qualifications of the firms and individuals providing legal counsel should be documented and retained to support the adequacy of the decision-making process. At a minimum, the conversion decision-making process should address the following issues:

Fiduciary issues:

a. The board's due diligence process should include a review of (1) customers' needs and how the conversion meets these needs, (2) any potential legal and other risks, (3) a stated reason to support the conversion, and (4) a method for obtaining customer approval (see points (c) and (d) below).

b. The bank should address all related fiduciary issues in its written policies, including conflict of interest issues concerning the need for, and prudence of, converting CIF's into mutual funds, and the reasonableness of the ongoing investment.

   Internal policy should require investments in proprietary funds to be evaluated on the same basis as any other investment product and proprietary funds should meet a bank's own minimum investment selection standards.

   There is an additional concern when banks operate both proprietary mutual funds and CIF's. The investment of trust accounts in proprietary mutual funds that under perform own bank CIF's is troubling, since banks that operate proprietary mutual funds have additional monetary incentives (which are unavailable in CIF's) to invest trust accounts in the funds. In such cases, the fiduciary should document the rationale for investing trust accounts in proprietary mutual funds when CIF's with similar or identical investment objectives and strategies are available.

   Even when permitted by statute, these transactions should be made in good faith. The fact that such investments are allowed (permissive authority) does not relieve the fiduciary of its "duty of care and skill" in the investment selection process. A failure to properly address all conflict of interest and investment prudence issues casts doubt on whether the fiduciary has satisfied the traditional fiduciary duty of undivided loyalty, and could lead to litigation and loss.

c. When necessary under local law or the governing instrument, banks should obtain the consent of CIF participants to convert their CIF units into mutual funds. Under IRC Section 584(h), "substantially all" (which was undefined at the time of this writing) CIF assets must be transferred into the mutual fund.

d. Accounts not participating in the conversion due to customer non-consent, prohibition within governing instruments, or prohibition under local law, should be provided reasonable investment alternatives consistent with the governing account instrument.

e. Investment in the mutual fund should also meet the tests of loyalty and prudent investment management.

One such test is to compare the consistency of the mutual fund's investment objectives with the governing instruments of the accounts converted. When converting from a CIF to a mutual fund the investment objective could change, and what was once a suitable investment for an account may become inappropriate. Another consideration is when a proprietary mutual fund's performance lags comparable, but unaffiliated, alternative investments.

Refer to Subsection F.4.a of Section 3 for additional guidance regarding proprietary mutual fund investments.

Regulatory issues:

a. Where required, the bank should: (1) obtain the consent of its State regulatory supervisor to convert CIF's into mutual funds, and/or (2) provide it formal pre-conversion notification. At the time of this writing, institutions supervised by the FDIC, FRB, and OCC were not required to obtain the consent of state authorities or notify state authorities of planned CIF conversions.

b. The bank should comply with all securities law requirements, including the registration of the mutual fund. If a bank subsidiary is involved in operating a mutual fund, it should also register as an investment adviser and, as needed, as a broker/dealer, in addition to the mutual fund registration.

c. The bank should determine whether it is permitted to receive both fiduciary fees and proprietary mutual fund servicing fees under local law and the governing instruments. Fiduciary fees and mutual fund servicing fees should be reasonable, and consistent with local law and the governing instrument.

   One of the more complex issues involving the operation of proprietary mutual funds is the charging of fees. Virtually all states have enacted statutes expressly authorizing a bank fiduciary to invest trust assets in the shares of a mutual fund for which the bank, or affiliate, performs services and receives reasonable compensation. Some states require that the fiduciary offset its mutual fund fee or its trust administration fees by an amount that corresponds to the bank's compensation for performing investment advisory and/or other services for the mutual fund. If permitted to receive fees for both trust fiduciary services and for the services performed for the proprietary mutual fund, all fees should be reasonable and disclosed to the customer, especially upon the conversion of a common trust fund to a mutual fund. There may also be other state requirements regarding disclosures, as well as investment restrictions.

d. The bank should provide participating accounts an initial prospectus of the mutual fund, and all necessary disclosures under Federal and State securities and banking laws. Participating accounts should continue to receive any prospectus and other disclosures required under these laws.

L.4. ERISA Considerations of Conversion

The conversion of a CIF to a mutual fund does cause ERISA concerns - in particular problems related to the prohibited transactions restrictions in Section 406 of ERISA. Section 406(a) of ERISA prohibits transactions between a plan and a party-in-interest. Section 406(b) prohibits transactions between a plan and a fiduciary with respect to a plan. Therefore, whenever plan assets are transferred to a mutual fund to which a fiduciary or party-in-interest provides services, or whenever a fiduciary or party-in-interest receives compensation as a result of a plan's investment in a mutual fund, the prohibited transaction rules should be considered.

There are two outstanding ERISA class exemptions to help guide such conversion activity.

1. Cash-to-Cash - Pursuant to Section 408 of ERISA, the Department of Labor issued Prohibited Transaction Class Exemption (PTE) 77-4 which provides an exemption from the prohibited transaction rules of ERISA, and the Internal Revenue Code, for the purchase of shares of a mutual fund for which the bank or its affiliates act as investment advisor. In applying PTE 77-4, the DOL requires banks to: (1) obtain the approval of an independent fiduciary, (2) provide disclosures to participating accounts, (3) obtain written consent for the conversion, and (3) adjust fees to ensure a double fee is not charged to accounts invested in proprietary mutual funds. These are in addition to the general supervisory concerns addressed in Subsection L.3. In Advisory Opinion 94-35, the DOL interpreted class exemption PTE 77-4 to apply only to "cash" (cash-to-cash) conversions which liquidate CIF assets and purchase shares of the mutual fund with the proceeds from the liquidation. In other words, the prohibited transaction exemption would not be applicable to conversions of "in kind" (asset to asset) transfers.

2. In-kind - Pursuant to Section 408 of ERISA, the Department of Labor issued PTE 97-41, which permits an employee benefit plan (the Client Plan) to purchase shares of a registered investment company (the Fund) that also serves as a fiduciary of the Client Plan. The investment advisor for the Fund may be a bank or plan advisor registered under the Investment Advisors Act of 1940. The exemption pertains to the exchange for plan assets transferred in-kind to the Fund from a CIF maintained by the Bank or Plan Advisor. It involves a complete withdrawal of a Client Plan's assets from the CIF.

   In applying PTE 97-41, the DOL requires banks to follow minimum guidelines. Additional information is found in Section 5 of the manual, Subsection H.7.f(10). These are in addition to the general supervisory concerns addressed in Subsection L.3.

The failure to convert the CIF within the confines of the proper exemption generally results in the purchase of proprietary mutual fund shares being considered a prohibited transaction under Section 406 of ERISA.

M. Mutual Fund and CIF Merger Rules

Sections 17(a)(1) and (2) of the Investment Company Act of 1940 restrict merger activities of registered mutual funds with affiliated funds (registered mutual funds or unregistered CIF's). To provide guidance in this area, the SEC issued Rule 17a-8, Mergers of Affiliated Companies (17 CFR 270.17a-8).

M.1. SEC Rule 17a-8

SEC Rule 17a-8, Mergers of Affiliated Companies permitted the merger of affiliated funds, if the funds were affiliated solely because they had common investment advisers, officers, and/or directors. However, the SEC expanded Rule 17a-8 in 2002 to include all affiliated funds regardless of the nature of their affiliation. In addition, the amended rule provides an updated set of requirements that need to be met in order to qualify for Sections 17(a)(1) and (2)exclusion. Mergers that do not meet Rule 17a-8 must be presented to the SEC for review on a case-by-case basis.

The purpose of the change was to expand the scope of Rule 17a-8 to more funds and thereby reduce the burden of obtaining Commission approval for mergers that presented little risk of overreaching.

SEC Rule 17a-8 governs mergers between affiliated mutual funds and also mergers between mutual funds and unregistered bank CIF's. The updated rule provides the following:

Board review

Mutual fund boards must thoroughly review merger transactions and their terms. Each mutual fund's board - including a majority of disinterested directors - must determine that the merger is in the best interests of the

mutual fund and will not dilute the interests of shareholders. Directors must request and evaluate any information reasonably necessary to their determinations, and give appropriate weight to all pertinent factors in making their findings under the rule, and in fulfilling the overall duty of care they owe to the fund's shareholders. According to the SEC, in making their determination, boards should consider relevant factors including:

- Any fees or expenses that will be borne directly or indirectly by the fund in connection with the merger;
- Any effect of the merger on annual fund operating expenses and shareholder fees and services;
- Any change in the fund's investment objectives, restrictions, and policies that will result from the merger; and
- Any direct or indirect federal income tax consequences of the merger to fund shareholders.

Shareholder approval

The acquired fund must have shareholder approval, if the merger materially alters the investment held by the fund shareholders.

SEC Rule 17a-8 as amended, requires a majority of the shareholders of the acquired fund to approve the merger if:

- Any policy of the acquired fund that under Section 13 of the Exchange Act could not be changed without a vote of a majority of its outstanding voting securities is materially different from a policy of the acquiring fund;
- The acquiring fund's advisory contract is materially different from that of the acquired fund, except for the identity of the funds as parties to the contract;
- After the merger, directors of the acquired fund who are not interested persons of the acquired fund and who were elected by its shareholders will not comprise a majority of the directors of the acquiring fund who are not interested persons of the acquiring fund; or
- After the merger, the acquiring fund will be authorized to pay charges under a plan that provides for use of fund assets for distribution ("rule 12b-1 plan") that are greater than charges authorized to be paid by the acquired fund under such a plan.

Unregistered CIF

Rule 17a-8 was expanded to permit mutual funds to merge with affiliated CIF's, provided that the survivor is a registered investment company. The SEC had written no-action letters to mutual funds seeking to merge with CIF's. When the SEC revised Rule 17a-8, it warned that mutual funds engaging in mergers on or after the compliance date of the final rule (October 25, 2002) should not rely on the no-action letters, but must either comply with the final rule or obtain an exemption from the SEC.

The SEC also requires that the board of directors of a mutual fund that merges with a CIF, in making its determination that the interests of the fund's shareholders will not be diluted as a result of the merger, approve the procedures for valuation of the securities (or other assets) that the unregistered entity will convey to the fund. These procedures must provide for the preparation of a report by an independent evaluator that sets forth the fair market value of the assets for which market quotations are not readily available. The independent evaluator's report must be included in the records of the merger.

Record Retention

Rule 17a-8 contains a requirement that each investment company that survives the merger preserve written records that document the merger and its terms. The records must include, among other things, the minute books setting forth the determinations of the funds' boards and the bases for those determinations, any

supporting documents provided to the directors in connection with the merger, and documentation of the prices at which securities were transferred in the merger.

The recordkeeping requirement ensures that examiners have adequate information to assess the merging funds' compliance with the rule.

N. Other Pooled Investment Vehicles

Below are examples of other types of pooled investment vehicles. The information presented is generic, since each institution can design the product to meet the needs of its clients.

N.1. Master Deposit Accounts

A master deposit account is a single interest-bearing deposit account in which the temporary funds of individual trust accounts are commingled. The master deposit account is often a money market deposit account of the fiduciary institution. Only deposits are involved, no other types of assets are held in a master deposit account. The number of trust accounts invested in and the balance of the master deposit account may vary from day-to-day. This is not a common or collective investment fund. The concerns with a master deposit account include, management's ability to:

- identify the amount of funds attributable to each trust account invested in the master deposit account,
- ensure that the funds of each trust account is not left in the master deposit account as a long term investment,
- determine how FDIC insurance applies to the trust account invested in the master deposit account, and
- identify conflicts of interest.

N.2. Wrap Accounts, Also Known as Asset Allocation Programs

This may be considered a pooled investment vehicle, even though assets of individual accounts are not necessarily pooled. By definition, these are accounts where a money manager (trust department) invests and manages a group of investments for a set annual fee. The term wrap comes from the idea that the customer pays a single fee for services, rather than a fee for individual trades. The fee may be a flat fee or based upon the market value of the individual account. There are two general types of wrap accounts - "traditional", comprised of a combination of securities in order to achieve a specific investment goal, and "mutual fund", comprised of a combination of mutual funds in order to achieve a specific investment goal. In a wrap account, a customer's funds are invested according to pre-established guidelines, often in the form of an asset allocation model.

For example, a client's objective may be aggressive growth and the institution has developed an asset allocation program using mutual funds or stocks to achieve this objective. The model is periodically adjusted. When the model is adjusted the client's holdings are automatically adjusted to match the model.

The pooling aspect occurs because there are a number of accounts in the program. Since all of the accounts invested in the program are adjusted at the same time, it may appear that management has created a nonregistered mutual fund made up of discretionary accounts. The appearance is further enhanced if the customer does not have the ability to adjust the investment mix, or if the wrap account agreement delegates full investment authority to the fiduciary.

Many departments employ asset allocation models to administer the majority of their discretionary trusts in order to gain economies of scale in asset management. The mere existence of asset allocation models does not indicate that the department is offering wrap accounts and could therefore be operating a nonregistered mutual fund.

SEC regulation 270.3a-4 provides guidance on wrap accounts and a "non-exclusive" safe harbor against inadvertently operating a nonregistered mutual fund.

Key provisions of the safe harbor include:

- provisions for individualized management of client accounts
- specific initial and ongoing client contact
- the ability of the client to impose reasonable restrictions on investments
- quarterly account statements
- client retention of ownership of the securities

If the provisions are met such accounts offered by the department will not be deemed a mutual fund. There are also exceptions if all provisions of the "non-exclusive" safe harbor are not met.

N.3. Private Equity Fund of Funds

A private equity fund of funds typically invests directly in private companies in one of several formats. A fund of funds is a general partnership that aggregates investor capital and provides professional selection and management of a portfolio of private equity funds. The formats include venture capital, buyouts, and mezzanine investments. Each fund will have its own investment objective, like a mutual fund, and a fund manager. Individuals often choose these funds when they want to passively invest in private equities.

Most private equity funds are not registered with the SEC under the Investment Company Act of 1940 (1940 Act). They are exempt from registering under the 1940 Act provided they meet specific restrictions. The exemptions from registration are found in Sections 3(c)(1) 100-Person Fund and 3(c)(7)-Qualified Purchaser Fund of the 1940 Act.

- The 100-Person fund is limited to 100 or fewer beneficial owners (partners) and may not be made available to the general public. One of the beneficial owners will be the general partner, for example the bank, and the remaining will be limited partners. It is also limited to "accredited investors". An "accredited investors" is generally defined as a person having a net worth of at least $1 million or income for two years of at least $200,000. Even though not required to register under the 1940 Act, the private equity fund is still subject to the Act's limitation on performance-based compensation (fees) does apply.

- The Qualified-Purchaser fund does not have the 100-person limit, but may only be purchased by "qualified purchasers" and may not be made available to the general public. Generally, the term "qualified" means an individual or married couple having at least $5 million in investments. Certain trusts, even with smaller amounts under management, may also invest, provided that investments are made by a "qualified purchaser" and the trust was not formed for the purpose of participating in the fund. This fund type is limited to 500 partners.

In 1999, the SEC issued guidance on a number of issues involving Sections 3(c)(1), 3(c)(7), and 2(a)(51)(A) of the 1940 Act. The SEC Letter Regarding Private Investment Companies (Private Collective Funds) under ICA of 1940 is located in Appendix G.

N.4. Bank Managed "Pooled Income Funds" Organized by Outside Organizations

"Pooled Income Funds" are defined under IRC Sections 642(c)(3) and 642(c)(5). These pooled funds consist of charitable gifts from donors which are maintained in a commingled investment fund by organizations described in IRC Section 170(b)(1)(A), including churches, educational institutions, hospitals, etc. The securities law exemptions for these funds are contained in: Section 3(a)(4) of the Securities Act of 1933, Section 3(a)(12)(A)(v) of the Securities Exchange Act of 1934, and Section 3(c)(10)(B) of the Investment Company Act of 1940.

Banks may be appointed as administrator or investment manager for these funds. The funds are not treated as bank CIF's under Federal tax and securities laws, nor operated under CIF requirements. Banks should not operate "Pooled Income Funds" as their own CIF's. To be operated in compliance with, and fall under the exemptions of, Federal tax and securities laws, these funds must be established, sponsored, and held in trust by the outside organization under a written governing instrument. Banks may, however, "manage" the portfolios of the pooled funds for outside organizations in the capacities of

administrator, investment advisor, or investment manager.

An assessment of the management of "Pooled Income Funds" typically includes a

1. determination of management's familiarity with applicable laws,

2. review of the fund's governing documents and management's conformance with applicable provisions,

3. review of documentation attesting to the charitable organization's qualification under IRC 501(a) and/or its authority to offer the funds under IRC Section 170(b)(1)(A), and

4. review of the organization's corporate authority, or bylaws, enabling it to establish such a fund.

Banks lacking such documentation, or awareness of applicable laws, should be advised to obtain the documentation and seek qualified counsel. As with all other fiduciary matters, banks lacking expertise should be cautioned against continuing to offer these services until they obtain ample working knowledge of the product offered.

N.5. Regulation D Exempted Securities Offerings

[Rules Governing the Offer and Sale of Securities Without Registration Under the Securities Act of 1933 (the Act)]

The SEC adopted Regulation D under the Securities Act of 1933 (17 C.F.R. 230.501 to 508) to facilitate the application of both the nonpublic offering exemption under Section 4(2) of the Act, and the "small offering" exemption under Section 3(b) of the Act. Regulation D (described in more detail below) is intended to be a basic element in a uniform system of Federal and State limited offering exemptions consistent with the provisions of Sections 18 and 19(c) of the Act (involving state jurisdiction over securities transactions, and Federal and State coordinated regulation). In those states that have adopted Regulation D, or any version of it, compliance with state law is also required.

Regulation D affords banks the opportunity to offer pooled investment funds without having to register the funds as securities under the act. However, banks need to be aware that the funds themselves (1) continue to be viewed as securities by the SEC, and (2) may still come under the definition of a mutual fund ("investment company") under the Investment Company Act of 1940 (1940 Act).

The regulation provides an exemption from the Act's Section 5 securities registration requirements under very specialized circumstances.

- The regulation exempts issuers from registering certain securities offerings. It is available only to the issuer of the securities. It is not available to any affiliate of the issuer, or any other person engaged in selling of the securities. Caution: The exemptions apply only to the transactions in which the securities are offered or sold by the issuer, not to the securities themselves.

- It prohibits the offer or sale of these securities by means of any general solicitation or advertising.

- It limits the resale of the securities without registration. Use of the regulation is not available to any issuer for any chain of transactions which, although technically in compliance with the regulation, is viewed by the SEC as a method or scheme for evading registration under the Act. Issuers which continuously sell investment products under Regulation D, and which establish a new investment product each time the current product reaches regulatory limits, may be viewed by the SEC as evading securities registration laws.

Securities offered and sold outside the U.S. in accordance with Regulation S (17 C.F.R. 230.901 to 904 - rules governing securities transactions made outside the U.S.) do not have to be registered under the Act. Transactions in accordance with Regulation S, even where coincident with Regulation D transactions, are not counted towards the number of

purchasers under Regulation D.

Properly applied, Regulation D permits securities issuers (including banks) to issue a security which:

1. does not have to be registered under Federal securities laws, and
2. does not have to be established and operated as a Regulation 9.18 CIF.

Therefore, some banks have used the exemptions afforded under Regulation D to collectively invest accounts which would not otherwise be permissibly invested in Regulation 9.18 CIF's, including, but not limited to, agency accounts and IRAs.

To avoid both securities registration and mutual fund treatment under Federal securities laws, Regulation D must be applied in concert with investment company exemptions allowed under Section 3(c)(1) of the 1940 Act:

- For purposes of the exemption categories in SEC Rule 505 (limited offers and sales of securities not exceeding $5 million) and Rule 506 (limited offers and sales without regard to the dollar amount of offering), Regulation D limits ownership to 35 investors plus an unlimited number of "Accredited Investors".
- Section 3(c)(1) of the 1940 Act limits ownership to 100 investors.
- Therefore, banks wishing to avail themselves of these exemptions must limit investors to no more than 100, with no more than 35 of that number being non "Accredited Investors."

In addition to restrictions on the number and sophistication of investors, Regulation D imposes numerous restrictions and requirements upon the issuer. Fluency with: Federal securities laws, current and past SEC positions on securities and mutual fund exemptions, Internal Revenue Code exemptions relating to pooled funds, trusts, and qualified employee benefit plans, Regulation 9.18, and applicable local securities and tax laws, is of paramount importance for any potential issuer of securities under these regulations.

The operation of such investment products requires a high degree of technical sophistication. Consequently, examiners encountering investment pools that have purportedly been established under Regulation D should review the following:

- Management's due diligence analysis of the product. Banks that have not performed a due diligence analysis should be cautioned.
- Outstanding legal opinions. Prior to establishing such funds, bank management should seek and obtain the written advice of qualified securities counsel. Examiners should recommend that management obtain a legal opinion from counsel familiar with such matters before selling additional participations in existing funds and before creating any additional funds.
- SEC No-Action Letter. Only by obtaining a letter can management be certain that their product conforms to Federal securities law requirements and meets with SEC approval.

Failure to comply with Federal securities laws may result in fines and other enforcement action by the SEC. Further, failure to qualify under both securities and tax laws could result in significant monetary losses to the fund, its investors, and ultimately, the bank.

O. Bank as Investment Adviser to CIF's and Mutual Funds

O.1. Interagency Policy Statement

font face="arial, helvetica, sans-serif" size="2">A bank may serve as the investment advisor for affiliated or non-affiliated pooled investment vehicles (CIF's, mutual funds, or other pooled investments). If a bank is advising registered mutual funds, the bank must register and comply with the Investment Advisors Act of 1940. Additional information is provided in Appendix D, Bank as Investment Adviser.

Transactions between a bank and its advised funds are restricted by the following regulations: 23A and 23B of the Federal Reserve Act, OCC Regulation 9, the Investment Company Act of 1940, the Investment Advisors Act of 1940, and ERISA. The regulatory restrictions and prohibited transactions address conflict of interest and self-dealing.

On January 5, 2004, The Federal Bank Regulatory Agencies issued a joint Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates. The purpose of the Policy Statement was to alert bank directorate and management to the safety and soundness implications and legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries or affiliates. The Policy Statement was issued in response to the elevated market volatility risk, credit risk, and interest rate risk present in advising money market mutual funds and other investment funds. The Policy Statement, located in Appendix G, provides risk management policy and procedural guidance for bank investment advisory activities.

P. Overview of Federal Laws

The operation of bank's pooled investment vehicles is directly linked to Federal securities, internal revenue, and banking laws. Failure to operate in conformity with the laws may jeopardize or cause the loss of securities and/or tax-exemptions to the collective fund or other pooled investment, its units of participation and, ultimately, its investors (trust accounts). Any losses sustained by investors by reason of a bank's failure to comply with these laws, whether through negligence or incompetence, would be the responsibility of the bank, both as a fiduciary, and as the issuer and operator of the pooled investment vehicle. Excerpts and summaries of some of the major applicable Federal securities and tax laws, regulations, and rulings follow.

P.1. Federal Securities Law

Federal securities laws empower the SEC to investigate any person or institution, including banks, suspected of violating Federal securities laws and SEC rules and regulations. The SEC has the authority to issue cease and desist orders, bring action in Federal courts to issue injunctions, impose monetary penalties on securities laws violators, and to bar individuals from serving as officers or directors of public companies. The SEC also has the authority to revoke licenses and impose civil money penalties in administrative proceedings against broker/dealers, municipal securities broker/dealers, government securities broker/dealers, transfer agents, and clearing agencies. Failure to adhere to Federal securities laws governing the operation of common trust funds, and tax and banking laws tied to securities law compliance, may not only result in the loss of a fund's exempt status under these laws, but also fines and censures against banks and bank officers administering the funds.

P.1.a Securities Act of 1933 (1933 Act):

One of the primary purposes of the Securities Act of 1933 (1933 Act) is the regulation of interstate securities transactions. The 1933 Act accomplishes this by: defining what constitutes a security; requiring the registration and regulation of securities; and, regulating interstate securities transactions. Unless a specific exemption is available, a "security" must be registered under the 1933 Act. Among other types of investments, a mutual fund, or the sale of participations in a pooled portfolio of investments, is regulated as a "security."

Section 3(a)(2)	Exempted Securities
	Section 3(a)(2) [Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts] Funds maintained by a bank for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian.

_Section 3(a)(2)(A)
[Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans]
Funds maintained by a bank which interest is issued in connection with a stock bonus, pension, or profit sharing plan, which meets the requirements for qualification under Section 401 of the IRC.

_Section 3(a)(2)(C)(ii)
[Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans]
Funds, exempted by the Commission, which interest is issued in connection with a stock bonus, pension, or profit sharing plan which covers employees who are employees within the meaning of Section 401(c) of the IRC.

_Section 3(a)(4) Exempted Security

[Non-Bank-Operated Commingled Investment Funds]
"Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

_Section 3(a)(11) Intrastate Exemption

[Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans]
Intrastate exemption for securities sold only to persons of a single state by an issuer incorporated and doing business in the same state.

_Section 3(b) Small Offering Exemption

SEC jurisdiction for ruling on securities registration exemptions for issues not exceeding $5,000,000.

_Section 4(2) Exempted Transactions

Securities registration exemption for transactions by an issuer not involving any public offering.

_Section 5 Registered Securities

Registration requirement for securities sold interstate.

_Section 18 State Jurisdiction Over Securities Transactions

Affirmation of state jurisdiction over securities and persons involved in securities transactions (preserving so-called "Blue Sky" laws

supervising securities broker/dealers, and securities transactions at the state level).

Section 19(c) Coordination of Federal and State Securities Regulation

Declaration of policy to cooperate and coordinate securities regulation with state authorities.

P.1.b. SEC Rule 180 (Sophisticated Investor Rule) under the 1933 Act :
17 C.F.R. 230.180 SEC Rule 180 provides what is often termed the "sophisticated investor" exemption for Keogh accounts. To qualify, the employer (plan sponsor):

a. must be a law firm, accounting firm, investment banking firm, pension consulting firm, or investment advisory firm, the nature of whose business requires a familiarity with financial matters which would reasonably be expected to permit the employer to adequately represent its employees, or

b. must obtain expert financial advice before adopting the plan from an entity which is independent of the bank operating the CIF.

In addition, to qualify for the exemption, the Keogh plan must only cover employees of a single employer or employees of interrelated partnerships. For more information, refer to Keogh Account information in Section H.2 and Appendix G, 17 C.F.R. Section 230.180- "Sophisticated Investor Rule".

P.1.c. Regulation D under the 1933 Act:
17 C.F.R. 230.501 to 508 : Regulation D
[Summary of Rules Governing the Offer and Sale of Securities Without Registration Under the Securities Act of 1933]

The rule provides exemption from Section 5 securities registration requirements for issuers of small nonpublic offerings. It also prohibits the offer or sale of securities by means of any general solicitation or advertising, and provides for limited resale of the securities (by the issuers) without registration.

The securities themselves, while exempt from securities registration when offered for sale by the issuer: (1) continue to be viewed as securities by the SEC and (2) may still come under the definition of a mutual fund ("investment company") under the Investment Company Act of 1940 (1940 Act).

To avoid both securities registration and mutual fund treatment under Federal securities laws, Regulation D must be applied in concert with investment company exemptions allowed under the 1940 Act (Section 3(c)(1) of the 1940 Act). More information can on Regulation D can be found in Subsection N.5. Regulation D Exempted Securities Offerings.

For purposes of the exemption categories in SEC Rule 505 (limited offers and sales of securities not exceeding $5 million) and Rule 506 (limited offers and sales without regard to the dollar amount of offering), Regulation D limits ownership to 35 investors plus an unlimited number of "Accredited Investors". However, Section 3(c)(1) of the 1940 Act limits ownership to 100 investors. Therefore, banks wishing to avail themselves of these exemptions must limit investors to no more than 100, with no more than 35 of that number being non "Accredited Investors".

Section 230.504 Exemption for Securities Offerings Not Exceeding $1 million

Section 230.505 Exemption for Securities Offerings Not Exceeding $5 million

Section 230.506 Exemption for Securities Offerings Without Regard to Dollar Amount of Offering

P.1.d. Securities and Exchange Act of 1934:

The Securities Exchange Act of 1934 (1934 Act) regulates the interstate trading of securities in the marketplace. The 1934 Act also provides for ongoing public dissemination of securities disclosures, the regulation and supervision of securities exchanges and marketplaces, and the regulation and supervision of securities brokers and dealers.

Section 3(a)(12) Exempted Securities

Section 3(a)(12)(A)(iii)

[Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts] Funds maintained by a bank for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian.

Section 3(a)(12)(A)(iv) and (C)(i)

[Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans] Funds maintained by a bank which interest is issued in connection with a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under Section 401 of the IRC.

Section 3(a)(12)(C)(iii)

[Collective Investment Funds - 9.18(a)(2) Funds - Government Plans] Funds maintained by

a bank which interest is issued in connection with a governmental plan as defined in Section 414(d) the IRC.

Section 3(a)(12)(C)(iii)(I)

[Collective Investment Funds - 9.18(a)(2) Funds - Keogh Plans] Funds, exempted by the Commission, which interest is issued in connection with a stock bonus, pension, or profit sharing plan which covers employees who are employees within the meaning of Section 401(c) of the IRC.

Section 3(a)(12)(A)(v) Exempted Security

[Non-Bank-Operated Commingled Investment Funds] "Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

P.1.e. Investment Company Act of 1940:

The Investment Company Act of 1940 (1940 Act) provides for the regulation of "investment companies," including mutual funds. Investment companies are issuers of securities which are engaged in the business of investing, trading, and holding securities. The sale of interests in a pool of investments may, under the 1940 Act, require the registration and regulation of the "investment company," or issuer of securities.

Section 3(c) Investment Company Exemption

Section 3(c)(1)

Any issuer whose outstanding securities are beneficially owned by not more than 100 persons, and which refrains from making a public offering of its securities.

Section 3(c)(3)

[Common Trust Funds - 9.18(a)(1) Funds - Personal Trust Accounts]
Any bank which maintains a common trust fund for the investment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator, or guardian.

Section 3(c)(11)(A)

[Collective Investment Funds - 9.18(a)(2) Funds - Employee Benefit Plans]
Any bank which maintains a collective trust fund for the investment of assets which are derived solely from a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under Section 401 of the IRC of 1986, or any governmental plan described in Section 3(a)(2)(C) of the Securities Act of 1933, or both.

Section 3(c)(11)(B)

[Collective Investment Funds - 9.18(a)(2) Funds - Government Plans]
Funds maintained by a bank which interest is issued in connection with a governmental plan as exempted from securities registration by Section 3(a)(2)(C) of the Securities Act of 1933.

Section 3(c)(10)(B)

[Non-Bank-Operated Commingled Investment Funds]
"Pooled Income Funds" maintained by charitable organizations operated in conformance with IRC Section 642(c)(5).

P.1.f. Investment Advisers Act of 1940:

The Investment Advisers Act of 1940 (Advisers Act) requires the registration and supervision of investment advisers, including those who advise "investment companies" as defined in the Investment Company Act of 1940. Prior to the passage of the Gramm-Leach-Bliley Act of 1999 (GLBA), banks were expressly exempted from the Advisers Act. Refer to Section 202 for the revised definitions in the Investment Advisors Act.

Section 202(a)(2) Definition of a Bank

A bank is defined as a banking institution organized under the laws of the United States, a member of the Federal Reserve System, or any banking institution or trust company doing business under the laws of any state or of the United States, a substantial portion of its business consisting of receiving deposits or exercising fiduciary powers similar to those

permitted to national banks.

Section 202(a)(11) Investment Adviser Exemption

Pre-GLBA, the definition of investment adviser did not include a bank, or any holding company, as defined in the Bank Holding Company Act of 1956, which is not an investment company.

Post-GLBA,, the revised definition of an investment advisor now includes banks and bank holding companies that provide investment advice to registered mutual funds. However, the bank exemption allowing for investment advisory services to individuals and those other than mutual funds (registered investment companies) continues to be intact (no registration required).

Note: Per Office of Thrift Supervision (OTS), the bank exemption of this particular section does not apply to thrifts.

P.2. Federal Banking Law

P.2.a. Banking Act of 1933:

The Banking Act of 1933 (codified into various sections of Title 12 of the U.S. Code), commonly referred to as the Glass-Steagall Act (Act), was intended to separate commercial banking activities from investment banking and securities activities. It generally prohibited banks from directly engaging in securities activities. However with the passage of the GLBA many of the prohibitions have been removed.

Section 16 Codified to 12 U.S.C. Section 24 Seventh

Prohibits a national bank from underwriting, buying or selling securities for its own account. National banks are permitted to invest in marketable debt obligations for their own account, which are not in excess of 10% of its capital and surplus.

This section is applicable to state member banks by virtue of the Federal Reserve Act. State nonmember banks are not subject to this section, but are subject to similar restrictions under Section 21 of the Act.

Section 21 Codified to 12 U.S.C. Section 378

This section is the only provision of the Act that is directly applicable by its terms to state nonmember banks.

It makes it unlawful for organizations engaged in the issuing, underwriting, selling, or distributing of securities to engage in the business of receiving deposits. These restrictions also apply to banks. In *Board of Governors of the Federal Reserve System v. Investment Company Institute,* the Supreme Court ruled, however, that the restrictions do not apply to non-banking affiliates of banks (450 U.S. 46, 58, 59 n.24 (1981)). This section allows state nonmember banks to purchase or sell securities for their own accounts. However, Section 24 of the Federal Deposit Insurance Act (12 U.S.C. Section 1831a) made state nonmember banks generally subject to the same limitations as apply to national banks, thereby limiting their advantage over national and state member banks.

Section 32 **Codified to 12 U.S.C. Section 78**

The Gramm-Leach-Bliley Act repealed Section 20 of the Banking of Act of 1933. Refer to Appendix D for additional details.

This section did not apply to state nonmember banks.

P.2.b. Title 12 C.F.R. 9.18

Regulation 9.18

National Banks derive their powers from the National Bank Act, enacted in 1863. The trust powers of national banks are set forth in 12 U.S.C. Section 92a. Initially, national banks were conferred the authority to act in a fiduciary capacity under Section 11(k) of the Federal Reserve Act of 1913. As early as 1927, banks were sponsoring collective investment funds. However, formal Federal bank regulation of bank-sponsored funds was not introduced until the Federal Reserve Board issued Regulation F in 1937. The modern equivalent of collective funds emerged a year earlier when Congress amended Federal tax laws, first granting tax-exemption to the funds. In 1956, the IRS extended the scope of CIF tax-exemption to include CIF's of retirement plans qualified under IRC Section 401. Regulation 9.18 emerged as the successor to Regulation F, when the Congress transferred CIF supervisory authority from the Federal Reserve Board to the OCC in 1962. The operation of CIF's in state nonmember banks rely on IRC Section 584 to achieve tax-exemption and must comply with OCC regulations. These CIF's are usually limited to personal trust CIF's, as compliance with OCC regulations is not mandatory for state nonmember banks operating employee benefit CIF's in compliance with RR 81-100.

P.3. Federal Tax Laws

P.3.a. Internal Revenue Code (IRC)

IRC Section 581 **Definition of "Bank"**

Defines a "bank" for the purposes of IRC Sections 582 and 584. By virtue of this section of the IRC, both banks and nondeposit trust companies are permitted to operate common trust funds.

IRC Section 584 **Common Trust Funds**

Describes requirements and procedures for the operation of bank operated common trust funds. This section primarily pertains to the operation of common trust funds for personal accounts (personal trusts, estates, guardianships, and accounts created under a Uniform Gifts to Minor Act).

Section 584 provides that any CIF which obtains its tax-exempt status from that section of the Code must comply with OCC Regulation 9.18. As a result, FDIC-supervised banks operating CIF's in accordance with the tax-exemption in IRC Section 584 must comply with OCC Regulation 9.18. State or local laws do not exempt state banks from compliance with this provision, as compliance is mandatory to achieve CIF tax-exemption under Section 584.

Banks may also rely on the tax-exempt treatment afforded CIF's by Section 584 when establishing funds exclusively for employee benefit and certain other tax-exempt fiduciary accounts administered in the capacity of trustee.

RR 81-100 **Collective Investment Funds**

This Revenue Ruling applies to the collective investment of trust and agency accounts of employee benefit plans which obtain their tax-exempt status from Section 401 of the Internal Revenue Code, or IRA accounts which obtain their tax-exempt status from Section 408 of the Internal Revenue Code.

IRAs are effectively barred from CIF's and, for all practical purposes, may only be collectively invested in registered mutual funds.

These CIF's are typically established in a form identical to that outlined by OCC Regulation 9.18(a)(2). However, unlike mandatory compliance with OCC Regulation 9.18(a)(1) with respect to personal trust CIF's (by virtue of IRC Section 584), there exists no similar Federal requirement that FDIC-supervised banks comply with OCC Regulation 9.18(a)(2). Unless local law requires state nonmember banks to comply with 9.18(a)(2), that regulation should be regarded as a prudent industry standard and as guidance in the operation of employee benefit CIF's, but not obligatory.

The Revenue Ruling requires: each participating employee benefit plan to adopt the group trust (CIF declaration of trust) itself as part of the plan; that the group trust prohibit CIF assets from being diverted to any purposes other than the exclusive benefit of participating plan beneficiaries; that the group trust prohibit assignment of any CIF assets by any of the participating plans; and that the group trust be established and maintained as a domestic U.S. trust.

IRC Section 642(c) Pooled Income Fund

Pooled funds comprise charitable gifts from donors which are maintained in a commingled investment fund by organizations described in IRC Section 170(b)(1)(A), including churches, educational institutions, and hospitals.

Securities law exemptions for these funds are contained in: Section 3(a)(4) of the Securities Act of 1933; Section 3(a)(12)(A)(v) of the Securities Exchange Act of 1934; and Section 3(c)(10)(B) of the Investment Company Act of 1940. Banks may be appointed as administrator or investment manager of these funds, which are not treated as bank CIF's under Federal tax and securities laws.

IRC Section 761 Partnership

A partnership is defined to include groups, pools, or other unincorporated organizations

through which a business is conducted, including investment activities (such as bank operated CIF's).

IRC Section 6032 Tax Returns for Bank Common Trust Funds

U.S. Treasury Regulation Section 1.6032.1 and IRC Section 6032 require banks (as defined in IRC Section 581) operating CIF's to file annual informational returns with the IRS for each fund established under Section 584 of the IRC. No specific form has been created by the IRS for this purpose. However, Schedule K-1 of Form 1065 (Partner's Share of Income, Credits, Deductions) is typically used to satisfy the reporting requirement.

The return is required to include for each fund participant: name, address, their proportional share of taxable income or losses, and capital gains or losses. This informational return is required, regardless of the taxable income earned during the reporting period. The aforementioned Treasury regulation also requires banks to file a full copy of the CIF's declaration of trust, and any amendments thereto, at least once with the return.

Employee benefit CIF's operated in accordance with RR 81-100, and which derive their tax-exemption under IRC Section 501(a), are not required to file any informational returns with the IRS. However, collective investment funds maintained by a bank, trust company, or similar institution, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations are defined by the Department of Labor as Direct Filing Entities (DFE). Such collective investment funds are required to file DOL Form 5500. The DFE Form 5500 is also an integral part of the annual report of each participating plan. As a result, the administrator of a plan may be subject to penalties for failing to file a complete annual report unless both the DFE Form

5500 and the plan's Form 5500 are properly filed.

Refer to Subsection 5.J.1.and Subsection 5.I.2. for information regarding various reporting requirements.

P.4. State Statutes

Common law places restrictions on commingling. All states and the District of Columbia now have enabling legislation which permits operation of collective funds. In many states, the Uniform Common Trust Fund Act is the *basis* of the enabling legislation that authorizes the operation of CIF's. State law may also include additional requirements, such as a requirement to furnish periodic accountings to a particular court and/or the state supervisory authority.

Trust Examination Manual

Section 8- Compliance/Conflicts of Interest, Self-Dealing and Contingent Liabilities

Table of Contents

Conflicts of interest are discussed throughout the Manual in relation to the other major sections. Conflicts of interest, including self-dealing, are major sources of Contingent Liabilities. These topics are therefore discussed together in this section.

A fiduciary has a duty to avoid conflicts of interest and self-dealing. However, total avoidance is not always possible. Furthermore, while the terms conflicts of interest and self-dealing are somewhat self-descriptive, they should not automatically be equated with exploitation or abuse by the fiduciary. For example, the use of own-bank deposits as a trust investment is by definition a conflict of interest and self-dealing, since the bank is investing funds held as a fiduciary with itself. Yet this action, in itself, is not necessarily abusive or detrimental to the interests of account beneficiaries. Before such investments are determined to be abusive or detrimental, an analysis of the facts surrounding the investment must be made by the examiner.

This section of the Manual is organized into the following parts:

A. Conflicts of Interest
  1. Definition
  2. Management of Conflicts
  3. Management Documentation Standards
B. Self-Dealing
C. Contingent Liabilities
D. Material Nonpublic Information
  1. General Overview and Management Actions
  2. Potential Consequences of Inappropriate Administration
E. Common Instances of Conflict of Interests and Self-Dealing
  1. Fees Other than for the Administration of an Account
    a. Investment in Proprietary Mutual Funds
    b. Receipt of 12b-1 Fees
    c. Receipt of Other Fees from Mutual Funds
  2. Securities-Related Activities
    a. Soft Dollars
    b. Use of Own-Bank or Affiliated Brokerage Service

c. Securities Trading Practices

d. Proprietary Pooled Investment Vehicles

e. Use of Only One Fund Family

f. Research Analyst Affiliate Relationships

g. Proxy Voting

h. Trading During Blackout Periods

i. Advertising Investment Performance

3. Use of Own-Bank or Affiliate Bank Deposits

a. General Overview

b. ERISA, Deposit Insurance, and Pledging

c. Suitability of Own-Bank Deposits

4. Investment in Own-Bank or Affiliate Company Securities

5. Sale or Purchase of Trust Assets to or From the Bank, Bank Insiders, Agents, or Affiliates

6. Investment in Securities Underwritten by Own-Bank or Affiliates

7. Relationships with Outside Service Providers

8. Inter-Account Transactions

9. Multi-Account Transactions

10. Contravention of Terms of the Governing Instrument

a. Ambiguous Language

b. Changing Circumstances

c. Unauthorized Commingling of Assets

d. Nonconforming Investments

e. Failure to Invest

f. Acts Without Consent or Approval of a Co-Fiduciary

11. Privacy

a. Privacy and On-line Banking

12. Prohibitions Against Tying Arrangements

A. Conflicts of interest

A.1. Definition

Conflicts of interest arise when a fiduciary's duty of loyalty to another opposes with other interests of that fiduciary. Chief Judge Cardozo of the Court of Appeals of the State of New York, in an often quoted passage from his opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545, 546 (1928), described a fiduciary's duty of loyalty as follows:

"Many forms of conduct permissible in a workaday world for those acting at arm's-length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of

equity when petitioned to undermine the rule of undivided loyalty b the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd."

The courts have long held that fiduciary transactions not made at arms-length may be set aside at the request of a beneficiary. This presumes the beneficiary was harmed by such transaction and, therefore, the fiduciary assumes the consequences of that harm. Consequently, a fiduciary effectively underwrites transactions involving conflicts of interest.

A.2. Management of Conflicts

The prudent administration of conflicts of interest includes management's (1) recognition that conflicts of interest exist or potentially exist and (2) assurance that there are sufficient procedural and supervisory guidelines to safeguard against breaches of the fiduciary's duty of loyalty. The type and complexity needed and the depth of the written policies governing conflicts of interest depend upon the nature of trust activities conducted and the likelihood that conflicts of interest will materialize. A typical policy may address any number of the following areas:

- Standards governing employee ethics
- Self-dealing and other conflicts of interest such as:
    - Receipt of fees beyond the trustee's fee
    - Securities related activities
    - Own-bank (and affiliate institution) deposits
    - A dministration of the discretionary purchase, sale, and retention of securities issued by the bank, its affiliates, insiders and their interests
    - Discretionary purchase, sale, or transfer of assets between trust accounts and the bank, its affiliates, or insiders and their interests
    - I nvestment in securities underwritten by own-bank or affiliates
    - R elationships with outside service providers
    - Inter-account and Multi-account transactions
    - Contravention of the terms of the governing agreement
    - Privacy

The use of material nonpublic (inside) information

With the exception of an ethics policy, each of these points is addressed later in this section. An ethics policy typically provides guidance with respect to the acceptance of gifts; serving as (an individual) fiduciary under an appointment in which the bank serves as the corporate fiduciary, extensions of credit from discretionary trusts to directors, officers, and employees of the bank and its affiliates, etc. At a minimum, the Board of Directors should receive prior notification of such activities. The ethics policy should also include guidelines for compliance with state and federal bribery statutes. The FDIC has established guidelines pursuant to the Bank Bribery Amendments Act of 1985 to assist bank employees, officers, agents and attorneys in complying with the law. These guidelines are located in the FDIC Statement of Policy, "Guidelines for Compliance with the Federal Bank Bribery Law".

A.3. Management Documentation Standards

The absence of risk in a transaction does not lessen or mitigate a conflict of interest. For example, investments in own-bank deposits may seem to involve little risk and appear to be an innocuous conflict of interest, but, as can be seen in Subsection 8.E.3, there are numerous considerations in making such an assessment. Where more onerous situations are encountered, fiduciaries must exercise extreme caution in properly discharging their duties. Examples include the purchase or retention of own-institution stock or the sale of a trust asset to a bank insider. Investments of this nature should not be made unless (1) lawfully authorized by the instrument creating the trust relationship, or (2) a court order, local law, or prior written approval has been obtained from all interested parties. The latter option is not always available, as interested parties may include: the unborn, minors or others lacking the legal capacity to approve a transaction, or beneficiaries (whose interests are contingent in some manner) who cannot be identified at the time of the transaction. Furthermore, while retention of such securities when received in- kind may be allowable under a general power of retention (*a*s opposed to retention that is directed by the

instrument or court order), a trustee should exercise caution when making the decision to retain.

Complete documentation supporting management's actions with respect to transactions involving real or potential conflicts of interest, including the prudence of such transactions, is essential and should be readily available. The documentation should include a statement supporting the permissibility of the given transaction, as well as the prudence and suitability for the account involved. It is not unusual for banks to seek court approval for particularly sensitive transactions involving self-dealing or conflicts of interest. Certainly, opinions of counsel provide both guidance and supporting documentation. However, counsel's opinion alone cannot insulate a bank from litigation and loss if management has acted improperly or imprudently.

B. Self-Dealing

Self-dealing always involves a conflict of interest, but not all conflicts of interest involve self-dealing. Self-dealing occurs when a fiduciary is a party to a transaction with itself or its affiliates. For example, in the sale of bank assets to a trust for which the bank is trustee, the bank is both the seller and the purchaser, and so is in fact dealing with itself. Other instances of self-dealing include transactions involving own-bank stock or other own-bank obligations, own-bank deposits, the sale of assets between trust accounts, and the purchase of securities underwritten by the bank, an affiliate or a subsidiary. Dealing with bank insiders is a conflict of interest, but is not self-dealing, though the potential for abuse is no less serious.

A clear statement of law regarding self-dealing was expressed by the U.S. Supreme Court in *Michoud v. Girod*, 11 L.Ed. 1076, 1099:

"The general rule stands upon our great moral obligation to refrain from placing ourselves in relations which ordinarily excite a conflict between self-interest and integrity. . . . It therefore prohibits a party from purchasing on his own account that which his duty or trust requires him to sell on account of another, and from purchasing on account of another that which he sells on his own account. In effect, he is not allowed to unite the two opposite characters of buyer and seller, because his interests, when he is the seller or buyer on his own account, are directly conflicting with those of the person on whose account he buys or sells."

These types of transactions may be set aside (considered null and void), after being brought to the attention of the trustee by the beneficiary or the beneficiary's agent. Generally, a court of law will decide these matters. If set aside, a trustee may be liable for damages resulting from, among other things, depreciation, loss of income, or the cost of lost opportunity. The prohibition against self-dealing applies with equal force to affiliates.

As an additional remedy, a beneficiary may ask a court to remove the administrator of a trust or will i the administrator acted under a severe conflict of interest or engaged in intentional self-dealing.

C. Contingent Liabilities

Certain definite principles and rules governing fiduciaries' actions have been laid down by statutes and court decisions (Common Law). A violation of any of these principles or rules of conduct, or the failure to carry out the terms of the trust instrument or a court order, may constitute a breach of trust and create a contingent liability. Whether a contingent liability becomes an actual liability, in which actual losses are incurred, depends upon the actions of account beneficiaries, the bank, and courts of law.

A breach of trust is a violation by the fiduciary of any duty that a fiduciary owes to a beneficiary. Breaches may occur either by an act of commission or omission. When a breach of trust occurs, the fiduciary is generally charged with: any loss or depreciation in the value of trust assets associated with the breach; any profit earned by the trustee as a result of the breach; or any profit which would have been earned by the account had the breach not occurred. For example, any gains made from trading errors belong to the beneficiary. Conversely, a fiduciary is not liable for any loss or depreciation in the value of trust assets not associated with a breach of trust. This precept recognizes that, when invested, trust principal is at risk and that a fiduciary is not a guarantor of investment results.

One of the primary purposes of examining the trust activities of FDIC-supervised banks is to determine whether the administration of trust accounts has resulted in liabilities against the bank. The liabilities identified are those attributable to the bank, as a result of its actions as a fiduciary, and are not the liabilities of the individual accounts administered. To reflect the degree of likelihood that a contingent

liability may result in a charge to capital accounts of the commercial department, the terms Potential Loss and Estimated Loss are used.

The classification system begins with Contingent Liabilities, increases to Potential Losses, and finally, to Estimated Losses. Note that while the wording of the definitions may appear to suggest an overlap of liabilities, there are no overlapping liabilities among these classifications. While the liabilities assigned to the administration of a particular account may include all three classifications (Contingent Liabilities, Potential Losses, and Estimated Losses), that portion of the liability which is assigned an Estimated Loss classification is not also contained in Potential Losses and/or Contingent Liabilities. Likewise, that portion of the liability that is assigned Potential Loss, is not also contained in Contingent Liabilities. The definition of each category of liability follows:

- Contingent Liabilities represent an estimation by the examiner o the gross possible liability of the institution resulting from the purchase of nonconforming investments for trust accounts, unwarranted retention of nonconforming assets, self-dealing, questionable practices and procedures, or other acts of omission or commission which appear not to comply with the terms of the governing trust instruments or applicable provisions of law, and which on accounting may be subject to objection by interested parties. Until appropriate consents, waivers or releases of liability are obtained from interested parties or no liability is determined to exist by a court of competent jurisdiction, the liabilities are regarded as contingent.

  The Contingent Liability category recognizes the possibility that department actions or omissions of action may, depending on:(1) account circumstances, (2) management's corrective measures, (3) ongoing litigation, and/or (4) future, or as yet unknown events, make uncertain whether losses will ever be sustained by the bank.

- Potential Losses represent the examiner's estimate of those portions of the contingent liabilities that may develop into losses to the institution. The amount of losses indicated is potential rather than definite and fixed, pending resolution of the dispute or settlement of the accounts.

  The Potential Losses category acknowledges that losses have an increased likelihood of being sustained. However, due to some measure of uncertainty, such as: ongoing negotiations with beneficiaries or their counsel, a decision not yet rendered by a court, management's ability to appeal a lower court's ruling, etc., it is not yet certain that losses will be sustained.

- Estimated Losses represent the amount of losses that, in the examiner's opinion, appear certain to be sustained by the institution as a result of its fiduciary activities.

  The Estimated Losses category recognizes the reasonable certainty that a known dollar amount of losses will be, or has been, sustained. In such cases, management has: (1) exhausted all of its legal appeals, or (2 agreed to reimburse an account, or (3) is in some manner, beyond its scope of influence or control, being compelled to reimburse an account or pay a known dollar amount of surcharges, penalties, or damages.

  Examiners are reminded that Estimated Losses should be reflected as a reduction in Part 325 capital in the commercial Report of Examination.

Contingent liabilities are based upon: (1) known facts and circumstances, and (2) the likelihood that the fiduciary will be required to make a monetary reimbursement to an account due to the fiduciary's improper actions, whether intentional or negligent. To effectively and accurately identify potential liabilities, contingent liabilities should not be arbitrary or based on speculation, hunches, or guesswork, but based on all pertinent facts available to the examiner. In determining the existence of contingent liabilities, unlike the assessment of Substandard, Doubtful, and Loss in the commercial Report of Examination, the examiner is not being asked to determine the value of an asset. Rather, it is the examiner's duty to determine whether: (1) the fiduciary acted imprudently or negligently in the administration of a fiduciary account, (2) the fiduciary's imprudent or negligent administration caused demonstrable harm to the account, i.e. the account suffered monetary losses or a depreciation in the value of some of its assets, (3) interested parties have or are expected to petition either the fiduciary or the courts for reimbursement for the harm caused by the fiduciary's imprudence or negligence, or (4) the fiduciary has agreed to reimburse such accounts for the harm the fiduciary has caused as a result of negligent or imprudent administration.

Note: In many cases, the imprudent or negligent administration of an account, including breach of trust,

does not result in contingent liability, potential losses or estimated losses, because the account affected will not have suffered any demonstrable harm by reason of the fiduciary's actions. Examiners must distinguish these instances from those where the fiduciary's actions have caused, or likely will cause demonstrable harm to the account, i.e., actual monetary harm such as the loss of investment principal or the loss of income. Only when the fiduciary's imprudent or negligent administration causes such demonstrable harm will a contingent liability exist. For example, the purchase and/or retention of a non-conforming asset that has not resulted in a monetary loss to an account, is reversible without any monetary losses, and for which no legal action is threatened or pending should not be scheduled as a contingent liability since the account has not suffered any demonstrable harm. Such matters should be described in detail in the Report of Examination, but without any contingent liability assigned. Only those instances where a fiduciary's imprudent or negligent actions have, or are likely to cause an account to suffer monetary losses should be assigned an associated contingent liability.

Examiners should avoid speculating over such questions as: returns on investment, lost opportunities, or what verdict a jury might render. Such speculation is neither the purpose nor the intent of identifying contingent liabilities in the report of examination. The examiner's responsibility is, to the extent possible, to provide a reasonable determination of contingent liabilities.

A meaningful supervisory analysis of the bank's condition is not provided by simply extending the entire dollar value of an investment, the entire dollar value of an account, or the outstanding balance of corporate bonds as contingent liabilities, in place of a reasonable and demonstrable assessment of dollar damages or harm to an account. Nevertheless, where a market value cannot be obtained for an asset because it is of such poor quality, clearly speculative, or of very limited marketability, it is reasonable to extend the book value (cost) of the asset as a contingent liability.

In some situations, a determination of the dollar amount of contingent liabilities cannot be made. Examiners should not refrain from criticizing weaknesses or faulty account administration due to an inability to determine a dollar value of liability. These may include situations where: (1) practices are in contravention of the governing instrument, fiduciary principles, or common law precedents, or (2) the dollar value of damages or potential court surcharges cannot be ascertained because they will not occur until some unknown future date. An example of such a situation would be the structuring of an investment portfolio in a manner favoring current income beneficiaries over remainder men, thus foregoing opportunities for capital appreciation by concentrating investments in fixed income securities. Under these circumstances, the examiner should fully discuss administrative and investment deficiencies, warn management of the inherent risk of loss posed by such practices, and recommend corrective action.

Examiners should be careful when scheduling contingent liabilities arising from pending litigation against the bank in its fiduciary capacity. All litigation should be discussed in some manner in the Report of Examination. The assignment of contingent liabilities with respect to litigation should be based upon: (1) fiduciary management's candid assessment, including the opinion of legal counsel, of the issues subject to the litigation, (2) a sound analysis of the facts and circumstances, and (3) outstanding Division of Supervision Safety and Soundness policies.

D. Material nonpublic information

D.1. General Overview and Management Actions

Insider trading, while not defined by the Federal securities laws, refers to the purchase or sale of securities while in possession of material information that is not available to the general public. Information is generally considered to be material when sufficient to induce a person to either buy or sell a security based on that information, e.g., the information is important to making an investment decision with respect to that security.

Banks may come into possession of material, nonpublic information in a number of ways:

- through information developed as apart of normal lending relationships with large commercial customers;
- by a director or officer sitting on the Board of Directors of an outside company;
- through the financing of tender offers, leveraged buy-outs, and management buyouts; or
- when serving as advisor for private placements and mergers and acquisitions.

In general, trust accounts maintained in FDIC-supervised banks do not invest in corporations for which the commercial department has extended credit. The commercial

department generally lends to local firms, while most trust investments involve either large, national firms or smaller firms that are located outside of the bank's trade area. However, it is possible that a bank could lend to and invest in the same company. This may occur should the bank originate or participate in loans to a national company headquartered in, or with a major facility in, the bank's trade area.

The prohibition against making investment decisions based on material inside information also applies to investments in small publicly traded companies. A bank insider may be aware of material nonpublic information by operation of the first two factors above. Examiners need to be aware of such instances.

Of particular concern is the availability to bank insiders of material inside information concerning the condition of and outlook for the bank itself, or the bank's parent company. It is difficult for a bank insider to be unaware of material changes in his or her own organization. Therefore, the investment in, and trading of, own-bank or parent holding company stock or debt instruments is worthy of particular scrutiny.

Financial institutions should adopt policies and procedures, appropriate to its own circumstances, to prevent the flow of material, nonpublic information from the commercial department to the trust department. Policies and procedures should be established prohibiting the use of material, nonpublic information, when deciding whether to buy or sell securities.

Appropriate procedures may include:

- Denying trust personnel access to commercial credit files;
- Prohibiting trust personnel from attending internal commercial loan meetings;
- Prohibiting bank personnel from serving simultaneously on a trust investment committee and a commercial lending committee; and
- Physically separating trust department personnel from commercial lending personnel.

D.2. Potential Consequences of Inappropriate Administration

The Insider Trading and Securities Fraud Enforcement Act of 1988, which added Section 20A to the Securities Exchange Act of 1934 [15 USC 78t-l], exposes a bank to substantial civil money penalties if an employee is caught trading on insider information and the "control person" has not taken adequate steps to prevent insider trading. Criminal penalties for insider trading have also been substantially increased, both in jail terms and monetary fines. Both the bank and the individual supervising trading activity are also subject to civil penalties should an employee be caught trading on insider information. As such, the bank, in addition to having appropriate written policies and procedures, should also be able to demonstrate that trading activities are adequately supervised and monitored and that its employees have been apprised of the penalties, both civil and criminal, for trading on material, nonpublic information. Adherence to the letter and spirit of Section 344.9 of the FDIC Rules and Regulations will aid the bank in meeting its monitoring responsibilities.

SEC Section 240.14e-3 places similar requirements on the purchase or sale of securities based on material, nonpublic information with respect to tender offers. Refer to the FDIC loose-leaf regulations service under the Miscellaneous Statutes and Regulations tab for further guidance.

SEC Section 240.10b-5 relates to the Employment of Manipulative and Deceptive Devices and provides that it is unlawful for any person to directly or indirectly use any mechanism, make an untrue statement or omission, or engage in any act which would be fraudulent in connection with the purchase or sale of any security. This regulation can be applied to the use of material inside information in making investment decisions for accounts. For instance, if the bank acts on material inside information in making investment decisions, then the actions could be considered manipulative and deceptive and in contravention of SEC Rule 10b-5.

Notwithstanding that trading on material, nonpublic information constitutes an illegal act subject to severe civil and criminal penalties, it is important to keep in mind that the bank,

in exercising its discretionary investment authority, has a fiduciary obligation to keep itself apprised of material *public* information with respect to securities it buys and sells. Policies and procedures should therefore be constructed in a manner to prevent unauthorized individuals from having access to material, nonpublic information, but not be designed in such a manner as to impede the flow of legitimate material public information or restrict the institution's ability to meet the needs of its customers by prohibiting all interaction between the trust department and the commercial department.

E. Common Instances of Conflict of Interests and Self-Dealing

The most frequently encountered instances of conflicts of interest and self-dealing (hereafter referred to as conflicts) are discussed below. The coverage given is not all-inclusive, but presents issues common to the vast majority of trust institutions. If examiners encounter problems during the review of any conflicts of interest they should be guided by the previous discussion of Contingent Liabilities.

Examiners might encounter a possible conflict situation considered to be an industry practice. Any such situation should be viewed in light of all available information. However, merely because it is an industry practice does not necessarily mean that a fiduciary duty, law or regulation has *not* been violated. For example, it was the practice of many banks in the 1960s to allocate brokerage business based on demand deposit relationships; however, in 1969 the Justice Department determined this practice to be in restraint of trade and threatened to sue for injunctive relief unless the practice was discontinued. It had been alleged that such banks often gave little or no consideration to the strength and integrity of the broker, the ability to execute orders efficiently, or the quality of research provided. Refer to Asset Management Section, Broker Selection on Basis of Deposits for further discussion.

E.1. Fees Other than for Account Administration

With an increased emphasis on profitability, many fiduciaries have sought and will continue to seek additional sources of revenue. With this focus there is the potential that the fiduciary may fail to act in the best interest of beneficiaries. The fiduciary may be tempted to place its interests before those of the beneficiaries, when it benefits from the investment of trust assets, hence the conflict of interest.

One way to augment revenue is through the receipt of fees beyond the customary trustee fee (fee for account administration). The additional fee is often associated with a mutual fund investment, but with changes in the industry it could occur in other investments as well. Set forth below are some typical situations currently being encountered regarding mutual funds. However, the examiner should be alert to and explore any type of fees a bank receives other than the usual and customary fee for the administration of an account. Such fee(s) should be reviewed with the knowledge of all surrounding circumstances, considering the fiduciary principles and any applicable laws and regulations.

E.1.a. Investment in Proprietary Mutual Funds

Receipt of additional fees beyond the traditional trustee fee is often encountered when investing in proprietary mutual funds. For example, the fiduciary or an affiliate receives a fee for serving as investment advisor to a proprietary fund. The receipt of this additional fee is not necessarily prohibited.

Some states have enacted legislation that makes certain conflict activities such as this permissible. The laws often govern whether both a trust account fee and a mutual fund investment advisor fee can be charged. They also may identify certain customer disclosure requirements and require the fee to be reasonable. Refer to Appendix C for a recap of state statutes authorizing fiduciary investment in proprietary mutual funds.

In receiving this additional fee, a trustee should do the following.

- Ensure that all applicable legal and regulatory requirements are met. If reasonableness is an element of the governing law, the reasonableness of fees associated with the investment in a proprietary mutual fund is a critical issue that a fiduciary should resolve prior to using such funds as discretionary investment vehicles.

- Determine that the investment is authorized by the governing trust instrument, is appropriate for the purpose of the account and/or the needs of the beneficiaries, and is prudent.

Guidance on investing in proprietary mutual funds is found in proprietary mutual funds. Additional conflicts regarding the use of proprietary mutual funds are discussed in Subsection 8.E.2.d.

E.1.b. Receipt of 12b-1 Fees

The receipt of 12b-1 fees from mutual funds is not unusual. The existence of this fee is disclosed in a fund's prospectus. The receipt of 12b-1 fees and how they affect ERISA and non-ERISA accounts is discussed in the Asset Management section of the Manual, Section E, and the Employee Benefit section of the manual Subsection 5.H.7.f(13). Also refer to Appendix D and the Southeastern Growth Fund, Inc. request for a No-action letter, regarding the rebating of 12b-1 fees.

Department of Labor Advisory Opinion 2003-09A, dated June 25, 2003, indicated that a trust company's receipt of 12b-1 fees from mutual funds, the investment advisers of which are affiliates of the trust company, for services in connection with investment by employee benefit plans in the mutual fund, would not violate section 406(b)(1) and 406(b)(3) of ERISA when the decision to invest in such funds is made by an employee benefit plan fiduciary or participant who is independent of the trust company and its affiliates. The opinion also allows for the use of proprietary funds of an affiliate, so long as the trustee does not provide investment advice to the participants and the participants are free to choose non-proprietary funds.

The receipt of 12b-1 fees are required to be disclosed in the prospectus of all mutual funds. However, even if adequate disclosure is given and no regulations are violated in connection with these fees, trust departments must continually perform due diligence procedures to ensure that all investments are chosen with the interest of the beneficiaries in mind. Furthermore, trust departments must be aware of state laws regulating securities.

One issue expected to receive the scrutiny of Congress and the SEC is the charging of 12b-1 fees by mutual funds who have closed their funds to new investors. Since the purposes of 12b-1 fees are to promote and distribute the funds to new investors, the need to charge these fees to existing investors is questioned

E.1.c. Receipt of Other Fees from Mutual Funds

General Overview

There is the increasing potential for fiduciaries to receive other fees from mutual funds beyond the traditional 12b-1 fee. These are often incentive based fees and may include payments structured as reimbursement for services (e.g. sub accounting fees, shareholder service fees, or shareholder administration fees) or payment for the bulk transferring of business to another mutual fund provider.

A reimbursement for service arrangement offers compensation in the form of fees to the fiduciary that invests assets in a particular fund. Information on this type of fee is found in the mutual fund's prospectus. The fee is structured as a payment reimbursing the fiduciary for performing standard recordkeeping and accounting functions, on behalf of the mutual fund, for the fiduciary accounts invested in the mutual fund. Generally, there is a master or omnibus account (sub-transfer agent) with the mutual fund's transfer agent and the sub-accounting is on the bank's recordkeeping system. There is typically an electronic interface between the omnibus account and the fiduciary's recordkeeping system for individual client accounts. It may also cover ancillary services such as responding directly to questions or requests

from customers whose funds have been invested in the mutual fund, forwarding shareholder communication, etc.

Regardless of the source of the fee, the decision to pace a fiduciary asset in a particular investment should be consistent with governing laws. Many states have modified laws to allow such fees, but have placed certain restrictions requiring compliance with standards of prudence, such as the quality of the investment and its suitability for an account. State laws may also require that fees be reasonable. State law, however, may not define what constitutes a reasonable fee. Whether or not state law requires fees to be reasonable or defines what is reasonable, management should consider the reasonableness of the fees received. State law often provides a good framework within which to evaluate the administration of this conflict of interest. Other pertinent issues include the permissibility of such fees under the governing document (the document may be silent) and whether the investment is in the best interest of a particular trust account. Documentation supporting all of these issues should be maintained by the fiduciary.

Caution: There is no uniform law requiring that such arrangements be disclosed to trust customers, but disclosure is encouraged. State statues may require disclosure and there are ERISA requirements to be considered. (See next subsection) In some states, the disclosure requirement is met by providing the client with a copy of the fund's prospectus, which includes a reference to shareholder service fees. Some states also require annual disclosure of the fee arrangement.

From a risk management perspective, it is essential that the fiduciary conduct a thorough due diligence review prior to receiving such fees from any mutual fund provider. The due diligence process should include the following: (These procedures also are contained in Board of Governors of the Federal Reserve System, Division of Banking Supervision and Regulation SR99-7, "Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest", March 26, 1999.)

- Reasoned Legal Opinion - Receipt of a legal opinion or citations of law that address the legality of this form of compensation. This includes Federal and State regulations. Examples of issues to be addressed include permissibility of the investment and compensation under applicable laws, trust agreement, or court order, as well as any applicable disclosure requirements or reasonableness standard for fees found in the governing law.
- Policies and Procedures - Policies and procedures should be developed to specifically address the acceptance of fees and other compensation from any mutual fund. Ideally, the policies would address who has the authority to accept the fee and what type of analysis and documentation are required to support the investment decision when such fees are received. It should also address monitoring the receipt of the fee to ensure compliance with governing law(s), and reporting compliance with the established policies to the appropriate authority.
- *Analysis and Documentation of Investment Decisions* - Minimum investment criteria should be established to support the investment decision-making process. Refer to Section 3.F.4 for discussion of the asset management aspects of investing in mutual funds.

ERISA Accounts

Receipt of any such fee for employee benefit accounts subject to ERISA would appear to be a violation of Sections 406(b)(1) and 406(b)(3). ERISA Section 406(b)(1) prohibits a fiduciary from dealing with plan assets in its own interests or for its own account. ERISA Section 406(b)(3) provides that a fiduciary with respect to a plan shall not "receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan."

The Department of Labor (DOL) has not issued any definitive statement on the subject of the retention of "sub-accounting fees" by fiduciaries. Trust management should be encouraged to obtain a favorable ruling from the DOL prior to accepting any such fees for accounts subject to ERISA. DOL has, however, issued Advisory Opinions (AO) 97-15A and 97-16A, respectively referred to as the "Frost" and "Aetna" opinions, which provide useful guidance. These AO's are discussed in detail in Subsection H.7.f.(13). Mutual Funds, Receipt of 12b-1 Fees, located in Section 5.

- In AO 97-15A, "Frost", the DOL took the position that a bank with discretionary authority to invest in a mutual fund that pays the bank a 12b-1 fee would appear to violate ERISA Section 406(b)(1) because it involves a conflict of interest. Even if a fiduciary does not administer or control investments in a plan, but has authority to delete or substitute mutual funds, the fiduciary may be able to cause 12b-1 fees to be paid to itself. In both situations, however, DOL took the position that if the fees were used to offset the plan's liability to the trustee (e.g., reduced the expense of administering the plan and thus not retaining the fees), the fiduciary would not violate Sections 406(b)(1) or (b)(3).

- In AO 97-16A, "Aetna", the DOL restated that the mere receipt of a fee or other compensation from a mutual fund in connection with a plan's investment would not in and of itself violate Section 406(b)(1) or (b)(3) if a service provider did not advise or otherwise exercise authority or control to cause a plan to invest in a mutual fund. Service providers, however, retaining the authority to delete or substitute the mutual funds made available to plan participants might be deemed to exercise the necessary discretionary authority to cause the payment of fees to themselves. Once again, he DOL took the position that if the fees were used to offset the plan's liability to the trustee, the fiduciary would not violate Sections 406(b)(1) and (b)(3).

It is important to note, however, that the practice of receiving fees for "secondary" shareholder services from proprietary mutual funds has not been determined by the DOL to violate any of the prohibitions of DOL PTE 77-4. "Secondary" shareholder services could include transfer agent, custodial, administrative, and accounting services provided to the mutual fund for which the plan fiduciary also serves as an investment advisor.

In those cases where an institution, as a plan fiduciary, improperly accepts mutual fund servicing fees, examiners should recommend that the fees either be returned to the individual accounts invested in the mutual funds providing the fees or that the servicing fees be used to offset plan expenses.

E.2. Securities-Related Activities

There is the potential that conflicts that are not readily evident may occur with various securities-related transactions. Included in this section are some of the more common situations that may be encountered. For each, there are unique reasons to consider it a conflict, but the underlying concept is that the bank receives a benefit from the transaction and the benefit is usually in a form other than cash/fees.

E.2.a Soft Dollars

The term soft dollars refers to an arrangement in which a discretionary money manager (for example, a trust department or investment advisor) receives, in addition to transaction execution, investment research services from a broker/dealer in exchange for the brokerage commissions from executing transactions for discretionary client accounts. Hence, the money manager receives investment research that is purchased with the funds of discretionary client accounts, i.e. those accounts which actually pay the broke/dealer's commission. Hard dollars, on the other hand, involve the money manager purchasing investment research services with its own

funds. In a soft dollar arrangement, the money manager is said to be paying up, i.e. paying more than the actual cost of executing a transaction.

Soft dollar arrangements present a conflict of interest since the money manager personally benefits from transactions involving trust assets. The purchase of investment research services with the commission dollars of a beneficiary or client, even if used for the benefit of the beneficiary or client, could be viewed as also benefiting the money manager in that the money manager is relieved of the obligation to produce the research himself or to purchase it with hard dollars. This is not to imply, however, that soft dollar arrangements are necessarily improper, since broker/dealers often provide an important service in producing and distributing investment research. Congress acknowledged as much when it added Section 28(e) to the Securities and Exchange Act of 1934, which permits money managers to consider the provision of investment research, as well as trade execution services, in evaluating the cost of brokerage services without violating their fiduciary responsibilities. Section 28(e) provides a safe harbor that permits, in certain circumstances, money managers to use commissions paid by discretionary accounts to acquire investment research as well as trade execution services. Excluded from the safe harbor provisions are transactions in futures or transactions done on a principal basis.

The acquisition of investment research services paid for by the commission paid by non-discretionary accounts, i.e. non-managed accounts, is **not** protected by Section 28(e). Non-discretionary accounts do not benefit from the investment research provided by the broker/dealer. The purchase of investment research services with the commissions paid by non-discretionary accounts should be explicitly permitted in the written agreement governing these accounts and disclosed to all interested parties.

A fiduciary exercising investment discretion is under the general duty to obtain best execution, which generally includes considerations such as the most favorable price for the securities, the lowest commission, the prompt and accurate execution of orders, the prompt and accurate confirmation of orders, and the prompt and accurate delivery of securities or proceeds. Prior to1975, when brokerage commissions were fixed and nonnegotiable this was not an issue. Since the advent of fully negotiable brokerage commissions on May 1, 1975, a fiduciary exercising discretion has been legitimately able to pay more than the lowest available brokerage commission if it also receives research services. As noted above, this limited safe harbor protection is provided by Section 28(e)(1) of the Securities Exchange Act of 1934.

The identification of soft dollars compensation is difficult. While brokerage commissions are generally readily identifiable, problems have arisen when non-research items have been claimed to represent research. The SEC has issued an interpretative release focusing on whether the product or service provides lawful and appropriate assistance to the money manager's investment decision making. If the service provided has a "mixed use" - meaning research and non research components (such as computer hardware) - the money manager should make a reasonable allocation of the cost according to its use. The portion of the service used in the investment decision-making process can be paid with commission dollars, while those services that provide administrative or other non-research assistance should be paid with hard dollars. Refer to Appendix D - Securities Exchange Act of 1934 Release No. 34-23170 Section 28(e) and Soft Dollars.

Potential conflicts of interest related to use of soft dollars include:

- Investment advisers may choose broker-dealers based on a business-related association. Additionally, the choices may be made solely on the basis of soft dollar products and services, to the exclusion of execution quality. The resulting trades could have both higher commissions and lower quality trade execution.

- Soft dollar arrangements could encourage increased transaction orders to pay for more soft dollar products and services. These arrangements might cause advisers to "over-consume" research because of the indirect nature of the transaction.

- Fiduciaries might be tempted to purchase products and services with only marginal research applications, such as periodical subscriptions, computer terminals or communication services, such as telephone, fax, etc.

- The lack of adequate controls could allow mixed uses for soft dollars, including products and services not used for research and not protected by safe harbor provisions of the Securities and Exchange Act of 1934. When different types of products are bundled together, management must be aware of any tendency to over-pay for the research portion of the bundled services, in order to pay with commission dollars.

- Products and services purchased with soft dollars are often bundled together in such a way that a manager does not know what he/she is paying for each service.

Before an institution begins to receive soft dollar benefits, policies and procedures governing the proper use and monitoring of soft dollars transactions should be in place. Management must be able to demonstrate that soft dollar benefits constitute bona fide investment research. In complex operations, this may be done with a budget that identifies the soft dollar benefits to be received and how they will be used. General guidelines for the use of soft dollars include:

- A fiduciary may retain soft dollar services and materials from a broker (or other source) for investment transactions generated by discretionary accounts, if the soft dollar payments are (1) not prohibited by the governing account instrument and (2) comply with the SEC's safe harbor requirements.

- A fiduciary may not retain soft dollar payments from a broker (or other source) for investment transactions generated by nondiscretionary accounts, since a nondiscretionary account cannot justify paying higher brokerage commissions to receive investment research which would not benefit the account. Nondiscretionary accounts may, however, agree to soft dollar transactions if specifically permitted in the instrument, or by the grantor, or, after full disclosure, by all account beneficiaries.

- A fiduciary must disclose specific types of products, research, or services obtained with soft dollars so that customers understand what is obtained with the commissions. This is required whether or not the product is subject to the safe harbor provisions of Section 28(e).

There are also specific requirements for different types of fiduciary accounts. Refer to Subsection 5.H.7.f.(19). for employee benefit accounts subject to ERISA. Also refer to the SEC's Release No. 3423170 in Appendix D for additional information on soft dollar arrangements.

E.2.b. Use of Own-Bank or Affiliated Brokerage Service

A conflict of interest arises when a fiduciary uses its own or an affiliate brokerage service to execute the trust department's securities transactions. It may also arise if a discount broker located in the commercial department is used (typically the third-party provider of non-deposit products). The problem is not the payment of commissions, provided they meet the concept of best execution and follow the concepts outlined in Section 3. The problem concerns other fee sharing arrangements, such as splitting of commissions

or the payment of rent based upon the volume of transactions.

FDIC General Counsel's Opinion No. 6, states, in part, "If the bank intends to utilize the contractual arrangement with the broker/dealer for transactions executed in connection with trust department accounts, the bank should not receive any additional compensation from the broker/dealer with regard to those transactions, i.e., the bank trust department should not share in any commission associated with the transaction. To do so would raise possibilities of a breach of fiduciary obligation toward the bank's trust account customers." Several FDIC Advisory Opinions address some limited situations in which it might be proper to share in such commissions. However, in background discussions, those opinions generally stress that best execution objections can be raised when only one broker is used, and the bank may be open to a charge of churning, if it has discretion and the commission-splitting arrangement is dependent upon the volume of trades. See FDIC Advisory Opinions 83-14, 83-15, 83-17, 83-18, 84-10, and 85-10 for further guidance.

Since the bank may profit indirectly through paying brokerage fees to an affiliate, the use of an affiliated brokerage service raises many of the same issues discussed in Subsection 8.E.1 - Fees Other than for the Administration of an Account. Also, the use of an affiliated brokerage service would appear to constitute a prohibited transaction under Section 406(b) of ERISA. While there is an apparent exception allowing reasonable transaction fees, the Department of Labor, in practice, has approved this exception only under very narrow conditions. Refer to the discussion in Subsection 5.H.7.f.(1) and Prohibited Transaction Class Exemption (PTE) 86-128.

The use of an own-bank or affiliated municipal brokerage department raises additional issues. It is a conflict for the fiduciary to direct discretionary transactions to an own-bank or affiliated municipal securities broker. This is particularly the case, when securities are purchased from the dealer's inventory (securities in which the dealer has taken a market position). When securities are purchased from the dealer's inventory, rather than on the open market, the possibility exists that the securities are being sold at above market prices, or that securities which cannot otherwise be sold profitably on the open market are being sold to the trust department. The purchase of any security at an above market price is an abusive self-dealing practice. Arrangements should be made for the reimbursement of any losses suffered by accounts that purchased any security at an above market price. Realized losses and depreciation should be extended as Contingent Liabilities. Refer also to the discussion of underwritten securities later in this section.

A ppropriate policies and procedures should be in place prior to entering into a brokerage service arrangement, regardless of whether the bank's brokerage services, an affiliated brokerage firm or a discount broker providing nondeposit products will be used. Other considerations include:

- Whether brokerage services must be performed on a nonprofit basis, requiring documentation of transaction costs;
- Whether best execution is being obtained; and
- Whether accounts are protected from potential churning.

In view of these and other fiduciary and legal requirements, the bank should be able to conclusively demonstrate, preferably through the opinion of competent legal counsel that any such use conforms to all applicable laws and regulations and that no fiduciary duty has otherwise been violated.

E.2.c. Securities Trading Practices

Problems arise when an employee puts his/her interests ahead of the interests of the beneficiaries in executing trades. A classic example is front running, which is an illegal practice whereby an individual knows that a block trade will influence the price of the security; the individual places his trade to

profit from the effects of the block trade. Policies or procedures should prohibit such transactions. Furthermore, policies and procedures should prevent employees from trading under the auspices of the bank, e.g., the employee should not be allowed to use the trust department's accounts with brokerage firms to effect personal trades.

Another potential conflict arises when trading errors result in a potential profit or loss to the beneficiary of a trust or participant in a defined-contribution retirement plan such as a 401(k). Given that a fiduciary must put the beneficiary's interests first, losses resulting in trading errors must be absorbed by the bank, and any profits must flow through to the account or beneficiaries thereof. Part 406(b)of ERISA prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account; consequently, any gains acquired by a fiduciary resulting from trading errors would result in an apparent error of the regulation.

Market Timing Trading in Mutual Funds

Market timing is the frequent purchase and redemption of mutual fund shares, exchange-traded funds (EFTs), or variable annuity or life contract, in an attempt to take advantage of a lag between a change in value of a fund or contract, and the reflection of that change in the fund or contract's share price. For example, time zone arbitrage is the buying of mutual funds that own securities in a foreign market at the previous day's net asset value, knowing that subsequent events occurred since that market closed will likely assure a profit. This practice may dilute the value of shares held by long-term shareholders; interfere with the management of the portfolio; and increase brokerage and administrative costs.

Management of defined-contribution plans such as 401(k)s must be aware of market timing trades by plan participants. An indication of such trading may be frequent trades. By allowing a few participants to benefit by taking temporary profits, participants interested in long-term gains may be armed.

An illegal form of market timing trading is late trading, which allows individuals to purchase mutual fund shares after 4:00 p.m. Eastern Time at the net asset value (NAV) for that day, when regulations require those shares to be priced at the NAV of the next day's close. Traders profit by trading on positive or negative after-hours news of major holdings of the mutual funds.

To address these and other concerns, the SEC issued the final rule for Disclosures Regarding Market Timing and Selective Disclosures of Portfolio Holdings. The effective date of the rule is May 28, 2004, with implementation on or after December 5, 2004. The rule requires mutual funds, EFTs, and variable annuity or life contracts to describe their policies and procedures for deterring frequent purchases and redemptions of the shares. The rule also allows a fund to reserve the right to reject a purchase or exchange request for any reason, as long as the fund discloses this ability in the prospectus. The fund disclosure must state whether the restrictions on frequent purchases and redemptions will be uniformly applied to trades occurring in omnibus accounts at intermediaries, such as investment advisers, broker dealers, transfer agents, third party administrators, and insurance companies. In disclosing the entities making frequent purchases and redemptions, mutual funds will be required to identify the group rather than the individual group member for 401(k) plans; this will be disclosed in the Statement of Additional Information (SAI), rather than in the prospectus.

The rule requires mutual funds and managed separate accounts that offer variable annuities, other than money market funds, to explain their use of fair value pricing. The rule states that funds are to use fair value pricing any time that market quotations for their portfolio securities are not readily available, including when they are unreliable. For domestic large cap funds, fair value pricing will be used under very limited circumstances, such as when the

stock exchange closes early or trading is halted in a specific security. Conversely, for mutual funds that have securities which are traded overseas, then the use will be more common. Disclosures for either circumstance will be included in the prospectus.

For fund of funds, the SEC requires the disclosure to refer the investor to the underlying fund prospectuses.

Banks should have policies and procedures which address trading in mutual fund shares. Management must review and understand mutual fund prospectuses to determine what practices related to trading are allowed. Furthermore, for employee benefit accounts, managers should have programs to detect and prevent plan participants from engaging in market timing trading. The management of bank-sponsored proprietary mutual funds must prohibit any practice that could prove detrimental to the shareholders.

E.2.d. Proprietary Pooled Investment Vehicles

Conflicts involving the use of proprietary investment products are frequently tied to the generation of additional fee income. When a bank, as fiduciary, invests fiduciary assets in proprietary products, a key consideration is whether the bank is acting in the best interest of the beneficiary or in its own interest. A common example is the continued use of a poor-performing proprietary investment product in order to maintain a critical mass of assets under management. In doing so, the fiduciary benefits from economies of scale and earns additional fee income at the expense of the beneficiary, who sacrifices the potentially higher return that could be obtained from investing in better performing mutual funds. This is a particularly sensitive situation if trust accounts own a majority of the shares of a proprietary mutual fund.

Important guidance regarding investment in proprietary mutual funds is found in Asset Management, Section 3, and in the Employee Benefit section, Subsection H.7.f.(11). Subsection 7.F.12 - Section 9.18(b)(8) Self-Dealing and Conflicts of Interest, Subsection 7.K - Proprietary Mutual Funds, and Subsection 7.L - Conversion of Collective Investment Funds to Mutual Funds discuss potential conflicts of interest regarding duties of loyalty and prudent investment management. Special coverage of this topic may also be found in state law.

E.2.e. Use of Only One Fund Family

Fiduciaries sometimes offer only one family of funds as its mutual fund investment option. Management may feel that it is easier to obtain reliable information and that they receive specialized attention due to the volume of the department's aggregate investment. This rationale is used in addition to the fee incentives previously discussed. Management may feel that these benefits compensate for the continued inclusion of a poor-performing fund as an investment option. However, the benefits of the use of only one fund family does not justify holding a poorly performing investment; and may represent a conflict of interest if the department is placing its interest, i.e. easing the administration of an account, ahead of the interest of the beneficiaries. To the appearance of such conflicts, management should ensure that all investments meet the trust department's approved investment criteria. Refer to Section 3 - Mutual funds, for a discussion of the investment selection process.

E.2.f. Research Analyst Affiliate Relationships

Potential conflicts of interest arise in a trust department affiliated with an investment company that conducts securities research. The conflicts occur when research analysts work for firms that have investment banking or other business relationships with issuers of the recommended securities, or when the analyst or firm owns securities of the recommended issuer. The recommendations must not be influenced by the relationships that affiliates have with the company being analyzed, including relationships related to

investment banking and trust activities. In 2002, the SEC approved rule changes made by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) which are designed to improve the objectivity of investment research provided by research analysts. Provisions in these rule changes include:

- Research analysts may not be subject to the supervision or control of the firm's investment banking department.
- Disclosures are required of any investment banking relationship with any company that was subject to an investment report.
- Research analysts employed by members of the NYSE or NASD may not receive compensation based on specific banking services transactions.
- The manager or co-manager of a subject company's offering may not publish research about the issuer for 40 days following an initial public offering and 10 days following a secondary offering.
- Member firms must disclose in research reports whether the firm or its affiliates, including banks and trust departments, own 1 percent or more of the common equity securities of the company being analyzed.
- Research analysts have prohibitions on purchasing or receiving pre-IPO shares, trading in recommended securities 30 days prior and 5 days after issuance of a report, and trading contrary to the analyst's own recommendations.

While these regulations only apply to registered investment advisors, the above rules provide guidelines for the conduct of research analyst affiliates. Please refer to NASD Rule 2711, Amendment to Research Analysts and Reports.

E.2.g. Proxy Voting

As discussed in Chapter 3, Asset Management, trust department management should establish policies regarding casting proxy votes for shares of stock held in a discretionary capacity. The purpose of these policies is to ensure proxies are voted in the best interest of the clients, and that all conflicts of interest are disclosed. An example of a conflict of interest is when a Trust Department votes on proxies for shares of stock of a corporation that it holds in discretionary accounts, and at the same time performs investment banking or other services for this corporation.

In 2003, the SEC adopted new rule 206(4)-6 [17 CFR 275.206(4)-6] and amended rule 204-2 [17 CFR 275.204-2 [17CFR 275.204-2] under the Investment Advisers Act of 1940 relating to proxy voting. These rues and rule amendments require advisors registered with the SEC to adopt policies and procedures to ensure that the adviser votes proxies in the best interest of clients, to disclose to clients information about those policies and procedures, to disclose to clients how they may obtain information on how the adviser has voted their proxies, and to provide clients with information about how their proxies are voted. Furthermore, the rules require advisers to maintain certain records relating to proxy voting.

Violations of the proxy voting regulations in the Investment Advisers Act of 1940 can result in substantial civil penalties. For example, on August 19, 2003, the SEC imposed a civil money penalty of $750,000 on Deutsche Asset Management, Inc., the investment advisory unit of Deutsche Bank AG, for failing to disclose a material conflict of interest in its voting of client proxies for the 2002 merger between Hewlett-Packard Company (HP) and Compaq Computer Corporation.

E.2.h. Trading During Blackout Periods

The term blackout period refers to an interval of time of more than 3 consecutive business days during which employees may not adjust the investments in their employee benefit pension plans, e.g. 401(k) plans. These blackout periods occur most frequently when the plan is undergoing certain changes, such as modification of investment options or replacement of plan record keepers. During a blackout period, the participants cannot make changes to the investments. The fiduciaries have effectively taken control away from the participants resulting in potential conflicts of interest; fiduciaries may be held liable if something goes wrong.

One of the most newsworthy conflicts of interest that caused substantial injury to beneficiaries occurred in 2001 at Enron Corporation. During a blackout period in which the pension plan trustee was changed, employees were not allowed to sell their Enron stock held in their 401(k) plans, and the stock lost much of its value. Corporate insiders, who had information regarding the deteriorating condition of the company, were able to sell their stock outside of the plan at much higher prices than employees who were required to wait until the blackout period ended.

In the wake of the Enron scandal, Congress passed the accounting reform bill known as the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). Section 306(a) of the Act makes it "unlawful for any director or executive officer of an issuer of any equity security (other than an exempted security), directly or indirectly to sell, or otherwise acquire or transfer any equity security of the issuer (other than an exempted security) during any blackout period with respect to such equity security if such director or officer acquires such equity security in connection with his or her service or employment as a director or executive officer."

Section 306(b) of Sarbanes-Oxley requires a thirty-day advance notice of any blackout period. The notice must be written in a manner calculated to be understood by the average plan participant and include the following:

- The reasons for the blackout period,
- An explanation of the investments and other rights affected;
- A statement informing the participants and beneficiaries that they should evaluate their investment selections in light of their inability to direct or diversify their investment choices during the blackout period.
- The name, address and telephone number of the plan administrator or other person responsible for answering questions about the blackout period.
- Such other matters the Department of Labor may require by regulation.

Sarbanes-Oxley provides three exceptions to the 30-days' advance notice requirement:

- The first exception applies when a fiduciary, acting with care, skill, prudence and diligence, determines that deferral of a blackout period would undermine the plan's exclusive purpose of providing benefits to participants and their beneficiaries and of defraying reasonable expenses of administering the plan.
- A second exception applies when the inability to provide the notice timely is caused by unforeseeable events or events out of the control of the plan administrator.
- A final exception applies if the blackout occurs in connection with a merger, acquisition, divestiture, or similar transaction involving the plan where individuals either become or cease to be plan participants.

Fiduciaries must document all exceptions to the 30-days' advance notice requirement.

Please refer for more information to Section 306 of Sarbanes-Oxley.

E.2.i. Advertising Investment Performance

Trust Departments that publicize the investment performance of their discretionary accounts must ensure the advertisements do not contain misleading, inaccurate, or exaggerated claims. Even factually correct statements may be inappropriate, if these statements lead clients or potential customers to believe extraordinarily strong performance achieved in the past can be expected in the future. Types of misleading advertisements include:

- Publicizing superior returns achieved over a period of time, implying that investors can be reasonably assured that these returns can be expected in the future.
- Identifying selective stocks that have performed well, without identifying all the stocks in the portfolio being managed or when these stocks were purchased.
- Comparing stocks to a dissimilar index. For example, a portfolio may contain numerous high-tech or small cap stocks and the advertisements will compare results to an index of large cap stocks, such as the S & P 500.
- Advertising performance without identifying the risks involved. All ads promoting investment performance should indicate that future recommendations may not be profitable or equal past performance.

SEC Rule 206(4)-1 under the Investment Advisors Act of 1940 prohibits the distribution of several types of advertising considered fraudulent or misleading. Additionally, the SEC Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 require disclosures when mutual fund performance is presented in sales material. While these rules only apply to Registered Investment Advisors, these rules can be used as guidelines in developing policies and procedures designed to preclude misleading advertising. Furthermore, management must be careful not to portray itself as an investment advisor.

E.3. Use of Own-Bank or Affiliate Bank Deposits

E.3.a. General Overview

When a fiduciary allows investments in proprietary investment products, there is an inherent conflict between the best interests of the account beneficiary and the interest of the fiduciary. Investments in own-bank and affiliate-bank deposits (hereafter referred to as own-bank deposits) provide a benefit to the commercial department, by generating revenue from fiduciary deposits. For example, the commercial department may purchase a short-term investment, such as selling Federal funds, or a medium-term investment, such as a loan or a security. The choice depends upon the aggregate size and maturity of fiduciary deposits. Own-bank deposits may be used on a deposit by deposit basis or on a pooled basis, such as in sweep or master deposit accounts. Refer to the master deposit account discussion in Section 7.

Investment in own-bank deposits is a common practice, legally permitted by almost all states. Many governing agreements include standardized language allowing the fiduciary to invest in own-bank deposits. The language may be narrow and reference only time deposits, or very broad and allow any type of deposit. Fiduciaries often claim that a low risk tolerance and the relative safety of principal are valid considerations when choosing federally insured deposits as trust investments. There are, however, many alternative investment options that provide current income with comparable safety. Therefore, investment decisions based purely on these factors should be evaluated critically.

If management uses own-bank deposits as an investment option for the trust accounts it administers, basic guidelines and monitoring procedures should

be established. These include appropriate policies, the monitoring of historical trends, and documentation that management has satisfactorily resolved the inherent conflict of interest posed by such investments. Written policies should address the use of own-bank demand and interest-bearing deposits. Documentation should include a review of alternative investment vehicles, the competitiveness of the interest rates paid o own-bank deposits, and appropriate approvals for such investments. Management should document that the bank has acted in the best interests of the account beneficiaries.

There are no specific guidelines addressing the propriety of various deposit terms, such as the maturity of the deposit, the rate of interest, the dollar size of own-bank deposits, or the percentage of total account assets invested in own-bank deposits. Therefore, examiners must determine whether the deposit(s):

- Are permitted under local and Federal law;
- Are permitted under the governing instrument;
- Met the objectives and needs of the account at the time of the investment;
- Provide the best investment alternative, considering alternate investment options available; and
- Provide a documented competitive rate of return.

E.3.b. ERISA, Deposit Insurance, and Pledging

In assessing such conflicts, there are issues to be considered beyond the broad concepts of permissibility under state statue and the governing agreement. Such issues include ERISA prohibitions, Federal deposit insurance, and pledging requirements. Management should have knowledge of and appropriate policies for each of these areas.

1. ERISA Considerations

Section 408(b)(4) provides an exemption from the prohibited transactions provisions of Section 406(a) that would otherwise prohibit the investment of plan assets in the deposits of a bank that is also a fiduciary to a plan. Therefore, both own-bank pension plans and the pension plans of other institutions may invest in such deposits provided that "(A) the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or (B) such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliate thereof) who is expressly empowered b the plan to so instruct the trustee with respect to such investment." Refer to Section 5, Subsection H.9 for additional discussion.

Therefore, investing employee benefit funds in own-bank interest-bearing deposits is a conflict that is not prohibited, but must be carefully managed to ensure that the interests of beneficiaries are protected. Even if authorized by the governing instrument and/or permitted by statute, such transactions must be made in good faith, e.g., permissive authority does not relieve the fiduciary of its duty of care and skill in the investment selection process. This requires interest rates to be competitive, and the fiduciary o have considered alternative investments and determined that the investment are both prudent and proper in light of the investment options available.

2. Deposit Insurance

Another consideration is the overall volume of discretionary investments in own-bank deposits held by an account. Generally, the amount of own-bank deposits held by an individual account (non-municipal account) should not exceed Federal deposit insurance coverage, unless the excess is adequately secured by other means. Section 24 of the FDI Act prohibits the pledging of bank assets to secure investments in non-public deposits, unless specifically approved via a Part 362 application.

In general, deposit insurance of fiduciary and other trust department accounts operates on a pass-through basis, with coverage provided to each beneficiary of each account. In most employee benefit accounts, deposit insurance is provided to the plan participant. It should, therefore, be uncommon for uninsured deposits to exist as long as each beneficiary's interest in fiduciary deposits does not exceed $100,000. The fiduciary institution must, however, adhere to certain requirements and there are some exceptions to the general rules. See Section 10 - Deposit Insurance of Trust Funds of the manual for further discussion.

3. Pledging Requirements

The pledging of bank assets to secure private deposits, generally for amounts not covered by FDIC insurance, is not a permissible activity for national banks, except for funds awaiting investment or distribution. In order for a state nonmember bank to pledge assets to secure private deposits, the bank must file an application for approval under Part 362 of the FDIC's Rules and Regulations.

E.3.c. Suitability of Own-Bank Deposits

In establishing policies and procedures, management considers if the pattern of use of own-bank deposits exposes the institution to claims that the deposits in general were not made in good faith or were not chosen with the requisite care and skill. This is especially important if fiduciary funds are swept daily to a own-bank interest bearing deposit account. For individual accounts, the policies and procedures should focus on the amount of own-bank time deposits, non-interest bearing demand deposits, the reasonableness of the interest rate received and whether these deposits are allowed by the governing instrument and state law..

1. Maturity and Size/Volume

To demonstrate that management is effectively monitoring this activity, policy and procedures should set parameters to guide the length of time own-bank deposits may be used and the level invested, such as a dollar amount or percentage of account assets. These parameters may be general in nature, but should include all own-bank deposit products used. There should be a method to report and monitor exceptions, with the level of detail depending upon the extent of use. For example, if an own-bank deposit product is used for daily sweeps, monitoring would be more extensive than for the infrequent use of time deposits. The monitoring of sweep activity should be on the same basis as the monitoring of similar investments with a third party.

Unless authorized by the governing instrument, court order or local law, trust funds should not be permanently invested in own-bank deposits. In general, discretionary funds that are awaiting investment or distribution should not be invested in own-bank time deposits. The short-term nature of deposits does not relieve fiduciary institutions from their duty of loyalty,

or the principles of care and skill when making investment decisions.

2. Uninvested Funds, Demand Deposits

Management must establish a formal system of monitoring uninvested funds. T he combined income and principal cash of all the department's accounts are generally deposited into one account. The key consideration is not the aggregate amount on deposit, but rather, the reasonableness of the uninvested balances of the individual accounts, considering both the individual account's liquidity requirements and the fiduciary's duty to make trust property productive.

To properly manage the conflict inherent in own-bank demand deposits, the amount held in demand balances of each account should be restricted to the minimum necessary. There have been a number of lawsuits in the past based on the fiduciary's management of demand deposits and its concurrent use of the funds for lending and investments, together with the benefit gained on the float of demand deposits. For employee benefit accounts subject to ERISA, of particular note is the Labor Department's position regarding Float Management; refer to Section 5, Subsection H.7.f.(3) and Advisory Opinion 93-24A.

3. Reasonableness of Interest Rates Paid

After taking into consideration the amount, term and type of deposit, management should be able to demonstrate that own-bank deposits pay a competitive rate of interest. In assessing the reasonableness of the interest rates offered on own-bank deposits, management should not rely solely on comparisons with interest rates offered by local depository institutions. Management should endeavor to obtain the *highest prudent rate of return possible*. Generally, national money market rates, as well as the interest rates offered by depository institutions nationwide, should be considered as a comparative benchmark when making such investment decisions. This is especially important when management uses own-bank deposits as a cash sweep vehicle.

The decision to use own-bank interest-bearing deposits should take into consideration the term of the deposit and the competitiveness of the interest rate paid. Each decision to invest in own-bank deposits must be properly supported and documented in the bank's records. Management must demonstrate that a valid basis existed for the use of own-bank or affiliated bank deposits.

E.4. Investment in Own-Bank or Affiliate Company Securities

Section 23A and 23B of the Federal Reserve Act are made applicable to the activities of insured state nonmember banks by Section 18(j) of the FDI Act. These statutes are primarily directed toward the prevention of abusive relationships between banks and their affiliates in the area of commercial banking. These sections do, however, have applicability to several types of fiduciary activities.

Careful review of the definition of "affiliate" in each section, and the differences in the definition between the two sections, is necessary when reviewing trust related transactions. Section 23B specifically excludes banks from its definition of affiliates. The term "bank" is defined in both sections 23A and 23B to include trust companies. Thus, bank-to-bank transactions and bank-to-trust company transactions are outside the scope of Section 23B. Examiners should be alert to the applicability of these statutes in all types of transactions with affiliates.

Fiduciaries are required to take an active shareholder role with respect to the companies whose securities it holds in a discretionary capacity. By exercising their shareholder right to vote in an informed and responsible manner they are afforded the opportunity to influence the management of those firms. Fiduciaries cannot readily claim a passive investor defense for not actively performing their role as shareholder. Doing so would evidence both imprudence and negligence as a fiduciary. Based upon the foregoing discussion, a fiduciary is required to vote own-bank stock held in a discretionary capacity, which places the fiduciary in a position of divided loyalty - it must place the interests of the account beneficiaries ahead of its own interest (which may not be the same), thus presenting a conflict of interest.

The voting of own-bank stock is further complicated when the fiduciary possesses, but is prevented from using, inside information (refer to Material Nonpublic Information). The fiduciary's ability to vote own-institution securities may also be influenced or restricted by local law or Federal law (e.g., ERISA, and Title 12 USC Section 61 with respect to National Banks).

In order to avoid the appearance of divided loyalty, many management teams have made a decision not to invest discretionary fiduciary funds in own-bank or affiliated company securities. However, many have not taken this same strong stance on securities that are received in-kind.

There are a number of actions that management may take to manage such conflicts of interest. The measures center primarily on the investment decision making and voting processes.

- Investment Decision - Management should fully document its rationale for retaining own-bank stock or obligations. For example, did management made the decision to purchase the shares or were the shares received in-kind. If shares are received in-kind, management should use diligence in selling such assets at an early date, unless the trust instrument, court order, or local law authorizes their retention. Typically, the retention of such securities is directed by the governing instrument or specific authority to retain such investments is obtained from all interested parties. Since state laws vary considerably with respect to the retention of own-institution stock received in-kind, it is important that the examiner be aware of the applicable state law.

- Voting Responsibility - When co-fiduciaries or others hold specific legal authority to exercise voting rights over such securities, management should permit such individuals or entities to vote the securities. When no other individuals or entities hold such authority, trust management should vote the securities exclusively in the best interests of the account beneficiaries, and document the rationale for how it voted the shares. Failure to exercise voting rights or continued voting with management (without exception or reason) can be viewed as a breach of trust. The reasons supporting a decision not to vote fiduciary shares should be fully documented. In order to ensure that shares are being voted independently, several trust departments have contracted with independent third parties to review all proxies and vote them in the best interest of the beneficiaries.

E.5. Sale or Purchase of Trust Assets to or From the Bank, Bank Insiders, Agents, or Affiliates

The sale or purchase of assets between an account and the bank, bank insiders, agents, or affiliates is an inherent conflict of interest. Inevitably, management is confronted with the dilemma of serving two diametrically opposed interests, one interest seeking the highest sales price and the other seeking the lowest sales price. Such transactions pose serious risk to both the account and the fiduciary, and should be scrutinized as to permissibility and fairness. The fiduciary, as arbiter and beneficiary of these transactions, may also be compelled to stand behind them as guarantor. Below are examples of such transactions, with suggested risk management procedures.

- Own-bank or affiliate repurchase agreements - Refer to Section 3 for a discussion of this activity.

Management purchasing own-bank, parent or affiliate stock held in an account. Such transactions may, or may not, be permitted under local law and the governing instrument. If permitted, the transactions should always be effected through non-affiliated third party brokers. Such transactions should always be covered by adequate written policies and documented as to the legal authority to engage in the transaction. Written approvals should also be obtained from all interested parties. Caution: this option is not always available, as interested parties may include the unborn, minors or others lacking the legal capacity to approve transactions, or beneficiaries who cannot be identified at the time of the transaction.

- Sale of assets to an account. This type of transaction must always receive careful evaluation by trust management. In addition to permissibility and fairness considerations, management must document the necessity for purchasing assets from itself or insiders when, as investment manager, it has numerous investment alternatives. When the legal authority to engage in the transaction is absent, and/or documentation as to the fairness and necessity of the transaction is either lacking or insufficient, such transactions should be scheduled for criticism. Consideration should be given to scheduling a Contingent Liability as discussed in the previous portion of this Section under Contingent Liabilities.

Section 23B(b)(1) of the Federal Reserve Act provides certain restrictions on fiduciary purchases of securities or other assets from an affiliate of the bank or its subsidiary. This provision is not directed toward transfers of trust departments (the "fiduciary book of business"), but is noted here because it is contained in Section 23B and it impacts the conduct of trust department business. Such purchases are prohibited unless permitted by the governing trust instrument, governing law, or court order. It is important to note that the term "permitted" is used in the statute, suggesting that Congress did not intend to require that express authorization for such purchases be incorporated into trust agreements.

E.6. Investment in Securities Underwritten by Own-Bank or Affiliates

Banks purchasing, as a fiduciary, securities for which the bank or an affiliate of the bank serves as an underwriter, is engaging in a self-dealing transaction. This traditionally occurred with municipal bonds. With the enactment of the Gramm-Leach-Bliley Act in 1999, the potential for such self-dealing transactions will increase, due to increased securities underwriting activity by financial subsidiaries of banks and bank holding companies.

Underwriting syndicates are composed of dealers that buy newly issued securities from issuers at a fixed price and sell them to the general public. Therefore, banks or bank affiliates participating in an underwriting syndicate have a vested interest in selling at a profit the securities underwritten. Failure to sell the securities in the open market at a price at least equal to the price paid by syndicate members (or the underwriting bid) constitutes a loss to the broker/dealer. Undivided syndicates are composed of dealers that share in the overall profits or losses on the sale of all securities sold by the entire syndicate.

The following policies and procedures should be in place to govern such purchases.

- Use of the same investment decision criteria for purchases of securities underwritten by the fiduciary or by its affiliates as is used when purchasing securities from non-interested parties (e.g., the normal investment criteria associated with any purchase decision).
- Compliance with the applicable law(s) and regulations governing such purchases. In particular, consideration to the relevant aspects of Section 23(b)(1)(B) and 23(b)(2) of the Federal Reserve Act.
- Assurance that the fiduciary is not making a market for the security and did in fact purchase the security at open market value.

Examiners should also be aware that the purchase of securities underwritten by the bank, its affiliates, or a member of an undivided syndicate in which the bank or affiliate is a member during the existence of the syndicate, is an apparent violation of Section 23B(b)(1)(B) of the Federal Reserve Act. Section 23B(b)(1)(B) states that a member bank "whether

acting as principal or fiduciary shall not knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of such bank." However, Section 23B(b)(2), as amended by Section 738 of the GLBA, provides an explicit statutory exception "if the purchase or acquisition of such securities has been approved, before such securities are initially offered for sale to the public, by a majority of the directors of the bank based on a determination that the purchase is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities."

Consequently, if a trust department held full investment discretion over an account and purchased securities during the existence of a syndicate, the transaction would not be a violation of Section 23B as long as a majority of the Board (who are neither officers nor employees of the bank) approved the transaction prior to the initial offering. Nevertheless, the transaction would be considered a conflict of interest and self-dealing. Any abusive situations or apparent violations of Section 23B should be discussed with management and appropriately noted in the Report of Examination.

E.6.a. Other Transfers and Agency Relationships between Affiliates

Instances may be encountered where, in lieu of an outright sale transaction, fiduciary business has effectively been transferred via written agreement. If a trust department enters into an agency relationship with certain affiliated entities, Section 23B(a)(2)(B) may apply. This requires the relationship to be on terms comparable to those existing for similar relationships where no affiliation exists. As previously noted, bank-to-bank and bank-to-trust company transactions are not covered by Section 23B. Where a sale transaction has not occurred, but an agency relationship has arisen, the discussion on Outside Contracting for Fiduciary Services in section G of this manual also applies.

In FDIC Legal Opinion on FRB Section 23B Fees and Affiliated Employee Benefit Plans, dated March 10, 1995, the FDIC has opined that a bank holding company's profit sharing plan may be an affiliate of the bank within that holding company. The opinion indicates that plans meeting certain prerequisites would be subject to both sections 23A and 23B. Therefore, dealings between a bank and such a plan, or a trust department and such a plan, should be reviewed in light of this opinion. (In particular, the definition of "affiliate" and "covered transaction" in Section 23A(b)(1) and (7) and 23B(d)(1) and (3) should be reviewed for purposes of this determination). Also, refer to Compliance - Employee benefits, Prohibited Transactions, for additional comments on this subject.

E.7. Relationships with Outside Service Providers

As with all other fiduciary activities, management's selection of outside service providers should be based exclusively upon the best interest of account beneficiaries, and not on the ancillary services or benefits that service providers may provide to the bank or trust department. Basing such relationships upon such ancillary services represents a breach of the duty of loyalty and a conflict of interest. Trust department management should support the reasonableness of the trust department's relationships with the outside service providers through a properly documented due diligence analysis. Refer to Section 10 - Outside Contracting for Fiduciary Services for further discussion.

Banks may have standing relationships or commitments with securities brokers, mutual funds, insurance agents, real estate agents, accountants, etc. Such relationships may include some form of rebate or reimbursement, whereby the bank receives a financial incentive for directing business to the service provider. The rebates and reimbursements may take various forms. Some may be based on a percentage of broker commissions (e.g., equity trades), or a percentage of the total dollar value of transactions executed (e.g., fixed income securities or mutual fund purchases). Some rebates may b hidden as a reduction in the price of a good or service due to the volume of assets invested, the number of items held in safekeeping, or the extent of services purchased. An example of the later would be to use the bank's external audit firm to perform audits for closely held businesses held in trust accounts or in the preparation of taxes for the trust customers, with the bank receiving a reduction in the cost of its annual audit and the trust customers

assessed a full fee.

Regardless of the form of such compensation, the following guidelines should govern such financial reimbursement arrangements. The arrangement must be (1) in the best interests of the account beneficiaries and (2) permitted by applicable laws and the governing instrument. With respect to agencies and revocable trusts, prior written approval should be obtained after a full disclosure of the financial arrangement s made to the customer. Periodic account statements should provide either a line item disclosure of the fees associated with such arrangements or a disclosure of the total annual fees associated with an account's usage of such services. Account statements should not report income, or gains/losses, on a "net" (net of applicable fees) basis. Net reporting is considered misleading and deceptive, and should be criticized by the examiner.

E.8. Inter-Account Transactions

Inter-account transactions occur when assets are sold directly from one account to another, bypassing a non-affiliated third party broker. While attractive from the standpoint of reducing or eliminating commissions paid to third parties, the fiduciary must demonstrate that the transactions' terms were as advantageous to all parties, involved had these transactions been conducted through a third party. Management must:

- Comply with Applicable Laws and Regulations - Applicable regulations include Section 344.8 of the FDIC's Rules and Regulations, which requires investment managers to have written policies governing the crossing of buy and sell orders on a fair and equitable basis.
- Establish Adequate Written Polices.
- Develop Procedures to Monitor and Report Inter-Account Transactions - Inter-Account transactions should be reported to the appropriate supervisory level. Management should be alert to situations where trust officers may be engaging in such transactions in an effort to dispose of assets, either because they were erroneously or improperly purchased, or because they have depreciated in value. The sale of assets between accounts under these circumstances would constitute a breach of trust and result in a Contingent Liability on the part of the bank. It may also involve a violation of FDIC Section 344.8(a)(4).

An example of a situation where an inter-account transaction would be appropriate is the transfer of assets between related accounts. For example, the sale of an interest in a closely held business from one trust account to another related trust account (where the accounts share the grantor, beneficiaries, remaindermen, etc., *and* (1) where the sale is directed or authorized by the grantor, or the governing instrument, or (2) where the written approval of all beneficiaries and, if necessary, remaindermen, is obtained, or (3) where the transaction is approved by a court of law). Also, as noted above, the department should have written policies governing this type of transaction. As with all conflicts of interest, fiduciaries should seek to avoid inter-account transactions, and limit them to instances that provide demonstrable benefits to all accounts involved.

E.9. Multi-Account Transactions

Multi-account transactions are intrinsically neither good nor bad. When permissible under local law or the governing instrument, they can, and in some instances, would be expected to occur in the normal course of business. In a typical multi-account transaction, the fiduciary purchase or sell shares in large blocks and allocate the shares purchased or sold among accounts. If the block was purchased at different prices from more than one broker, management must take extraordinary care to ensure that all aspects of the allocation, including the price of the security, number of shares, and commissions charged is fair for all parties.

Management must ensure that all accounts are treated fairly in the allocation process and that proper policies are in place to govern such transactions. Accounts, by virtue of their size or other consideration, must not be permitted to benefit unfairly at the expense of other accounts. FDIC Section 344.8(a)(3) requires investment managers to have written policies governing fairness in the execution of multi-account securities transactions.

E.10. Contravention of Terms of the Governing Instrument

Failing to act according to the terms of the agreement or deviating from the governing terms of the agreement without proper authority may give rise to a contingent liability. The contravention may be due to circumstances beyond the fiduciary's control, such as an unforeseen event, or may be due to breaches of the fiduciary's duties. The latter might involve an investment decision or a failure to consult with a co-fiduciary. Contraventions due to unforeseen circumstances are an inherent risk of fiduciary activity. However, contraventions caused by the failure of the fiduciary to properly administer an account are unacceptable.

E.10.a. Ambiguous Language

Contraventions may occur when the terms of the instrument are ambiguous. In such instances, the fiduciary *may be* permitted to consider circumstances and conditions outside of the instrument to determine the settler's intent. One method of limiting such risks is to carefully review the governing agreement prior to accepting an account in order to ensure that the language of the agreement is precise and that all of the fiduciary's powers and duties are clearly defined in the agreement. This applies to both revocable and irrevocable trusts, since, due to future events, a revocable trust may become irrevocable.

E.10.b. Changing Circumstances

Frequently circumstances regarding either the settlor, the beneficiary or conditions affecting the administration of the trust will result in contraventions of the governing instrument. An example is the receipt of instructions from the settlor that contradict the terms of the original agreement. Management must be cautious when following the settlor's directions subsequent to the creation of the governing agreement. Unless the instrument permits the revocation or the modification of the agreement, the terms may not be changed. If the trust is revocable, it should be amended to permit the otherwise impermissible act. Another example occurs when required actions become impossible, illegal, or due to a change of circumstance, defeat the original purpose of the trust. For example, older trusts were written with very restrictive investment directions, such as only permitting investments in the direct obligations of the United States. Years later the trust, which may be small, may need to generate income and principal growth for an incapacitated remainderman. A mutual fund investing in U.S. Government and Agency securities may be a suitable investment, except for the very restrictive investment provisions of the original trust agreement. In the absence of an emergency, the trustee should first obtain authorization from a court of competent jurisdiction before deviating from the terms of a trust. A trustee who deviates from the letter of the trust without the sanction of the court and/or beneficiary does so at the peril of afterward having to provide evidence that the deviation was both necessary and appropriate.

E.10.c. Unauthorized Commingling of Assets

There should be no unauthorized commingling of assets by a fiduciary. In the following instances, however, commingling is allowed:

- State law permits a trustee to deposit uninvested funds belonging to several fiduciary accounts into a single deposit account.
- Assets are held in a special form of partnership, called a nominee, to facilitate the purchase, sale, and collection of income. Most governing agreements (personal, agency, and employee benefit) allow for assets to be held in a nominee name.
- Funds are invested in collective investment funds. Most modern trust agreements allow for this type of investment.

In all other respects, unless specifically permitted by law, assets of each fiduciary account should be kept separate from both the assets of other fiduciary accounts and the assets of the bank. In carrying out this responsibility, the bank should identify all assets with the name of the

fiduciary account. For example, mortgages, deeds, stocks, and registered securities should be in the name of the bank as fiduciary for the account. If the bank is acting in a agency or custodial capacity, registration would be in the name of the principal, unless otherwise directed or authorized by the governing agreement. Such authorization, however, is common.

E.10.d. Nonconforming Investments

Accounts must not hold nonconforming assets. For personal trust accounts, nonconforming investments are those that do not conform to state law, the terms of the governing instrument, or, in the case of employee benefit plans subject to ERISA, investments that do not conform with the plan documents (refer to Subsection 5.H.3.), do not meet the prudence and diversification requirements of ERISA, or which result from transactions prohibited by ERISA (refer to Subsection 5.H.7.).

E.10.e. Failure to Invest

All funds, including income and principal cash, should be made productive, unless the trust instrument, local law, court order, or a party empowered to direct investments provides otherwise. A fiduciary's failure to invest may result in liability for the loss of income. When required to invest in a particular investment vehicle, the failure to do so will result in liability for the loss of any increase in value if the investment appreciates. Any decision to leave cash uninvested should be properly documented

E.10.f. Acts Without Consent or Approval of a Co-Fiduciary

When there is more than one trustee, the general rule is that they cannot exercise the powers conferred upon them unless they agree. As such, co-fiduciaries should execute the duties of their office in their joint capacity. *Where discretion is required*, as distinguished from purely ministerial acts, the *joint action of the trustees is required unless the trust instrument or applicable statute provides otherwise*. The decision to purchase, sell, or distribute (invade principal) trust property involves the exercise of discretion requiring the joint action of the co-fiduciaries, and should have the written approval. Absence of documentation evidencing joint approval may expose the bank to the risk of loss in the event actions are subsequently challenged.

In certain instances, Section 405 of ERISA makes a fiduciary liable for the wrongful acts of co-fiduciaries. Refer to Subsection 5.H.6.a. for a discussion on how proper allocation procedures will permit one fiduciary to insulate itself the actions of co-fiduciaries..

E.11. Privacy

Conflicts of interest related to privacy include breaches of loyalty due to the sale of confidential information to third-parties and to maintain control over trust property. The first breach may occur when the sale of non-public customer information to increase fiduciary revenue supersedes the beneficiaries' need or desire for confidentiality. The second breach may occur when the fiduciary fails to adequately safeguard confidential information. The current concern in this area focuses on information aggregators. Information aggregators assemble client information, often financial in character, from various on-line sources and present the client's information in a single convenient interface. The activity is sometimes referred to as screen scraping, and is addressed in the next subsection. Regardless of the cause of the breach, adequate policies and procedures are required to control conflicts arising from consumer privacy issues. Refer to Section 10 of the Manual for a discussion of the required contents of a privacy program.

E.11.a. Privacy and On-line Banking

When a fiduciary offers on-line access to client information, the potential exists that an unauthorized entity or person may access the information. Even when done with the permission of the client, such on-line access can expose the fiduciary to liability for failing to properly safeguard confidential information. Essentially, the client provides the information aggregator with pin numbers and passwords to all their financial accounts and the aggregator enters each entities system, collects the client's data, and presents it to the

client in a combined format. In many cases, trust and agency agreements do not allow the sharing of information with parties other than the beneficiaries. Methods for managing the risk to the fiduciary include:

- Separating fiduciary customer information from general customer information on on-line systems, e.g., separate pin and password to access fiduciary information;
- Informing customers of the potential risks of screen scraping and adding language to written on-line user agreements to address this activity;
- Modifying the language of governing documents (trust and agency agreements) to allow for this activity;
- Including cautionary disclosures on the fiduciary's website which request customers to notify the fiduciary if they have provided an information aggregator with on-line access to account information; and/or
- Establishing procedures for monitoring screen scraping activity.

E.12 Prohibitions against Tying Arrangements

Trust departments and banks must be aware of potential conflicts of interest when they condition the price or availability of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank. Although Section 106 of the Bank Holding Amendments of 1970 prohibits this type of activity, the regulations specifically permit tying arrangements if the customer is required to obtain a "traditional bank product" such as a "loan, discount, deposit or trust service". Section 106 also prohibits a bank from preventing a customer from obtaining a product or service from a competitor, unless the condition is imposed in a credit transaction to ensure the soundness of the credit. Tying arrangements are prohibited by the Sherman and Clayton Anti-trust Acts; however, these acts require showing that a practice harms the public, while Section 106 has no such requirement.

The difficulty for a bank or its trust department is understanding what is a traditional bank product. The Board of Governors of the Federal Reserve System has provided the following specific examples of traditional bank products as guidance:

- All types of extensions of credit, including loans, lines of credit, and backup lines of credit;
- Lines of credit and financial guarantees;
- Lease transactions that are the functional equivalent of an extension of credit;
- Credit derivatives where the bank or affiliate is the seller of credit protection;
- Acquiring, brokering, arranging, syndicating and servicing loans or other extensions of credit;
- All forms of deposit accounts, including demand, negotiable order of withdrawal (NOW), savings and time deposit accounts;
- Safe deposit box services;
- Escrow services;
- Payment and settlement services, including check clearing, check guarantee, ACH, wire transfer, and debit card services;
- Payroll services;
- Traveler's check and money order services;
- Cash management services;
- Services provided as trustee or guardian, or as executor or administrator of an estate;
- Discretionary asset management services provided as fiduciary;
- Custody services (including securities lending services); and
- Paying agent, transfer agent and registrar service.

Several other types of arrangements are allowed under Section 106. The regulations do not prohibit a bank from imposing conditions in order to enhance the credit of its borrowers, such as requesting additional collateral, requiring insurance on collateral or restricting a

borrower's total debt, even at a competing institution. Section 106 also does not restrict non-bank affiliates from requiring a customer to use bank's services. Furthermore, a bank may require a customer, in accepting bank services, to choose from a combination of traditional and non-traditional products, so long as the customer can fulfill its obligation to the bank solely through traditional products.

Some specific examples of violations are cited by the Federal Reserve. A bank may not require a borrower to do any of the following in order to obtain a loan:

- Purchase an insurance product from the bank or an affiliate of the bank (a prohibited tie);
- Obtain corporate debt or equity underwriting services from an affiliate of the bank (a prohibited tie);
- Sell the bank or an affiliate of the bank a piece of real estate unrelated to the requested loan (a prohibited reciprocity arrangement); or
- Refrain from obtaining insurance products or securities underwriting services from a competitor of the bank or from the competitor of an affiliate of the bank (a prohibited exclusive dealing arrangement).

As tying arrangements can be very complicated, it is imperative that management establish policies and procedures to ensure that bank employees comply with the anti-tying prohibitions of Section 106. The procedures should include education and training, particularly for personnel that have direct contact with customers for purposes of marketing and selling the bank's products, especially in the bundling of traditional and non-traditional products. Trust department employees should be aware that securities underwriting, insurance products and securities advisory services are not considered traditional banking services for the purposes of Section 106. Furthermore, employees should be free to seek legal advice in the event of a potential violation of Section 106.

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FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Section 9- Earnings, Volume Trends and Prospects

Table of Contents

This section discusses the evaluation of the current operating results of a trust department and its impact on the bank's profitability. In reviewing the trust department's earnings performance, the examiner must evaluate past earnings trends and assess the effect on profitability of anticipated future business growth. The evaluation of earnings also considers senior bank and trust department management's views about trust department profitability, including the emphasis placed on establishing reasonable goals and objectives for profitability, expressed either in terms of an expected level of profitability or the growth of new business).

This section of the Manual is organized into the following parts:

A. General

B. Policies

C. Accounting for income, expenses and losses

1. Income
2. Expenses
3. Loses

D. Evaluating profitability

E. Budgets

F. Direct and indirect trust expenses

G. Regulatory reporting

1. Call Report - Report of Income
2. Call Report - Fiduciary Schedule RC-T
3. Annual Report of Trust Assets - Schedule E (Trust Income Statement)

H. FDIC implementation of 1998 uniform interagency trust rating system

I. Alternate earnings rating standards for smaller institutions

A. General

In recent years banks have become increasingly aware of, and focused on, the contribution of noninterest income to profitability. Recurring fee income can enhance profitability, and it is often less volatile than interest income. Trust department income can be an important component of noninterest income. As individuals increasingly accumulate financial assets to store wealth, trust departments have experienced vigorous growth in assets under management. The profitability of these departments has heightened the attention of management. This trend has also resulted in a proliferation of nonbank financial and fiduciary

service providers, greatly increasing the competition faced by banks offering trust and other fiduciary services.

The Corporation recognizes that not every trust department will be profitable. Many small trust departments are operated primarily as a community service. Trust services are also offered in order to retain more profitable relationships elsewhere in the bank.

Although various reasons for offering trust services exist, the FDIC expects each bank operating a trust department to be aware of the department's contribution, or cost, to the operating earnings of the bank. Banks operating trust departments should regularly measure and evaluate the impact of both direct and indirect trust income and expenses on their overall profitability. Some form of accounting system should be implemented to provide the basis for an analysis of the department's income and expense data. Management may use those results to determine which services should be continued or discontinued, whether fees should be adjusted, and which types of accounts should be emphasized in new business development efforts.

B. Policies

The shareholders of a bank operating a trust department have the right to expect a reasonable return on their investment. This requires profit motivation from the board of directors, and a fee structure which covers the costs of providing trust and fiduciary services and provides a reasonable return. A trust department's fee structure should be reviewed and approved periodically by the trust committee, or some other senior operating committee. Trust management should establish a business plan, with realistic goals, that takes into consideration the department's size and resources. Business plans and budgets that are integrated with those of the entire bank have a greater likelihood of communicating trust profitability goals, objectives, and expectations to bank management and personnel. However, in banks with very small trust departments, policies or plans covering overall bank operating performance may satisfactorily embody the trust department's budget, fee schedule, or business plan. In these situations, examiners should avoid criticizing a bank for not establishing separate trust operating policies, or for not integrating these policies with the institution's operating plan.

Trust policies should also include management's position on fee discounting, fee concessions and waivers, and compensating balances. Policies should clearly describe those to whom discounts will be allowed, the purpose for granting discounts, the types of services for which fees may be discounted, and the method by which the trust department may be compensated by the bank for such discounts. Trust policies should require that all discounts, concessions, or compensatory arrangements be documented and approved by the trust committee, or some other operating committee. The policies should also indicate who is authorized to grant such discounts. Policies which permit trust personnel to unilaterally approve discounts, concessions, or waivers without the informed approval of a senior operating committee pose control weaknesses. Such policies permit individual staff members to alter approved fee schedules without the directorate's knowledge and approval. They also provide individuals with the ability to waive account fees to mask account problems and errors that should be brought to management's attention.

Another aspect of rating trust profitability is the department's prospects for future growth. Examiners should evaluate the control and management of the trust department growth and new business development prospects. An essential element in a successful business plan is marketing, which should identify the segments of the fiduciary services market where the department will concentrate its new business development efforts. In marketing the department's services, management must ensure that the bank has the expertise, staff, and facilities to satisfactorily manage the volume and types of new business sought.

Examiners should evaluate the reasonableness of the marketing plan. While no one approach will suit every bank and market, there are some areas which are common to most departments. The marketing plan should include a definition of the market area for trust services (which may differ from the market identified for commercial and retail banking products). The characteristics of the market area, including demographics, geographic or legal impediments (e.g., there may be difficulties in marketing some products in an adjoining state), and existing trust competition should be considered in estimating the growth potential of various services. Sources of new business (existing bank customers, new customers based on demographics, professional referrals, etc.) should be evaluated. Finally, the means of generating new business should be addressed. These may take the form of presentations to attorneys or public groups, direct mailings and statement fliers, lobby posters and brochures, and print and broadcast advertising. The bank's strengths and capabilities must be factored into any plan, particularly one which

projects large or rapid growth, or contemplates offering new products.

C. Accounting for income, expenses and losses

Each trust department should have a system for measuring and monitoring its income and expenses. The system does not necessarily need to be elaborate to provide sufficient information for management, but it should be commensurate with the department's size and growth trends. Systems should track direct income and expenses and, to the extent possible, include indirect expenses, as well.

C.1. Income

Fee and other direct income of a particular department are usually measured using either a cash or an accrual accounting method. Fees charged to trust accounts are usually the primary component of direct rust revenue. These fees are often based on the size (market value) of the account, but may take into consideration the type and complexity of the assets under management, the volume of transactions in the account, the customer's total relationship with the bank, and other factors. Less often, fees may be assessed as a percentage of the income earned by an account. Other direct income may include sweep fees, 12b-1 fees, etc. (Note: Gross income from the trust department is reported as a separate line item of noninterest income on the quarterly Report of Income) Other common contributors to trust income are:

- Indirect income - Indirect income may include intracompany income credits, such as credits for deposits, allocated to the trust department in recognition of income earned in other areas of the bank's operations as a result of the business relationship developed by the trust department. Indirect income is more difficult to measure than direct income. While it is generally recognized that a trust department generates other, often more profitable, business for an institution, many institutions do not attempt to estimate the profits that client relationships developed in the trust department produce in other areas of the institution.

- Bank calculated credit for deposits - A credit for deposits is based upon deposit balances maintained in the commercial bank by accounts in the trust department. Both interest bearing and non-interest bearing deposits should be included in the calculation to obtain a realistic estimate of contribution of the department's deposits to commercial bank profitability. Typically, the calculation considers how the bank is investing the funds deposited by the department, determines (or estimates) the average interest rate the assets acquired when investing trust department deposits are earning, and subtracts the interest paid for each type of deposit (plus deposit insurance premiums and administrative costs) in arriving at the net rate earned. The net rate is then applied to the average balances for each type of deposit account to determine or estimate the dollar value of credit for deposits.

The role played by trust department deposits in bank profitability should not be ignored when evaluating the profitability of the department. Credit for deposits remains a key element in determining a trust department's contribution to bank profitability. Furthermore, specialized trust activities such as corporate trusts and agencies (refer to subsection B. in Section 6), frequently rely on trust deposit balances to achieve trust profitability in the highly competitive market for these services. Consequently, the volume and anticipated float duration of corporate trust deposits plays a vital role in the structuring of corporate trust and agency fees and commissions. With respect to the deposits of personal and employee benefit accounts, however, a high level of trust deposits, and a correspondingly higher credit for deposits, may be indicative of a breach of prudent fiduciary practice, since investments in own-bank deposits is both a conflict of interest and self-dealing. Refer to subsection E.3. Use of Own-Bank or Affiliate Bank Deposits, located in Section 8 for specific conflict of interest issues relating to trust deposits.

Since banks may include a credit for deposits in calculating the profitability of trust services, examiners should evaluate the reasonableness of the methodology and assumptions used to calculate the credit for deposits. An analysis that includes a credit for deposits should not be limited to own-bank demand deposits, but should include all trust-generated own-bank deposits in determining the credit for deposits, since all deposits, including savings and time deposits, can be invested to provide a positive return to the institution.

With the advent of the automated sweeping of uninvested funds (refer to subsection F.1.b. Sweep Arrangements, located in Section 3) into overnight investments, the volume of idle demand deposits, as well as the associated credits for deposits, has significantly diminished in many trust departments. Nevertheless, departments with a high volume of corporate trust activity may still carry significant uninvested cash balances. The investment of these funds for the department's benefit, in the form of relatively risk-free overnight investments, should not be criticized unless the fiduciary is required to invest the funds for the benefit of the obligor under terms of the governing instrument or corporate trust indenture**.**

C.2. Expenses

Departmental expenses generally fall into two categories, direct and indirect. Direct expenses are identifiable costs directly chargeable to, for and under the control of the fiduciary and related services function. These expenses include: salaries, bonuses, hourly wages, overtime pay and incentive pay associated with officers and employees, expenses associated with employee benefits, such as contributions to employee benefit plans, health and life insurance costs, social security and unemployment taxes, relocation expenses and other fringe benefits, expenses associated with occupancy, such as maintenance, service and repairs, telephones and utilities, insurance coverage, real estate or property taxes, depreciation/amortization, lease/retail payments for premises and equipment, any leasehold improvements charged directly to expense, fees paid directly for external or internal audits of the fiduciary and related services, trust examination fees, employee training, fees directly paid for outside legal counsel and/or consultants, and, expenses paid directly for advertising and business development activities.

Indirect expenses are those expenses charged to the fiduciary and related services activity from other departments of the institution. Indirect expenses are generally reflected in the institution's retail accounting system and include any allocation for the proportionate share of corporate expenses that are not directly charged to a particular department or function. If the institution's internal accounting system is unable to provide the information, the institution may use a reasonable alternate method to estimate indirect expenses. Indirect expenses include: the proportionate share of data processing expenses, building rent or depreciation, utilities, real estate taxes, and insurance, internal and external audits of trust activities, in-house and/or outside legal expenses, non-trust employee incentives, business development activities, charitable contributions, and corporate overhead, such as allocated expenses for corporate planning and/or financial staff, board of director/committee fees, training, temporary personnel and professionals, travel, entertainment, stationary and postage, and automobile expenses. Reporting methods for indirect expenses should remain consistent from period to period.

Settlements, surcharges and other losses should not be included in direct or indirect expenses, but should be reported separately. Refer to discussion of losses below.

It is not unusual for a given type of expense to be incurred on both a direct and an allocated basis. Salaries are likely to be the largest direct expense category in most trust departments. Examples of expenses likely to be incurred, other than salaries, are listed in the Direct and Indirect Trust Expenses table located in subsection F.

In larger departments, cost accounting systems may provide a sophisticated means of measuring trust department profitability. Elaborate systems can measure costs by product line, type of account, individual administrator, type of transaction, or other areas or functions within a department. An effective cost accounting system may also help establish a fiduciary services pricing structure based upon the cost of services provided, such as the amount of labor required to provide particular services or to execute transactions, the number of transactions processed, portfolio valuations and investment advisory services, etc.

Even in small departments, the major expense category, salaries, can be estimated by determining the percentage of each staff member's time devoted to trust activities. In the same way, employee benefits may be allocated to the trust department by taking the total amount of benefits for the bank as a whole and dividing it by total salaries. This percentage can then be applied against the previously determined trust salary figure. Data processing and auditing costs can often be identified, or easily allocated to the trust department as well.

C.3. Losses

An important consideration in any evaluation of trust department profitability is the level of settlements, surcharges and other losses. Persistent or a large volume of losses usually indicates underlying account or asset administration problems, or other operational weaknesses. Management should have reliable systems that identify all settlements, surcharges, and other losses. Settlements, surcharges and other losses should be reported to the trust committee, or some other senior operating committee. Losses may be attributable to the following:

- Settlements

  Formal and informal agreements to reimburse trust accounts, customers, or beneficiaries, but which are reached without a court decree.

- Surcharges

  Amounts that the fiduciary is required by court decree to pay trust accounts, customers, or beneficiaries. Surcharges are normally associated with negligence, failure to perform fiduciary duties, or misconduct.

- Fee Waivers and Concessions

  The most common form of fee loss. Many departments will waive or rebate previously charged fees and commissions. While some fee waivers may be based on banking relationships, some fee waivers may also be a way to adjust an account in response to customer complaints for: operating, administrative, or investment errors, the failure to invest funds promptly, the failure to file timely tax returns, losses attributable to the failure to renew a insurance policy or losses attributable to inadequate insurance coverage of property losses, etc

- Operational Errors

  E rrors from trade processing, lost or stolen securities, miscalculation of fees or taxes, pricing discrepancies or other losses that are realized in the reporting period attributable to the fiduciary and related services.

Other sources of losses from fiduciary activities include: defalcations; uncollectible fees; and civil money penalties imposed by regulatory agencies; etc.

In analyzing settlements, surcharges and losses, examiners should recognize that the gross amount of the loss may be offset, in many cases, by insurance coverage. Further, trust accounting systems may account for settlements, surcharges and losses on either a gross or net basis. On a gross basis, the entire amount is reported as loss, and any recovery, such as from insurance proceeds, is reported as an income item. On a net basis, insurance proceeds and other recoveries are netted against the loss, with only the net figure reflected. Either approach is satisfactory if applied on a consistent basis. However, when trust policies permit any form of netting, examiners should determine whether trust management is reporting gross losses to senior management, or "netting" the losses as a method of masking, or hiding, the actual amount of trust losses.

Examiners should be aware that many institutions do not recognize settlements, surcharges, and losses as a component of trust department profitability. Instead, they are shown as losses and recoveries in the bank's general accounting system. Thus, the review of trust profitability should consider the possibility that significant settlements, surcharges and losses may not appear in the trust accounting system at all. It is imperative that the trust department's reporting systems inform senior management and the directorate of the actual dollar amount and nature of trust losses. If not, senior management and the Board may remain unaware of serious operational and administrative deficiencies. Such Internal control weaknesses should be brought to senior management's attention and discussed in the report of examination.

Trust departments with greater than $100 million in fiduciary assets must report fiduciary settlements, surcharges, losses, and recoveries in Memorandum item 4 of Call Report of Condition Schedule RC-T. Institutions complete Memorandum item 4 only for the

December 31st filing, and are required to report settlements surcharges, losses and recoveries on a gross basis, i.e. before insurance payments. Recoveries reported may be for current or prior years' losses, and are reported only when the recovery is actually realized, i.e. payment is received. The filing of an insurance claim does not support the realization of a recovery for RC-T purposes.

D. Evaluating Profitability

While earnings can largely be determined through a review of the trust department's accounting system, several other factors should be evaluated concurrently. These are:

- The emphasis placed by senior management on profitability, in terms of establishing profitability objectives and monitoring operating results;
- The bank's size and demographics of geographical market (e.g., a young population is not likely to produce many estates; trust department or commercial bank size may impose natural limitations on absolute levels of profitability; and geographic location may dictate the level of competition for fiduciary services);
- The degree of dependence on nonrecurring fees (e.g., estates or other court appointed accounts);
- Special circumstances, such as major declines in the securities markets, or the loss of a major local employer; and
- Unusual circumstances regarding the composition of business, fee schedules, settlements, charge-offs or other compromise actions, or adverse publicity.

In evaluating earnings, emphasis should be placed not only on the existing levels of profitability, but also on recent earnings trends, the department's new business development efforts, and competitive factors. Such n analysis will permit examiners to determine the likelihood that current earnings performance will continue.

E. Budgets

Budgets are encouraged for all trust departments, and should be expected in larger, more complex trust departments. Management should document the reasonableness of the assumptions used in the budget process. Budgets should be established, approved, and periodically reviewed by senior management. Significant deviations between actual and budgeted performance should be brought to the attention of senior management.

Examiners should evaluate policies regarding the operating performance and earnings prospects of the trust department. In situations where management has no clear policy in these matters, or where record keeping is inadequate, the examiner should make appropriate comments in the report of examination.

F. Direct and indirect trusts expenses

Other than salaries, expenses likely to be incurred by trust departments are listed below:

Category	Direct Trust Expenses	Allocated Expenses: (Trust function's proportionate share):
Employee Benefits	• Contributions to employee benefit plans (pension, profit-sharing, 401(k), ESOP, etc.). • Health and life insurance. • Social Security and unemployment taxes. • Employee relocation expenses. • All other "fringe" benefits.	• N/A
	• Trust department processing performed on trust department equipment or by outside data processing servicers. • Lease or rental of trust EDP	• Data processing expense for applications performed by other areas of the bank or its affiliates.

Data Processing	equipment. • Depreciation or amortization for trust EDP equipment. • Repairs and maintenance, service or maintenance contracts. • Non-capitalized purchases of software. • Related supplies etc.	
Occupancy	• Ordinary repairs and maintenance, service or maintenance contracts. • Telephone and utilities. • Insurance coverage. • Real estate and other property taxes. • Depreciation r amortization, lease and rental payments for premises and equipment (exclusive of EDP). • Leasehold improvements charged directly to expense and not booked as assets.	• Building rent or depreciation, utilities, real estate taxes, and insurance.
Audit	• Fees paid for external audits of trust activities.	Estimated costs for: • Internal and external audits of trust activities. • Audits performed by the bank's parent holding company.
Legal	• Fees paid for outside legal counsel, whether as a retainer or for specific legal services.	• Institution's in-house and/or outside legal costs.
Marketing	• All expenses paid by, or directly chargeable to, the trust function for advertising and other business development activities	• Incentives paid to non-trust employees. • Institution's business development activities, whether performed in-house or by outside contractors.
Corporate Overhead	• N/A	• Non-trust audit and examination fees. • Salaries and benefits of executive management. • Board of directors, trust committee (and related subcommittees) fees. • Public relations and institutional marketing. • Charitable contributions. • Customer parking. • Holding company overhead. • Functions such as personnel, corporate planning, and corporate financial staff.

Other expenses which would likely be found in a trust department operation are:

- Stationery, postage, travel and entertainment, vault and security costs, automobile expenses, etc.
- Applicable state trust examination fees.
- Temporary staffing expenses, including those for attorneys, accountants, consultants, investment advisors or managers, and other professionals who are not salaried officers or employees of the institution.
- Training and testing expenses, as well as dues, fees, and other expense associated with memberships in clubs and organizations.

G. Regulatory reporting

Trust institutions are required to report certain data concerning the profitability of trust and fiduciary services. Because these reports provide a standardized set of data prepared in a uniform manner, they should be used whenever possible to aid examiner efficiency and eliminate needless requests for earnings data. Nonetheless, examiners should review the reasonableness and accuracy of the trust and fiduciary services profitability data reported. If significant errors in the reported data are found, the institution should be requested to promptly file amended reports correcting the errors.

G.1. Call Report - Report of Income

Gross fiduciary income is reported as a separate noninterest income line item (5a) of the Report of Income on both the small-bank report (FFIEC Form 041) and the large-bank report (FFIEC Form 031).

Through year-end 2000, gross fiduciary income was reported as a separate line item of noninterest income only by large bans (i.e. banks with $100 million or more in total bank assets), which filed FFIEC Form 031. Smaller banks and trust companies aggregated trust income with other fee income.

G.2. Call Report - Fiduciary Schedule RC-T

Beginning in December 2001, a new schedule, RC-T, "Fiduciary and Related Services," was added to the Call Report of Condition. Schedule RC-T includes information on Fiduciary and Related Services Income, as well as a memorandum item which covers Fiduciary Settlements, Surcharges, and Losses. Fiduciary and Related Services Income data, as well as the Fiduciary Settlements, Surcharges, and Losses data are confidential and, therefore, not available to the public on an individual-bank basis. Not all institutions, however, are required to report data on fiduciary income, expenses and losses. Only those institutions with greater than $100 million in fiduciary assets, as of the previous year-end, and those that do not meet the fiduciary income test , i.e. institutions where gross fiduciary and related services income exceeds ten percent of revenue (net interest income plus noninterest income), are required to report income, expense and loss data in Schedule RC-T.

Trust companies, large institutions (i.e. those with more than $250 million in total fiduciary assets), and institutions that do not meet the fiduciary income test are required to complete certain line items of Schedule RC-T on a quarterly basis. Banks with total fiduciary-related assets between $100 and $250 million must complete all applicable line items of Schedule RC-T only as of the December 31st year-end Call Report submission. The trust asset thresholds are based on total fiduciary assets as of the previous year-end.

In reviewing Schedule RC-T for accuracy, examiners must be familiar with the instructions for completing Schedule RC-T. The instructions for completing Schedule RC-T are available on FDIC website, http://www.fdic.gov/regulations/resources/call/crinst/602rc-t.pdf. Particular note is made of the following:

- Fiduciary and related services income should be reported on the basis of the various lines of trust business reported in the Fiduciary and Related Assets section of Schedule RC-T.

- Direct and indirect fee income is reported in Items 12 through 18 of Schedule RC-T. The total of these items must equal the amount reported in Item 5.a., i.e. Income from Fiduciary Services, of the Call Report of Income.

- Item 18 (Other fiduciary & related services income) is used to report investment advisory fees when the assets are not held by the institution.

- Item 20 (Expenses) includes all direct and indirect expenses attributable to the fiduciary and related services reported in RC-T.

- Item 21 (Net losses from fiduciary and related services) must equal the net totals from Memorandum # 4 (Fiduciary settlements, surcharges, and other losses).

- Item 22 (Intracompany income credits for fiduciary and related services). Three basic types of income credits should be reported at this item: any credit for own-bank deposits calculated by the bank; allocations of income received from elsewhere in the bank; and credits received for other intracompany services and transactions.

G.3. Annual Report of Trust Assets - Schedule E (Fiduciary Income Statement)

Prior to the implementation of Call Report Schedule RC-T, institutions reported fiduciary income, expenses and losses in Schedule E of the Annual Report of Trust Assets. Schedule E was implemented in 1996, and, as is the case with the income, expense and loss data reported in Call Report Schedule RC-T, the information reported in Schedule E is confidential and not available on an individual institution basis. Aggregate Schedule E data, however, is available to the public via the FFIEC publication "Trust Assets of Financial Institutions." Schedule E aggregate reports can accessed via the FDIC's website at http://www2.fdic.gov/structur/trust/index.asp .

H. FDIC implementation of 1998 Uniform Interagency Trust Rating System

The 1998 Uniform Interagency Trust Rating System (UITRS) [refer to subsection A. in Appendix B] was implemented under Division of Supervision Regional Director Memorandum transmittal number 98-102, which was issued on December 31, 1998. Guidelines for the Corporation's implementation of the new rating system, including instructions for the preparation of the Earnings examination schedule, and an alternative rating system for small trust departments, were outlined in this Regional Director memorandum.

The 1998 UITRS permits agencies to adopt their own guidelines governing the assignment of an Earnings rating for institutions total assets of less than $100 million, as reported on Schedule A, Line 18, Column F of the FFIEC Annual Report of Trust Assets (FFIEC 001). [Note that with the discontinuation of the Annual Report of Trust Assets at the end of the 2000 reporting year, the $100 million threshold is calculated by adding total fiduciary assets reported on line 9 of Call Report Schedule RC-T to total custody and safekeeping assets reported on line 10 of RC-T.] The Corporation issued the following guidelines in its December 31, 1998 memorandum:

- Required Examination Coverage **-** Trust earnings must be reviewed, analyzed and evaluated at each trust examination.
- Mandatory Ratings - Trust earnings are to be routinely rated only at:
  - Institutions with $100 million or more in trust assets (based on the latest FFIEC Annual Report of Trust Assets) and
  - Trust company subsidiaries of nonmember banks.
- Alternative Ratings Assignment for Small Trust Institutions - Trust earnings must be rated in small ("community") trust institutions when one o the following is present:
  - The trust department has $90 million or more in total fiduciary and custody and safekeeping assets, as reported in Call Report Schedule RC-T, and its recent growth indicates that it is reasonable to believe that it will exceed the $100 million asset threshold by the end of the current calendar year.
  - The trust department has dropped below $100 million asset threshold in the past year, but is reasonably expected to exceed $100 million in the near future.
  - Trust department earnings are a significant to the bank's overall earnings (gross trust fees are 50 percent or more of net bank income).

When trust earnings are rated in smaller trust institutions, the revised UITRS provides a different set of standards for evaluating the adequacy of trust earnings. In these cases, the examiner should primarily focus on the following management oversight and approval issues, rather than numerical profitability:

- A reasonable method of measuring trust income and expense, commensurate with the volume and nature of fiduciary services offered,
- Appropriate reporting of trust profitability, not less than annually, to the board of directors or an appropriate committee thereof, and

- Approvals, from the board of directors or an appropriate committee thereof, for the offering of fiduciary services.

I. Alternate earnings rating standards for smaller institutions

The 1998 Uniform Interagency Trust Rating System (UITRS) [refer to subsection A. in Appendix B], provides minimum standards and ratings definitions for rating the earnings component of smaller institutions under an alternate rating system. As discussed above, the Corporation adopted the alternate earnings rating approach for smaller institutions in 1998.

Minimum Standards for Smaller Institutions:

Alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management. These standards are:

- Standard No. 1--The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- Standard No. 2--The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- Standard No. 3--The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- Standard No. 4--The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services even if the institution does not earn sufficient income to cover the expenses of providing those services.

Alternate Ratings Definitions for Smaller Institutions:

A **rating of 1** may be assigned where an institution as **implemented all four minimum standards**. If fiduciary earnings are lacking, management views this as a cost of doing business as a full service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A **rating of 2** may be assigned where an institution has **implemented, at a minimum, at least three of the four standards**. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A **rating of 3** may be assigned if the institution has **implemented at least two of the four standards**. While management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A **rating of 4** may be assigned if the institution has **implemented only one of the four standards**. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A **rating of 5** may be assigned if the institution has **implemented none of the standards**.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Section 10- Other Trust Matters

Table of Contents

This section contains an overview of Federal regulations and other matters related to fiduciary activities.

A. Trust powers

B. FDIC consent to exercise trust powers

1. FDIC Part 333 Consent Requirement
2. FDIC Part 303 Applications for Consent
3. Unauthorized Trust Activities

C. Mergers, acquisitions, and transfers of fiduciary business

1. Federal Deposit Insurance Act Section 18(c)(1)
2. Affiliates - Federal Reserve Act Sections 23A and 23B
3. Applicable State Law
4. FDIC Consent
5. Nonstatutory Considerations

D. Methods used to deliver fiduciary services

1. Trust Branches and Trust Service Offices
2. Interstate Trust Branch Offices
3. Trust Companies
4. Trust Referral Arrangements
5. Private Banking Services

E. Examination authority of subsidiaries and affiliates

1. FDI Act Section 10 and the Gramm-Leach-Bliley Act
2. Bank Service Corporation Act

F. GLBA provisions for fiduciary activities

1. SEC Registration Requirements

a. Registered Broker

1. Regulation R

a. Trust & Fiduciary Exception

1. Chiefly Compensated

2. Trade Execution Requirements

b. Custody & Safekeeping Exception

1. Exemption for Employee Benefit, IRA, and Other Accounts

2. Exemption for Accommodation Trades

3. Subcustodians

c. Networking Exception

1. Referral Fees

2. Bonus Programs

d. Exemption for Referrals of High Net Worth/Institutional Customers

e. Sweeps Account Exception/Money Market Fund Exemption

f. Exemption for Transactions in Regulation S Securities

g. Exemption for Securities Lending Transactions

b. Registered Dealer

c. Investment Advisers

2. Privacy Issues Faced by the Fiduciary

a. Applicability to Trust Operations

b. Applicability to Fiduciary Customers/Consumers

G. Outside contracting for fiduciary services

1. Applicable Regulations

2. Due Diligence Reviews

3. Written Agreements With Agents

4. Periodic Monitoring of Agent's Condition and Performance

5. Client Disclosures

6. Delegation of Investment Management Services

7. Use of a Registered Securities Broker as Custodian

H. Servicing contract accounts

I. Enforcement actions

1. Types of Enforcement Actions

a. Informal Actions

b. Formal Actions

2. Enforcement Action Resources

3. Civil Money Penalties

J. Criminal activities

K. Insurance of fiduciary activities

1. Errors and Omissions (Trust Department Surcharge Liability)

2. Real Estate and Mortgages

3. Other Desirable Insurance

L. Deposit insurance of trust funds

1. Deposits of Revocable Trusts

2. Deposits of Estates

3. Deposits of Irrevocable Trust Accounts

4. Deposits of Trust Agency Accounts

5. Deposits of Employee Benefit Accounts

6. Deposits of Certain Retirement Accounts

M. Applicability of consumer regulations to fiduciary activities

A. Trust Powers

Trust powers are granted to state-chartered banks under state law, which is usually administered through a bank's chartering authority. It is state law, therefore, which defines activities constituting fiduciary or trust powers. The FDIC always defers to state law in these matters.

State statutes and Corporation regulations do not always uniformly identify what functions constitute "fiduciary" activities requiring trust powers. Some state statutes define "trust activity" as serving in a (state's) legally defined capacities of trustee, executor or administrator of estates, or guardian of the estate of a minor or incompetent. However, the term "trust activity" is not as clear when a bank is performing an agency function which may, or may not, require trust powers. Some banks administer "managed agency accounts" wherein there is no "trust" relationship, yet the bank often assumes full control of cash and assets, including investment discretion. In these cases, the bank's responsibilities exceed those exercised in passive, or directed personal trust accounts, or in court directed estates and guardianships. While a bank may claim it is not acting in a "trust" capacity for such accounts, its activities may require trust powers under state law.

The term "fiduciary capacity" is neither universally defined, nor does it have identical meaning among the states in setting their requirements for trust powers. The term "fiduciary" is broadly defined. It can be almost any party performing a financial or other service for another party. For example, some banks operate corporate trust departments in which they do not serve as "trustee" for any account, but perform extensive financial services which require trust powers. Some states distinguish between "court" and "private" accounts, and require such things as a faithful performance bond or uninvested cash pledge for designated court accounts. Furthermore, the term "trustee" per se, is not always a determinative, since banks have been authorized to serve as "trustee" over certain types of accounts (IRA's) without having been granted trust powers.

It is also necessary to clarify the types of "agency functions" which are considered "trust activities" requiring state authorization. Many commercial banks are permitted to provide escrow, safekeeping, custodian, or similar directed-agency services, without having a trust department or regulatory authorization to perform trust powers. This may include physical custody of assets, record keeping, collecting and remitting income, performing some administrative actions (as in escrow services), or similar activities. Whether any such activities are permitted without "trust powers" is wholly dependent

upon state law.

B. FDIC Consent to exercise trust powers

In 1958, the Corporation articulated its basis for requiring consent to exercise trust powers (refer to Appendix C, FDIC Memorandums Regarding Consent to Exercise Trust Powers, dated June 30, 1958), and established conditions for grandfathering consent. Banks granted trust powers by State statute or charter prior to December 1, 1950, regardless of whether or not such powers have ever been exercised, are not required to file an application with the Corporation for consent to exercise trust powers. Such consent is grandfathered with the approval for Federal deposit insurance.

Banks approved for Federal deposit insurance after December 1, 1950, are required to file an application to exercise trust powers, unless such filing was made simultaneously with the application for Federal deposit insurance.

B.1. FDIC Part 333 Consent Requirement

The Corporation does not grant trust powers, but only gives its consent to exercise such powers as granted by state authorities. Section 333.2 of the FDIC Rules and Regulations prohibits an insured state nonmember bank from changing the general character of its business without the Corporation's prior written consent. The test to determine when a change in character of business has occurred is left to the discretion of the Corporation. For trust powers, this normally occurs when a fiduciary relationship is created under the laws of the governing state authority. Therefore, it is general policy that unless a bank is exempted through the circumstances described in the background section above, it must file a formal application with the Corporation to obtain prior written consent before it may exercise trust powers.

It should also be noted that the statute applies only to banks. Separately chartered and capitalized uninsured trust company subsidiaries of banks need not apply for FDIC consent to exercise trust powers. Also, state nonmember institutions that acquire or start registered investment adviser subsidiaries do not have to apply for FDIC consent to exercise trust powers under Section 24 of the FDI Act or Part 362 of the FDIC Rules and Regulations.

B.2. FDIC Part 303 Applications for Consent

Part 303 of the FDIC Rules and Regulations governs the administrative handling of applications for consent to exercise trust powers. Application procedures are set forth in Part 303, the Manual of Examination Policies (Manual), and the Case Managers Procedures Manual (CM Manual). Banks eligible for expedited processing under Part 303 (as defined therein) may file an abbreviated application. Application forms for both expedited and non-expedited processing can be downloaded or requested from an FDIC Regional Office .

Applications are reviewed in the context of the financial institution's ability to satisfactorily perform trust activities. In reviewing any such application, the statutory factors set forth in Section 6 of the Federal Deposit Insurance Act are considered along with the factors discussed in the Manual of Examination Policies and CM Manual applications sections.

B.3. Unauthorized Trust Activities

Commercial banks may be found performing fiduciary services without having obtained full or limited trust powers, or the Corporation's consent to exercise such powers. In these cases, the examiner should determine what services are being performed, and review all written customer agreements. If a bank is acting in any capacity requiring trust powers, the examiner should:

- Cite an apparent violation of state law for performing fiduciary services without trust powers (if applicable);
- Cite an apparent violation of FDIC Section 333.2 for changing the character of its business without the Corporation's prior written consent; and,
- Advise management of the following:
  - that it must discontinue accepting any additional appointments;
  - that it should (upon advice of counsel) discontinue performing fiduciary services, if it can do so without jeopardizing its accounts or incurring additional liability upon itself;

- that it must apply to its state authority for trust powers (if applicable); and
- that it must also apply to the Corporation for consent to exercise the powers.

Refer to the applications section of the Manual of Examination Policies for further information.

C. Mergers, acquisitions, and transfers of fiduciary business

Purchases, sales, or transfers of fiduciary business between banks and other entities can involve complex legal issues. Several statutes may govern such transactions, depending on individual case-specific circumstances. Mergers, acquisitions, and transfers are predominantly a safety and soundness issue and inquiries from bank management and examiners on this subject should generally be referred to the applicable FDIC Regional Office. The five items discussed below are intended to provide an appreciation of the regulations and risk management process that management should follow in mergers, acquisitions, or transfers of a "fiduciary book of business".

C.1. Federal Deposit Insurance Act Section 18(c)(1)

Section 18(c)(1) of the Federal Deposit Insurance Act is sometimes referred to as the Bank Merger Act (BMA). In general, the BMA is applicable whenever insured deposits are involved in a "merger" transaction. However, in instances where a trust department, or fiduciary "book of business", is "purchased" outright and is not involved in a "merger" transaction, it is not clear whether the Act is applicable. A critical determinant may be whether "deposits," as defined in Section 3 of the FDI Act, are part of an assumption or merger transaction. The Corporation's "Statement of Policy; Bank Merger Transactions" should be reviewed in determining BMA applicability. Where applicable, the BMA requires the prior written approval of the FDIC for any merger, consolidation, or purchase and assumption transaction. Refer to the Manual, Applications for Mergers, for further discussion of the application process.

C.2. Affiliates - Federal Reserve Act Sections 23A and 23B

Sections 23A and 23B of the Federal Reserve Act are made applicable to the activities of insured state nonmember banks by Section 18(j) of the FDI Act. These statutes are primarily directed toward the prevention of abusive relationships between banks and their affiliates in the area of commercial banking. These sections do, however, have applicability to purchases and sales of trust departments between affiliated entities.

Careful review of the definition of "affiliate" in each section, and the differences in the definition between the two sections, is necessary when reviewing trust related transactions. Section 23B specifically excludes banks from its definition of affiliates. The term "bank" is defined in both sections 23A and 23B to include trust companies. Thus, bank-to-bank transactions and bank-to-trust company transactions are outside the scope of Section 23B.

1. Applicability to Purchases and Sales of Trust Departments between a Bank and its Affiliates

   In transactions where assets are purchased from an affiliate, Section 23A(a)(4) applies. It requires the transaction to be on terms and conditions consistent with safe and sound banking practices. Such provisions are designed to ensure inter-affiliate transactions occur on a commercially reasonable basis; and that compensation between the parties, where warranted, is reasonable.

   In transactions where assets are sold to an affiliate, Section 23B applies in some cases. This Section requires the transaction to occur on terms, and under circumstances, such as those prevailing for non-affiliated entities. As previously noted, bank-to-bank and bank-to-trust company transactions are not covered by Section 23B.

   It is important to note that, in transactions where a trust department or fiduciary business is purchased or sold, the "asset" involved is an intangible expected future flow of fee income arising from the underlying trust accounts. Incidental assets, such as premises and equipment used to conduct business, may also be involved in such transactions.

The following chart illustrates the applicability of Federal Reserve Act Section 23B to several types of transactions involving purchases or sales of fiduciary activities:

Application of FRB Section 23B [Re: Compensation] on the Purchase (or sale) of a trust department to (or From) Another Institution:						
FROM:	**TO:**					
	OWN BANK	**OWN BANK SUB**	**AFFILIATED INSURED BANK-SUB**	**BHC NONBANK SUB**	**NON-AFFIL INSURED BANK**	**NON-AFFIL UN-INS ENTITY**
OWN BANK	N/A	No	No	**YES**	No	No
OWN BANK SUB	No	No	No	**YES**	No	No
BHC SUBSIDIARY	**YES**	**YES**	**YES**	No	No	No
NON-AFFILIATED UNINSURED ENTITY	No	No	No	No	No	No

Expanded discussions of Federal Reserve Act Sections 23A and 23B are provided in Section 8.E.4 Conflicts of Interest and Section 4.3 of the Manual of Examination Policies.

C.3. Applicable State Law

State nonmember banks, and other companies, must obtain authority to exercise trust powers from the applicable state in which they operate. Applicable state law may also address certain types of transactions involving consolidations of trust business. These provisions, if any, will ordinarily be found under a state's organization and merger statutes. State law will also typically address transfers, or substitutions, of fiduciaries. In some jurisdictions, and with some types of accounts, court approval may be required. Provisions related to this will usually be found in state statutes dealing with trusts. Where questions arise, the Regional Office or appropriate state authority should be contacted for guidance.

C.4. FDIC Consent

As discussed at the beginning of this section, if the acquiring or resulting entity is a state nonmember bank, application to the Corporation for consent to exercise trust powers may be necessary in merger or other acquisition transactions. FDIC consent is nontransferable. Therefore, the act of purchasing a trust department from a bank which has such consent does not convey that consent to the purchaser. Consent must be applied for unless the acquiring bank already has such consent. In all instances where the acquiring entity is a state nonmember bank, examiners should ensure the transaction was

in compliance with FDIC Parts 303 and 333.

C.5. Nonstatutory Considerations

In addition to adherence to various Federal and state statutes, a host of other concerns attend the purchase, sale, or transfer of trust activities or accounts from one fiduciary to another. While several of these issues are discussed in depth elsewhere in this manual, they are listed here to facilitate a review of transactions involving institutional transfers of trust business. These issues necessarily emphasize the impact such transactions have on the safety and soundness of the institutions involved:

1. Compensation

   The valuation of trust departments for purposes of a sale is not a well-defined process. Conventional business valuation methods may employ the use of average gross income generated by the activity, times some multiple, to arrive at a price or value. Present value analysis of expected cash flows from fees may also be used. In analyzing either a purchase or sale, the examiner should request and evaluate documentation of the basis for the sales price and terms. In some instances, no compensation may be warranted. In other instances, the lack of adequate compensation could be a Federal Reserve Act 23A or 23B issue (for non-exempt parties) or a general safety and soundness concern.

2. Written Agreement

   Trust transfers and sales should be subject to a written agreement. The agreements should address:

   - the effective date of the transaction;
   - indemnification between the parties relevant to fiduciary actions, and in the event of future contingencies;
   - provision allowing a due diligence process;
   - division of fees between buyer and seller during transition;
   - compensation, or a sales price, as discussed above;
   - specific identification of accounts to be transferred;
   - duties and responsibilities of each party in effecting the transfer of accounts and records;
   - duties and responsibilities of each party in effecting the transfer of underlying assets;
   - termination and modification provisions; and
   - escape clauses, as necessary, to address such contingencies as failure to obtain regulatory approval.

3. Capabilities of the Fiduciary

   The entity acquiring the trust business should be legally qualified to do so. State authority and FDIC consent to exercise the types of powers associated with the acquired business should be in place. Moreover, management should possess the skills necessary to administer the new accounts. Management should have evaluated the need for additional trust personnel, data processing capabilities, bank premises, and other facilities to accommodate the new business well in advance of the acquisition.

4. Resultant Earnings

   Depending on the circumstances, pro forma projections of earnings may be requested as part of the FDIC application process. Regardless, management is expected to have evaluated the impact of such transfers on the bank's earnings. Economies of scale are often cited as a reason for acquiring or selling trust departments. While this is a legitimate factor, such economies are not guaranteed and may not materialize in every consolidation. Moreover, they do not always translate into improved bank earnings.

5. Capital Adequacy and Accounting Considerations

Engaging in fiduciary activities subjects an institution's capital to additional risk. Capital adequacy can be adversely affected by the acquisition of significant new accounts or new business lines if not properly managed. Related deposit growth from the acquisition may also place strains on capital.

Trust activities may be referred to as "off balance sheet" activities, in as much as there typically is no book value assigned to the business. In instances where a bank purchases or sells a group of trust accounts from another entity for some value, the bank will need to properly account for the transaction on its books. Where the bank purchases only fiduciary activities, the purchase price should normally be recorded on its statement of condition as "goodwill" or "trust department intangibles." This value: (1) should be amortized in accordance with generally accepted accounting principles, but (2) it should not be included in Tier 1 capital computations. In some instances, the purchase may also involve tangibles, such as fixed assets in which trust activities are conducted. Those assets should be accounted for in the usual fashion. In all cases, underlying trust account assets continue to be the property of the respective trusts. As such, they are not subject to purchase or sale between the buying and selling institutions. Where a bank sells its trust business, it will typically not have a basis, or book value, for the business. Consequently, the entire price it receives should be reported on its income statement as a nonrecurring income item and under "other operating income" on the Call Report.

6. Notification to Account Parties

   Written notification to the respective account parties on each account transferred is mandatory from a prudence standpoint. In some states, state law may require such notification or otherwise address this issue.

7. Successor Fiduciary Issues

   To the extent that the purchasing entity becomes a successor fiduciary of the acquired trust accounts, several well-recognized duties accrue. These are discussed both in Compliance - Personal and Charitable Accounts, and Compliance - Employee Benefit Accounts, Fiduciary Responsibilities.

   In addition to ensuring the prompt and orderly transfer of assets held in trust between fiduciaries, and ensuring the uninterrupted administration of the accounts, successors are obliged under general common law tenets to scrutinize the acts of their predecessors. Successor fiduciaries should seek redress for any wrongs committed by previous fiduciaries. This is considered an essential due diligence procedure. In doing so, successor fiduciaries should: (1) obtain and review an accounting from the previous fiduciary for each account acquired, and (2) request an indemnification from the prior fiduciary for all actions taken during its administration of an account.

8. Fidelity and Indemnity Coverage

   Purchasing entities should alert their carriers early to the acquisition of new business. Bank management should ensure that coverage is afforded, including coverage for acts of all prior fiduciaries "discovered" following their acquisition of an account.

D. Methods used to deliver fiduciary services

The trust department, as a separate and visibly distinct department of the bank, remains the most prevalent method for banks to deliver fiduciary services. However, the recent trend toward consolidation within the financial services sector has led to diverse restructuring and merger activity. In some instances, banks previously lacking trust product lines may have acquired them through mergers. In other cases, the "trust" line of business may have been purchased or sold by a bank. In some cases, trust services being provided by several individual banks owned by the same holding company may have

been consolidated within one bank, or within a separately chartered trust company. In still other instances, a bank may have contracted with an unrelated outside party, to provide such services on-premises. Conversely, the bank under examination may provide such services to other banks. To effectively assess the risk such relationships pose to the institution, the examiner may find it helpful to understand the organization, the legal structure of the delivery system, the reasonableness of the relationship, and the reasonableness of the compensation to the bank.

D.1. Trust Branches and Trust Service Offices

In some instances banks may wish to establish "branch" offices of their trust departments. Where the trust branch is to be located within an existing *intrastate* branch of the bank, there are usually no legal barriers and no further legal hurdles. When a trust branch office is proposed at a location where the institution *does not have an existing branch*, the procedure is more complex.

If a trust branch (or "trust service office"), in the course of conducting its business, is an office where "deposits are received, or checks paid, or money lent" - (1) such office is considered by the FDIC as a "domestic branch" under Section 3 of the FDI Act, and (2) the bank must apply to the FDIC (and state) for permission to establish and operate a new branch.

This is due largely to the statutory definition of the term "deposit". Section 3(l) of the FDI Act defines the term deposit to include trust funds, *w*hether held in the trust department, or held or deposited in any other department of the bank or savings association. The broad inclusion (within the statutory term "deposit") of virtually all trust monies which may be on hand anywhere in the bank, in any form, has implications. It will generally mean that the conduct of trust activities which involve accepting funds will also be considered to be branch banking or accepting deposits. This necessitates that banks either conduct trust activities in existing branches, or that they apply for a branch, if they intend to accept funds (other than non-cash assets) at the "trust branch" or "trust service office."

D.2. Interstate Trust Branch Offices

State nonmember banks, and other companies, must obtain authority to exercise trust powers from the applicable state in which they operate. States may limit the authority of out-of-state entities to engage in fiduciary activities within their borders. Therefore, banks or other state-chartered entities which legally offer trust services in one state, typically need to obtain separate approval from another state before conducting trust business there.

In contrast with the foregoing, both the OCC and OTS have issued similar opinions effectively permitting national banks and federal savings associations to operate trust businesses on an interstate basis. A national bank with trust powers (under 12 USC 92a) may engage in trust activities to the same extent that state banks, trust companies, or other corporations in competition with national banks, are permitted to engage in. If a state permits the foregoing state licensed entities to compete with national banks in trust activities, but prohibits out-of-state companies from doing so, Section 92a may be used to preempt state law. This effectively permits national banks to engage in trust activities in any state in which its branches are located.

In 1996, the Conference of State Bank Supervisors (CSBS), the FDIC, and the Federal Reserve Board signed an interstate banking and branching agreement for state-chartered banks. This agreement, revised in December 1997, allows states to adopt laws permitting interstate operation of trust businesses. This permits state chartered entities to be competitive, and complement the interstate activities in the commercial banking arena.

CSBS assisted in the drafting of the "Nationwide Cooperative Agreement for Supervision and Examination of Multi-State Trust Institutions" that was executed in June 1999. To date, 42 states have signed the agreement, which lays out the framework for the supervision and regulation of multi-state trust institutions. The agreement is on CSBS's web site at http://www.csbs.org/government/agreements/agreements.asp.

D.3. Trust Companies

-Trust Companies

The term "trust company" can be misleading. In some states, a bank must have trust powers in order to have "trust" in its name. In other instances, banks have incorporated the term into their name, even when the bank does not have trust powers. Thus, the term may simply denote an insured bank.

In other instances, trust activities may be conducted from a separate corporate entity, or "trust company". In many cases, trust companies are subsidiaries of bank holding companies, but there are a few that are direct subsidiaries of insured banks. In other cases, the trust company may be owned by the parent company or it may be a truly independent "stand alone" trust company and have no parent organization.

FDIC-Insured Trust Companies

Trust companies may be an insured bank which does almost all of its business as a trust institution. They qualify for deposit insurance under 12 C.F.R. § 303.14, which states that a single non-trust deposit of at least $500,000 would meet the statutory standard of Section 3(a)(2)(A) of the Federal Deposit Insurance Act. An institution with a single non-trust deposit of at least $500,000 will be considered "... in the business of receiving deposits, other than trust funds ..." and, thus, qualifies for Federal deposit insurance. These institutions may receive a bank charter from the state or the OCC, or a federal savings bank charter from the OTS. These insured trust banks are examined the same as other insured banks.

Non-FDIC-Insured Trust Companies

Most trust companies are not insured by the FDIC. These companies are chartered and regulated by the state or by the OCC. Trust companies which are owned by a bank holding company are also subject to supervision by the Federal Reserve Board. Trust companies that are owned by banks are subject to examination and supervision by the parent bank's primary regulator.

A trust company that is a direct subsidiary of an FDIC-supervised bank is viewed as a separately-chartered and separately-capitalized entity. As such, its trust powers are granted solely by the chartering agency, and the trust company is not required to seek the FDIC's consent to exercise trust powers. In like manner, the trust company's parent bank is not required to have the FDIC's consent to exercise trust powers if all of its trust activities are conducted by the separately-chartered subsidiary trust company.

Instructions for Call Report Schedule RC-T states that the schedule should be completed on a fully consolidated basis, i.e., including any trust company subsidiary (or subsidiaries) of the reporting institution.

As noted under Section E. Examination Authority , trust companies that are direct subsidiaries of FDIC-supervised banks may be examined by the FDIC. However, such examinations are not required under GM-1 requirements. However, they may be examined if the supervisory Regional Office determines that their activities have a material and substantive impact on the parent bank. Also, refer to coverage of the Gramm-Leach-Bliley Act (GLBA) concerning examinations of affiliates. Examination reports furnished by the trust company's primary regulatory agency may also be reviewed for normal monitoring of the trust company's activities .

If an examination of a trust company that is a direct subsidiary of an FDIC-supervised bank is performed, examiners should determine that its activities are generally consistent with the Statement of Principles of Trust Department Management. If examiners suspect that the uninsured trust company is being utilized to generate deposits for the parent bank in an unauthorized fashion, the activity should be investigated and compared with the Section 3(o) of the FDI Act definition of a domestic branch and applicable State Law. Consult with the respective Regional Office, if corrective action is needed.

D.4. Trust Referral Arrangements

Some institutions ("host banks") have entered into third-party agreements with unaffiliated trust institutions and registered investment advisers for the offering of fiduciary services to "host bank" customers. The "host bank" does not need trust powers because the fiduciary relationship is between the client and the third party and typically receives a one time or annual referral fee based on the assets of the referred clients. While the "host bank" does

not have any investment or fiduciary powers, it may retain administrative responsibilities and receive administration fees in addition to the referral fee. All trust referral arrangements, regardless of whether the bank retains any administrative duties, should be governed by a written agreement that outlines the responsibilities of all parties.

Additionally, the client should be sufficiently informed of the general terms of this relationship with reasonable and meaningful disclosures. For example, disclosures should be given upon the establishment of an account and periodically (but not less frequently than annually) thereafter. The disclosures should be sufficient to identify to the client the party that is administering the client's account. If the third-party is responsible for making such disclosures, the host bank should ensure that the disclosures are provided, and, if appropriate disclosures have not been made, should take the necessary actions to provide the disclosures.

Some banks have entered into arrangements whereby customers are referred to third-parties who are not located on bank premises. Such arrangements can include referrals by trust department personnel that may involve the sale of non-deposit products (NDPs). The bank may receive a fee or other monetary benefit for making such referrals.

The Interagency Statement on Retail Sales of Nondeposit Investment Products applies to trust activity under the following two circumstances:

- When non-institutional customers direct investments for their fiduciary accounts, such as self-directed IRA and KEOGH plans in trustee or custodial accounts. For such accounts, the three minimum disclosures from the Interagency Statement apply.
- When the customer has sole investment discretion for an agency account. For such accounts, the entire statement would be applicable.

The above two circumstances were outlined in Regional Director Memorandum "Nondeposit Investment Products (NDIP) and Recordkeeping Requirements Questions and Answers, issued June 23, 1998. The memorandum states that self-directed employee benefit accounts such as 401(k) accounts are not subject to the Interagency Statement, as ERISA laws considers them to be fiduciary accounts. The Statement also does not apply to custodial accounts (other than self-directed retirement accounts) where the institution is performing ministerial acts such as collecting interest and dividend payments for securities held in the accounts and handling the delivery or collection of securities or funds in connection with a transaction.

Determining whether a bank offering such trust products on the premises of another bank is in fact, operating a "domestic branch" can be difficult. One critical determinant may be whether the bank offering trust products is "receiving deposits." A variety of contractual provisions may also impact the final determination, including the use of the host-bank as a "correspondent bank" to accept trust customer deposits. In some instances, it has been held that banks may contract with other banks to act as their agent in conducting certain limited activities, including the taking of deposits, without being deemed to be operating a branch. Refer to FDIC Advisory Opinions 93-57 and 95-22 for additional information.

But, the process of "offering trust services" goes beyond the receipt of deposits. In the absence of established examination policies, examiners should ascertain the facts, document the contractual provisions and practical operation of the arrangement, and forward the information to the Regional Office for its determination.

D.5. Private Banking Services

The USA PATRIOT Act, Section 312, provides the following definition of a "private banking account" as it applies to the Act. - The term 'private banking account' means an account (or any combination of accounts) that--(i) requires a minimum aggregate deposit of funds or other assets of not less than $1,000,000; (ii) is established on behalf of 1 or more individuals who have a direct or beneficial ownership interest in the account; and (iii) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account.

Generally, a bank might offer "private banking" services to a select group of its more wealthy customers - high net worth individuals and their corporate interests. Such services will usually provide the customer with all conventional banking products at one location and through one bank officer, or a team of such officers, thus eliminating the need for the customer to physically visit several separate departments. Typically, a private banking department will provide an array of personal and financial services, including estate and financial planning, trust and investment advisory services, personal loans, and maintenance of deposit relationships. Many private banking clients choose this method of financial management for the personalized service and confidentiality provided.

Private banking services have increased in popularity in recent years as more banks have begun to rely on the income generated by this service. The structure and sophistication of private banking services varies by bank size and business structure. Examiners are also reminded that smaller institutions may offer similar services to certain customers while not designating it as private banking. Without the implementation of appropriate oversight, policies, and risk management systems, management may expose itself to increased reputational and legal risks inherent in this business.

D.5.a. Management Oversight - Private Banking

As with all significant business lines, senior management has a responsibility to formulate a sound risk management and control environment. A business plan outlining the targeted client base, range of services provided, and financial risk objectives and tolerance levels should be implemented. The scope and depth of coverage typically vary depending upon the size and complexity of services offered. However, management has a responsibility to define acceptable targets and review for compliance with such targets.

D.5.b. Policies - Private Banking

As with other areas of the bank, suitable written policies provide a basis upon which to operate. If appropriate policies and internal controls have not been implemented, there may be cause for concern. Management may expose the institution to reputational and legal risks, if compliance with USA PATRIOT Act and Anti-Money Laundering regulations are lacking. A sound private banking operation will typically have written customer due diligence guidelines to assist in the prevention of illicit acts.

Some standard customer due diligence guidance includes:

- obtaining identification and basic background information on clients,
- describing the clients' source of wealth and lines of businesses,
- requesting references and handling referrals, and
- identifying suspicious transactions.

The USA PATRIOT Act requirements for a customer identification program promotes a risk-focused approach { Section 1.H.2 USA Patriot Act Compliance}. For example, Section 312 of the Act requires private banking accounts involving foreign persons to be considered for enhanced due diligence.

- Section 312(a)(i)(1): IN GENERAL- Each financial institution that establishes, maintains, administers, or manages a private banking account or a correspondent account in the United States for a non-United States person, including a foreign individual visiting the United States, or a representative of a non-United States person shall establish appropriate, specific, and, where necessary, enhanced, due diligence policies, procedures, and controls that are reasonably designed to detect and report instances of money laundering through those accounts.
- Section 312(a)(i)(3): Minimum Standards For Private Banking Accounts- If a private banking account is requested or maintained by,

or on behalf of, a non-United States person, then the due diligence policies, procedures, and controls required under paragraph (1) shall, at a minimum, ensure that the financial institution takes reasonable steps--`(A) to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, such account as needed to guard against money laundering and report any suspicious transactions under subsection (g); and `(B) to conduct enhanced scrutiny of any such account that is requested or maintained by, or on behalf of, a senior foreign political figure, or any immediate family member or close associate of a senior foreign political figure that is reasonably designed to detect and report transactions that may involve the proceeds of foreign corruption.

D.5.c. Risk Management - Private Banking

Management should be able to identify, measure, monitor and control the reputational, fiduciary, legal, credit and operational risks inherent in private banking. This should include relationship documentation and due diligence standards, controls over the flow of client funds , adequate management information systems, and procedures to identify and report suspicious activity.

State law in most cases continues to require that a separate set of books and records for trust services be maintained. (This is required by the Statement of Principles of Trust Department Management, also.) This will hold even though they may be located in several areas of the bank, and not integrated with the records of the trust department. Examiners will thus need to ascertain the particulars of recordkeeping for all trust activities in banks under examination. Examiners should also ensure that the fiduciary assets of private banking activities are reported in the bank's Call Report Schedule RC-T.

D.5.d. Segregation of Duties, Compliance and Audit - Private Banking

Many successful private banking operations employ the principle of segregation of duties in order to maintain an effective internal control environment. The effective segregation of duties enhances compliance with policies and procedures by facilitating the identification and correction of errors and the detection and investigation of irregularities. The compliance program should be independent of management to enhance its effectiveness. Reviewing for compliance with customer due diligence guidelines, bank policies, and other laws and regulations is an essential part of a compliance program. Lastly, an effective independent audit function can provide assurance that the internal control structure of the private banking function is being maintained and operated adequately.

E. Examination authority of subsidiaries and affiliates

An expanded discussion of the Corporation's authority to conduct examinations of affiliates is contained in Section 4.3 of the Manual of Examination Policies (Manual) and the Case Manager's Procedures Manual (CM Manual). Relevant statutory provisions are discussed below.

E.1. FDI Act Section 10 and the Gramm-Leach-Bliley Act

Section 10(b) of the FDI Act empowers examiners to make a thorough examination of insured institutions and their affiliates, while Section 10(c) of the Act gives the Corporation limited authority to examine other entities which may not be affiliated with the financial institution in question. An assessment of whether a review of affiliated entities is needed should be determined during the pre-examination risk-scoping process. Examiners must support the need for affiliate examinations and must undertake no affiliate examination without prior approval from the Regional Office.

Prior to initiating formal procedures seeking to exercise statutory authority to examine third parties, it is expected that informal, voluntary avenues (simply asking the bank to request the third party to provide data) will have been exhausted. In all cases, the examiner should consult with the Regional Office on such matters.

The enactment of the Gramm-Leach-Bliley Act (GLBA) provides additional guidance on the review of affiliates. The GLBA reserves the FDIC's authority under Section 10 of the FDI Act to examine affiliates and subsidiaries of insured depository institutions to the extent it is necessary for the FDIC to determine the relationship between the institution and the affiliate and the effect the relationship has on the depository institution. However, before conducting an examination, visitation, or investigation of a functionally regulated subsidiary or an affiliate of a bank, the examiner should communicate with the functional regulator. Examiners should determine whether a review of an affiliate's activities is necessary during the pre-examination risk-scoping process. Contact with the functional regulator should be made in accordance with Regional Office guidance.

E.2. Bank Service Corporation Act

Section 7 of the Bank Service Corporation Act provides statutory authorization for primary federal regulators of the banks which are principal investors of the service corporation to examine service corporations. To the extent that an entity is definable as a bank service corporation, the statute provides that the entity may be examined, not only by regulators of banks owning the entity, but also by regulators of non-shareholder banks serviced by the entity. The Act can be referenced at www.fdic.gov under Miscellaneous Statutes and Regulations. While the Act has specific applicability to corporations providing data processing services for banks, it may also apply when other types of services, such as fiduciary, are being provided. However, the narrow definition of bank service corporation (especially in regard to ownership) serves to substantially limit the Act's scope.

F. Gramm-Leach-Bliley Act (GLBA) Provisions for fiduciary activities

F.1. SEC Registration Requirements

The passing of the GLBA in 1999 permits institutions to adopt a financial holding company structure, wherein financial institutions are permitted to conduct securities and insurance activities through affiliated entities.

The GLBA rules also affect various securities activities which may be present in a bank or bank trust department. If bank's activities do not meet specified exemptions or exceptions from the definition of "broker," the bank must register as a broker or dealer with the Securities and Exchange Commission (SEC) and would be subject to applicable SEC regulations. The exemption and exceptions and possible registration for banks as 'broker', 'dealer', and 'investment adviser' are discussed below and in Appendix D. If the bank is claiming an exemption or exception under the broker or dealer designations, recordkeeping requirements established by the Federal bank regulaory agencies must be met. These recordkeeping rules are expected to be finalized in late 2008.

Appendix D - Securities Law contains further examination guidance, statutory excerpts, and SEC rules related to bank securities activities.

F.1.a. Registered Broker

Section 201 of the GLBA repealed the blanket exemption of banks from the definition of "broker" under the Securities Exchange Act of 1934 and replaced it with 11 specific exceptions from the Exchange Act definition of "broker." Under the statute, banks that engage in securities activities must either satisfy the conditions for one of the specific GLBA exceptions or other exemptions provided by Regulatin R (discussed below) or conduct those activities through a registered broker-dealer subsidiary or affiliate. For this reason, the broker exceptions are referred to as the "push-out" rules, since an institution that can not qualify for an exception or exemption must "push-out" its securities activities to a registered entity. The exception-related activities are detailed GLBA and can be found in Appendix D, Bank as Broker.

On October 13, 2006, the Financial Services Regulatory Relief Act of 2006 (FSRRA) was signed into law. Among other things, the FSRRA required the Federal Reserve and the SEC to jointly issue a regulation implementing the GLBA broker exception rules. In doing so, the Federal Reserve was required to consult FDIC, OCC, and OTS. In addition to implementing certain of the GLBA exceptions from the definition of "broker," which required further

guidance, the joint rule, designated as Regulation R, provided additional administrative exemptions from the definition of the term "broker" as defined in the Exchange Act. The joint FRB/SEC final Regulation R was published in the Federal Register on October 3, 2007. See Exchange Act Release No. 34-566501:File No. S7-22-06 (353KB PDF file - PDF Help)

F.1.a.1. Regulation R

Regulation R details the requirements for a bank to qualify for a number of the GLBA exceptions and other administrative exemptions from the definition of "broker," including the trust & fiduciary exception; the custody and safekeeping exemption; the networking exception; and the sweep accounts exception. Other administrative exemptions provided in Regulation R include exemptions for transactions in Regulation S securities, non-custodial securities lending activities, referrals of high net worth/institutional clients under a third-party networking arrangement, as well as certain exemptions from the Exchange Act's Section 3(a)(4)(C)(i) trade execution requirements. These are discussed in greater detail below.

F.1.a.1.a. Trust & Fiduciary Exception

The Trust & Fiduciary exception allows a bank, in its capacity as trustee or fiduciary, to effect securities transactions for the accounts it administers if the following conditions are satisfied:

- Transactions are effected in the bank's trust department or other department that is regularly examined for compliance with fiduciary principles and standards;
- The bank does not publicly solicit brokerage business; and
- The bank is "chiefly compensated" for its trust and fiduciary activities on the basis of:
    - An administrative or annual fee; or
    - A percentage of assets under management; or
    - A flat or capped per order processing fee equal to not more than the cost incurred; or
    - A combination of the above; and .
- Trades are effected in compliance with Exchange Act Section 3(a)(4)(C), which requires trades to be effected:
    - By a registered broker-dealer; or
    - Via a cross trade or substantially similar trade either within the bank or between the bank and an affiliated fiduciary in a manner that is not contrary to fiduciary principles; or
    - In some other manner that the SEC permits.

Fiduciary capacity, for the purposes of Regulation R, is defined by the Office of the Comptroller's Part 9 definition. Fiduciary capacity includes acting as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minors act, or as an investment adviser if the bank receives a fee for its investment advice, or in any capacity in which the bank possesses investment discretion on behalf of another.

The prohibition on solicitation of brokerage business restricts the extent to which a bank can advertise that is effects securities transactions. In its advertisements, a bank may only

indicate that it effects securities transactions in connection with its trust and fiduciary services. The fact that a bank effects securities transactions cannot be made more prominent that the material advertising the bank's provision of trust and fiduciary services.

F.1.a.1.a.1 Chiefly Compensated

Regulation R defines what it means to be "chiefly compensated" for trust and fiduciary services on the basis of an annual/administrative fee, a percentage of assets under management, a flat or capped per order processing fee equal to no more than the cost of executive, or a combination of these. Whether a bank satisfies the chiefly compensated requirement depends on the amount of "relationship" compensation in relation to total compensation. Thus, the ratio of relationship compensation, discussed below, to total compensation, either for each trust and fiduciary account or on a bank-wide basis, must equal or exceed a specific percentage. The chiefly compensation ratio calculation is discussed in more detail below.

Chiefly Compensated Test

The chiefly compensated test consists of calculating the ratio of relationship compensation to total compensation for the preceding year and the year preceding that year. The ratio for each year is expressed as a percentage and the percentages for the two years are averaged. Thus, whether a bank satisfies the chiefly compensated test is determined by calculating the moving average of the relationship compensation to total compensation percentages for the two immediately preceding years. Banks may use either a calendar or fiscal year as the basis for the yearly percentages to be calculated. The two year moving average must be computed within 60 days following the end of that year. Since the compliance period begins in the first fiscal year commencing after September 30, 2008, the first calculation of chiefly compensated test will occur by March, 2011, for banks using a calendar year. While the calculation is only required within the two months following the end of the year, banks are encouraged to monitor the percentage throughout the year in order to be able to identify and address any problems that might emerge.

Banks have two options regarding the basis on which the chiefly compensated test is calculated. The test may be determined on an account-by-account basis. Under the account-by-account methodology, the bank would determine the ratio

of relationship compensation to total trust and fiduciary compensation attributable to each account for each trust and fiduciary account, except for those accounts that Regulation R requires or allows to be excluded from the test. The bank meets the chiefly compensated test if the chiefly compensated percentage for each account is greater than 50%.

The second option allows a bank to determine compliance with the chiefly compensated test on a bank-wide basis. Under the bank-wide methodology, the bank would calculate a single percentage for each year. The single percentage would include total relationship compensation from all trust and fiduciary accounts required to be included in the computation and the total compensation received by the bank in connection with its provision of trust and fiduciary services. Under this method, the bank satisfies the chiefly compensated test if the percentage is greater than or equal to 70%. Relationship and total compensation are addressed below.

Relationship Compensation

Relationship compensation is any compensation a bank receives that is attributable to a trust or fiduciary account, or to trust and fiduciary activities if calculated on a bank-wide basis, that consists of:

- Annual or administrative fees, including, but not limited to, fees:
  - For personal services, tax preparation, or real estate settlement services; or
  - For disbursing funds from, or for recording receipt of payments to, a trust or fiduciary account; or
  - In connection with securities lending or borrowing transactions; or
  - For custody fees.

Administrative fees also include various fees in connection with investments in mutual funds. The fees do not have to be paid to the bank by the mutual fund, but can be paid by a third-party, such as the fund's distributor, transfer agent, administrator or an advisor to the fund. Such fees include:

- Fees for personal services;
- Fees for the maintenance of shareholder accounts;
- Fees based on a percentage of assets under management for the following services:
  - Transfer or sub-transfer agent services;
  - Aggregating and processing purchase and redemption orders;
  - Providing account statements to beneficial owners;
  - Processing dividend payments;

- Providing sub-accounting services;
- Forwarding communications to beneficial owners; and
- Receiving, tabulating, and transmitting proxies.

12b-1 fees are considered relationship compensation since they comprise fees that are based on a percentage of assets under management. The receipt of 12b-1 fees, like the receipt of all compensation related to securities transactions, must be consistent with the fiduciary principles and standards governing the bank's trust and fiduciary accounts.

Finally, flat or capped per order processing fees that do not exceed the cost incurred in effecting securities transactions qualify as relationship compensation. These fees may include the fee charged by the executing broker-dealer and the addition of the fixed or variable cost incurred by the bank in effecting the transaction. Banks, however, may not include a profit margin to the cost charged to the customer and still have the fees qualify as relationship compensation. Banks, therefore, are expected to document any fixed or variable costs allocated to transactions in order to support that such allocations include only the actual cost incurred by the bank in effecting the transaction.

It is important to note that relationship compensation is not limited to compensation received by the bank for securities-related transactions, but include all forms of compensation related to the administration of trust and fiduciary accounts, regardless of whether the amounts are paid by the trust or fiduciary account or by a third party.

Total Compensation

The ratio of relationship compensation to total compensation determines whether a bank satsifies the "chiefly compensated" requirement for the Trust & Fiduciary exception from the definition of broker in the Exchange Act. Total compensation encompasses all compensation attributable to a trust or fiduciary account or to the trust and fiduciary business of a bank if the determination is made on a bank-wide basis. However, as discussed below, some forms of compensation are specifically excluded by Regulation R. Total compensation does not include any revenues that are not derived from the provision of trust or fiduciary services. Examples of compensation that should not be included as either relationship compensation or total compensation are:

- Providing bank-office services to third parties;
- The sale of an office or assets of the trust

department;

- Internal credits, such as a credit for deposits of trust funds in the commercial bank; or
- "Soft Dollar" credits.

Excluded Compensation

Regulation R provides for the exclusion of various revenues from both relationship compensation and total compensation. Of particular importance is the exclusion of any compensation that is received in connection with another transaction for which the bank is relying on an exception or exemption other than the Trust & Fiduciary exception. For example, Regulation S provides an exemption for transactions in securities issued in an offshore transaction under SEC Regulation S. A bank purchasing such Regulation S securities and relying on the Regulation S exemption could not include compensation from those transaction in calculating the "chiefly compensated" ratio.

Similarly, revenues derived from trust and fiduciary accounts held at a foreign branch are excluded if:

- Held at a non-shell foreign branch; and
- The bank has a reasonable cause to believe that the trust and fiduciary accounts of the foreign branch that are held by or for the benefit of U.S. persons constitute less than 10% of the foreign branch's trust and fiduciary accounts.

A non-shell foreign branch is one that is located outside the U.S.; provides services to residents of the foreign jurisdiction where it is located; and the day-to-day decision-making is not done by an office or branch in the U.S. A bank would have a reasonable cause to believe that an accountholder is not a U.S. person if the person's principal mailing address is outside the U.S. or the foreign branch's records indicate that the accountholder is a non-U.S. person. The exclusion of revenues from accounts held at a foreign branch only applies if the bank utilizes the bank-wide method for calculating the ratio of relationship compensation to total compensation.

Under both the account-by-account and bank-wide methods, compensation from short-term accounts, i.e. those open for less than three months in the relevant year, is not included in total compensation. Compensation from acquired accounts, i.e. accounts that the bank acquired from another entity as part of a merger, consolidation, acquisition, purchase of assets or similar transaction, can be excluded for the first twelve months.

Regulation R also provides for a De Minimis

Exclusion where those banks using the account-by-account method can exclude the revenues from the lesser of 1% or 500 accounts in determining compliance with the chiefly compensated requirement. In order to do so, the bank must maintain records demonstrating that the securities transactions by or on behalf of the account were undertaken in the exercise of its trust or fiduciary duties and the bank must not have used the exclusion in the preceding year.

Finally, a transferred account will not cause a bank to fail the chiefly compensated test if the account or its securities is transferred to a registered broker dealer or an unaffiliated entity that is not required to be registered as a broker within three months following the end of the relevant year.

F.1.a.1.a.2 Trade Execution Requirements

The Trust & Fiduciary exception, as well as the other GLBA/Regulation R exceptions and exemptions, require that securities transactions be executed in accordance with the Exchange Act's execution requirements, which generally require securities transactions to be executed by a registered broker-dealer or in a cross trade. Regulation R, however, provides several exemptions from the Exchange Act's trade execution requirement. Regulation R permits banks to effect certain transactions directly through the NSCC, the issuer's transfer agent, or an insurance company, if certain requirements are met.

Regulation R permits transactions in "covered securities" to be effected through the NSCC, directly with the transfer agent, or with an insurance company or separate account that is excluded from the definition of transfer agent in the Exchange Act. A "covered security" is a registered mutual fund or a variable insurance contract funded by a separate account that is registered. The following two requirements must be satisfied:

- The security is not traded on a national securities exchange or through the facilities of a national securities association or an interdealer quotation system; and
- The security is distributed by a registered broker-dealer, or the sales charge is no more than the amount permissible for a security sold by a registered broker-dealer under Investment Company Act of 1940 rules.

Regulation R also provides an exemption whereby transactions in employer securities for employee benefit plans can be effected directly with the transfer agent provided that:

- No commission is charged;
- The transaction is solely for the benefit of an employee benefit plan account;
- The security is obtained directly from:
  - The employer; or
  - An employee benefit plan of the employer.
- The security is transferred only to:
  - The employer; or
  - An employee benefit plan of the employer.

F.1.a.1.b. Custody & Safekeeping Exception

GLBA provides an exception from the definition of broker for banks that provide custody and safekeeping services. GLBA specifically provides that a bank will not be considered a broker if it engages in the following custodial and safekeeping activities:

- Providing safekeeping and custody services to customers with regard to securities, including the exercise of warrants and other rights on behalf of bank customers;
- Facilitating the transfer of funds or securities as a custodian or clearing agent in connection with the clearance and settlement of its customers' transactions in securities;
- Facilitating lending or financing transactions or investing cash in connection with its safekeeping, custody, and securities transfer services;
- Holding securities pledged by a customer to another person or securities subject to repurchase agreements involving a customer, or facilitating the pledging or transfer of such securities by book entry or as otherwise provided by law, provided that the bank maintains records separately identifying the securities and the customer; or
- Serving as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

In addition to the statutory exceptions, Regulation R provides two exemptions whereby a bank can take orders for the purchase and sale of securities from custody account customers. One exemption allows a bank, as part of its customary banking activities, to accept orders for

securities transactions from employee benefit plan accounts, individual retirement accounts, and similar accounts. The second exemption allows a bank to accept orders for securities transactions from custody account customers on an accommodation basis.

The exemptions discussed below apply to accounts for which the bank acts as a custodian. Regulation R defines an account for which a bank acts as a custodian as an account that is:

- An employee benefit account;
- An individual retirement account or similar account;
- An account established by a written agreement between the bank and the customer that sets forth the terms that will govern the fees payable to, and rights and obligations of, the bank regarding the safekeeping or custody of securities; or
- An account for which the bank acts as a directed trustee.

Whether a bank serves as custodian for securities or other assets of an account depends on the services the bank provides to the account with respect the securities or assets, rather than the label used to identify the account or the bank's services in the agreement between the bank and the customer. Thus, a bank that acts as an escrow agent or paying agent and that provides custody and safekeeping services to the account is considered an account for which the bank acts as custodian, notwithstanding the fact that the account is not called a custody or safekeeping account.

F.1.a.1.b.1. Exemption for EB, IRA, and Similar Accounts

A bank may accept orders for securities transaction from custody accounts for employee benefit plans, individual retirement plans and similar accounts provided that:

- The bank does not advertise that it accepts orders, except as part of advertising its other custody and safekeeping services;
- No bank employee is compensated based on whether a securities transaction is executed or on the quantity, price, or type of security involved;
- The bank is not a trustee or fiduciary, other than a directed trustee;
- The bank is not acting as a carrying broker; and
- The bank complies with the trade execution requirements in Exchange Act Section 3(a)(4)(C)(i).

Banks may not advertise that custody accounts are securities brokerage accounts or are a substitute for a brokerage account. While the bank cannot be a trustee or fiduciary and still rely on the custody exemption, there is an exception made for banks that serve as directed trustees. A bank that serves as a directed trustee is eligible for the custody exemption provided it complies with the other requirements of the exemption. A directed trustee is a trustee that does not hold any investment discretion over an account.

Within common securities industry usage, the terms "carrying broker" and "clearing broker" are virtually identical and often are used interchangeably. In certain instances, the terms mean a broker that, as part of an arrangement with a second broker (an "introducing" or "corresponding" broker), allows the second broker to be subject to lesser regulatory requirements (e.g. under the net capital provisions of Exchange Act Rule 15c3-1 and the customer protection provisions of Exchange Act Rule 15c3-3). Technically, however, a "carrying broker" is a broker that holds funds and securities on behalf of customers, whether its own customers or customers introduced by another broker-dealer, and a "clearing broker" is a member of a registered clearing agency.

The preamble to the final Regulation R discusses factors that the SEC would consider in determining if a bank was acting as a carrying broker. The SEC indicated that it would consider the existence of shared clients between a broker-dealer and bank and the reason why clients of the broker-dealer have established custody accounts at a bank. The existence of shared customers where the broker-dealer causes its customers to establish custody accounts at a bank could result in a determination that the bank was acting as a carrying broker for the broker-dealer. If, however, the clients of the broker-dealer independently decide to open a custody account at a bank, then the bank would likely not be viewed as acting as a carrying broker for the broker-dealer. Banks may share systems and platforms with a broker-dealer, for example an affiliated broker-dealer with which a common BSA/AML compliance system is used. Other examples of permissible arrangements include legal and compliance functions, accounting and finance functions (such as payroll and expense account reporting), and administrative functions (such as human resources and internal audit). Moreover, banks may perform limited back office functions for a broker-dealer without being deemed as acting as a carrying broker. A broker-dealer cannot delegate to a bank functions that require registration with a self-regulatory organization (SRO) and the broker-dealer must retain control of its property, cash, and securities.

In addition to bank custodians, non-custodial, non-fiduciary third-party administrators and record keepers for employee benefit plans may rely on the EB/IRA custody exemption provided that:

- Both the custodian bank and the third-party administrator/record keeper comply with the requirements of the exemption; and
- The administrator/record keeper does not execute cross trades other than:
  - Crossing or netting open-end mutual funds not traded on an exchange; or
  - Crossing or netting orders for accounts held at the custodian bank that contracted with the third-party administrator/record keeper.

F.1.a.2.b.2. Exemption for Accommodation Trades

For custody accounts that are not maintained by an employee benefit plan, individual retirement accounts, or other similar accounts, a bank may accept orders for securities transactions as an accommodation to the customer provided:

- Any fee charged or received by the bank does not vary based on:
  - Whether the bank accepted the order; or
  - The quantity or price of the securities bought or sold.
- Advertisements do not state that the bank accepts orders for securities transactions;
- Sales literature does not state that the bank accepts orders, except as part of describing other aspects of its custodial and safekeeping services;
- The bank does not provide investment advice or research, make recommendations, or solicit transactions. However, the bank may:
  - Advertise or provide sales literature as allowed in the exemption;
  - Respond to customer inquiries about custody and safekeeping services by providing -
    - Advertisements and sales literature;
    - Prospectus or sales literature prepared by a registered investment company; or
    - Materials based on the above.
- The bank complies with the compensation and trade execution requirements of the EB/IRA exemption.

The requirement that the bank not provide investment advice or research, make recommendations, or solicit transactions does not prohibit a bank from cross-marketing its trust and fiduciary services to custody account customers. Banks may cross-market investment advisory services to custody customers by:

- Providing non-account specific information via newsletters, websites, etc.;
- Providing examples of research, including stock specific research that the bank provides to other persons for marketing purposes.

A bank, however, may not provide personalized investment research regarding securities held in a custody account. Lists and menus of securities that can be purchased or sold is not considered investment advice.

If a customer has both a trust or fiduciary account and a custody account at the bank, the bank may provide investment advice and research to the customer in connection with the trust or fiduciary account. The bank is not responsible for how the trust or fiduciary accountholder uses such advice or research.

F.1.a.1.b.3. Subcustodians

A bank that acts as a subcustodian for an account for which another bank acts as custodian may rely on either the EB/IRA exemption or the Accommodation Trade exemption, depending on the type of account at the custodial bank, provided that:

- Both the subcustodian and the custodian bank comply with the requirements of the respective exemption; and
- The subcustodian does not execute cross trades, other than -
  - Crossing or netting open-end mutual funds not traded on an exchange; or
  - Crossing or netting orders for accounts of the custodian.

F.1.a.1.c. Networking Exception

The networking exception permits non-licensed employees to receive compensation for the referral of a retail customer to a registered broker-dealer without causing the bank to be considered a broker-dealer under the Exchange Act. Regulation R defines "referral" as "as action taken by one or more bank employees to direct a customer of the bank to a broker-dealer for the purchase or sale of securities for the customer's account." Normally, a non-licensed individual is not allowed to receive incentive compensation in

relation to a securities transaction. The networking exception allows non-licensed bank employees to receive a referral fee, which will not be considered incentive compensation, provided that the fee received is a nominal, one-time cash fee of a fixed dollar amount and the payment is not contingent on whether the referral results in a transaction. In addition to limiting referral fees to a nominal amount, the regulation also addresses bank bonus plans and the circumstances under which such plans can include securities-related activities without being considered incentive compensation for purposes of the Exchange Act. Referral fees and bonus programs are discussed in detail below.

F.1.a.1.c.1. Referral Fees

Nominal

Regulation R defines the term nominal referral fee as a payment to a bank employee personally involved in making the referral that does not exceed:

- Twice the average of the minimum and maximum hourly wage established by the bank for the current or prior year for the job family that includes the employee; or
- 1/1000th of the average of the minimum and maximum annual salary established by the bank for the current or prior year for the job family that includes the employee; or
- Twice the actual hourly wage established by the bank for the current or prior year for the job family that includes the employee; or
- 1/1000th of the actual annual salary established by the bank for the current or prior year for the job family that includes the employee; or
- $25

Banks are not limited to using a single definition for determining whether a referral fee is nominal. Banks may use different methodologies for different lines of business or operating units. Banks may also change the methodologies used within a given year. An employee's "job family" means a group of jobs or positions involving similar responsibilities, or requiring similar skills, education, or training, that a bank, ...uses...for purposes of hiring, promotion, and compensation. Examiners should review these job families in order to ensure that they are not being used to evade the "nominal referral fee" requirement.

The $25 definition of "nominal" will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

Non-Contingent

A fee is non-contingent if it does not depend on whether:

- The referral results in the purchase or sale of a security; or
- The referral results in an account being opened with a broker-dealer; or
- The referral results in multiple transactions.

A referral fee can, however, be contingent on whether the customer:

- Keeps an appointment with the broker-dealer; or
- Meets base-line qualification criteria for referral, such as minimum net worth, etc.

F.1.a.1.c.2. Bonus Programs

Incentive compensation is compensation intended to encourage a bank employee to refer customers to a broker-dealer or give a bank employee an interest in the success of a securities transaction at a broker dealer. Regulation R provides, however, that incentive compensation does not include a bonus or similar plan that is:

- Paid on a discretionary basis. A bonus plan is discretionary if the amounts paid are not fixed in advanced and employees do not have an enforceable right to the bonus before it is declared by the board;
- Based on multiple factors or variables;
- Include multiple significant factors or variables that are not related to securities transactions at a broker-dealer;
- Referrals by employees are not a factor; and
- Referrals by any other person are not a factor.

Bonus programs can also be based on the overall profitability or revenue of:

- The bank, on a stand-alone or consolidated basis;
- An affiliate or operating unit of a bank, if they do not predominately engage in making referrals to a broker-dealer; or
- A broker-dealer, if:
  - Overall profitability or revenue is only one of multiple factors or variables used to determine compensation;
  - Referrals are not a factor; and
  - Referrals by other employees is not a factor.

In assessing bonus programs for compliance with Regulation R, examiners will consider the following factors:

- Whether the factors and variables of the bonus plan relate to activities actually being conducted;
- The resources being devoted to the activities being conducted; and
- Whether the business lines or activities materially contribute to the amount of bonus payments.

Over time, it is expected that factors and variables related to securities transactions will not predominate the determination of the amount of bonus payments awarded.

F.1.a.1.d. Exemption for Referral of High Net Worth/Institutional Customers

Regulation R provides an additional exemption for referrals by non-licensed bank employees of high net worth (HNW) or institutional customers to a third-party broker-dealer. Unlike referrals of retail customers, payments can be more than nominal in amount and may be contingent in nature. To receive payments under this exemption bank employees must meet the following requirements:

- Not be licensed;
- Be predominately engaged in banking activities other than making referrals to broker-dealers;
- Not be subject to any statutory disqualification; and
- Encounter customers in the ordinary course of the employee's duties.

Regulation R defines a HNW customer as either:

- A natural person who, either individually or jointly with a spouse, has a net worth of at least $5 million, excluding equity in his/her primary residence; or
- Any revocable, living trust, where the settlor is a natural person meeting the $5 million net worth requirement.

For purposes of determining whether a natural person meets the $5 million net worth test, the assets of a person include: (1) any assets held individually; (2) if the person is acting jointly with his or her spouse, any assets of the person’s spouse (whether not such assets are held jointly); and (3) if the person is not acting jointly with his or her spouse, fifty percent of any assets held jointly with such person’s spouse and any assets in which such person shares with such person’s spouse a community property or similar shared ownership interest.

Regulation R defines an institutional customer as a corporation, partnership, limited liability company, trust, or other non-natural person with at least:

- $10 million in investments; or
- $20 million in revnues; or
- $15 million in revenues if the referral is for investment banking services.

The final rule defines “investment banking services” to include, without limitation, acting as an underwriter in an offering for an issuer, acting as a financial adviser in a merger, acquisition, tender-offer or similar transaction, providing venture capital, equity lines of credit, private investment-private equity transactions or similar investments, serving as placement agent for an issuer, and engaging in similar activities. The phrase “other similar services” would include, for example, acting as an underwriter in a secondary offering of securities and acting as a financial adviser in a divestiture.

The dollar thresholds detailed above will be adjusted for inflation beginning on April 1, 2012 and every 5 years thereafter.

When making a referral of a HNW/Institutional customer the bank must disclose the following:

- The name of the broker-dealer; and
- The fact that the bank employee participates in an incentive program where the employee may receive a fee of more than a nominal amount that may be contingent on whether the referral results in a transaction.

The disclosures must be provided either:

- In writing prior to or at the time of the referral; or
- Orally prior to or at the time of referral, provided that the bank provides the required information in writing within 3 days of the referral.

Banks may, however, contract with the broker-dealer to provide the required disclosures, provided the agreement is in writing. When provided by the broker-dealer, the disclosures must be provided:

- Prior to or at the time the customer begins the process of opening an account; or
- If the customer already has an account at the broker-dealer, prior to the time the customer places an order.

The bank must have a reasonable basis for believing that the customer is a HNW or institutional customer at the time of the referral for natural persons or before the referral is paid

to the employee for a non-natural person.

The exemption imposes the following obligations on the broker-dealer with which the bank contracts for third-party brokerage services:

- Determine whether the referring bank employee is subject to a statutory disqualification;
- Have a reasonable basis to believe that the customer referred is a HNW/institutional customer;
- If the referral fee is contingent, perform a suitability analysis of the transaction before execution;
- If the referral fee is non-contingent, determine that the customer:
    - Has the capability to evaluate investment risk and make independent decisions; and
    - Is exercising independent judgment based on individual assessment; or
    - Perform a suitability analysis of all transactions requested by the customer contemporaneously with the referral.

The broker-dealer is required to determine whether the referring employee is subject to a statutory disqualification prior to paying the first referral and once a year thereafter as long as the employee remains eligible to receive such referral fees. The rule requires that, before a higher-than-nominal referral fee is paid to a bank employee under the HNW/institutional customer exemption, the bank provide the broker-dealer the name of the employee and such other identifying information that the broker-dealer may need to determine whether the employee is subject to statutory disqualification. The bank should provide at least annually its broker-dealer partner any changes to the identifying information initially provided.

A bank or broker-dealer would have a “reasonable basis to believe” that a customer is a high net worth customer or institutional customer if, for example, the bank or broker-dealer obtains a signed acknowledgment from the customer (or, in the case of an institutional customer, from an appropriate representative of the customer) that the customer meets the applicable standards to be considered a high net worth customer or an institutional customer, and the bank employee making the referral or the broker-dealer dealing with the referred customer does not have information that would cause them to believe that the information provided by the customer (or representative) is false.

The broker-dealer is required to inform the customer if the customer does not meet the suitability criteria. The broker-dealer must also

notify the bank if it determines that the customer is not a HNW or institutional customer and if it determines that a referring employee is subject to a statutory disqualification.

For purposes of the HNW/Institutional Customer exemption the term "referral fee" is defined as a predetermined dollar amount, or a dollar amount determined by a predetermined formula that does not vary based on:

- The revenue generated by or the profitability of the securities transactions of customers; or
- The quantity, price, or identity of the securities transactions conducted over time by the customer; or
- The number of customer referrals made.

A referral fee can be based on a fixed percentage of the revenues received by a broker-dealer for investment banking services provided to the customer.

The exemption provides that a bank that acts in good faith and that has reasonable policies and procedures in place to comply with the requirements of the exemption will not be considered a “broker” under Section 3(a)(4) of the Exchange Act solely because the bank fails, in a particular instance, to determine that a customer is an institutional or high net worth customer; provide the customer the required disclosures; or provide the broker-dealer the required information concerning the bank employee receiving the referral fee within the time periods prescribed. If the bank is seeking to comply and takes reasonable and prompt steps to remedy the error, such as by promptly making the required determination or promptly providing the broker-dealer the required information, the bank will not lose the exemption from registration in these circumstances. Following any required remedial action, the bank must make reasonable efforts to reclaim the portion of the referral fee paid to the bank employee for a referral that does not, following any required remedial actions, meet the requirements of the exemption and that exceeds the amount the bank otherwise would be permitted to pay.

F.1.a.1.e. Sweep Account Exception/Money Market Fund Exemption

The Sweep Account Exception allows a bank to effect transactions as part of a program for the investment or reinvestment of deposit funds in a no-load money market fund. Regulation R defines a no-load fund as a fund that does not charge an upfront sales load or a deferred sales load, and where total charges against the net assets for sales, sales promotion, personal

services or the maintenance of shareholder accounts does not exceed 25 basis points. Under the statutory exception, a bank may also sweep deposit funds on behalf of another bank into a no-load money market fund. Regulation R provides an exemption under which a bank may, on behalf of both bank customers or other banks, invest or reinvest funds in a money market fund that is not a no-load fund, as defined in the regulation.

In order to effect transactions in a no-load money market fund the bank must:

- Provide the customer, directly or indirectly, another product or service that would not cause the bank to register as a broker dealer;
- Provide the customer with a prospectus for the fund not later than at the time the customer authorizes the transactions; and
- Not refer to or characterize the fund as a no-load fund

F.1.a.1.f. Exemption for Transactions in Regulation S Securities

Regulation S is an SEC regulation that governs the conditions under which securities offered to investors outside the U.S. are exempt from registration under the Securities Act of 1933. A Regulation S security is an equity security issued by a public company located in the U.S. to non-U.S. persons in an offshore transaction.

Regulation R exempts a bank effecting transactions in Regulation S securities from the definition of broker to the extent that the bank, acting as an agent:

- Effects a sale of an eligible security to a purchaser who is not in the U.S.; or
- Effects, by or on behalf of a person who is not a U.S. person, a resale of an eligible security after its initial sale with a reasonable belief that the security was sold outside the U.S. to a purchaser who is not in the U.S. or a broker-dealer. If the resale is made prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of Regulation S; or
- Effects, by or on behalf of a registered broker-dealer, a resale of an eligible security after its initial sale with a reasonable belief that the eligible security was initially sold outside the U.S. to a purchaser who is not in the U.S. If the resale is made prior to any applicable distribution compliance period under Rule 903(b)(2) or (b)(3) of Regulation S, the resale must comply with Rule 904 of

Regulation S

An eligible security is a security that:

- Is not being sold from the inventory of the bank or an affiliate of the bank; and
- Is not being underwritten by the bank or an affiliate of the bank on a firm commitment basis, unless the bank acquired the security from an unaffiliated distributor that did not purchase the security from the bank or an affiliate of the bank.

A purchaser is a person who purchases an eligible security and who is not a U.S. person.

F.1.a.1.g. Exemption for Securities Lending Transactions

Regulation R provides an exemption from the definition of broker for banks that, as an agent, engage in securities lending transactions or securities lending services. A bank may engage is these activities with or on behalf of persons the bank reasonably believes to be:

- A qualified investor as defined in the Securities Exchange Act of 1934; or
- An employee benefit plan that owns or invests on a discretionary basis not less than $25 million in investments.

A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner and has the right to terminate the transaction and recall the loaned securities on terms agreed by the parties.

Regulation R defines "securities lending services" as:

- Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrowers:
- Receiving, delivering, or directing the receipt or delivery of loaned securities;
- Receiving, delivering, or directing the receipt or delivery of collateral;
- Providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending activity;
- Investing, or directing the investment of, cash collateral; or
- Indemnifying the lender of securities with respect to various matters.

F.1.b. Registered Dealer

Bank Dealer Exceptions to Registration with the SEC for Certain Securities Activities

Section 202 of the GLBA amended the definition of "dealer" by repealing the Securities Exchange Act exclusion for banks from dealer registration and regulation.

The SEC has issued a final rule concerning the bank dealer exceptions to the Securities Exchange Act of 1934 ("Exchange Act"), as amended in Section 202 of the GLBA. See 68 Federal Register 8686 (February 24, 2003). Also refer to Appendix D, Bank as Dealer. The compliance date of the rule is September 30, 2003. Exchange Act section 3(a)(5) defines a "dealer" as a person that is "engaged in the business of buying and selling securities" for its own account through a broker or otherwise, and exempts persons, whether banks or non-banks, who do not buy or sell securities "as part of a regular business". Banks do not need to register with the SEC and the National Association of Securities Dealers unless they act as dealers and do not qualify under any of the exceptions under Section 202 of GLBA. The SEC has recently issued a Staff Compliance Guide to Bank on Dealer Statutory Exceptions and Rules, which is available on the SEC Division of Market Regulation's website and in Appendix D of this manual.

GLBA replaced the former uniform bank exception for securities dealer registration under the Exchange Act with four specific exceptions. These statutory exceptions are:

Investment transactions : permits banks to buy and sell securities for investment purposes for the bank and in its customers' trustee and fiduciary accounts.

Permissible securities transactions : permits banks to buy and sell exempted securities, certain Canadian government obligations, and Brady bonds.

Identified banking products : permits banks to buy and sell certain "identified banking products," as defined in Section 206 of GLBA.

Asset-backed transactions : permits banks through a grantor trust or other separate entity to issue and sell to qualified investors certain asset-backed securities representing obligations predominately originated by a bank, an affiliate of a bank other than a broker-dealer, or a syndicate in which the bank is a member for some types of products.

The SEC's bank dealer rule addresses certain interpretive issues arising from these statutory exceptions for bank dealer activities. In addition, it addresses certain additional exemptions that involve bank dealer activities that also could be covered as broker activities. These additional exemptions provided under the SEC's bank dealer rule include:

Riskless principal transactions . This exemption permits banks to engage in a limited number (up to 500) of "riskless principal" transactions per calendar year without registering with the SEC as dealers. A "riskless principal" transaction is one in which, after having received an order to buy from a customer, a bank purchases the security from another person to offset that contemporaneous sale. Alternatively, a riskless principal transaction is one in which after having received an order to sell from a customer, a bank sells the security to another person to offset that contemporaneous purchase.

- How to count transactions for purposes of this exemption: Transactions with two customers where the bank acts as a

riskless principal between them count as one transaction. However, if a bank acts as a riskless principal between one counterparty and multiple counterparties by arranging multiple transactions, each of the transactions on the side that involves the largest number of transactions would count as separate transactions against the annual transaction-limit.

- How counting will be affected by banks' brokerage activities: The Exchange Act also permits banks to engage in certain "broker" activities without registering with the Commission. At the time the "dealer" provisions become effective, however, the "broker" provisions still will be subject to a Commission order delaying their effectiveness. One of the "broker" exceptions - known as the de minimis exception - permits banks to engage in no more than 500 brokerage transactions per year that are not otherwise exempt without registering with the Commission. When banks utilize this exception after the compliance date is set for the broker rules, banks' riskless principal transactions **and** brokerage transactions effected under the de minimis exception will count toward the same 500-transaction limit. In other words, banks may be able to engage in any combination of brokerage transactions under the de minimis exception and riskless principal transactions under Rule 3a5-1, so long as the total number of these transactions does not exceed 500 per year. Until the broker rules are effective, however, banks may use the entire 500-transaction limit for riskless principal transactions.

Securities lending transactions . This exemption permits banks to engage in, or effect, securities lending transactions with certain counterparties. A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party under a written securities lending agreement. Through this agreement, the lender retains the economic interests of an owner of the securities. Subject to the terms agreed upon by the parties, including an agreement to loan the securities for a fixed term, the lender also has the right to terminate the transaction and to recall the loaned securities.

F.1.c. Investment Advisers

Section 217 of the GLBA amends certain sections of the Investment Advisers Act of 1940 (Advisers Act) to require any bank or bank holding company which serves as an investment adviser to a registered investment company (i.e. open-end mutual fund) to register under the Advisers Act. A bank or bank holding company can also register a separately identifiable department or division (SIDD). Under the GLBA, regulatory agencies and the Commission are required to provide each other with the results of any examinations or inspections conducted with respect to the investment

advisory activities. Refer to Appendix D, Bank as Investment Advisor, for additional information.

F.2. Privacy Issues Faced by the Fiduciary

Privacy applies to all financial institutions. It is an emerging area of concern, therefore, rules and regulations applicable to financial institutions are continuing to evolve and will for some time. In order to assess privacy issues in the context of fiduciary activity, a few fundamental concepts and terms/definitions are necessary. Part 332 of the FDIC's Rules and Regulations is the privacy regulation applicable to state nonmember banks. The regulation contains extensive definitions of terms, and numerous examples to illustrate the definition. Some of the defined terms include:

- A "financial institution" is any institution the business of which is to engage in financial activities as described in section 4(k) of the Bank Holding Company Act of 1956. Industry publications have stated this, in general terms, means "any institution the business of which is engaged in financial services". The definition includes providing investment advisory services and issuing and selling of interests in pooled assets.

- Privacy rules pertain to "nonpublic personal information" which is defined as personally identifiable financial information. It includes information provided by the consumer to obtain a product or a service and/or information gleaned from transactions with the consumer or performed for the consumer. It excludes "publicly available" information. Information is "publicly available" if a financial institution has a reasonable basis to believe that the information is lawfully made available to the general public from one of the categories of sources listed in Part 332.

- It only covers "personal" information. Therefore, it only applies to consumers, not to business or institutional customers.

- A consumer is defined as an individual, who obtains from a financial institution, financial products or services used primarily for personal, family, or household purposes. The definition also includes the legal representatives of such an individual.

    - Federal banking authorities have excluded beneficiaries of trusts and participants of employee benefit plans that the bank either sponsors, or for which it acts as trustee or fiduciary. The rationale is that the trust/plan itself is the customer and not an individual, and therefore the rules do not apply.

    - An investment management agency relationship with a business or a trust would not fall under this regulation.

    - However, in the case of an individual who selects a financial institution as custodian of securities or assets, as in an IRA, the individual is viewed as a consumer. Another example is an investment management agency with an individual(s).

    - Refer to Section 332.3(e) for the complete definition of "consumer" and Section 332.3(i) for the complete definition of "customer relationship."

- A financial institution is prohibited from disclosing "nonpublic personal information" about a consumer to nonaffiliated third parties unless the institution satisfies various notice and opt-out requirements, and the consumer has not elected to opt-out. A nonaffiliated third party means any person except: (i) a bank affiliate; or (ii) a person employed jointly by the bank and any company that is not a bank affiliate. The company the person works for is considered a nonaffiliated third party. Also, an affiliate that is an affiliate solely by virtue of its direct or indirect ownership in an entity conducting merchant banking or insurance company activities (as defined in Section 4(k) of the Bank Holding Company Act of 1956) is considered a nonaffiliated third party.

- A financial institution is required to disclose to all of its customers the institution's privacy policies and practices with respect to information sharing with both affiliates

and nonaffiliated third parties. This is discussed below in item F.2.b.

- Federal privacy guidelines do not supersede more stringent State regulations. Nor do they preempt the Fair Credit Reporting Act.

F.2.a. Applicability to Trust Operations

A financial institution is required to develop guidelines for the safeguarding of customer information. The guidelines are applicable to trust operations. These guidelines pertain to the administration and physical safeguarding of customer records and information. There are three elements to consider when establishing policies and procedures with regard to privacy. First, the fiduciary is to insure the security and confidentiality of customer records. Second, the fiduciary is to protect against any *anticipated* threats or hazards to the security or integrity of such records. Third, the fiduciary is to protect against unauthorized access to, or use of, such records or information that could result in substantial harm or inconvenience to any customer. This includes: the fiduciary's use of information; the re-disclosure and reuse of information (Section 332.11); and the use of information by contractually obligated third party service providers (Section 332.13). The guidelines will be unique to each institution and dependent upon the size and complexity of the operation. To develop an effective risk management program to govern privacy, the following will be required:

1. Identification and assessment of risk;
2. Development of written plans and procedures to manage the risk;
3. Implementation and testing of compliance with established policies; and
4. Adjustments to the policies, as needed, based upon findings and changes in the operating environment.

The Board of Directors should approve the written policies and periodically receive reports on the implementation and effectiveness of the policies. Management should continually evaluate the operating environment to determine needed changes to, and monitor compliance with, the policies.

F.2.b. Applicability to Fiduciary Customers/Consumers

The privacy regulation contains customer and consumer disclosure requirements. There is no preset method for disclosure. However, alternative methods are available to satisfy disclosure requirements, including the use of short-form initial disclosures; toll-free telephone numbers, hand-delivered disclosures, etc. The disclosures may be provided in paper or electronic format. The only requirement is that "each consumer should reasonably be expected to receive the notice"**.** Verbal notification is prohibited. However, regardless of the method used, detailed guidelines govern the type of information to be contained in disclosures, as summarized below:

1. Typically, a fiduciary must disclose the privacy policy at the initiation of the relationship and annually thereafter. However, Sections 332.14 and 332.15 identify exceptions to this rule. Annually has been defined to mean at least once in any 12 consecutive months during which the relationship exists. A fiduciary may define any 12-consecutive-month period so long as it is applied consistently.
2. Disclosures are to be "clear and conspicuous". Section 332.3(b) provides a detailed definition of "clear and conspicuous". There is also guidance for web site notices. There is no predefined disclosure language or form.
3. There are minimum requirements (Section 332.6) governing the content of annual and periodic disclosure statements. In general, the

disclosure statement includes the following information: categories of nonpublic information that are collected; the categories of information that are disclosed; the categories of affiliated and nonaffiliated third parties to whom the information is disclosed; and the categories of information disclosed about former customers. A statement of the categories of information disclosed, and to whom it is disclosed, is also required if "nonpublic personal information" is disclosed to nonaffiliated third parties. At this point, the consumer's right to "opt-out" must also be disclosed. Finally, all statements must also include the fiduciary's policy and practices with respect to protecting the confidentiality and security of "nonpublic personal information."

4. The "opt-out" information must also be "clear and conspicuous". In general, the notice must include language to the effect that the fiduciary reserves the right to disclose nonpublic personal information to nonaffiliated third parties, that the consumer has the right to opt-out of the disclosure, and a "reasonable" means by which the customer may opt-out. Significantly, the "opt-out" requirement typically does not pertain to the disclosure of nonpublic personal information to a nonaffiliated third party that performs services or functions on behalf of the fiduciary. Instead, at a minimum, the contractual agreement with the third party should prohibit the third party from disclosing, or using the information, other than to carry out its duties.

G. Outside Contracting for fiduciary services

Increasingly, financial institutions are contracting with affiliates and third parties to facilitate the offering of trust services to their customers. These contracts can be for services ranging from trust data processing, custody, investment management, and complete fiduciary services. Many small trust departments have historically outsourced data processing, tax preparation, and certain specialized asset management tasks.

Outsourcing is one method for obtaining expertise not internally available, improving services, and managing costs. However, outsourcing may also expose the department to additional risk. This includes security of customer information, and the availability of information and management reporting systems. Management should identify the key risks associated with outsourcing arrangements, and implement appropriate oversight programs to monitor each service provider's controls, performance, and financial condition on a continuing basis.

Today, it may be possible for banks to delegate virtually the entire process of providing and administering trust services, while retaining the appearance of, and some of the income from, providing such services. The Corporation neither endorses nor prohibits an institution's full delegation of services and duties to outside service providers. Rather, this practice is considered a business risk decision. In doing so, bank management is expected to *fully investigate and document beforehand* the inherent challenges and legal obstacles to providing fiduciary services in this manner. Bank management is also expected to *demonstrate its continuous monitoring* of service provider activities, the quality of services provided its customers, and any associated business or legal risk. The Corporation's approach in evaluating business plans to extend trust services in this manner is to consider the merits of each business plan on a case-by-case basis.

Once a decision has been made to employ an outside service provider, the selection process itself must be prudent. Before selecting an agent, the board and senior management should first investigate and acquire a suitable working knowledge of the business or service to be contracted. Management should then perform and document its due-diligence review of prospective agents. These activities may later aid the bank in demonstrating that care and prudence were exercised in selecting an agent to assist in, or perform, fiduciary duties. Significantly, although fiduciaries may be permitted under law to delegate duties to agents, they retain responsibility for the *careful selection* of such agents (refer to section 9 of the Uniform Prudent Investor Act). And while the initial selection process is important, management has a continuing responsibility to ensure the service provider's suitability after the relationship has been established.

States still operating under the Prudent Man Rule may prohibit the out-outsourcing of account administrations, fiduciary and/or investment management responsibilities. Refer to Prudent Man Rule in

Appendix C.

G.1. Applicable Regulations

When establishing a relationship with a third party or affiliate, management must be conversant with all applicable regulations. For relationships with affiliates, Section 23A and 23B of the Federal Reserve Act may apply. Section 23B requires all transactions between a financial institution and a non-bank affiliate to be conducted on a basis comparable to that of similar transactions between nonaffiliated entities. Management must also ensure that state law permits the delegation of services to third parties. For those states that have enacted the Prudent Investor Act, management is typically granted broad delegation power. This power is further addressed below. In all instances, contracts between the bank and third parties should meet the requirements of Section 30 of the FDI Act; namely, that the contract does not adversely affect the safety and soundness of the institution.

G.2. Due Diligence Reviews

Prior to designating a servicing agent for its fiduciary activities, the serviced institution should document its exercise of reasonable caution in selecting agents. Compatibility and performance should be considered in conjunction with the cost of the services to be provided. The scope of the due diligence may depend upon the type and significance of outsourcing activity. However, detailed below are common considerations in any due diligence review. The listing does not supersede provisions of law or regulation, nor does it preclude additional concerns which may occur in some situations.

1. An assessment should be made of the servicing organization's ability to handle the volume and nature of trust accounts and assets to be serviced. Obtaining a list of servicer references and contact names is a common practice.

2. The financial strength and viability of the servicing organization should be considered. In this regard, the strength provided by a parent holding company or similar organization may also be considered. This would entail a review of financial statements and audit reports, and a search of pending or threatened financial or legal claims.

3. If investment management is being outsourced, then a review of the servicer's investment performance (over a minimum of 5 to 10 years, or several investment cycles) should be reviewed. SEC advisers Form ADV, if required, may provide some insight on the registered investment advisers investment philosophy.

4. Audit or supervisory evaluations of the servicing organization, if available. Depending upon the outsourced function, management may obtain AICPA Statement of Auditing Standards SAS 70 Reports, if conducted, or other available reports.

5. A review of certain policies, procedures, and controls of the servicing organization should be made. Knowledge of a service provider's business strategies, privacy policies, service philosophies, and quality control initiatives may be beneficial in choosing a firm whose standards correspond to the bank's standards.

6. Evidence supporting the maintenance of fidelity insurance coverage by the servicing organization should be obtained.

G.3. Written Agreements With Agents

Once a service provider is chosen, a written agreement should be drafted that governs the arrangement. The institution's legal counsel should be involved in the drafting and/or review of the contract when critical functions are being outsourced. The contract should be flexible, yet clearly outline the expectations and responsibilities of all parties. The contract should specify the scope and risks of the outsourced activity, all relevant terms, conditions and responsibilities, and the liabilities of each party. The minimum provisions which should be included are:

- the duties and responsibilities of each party; and
- compensation and any cost sharing arrangements.

Institutions should be strongly encouraged to include the following in written servicing agreements:

- Minimum service levels, dispute resolution procedures , termination clauses - It is prudent for the contract to include bankruptcy clauses, and warranties allowing for termination for cause without penalty by the serviced institution. Examiners should be alert for contracts with extended termination dates between the bank and affiliated entities which may be used to create "value" on the books of the affiliate. Contracts should be reasonable in length, given services performed.
- Documentation Standards - The files and computer records relating to the serviced bank should be identified as accounts of the serviced bank, and not that of the servicer, to facilitate audits, examinations, preparation required regulatory reports (e.g. Call Report Schedule RC-T), and any similar reporting requirements. Additionally, the confidentiality of shared information and client data should be addressed.
- Audit Provisions - The contract should include the right of the serviced entity to obtain SAS 70 Reports, or other third-party reviews and audits. Or, the contract may allow for the serviced entity to conduct audits of the service provider's operations. Some contracts may also allow for receipt of the servicing entities audit reports, or those sections of audits which apply to the serviced institution.
- Supervisory Access - The rights of the institution's supervisory authorities to access information of the institution and the operations of the servicer.
- File Recovery at Termination - Clauses in the contract should address the return of hardcopy and electronic files to the serviced institution, or its designee.
- Liability Clauses - An indemnity provision in the agreement should set forth the liability of each party.
- Insurance Coverage - There should be a provision requiring sufficient fidelity and liability insurance coverage on the activity by both parties.

In all instances, contracts between the bank and third parties should meet the requirements of Section 30 of the Federal Deposit Insurance Act; namely, contracts must not adversely affect the safety and soundness of the institution.

G.4. Periodic Monitoring of Agent's Condition and Performance

In addition to performing an initial review of the servicing agent, management has a responsibility to monitor and periodically update its documentation on the condition and activities of the servicing organization, while ensuring that the provisions of the agreement are being met. At a minimum, the institution's monitoring program should incorporate:

- Conducting, or reviewing results of, independent audits of the service provider's operation;
- Verifying and reviewing the adequacy of the service provider's contingency plans; and
- Developing contingency plans in the event of deteriorating performance or other problems encountered with the service provider.
- Monitoring the investment performance of the servicer, if the servicer provides investment management services.

G.5. Client Disclosures

Since it is possible for an institution to delegate virtually the entire process of providing and administering trust services, the question arises as to how much disclosure should be made to clients regarding such arrangements. An institution that delegates virtually all of

its responsibilities would be expected to disclose more than those which only outsource ancillary services. Regardless, disclosures should provide clients with sufficient information to make informed decisions, and to maintain a rapport commensurate with the fiduciary relationship itself. State laws may also dictate the extent of disclosures made to clients.

G.6. Delegation of Investment Management Services

Some departments do not have the expertise or staffing resources to provide investment management services. These institutions either do not offer investment management services to their clients, or have delegated this function to a third party. To some degree, the legality of delegating fiduciary investment management authority is dependent on state law. FDIC-supervised financial institutions located in states in which fiduciary investments are governed by the Prudent Man Rule or by a Legal List, may not delegate the servicing of their fiduciary accounts to another institution, unless state law explicitly provides for such a delegation. FDIC-supervised financial institutions located in states in which fiduciary investments are governed by the Prudent Investor Act**,** may delegate the servicing of their fiduciary accounts to another trust department or other entity.

Those firms that have delegated investment management responsibilities to others may use Registered Investment Advisers as defined under the Investment Advisers Act of 1940. Registered Investment Advisers are paid to provide investment advice, and generally must register with the SEC or the state securities agency where their principal place of business is located. Generally, those who manage client assets of $25 million or more must register with the SEC, while all others register with their respective state agency.

The SEC adopted a rule amendment under the Investment Advisors Act of 1940 to exempt certain investment advisers that provide advisory services through the Internet from the prohibition on Commission registration. The rule amendments permit these advisers, whose businesses are not connected to any particular state, to register with the Commission instead of with state securities authorities. The final rule (Release No. IA-2091) became effective January 20, 2003.

All registered advisers are required to file a "Form ADV," which is an application to apply for registration or amend registration. Form ADV consists of two parts. Part I contains general and personal information about the applicant. Part II contains information on the nature of the applicant's business, including: operations, services offered, fees charged, type of clients advised, educational and business backgrounds of associated persons, and other business activities of the applicant. The ADV is a public document, and registered investment advisers should provide a copy of the form to their clients. Therefore, if the department utilizes the services of a registered adviser, management should have a copy of the most recent Form ADV on hand. Additionally, management should have a contract with the adviser outlining the responsibilities of both parties. The receipt and periodic review of such documents is an integral task of the due diligence process.

G.7. Use of a Registered Securities Broker as Custodian

Increasingly, departments are utilizing the services of registered securities brokers as custodian for the assets of trust department accounts. While this practice was previously prohibited under Corporation guidelines and long-standing precedents of the OCC, the revised OCC Regulation 9 no longer contains such prohibitions. As such, other regulatory agencies have reportedly permitted institutions to utilize similar arrangements. If such an arrangement is encountered, the examiner should expect to see an appropriate due diligence program to manage associated risks. Bank management has the responsibility to ensure that the legal agreement with the broker offers sufficient protections to the bank and its trust beneficiaries. Please refer to Section 2.J. Use of Broker Dealer for Securities Safekeeping for more information.

H. Servicing Contract Accounts

The trust department may engage in contracts to provide services for outside companies, such as accepting a role (agent, custodian, trustee, etc.) from outside organizations marketing employee benefit plans, IRAs, investment plans, trusteeship of prototype trusts, and other similar products. Since these types of arrangements inherently contain additional risk exposure, management should ensure that they

are fulfilling all their responsibilities under written agreements and fiduciary laws. Many of the same due diligence efforts discussed above would be applicable to the institution providing such services.

I. Enforcement Actions

Trust department activities are subject to supervisory enforcement actions just as any other activity or department of the bank. The underlying rationale for all "enforcement actions" or supervisory initiatives is to obtain correction or improvement of a perceived problem, condition, or weakness. The examiner's careful selection and judicious recommendation for the use of such actions continues to be paramount in preserving the effectiveness of these tools.

I.1. Types of Enforcement Actions

I.1.a. Informal Actions

Informal actions include: memorandums of understanding, board resolutions, written agreements, and capital directives. Examiners should consider an informal action for those departments exhibiting supervisory concern, but where the problems do not pose a threat to trust beneficiaries or the safety and soundness of the institution. An informal administrative action should be considered, but is not mandatory, for any department rated a composite "3". The relative significance of weaknesses, management's recognition of the weaknesses and its willingness to take corrective measures, together with the extent of corrections made during the course of an examination, should be all evaluated when considering an informal action. However, at a minimum, an informal action may be necessary where significant weaknesses remain uncorrected from prior examinations.

I.1.b. Formal Actions

Section 8 of the FDI Act gives the FDIC Board of Directors broad enforcement powers including: Termination of Insurance Actions (Section 8(a)), Cease and Desist Actions (Sections 8(b) and 8(c)), and Suspension and Removal procedures (Section 8(e)). Problem trust departments are those which are assigned a composite rating of "4" or "5" under the Uniform Interagency Trust Rating System. It is expected that such departments will normally be subject to some type of formal enforcement action designed to return the department to an acceptable condition. If a formal action is not undertaken, examiner comments should describe alternative actions taken and justify their reasonableness.

I.2. Enforcement Action Resources

There are various resources available to the examiner if the examination findings indicate some type of enforcement action may be necessary. Examiners are reminded that they should be in contact with the Regional Office when considering such action. Detailed below are some resources available for review.

- Manual of Examination Policies (Manual) - Section 13 provides expanded guidance on the use of informal and formal enforcement actions.
- Formal and Informal Action Procedures Manual (FIAP Manual) - Contains procedural guidance when departmental conditions indicate some type of enforcement action is warranted.
- Case Manager Procedures Manual (CM Manual) - For use at the Regional Office; it contains procedures to guide in the review and processing of enforcement actions.

I.3. Civil Money Penalties

In connection with examinations of fiduciary activities, infractions of certain laws may be detected for which the assessment of civil money penalties (CMPs) is authorized. A full discussion of criteria and procedures for recommending such penalties is provided in Section 14 of the Manual. In addition, further guidance, as well as the scoring matrix to be used in CMP decisions, is provided in the Formal and Informal Action Procedures Manual (FIAP Manual).

J. Criminal Activities

The examination of trust activities within a financial institution may disclose apparent violations of criminal

law, or suspicious activities related to money laundering and the Bank Secrecy Act. When such conduct involves the institution, either as a victim or potential victim, or where the bank is used to facilitate criminal activity, it is the examiner's responsibility to ensure that proper action is taken and that reporting procedures are followed. The prescribed action and reporting procedures are set forth in Section 9.2 of the Manual of Examination Policies. In addition, FDIC Part 353: Suspicious Activity Reports sets forth reporting procedures for FDIC-supervised banks with respect to known, attempted, or suspected crimes.

K. Insurance of fiduciary activities

Insurance is a fundamental part of a department's risk management program. Once management has identified and analyzed potential risk areas, and reviewed its internal control structure, it may determine the appropriate method to deal with particular risks. The transfer of risk through insurance is one method commonly used. The specific needs of a department will dictate the type of coverage that should be obtained, as well as the level of such coverage. Examiners should refer to Section 4.4 of the Manual of Examination Policies for a general discussion of insurance management. In addition to coverage of trust activities under the bank's blanket bond and excess coverage, the following types of insurance are sometimes obtained by trust departments:

K.1. Errors and Omissions (Trust Department Surcharge Liability)

This form of coverage usually covers four types of losses:

- Loss from a claim made against the insured by reason of any alleged negligent act, error, or omission while discharging duties enumerated in the policy. These duties generally consist of administering estates or trusts; managing real and personal property; acting as a custodian; rendering investment advice; or acting as stock transfer agent, registrar, dividend disbursing agent, escrow agent, or trustee under a bond indenture.
- Loss from any claim made against the insured arising out of any alleged failure to act prudently under the Employee Retirement Income Security Act of 1974, or in an insured capacity as a fiduciary for any employee benefit account. It is important to note that for employee benefit accounts to be covered, specific language indicating their inclusion must be present in either the policy or a rider.
- Expenses incurred in the defense of any claim, as long as the coverage for that claim exists under the policy.
- Payments made to reimburse any officer, director, or employee for reasonable expenses and attorney fees incurred defending any claims as an individual. Insurance policies normally will provide for bank reimbursement only if the bank has indemnified the individual. In cases where the bank does not indemnify the director, officer, or employee, there is generally no coverage for the costs incurred by that individual.

K.2. Real Estate and Mortgages

Blanket real estate insurance covers all real estate owned by trust accounts, and real estate pledged on mortgages held by the department. This coverage can be less expensive than purchasing individual policies when numerous parcels are held. The blanket policy covering mortgaged real estate usually provides coverage where the mortgagee fails to keep the property insured. During the examination, there is no need to check individual insurance policies for mortgaged real estate loans where a blanket policy covering losses arising out of mortgaged real estate is in force in an adequate amount. However, examiners should check compliance with any covenants of the policy requiring the bank to perform duties to keep the protection effective.

K.3. Other Desirable Insurance

Although insurance is not the only consideration, thought should be given to exposure arising from employment of agents by the department. In dealing with a variety of assets and accounts, the department often employs others to perform tasks critical to proper account administration. These agents may not be covered by the bank's insurance policies. Therefore, the department should be certain that both account beneficiaries and itself are properly protected by appropriate third party bonding.

L. Deposit insurance of trust funds

Deposit insurance regulations are contained in Part 330 of FDIC Rules and Regulations. The publication

"The Financial Institution Employee's Guide to Deposit Insurance" (http://www.fdic.gov/deposit/deposits/financial/index.html), provides another reference source. Questions arising during examinations regarding specific circumstances, may be referred to the FDIC Call Center at 1-877-ASKFDIC (877-275-3342). For TDD the toll free phone number is 1-800-925-4618. The hours of operation of the FDIC Call Center are Monday thru Friday from 8 a.m. to 8 p.m. Eastern Time.

From the examiner's perspective, questions concerning deposit insurance generally arise in connection with deposits held as trust account assets. It is generally accepted that, to the extent trust monies are invested in bank deposits, they should be kept within insurance limits. Fundamental principles of deposit insurance for certain types of accounts are provided below, but examiners are cautioned that the complexities of the subject preclude exhaustive coverage here. Bank management and clients should consult with their attorneys, tax advisers, or other private professional advisers, as appropriate, to determine the coverage of their trust accounts under the deposit insurance regulations.

Deposit insurance is based on ownership rights and capacities, as disclosed in the records of the insured depository institution. The precise documentation of account ownership in the records of the depository institution is critical. Deposit records include, but are not limited to, signature cards, passbooks, and account ledgers and computer records that relate to the bank's deposit taking function. With the exception of deposit accounts in the certain retirement accounts ownership category, the maximum coverage is $100,000 per depositor. For those employee benefit accounts and trust accounts that qualify for pass-through deposit insurance, $100,000 per employee benefit plan participant or trust beneficiary. The maximum coverage for deposit accounts of certain retirement accounts is $250,000. Coverage is per institution: the deposits in each individually-insure bank or savings institution are separately insured, even if the institutions are affiliated through common ownership by a bank holding company. However, deposits at separate branch offices operated under a single charter are not separately insured.

Various types of deposits are eligible for coverage, such as savings accounts, certificates of deposit, checking accounts, money market accounts, retirement accounts, official checks, outstanding drafts, etc. For purposes of deposit insurance coverage, deposits are categorized according to eight ownership categories: Single Ownership Accounts; Joint Ownership Accounts; Revocable Trust Accounts; Irrevocable Trust Accounts; Accounts of a Corporation, Partnership, or Unincorporated Association; Certain Retirement Accounts and Employee Benefit Plan Accounts; and Government Accounts. The discussion below centers on those account ownership categories typically encountered in a trust examination.

L.1. Deposits of Revocable Trusts

On January 13, 2004, the FDIC adopted new rules for the insurance coverage of revocable trust accounts, also referred to as living trusts. (See FDIC Rules and Regulations Section 330.10, "Revocable Accounts.") The new rules took effect on April 1, 2004. The owner, i.e. the grantor, of a revocable trust will be insured up to $100,000 per beneficiary if all the following requirements are met:

• The beneficiary is the grantor’s spouse, child, grandchild, parent, or sibling. Stepparents, stepchildren, adopted children and similar relationships also qualify. Beneficiaries that are in-laws, cousins, nieces and nephews, and charitable organizations do not qualify;
• The beneficiary’s interest in the trust vests upon the death of the grantor of the trust; and
• The deposit account must be titled at the bank in a manner that indicates that the deposit account is held by a trust.

The amount of coverge is based on the actual interest of each qualifying beneficiary. Unless the trust states otherwise, the FDIC will assume that each beneficiary, including beneficiaries with a life estate, has an equal interest in the trust.

The new rules differ from the old rules in that the FDIC will ignore conditions that may limit a beneficiary’s right to his/her interest in the trust. Prior to the new rule, beneficiaries with contingent interests in a trust were not eligible for per-beneficary coverage. Also, the new rule elimiated the requirement that the bank maintain account records of the names of the trust beneficiaries. Now, the bank need only indicate in the title of the deposit account that

it is held by a trust. The rule for payable on death (POD) accounts, however, still requires that the names of the beneficiaries of a POD account be identified in the bank's records.

If the trust has more than one grantor, deposit insurance coverage would be up to $100,000 for each qualifying beneficiary for each grantor, provided that the beneficiary's interest in the trust vests upon the death of the last surviving grantor.

The trust interest of a non-qualifying beneficiary is insured as the grantor's single ownership funds. In the case of single ownership funds, the grantor's funds would be added to any other single ownership funds of the grantor, with the total amount of single ownership funds insured up to $100,000.

L.2. Deposits of Estates

Deposits of an estate (made by an executor or administrator) are considered to fall in the "single ownership" category of deposits. (See FDIC Rules and Regulations Section 330.6, "Single Ownership Accounts.") These deposits are separately insured to the decedent, but would be added to any other deposits denominated in the name of the deceased which have not yet been marshaled by the executor. The decedent's funds are, of course, separately insured from any funds owned and deposited in the same insured institution by the estate's executors or administrators, or the estate's beneficiaries. The fiduciary capacity of the executor or administrator must be disclosed on the institution's records.

L.3. Deposits of Irrevocable Trust Accounts

The interests of a beneficiary in all deposit accounts established by the same grantor and held at the same insured bank under an irrevocable trust are added together and insured up to $100,000, if all of the following requirements are met:

• The insured bank's deposit account records disclose the existence of the trust relationship;
• The beneficiaries and their interests in the trust must be identifiable from the bank deposit account records or from the trust's records;
• Each beneficiary's interest in the trust must be non-contingent, as defined in Section 330.1 of the FDIC's Rules and Regulations; and
• The trust must be valid under state law.

Section 330.1 defines a non-contingent trust interest as a trust interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031--7 of the Federal Estate Tax Regulations (26 CFR 20.2031--7) or any similar present worth or life expectancy tables which may be adopted by the Internal Revenue Service. Note that, unlike the rules covering revocable trusts, the beneficiary of an irrevocable trust does not have to be related to the grantor.

If the grantor retains an interest in the trust, the amount of the grantor's retained interest would be added to any single ownership accounts owned by the grantor at the same bank and the total insured up to $100,000. For such a situation to exist, the grantor of the trust must still be alive.

The following are situations where an irrevocable trust would not be insured on a per beneficiary basis, in which case the deposits of the trust as a whole would only be insured up to $100,000.

• The trust agreement does not name the beneficiaries or provide any means of identifying the beneficiaries;
• The trust agreement provides that a beneficiary will receive no assets unless certain conditions are satisfied;
• The trust agreement provides that a trustee may invade the principal of the trust, with the result that the assets available for other beneficiaries may be reduced or eliminated; or
• The trust agreement provides that the trustee or a particular beneficiary may exercise discretion in allocating assets among the beneficiaries, with the result that the future

distribution to each beneficiary is impossible to determine.

L.4. Deposits of Accounts Held by an Agent, Nominee, Guardian, Custodian, or Conservator

Funds held in the name of an agent, nominee, custodian, guardian or conservator on behalf of a principal are insured as the funds of the principal. The funds are added together with any other funds the principal owns in the same right and capacity at the insured institution, either directly or through an agent, and insured to the same extent as if the funds had been deposited directly by the principal.

Funds held by an agent, nominee, guardian, custodian, conservator or loan servicer on behalf of two or more persons jointly, shall be treated as a joint ownership accounts. See Section 330.9, "Joint Ownership Accounts," for details on coverage of joint ownership accounts.

L.5. Deposits of Employee Benefit Accounts

Employee benefit plan account deposits are deposits of a pension plan, profit sharing plan or other employee benefit plan described in Section 3(3) of the Employee Retirement Income Security Act (ERISA). Deposits of employee benefit plans are insured to a maximum of $100,000 for each participant's non-contingent interest in the plan, provided that the recognition of deposit ownership requirements of Section 330.5 are satisfied. (See FDIC Rules and Regulations Section 330.14, "Retirement and Other Employee Benefit Plan Accounts") This coverage is known as "pass-through" insurance because the insurance coverage passes through the plan administrator, who for purposes of Section 330.14 is the "depositor" with respect to these accounts, to each participant's interest. Coverage for a plan's deposits is not based on the number of participants, but rather on each participant's share of the plan.

The value of a participant's non-contingent interest in the deposit of a defined contribution employee benefit plan is the employee's account balance as of the date of default of the insured depository institution, regardless of whether the amount was derived, in whole or in part, from contributions of the employee and/or the employer to the account. The value of a participant's non-contingent interest in a defined benefit employee benefit plan is the present value of the employee's interest in the plan, evaluated in accordance with the method of calculation ordinarily used under such plan, as of the date of default of the insured depository institution. In the case of an overfunded plan, an employee benefit plan's deposits that can not be attributed to the interests of the plan's participants will be aggregated and insured up to a maximum of $100,000. Similarly, desposits of an employee benefit plan that represent contingent interests will be aggregated and insured to a maximum of $100,000. A non-contingent interest is an interest capable of determination without evaluation of contingencies except for those covered by the present worth tables and rules of calculation for their use set forth in § 20.2031--7 of the Federal Estate Tax Regulations (26 CFR 20.2031--7) or any similar present worth or life expectancy tables which may be adopted by the Internal Revenue Service.

L.6. Deposits of Certain Retirement Accounts

Deposits of certain retirement accounts are deposits owned by one person and titled in the name of that person's retirement account. See Section 330.14, "Retirement and Other Employee Benefit Plan Accounts." The following types of retirement plan deposits qualify for coverage as certain retirement accounts:

- All types of IRAs including traditional IRAs, Roth IRAs, Simplified Employee Pension (SEP) IRAs, and Savings Incentive Match Plans for Employees (SIMPLE) IRAs;
- All Section 457 deferred compensation plan accounts, such as eligible deferred compensation plans of state and local governments, regardless of whether they are self-directed;

- Self-directed defined contribution plan accounts, such as self-directed 401(k) plans, self-directed SIMPLE IRAs held in the form of 401(k) plans, self-directed defined contribution money purchase plans, and self-directed defined contribution profit-sharing plans; and
- Self-directed Keogh plan accounts (or H.R. 10 plan accounts) designed for self-employed individuals.

The above listed retirement accounts owned by the same person in the same FDIC-insured bank are added together and the total is insured up to a maximum of $250,000.

For deposit insurance purposes, a "self-directed" account means that plan participants have the right to direct how the assets of their account are invested, including the right to invest funds in deposits of an FDIC-insured bank. If a plan has as its default investment option deposit accounts at a particular FDIC-insured institution, the FDIC considers such a plan to be self-directed for deposit insurance purposes. If a plan's only investment vehicle is a deposit account(s) of a particular bank so that the participants have no choice as to how to invest the assets in their account, such a plan would not be considered self-directed. However, if a plan is a single employer/employee plan, then the fact that there is only a single investment option, e.g. a deposit in an FDIC-insured institution, would not cause the deposits on such a plan to not be insured.

Coverdell Education Savings Accounts (formerly known as Education IRAs), Health Savings Accounts, and Medical Savings Accounts are not included in the Certain Retirement Accounts ownership category. Nor are 403(b) plans (annuity contracts for certain employees of public Schools, tax-exempt organizations and ministers) included in the Certain Retirement Accounts ownership category.

M. Applicability of consumer regulations to fiduciary activities

Unless specifically exempted, the activities of trust accounts are subject to compliance with applicable laws. Consumer law is one category of such laws. Thus, a particular trust account which engages in a regulated activity, such as lending, may be required to comply with consumer lending laws. Responsibility for compliance will generally rest with the financial institution, or other party, acting in the capacity of trustee.

Primary regulatory responsibility for reviewing the institution's compliance with these laws (both for its own account, as well as in its role as trustee) rests with Division of Supervision and Consumer Protection (DSC). Examiners may review the activity to determine: (a) if particular statutes are applicable to specific accounts under review and, (b) if so, that basic procedures are in place to effect compliance. If performed, the scope of the review should allow an assessment of whether any contingent liability attaches. Where significant activity or problems are encountered, the matter should also be referred to DSC - Consumer Protection and Compliance.

Foremost among these regulations will be the Federal Reserve Board's Regulation Z (Truth in Lending) at 12 CFR 226. The regulation may apply if a trust account meets the definition of a creditor, as noted at Section 226.2(a)(17) of the regulation. The fundamental provisions of the definition require that the creditor regularly (more than 25 times per year, or five times if secured by dwellings) extends consumer credit (for personal, family, or household purposes) that is subject to a finance charge, and payable in more than four installments. As noted in the Official Staff Commentary for Section 226.2(a)(17)(i), item 7, each trust is considered a separate entity for purposes of applying criteria in the definition.

Activities of trusts can also fall within the purview of other consumer regulations, such as Equal Credit Opportunity, FRB Regulation B. For an overview of compliance regulations and statutes, refer to the Compliance Examination Handbook.

In some instances, personal, charitable, or corporate trust accounts may be found to be subject to the above regulations. More frequently, applicability will occur with employee benefit plans. A discussion of compliance issues in employee benefit plans may also be found in subsection H.9.g.(4). Consumer

Protection Laws and Loans to Plan Participants, located in Section 5.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Section 11- FDIC:Registered Transfer Agent Examination Manual

Table of Contents

A. Foreword

B. Introduction

1. Rationale for Examinations
    a. Public Policy Concerns
    b. The Statutory Framework

C. Role of the Transfer Agent

1. Stock Transfer Agent
2. Stock Registrar
3. Bond Registrar
4. Mutual Fund Transfer Agent

D. Registration of Transfer Agents

1. Summary Table of Transfer Agent Registration Requirements
2. Voluntary Registration of Securities
3. Counting the Number of Shareholders of Record

E. Registered Transfer Agent Examinations

1. FDIC Registered Transfer Agent Examination Ratings
    a. Rating Guidelines
    b. Disclosure of Rating
2. Discussions With Management
3. Registered Transfer Agent Examination Intervals
4. Examinations by State Authorities
5. Limited Scope Examinations and Visitations
6. Examination Planning
7. Disclosure of Report of Examination
8. Workpapers

F. Registration and Reporting Requirements
  1. FDIC Registration Requirements
    a. Part 341 - Registration of Securities Transfer Agents
      i. Initial Registrations
        i(a). Examples of Initial Registration
      ii. Amendments to Registration
        ii(a). Examples of Registration Amendments
      iii. Deregistration of Registered Transfer Agents
    b. Voluntary Registration of Transfer Agents
  2. SEC Reporting Requirements
    a. Form TA-2
    b. Notice of Assumption or Termination of Transfer Agent Services
      i. Depository Notifications Required
      ii. Contents of Depository Notifications
G. Management
  1. Securities Transfer Policies
  2. Earnings
  3. Management of Transfer Agent Activities
    a. Organization and Staffing
    b. Parent Holding Company or Affiliate Support Services
    c. Acceptance of New Accounts
    d. Closed Accounts
    e. Account Administration
    f. Account Reviews
    g. Risk Management
  4. Fingerprinting of Personnel
    a. Exemptions from Fingerprinting
    b. Notice Pursuant to Rule 17f-2
    c. Retention of Fingerprinting Related Records
H. Internal Controls
  1. Controls Governing the Processing of Securities Transfers
    a. Appropriate Person
    b. Consequences of Unauthorized Endorsements or Instructions
    c. Signature Guarantees

i. Medallion Programs

ii. SEC Requirements for Signature Guarantees

ii(a). Standards and Procedures

ii(b). Rejection of Signature Guarantees

iii. Liability for Unreasonable Rejection of Guarantees

d. Controls Over the Overissuance of Securities

i. Prompt Posting of Securities Transfer Records

i(a). Prompt Posting Criteria

i(b). Failure to Promptly Post

ii. Aged Record Differences

ii(a). Reports to Issuers

ii(b). Reports to Regulatory Agency

iii. Buy-Ins

iii(a)(1). SEC Requirements

iii(a)(2). Reports to Issuers

iii(a)(3). Reports to Regulatory Agency

2. Safeguarding of Funds and Securities

a. Physical Security Controls

b. Segregation of Duties

c. Vacation Policy

d. Reconciliation Procedures

e. Controls Over Securities Certificates

i. Controls Over Unissued Securities Certificates

ii. Controls Over Cancelled Securities Certificates

f. Controls Over Funds and Disbursements

3. Mail Handling Procedures

a. Lost Securityholders

4. Annual Meeting and Proxy Processing Services

I. Audits

a. Internal Audits

i. Frequency and Scope

b. External Audit

i. SEC Requirements

b(i)(a). Exceptions From SEC Requirements

- c. SAS 70 Reports

J. Transfer Agent Operations

1. Introduction
2. Definitions
    - a. "Item"
    - b. Routine/Non-Routine
    - c. Deposit Shipment Control List
    - d. Withdrawal Shipment Control List
    - e. Made Available
    - f. Transfer
    - g. Process
    - h. Receipt
    - i. Business Day
3. Exempt Transfer Agents
4. Turnaround Performance
5. Turnaround, Processing, and Forwarding of "Items"
    - a. SEC Turnaround Requirements
    - b. Exceptions from SEC Turnaround Performance
    - c. Failure to Meet Turnaround Standards
        - i. Required Reports
        - ii. Limitation on Expansion and Other Required Reports
        - iii. Stock Exchange Turnaround and Operational Standards
        - iv. New York Stock Exchange (NYSE) Rule 496
        - v. American Stock Exchange (AMEX) Rule 891
        - vi. Written Inquiries and Requests
        - vii. Turnaround Standards for Written Inquiries and Requests
            - vii(a). Inquiries and Requests from Persons
            - vii(b). Inquiries and Requests from Broker-Dealers
            - vii(c). Written Inquiries Concerning Dividend and Interest Payments
            - vii(d). Summary of Timeframes for Written Inquiries
            - vii(e). Recordkeeping
            - vii(f). Daily Transactions
            - vii(g). Monthly Transactions

vii(h). Outside Registrars

vii(i). Turnaround Performance

vii(j). Written Inquiries

vii(k). Appointment Documentation

vii(l). Other Records

vii(l)(1). Transfer Restrictions

vii(l)(2). Journals

vii(l)(3). Control Book

vii(l)(4). Cancelled Certificates

vii(m). Record Retention

vii(m)(1). Two Years - Six Months Easily Accessible

vii(m)(2). Two Years - First Year Easily Accessible

vii(m)(3). Three Years - First Year Easily Accessible

vii(m)(4). Easily Accessible After Termination

vii(m)(5). Six Years - First Year Easily Accessible

vii(m)(6). Upon Termination of Appointment

vii(m)(7). Electronic and Micrographic Recordkeeping

vii(n). Access to Records

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FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Appendix B - Examination Aids

Table of Contents

Introduction

Uniform Interagency Trust Rating System

Overview

Composite Ratings

Component Ratings

Management

Operations, Internal Controls & Auditing

Earnings

Compliance

Asset Management

First Day Letter

Introduction

This appendix is intended to serve the examiner in gathering and recording information for the trust examination. Examiners have the discretion of using all, part, or none of these tools. Nevertheless, their use, particularly by inexperienced trust examiners, is encouraged.

The trust examination report is in narrative form. Its core pages only contain a few schedules. Normally, most other documents or information supporting report comments and conclusions should be placed in examination work papers. The information contained in this appendix offers examiners a means for both examining trust departments and documenting their work papers.

Uniform Interagency Trust Rating System (UITRS)

The UITRS was originally adopted in 1978 and was revised in 1998. The 1998 revision of the UITRS is appears later in this appendix. It has been adopted by each of the Federal financial institution regulatory agencies. Both the Trust Manual and examination report have been designed around its structure. Examiners should review each of the five UITRS rating guidelines and summaries when assigning ratings and preparing comments for the report.

Trust Examiner's First Day Letter

The first day letter requests management to provide specific information. A copy of this letter is reproduced in this appendix. Use of this letter is optional, and it may be modified by deleting or adding information at the discretion of the Examiner-in-Charge. In addition, the distribution of the letter should be coordinated with the state banking authority if that agency will participate in the examination. It should be prepared during the pre-

examination work phase, and submitted to trust management, together with the "Trust Officer's Questionnaire" [FDIC Form 6350/11 (7-95)], prior to beginning the examination.

In the automated version of the first day letter, deletion of an entire question (from the beginning of the question # to the end of the question) will automatically renumber questions and repaginate the entire letter.

Uniform Interagency Trust Rating System

The information that follows was published 10-13-98 in the Federal Register (63 FR 54711) and was distributed by FDIC in FIL 115-98 dated 10-21-98.

Introduction

The Uniform Interagency Trust Rating System (UITRS) was adopted on September 21, 1978 by the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (FRB), and in 1988 by the Federal Home Loan Bank Board, predecessor agency to the Office of Thrift Supervision (OTS). Over the years, the UITRS has proven to be an effective internal supervisory tool for evaluating the fiduciary activities of financial institutions on a uniform basis and for identifying those institutions requiring special attention.

A number of changes have occurred in both the banking industry and the Federal supervisory agencies' policies and procedures which prompted a review and revision of the 1978 rating system. The revisions to the UITRS:

- Realign the UITRS rating definitions to bring them in line with the Uniform Financial Institutions Rating System (UFIRS).
- Reduce the component rating categories from six to five, combining the Account Administration and Conflicts of Interest components into a new Compliance component.
- Require Earnings to be rated only in institutions with more than $100 million in total trust assets, and in all non-deposit trust companies. An earnings rating is not required for the remaining institutions; however, each Federal supervisory agency has the option of requiring the earnings of these institutions to be rated using the alternate rating definitions where applicable.
- Explicitly refer to the quality of risk management processes in the management component, and the identification of risk elements within the composite and component rating definitions.

These revisions are intended to promote and complement efficient examination processes. The revisions update the rating system but retain its basic framework. Consequently, the revised rating system will not result in additional regulatory burden to institutions or require additional policies or processes.

The UITRS considers certain managerial, operational, financial and compliance factors that are common to all institutions with fiduciary activities. Under this system, the supervisory agencies endeavor to ensure that all institutions with fiduciary activities are evaluated in a comprehensive and uniform manner, and that supervisory attention is appropriately focused on those institutions exhibiting weaknesses in their fiduciary operations.

Overview

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. These components address the following: the capability of management; the adequacy of operations, controls and audits; the quality and level of earnings; compliance with governing instruments, applicable law (including self-dealing and conflicts of interest laws and regulations), and sound fiduciary principles; and the management of fiduciary assets.

Composite and component ratings are assigned based on a 1 to 5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk management practices

and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk management practices and, therefore, the highest degree of supervisory concern. Evaluation of the composite and components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity, and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

The following two sections contain the composite rating definitions, and the descriptions and definitions for the five component ratings.

Composite Ratings

The five composite ratings are defined as follows:

Composite 1
Administration of fiduciary activities is sound in every respect. Generally all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in accordance with sound fiduciary principles and give no cause for supervisory concern.

Composite 2
Administration of fiduciary activities is fundamentally sound. Generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may reveal some significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. While problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally, or to the soundness of the institution. The institution's fiduciary activities require more than normal supervision and may include formal or informal enforcement actions.

Composite 4

Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and ultimately undermine the public confidence in the institution. Close supervisory attention is required, which means, in most cases, for mal enforcement action is necessary to address the problems.

Composite 5

Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant and/or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

Component Ratings

Each of the component rating descriptions is divided into three sections: a narrative description of the component; a list of the principal factors used to evaluate that component; and a description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelationship among components. The listing of evaluation factors is in no particular order of importance.

Management

Description

This rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor and control the risks of an institution's fiduciary activities. It also reflects their ability to ensure that the institution's fiduciary activities are conducted in a safe and sound manner, and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk exposure levels and ensure that appropriate policies, procedures and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity and other risks. Sound management practices are

demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

Factors Evaluated

The management rating is based upon an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- The level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions.
- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the introduction of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies, practices and controls addressing the operations and risks of significant fiduciary activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity, and fiduciary risk profile.
- The overall level of compliance with laws, regulations, and sound fiduciary principles.
- Responsiveness to recommendations from auditors and regulatory authorities.
- Strategic planning for fiduciary products and services.
- The level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning.
- The adequacy of insurance coverage.
- The availability of competent legal counsel.
- The extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation.
- The process for identifying and responding to fiduciary customer complaints.

Ratings .

A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board are proactive, and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the size, complexity and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist, but are

not material to the sound administration of fiduciary activities, and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that needs improvement or risk management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management or the board of directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the size, complexity, and risk profile of the institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities, and pose a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

Operations, Internal Controls & Auditing

Description

This rating reflects the adequacy of the institution's fiduciary operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must assure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

The institution's fiduciary operating systems, internal controls, and audit function subject it primarily to transaction and compliance risk. Other risks including reputation, strategic, and financial risk may also be present. The ability of management to identify, measure, monitor and control these risks is reflected in this rating.

Factors Evaluated

The operations, internal controls and auditing rating is based upon, but not limited to, an assessment of the following evaluation factors:

- Operations and Internal Controls, including the adequacy of:
  - Staff, facilities and operating systems;
  - Records, accounting and data processing systems (including controls over systems access and such accounting procedures as aging, investigation and disposition of items in suspense accounts);
  - Trading functions and securities lending activities;
  - Vault controls and securities movement;

        - Segregation of duties;
        - Controls over disbursements (checks or electronic) and unissued securities;
        - Controls over income processing activities;
        - Reconciliation processes (depository, cash, vault, sub-custodians, suspense accounts, etc.);
        - Disaster and/or business recovery programs;
        - Hold-mail procedures and controls over returned mail; and,
        - Investigation and proper escheatment of funds in dormant accounts.
    - Auditing, including :
        - The independence, frequency, quality and scope of the internal and external fiduciary audit function relative to the volume, character and risk profile of the institution's fiduciary activities;
        - The volume and/or severity of internal control and audit exceptions and the extent to which these issues are tracked and resolved; and
        - The experience and competence of the audit staff.

Ratings

A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates that operations, internal controls and auditing are satisfactory in relation to the volume and character of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates that operations, internal controls or auditing need improvement in relation to the volume and character of the institution's fiduciary activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient operations, internal controls or audits. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's fiduciary activities. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits, or may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

A rating of 5 indicates critically deficient operations, internal controls or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

Earnings

Description

This rating reflects the profitability of an institution's fiduciary activities and its effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

An evaluation of earnings is required for all institutions with fiduciary activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than $100 million, or are a non-deposit trust company.

For institutions where the assignment of an Earnings rating is not required by the UITRS, the Federal supervisory agency has the option to assign an earnings rating using an alternate set of ratings. A rating will be assigned in accordance with implementing guidelines adopted by the supervisory agency. The definitions for the alternate ratings are included in the revised UITRS and may be found in the section immediately following the definitions for the required ratings.

Factors Evaluated

The evaluation of earnings is based upon, but not limited to, an assessment of the following factors:

- The profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution.
- The overall importance to the institution of offering fiduciary services to its customers and local community.
- The effectiveness of the institution's procedures for monitoring fiduciary activity income and expense relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof.

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- The level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business.
- Dependence upon non-recurring fees and commissions, such as fees for court accounts.
- The effects of charge-offs or compromise actions.
- Unusual features regarding the composition of business and fee schedules.
- Accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services and/or processing functions.
- The extent of management's use of budgets, projections and other cost analysis procedures.

- Methods used for directors' approval of financial budgets and/or projections.
- Management's attitude toward growth and new business development.
- New business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local organizations, and an evaluation by management of risk potential inherent in new business areas.

Ratings

A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring earnings performance are fully adequate and there is appropriate oversight by the institution's board of directors or a committee thereof. Management makes effective use of budgets and cost analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A rating of 2 indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its fiduciary obligations. Generally, fiduciary earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary activities that exist, and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar, or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A rating of 3 indicates less than satisfactory earnings. Earnings are not commensurate with the risk associated with the fiduciary activities undertaken. Earnings may be erratic or exhibit downward trends, and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its fiduciary activities. The institution is characterized by fiduciary earnings performance that is poor historically, or faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A rating of 5 indicates critically deficient earnings. In general, an institution with this rating is experiencing losses from fiduciary activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

Alternate Rating of Earnings

Description

Alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management. These standards are:

- Standard No. 1 - The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- Standard No. 2 - The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- Standard No. 3 - The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- Standard No. 4 - The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services even if the institution does not earn sufficient income to cover the expenses of providing those services.

Ratings.

A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum, at least three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. While management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

Compliance

Description

This rating reflects an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically

incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally, and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of the fiduciary account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include: failure to comply with applicable laws, regulations or terms of the governing instrument; inadequate account administration practices; and inexperienced management or inadequately trained staff. Risks associated with a fiduciary's duty of undivided loyalty generally stem from engaging in self-dealing or other conflict of interest transactions. An institution may be exposed to compliance, strategic, financial and reputation risk related to account administration and conflicts of interest activities. The ability of management to identify, measure, monitor and control these risks is reflected in this rating. Policies, procedures and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

Factors Evaluated

The compliance rating is based upon, but not limited to, an assessment of the following evaluation factors:

- Compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes;
- Compliance with the terms of governing instruments;
- The adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities;
- The adequacy of policies and procedures addressing account administration;
- The adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information";
- The effectiveness of systems and controls in place to identify actual and potential conflicts of interest;
- The adequacy of securities trading policies and practices relating to the allocation of brokerage business, the payment of services with "soft dollars" and the combining, crossing, and timing of trades;
- The extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested;

- The decision making process used to accept, review, and terminate accounts; and,
- The decision making process related to account administration duties, including cash balances, overdrafts, and discretionary distributions.

Ratings .

A rating of 1 indicates strong compliance policies, procedures and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's fiduciary activities. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature and easily correctable. All significant risks are consistently and effectively identified, measured, monitored and controlled.

A rating of 2 indicates fundamentally sound compliance policies, procedures and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial noncompliance with laws, regulations or governing instruments, but losses are no worse than minimal. While management may have the ability to achieve compliance, the number of violations that exist, or the failure to correct prior violations, are indications that management has not devoted sufficient time and attention to its compliance responsibilities. Risk management practices generally need improvement.

A rating of 4 indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary activities. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self-dealing, and is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and regulations exist and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored and controlled.

A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments and efforts to obtain voluntary compliance have been unsuccessful. The severity of

noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

Asset Management

Description

This rating reflects the risks associated with managing the assets (including cash) of others. Prudent portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset management activities subject it to reputation, compliance and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest rate risk, as well as transaction and compliance risk. The ability of management to identify, measure, monitor and control these risks is reflected in this rating.

Factors Evaluated

The asset management rating is based upon, but not limited to, an assessment of the following evaluation factors:

- The adequacy of overall policies, practices and procedures governing asset management, considering the size, complexity and risk profile of the institution's fiduciary activities.
- The decision-making processes used for selection, retention, and preservation of discretionary assets including adequacy of documentation, committee review and approval, and a system to review and approve exceptions.
- The use of quantitative tools to measure the various financial risks in investment accounts and portfolios.
- The existence of policies and procedures addressing the use of derivatives or other complex investment products.
- The adequacy of procedures related to the purchase or retention of miscellaneous assets including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance, and other unique assets.
- The extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio.
- The monitoring of changes in the composition of fiduciary assets for trends and related risk exposure.
- The quality of investment research used in the decision-making process and documentation of the research.
- The due diligence process for evaluating investment advice received from vendors and/or brokers (including approved or focus lists of securities).
- The due diligence process for reviewing and approving brokers and/or counter parties used by the institution.

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets. Functions of this type would include, but not necessarily be limited to, directed agency relationships, securities clearing, non-fiduciary custody relationships, transfer agent and registrar activities. In institutions of this type, the rating for Asset Management may be omitted by the examiner in accordance with the examining agency's implementing guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant directed 401(k) plans.

Ratings .

A rating of 1 indicates strong asset management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

A rating of 2 indicates satisfactory asset management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

A rating of 3 indicates that asset management practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such significance as to generally pose a threat to the interests of account beneficiaries. Asset management and risk management practices generally need to be improved. An elevated level of supervision is normally required.

A rating of 4 indicates deficient asset management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally, and if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

A rating of 5 represents critically deficient asset management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.

Trust Examination Request List

NAME OF INSTITUTION:

DATE OF EXAMINATION:

PRIOR EXAMINATION DATE:

EXAMINER-IN-CHARGE:

THE FOLLOWING ITEMS OR MATERIALS ARE REQUESTED TO EXPEDITE THE EXAMINATION OF YOUR INSTITUTION'S TRUST ACTIVITIES. THE ACCURACY AND TIMELINES OF DATA PROVIDED ARE VITAL TO THE SUCCESSFUL EXAMINATION OF YOUR INSTITUTION. PLEASE HAVE THE FOLLOWING AVAILABLE ON (INSERT DATE).

Please provide the following information as of (Insert Date).

If information requested is not applicable, please indicate with a NA.

Feel free to use your software provider's audit package to provide the requested information.

Regulatory and Legal Information

1. Trust Officer's Questionnaire (form provided), certified by the senior trust officer or other senior bank officer as of (Insert Date).

2. Current trust department statement of assets and liabilities or trust department statement of condition.

3. Information on pending fiduciary matters describing any threatened and/or pending litigation against the bank in connection with its fiduciary activities. Please include the following information:

   a. identification of accounts concerned;

   b. nature of, or basis for, the litigation;

   c. amount involved;

   d. present status of the action; and

   e. statement as to the probable outcome of the action, together with its cost to the bank.

4. Indicate if legal counsel is retained on an on-going basis to advise the Board of Directors, the trust committee(s), and the trust officer(s) on legal matters pertaining to fiduciary administration.

5. Indicate if written legal opinions are obtained and filed in connection with legal questions arising during the course of an account's administration.

6. Provide a copy of any communication with the Department of Labor, Securities and Exchange Commission, Internal Revenue Service, or National Association of Securities Dealers for the bank, its subsidiaries or affiliates since the previous examination.

7. Provide a copy of the customer complaint log since the last examination. If a complaint log is not maintained, provide a list of customer complaints filed since the last examination including the following information:

   a. name of complainant;

   b. date of complaint;

   c. description of the complaint

   d. resolution of the complaint

Organization

8. Provide an organization chart of the department.

9. Provide a copy of the department's current strategic plan, marketing plan, and budget.

10. Provide a list of all bank subsidiaries and affiliates, together with a brief synopsis of capitalization and activities engaged in by the subsidiary or affiliate. (Annual report will suffice.)

11. If there has been any acquisition of, or mergers with, other trust departments since the last examination, please provide the following:

    a. method for establishing the purchase price;

    b. extent of due diligence performed on trust accounts before acquisition or merger; and

    c. date of regulatory approval received from state or FDIC, if required.

12. Make available the Minutes of the Board of Directors and/or trust committee(s) pertaining to trust activities since (Insert Date).

13. Provide the following information with respect to each committee supervising trust (and transfer agent) activities:

    a. name of committee;

    b. principal functions of the committee;

    c. number of members authorized by the Board of Directors;

    d. annual fees paid, if any;

    e. attendance fee paid members;

    f. list of committee members;

    g. year of birth of committee members;

    h. principal business interests, or occupation of committee members;

    i. salary of committee members who are also officers of the bank.

14. Provide the following information with respect to principal officers:

    a. name and title;

    b. principal duties;

    c. year of birth;

    d. percent of time devoted to the trust institution;

    e. current salary and last year's bonus;

    f. if hired since the last examination, please provide a résumé of the officer or list education and degrees awarded, work history, names of other financial institutions where employed, title, and principal duties.

    g. proof of quarterly investment reports completed by applicable department/bank personnel since the previous examination pursuant to Section 344.9(d) of the FDIC's Rules and Regulations.

15. Provide aggregate number of junior officers and the total amount of their salaries.

16. Provide aggregate number of staff other than officers and the total amount of their salaries.

17. With respect to directors, officers, and employees of the bank, provide the following:

    a. a list of their direct obligations held in any account, indicating whether any such items are receiving special or preferential treatment, e.g., rates of interest, etc;

    b. a list of holdings of stock and/or obligations of their corporations held in any account; and

    c. a list of fiduciary accounts for which they serve as co-fiduciary; a list of fiduciary accounts for which they have any interest as either a donor or beneficiary (exclude interests in own bank employee benefit plans).

18. Provide a summary of insurance policies currently carried to cover fiduciary activities, including coverage for real estate properties held in trust.

General Account Administration

19. Make available a copy of the department's written policies and procedures. Please indicate the date on which the Board of Directors approved the policies.

20. Provide a copy of the bank and/or department's privacy policy and customer disclosures.

21. Provide a list of all accounts (e.g., account trial balance), listing for each: (Note: for items f, g and h please identify if shown at "book" or "market" value)

    a. account title and number;

    b. account officer;

    c. investment officer;

    d. principal cash;

    e. income cash;

    f. invested principal (summary total per account, not detail of assets or tax lots unless requested);

    g. invested income (summary total per account, not detail of asset or tax lots unless requested); and

    h. summary totals for cash and assets of all accounts (by major appointment category).

22. Provide a summary listing of assets by type and CUSIP number and the aggregate number of units held. The report should also provide the total "book" and "market" value of each asset.

23. Provide a copy of the account codes used to read the reports requested in items 2 1 and 22.

24. Provide a list of liabilities within accounts, such as borrowings, etc. Please indicate the dollar value of assets pledged by the account, if any, to collateralize such liabilities.

25. Provide a list of terminated accounts that have not been distributed, including the reasons therefore.

26. Provide a list of watch-listed accounts.

Operations/Audits

27. Provide copies of following reports, as they pertain to overall trust activity, since the previous examination.

    a. internal audits, including scope of account review;

    b. external audits' including scope of account review;

    c. FDICIA Risk matrix, if applicable; and

    d. SAS 70, if applicable.

28. Provide the most recent reconcilement(s) and supporting documentation of the department's

    a. demand deposit account(s);

    b. safekeeping and/or safekeeping exception report;

    c. brokerage accounts;

    d. suspense accounts;

e. house accounts; and

f. failed trades.

29. Provide a list of bank assets (indicate par and market values of each security):

    a. pledged with state authorities;

    b. pledged with the trust department; or

    c. otherwise segregated and earmarked to secure trust activities or uninvested trust cash.

30. Provide copies of the last year-end Call Report and the work papers for the preparation of Schedule RC-T. If the institution files Schedule RC-T data on a quarterly basis, also provide the last quarter's Call Report and the work papers for the preparation of Schedule RC-T.

31. Provide reports used to review the following:

    a. overdrafts;

    b. cash equivalent balances;

    c. large cash balances; and

    d. other cash balances available for investment.

32. Provide a listing of outside service providers and have copies of their contracts available for review. Examples include software service providers, pricing services, record keepers, proxy voting services, and so on.

33. Provide the date of the most recent business resumption (contingency) plan and the results of the last contingency plan test.

34. Please provide summary information on the following trust activities, if applicable

    a. electronic banking, including the use of web sites. Please provide web site addresses, if any:

    b. new trust products developed since last examination.

Investments

35. Provide a list of accounts with discretionary investment authority that hold own-bank or affiliated financial institution interest-bearing deposits. Please indicate interest rates paid and maturity. Report own bank and affiliated-institution deposits separately. Also report money market deposits and certificates of deposit separately.

36. Provide a copy of the following:

    a. a list of approved investments (buy/sell list), including mutual funds and cash equivalents;

    b. details of any asset allocation models used to select investments; and

    c. investments on any internal watch list.

37. Provide a copy of the last Rule 13f-1 quarterly report submitted to the Securities and Exchange Commission pursuant to Regulation 240.13f-1, if applicable. (Institutional investment managers that use the United States mail, or other means or instrumentality of interstate commerce, in the course of their business and that exercise investment discretion over $100 million or more in Section 13(f) securities must file Form 13F)

38. Provide the following information on broker-relationships:

   a. a list of brokers utilized and broker fees and commissions paid during the last three calendar years and year-to-date;

   b. a description of the procedures followed regarding the placement of brokerage business for fiduciary accounts;

   c. a description of the procedures followed to ensure that the most favorable execution and commission rates are obtained; and

   d. the last formal analysis of broker relationships.

39. Describe all payments, since the last examination, of soft dollars to securities brokers and dealers. Please state if written policies have been adopted to ensure compliance with the safe harbor provisions of Section 28(e) of the Securities Exchange Act of 1934.

40. List appointments where the institution has sole or joint responsibility for assets that are not in its possession, or those over which accounting control has not been established.

41. If the bank operates common or collective investment funds or other pooled investment vehicles, provide for each fund:

   a. if a new fund has been established or a previously established fund has been closed since the last FDIC examination, the rationale and analysis supporting the decision to open or close the fund;

   b. a copy of any amendments to governing instruments since the previous examination;

   c. a list of all participants, providing detail and summary totals for: number of participants, units held, and cost of units held;

   d. a copy of the last valuation for each fund;

   e. a copy of each fund's last annual report; and

   f. a list of assets held by each fund as of the last valuation date.

42. Provide a list of voting securities held in discretionary fiduciary accounts where the department holds, in the aggregate:

   a. 5% or more of the outstanding class of securities (if securities are registered pursuant to Section 12 of the Securities Exchange Act of 1934); and

   b. 25% or more of the outstanding class of securities, if not registered under Section 12.

43. Provide the following with respect to own bank, parent, or affiliate stock and/or obligations:

   a. a list of discretionary fiduciary accounts that hold such securities and/or obligations, together with the number of shares and/or face value of obligations held (*include all shares held in any account, including custodial and safekeeping, if management holds or exercises voting authority*);

   b. total number of shares held in all trust department accounts that were voted by management at the last stockholders meeting;

   c. total number of shares held in discretionary fiduciary accounts that were voted by others;

d. total number of shares voted at the last stockholders meeting;

e. total number of shares outstanding at the last stockholders meeting, and currently outstanding;

f. date of the last review of such holdings, if reviewed in the aggregate, by the trust committee;

g. if the stock is publicly traded, provide the date of the last activity in such stock, total shares traded, and the closing price;

h. if the stock is not publicly traded, provide the date of the last sale of such stock, the number of shares sold, and the execution price; and

i. current dividend (state whether annual or other basis is being quoted).

44. If the department does not have written policies on the following, identify current practices with respect to these areas:

a. purchase and/or retention of own bank, parent and/or affiliate stock and obligations; and

b. voting of own bank, parent, and/or affiliate stock held in any account.

45. Describe the department's policies regarding the voting of stock held in accounts, including common and collective investment funds. Indicate whether the department has solicited written instructions from beneficial owners as to the forwarding of proxy material and voting of securities held on their behalf.

46. Describe any receipt of fees from 12b-1, shareholder servicing, record keeping or any other arrangements with mutual fund companies. Please provide copies of any written solicitations for customer approval to use their accounts in such arrangements.

47. Describe any receipt of sweep fees. Please provide copies of any written solicitations for customer approval to use their accounts in such arrangements.

48. Provide the following information on real estate holdings within trust accounts:

a. a list of mortgaged property on which payments of principal, interest, or taxes are delinquent;

b. a list of any real property held by accounts on which taxes are delinquent;

c. a list of expired property insurance on mortgaged property, or other real property held as assets, unless liability thereon is covered by blanket insurance;

d. a statement of the department's policy/practice concerning employment of agents in the operation or management of real estate owned in fiduciary accounts. If such agents make cash collections, describe procedures for monitoring the receipt of the funds.

e. a list of pending foreclosures involving mortgages held as trust assets;

f. a list of real estate held by accounts on which there exist delinquencies in rental income; and

g. a list of real property held in any fiduciary account, that is leased to the bank, an affiliate, or to any director, officer, or employee.

Earnings

49. Provide the trust department income (by product line, if available) and expenses on a calendar basis for the last 3 years and for the year-to-date. Also, include

information on surcharges, losses, fees waived, charge-offs, and recoveries. Items of less than $100 may be grouped.

50. Provide a list of accounts on which no fees or commissions are charged, including the reasons therefore.

51. Provide a list of client fees billed but unpaid for six months or more.

52. Provide a copy of the current fee schedule. Describe briefly the procedures for approving exceptions to the schedule.

53. Describe the department's new business development efforts, including types of business solicited, minimum dollar size of accounts that will be accepted, nature of new business efforts, competition, market potential and projected growth.

Personal Trusts and Estates

54. Provide a list of accounts for which accountings have not been filed with courts, beneficiaries, or other parties holding authority to release the bank from liability.

55. Provide a list of estates that remain open for a period exceeding 18 months and where the institution has not filed an accounting.

Bank Sponsored Employee Benefit Plans

56. With respect to own bank, holding company, or subsidiary employee benefit plans carried within the department, please supply:

    a. the plan document and trust agreements, if new since the previous examination;

    b. amendments made to the plan since the last examination;

    c. the Form 5500 filed since the previous examination;

    d. the last year-end and most recent listing of assets;

    e. all audits conducted since the last examination;

    f. trustee and/or plan administrator committee minutes;

    g. information packet, initial and continuing education, provided to participants; and

    h. last investment analysis on reasonableness of available investment options.

Corporate Trust Accounts

57. Provide a list of transfer agent and/or registrar appointments.

58. Provide a list of transfer agent and/or registrar accounts that are out of proof.

59. List corporate trusteeship appointments. Please provide:

    a. face value of bonds originally issued;

    b. face value currently outstanding; and

    c. whether any appointment is subject to the Trust Indenture Act of 1939.

60. Provide a list of all corporate trusteeships that are in default. Please indicate:

    a. the date and nature of default;

    b. actions taken by the institution;

c. current status; and

d. face value of bonds outstanding.

61. Provide a list of corporate trusteeships that are receiving special administrative attention, and those in which obligors have not complied with indenture requirements.

Other Activities

62. If the department engages in customer securities lending activities, please provide the following:

    a. a copy of the securities lending agreement executed with trust department customers and counterparties; and

    b. a copy of the department's securities lending confirmation.

63. If the bank as principal or agent (a) underwrites, trades, or deals in municipal securities, or (b) provides investment or consultant services to issuers or purchasers of municipal securities, please provide the name of the individual supervising this activity.

64. If the bank as principal or agent trades or deals in U.S. Treasury securities, please provide the name of the individual supervising this activity.

65. If the bank or an affiliate conducts securities brokerage activities, please provide the name of the individual supervising this activity.

66. If the bank, any subsidiary, or any affiliate serves as investment advisor or investment manager for any mutual fund, or acts as sponsor, distributor, or custodian for any outside, own bank, subsidiary or affiliate operated mutual fund, please provide the name of the individual supervising this activity.

67. If the bank as principal or agent sells securities under agreement to repurchase, or purchases securities under agreement to resell (whether or not the trust department participates in the program on behalf of its customers), please provide the name of the individual supervising this activity.

Trust Examination Manual

Appendix C - Fiduciary Law

Table of Contents

Index of Laws & Regulations Found in FDIC Loose-leaf Rules & Regulations Service

"Prudent Man" Rule

Uniform Prudent Investor Act

List of States Adopting the Uniform Prudent Investor Act

Uniform Principal and Income Act 1962 Act

Uniform Principal and Income Act 1997 Act (Act)

List of States Adopting the Uniform Principal and Income Act

FDIC Memorandums Regarding Consent to Exercise Trust Powers

FDIC Legal Opinion on FRB Section 23B Fees and Affiliated Employee Benefit Plans

FDIC Financial Institution Letter 76-93: Problems from Customer "Free-Riding" in Custody Accounts

FRB Memorandum on "Free Riding"

FFIEC Examination Council Supervisory Policy on Repurchase Agreements Of Depository Institutions With Securities Dealers And Others

FFIEC Examination Council Supervisory Policy on Securities Lending

State Statutes Authorizing Fiduciary Investments in Proprietary Mutual Funds

Subject: FRB SR 99-7: Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest

FDIC General Counsel's Opinion No. 12: "Engaged in the Business of Receiving Deposits Other Than Trust Funds"

FDIC Financial Institution Letter 38-2002: Credit Risks Arising From Bank Investment Securities and Custodial Accounts Held at Securities Broker-Dealers

Index of Laws & Regulations Found in FDIC Loose-leaf Rules & Regulations Service

FDIC Regulations Topic
Section 303.6 Application to Extend Corporate Powers (Trust)

Part 333 Extension of Corporate Powers (Trust)

"Prudent Man" Rule

Source: Restatement (Second) of Trusts: Prudent Man Rule (1959), issued by the American Law Institute, Philadelphia. This is commonly referred to as the Restatement of Trusts 2d: Prudent Man Rule.

Investment Of Trust Funds

Section 227

Investments Which a Trustee Can Properly Make

In making investments of trust funds the trustee is under a duty to the beneficiary -

a. In the absence of provisions in the terms of the trust or of a statute otherwise providing, to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived;

b. in the absence of provisions in the terms of the trust, to conform to the statutes, if any, governing investments by trustees;

c. to conform to the terms of the trust, except as stated in § 165-168.

Comment:

a. Scope of the rule. Except as otherwise provided by the terms of the trust the trustee is under a duty to the beneficiary to use reasonable care and skill to preserve the trust property and to make it productive. This topic deals with the manner in which the trustee should perform these duties in making investments.

The rule stated in this Section is the so-called "prudent-man rule" first laid down by the Massachusetts court and followed in a number of States, even in the absence of a statute. In many States this rule has now been adopted by statute. In a few States, by statute or otherwise, the scope of trust investments is more limited.

Comment on Clause (a):

b. Requirement of care. The trustee does not use due care in making an investment unless he makes an investigation as to the safety of the investment and the probable income to be derived therefrom. Ordinarily this involves securing information from sources on which prudent men in the community customarily rely. He may take into consideration advice given to him by attorneys, bankers, brokers and others whom prudent men in the community regard as qualified to give advice, but he is not ordinarily justified in relying solely on such advice, but must exercise his own judgment.

c. Requirement of skill. The trustee is liable for a loss resulting from his failure to use the skill of a man of ordinary intelligence, although he may have exercised all the skill of which he was capable. On the other hand, if the trustee has a greater degree of skill than that of a man of ordinary intelligence, he is liable for a loss resulting from the failure to use such skill as he has.

So also, if a trustee, for example a corporate or professional trustee, procured his appointment as trustee by representing that he has greater skill than that of a man of ordinary knowledge, he is liable for a loss resulting from the failure to use such skill.

d. Corporate trustees. If the trustee is a bank or trust company, it must use in selecting investments the facilities which it has or should have, and it may properly be required to show that it has made a more thorough and complete investigation than would ordinarily be expected from an individual trustee.

e. Requirement of caution. In making investments not only is the trustee under a duty to use due care and skill, but he must use the caution of a prudent man. In the absence of provisions in the terms of the trust or statutory provisions, the investments which a trustee can properly make are those which a prudent man would make in investing property with a view to the safety of the principal and to the securing of an income reasonable in amount and payable with regularity.

In making investments, however, a loss is always possible, since in any investment there is always some risk. The question of the amount of risk, however, is a question of degree. No man of intelligence would make a disposition of property where in view of the price the risk of loss is out of

proportion to the opportunity for gain. Where, however, the risk is not out of proportion, a man of intelligence may make a disposition which is speculative in character with a view to increasing his property instead of merely preserving it. Such a disposition is not a proper trust investment, because it is not a disposition which makes the preservation of the fund a primary consideration.

It is not ordinarily the duty of a trustee to invest only in the very safest and most conservative securities available. Thus, assuming that United States government bonds are the safest and most conservative securities available but that the income yield thereon is lower than on other securities, it is not necessarily the duty of the trustee to invest the whole trust property, or even any part of it, in such bonds, even when no question of favoring one beneficiary over another is involved. The reason for this is that by the use of care, skill and caution, an investment can ordinarily be made which will yield a higher income and as to which there is no reason to anticipate a loss of principal.

The trustee, in considering the scope of investments that he should make, should take into consideration many circumstances, such as:

- the amount of the trust estate,
- the situation of the beneficiaries,
- the trend of prices and of the cost of living,
- the prospect of inflation and of deflation.

In some circumstances the amount and regularity of the income may be more important than the preservation of the principal; under other circumstances the preservation of the principal may be of primary importance. It is impossible to lay down a hard-and-fast rule as to what is a prudent investment, since much may depend upon the time and place of the administration of the trust and much may depend upon the character of the particular trust.

f. Kinds of investments. Ordinarily it is proper for a trustee to invest in government securities, such as bonds of the United States or of the State or of municipalities, in first mortgages on land, or in corporate bonds. In any case, however, whether the investment is proper depends upon the circumstances. Such investments are not proper if under all the circumstances they are not prudent investments. *See* Comment o.

Unless it is otherwise provided by the terms of the trust, the following are not proper trust investments:

1. purchase of securities for purposes of speculation, for example, purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on maturity;
2. purchase of securities in new and untried enterprises;
3. employment of trust property in the carrying on of trade or business;
4. purchase of land or other things for resale.

g. Acquiring property for resale. Although a trustee cannot properly purchase property for resale, yet if he holds a mortgage in trust and the mortgage is foreclosed he can properly purchase the property on the foreclosure sale, if it is prudent to do so. Also, the trustee may be justified in taking real or personal property in payment of a debt that is not otherwise collectible.

h. Junior mortgages. Ordinarily second or other junior mortgages are not proper trust investments. It may be proper for the trustee, however, to take a second mortgage where this is a reasonable method of settling a claim, or where the trustee is authorized or directed to sell land and it is reasonably necessary to take a second mortgage in order to enable him to make the sale.

i. Unsecured Loan. An unsecured loan of trust funds may be improper because imprudent. Such a loan, however, is not necessarily imprudent. Thus, a trustee can properly make a general deposit of trust money in a bank, as a method of safekeeping.

A deposit in a bank at interest, as, for example, a deposit in a savings account, may be proper as a method of investing trust funds. Such a deposit was generally held to be prudent as an investment even before such deposits were at least partially insured by the Federal Deposit Insurance Corporation. In some States statutes have permitted such deposits to the extent to which they are insured.

j. Combining trust funds in making investments. The fact that in making investments trust funds of one trust are combined with funds of other trusts administered by the trustee does not make the investment improper, provided that it is in other respects proper. Thus, an investment of trust funds in a participating interest in one or more mortgages on land held by the trustee is a proper trust investment if the mortgage or mortgages were a proper trust investment.

   If the investment is otherwise proper, the mere fact that a corporate trustee advanced its own money in the first place and acquired the mortgage or mortgages for the purpose of distributing them among the trust estates administered by it, where only a short interval elapses between the purchase and the distribution, does not constitute such self-dealing as to make the transaction improper.

k. Common trust funds. By statute in almost all of the States, corporate trustees are permitted to invest trust funds in a common trust fund maintained by the trustee, subject to the restrictions specified in the statute.

   By the federal Revenue Act of 1936, common trust funds were exempted from taxation as corporations or associations, provided that the fund was maintained by a bank " (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and (2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System pertaining to the collective investment of trust funds by national banks." See Internal Revenue Code of 1954, § 584.

   By § 17 of Regulation F, issued by the Board of Governors of the Federal Reserve System, provision is made for the establishment and maintenance by banks of common trust funds. [FDIC Note: this is now OCC Regulation 9.18.]

l. Investments outside the State. Investments outside the State in which the trust is administered are not ordinarily improper, although the fact that they are outside the State may be one element in considering whether the trustee is acting prudently. In earlier decisions, the courts were inclined to look with disfavor on investments outside the United States or even outside the State in which the trust was administered. It is quite otherwise today. Information with respect to such investments is today very often as easy to acquire and as full as information with respect to local securities; and, if such information would lead a reasonable man to think that the investment is a prudent one, it is proper for a trustee to make it. Thus, investments in mortgages on land outside the State or in securities of a corporation incorporated and carrying on business in another State, or in bonds of another State or of a foreign government, are not ordinarily improper.

m. Shares of stock. The purchase of shares of preferred or common stock of a company with regular earnings and paying regular dividends which may reasonably be expected to continue is a proper trust investment if prudent men in the community are accustomed to invest in such shares when making an investment of their savings with a view to their safety.

   The fact that shares of stock are non-voting in character, does not of itself make the investment in such shares by a trustee improper.

   In many States in which it was previously improper for a trustee to invest in shares of stock, statutes have permitted such investments. In several of the States such an investment is permitted only as to a specified proportion of the trust estate.

n. Investment trusts (Mutual Funds). In several States trustees are permitted, subject to certain restrictions, to invest in stocks or other securities of management type

investment companies. In many of the statutes the company, whether a trustee or corporation, must be qualified under the Investment Company Act of 1940. Apart from statute, it would seem to be not improper for a trustee to make such an investment, provided that it is a prudent one, and that such an investment does not involve any delegation by the trustee of his powers.

o. Matters to be considered in the selection among authorized investments. Although trustees may properly invest in a particular type of security, a trustee must use care and skill and caution in selecting an investment within the type. Among the matters which the trustee should consider in selecting a given investment, in addition to those relating to the safety of the fund invested and the amount and regularity of the income, are:

    1. the marketability of the particular investment;
    2. the length of the term of the investment, for example, the maturity date, if any, the callability or redeemability, if any;
    3. the probable duration of the trust;
    4. the probable condition of the market with respect to the value of the particular investment at the termination of the trust especially if at the termination of the trust the investment must be converted into money for the purpose of distribution;
    5. the probable condition of the market with respect to reinvestment at the time when the particular investment matures;
    6. the aggregate value of the trust estate and the nature of the other investments;
    7. the requirements of the beneficiary or beneficiaries, particularly with respect to the amount of the income;
    8. the other assets of the beneficiary or beneficiaries including earning capacity;
    9. the effect of the investment in increasing or diminishing liability for taxes;
    10. the likelihood of inflation.

    Whether the trustee has acted properly in making an investment depends upon the circumstances at the time when the investment is made and not upon subsequent events. If at the time when the trustee makes an investment it is an investment that a prudent man would make at that time, he incurs no liability although subsequently the investment depreciates in value.

    Ordinarily, if the trust is to terminate at a fixed time, as after the lapse of a certain period or when a designated person reaches a certain age, the trustee should not make an investment which cannot readily be disposed of and converted into cash at the time of the termination of the trust. Thus, if the trust is to terminate within a year or two, the trustee should not invest in a mortgage which will not mature until a considerable time after the creation of the trust, if it is probable that such a mortgage cannot readily be sold. On the other hand, the trustee need not necessarily invest in short term obligations, but can property invest in bonds which are proper trust investments, even though they may not mature until a long time after the termination of the trust, provided that they are of such a character that it is probable that they can readily be sold and converted into cash.

Comment on Clause (b):

p. Statutes. In many States there are statutes governing investments by trustees. In many States the prudent-man rule, stated in this Section, has been adopted by statute. In some States statutes are more restricted, allowing only such investments as government securities, first mortgages on land, and certain types of bonds. The modern [in 1959] trend of legislation is toward the adoption of the prudent-man rule.

    In some States statutes are merely permissive, designating the kind of securities in which it is proper for a trustee to invest, but without confining the trustee to such investments. In other States, no investments except those designated by statute are proper investments for a trustee, unless it is otherwise provided by the terms of the trust.

Statues confining trustees to certain types of investments are not construed as preventing the settlor from empowering the trustee to make investments not designated by the statute.

When discretion as to investments is conferred upon the trustee by the terms of the trust, it is a question of interpretation whether the settlor intends to enlarge the scope of investments permissible under the statutes, and if so to what extent. Where by statute trustees are confined to certain types of investments, but by the terms of the trust it is provided that the trustee may invest in securities "other than legal trust investments," the scope of the proper investments is enlarged and the trustee can properly invest in such securities as are permitted under the rule stated in Clause (a). The result is ordinarily the same if the trustee is authorized to make investments "in his discretion," or such investments as may to him appear to be expedient or advisable. By the terms of the trust the trustee may be permitted to invest in securities which are speculative or otherwise improper under the rule stated in Clause (a). The provisions of the trust instrument, however, are ordinarily strictly construed against an enlargement of the scope of permissible investments beyond those allowed under the rule stated in Clause (a).

An authorization by statute to invest in a particular type of security does not mean that any investment in securities of that type is proper. The trustee must use care and skill and caution in making the selection. Thus, if by statute trustees are authorized to invest in bonds of foreign governments, a trustee must use care and skill and caution in selecting the particular bonds.

Whether an investment is proper is determined by the terms of the statute in force at the time when the investment is made, and not by the statutory or other rules in force at the time of the creation of the trust unless it is otherwise provided by the terms of the trust.

Comment on Clause (c):

q. Terms of the trust. As a general rule a trustee can properly make such investments as are authorized by the terms of the trust and cannot properly make investments which are forbidden by the terms of the trust. In making investments, however, the trustee is not under a duty to the beneficiary to comply with a term of the trust with which it is impossible for him to comply, or to comply with a term of the trust which is illegal. The trustee is not under a duty to the beneficiary to comply with a term of the trust if he is directed or permitted by a proper court not to comply where owing to circumstances not known to the settlor and not anticipated by him compliance would defeat or substantially impair the accomplishment of the purposes of the trust; and under such circumstances the trustee may be subject to liability if he fails to apply to the court for permission to deviate from the terms of the trust.

r. Terms restricting investments. By the terms of the trust the scope of the investments which the trustee could otherwise properly make can be restricted both with respect to investments permitted by statute under Clause (b) and those which in the absence of statutory regulation would be permitted under the rules stated in Clause (a). Thus, although by a statute trustees are permitted to invest in railroad bonds or public utility bonds, by the terms of the trust the trustee may be forbidden to invest in public utility bonds. Similarly, although in the absence of a statute an investment in a certain type of bonds would be proper, by the terms of the trust the trustee can be forbidden to invest in bonds of that type.

s. Terms enlarging permissible investments. On the other hand, by the terms of the trust the scope of investments which the trustee could otherwise properly make can be enlarged. Thus, although by statute trustees are permitted to invest only in government securities or first mortgages on land, by the terms of the trust the trustee can be permitted to invest in bonds or in shares of private corporations or to make other investments not permitted by the statute. *See* Comment p. Similarly, although in the absence of a statute an investment in a certain type of bond would be improper, by the terms of the trust the trustee can be permitted to invest in bonds of that type, although there is an element of risk which would make the investment otherwise improper.

t. Permissive or mandatory terms of the trust. The terms of the trust as to investments may be either permissive or mandatory; that is, the trustee may be merely authorized or he may be directed to invest in certain securities or kinds of securities. If he is merely authorized to make certain investments, he has a privilege but not a duty to make such investments; if he is directed to make such investments, he has not merely a privilege but a duty to do so.

u. Interpretation of the terms of the trust. When discretion as to investments is conferred upon the trustee by the terms of the trust, it is a question of interpretation whether and to what extent the settlor intends to enlarge the scope of permissible investments. If by the terms of the trust the trustee is authorized to make investments "in his discretion," such an authorization does not ordinarily permit the trustee to make investments other than those which a prudent man would make under the rule stated in Clause (a). By the terms of the trust, however, the trustee may be permitted to invest in securities which are speculative or otherwise improper under the rule stated in Clause (a). The provisions of the trust instrument are ordinarily strictly construed against an enlargement of the scope of permissible investments beyond those allowed under the rule stated in Clause (a).

Even though by the terms of the trust the trustee is authorized to invest according to his absolute and uncontrolled discretion, he cannot properly lend trust money to himself individually or purchase securities from himself individually.

A provision in the terms of the trust authorizing the trustee to invest in "securities" is ordinarily interpreted as broad enough to include not merely secured obligations but also other investments such as shares of stock or debentures. An authorization to invest in securities, however, does not of itself empower the trustee to make an investment which would not be made by a prudent man dealing with his own property and having primarily in view the preservation of the trust estate and the amount and regularity of the income to be derived.

v. An authorization by the terms of the trust to invest in a particular type of security does not mean that any investment in securities of that type is proper. The trustee must use care and skill and caution in making the selection. Thus, if the trustee is authorized by the terms of the trust to invest in railroad bonds, he is guilty of a breach of trust if he invests in bonds of a railroad company in which a prudent man would not invest because of the financial condition of the company.

Where by the terms of the trust discretion is conferred upon the trustee to make certain investments, he is subject to liability if he abuses the discretion. Thus, if the trustee is permitted to invest in a particular security or type of security in his discretion and the circumstances are such that it would be beyond the bounds of a reasonable judgment to make the investment, the trustee is subject to liability if he makes it.

w. If by the terms of the trust the trustee is authorized or directed to invest in a particular security or a particular type of security, he may nevertheless be liable for making such an investment, where owing to circumstances not known to the settlor and not anticipated by him the making of such investment would defeat or substantially impair the accomplishment of the purposes of the trust. Thus, where by the terms of the trust the trustee was authorized to invest in shares of a particular company which at the time of the creation of the trust was in sound financial condition but which has since fallen into such financial difficulties that the shares have become highly speculative, the trustee is subject to liability if he invests in these shares.

x. Informal trusts. In the case of an informal trust, as where one hands over money to another to invest for him, the duty to invest and the propriety of investments are governed by the intention of the parties as shown by their words or other conduct as interpreted in the light of all the circumstances. Whether the trust is created by a formal instrument such as a will or deed, or is not so created, the duty of the trustee in making investments is to conform to the rules stated in this Section. The circumstances, however, surrounding informal trusts may more freely lend themselves to an interpretation of the terms of the trust as permitting a wider latitude in making investments, or may show an intention that the trustee should not make any

investments. If the trust is one created by will or deed of trust, the trust instrument must itself express a latitude to invest in securities that would not otherwise be proper trust investments.

y. Successive beneficiaries. An investment which would not otherwise be improper as a trust investment is improper where the trust is created for successive beneficiaries, if the investment would be unduly favorable to one beneficiary at the expense of the other.

z. General duties of trustee. In making investments, as in other matters relating to the administration of the trust, the trustee is under a duty to act solely in the interest of the beneficiary. It is a breach of trust for the trustee in making an investment to purchase property owned by him individually.

Delegation of Duties - In making investments, as in other matters relating to the administration of the trust, the trustee is under a duty not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform. He cannot properly delegate to another power to select investments.

Uniform Prudent Investor Act

Uniform Prudent Investor Act

Drafted by the

National Conference of Commissioners

on Uniform State Laws

and by it

approved and recommended for enactment

in all the states

at its

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Uniform Prudent Investor Act

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Uniform Prudent Investor Act

Prefatory Note

Over the quarter century from the late 1960's the investment practices of fiduciaries experienced significant change. The Uniform Prudent Investor Act (UPIA) undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice. These changes have occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as "modern portfolio theory."

This Act draws upon the revised standards for prudent trust investment promulgated by the American Law Institute in its Restatement (Third) of Trusts: Prudent Investor Rule (1992) [hereinafter Restatement of Trusts 3d: Prudent Investor Rule; also referred to as 1992 Restatement].

Objectives of the Act. UPIA makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement of Trusts 3d: Prudent Investor Rule.

(1) The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term "portfolio" embraces all the trust's assets. UPIA § 2(b).

(2) The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration. UPIA § 2(b).

(3) All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing. UPIA § 2(e).

(4) The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing. UPIA § 3.

(5) The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards. UPIA § 9.

Literature. These changes in trust investment law have been presaged in an extensive body of practical and scholarly writing. See especially the discussion and reporter's notes by Edward C. Halbach, Jr., in Restatement of Trusts 3d: Prudent Investor Rule (1992); see also Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 27 Real Property, Probate & Trust J. 407 (1992); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U.L. Rev. 52 (1987); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); Note, The Regulation of Risky Investments, 83 Harvard L. Rev. 603 (1970). A succinct account of the main findings of modern portfolio theory, written for lawyers, is Jonathan R. Macey, An Introduction to Modern Financial Theory (1991) (American College of Trust & Estate Counsel Foundation). A leading introductory text on modern portfolio theory is R.A. Brealey, An Introduction to Risk and Return from Common Stocks (2d ed. 1983).

Legislation. Most states have legislation governing trust-investment law. This Act promotes uniformity of state law on the basis of the new consensus reflected in the Restatement of Trusts 3d: Prudent Investor Rule. Some states have already acted. California, Delaware, Georgia, Minnesota, Tennessee, and Washington revised their prudent investor legislation to emphasize the total-portfolio standard of care in advance of the 1992 Restatement. These statutes are extracted and discussed in Restatement of Trusts 3d: Prudent Investor Rule § 227, reporter's note, at 60-66 (1992).

Drafters in Illinois in 1991 worked from the April 1990 "Proposed Final Draft" of the Restatement of Trusts 3d: Prudent Investor Rule and enacted legislation that is closely modeled on the new Restatement. 760 ILCS § 5/5 (prudent investing); and § 5/5.1 (delegation) (1992). As the Comments to this Uniform Prudent Investor Act reflect, the Act draws upon the Illinois statute in several sections. Virginia revised its prudent investor act in a similar vein in 1992. Virginia Code § 26-45.1 (prudent investing) (1992). Florida revised its statute in 1993. Florida Laws, ch. 93-257, amending Florida Statutes § 518.11 (prudent investing) and creating § 518.112 (delegation). New York legislation drawing on the new Restatement and on a preliminary version of this Uniform Prudent Investor Act was enacted in 1994. N.Y. Assembly Bill 11683-B, Ch. 609 (1994), adding Estates, Powers and Trusts Law § 11-2.3 (Prudent Investor Act).

Remedies. This Act does not undertake to address issues of remedy law or the computation of damages in trust matters. Remedies are the subject of a reasonably distinct body of doctrine. See generally Restatement (Second) of Trusts §§ 197-226A (1959) [hereinafter cited as Restatement of Trusts 2d; also referred to as 1959 Restatement].

Implications for charitable and pension trusts. This Act is centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family. Nevertheless, the prudent investor rule also bears on charitable and pension trusts, among others. "In making investments of trust funds the trustee of a charitable trust is under a duty similar to that of the trustee of a private trust." Restatement of Trusts 2d § 389 (1959). The Employee Retirement Income Security Act (ERISA), the federal regulatory scheme for pension trusts enacted in 1974, absorbs trust-investment law through the prudence standard of ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a). The Supreme Court has said: "ERISA's legislative history confirms that the Act's fiduciary responsibility provisions 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'" *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 110-11 (1989) (footnote omitted).

Other fiduciary relationships. The Uniform Prudent Investor Act regulates the investment responsibilities of trustees. Other fiduciaries - such as executors, conservators, and guardians of the property - sometimes have responsibilities over assets that are governed by the standards of prudent investment. It will often be

appropriate for states to adapt the law governing investment by trustees under this Act to these other fiduciary regimes, taking account of such changed circumstances as the relatively short duration of most executorships and the intensity of court supervision of conservators and guardians in some jurisdictions. The present Act does not undertake to adjust trust-investment law to the special circumstances of the state schemes for administering decedents' estates or conducting the affairs of protected persons.

Although the Uniform Prudent Investor Act by its terms applies to trusts and not to charitable corporations, the standards of the Act can be expected to inform the investment responsibilities of directors and officers of charitable corporations. As the 1992 Restatement observes, "the duties of the members of the governing board of a charitable corporation are generally similar to the duties of the trustee of a charitable trust." Restatement of Trusts 3d: Prudent Investor Rule § 379, Comment *b*, at 190 (1992). See also id. § 389, Comment *b*, at 190-91 (absent contrary statute or other provision, prudent investor rule applies to investment of funds held for charitable corporations).

Uniform Prudent Investor Act

Section 1. Prudent Investor Rule.

(a) Except as otherwise provided in subsection (b), a trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this [Act].

(b) The prudent investor rule, a default rule, may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust.

Comment

This section imposes the obligation of prudence in the conduct of investment functions and identifies further sections of the Act that specify the attributes of prudent conduct.

Origins. The prudence standard for trust investing traces back to *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). Trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Id. at 461.

Prior legislation. The Model Prudent Man Rule Statute (1942), sponsored by the American Bankers Association, undertook to codify the language of the *Amory* case. See Mayo A. Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 Ohio State L.J. 491, at 501 (1951); for the text of the model act, which inspired many state statutes, see id. at 508-09. Another prominent codification of the *Amory* standard is Uniform Probate Code § 7-302 (1969), which provides that "the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent man dealing with the property of another . . . ."

Congress has imposed a comparable prudence standard for the administration of pension and employee benefit trusts in the Employee Retirement Income Security Act (ERISA), enacted in 1974. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a), provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims . . . ."

Prior Restatement. The Restatement of Trusts 2d (1959) also tracked the language of the *Amory* case: "In making investments

of trust funds the trustee is under a duty to the beneficiary . . . to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived . . . ." Restatement of Trusts 2d § 227 (1959).

Objective standard. The concept of prudence in the judicial opinions and legislation is essentially relational or comparative. It resembles in this respect the "reasonable person" rule of tort law. A prudent trustee behaves as other trustees similarly situated would behave. The standard is, therefore, objective rather than subjective. Sections 2 through 9 of this Act identify the main factors that bear on prudent investment behavior.

Variation. Almost all of the rules of trust law are default rules, that is, rules that the settlor may alter or abrogate. Subsection (b) carries forward this traditional attribute of trust law. Traditional trust law also allows the beneficiaries of the trust to excuse its performance, when they are all capable and not misinformed. Restatement of Trusts 2d § 216 (1959).

Section 2. Standard of Care; Portfolio Strategy; Risk and Return Objectives.

(a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;

(2) the possible effect of inflation or deflation;

(3) the expected tax consequences of investment decisions or strategies;

(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

(5) the expected total return from income and the appreciation of capital;

(6) other resources of the beneficiaries;

(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

Comment

Section 2 is the heart of the Act. Subsections (a), (b), and (c) are patterned loosely on the language of the Restatement of Trusts 3d: Prudent Investor Rule § 227 (1992), and on the 1991 Illinois statute, 760 § ILCS 5/5a (1992). Subsection (f) is derived from Uniform Probate Code § 7-302 (1969).

Objective standard. Subsection (a) of this Act carries forward the relational and objective standard made familiar in the *Amory* case, in earlier prudent investor legislation, and in the Restatements. Early formulations of the prudent person rule were sometimes troubled by the effort to distinguish between the standard of a prudent person investing for another and investing on his or her own account. The language of subsection (a), by relating the trustee's duty to "the purposes, terms, distribution requirements, and other circumstances of the trust," should put such questions to rest. The standard is the standard of the prudent investor similarly situated.

Portfolio standard. Subsection (b) emphasizes the consolidated portfolio standard for evaluating investment decisions. An investment that might be imprudent standing alone can become prudent if undertaken in sensible relation to other trust assets, or to other nontrust assets. In the trust setting the term "portfolio" embraces the entire trust estate.

Risk and return. Subsection (b) also sounds the main theme of modern investment practice, sensitivity to the risk/return curve. See generally the works cited in the Prefatory Note to this Act, under "Literature." Returns correlate strongly with risk, but tolerance for risk varies greatly with the financial and other circumstances of the investor, or in the case of a trust, with the purposes of the trust and the relevant circumstances of the beneficiaries. A trust whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.

Subsection (b) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule § 227(a), which provides that the standard of prudent investing "requires the exercise of reasonable care, skill, and caution, and is to be applied to investments not in isolation but in the context of the trust portfolio and as a part of an overall investment strategy, which should incorporate risk and return objectives reasonably suitable to the trust."

Factors affecting investment. Subsection (c) points to certain of the factors that commonly bear on risk/return preferences in fiduciary investing. This listing is nonexclusive. Tax considerations, such as preserving the stepped up basis on death under Internal Revenue Code § 1014 for low-basis assets, have traditionally been exceptionally important in estate planning for affluent persons. Under the present recognition rules of the federal income tax, taxable investors, including trust beneficiaries, are in general best served by an investment strategy that minimizes the taxation incident to portfolio turnover. See generally Robert H. Jeffrey & Robert D. Arnott, Is Your Alpha Big Enough to Cover Its Taxes?, Journal of Portfolio Management 15 (Spring 1993).

Another familiar example of how tax considerations bear upon trust investing: In a regime of pass-through taxation, it may be prudent for the trust to buy lower yielding tax-exempt securities for high-bracket taxpayers, whereas it would ordinarily be imprudent for the trustees of a charitable trust, whose income is tax exempt, to accept the lowered yields associated with tax-exempt securities.

When tax considerations affect beneficiaries differently, the trustee's duty of impartiality requires attention to the competing interests of each of them.

Subsection (c)(8), allowing the trustee to take into account any preferences of the beneficiaries respecting heirlooms or other prized assets, derives from the Illinois act, 760 ILCS § 5/5(a)(4) (1992).

Duty to monitor. Subsections (a) through (d) apply both to investing and managing trust assets. "Managing" embraces monitoring, that is, the trustee's continuing responsibility for oversight of the suitability of investments already made as well as the trustee's decisions respecting new investments.

Duty to investigate. Subsection (d) carries forward the traditional responsibility of the fiduciary investor to examine information likely to bear importantly on the value or the security of an investment - for example, audit reports or records of title. E.g., *Estate of Collins*, 72 Cal. App. 3d 663, 139 Cal. Rptr. 644 (1977) (trustees lent on a junior mortgage on unimproved real estate, failed to have land appraised, and accepted an unaudited financial statement; held liable for losses).

Abrogating categoric restrictions. Subsection 2(e) clarifies that no particular kind of property or type of investment is inherently imprudent. Traditional trust law was encumbered with a variety of categoric exclusions, such as prohibitions on junior mortgages or new ventures. In some states legislation created so-called "legal lists" of approved trust investments. The universe of investment products changes incessantly. Investments that were at one time thought too risky, such as equities, or more recently, futures, are now used in fiduciary portfolios. By contrast, the investment that was at one time thought ideal for trusts, the long-term bond, has been discovered to import a level of risk and volatility - in this case, inflation risk - that had not been anticipated. Accordingly, section 2(e) of this Act follows Restatement of Trusts 3d: Prudent Investor Rule in abrogating categoric restrictions. The Restatement says: "Specific investments or techniques are not per se prudent or imprudent. The riskiness of a specific property, and thus the propriety of its inclusion in the trust estate, is not judged in the abstract but in terms of its anticipated effect on the particular trust's portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment f, at 24 (1992). The premise of subsection 2(e) is that trust beneficiaries are better protected by the Act's emphasis on close attention to risk/return objectives as prescribed in subsection 2(b) than in attempts to identify categories of investment that are per se prudent or imprudent.

The Act impliedly disavows the emphasis in older law on avoiding "speculative" or "risky" investments. Low levels of risk may be appropriate in some trust settings but inappropriate in others. It is the trustee's task to invest at a risk level that is suitable to the purposes of the trust.

The abolition of categoric restrictions against types of investment in no way alters the trustee's conventional duty of loyalty, which is reiterated for the purposes of this Act in Section 5. For example, were the trustee to invest in a second mortgage on a piece of real property owned by the trustee, the investment would be wrongful on account of the trustee's breach of the duty to abstain from self-dealing, even though the investment would no longer automatically offend the former categoric restriction against fiduciary investments in junior mortgages.

Professional fiduciaries. The distinction taken in subsection (f) between amateur and professional trustees is familiar law. The prudent investor standard applies to a range of fiduciaries, from the most sophisticated professional investment management firms and corporate fiduciaries, to family members of minimal experience. Because the standard of prudence is relational, it follows that the standard for professional trustees is the standard of prudent professionals; for amateurs, it is the standard of prudent amateurs. Restatement of Trusts 2d § 174 (1959) provides: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." Case law strongly supports the concept of the higher standard of care for the trustee representing itself to be expert or professional. See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. at 48-49.

The Drafting Committee declined the suggestion that the Act should create an exception to the prudent investor rule (or to the diversification requirement of Section 3) in the case of smaller trusts. The Committee believes that subsections (b) and (c) of the Act emphasize factors that are sensitive to the traits of small trusts; and that subsection (f) adjusts helpfully for the distinction between professional and amateur trusteeship. Furthermore, it is always open to the settlor of a trust under Section 1(b) of the Act to reduce the trustee's standard of care if the settlor deems such a step appropriate. The official comments to the 1992 Restatement observe that pooled investments, such as mutual funds and bank common trust funds, are especially suitable for small trusts. Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *h*, *m*, at 28, 51; reporter's note to Comment *g*, id. at 83.

Matters of proof. Although virtually all express trusts are created by written instrument, oral trusts are known, and accordingly, this Act presupposes no formal requirement that trust terms be in writing. When there is a written trust instrument, modern authority strongly favors allowing evidence extrinsic to the instrument to be consulted for the purpose of ascertaining the settlor's intent. See Uniform Probate Code § 2-601 (1990), Comment; Restatement (Third) of Property: Donative Transfers (Preliminary Draft No. 2, ch. 11, Sept. 11, 1992).

Section 3. Diversification.

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

Comment

The language of this section derives from Restatement of Trusts 2d § 228 (1959). ERISA insists upon a comparable rule for pension trusts. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). Case law overwhelmingly supports the duty to diversify. See Annot., Duty of Trustee to Diversify Investments, and Liability for Failure to Do So, 24 A.L.R. 3d 730 (1969) & 1992 Supp. at 78-79.

The 1992 Restatement of Trusts takes the significant step of integrating the diversification requirement into the concept of prudent investing. Section 227(b) of the 1992 Restatement treats diversification as one of the fundamental elements of prudent investing, replacing the separate section 228 of the Restatement of Trusts 2d. The message of the 1992 Restatement, carried forward in Section 3 of this Act, is that prudent investing ordinarily requires diversification.

Circumstances can, however, overcome the duty to diversify. For example, if a tax-sensitive trust owns an underdiversified block of low-basis securities, the tax costs of recognizing the gain may outweigh the advantages of diversifying the holding. The wish to retain a family business is another situation in which the purposes of the trust sometimes override the conventional duty to diversify.

Rationale for diversification. "Diversification reduces risk . . . [because] stock price movements are not uniform. They are imperfectly correlated. This means that if one holds a well diversified portfolio, the gains in one investment will cancel out the losses in another." Jonathan R. Macey, An Introduction to Modern Financial Theory 20 (American College of Trust and Estate Counsel Foundation, 1991). For example, during the Arab oil embargo of 1973, international oil stocks suffered declines, but the shares of domestic oil producers and coal companies benefitted. Holding a broad enough portfolio allowed the investor to set off, to some extent, the losses associated with the embargo.

Modern portfolio theory divides risk into the categories of "compensated" and "uncompensated" risk. The risk of owning shares in a mature and well-managed company in a settled industry is less than the risk of owning shares in a start-up high-technology venture. The investor requires a higher expected return to induce the investor to bear the greater risk of disappointment associated with the start-up firm. This is compensated risk - the firm pays the investor for bearing the risk. By contrast, nobody pays the investor for owning too few stocks. The investor who owned only international oils in 1973 was running a risk that could have been reduced by having configured the portfolio differently - to include investments in different industries. This is uncompensated risk - nobody pays the investor for owning shares in too few industries and too few companies. Risk that can be eliminated by adding different stocks (or bonds) is uncompensated risk. The object of diversification is to minimize this uncompensated risk of having too few investments. "As long as stock prices do not move exactly together, the risk of a diversified portfolio will be less than the average risk of the separate holdings." R.A. Brealey, An Introduction to Risk and Return from Common Stocks 103 (2d ed. 1983).

There is no automatic rule for identifying how much diversification is enough. The 1992 Restatement says: "Significant diversification advantages can be achieved with a small number of well-selected securities representing different industries . . . . Broader diversification is usually to be preferred in trust investing," and pooled investment vehicles "make thorough diversification

practical for most trustees." Restatement of Trusts 3d: Prudent Investor Rule § 227, General Note on Comments *e-h*, at 77 (1992). See also Macey, supra, at 23-24; Brealey, supra, at 111-13.

Diversifying by pooling. It is difficult for a small trust fund to diversify thoroughly by constructing its own portfolio of individually selected investments. Transaction costs such as the round-lot (100 share) trading economies make it relatively expensive for a small investor to assemble a broad enough portfolio to minimize uncompensated risk. For this reason, pooled investment vehicles have become the main mechanism for facilitating diversification for the investment needs of smaller trusts.

Most states have legislation authorizing common trust funds; see 3 Austin W. Scott & William F. Fratcher, The Law of Trusts § 227.9, at 463-65 n.26 (4th ed. 1988) (collecting citations to state statutes). As of 1992, 35 states and the District of Columbia had enacted the Uniform Common Trust Fund Act (UCTFA) (1938), overcoming the rule against commingling trust assets and expressly enabling banks and trust companies to establish common trust funds. 7 Uniform Laws Ann. 1992 Supp. at 130 (schedule of adopting states). The Prefatory Note to the UCTFA explains: "The purposes of such a common or joint investment fund are to diversify the investment of the several trusts and thus spread the risk of loss, and to make it easy to invest any amount of trust funds quickly and with a small amount of trouble." 7 Uniform Laws Ann. 402 (1985).

Fiduciary investing in mutual funds. Trusts can also achieve diversification by investing in mutual funds. See Restatement of Trusts 3d: Prudent Investor Rule, § 227, Comment *m*, at 99-100 (1992) (endorsing trust investment in mutual funds). ERISA § 401(b)(1), 29 U.S.C. § 1101(b)(1), expressly authorizes pension trusts to invest in mutual funds, identified as securities "issued by an investment company registered under the Investment Company Act of 1940 . . . ."

Section 4. Duties at Inception of Trusteeship.

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act].

Comment

Section 4, requiring the trustee to dispose of unsuitable assets within a reasonable time, is old law, codified in Restatement of Trusts 3d: Prudent Investor Rule § 229 (1992), lightly revising Restatement of Trusts 2d § 230 (1959). The duty extends as well to investments that were proper when purchased but subsequently become improper. Restatement of Trusts 2d § 231 (1959). The same standards apply to successor trustees, see Restatement of Trusts 2d § 196 (1959).

The question of what period of time is reasonable turns on the totality of factors affecting the asset and the trust. The 1959 Restatement took the view that "[o]rdinarily any time within a year is reasonable, but under some circumstances a year may be too long a time and under other circumstances a trustee is not liable although he fails to effect the conversion for more than a year."

Restatement of Trusts 2d § 230, comment *b* (1959). The 1992 Restatement retreated from this rule of thumb, saying, "No positive rule can be stated with respect to what constitutes a reasonable time for the sale or exchange of securities." Restatement of Trusts 3d: Prudent Investor Rule § 229, comment *b* (1992).

The criteria and circumstances identified in Section 2 of this Act as bearing upon the prudence of decisions to invest and manage trust assets also pertain to the prudence of decisions to retain or dispose of inception assets under this section.

Section 5. Loyalty.

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.

Comment

The duty of loyalty is perhaps the most characteristic rule of trust law, requiring the trustee to act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. The language of Section 4 of this Act derives from Restatement of Trusts 3d: Prudent Investor Rule § 170 (1992), which makes minute changes in Restatement of Trusts 2d § 170 (1959).

The concept that the duty of prudence in trust administration, especially in investing and managing trust assets, entails adherence to the duty of loyalty is familiar. ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B), extracted in the Comment to Section 1 of this Act, effectively merges the requirements of prudence and loyalty. A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.

The duty of loyalty is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust. "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person. Thus, it is improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust." Restatement of Trusts 2d § 170, comment *q*, at 371 (1959).

No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries - for example, by accepting below-market returns - in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause. See, e.g., John H. Langbein & Richard Posner, Social Investing and the Law of Trusts, 79 Michigan L. Rev. 72, 96-97 (1980) (collecting authority). For pension trust assets, see generally Ian D. Lanoff, The Social Investment of Private Pension Plan Assets: May it Be Done Lawfully under ERISA?, 31 Labor L.J. 387 (1980). Commentators supporting social investing tend to concede the overriding force of the duty of loyalty. They argue instead that particular schemes of social investing may not result in below-market returns. See, e.g., Marcia O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 American U.L. Rev. 1 (1992). In 1994 the Department of Labor issued an Interpretive Bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA §§ 403-404. Interpretive

Bulletin 94-1, 59 Fed. Regis. 32606 (Jun. 22, 1994), to be codified as 29 CFR § 2509.94-1. The Bulletin reminds fiduciary investors that they are prohibited from "subordinat[ing] the interests of participants and beneficiaries in their retirement income to unrelated objectives."

Section 6. Impartiality.

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

Comment

The duty of impartiality derives from the duty of loyalty. When the trustee owes duties to more than one beneficiary, loyalty requires the trustee to respect the interests of all the beneficiaries. Prudence in investing and administration requires the trustee to take account of the interests of all the beneficiaries for whom the trustee is acting, especially the conflicts between the interests of beneficiaries interested in income and those interested in principal.

The language of Section 6 derives from Restatement of Trusts 2d § 183 (1959); see also id., § 232. Multiple beneficiaries may be beneficiaries in succession (such as life and remainder interests) or beneficiaries with simultaneous interests (as when the income interest in a trust is being divided among several beneficiaries).

The trustee's duty of impartiality commonly affects the conduct of investment and management functions in the sphere of principal and income allocations. This Act prescribes no regime for allocating receipts and expenses. The details of such allocations are commonly handled under specialized legislation, such as the Revised Uniform Principal and Income Act (1962) (which is presently under study by the Uniform Law Commission with a view toward further revision).

Section 7. Investment Costs.

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.

Comment

Wasting beneficiaries' money is imprudent. In devising and implementing strategies for the investment and management of trust assets, trustees are obliged to minimize costs.

The language of Section 7 derives from Restatement of Trusts 2d § 188 (1959). The Restatement of Trusts 3d says: "Concerns over compensation and other charges are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. . . . [I]t is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *m*, at 58 (1992).

Section 8. Reviewing Compliance.

Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's

decision or action and not by hindsight.

Comment

This section derives from the 1991 Illinois act, 760 ILCS 5/5(a)(2) (1992), which draws upon Restatement of Trusts 3d: Prudent Investor Rule § 227, comment *b*, at 11 (1992). Trustees are not insurers. Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard. In the language of law and economics, the standard is ex ante, not ex post.

Section 9. Delegation of Investment and Management Functions.

(a) A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;

(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and

(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

(b) In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

(c) A trustee who complies with the requirements of subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated.

(d) By accepting the delegation of a trust function from the trustee of a trust that is subject to the law of this State, an agent submits to the jurisdiction of the courts of this State.

Comment

This section of the Act reverses the much-criticized rule that forbad trustees to delegate investment and management functions. The language of this section is derived from Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992), discussed infra, and from the 1991 Illinois act, 760 ILCS § 5/5.1(b), (c) (1992).

Former law. The former nondelegation rule survived into the 1959 Restatement: "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the trustee can reasonably be required personally to perform." The rule put a premium on the frequently arbitrary task of distinguishing discretionary functions that were thought to be nondelegable from supposedly ministerial functions that the trustee was allowed to delegate. Restatement of Trusts 2d § 171 (1959).

The Restatement of Trusts 2d admitted in a comment that "There is not a clear-cut line dividing the acts which a trustee can properly delegate from

those which he cannot properly delegate." Instead, the comment directed attention to a list of factors that "may be of importance: (1) the amount of discretion involved; (2) the value and character of the property involved; (3) whether the property is principal or income; (4) the proximity or remoteness of the subject matter of the trust; (5) the character of the act as one involving professional skill or facilities possessed or not possessed by the trustee himself." Restatement of Trusts 2d § 171, comment *d* (1959). The 1959 Restatement further said: "A trustee cannot properly delegate to another power to select investments." Restatement of Trusts 2d § 171, comment *h* (1959).

For discussion and criticism of the former rule see William L. Cary & Craig B. Bright, The Delegation of Investment Responsibility for Endowment Funds, 74 Columbia L. Rev. 207 (1974); John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 American Bar Foundation Research J. 1, 18-24.

The modern trend to favor delegation. The trend of subsequent legislation, culminating in the Restatement of Trusts 3d: Prudent Investor Rule, has been strongly hostile to the nondelegation rule. See John H. Langbein, Reversing the Nondelegation Rule of Trust-Investment Law, 59 Missouri L. Rev. 105 (1994).

The delegation rule of the Uniform Trustee Powers Act. The Uniform Trustee Powers Act (1964) effectively abrogates the nondelegation rule. It authorizes trustees "to employ persons, including attorneys, auditors, investment advisors, or agents, even if they are associated with the trustee, to advise or assist the trustee in the performance of his administrative duties; to act without independent investigation upon their recommendations; and instead of acting personally, to employ one or more agents to perform any act of administration, whether or not discretionary . . . ." Uniform Trustee Powers Act § 3(24), 7B Uniform Laws Ann. 743 (1985). The Act has been enacted in 16 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

UMIFA's delegation rule. The Uniform Management of Institutional Funds Act (1972) (UMIFA), authorizes the governing boards of eleemosynary institutions, who are trustee-like fiduciaries, to delegate investment matters either to a committee of the board or to outside investment advisors, investment counsel, managers, banks, or trust companies. UMIFA § 5, 7A Uniform Laws Ann. 705 (1985). UMIFA has been enacted in 38 states, see "Record of Passage of Uniform and Model Acts as of September 30, 1993," 1993-94 Reference Book of Uniform Law Commissioners (unpaginated, following page 111) (1993).

ERISA's delegation rule. The Employee Retirement Income Security Act of 1974, the federal statute that prescribes fiduciary standards for investing the assets of pension and employee benefit plans, allows a pension or employee benefit plan to provide that "authority to manage, acquire or dispose of assets of the plan is delegated to one or more investment managers . . . ." ERISA § 403(a)(2), 29 U.S.C. § 1103(a)(2). Commentators have explained the rationale for ERISA's encouragement of delegation:

ERISA . . . invites the dissolution of unitary trusteeship. . . . ERISA's fractionation of traditional trusteeship reflects the complexity of the modern pension trust. Because millions, even billions of dollars can be involved, great care is required in investing and safekeeping plan assets. Administering such plans-computing and honoring benefit entitlements across decades of employment and retirement-is also a complex business. . . . Since, however, neither the sponsor nor any other single entity has a comparative advantage in performing all these functions, the tendency has been for pension plans to use a variety of specialized providers. A consulting actuary, a plan administration firm, or an insurance company may oversee the design of a plan and arrange for processing benefit claims. Investment industry professionals manage the portfolio (the largest plans spread their pension investments among dozens of money management firms).

John H. Langbein & Bruce A. Wolk, Pension and Employee Benefit Law 496 (1990).

The delegation rule of the 1992 Restatement. The Restatement of Trusts 3d: Prudent Investor Rule (1992) repeals the nondelegation rule of Restatement of Trusts 2d § 171 (1959), extracted supra, and replaces it with substitute text that reads:

§ 171. Duty with Respect to Delegation. A trustee has a duty personally to perform the responsibilities of trusteeship except as a prudent person might delegate those responsibilities to others. In deciding whether, to whom, and in what manner to delegate fiduciary authority in the administration of a trust, and thereafter in supervising agents, the trustee is under a duty to the beneficiaries to exercise fiduciary discretion and to act as a prudent person would act in similar circumstances.

Restatement of Trusts 3d: Prudent Investor Rule § 171 (1992). The 1992 Restatement integrates this delegation standard into the prudent investor rule of section 227, providing that "the trustee must . . . act with prudence in deciding whether and how to delegate to others . . . ." Restatement of Trusts 3d: Prudent Investor Rule § 227(c) (1992).

Protecting the beneficiary against unreasonable

delegation. There is an intrinsic tension in trust law between granting trustees broad powers that facilitate flexible and efficient trust administration, on the one hand, and protecting trust beneficiaries from the misuse of such powers on the other hand. A broad set of trustees' powers, such as those found in most lawyer-drafted instruments and exemplified in the Uniform Trustees' Powers Act, permits the trustee to act vigorously and expeditiously to maximize the interests of the beneficiaries in a variety of transactions and administrative settings. Trust law relies upon the duties of loyalty and prudent administration, and upon procedural safeguards such as periodic accounting and the availability of judicial oversight, to prevent the misuse of these powers. Delegation, which is a species of trustee power, raises the same tension. If the trustee delegates effectively, the beneficiaries obtain the advantage of the agent's specialized investment skills or whatever other attributes induced the trustee to delegate. But if the trustee delegates to a knave or an incompetent, the delegation can work harm upon the beneficiaries.

Section 9 of the Uniform Prudent Investor Act is designed to strike the appropriate balance between the advantages and the hazards of delegation. Section 9 authorizes delegation under the limitations of subsections (a) and (b). Section 9(a) imposes duties of care, skill, and caution on the trustee in selecting the agent, in establishing the terms of the delegation, and in reviewing the agent's compliance.

The trustee's duties of care, skill, and caution in framing the terms of the delegation should protect the beneficiary against overbroad delegation. For example, a trustee could not prudently agree to an investment management agreement containing an exculpation clause that leaves the trust without recourse against reckless mismanagement. Leaving one's beneficiaries remediless against willful wrongdoing is inconsistent with the duty to use care and caution in formulating the terms of the delegation. This sense that it is imprudent to expose beneficiaries to broad exculpation clauses underlies both federal and state legislation restricting exculpation clauses, e.g., ERISA §§ 404(a)(1)(D), 410(a), 29 U.S.C. §§ 1104(a)(1)(D), 1110(a); New York Est. Powers Trusts Law § 11-1.7 (McKinney 1967).

Although subsection (c) of the Act exonerates the trustee from personal responsibility for the agent's conduct when the delegation satisfies the standards of subsection 9(a), subsection 9(b) makes the agent responsible to the trust. The beneficiaries of the trust can, therefore, rely upon the trustee to enforce the terms of the delegation.

Costs. The duty to minimize costs that is articulated in Section 7 of this Act applies to delegation as well as to other aspects of fiduciary investing. In deciding whether to delegate, the trustee must balance the

projected benefits against the likely costs. Similarly, in deciding how to delegate, the trustee must take costs into account. The trustee must be alert to protect the beneficiary from "double dipping." If, for example, the trustee's regular compensation schedule presupposes that the trustee will conduct the investment management function, it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.

Section 10. Language Invoking Standard of [ACT].

The following terms or comparable language in the provisions of a trust, unless otherwise limited or modified, authorizes any investment or strategy permitted under this [Act]: "investments permissible by law for investment of trust funds," "legal investments," "authorized investments," "using the judgment and care under the circumstances then prevailing that persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital," "prudent man rule," "prudent trustee rule," "prudent person rule," and "prudent investor rule."

Comment

This provision is taken from the Illinois act, 760 ILCS § 5/5(d) (1992), and is meant to facilitate incorporation of the Act by means of the formulaic language commonly used in trust instruments.

Section 11. Application to existing trusts.

This [Act] applies to trusts existing on and created after its effective date. As applied to trusts existing on its effective date, this [Act] governs only decisions or actions occurring after that date.

Section 12. Uniformity of Application and Construction.

This [Act] shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this [Act] among the States enacting it.

Section 13. Short Title.

This [Act] may be cited as the "[Name of Enacting State] Uniform Prudent Investor Act."

Section 14. Severability.

If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

Section 15. Effective Date.

This [Act] takes effect . . . .

Section 16. Repeals.

The following acts and parts of acts are repealed:

List of States Adopting the Uniform Prudent Investor Act

(As of August 2004)

1. Alaska AS §§ 13.36.200 to 13.36.275.

2. Arizona West's Ariz. Rev. Stat. Ann. §§ 14-7601 to 14-7611.
3. Arkansas A.C.A §§ 24-3-417 to 24-3-426.
4. California West's Ann. Cal. Probate Code, §§ 16045 to 16054.
5. Colorado West's C.S.R.A. §§ 15-1.1-101 to 15-1.1-115.
6. Connecticut C.G.S.A. §§ 45a-541 to 45a-541/.
7. District of Columbia D.C. Code 1981, §§ 28-4701 to 28-4712.
8. Hawaii H.R.S §§ 554C-1 to 554C-12.
9. Idaho I.C. §§ 68-501 to 68-514.
10. Illinois West's 760 ILL Comp. Stat. §§ 5/5 and 5/5.1.
11. Indiana West's A.I.C. §§ 30-4-3.5-1 to 30-4-3.5-13.
12. Iowa West's Iowa Code Ann. § 633.4301 to 633.4310.
13. Kansas (a) West's Kan. Stat. Ann. § 17-5004.
14. Maine West's Me. Rev. Stat. Ann. tit. 18-A, § 7-302, 7-302 note.
15. Maryland West's Md. Code Ann., Est. & Trusts § 15-114. (substantially similar)
16. Massachusetts M.G.L.A c 203C, §§ 1 to 11.
17. Michigan M.C.L.A. §§ 700.1501 to 700.1512.
18. Minnesota West's Minn. Stat. Ann. § 501B.151, 501B.152.
19. Missouri West's Mo. Ann. Stat. §§ 456.900 to 456.913.
20. Montana West's Mont. Code Ann. § 72-34-114
21. Nebraska R.R.S. 1943, §§ 8-2201 to 8-2213.
22. Nevada West's Nev. Rev. Stat. § 164.050.
23. New Hampshire RSA 564 A:3:B
24. New Jersey West's N.J. Stat. Ann. § 3B:20-11.1 to 3B:20-11.12.
25. New Mexico West's N.M. Stat. Ann. §§ 45-7-601 to 45-7-612.
26. North Carolina G.S. §§ 36A-161 to 36A-173.
27. North Dakota West's N.D. Cent. Code § 59-02-08.1 to 59-02-08.11.
28. Ohio R.C. §§ 1339.52 to 1339.61.
29. Oklahoma West's 60 Okla. Stat. Ann. tit. 60 §§ 175.60 to 175.72.
30. Oregon West's Or. Rev. Stat. § 128.192 to 128.218.
31. Pennsylvania 20 Pa. C.S.A. §§ 7201 to 7214.
32. Rhode Island Gen. Laws 1956, §§ 18-15-1 to 18-15-13.
33. South Carolina West's S.C. Code Ann. § 62-7-302.
34. Tennessee
35. Texas West's Tex Prop. Code Ann. § 113.056.
36. Utah West's Utah Code Ann. § 75-7-302.
37. Vermont 9 V.S.A §§ 4651 to 4662.
38. Virginia West's Va. Code Ann. § 26-45.3 to 26-45.14.
39. Washington West's Wash. Rev. Code Ann. § 11.100.010 et. seq.
40. West Virginia Code, 44-6C-1 to 44-6C-15.
41. Wisconsin
42. Wyoming Wyo. Stat. Ann. §§ 4-9-101 to 4-9-113.

List of States Adopting a Quasi form of the Uniform Prudent Investor Act

1. Alabama West's Ala. Code § 19-3-120.2.
2. Delaware West's Del. Code Ann. tit. 12 § 3302.
3. Florida West's F.S.A. §§ 518.11 and 518.11
4. Georgia West's Ga. Code Ann. § 53-12-280.
5. Kentucky Revised Statutues 287.277
6. New York West's N.Y. Est. Powers and Trusts Law § 11-2.3
7. South Dakota West's S.D. Codified Laws Ann. § 55-5-6.

The remaining states to adopt some form of the Uniform Prudent Investor Act are Mississippi and Louisiana.

Uniform Principal and Income Act 1962 Act

Introduction

The 1962 version of the Act replaces the previous version, which had been approved in 1931. The revised Act provides, as did the original Act, that the settlor's intent is the guiding principle which should control the disposition of all receipts. But settlors have not always foreseen the multitude of problems that may have to be faced and even draftsmen have found it difficult to foresee all the possible kinds of receipts and disbursements. It is important, therefore, to set

forth some clear and uniform standards to assist those to whom the power of decision has been committed, that is, the trustees, and this Act attempts to provide these standards.

The aim of the revised Act is simplicity and convenience of administration of the estate. Of course, fairness to all beneficiaries both present and future has also been considered. As a result, the revised Act is made applicable to all trusts and estates whether in existence at the time the revised Act becomes law or not. A trustee who administers several trusts, it was thought, would have difficulty attempting to administer the various trusts under different rules for distribution of receipts and allocation of disbursements and it was thought better, therefore, to make the Act applicable to all trusts.

The original Act followed the so-called "Massachusetts Rule" of awarding cash dividends on corporate stock to income and stock dividends to principal, thereby rejecting the Pennsylvania Rule or some variation of it requiring apportionment between the two funds. The revised Act continues to follow the Massachusetts Rule but provides for some newer problems that have arisen since the original Act was promulgated.

Provision is now made for corporate distributions pursuant to a court decree such as a divestiture order in an anti-trust suit. Provision is also made for treatment of the distributions of a regulated investment company or estate investment trust. Since the original Act was promulgated development has occurred in methods of issuing bonds, notably the discount type of bond such as the Series E bond of the United States government and provision had been made for allocating the increment in value between principal and income.

The revised Act provides for an allocation of natural resources substantially different from that provided in the original Act but not substantially different from the rules adopted in many of the states producing natural resources. Because of the difficulty of apportioning receipts from extraction of natural resources among the income and principal beneficiaries it is provided in the revised Act that an arbitrary allocation should occur, that is, 27½% of the gross receipts shall be added to principal as a "depletion reserve," and the balance should be payable to the income beneficiary. Attempts to apportion the receipts on the relation of the amount of minerals extracted to the amount of minerals remaining in the ground have proved difficult of calculation and this method of allocation was accordingly rejected in favor of simplicity.

While the revised Act continues to deal specifically with a number of subjects, it also contains a "catchall" providing for disposition of receipts where there is no specific section in the Act dealing with the allocation. A form of "prudent man" rule has been adopted to handle this situation.

The Act, therefore, sets forth simple and workable rules of administration which are believed to be consistent with the wishes of settlors upon the subject treated unless the settlor specifically provides for a different treatment in his own trust instrument.

Uniform Principal and Income Act

1962 Act

Section

1. Definitions
2. Duty of Trustee as to Receipts and Expenditure
3. Income; Principal; Charges
4. When Right to Income Arises; Apportionment of Income
5. Income Earned During Administration of a Decedent's Estate
6. Corporate Distributions
7. Bond Premium and Discount
8. Business and Farming Operations
9. Disposition of Natural Resources
10. Timber
11. Other Property Subject to Depletion
12. Underproductive Property
13. Charges Against Income and Principal
14. Application of Act
15. Uniformity of Interpretation
16. Short Title

17. Severability
18. Repeal
19. Time of Taking Effect of This Act

Section 1
Definitions

As used in this Act:

1. "income beneficiary" means the person to whom income is presently payable or for whom it is accumulated for distribution as income;
2. "inventory value" means the cost of property purchased by the trustee and the market value of other property at the time it became subject to the trust, but in the case of a testamentary trust the trustee may use any value finally determined for the purposes of an estate or inheritance tax;
3. "remainderman" means the person entitled to principal, including income which has been accumulated and added to principal;
4. "trustee" means an original trustee and any successor or added trustee.

Section 2
Duty of Trustee as to Receipts and Expenditure

a. A trust shall be administered with due regard to the respective interests of income beneficiaries and remaindermen. A trust is so administered with respect to the allocation of receipts and expenditures if a receipt is credited or an expenditure is charged to income or principal or partly to each -

    1. in accordance with the terms of the trust instrument, notwithstanding contrary provisions of this Act;
    2. in the absence of any contrary terms of the trust instrument, in accordance with the provisions of this Act; or
    3. if neither of the preceding rules of administration is applicable, in accordance with what is reasonable and equitable in view of the interests of those entitled to income as well as of those entitled to principal, and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their own affairs.

b. If the trust instrument gives the trustee discretion in crediting a receipt or charging an expenditure to income or principal or partly to each, no inference of imprudence or partiality arises from the fact that the trustee has made an allocation contrary to a provision of this Act.

Section 3
Income; Principal; Charges

a. Income is the return in money or property derived from the use of principal, including return received as -

    1. rent of real or personal property, including sums received for cancellation or renewal of a lease;
    2. interest on money lent, including sums received as consideration for the privilege of prepayment of principal except as provided in section 7 on bond premium and bond discount;
    3. income earned during administration of a decedent's estate as provided in section 5;
    4. corporate distributions as provided in section 6;
    5. accrued increment on bonds or other obligations issued at discount as provided in section 7;
    6. receipts from business and farming operations as provided in section 8;
    7. receipts from disposition of natural resources as provided in sections 9 and 10;
    8. receipts from other principal subject to depletion as provided in section 11;
    9. receipts from disposition of underproductive property as provided in

section 12.

b. Principal is the property which has been set aside by the owner or the person legally empowered so that it is held in trust eventually to be delivered to a remainderman while the return or use of the principal is in the meantime taken or received by or held for accumulation for an income beneficiary. Principal includes -

   1. consideration received by the trustee on the sale or other transfer of principal or on repayment of a loan or as a refund or replacement or change in the form of principal;
   2. proceeds of property taken on eminent domain proceedings;
   3. proceeds of insurance upon property forming part of the principal except proceeds of insurance upon a separate interest of an income beneficiary;
   4. stock dividends, receipts on liquidation of a corporation, and other corporate distributions as provided in section 6;
   5. receipts from the disposition of corporate securities as provided in section 7;
   6. royalties and other receipts from disposition of natural resources as provided in sections 9 and 10;
   7. receipts from other principal subject to depletion as provided in section 11;
   8. any profit resulting from any change in the form of principal except as provided in section 12 on underproductive property;
   9. receipts from disposition of underproductive property as provided in section 12;
   10. any allowances for depreciation established under sections 8 and 13(a)(2).

c. After determining income and principal in accordance with the terms of the trust instrument or of this Act, the trustee shall charge to income or principal expenses and other charges as provided in section 13.

Section 4
When Right to Income Arises; Apportionment of Income

a. An income beneficiary is entitled to income from the date specified in the trust instrument, or, if none is specified, from the date an asset becomes subject to the trust. In the case of an asset becoming subject to a trust by reason of a will, it becomes subject to the trust as of the date of the death of the testator even though there is an intervening period of administration of the testator's estate.
b. In the administration of a decedent's estate or an asset becoming subject to a trust by reason of a will -

   1. receipts due but not paid at the date of death of the testator are principal;
   2. receipts in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due at the date of the death of the testator shall be treated as accruing from day to day. That portion of the receipt accruing before the date of death is principal, and the balance is income.

c. In all other cases, any receipt from an income-producing asset is income even though the receipt was earned or accrued in whole or in part before the date when the asset became subject to the trust.
d. On termination of an income interest, the income beneficiary whose interest is terminated, or his estate, is entitled to

   1. income undistributed on the date of termination;
   2. income due but not paid to the trustee on the date of termination;
   3. income in the form of periodic payments (other than corporate distributions to stockholders), including rent, interest, or annuities, not due on the date of termination, accrued from day to day.

e. Corporate distributions to stockholders shall be treated as due on the day fixed by the corporation for determination of stockholders of record entitled to distribution or, if no

date is fixed, on the date of declaration of the distribution by the corporation.

Section 5

Income Earned During Administration of a Decedent's Estate

a. Unless the will otherwise provides and subject to subsection (b), all expenses incurred in connection with the settlement of a decedent's estate, including debts, funeral expenses, estate taxes, interest and penalties concerning taxes, family allowances, fees of attorneys and personal representatives, and court costs shall be charged against the principal of the estate.
b. Unless the will otherwise provides, income from the assets of a decedent's estate after the death of the testator and before distribution, including income from property used to discharge liabilities, shall be determined in accordance with the rules applicable to a trustee under this Act and distributed as follows:

    1. to specific legatees and devisees, the income from the property bequeathed or devised to them respectively, less taxes, ordinary repairs, and other expenses of management and operation of the property, and an appropriate portion of interest accrued since the death of the testator and of taxes imposed on income (excluding taxes on capital gains) which accrue during the period of administration;
    2. to all other legatees and devisees, except legatees of pecuniary bequests not in trust, the balance of the income, less the balance of taxes, ordinary repairs, and other expenses of management and operation of all property from which the estate is entitled to income, interest accrued since the death of the testator, and taxes imposed on income (excluding taxes on capital gains) which accrue during the period of administration, in proportion to their respective interests in the undistributed assets of the estate computed at times of distribution on the basis of inventory value.

c. Income received by a trustee under subsection (b) shall be treated as income of the trust.

Section 6

Corporate Distributions

a. Corporate distributions of shares of the distributing corporation, including distributions in the form of a stock split or stock dividend, are principal. A right to subscribe to shares or other securities issued by the distributing corporation accruing to stockholders on account of their stock ownership and the proceeds of any sale of the right are principal.
b. Except to the extent that the corporation indicates that some part of a corporate distribution is a settlement of preferred or guaranteed dividends accrued since the trustee became a stockholder or is in lieu of an ordinary cash dividend, a corporate distribution is principal if the distribution is pursuant to -

    1. a call of shares;
    2. a merger, consolidation, reorganization, or other plan by which assets of the corporation are acquired by another corporation; or
    3. a total or partial liquidation of the corporation, including any distribution which the corporation indicates is a distribution in total or partial liquidation or any distribution of assets, other than cash, pursuant to a court decree or final administrative order by a government agency ordering distribution of the particular assets.

c. Distributions made from ordinary income by a regulated investment company or by a trust qualifying and electing to be taxed under federal law as a real estate investment trust are income. All other distributions made by the company or trust, including distributions from capital gains, depreciation, or depletion, whether in the form of cash or an option to take new stock or cash or an option to purchase additional shares, are principal.
d. Except as provided in subsections (a), (b), and (c), all corporate distributions are income, including cash dividends, distributions of or rights to subscribe to shares or securities or obligations of corporations other than the distributing corporation, and the

proceeds of the rights or property distributions. Except as provided in subsections (b) and (c), if the distributing corporation gives a stockholder an option to receive a distribution either in cash or in its own shares, the distribution chosen is income.

e. The trustee may rely upon any statement of the distributing corporation as to any fact relevant under any provision of this Act concerning the source or character of dividends or distributions of corporate assets.

Section 7

Bond Premium and Discount

a. Bonds or other obligations for the payment of money are principal at their inventory value, except as provided in subsection (b) for discount bonds. No provision shall be made for amortization of bond premiums or for accumulation for discount. The proceeds of sale, redemption, or other disposition of the bonds or obligations are principal.
b. The increment in value of a bond or other obligation for the payment of money payable at a future time in accordance with a fixed schedule of appreciation in excess of the price at which it was issued is distributable as income. The increment in value is distributable to the beneficiary who was the income beneficiary at the time of increment from the first principal cash available or, if none is available, when realized by sale, redemption, or other disposition. Whenever unrealized increment is distributed as income but out of principal, the principal shall be reimbursed for the increment when realized.

Section 8

Business and Farming Operations

a. If a trustee uses any part of the principal in the continuance of a business of which the settlor was a sole proprietor or a partner, the net profits of the business, computed in accordance with generally accepted accounting principles for a comparable business, are income. If a loss results in any fiscal or calendar year, the loss falls on principal and shall not be carried into any other fiscal or calendar year for purposes of calculating net income.
b. Generally accepted accounting principles shall be used to determine income from an agricultural or farming operation, including the raising of animals or the operation of a nursery.

Section 9

Disposition Of Natural Resources

a. If any part of the principal consists of a right to receive royalties, overriding or limited royalties, working interests, production payments, net profit interests, or other interests in minerals or other natural resources in, on or under land, the receipts from taking the natural resources from the land shall be allocated as follows:

   1. If received as rent on a lease or extension payments on a lease, the receipts are income.
   2. If received from a production payment, the receipts are income to the extent of any factor for interest or its equivalent provided in the governing instrument. There shall be allocated to principal the fraction of the balance of the receipts which the unrecovered cost of the production payment bears to the balance owed on the production payment, exclusive of any factor for interest or its equivalent. The receipts not allocated to principal are income.
   3. If received as a royalty, overriding or limited royalty, or bonus, or from a working, net profit, or any other interest in minerals or other natural resources, receipts not provided for in the preceding paragraphs of this section shall be apportioned on a yearly basis in accordance with this paragraph whether or not any natural resource was being taken from the land at the time the trust was established. Twenty-seven and one-half per cent of the gross receipts (but not to exceed 50% of the net receipts remaining after payment of all expenses, direct and indirect, computed without allowance for depletion) shall be added to principal as an

allowance for depletion. The balance of the gross receipts, after payment therefrom of all expenses, direct and indirect, is income.

b. If a trustee, on the effective date of this Act, held an item of depletable property of a type specified in this section he shall allocate receipts from the property in the manner used before the effective date of this Act, but as to all depletable property acquired after the effective date of this Act by an existing or new trust, the method of allocation provided herein shall be used.
c. This section does not apply to timber, water, soil, sod, dirt, turf, or mosses.

Section 10
Timber

If any part of the principal consists of land from which merchantable timber may be removed, the receipts from taking the timber from the land shall be allocated in accordance with section 2(a)(3).

Section 11
Other Property Subject to Depletion

Except as provided in sections 9 and 10, if the principal consists of property subject to depletion, including leaseholds, patents, copyrights, royalty rights, and rights to receive payments on a contract for deferred compensation, receipts from the property, not in excess of 5% per year of its inventory value, are income, and the balance is principal.

Section 12
Underproductive Property

a. Except as otherwise provided in this section, a portion of the net proceeds of sale of any part of principal which has not produced an average net income of at least 1% per year of its inventory value for more than a year (including as income the value of any beneficial use of the property by the income beneficiary) shall be treated as delayed income to which the income beneficiary is entitled as provided in this section. The net proceeds of sale are the gross proceeds received, including the value of any property, received in substitution for the property disposed of less the expenses, including capital gains tax, if any, incurred in disposition and less any carrying charges paid while the property was underproductive.
b. The sum allocated as delayed income is the difference between the net proceeds and the amount which, had it been invested at simple interest at [4%] per year while the property was underproductive, would have produced the net proceeds. This sum, plus any carrying charges and expenses previously charged against income while the property was underproductive, less any income received by the income beneficiary from the property and less the value of any beneficial use of the property by the income beneficiary, is income, and the balance is principal.
c. An income beneficiary or his estate is entitled to delayed income under this section as if it accrued from day to day during the time he was a beneficiary.
d. If principal subject to this section is disposed of by conversion into property which cannot be apportioned easily, including land or mortgages (for example, realty acquired by or in lieu of foreclosure), the income beneficiary is entitled to the net income from any property or obligation into which the original principal is converted while the substituted property or obligation is held. If within 5 years after the conversion the substituted property has not been further converted into easily apportionable property, no allocation as provided in this section shall be made.

Section 13
Charges Against Income and Principal

a. The following charges shall be made against income:

    1. ordinary expenses incurred in connection with the administration, management, or preservation of the trust property, including regularly recurring taxes assessed against any portion of the principal, water rates, premiums on insurance taken upon the interests of the income beneficiary, remainderman, or trustee, interest paid by the trustee, and

ordinary repairs;
2. a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles, but no allowance shall be made for depreciation of that portion of any real property used by a beneficiary as a residence or for depreciation of any property held by the trustee on the effective date of this Act for which the trustee is not then making an allowance for depreciation;
3. one-half of court costs, attorney's fees, and other fees on periodic judicial accounting, unless the court directs otherwise;
4. court costs, attorney's fees, and other fees on other accountings or judicial proceedings if the matter primarily concerns the income interest, unless the court directs otherwise;
5. one-half of the trustee's regular compensation, whether based on a percentage of principal or income, and all expenses reasonably incurred for current management of principal and application of income;
6. any tax levied upon receipts defined as income under this Act or the trust instrument and payable by the trustee.

b. If charges against income are of unusual amount, the trustee may by means of reserves or other reasonable means Charge them over a reasonable period of time and withhold from distribution sufficient sums to regularize distributions.
c. The following charges shall be made against principal:

1. trustee's compensation not chargeable to income under subsections (a)(4) and (a)(5), special compensation of trustees, expenses reasonably incurred in connection with principal, court costs and attorney's fees primarily concerning matters of principal, and trustee's compensation computed on principal as an acceptance, distribution, or termination fee;
2. charges not provided for in subsection (a), including the cost of investing and reinvesting principal, the payments on principal of an indebtedness (including a mortgage amortized by periodic payments of principal), expenses for preparation of property for rental or sale, and, unless the court directs otherwise, expenses incurred in maintaining or defending any action to construe the trust or protect it or the property or assure the title of any trust property;
3. extraordinary repairs or expenses incurred in making a capital improvement to principal, including special assessments, but, a trustee may establish an allowance for depreciation out of income to the extent permitted by subsection (a)(2) and by section 8;
4. any tax levied upon profit, gain, or other receipts allocated to principal notwithstanding denomination of the tax as an income tax by the taxing authority;
5. if an estate or inheritance tax is levied in respect of a trust in which both an income beneficiary and a remainderman have an interest, any amount apportioned to the trust including interest and penalties, even though the income beneficiary also has rights in the principal.

d. Regularly recurring charges payable from income shall be apportioned to the same extent and in the same manner that income is apportioned under section 4.

Section 14
Application of Act

Except as specifically provided in the trust instrument or the will or in this Act, this Act shall apply to any receipt or expense received or incurred after the effective date of this Act by any trust or decedent's estate whether established before or after the effective date of this Act and whether the asset involved was acquired by the trustee before or after the effective date of this Act.

Section 15
Uniformity of Interpretation

This Act shall be so construed as to effectuate its general purpose to make uniform the law of

those states which enact it.

Section 16
Short Title

This Act may be cited as the Revised Uniform Principal and Income Act.

Section 17
Severability

If any provision of this Act or the application thereof to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of the Act which can be given effect without the invalid provision or application and to this end the provisions of this Act are severable.

Section 18
Repeal

The following acts and parts of acts are repealed:

Section 19
Time of Taking Effect of This Act

This Act shall take effect on ....

Uniform Principal and Income Act 1997 Act (Act)

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Uniform Principal and Income Act

(Last Amended or Revised in 2000)

Drafted by the

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on Uniform State Laws

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Uniform Principal and Income Act

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Uniform Principal and Incoem Act

Table of Contents

Article 1. Definitions and Fiduciary Duties

Section 101.Short Title. 5

Section 102.Definitions. 5

Section 103.Fiduciary Duties; General PRINCIPLES. 7

Section 104.Trustee's Power To Adjust. 10

Section 105. Judicial Control Of Discretionary Power.. 19

Article 2. Decendant's estate or terminating income interest

Section 201.Determination and Distribution Of Net Income. 25

Section 202.Distribution To Residuary and Remainder Beneficiaries. 29

Article 3. Apportionment at beginning and end of income interest

Section 301.When Right To Income Begins and Ends. 32

Section 302.Apportionment Of Receipts and Disbursements When Decedent

Dies Or Income Interest Begins. 33

Section 303.Apportionment When Income Interest Ends. 35

Article 4. Allocation of receipts during administration of trust

Part 1. Receipts From Entities

Section 401.Character Of Receipts. 37

Section 402.Distribution From Trust Or Estate. 39

Section 403.Business and Other Activities Conducted By Trustee. 40

Part 2. Receipts Not Normally Apportioned

Section 404.Principal Receipts. 42

Section 405.Rental Property. 43

Section 406. Obligation To Pay Money. 44

Section 407.Insurance Policies and Similar Contracts. 45

PART 3. Receipts Normally Apportioned

Section 408.Insubstantial Allocations Not Required. 46

Section 409.Deferred Compensation, Annuities, and Similar Payments. 47

Section 410.Liquidating Asset. 50

Section 411.Minerals, Water, and Other Natural
Resources. 51

Section 412.Timber. 53

Section 413.Property Not Productive Of
Income. 55

Section 414.Derivatives and Options. 57

Section 415.Asset-Backed Securities. 59

Article 5. Allocation of disbursements during administration of trust

Section 501.Disbursements From Income. 61

Section 502.Disbursements From Principal. 62

Section 503.Transfers From Income To Principal For Depreciation. 64

Section 504.Transfers From Income To Reimburse Principal. 65

Section 505. Income Taxes. 66

Section 506. Adjustments Between Principal and Income Because Of Taxes. 67

Article 6. Miscellaneous Provisions

Section 601. Uniformity Of Application and Construction. 71

Section 602. Severability Clause. 71

Section 603. Repeal. 71

Section 604. Effective Date. 71

Section 605. Application Of [ACT] To Existing Trusts and Estates. 71

Uniform Principal and Income Act

Prefatory Note

This revision of the 1931 Uniform Principal and Income Act and the 1962 Revised Uniform Principal and Income Act has two purposes.

One purpose is to revise the 1931 and the 1962 Acts. Revision is needed to support the now widespread use of the revocable living trust as a will substitute, to change the rules in those Acts that experience has shown need to be changed, and to establish new rules to cover situations not provided for in the old Acts, including rules that apply to financial instruments invented since 1962.

The other purpose is to provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of "income" as traditionally perceived in terms of interest, dividends, and rents.

Revision of the 1931 and 1962 Acts

The prior Acts and this revision of those Acts deal with four questions affecting the rights of beneficiaries:

(1) How is income earned during the probate of an estate to be distributed to trusts and to persons who receive outright bequests of specific property, pecuniary gifts, and the residue?

(2) When an income interest in a trust begins (i.e., when a person who creates the trust dies or when she transfers property to a trust during life), what property is principal that will eventually go to the remainder beneficiaries and what is income?

(3) When an income interest ends, who gets the income that has been received but not distributed, or that is due but not yet collected, or that has accrued but is not yet due?

(4) After an income interest begins and before it ends, how should its receipts and disbursements be allocated to or between principal and income?

Changes in the traditional sections are of three types: new rules that deal with situations not covered by the prior Acts, clarification of provisions in the 1962 Act, and changes to rules in the prior Acts.

New rules. Issues addressed by some of the more significant new rules include:

(1) The application of the probate administration rules to revocable living trusts after the settlor's death and to other terminating trusts. Articles 2 and 3.

(2) The payment of interest or some other amount on the delayed payment of an outright pecuniary gift that is made pursuant to a trust agreement instead of a will when the agreement or state law does not provide for such a payment. Section 201(3).

(3) The allocation of net income from partnership interests acquired by the trustee other than from a decedent (the old Acts deal only with partnership interests acquired from a decedent). Section 401.

(4) An "unincorporated entity" concept has been introduced to deal with businesses operated by a trustee, including farming and livestock operations, and investment activities in rental real estate, natural resources, timber, and derivatives. Section 403.

(5) The allocation of receipts from discount obligations such as zero-coupon bonds. Section 406(b).

(6) The allocation of net income from harvesting and selling timber between principal and income. Section 412.

(7) The allocation between principal and income of receipts from derivatives, options, and asset-backed securities. Sections 414 and 415.

(8) Disbursements made because of environmental laws. Section 502(a)(7).

(9) Income tax obligations resulting from the ownership of S corporation stock and interests in partnerships. Section 505.

(10) The power to make adjustments between principal and income to correct inequities caused by tax elections or peculiarities in the way the fiduciary income tax rules apply. Section 506.

Clarifications and changes in existing rules. A number of matters provided for in the prior Acts have been changed or clarified in this revision, including the following:

(1) An income beneficiary's estate will be entitled to receive only net income actually received by a trust before the beneficiary's death and not items of accrued income. Section 303.

(2) Income from a partnership is based on actual distributions from the partnership, in the same manner as corporate distributions. Section 401.

(3) Distributions from corporations and partnerships that exceed 20% of the entity's gross assets will be principal whether or not intended by the entity to be a partial liquidation. Section 401(d)(2).

(4) Deferred compensation is dealt with in greater detail in a separate section. Section 409.

(5) The 1962 Act rule for "property subject to depletion," (patents, copyrights, royalties, and the like), which provides that a trustee may allocate up to 5% of the asset's inventory value to income and the balance to principal, has been replaced by a rule that allocates 90%

of the amounts received to principal and the balance to income. Section 410.

(6) The percentage used to allocate amounts received from oil and gas has been changed - 90% of those receipts are allocated to principal and the balance to income. Section 411.

(7) The unproductive property rule has been eliminated for trusts other than marital deduction trusts. Section 413.

(8) Charging depreciation against income is no longer mandatory, and is left to the discretion of the trustee. Section 503.

Coordination with the Uniform Prudent Investor Act

The law of trust investment has been modernized. See Uniform Prudent Investor Act (1994); Restatement (Third) of Trusts: Prudent Investor Rule (1992) (hereinafter Restatement of Trusts 3d: Prudent Investor Rule). Now it is time to update the principal and income allocation rules so the two bodies of doctrine can work well together. This revision deals conservatively with the tension between modern investment theory and traditional income allocation. The starting point is to use the traditional system. If prudent investing of all the assets in a trust viewed as a portfolio and traditional allocation effectuate the intent of the settlor, then nothing need be done. The Act, however, helps the trustee who has made a prudent, modern portfolio-based investment decision that has the initial effect of skewing return from all the assets under management, viewed as a portfolio, as between income and principal beneficiaries. The Act gives that trustee a power to reallocate the portfolio return suitably. To leave a trustee constrained by the traditional system would inhibit the trustee's ability to fully implement modern portfolio theory.

As to modern investing see, e.g., the Preface to, terms of, and Comments to the Uniform Prudent Investor Act (1994); the discussion and reporter's note by Edward C. Halbach, Jr. in Restatement of Trusts 3d: Prudent Investor Rule; John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996); Bevis Longstreth, Modern Investment Management and the Prudent Man Rule (1986); John H. Langbein & Richard A. Posner, The Revolution in Trust Investment Law, 62 A.B.A.J. 887 (1976); and Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52 (1987). See also R.A. Brearly, An Introduction to Risk and Return from Common Stocks (2d ed. 1983); Jonathan R. Macey, An Introduction to Modern Financial Theory (2d ed. 1998). As to the need for principal and income reform see, e.g., Joel C. Dobris, Real Return, Modern Portfolio Theory and College, University and Foundation Decisions on Annual Spending From Endowments: A Visit to the World of Spending Rules, 28 Real Prop., Prob., & Tr. J. 49 (1993); Joel C. Dobris, The Probate World at the End of the Century: Is a New Principal and Income Act in Your Future?, 28 Real Prop., Prob., & Tr. J. 393 (1993); and Kenneth L. Hirsch, Inflation and the Law of Trusts, 18 Real Prop., Prob., & Tr. J. 601 (1983). See also, Jerold I. Horn, The Prudent Investor Rule - Impact on Drafting and Administration of Trusts, 20 ACTEC Notes 26 (Summer 1994).

Uniform Principal and Income Act

[Article] 1

Definitions and Fiduciary Duties

Section 101. Short Title. This [Act] may be cited as the Uniform Principal and Income Act.

Section 102. Definitions. In this [Act]:

(1) "Accounting period" means a calendar year unless another 12-month period is selected by a fiduciary. The term includes a portion of a calendar year or other 12-month period that begins when an income interest begins or ends when an income interest ends.

(2) "Beneficiary" includes, in the case of a decedent's estate, an heir [, legatee,] and devisee and, in the case of a trust, an income beneficiary and a remainder beneficiary.

(3) "Fiduciary" means a personal representative or a trustee. The term includes an

executor, administrator, successor personal representative, special administrator, and a person performing substantially the same function.

(4) "Income" means money or property that a fiduciary receives as current return from a principal asset. The term includes a portion of receipts from a sale, exchange, or liquidation of a principal asset, to the extent provided in [Article] 4.

(5) "Income beneficiary" means a person to whom net income of a trust is or may be payable.

(6) "Income interest" means the right of an income beneficiary to receive all or part of net income, whether the terms of the trust require it to be distributed or authorize it to be distributed in the trustee's discretion.

(7) "Mandatory income interest" means the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.

(8) "Net income" means the total receipts allocated to income during an accounting period minus the disbursements made from income during the period, plus or minus transfers under this [Act] to or from income during the period.

(9) "Person" means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, government; governmental subdivision, agency, or instrumentality; public corporation, or any other legal or commercial entity.

(10) "Principal" means property held in trust for distribution to a remainder beneficiary when the trust terminates.

(11) "Remainder beneficiary" means a person entitled to receive principal when an income interest ends.

(12) "Terms of a trust" means the manifestation of the intent of a settlor or decedent with respect to the trust, expressed in a manner that admits of its proof in a judicial proceeding, whether by written or spoken words or by conduct.

(13) "Trustee" includes an original, additional, or successor trustee, whether or not appointed or confirmed by a court.

Comment

"Income beneficiary." The definitions of income beneficiary (Section 102(5)) and income interest (Section 102(6)) cover both mandatory and discretionary beneficiaries and interests. There are no definitions for "discretionary income beneficiary" or "discretionary income interest" because those terms are not used in the Act.

Inventory value. There is no definition for inventory value in this Act because the provisions in which that term was used in the 1962 Act have either been eliminated (in the case of the underproductive property provision) or changed in a way that eliminates the need for the term (in the case of bonds and other money obligations, property subject to depletion, and the method for determining entitlement to income distributed from a probate estate).

"Net income." The reference to "transfers under this Act to or from income" means transfers made under Sections 104(a), 412(b), 502(b), 503(b), 504(a), and 506.

"Terms of a trust." This term was chosen in preference to "terms of the trust instrument" (the phrase used in the 1962 Act) to make it clear that the Act applies to oral trusts as well as those whose terms are expressed in written documents. The definition is based on the Restatement (Second) of Trusts § 4 (1959) and the Restatement (Third) of Trusts § 4 (Tent. Draft No. 1, 1996). Constructional preferences or rules would also apply, if necessary, to determine the terms of the trust.

Section 103. Fiduciary Duties; General Principles.

(a) In allocating receipts and disbursements to or between principal and income, and with respect to any matter within the scope of [Articles] 2 and 3, a fiduciary:

(1) shall administer a trust or estate in accordance with the terms of the trust or the will, even if there is a different provision in this [Act];

(2) may administer a trust or estate by the exercise of a discretionary power of administration given to the fiduciary by the terms of the trust or the will, even if the exercise of the power produces a result different from a result required or permitted by this [Act];

(3) shall administer a trust or estate in accordance with this [Act] if the terms of the trust or the will do not contain a different provision or do not give the fiduciary a discretionary power of administration; and

(4) shall add a receipt or charge a disbursement to principal to the extent that the terms of the trust and this [Act] do not provide a rule for allocating the receipt or disbursement to or between principal and income.

(b) In exercising the power to adjust under Section 104(a) or a discretionary power of administration regarding a matter within the scope of this [Act], whether granted by the terms of a trust, a will, or this [Act], a fiduciary shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries. A determination in accordance with this [Act] is presumed to be fair and reasonable to all of the beneficiaries.

Comment

Prior Act. The rule in Section 2(a) of the 1962 Act is restated in Section 103(a), without changing its substance, to emphasize that the Act contains only default rules and that provisions in the terms of the trust are paramount. However, Section 2(a) of the 1962 Act applies only to the allocation of receipts and disbursements to or between principal and income. In this Act, the first sentence of Section 103(a) states that it also applies to matters within the scope of Articles 2 and 3. Section 103(a)(2) incorporates the rule in Section 2(b) of the 1962 Act that a discretionary allocation made by the trustee that is contrary to a rule in the Act should not give rise to an inference of imprudence or partiality by the trustee.

The Act deletes the language that appears at the end of 1962 Act Section 2(a)(3) - "and in view of the manner in which men of ordinary prudence, discretion and judgment would act in the management of their affairs" - because persons of ordinary prudence, discretion and judgment, acting in the management of their own affairs do not normally think in terms of the interests of successive beneficiaries. If there is an analogy to an individual's decision-making process, it is probably the individual's decision to spend or to save, but this is not a useful guideline for trust administration. No case has been found in which a court has relied on the "prudent man" rule of the 1962 Act.

Fiduciary discretion. The general rule is that if a discretionary power is conferred upon a trustee, the exercise of that power is not subject to control by a court except to prevent an abuse of discretion. Restatement (Second) of Trusts § 187. The situations in which a court will control the exercise of a trustee's discretion are discussed in the comments to § 187. See also id. § 233 Comment *p.*

Questions for which there is no provision. Section 103(a)(4) allocates receipts and disbursements to principal when there is no provision for a different allocation in the terms of the trust, the will, or the Act. This may occur because money is received from a financial instrument not available at the present time (inflation-indexed bonds might have fallen into this category had they been announced after this Act was approved by the Commissioners on Uniform State Laws) or because a transaction is of a type or occurs in a manner not anticipated by the Drafting Committee for this Act or the drafter of the trust instrument.

Allocating to principal a disbursement for which there is no provision in the Act or the terms of the trust preserves the income beneficiary's level of income in the year it is allocated to principal, but thereafter will reduce the amount of income produced by the principal. Allocating to principal a receipt for which there is no provision will increase the income received by the income beneficiary in subsequent years, and will eventually, upon termination of the trust, also favor the remainder beneficiary. Allocating these items to principal

implements the rule that requires a trustee to administer the trust impartially, based on what is fair and reasonable to both income and remainder beneficiaries. However, if the trustee decides that an adjustment between principal and income is needed to enable the trustee to comply with Section 103(b), after considering the return from the portfolio as a whole, the trustee may make an appropriate adjustment under Section 104(a).

Duty of impartiality. Whenever there are two or more beneficiaries, a trustee is under a duty to deal impartially with them. Restatement of Trusts 3d: Prudent Investor Rule § 183 (1992). This rule applies whether the beneficiaries' interests in the trust are concurrent or successive. If the terms of the trust give the trustee discretion to favor one beneficiary over another, a court will not control the exercise of such discretion except to prevent the trustee from abusing it. Id. § 183, Comment *a.* "The precise meaning of the trustee's duty of impartiality and the balancing of competing interests and objectives inevitably are matters of judgment and interpretation. Thus, the duty and balancing are affected by the purposes, terms, distribution requirements, and other circumstances of the trust, not only at the outset but as they may change from time to time." Id. § 232, Comment *c.*

The terms of a trust may provide that the trustee, or an accountant engaged by the trustee, or a committee of persons who may be family members or business associates, shall have the power to determine what is income and what is principal. If the terms of a trust provide that this Act specifically or principal and income legislation in general does not apply to the trust but fail to provide a rule to deal with a matter provided for in this Act, the trustee has an implied grant of discretion to decide the question. Section 103(b) provides that the rule of impartiality applies in the exercise of such a discretionary power to the extent that the terms of the trust do not provide that one or more of the beneficiaries are to be favored. The fact that a person is named an income beneficiary or a remainder beneficiary is not by itself an indication of partiality for that beneficiary.

Section 104. Trustee's Power to Adjust.

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust's income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

(b) In deciding whether and to what extent to exercise the power conferred by subsection (a), a trustee shall consider all factors relevant to the trust and its beneficiaries, including the following factors to the extent they are relevant:

(1) the nature, purpose, and expected duration of the trust;

(2) the intent of the settlor;

(3) the identity and circumstances of the beneficiaries;

(4) the needs for liquidity, regularity of income, and preservation and appreciation of capital;

(5) the assets held in the trust; the extent to which they consist of financial assets, interests in closely held enterprises, tangible and intangible personal property, or real property; the extent to which an asset is used by a beneficiary; and whether an asset was purchased by the trustee or received from the settlor;

(6) the net amount allocated to income under the other sections of this [Act] and the increase or decrease in the value of the principal assets, which the trustee may estimate as to assets for which market values are not readily available;

(7) whether and to what extent the terms of the trust give the trustee the power to invade principal or accumulate income or prohibit the trustee from invading principal or accumulating income, and the extent to which the trustee has exercised a power from time to time to invade principal or accumulate income;

(8) the actual and anticipated effect of economic conditions on principal and income

and effects of inflation and deflation; and

(9) the anticipated tax consequences of an adjustment.

(c) A trustee may not make an adjustment:

(1) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;

(2) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;

(3) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;

(4) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;

(5) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;

(6) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;

(7) if the trustee is a beneficiary of the trust; or

(8) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

(d) If subsection (c)(5), (6), (7), or (8) applies to a trustee and there is more than one trustee, a cotrustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

(e) A trustee may release the entire power conferred by subsection (a) or may release only the power to adjust from income to principal or the power to adjust from principal to income if the trustee is uncertain about whether possessing or exercising the power will cause a result described in subsection (c)(1) through (6) or (c)(8) or if the trustee determines that possessing or exercising the power will or may deprive the trust of a tax benefit or impose a tax burden not described in subsection (c). The release may be permanent or for a specified period, including a period measured by the life of an individual.

(f) Terms of a trust that limit the power of a trustee to make an adjustment between principal and income do not affect the application of this section unless it is clear from the terms of the trust that the terms are intended to deny the trustee the power of adjustment conferred by subsection (a).

Comment

Purpose and Scope of Provision. The purpose of Section 104 is to enable a trustee to select investments using the standards of a prudent investor without having to realize a particular portion of the portfolio's total return in the form of traditional trust accounting income such as interest, dividends, and rents. Section 104(a) authorizes a trustee to make adjustments between principal and income if three conditions are met: (1) the trustee must be managing the trust assets under the prudent investor rule; (2) the terms of the trust must express the income beneficiary's distribution rights in terms of the right to receive "income" in the sense of traditional trust accounting income; and (3) the trustee must determine, after applying the rules in Section 103(a), that he is unable to comply with Section 103(b). In

deciding whether and to what extent to exercise the power to adjust, the trustee is required to consider the factors described in Section 104(b), but the trustee may not make an adjustment in circumstances described in Section 104(c).

Section 104 does not empower a trustee to increase or decrease the degree of beneficial enjoyment to which a beneficiary is entitled under the terms of the trust; rather, it authorizes the trustee to make adjustments between principal and income that may be necessary if the income component of a portfolio's total return is too small or too large because of investment decisions made by the trustee under the prudent investor rule. The paramount consideration in applying Section 104(a) is the requirement in Section 103(b) that "a fiduciary must administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." The power to adjust is subject to control by the court to prevent an abuse of discretion. Restatement (Second) of Trusts § 187 (1959). See also id. §§ 183, 232, 233, Comment *p* (1959).

Section 104 will be important for trusts that are irrevocable when a State adopts the prudent investor rule by statute or judicial approval of the rule in Restatement of Trusts 3d: Prudent Investor Rule. Wills and trust instruments executed after the rule is adopted can be drafted to describe a beneficiary's distribution rights in terms that do not depend upon the amount of trust accounting income, but to the extent that drafters of trust documents continue to describe an income beneficiary's distribution rights by referring to trust accounting income, Section 104 will be an important tool in trust administration.

Three conditions to the exercise of the power to adjust. The first of the three conditions that must be met before a trustee can exercise the power to adjust - that the trustee invest and manage trust assets as a prudent investor - is expressed in this Act by language derived from the Uniform Prudent Investor Act, but the condition will be met whether the prudent investor rule applies because the Uniform Act or other prudent investor legislation has been enacted, the prudent investor rule has been approved by the courts, or the terms of the trust require it. Even if a State's legislature or courts have not formally adopted the rule, the Restatement establishes the prudent investor rule as an authoritative interpretation of the common law prudent man rule, referring to the prudent investor rule as a "modest reformulation of the Harvard College dictum and the basic rule of prior Restatements." Restatement of Trusts 3d: Prudent Investor Rule, Introduction, at 5. As a result, there is a basis for concluding that the first condition is satisfied in virtually all States except those in which a trustee is permitted to invest only in assets set forth in a statutory "legal list."

The second condition will be met when the terms of the trust require all of the "income" to be distributed at regular intervals; or when the terms of the trust require a trustee to distribute all of the income, but permit the trustee to decide how much to distribute to each member of a class of beneficiaries; or when the terms of a trust provide that the beneficiary shall receive the greater of the trust accounting income and a fixed dollar amount (an annuity), or of trust accounting income and a fractional share of the value of the trust assets (a unitrust amount). If the trust authorizes the trustee in its discretion to distribute the trust's income to the beneficiary or to accumulate some or all of the income, the condition will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.

To meet the third condition, the trustee must first meet the requirements of Section 103(a), i.e., she must apply the terms of the trust, decide whether to exercise the discretionary powers given to the trustee under the terms of the trust, and must apply the provisions of the Act if the terms of the trust do not contain a different provision or give the trustee discretion. Second, the trustee must determine the extent to which the terms of the trust clearly manifest an intention by the settlor that the trustee may or must favor one or more of the beneficiaries. To the extent that the terms of the trust do not require partiality, the trustee must conclude that she is unable to comply with the duty to administer the trust impartially. To the extent that the terms of the trust do require or permit the trustee to favor the income beneficiary or the remainder beneficiary, the trustee must conclude that she is unable to achieve the degree of partiality required or permitted. If the trustee comes to either conclusion - that she is unable to administer the trust impartially or that she is unable to achieve the degree of partiality required or permitted - she may exercise the power to adjust under Section 104(a).

Impartiality and productivity of income. The duty of impartiality between income and remainder beneficiaries is linked to the trustee's duty to make the portfolio productive of trust accounting income whenever the distribution requirements are expressed in terms of distributing the trust's "income." The 1962 Act implies that the duty to produce income applies on an asset by asset basis because the right of an income beneficiary to receive "delayed income" from the sale proceeds of underproductive property under Section 12 of that Act arises if "any part of principal ... has not produced an average net income of a least 1% per year of its inventory value for more than a year ... ." Under the prudent investor rule, "[t]o whatever extent a requirement of income productivity exists, ... the requirement applies not investment by investment but to the portfolio as a whole." Restatement of Trusts 3d: Prudent Investor Rule § 227, Comment *i,* at 34. The power to adjust under Section 104(a) is also to be exercised by considering net income from the portfolio as a whole and not investment by investment. Section 413(b) of this Act eliminates the underproductive property rule in all cases other than trusts for which a marital deduction is allowed; the rule applies to a marital deduction trust if the trust's assets "consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets ..." - in other words, the section applies by reference to the portfolio as a whole.

While the purpose of the power to adjust in Section 104(a) is to eliminate the need for a trustee who operates under the prudent investor rule to be concerned about the income component of the portfolio's total return, the trustee must still determine the extent to which a distribution must be made to an income beneficiary and the adequacy of the portfolio's liquidity as a whole to make that distribution.

For a discussion of investment considerations involving specific investments and techniques under the prudent investor rule, see Restatement of Trusts 3d: Prudent Investor Rule § 227, Comments *k-p.*

Factors to consider in exercising the power to adjust. Section 104(b) requires a trustee to consider factors relevant to the trust and its beneficiaries in deciding whether and to what extent the power to adjust should be exercised. Section 2(c) of the Uniform Prudent Investor Act sets forth circumstances that a trustee is to consider in investing and managing trust assets. The circumstances in Section 2(c) of the Uniform Prudent Investor Act are the source of the factors in paragraphs (3) through (6) and (8) of Section 104(b) (modified where necessary to adapt them to the purposes of this Act) so that, to the extent possible, comparable factors will apply to investment decisions and decisions involving the power to adjust. If a trustee who is operating under the prudent investor rule decides that the portfolio should be composed of financial assets whose total return will result primarily from capital appreciation rather than dividends, interest, and rents, the trustee can decide at the same time the extent to which an adjustment from principal to income may be necessary under Section 104. On the other hand, if a trustee decides that the risk and return objectives for the trust are best achieved by a portfolio whose total return includes interest and dividend income that is sufficient to provide the income beneficiary with the beneficial interest to which the beneficiary is entitled under the terms of the trust, the trustee can decide that it is unnecessary to exercise the power to adjust.

Assets received from the settlor. Section 3 of the Uniform Prudent Investor Act provides that "[a] trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying." The special circumstances may include the wish to retain a family business, the benefit derived from deferring liquidation of the asset in order to defer payment of income taxes, or the anticipated capital appreciation from retaining an asset such as undeveloped real estate for a long period. To the extent the trustee retains assets received from the settlor because of special circumstances that overcome the duty to diversify, the trustee may take these circumstances into account in determining whether and to what extent the power to adjust should be exercised to change the results produced by other provisions of this Act that apply to the retained assets. See Section 104(b)(5); Uniform Prudent Investor Act § 3, Comment, 7B U.L.A. 18, at 25-26 (Supp. 1997); Restatement of Trusts 3d: Prudent Investor Rule § 229 and Comments *a-e.*

Limitations on the power to adjust. The purpose of subsections (c)(1) through (4) is to preserve tax benefits that may have been an important purpose for creating the trust.

Subsections (c)(5), (6), and (8) deny the power to adjust in the circumstances described in those subsections in order to prevent adverse tax consequences, and subsection (c)(7) denies the power to adjust to any beneficiary, whether or not possession of the power may have adverse tax consequences.

Under subsection (c)(1), a trustee cannot make an adjustment that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction is allowed; but this subsection does not prevent the trustee from making an adjustment that increases the amount of income paid from a marital deduction trust to the spouse. Subsection (c)(1) applies to a trust that qualifies for the marital deduction because the spouse has a general power of appointment over the trust, but it applies to a qualified terminable interest property (QTIP) trust only if and to the extent that the fiduciary makes the election required to obtain the tax deduction. Subsection (c)(1) does not apply to a so-called "estate" trust. This type of trust qualifies for the marital deduction because the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies; it is not necessary for the terms of an estate trust to require the income to be distributed annually. Reg. § 20.2056(c)-2(b)(1)(iii).

Subsection (c)(3) applies to annuity trusts and unitrusts with no charitable beneficiaries as well as to trusts with charitable income or remainder beneficiaries; its purpose is to make it clear that a beneficiary's right to receive a fixed annuity or a fixed fraction of the value of a trust's assets is not subject to adjustment under Section 104(a). Subsection (c)(3) does not apply to any additional amount to which the beneficiary may be entitled that is expressed in terms of a right to receive income from the trust. For example, if a beneficiary is to receive a fixed annuity or the trust's income, whichever is greater, subsection (c)(3) does not prevent a trustee from making an adjustment under Section 104(a) in determining the amount of the trust's income.

If subsection (c)(5), (6), (7), or (8), prevents a trustee from exercising the power to adjust, subsection (d) permits a cotrustee who is not subject to the provision to exercise the power unless the terms of the trust do not permit the cotrustee to do so.

Release of the power to adjust. Section 104(e) permits a trustee to release all or part of the power to adjust in circumstances in which the possession or exercise of the power might deprive the trust of a tax benefit or impose a tax burden. For example, if possessing the power would diminish the actuarial value of the income interest in a trust for which the income beneficiary's estate may be eligible to claim a credit for property previously taxed if the beneficiary dies within ten years after the death of the person creating the trust, the trustee is permitted under subsection (e) to release just the power to adjust from income to principal.

Trust terms that limit a power to adjust. Section 104(f) applies to trust provisions that limit a trustee's power to adjust. Since the power is intended to enable trustees to employ the prudent investor rule without being constrained by traditional principal and income rules, an instrument executed before the adoption of this Act whose terms describe the amount that may or must be distributed to a beneficiary by referring to the trust's income or that prohibit the invasion of principal or that prohibit equitable adjustments in general should not be construed as forbidding the use of the power to adjust under Section 104(a) if the need for adjustment arises because the trustee is operating under the prudent investor rule. Instruments containing such provisions that are executed after the adoption of this Act should specifically refer to the power to adjust if the settlor intends to forbid its use. See generally, Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Examples. The following examples illustrate the application of Section 104:

Example (1) - T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20% in stocks and 80% in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50% in stocks and 50% in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a smaller amount of dividend and interest income. After considering the factors in Section 104(b), T may transfer cash from principal to income

to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

Example (2) - T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

Example (3) - T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to charity F. E is a retired schoolteacher who is single and has no children. E's income from her social security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Example (4) - T is the trustee of a trust that is governed by the law of State X. The trust became irrevocable before State X adopted the prudent investor rule. The terms of the trust require all of the income to be paid to G for life, remainder to H, and also give T the power to invade principal for the benefit of G for "dire emergencies only." The terms of the trust limit the aggregate amount that T can distribute to G from principal during G's life to 6% of the trust's value at its inception. The trust's portfolio is invested initially 50% in stocks and 50% in bonds, but after State X adopts the prudent investor rule T determines that, to achieve suitable risk and return objectives for the trust, the assets should be invested 90% in stocks and 10% in bonds. This change increases the total return from the portfolio and decreases the dividend and interest income. Thereafter, even though G does not experience a dire emergency, T may exercise the power to adjust under Section 104(a) to the extent that T determines that the adjustment is from only the capital appreciation resulting from the change in the portfolio's asset allocation. If T is unable to determine the extent to which capital appreciation resulted from the change in asset allocation or is unable to maintain adequate records to determine the extent to which principal distributions to G for dire emergencies do not exceed the 6% limitation, T may not exercise the power to adjust. See Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Example (5) - T is the trustee of a trust for the settlor's child. The trust owns a diversified portfolio of marketable financial assets with a value of $600,000, and is also the sole beneficiary of the settlor's IRA, which holds a diversified portfolio of marketable financial assets with a value of $900,000. The trust receives a distribution from the IRA that is the minimum amount required to be distributed under the Internal Revenue Code, and T allocates 10% of the distribution to income under Section 409(c) of this Act. The total return on the IRA's assets exceeds the amount distributed to the trust, and the value of the IRA at the end of the year is more than its value at the beginning of the year. Relevant factors that T may consider in determining whether to exercise the power to adjust and the extent to which an adjustment should be made to comply with Section 103(b) include the total return from all of the trust's assets, those owned directly as well as its interest in the IRA, the extent to which the trust will be subject to income tax on the portion of the IRA distribution that is allocated to principal, and the extent to which the income beneficiary will be subject to income tax on the amount that T distributes to the income beneficiary.

Example (6) - T is the trustee of a trust whose portfolio includes a large parcel of undeveloped real estate. T pays real property taxes on the undeveloped parcel from income each year pursuant to Section 501(3). After considering the return from the trust's portfolio as a whole and other relevant factors described in Section 104(b), T may exercise the power to adjust under Section 104(a) to transfer cash from principal to income in order to distribute to the income beneficiary an amount that T considers necessary to comply with Section 103(b).

Example (7) - T is the trustee of a trust whose portfolio includes an interest in a mutual fund that is sponsored by T. As the manager of the mutual fund, T charges the fund a management fee that reduces the amount available to distribute to the trust by $2,000. If the fee had been paid directly by the trust, one-half of the fee would have been paid from income under Section 501(1) and the other one-half would have been paid from principal under Section 502(a)(1). After considering the total return from the portfolio as a whole and other relevant factors described in Section 104(b), T may exercise its power to adjust under Section 104(a) by transferring $1,000, or half of the trust's proportionate share of the fee, from principal to income.

Section 105. Judicial Control Of Discretionay Power.

(a) The court may not order a fiduciary to change a decision to exercise or not to exercise a discretionary power conferred by this [Act] unless it determines that the decision was an abuse of the fiduciary's discretion. A fiduciary's decision is not an abuse of discretion merely because the court would have exercised the power in a different manner or would not have exercised the power.

(b) The decisions to which subsection (a) applies include:

(1) a decision under Section 104(a) as to whether and to what extent an amount should be transferred from principal to income or from income to principal.

(2) a decision regarding the factors that are relevant to the trust and its beneficiaries, the extent to which the factors are relevant, and the weight, if any, to be given to those factors, in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a).

(c) If the court determines that a fiduciary has abused the fiduciary's discretion, the court may place the income and remainder beneficiaries in the positions they would have occupied if the discretion had not been abused, according to the following rules:

(1) To the extent that the abuse of discretion has resulted in no distribution to a beneficiary or in a distribution that is too small, the court shall order the fiduciary to distribute from the trust to the beneficiary an amount that the court determines will restore the beneficiary, in whole or in part, to the beneficiary's appropriate position.

(2) To the extent that the abuse of discretion has resulted in a distribution to a beneficiary which is too large, the court shall place the beneficiaries, the trust, or both, in whole or in part, in their appropriate positions by ordering the fiduciary to withhold an amount from one or more future distributions to the beneficiary who received the distribution that was too large or ordering that beneficiary to return some or all of the distribution to the trust.

(3) To the extent that the court is unable, after applying paragraphs (1) and (2), to place the beneficiaries, the trust, or both, in the positions they would have occupied if the discretion had not been abused, the court may order the fiduciary to pay an appropriate amount from its own funds to one or more of the beneficiaries or the trust or both.

(d) Upon [petition] by the fiduciary, the court having jurisdiction over a trust or estate shall determine whether a proposed exercise or nonexercise by the fiduciary of a discretionary power conferred by this [Act] will result in an abuse of the fiduciary's discretion. If the petition describes the proposed exercise or nonexercise of the power and contains sufficient information to inform the beneficiaries of the reasons for the proposal, the facts upon which the fiduciary relies, and an explanation of how the income and remainder beneficiaries will be affected by the proposed exercise or nonexercise of the power, a beneficiary who challenges the proposed exercise or nonexercise has the burden of establishing that it will result in an abuse of discretion.

Comment

General. All of the discretionary powers in the 1997 Act are subject to the normal rules that govern a fiduciary's exercise of discretion. Section 105 codifies those rules for purposes of the

Act so that they will be readily apparent and accessible to fiduciaries, beneficiaries, their counsel and the courts if and when questions concerning such powers arise.

Section 105 also makes clear that the normal rules governing the exercise of a fiduciary's powers apply to the discretionary power to adjust conferred upon a trustee by Section 104(a). Discretionary provisions authorizing trustees to determine what is income and what is principal have been used in governing instruments for years; Section 2 of the 1931 Uniform Principal and Income Act recognized that practice by providing that "the person establishing the principal may himself direct the manner of ascertainment of income and principal...or grant discretion to the trustee or other person to do so...." Section 103(a)(2) also recognizes the power of a settlor to grant such discretion to the trustee. Section 105 applies to a discretionary power granted by the terms of a trust or a will as well as the power to adjust in Section 104(a).

Power to Adjust. The exercise of the power to adjust is governed by a trustee's duty of impartiality, which requires the trustee to strike an appropriate balance between the interests of the income and remainder beneficiaries. Section 103(b) expresses this duty by requiring the trustee to "administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or the will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." Because this involves the exercise of judgment in circumstances rarely capable of perfect resolution, trustees are not expected to achieve perfection; they are, however, required to make conscious decisions in good faith and with proper motives.

In seeking the proper balance between the interests of the beneficiaries in matters involving principal and income, a trustee's traditional approach has been to determine the settlor's objectives from the terms of the trust, gather the information needed to ascertain the financial circumstances of the beneficiaries, determine the extent to which the settlor's objectives can be achieved with the resources available in the trust, and then allocate the trust's assets between stocks and fixed-income securities in a way that will produce a particular level or range of income for the income beneficiary. The key element in this process has been to determine the appropriate level or range of income for the income beneficiary, and that will continue to be the key element in deciding whether and to what extent to exercise the discretionary power conferred by Section 104(a). If it becomes necessary for a court to determine whether an abuse of the discretionary power to adjust between principal and income has occurred, the criteria should be the same as those that courts have used in the past to determine whether a trustee has abused its discretion in allocating the trust's assets between stocks and fixed-income securities.

A fiduciary has broad latitude in choosing the methods and criteria to use in deciding whether and to what extent to exercise the power to adjust in order to achieve impartiality between income beneficiaries and remainder beneficiaries or the degree of partiality for one or the other that is provided for by the terms of the trust or the will. For example, in deciding what the appropriate level or range of income should be for the income beneficiary and whether to exercise the power, a trustee may use the methods employed prior to the adoption of the 1997 Act in deciding how to allocate trust assets between stocks and fixed-income securities; or may consider the amount that would be distributed each year based on a percentage of the portfolio's value at the beginning or end of an accounting period, or the average portfolio value for several accounting periods, in a manner similar to a unitrust, and may select a percentage that the trustee believes is appropriate for this purpose and use the same percentage or different percentages in subsequent years. The trustee may also use hypothetical portfolios of marketable securities to determine an appropriate level or range of income within which a distribution might fall.

An adjustment may be made prospectively at the beginning of an accounting period, based on a projected return or range of returns for a trust's portfolio, or retrospectively after the fiduciary knows the total realized or unrealized return for the period; and instead of an annual adjustment, the trustee may distribute a fixed dollar amount for several years, in a manner similar to an annuity, and may change the fixed dollar amount periodically. No inference of abuse is to be drawn if a fiduciary uses different methods or criteria for the same trust from

time to time, or uses different methods or criteria for different trusts for the same accounting period.

While a trustee must consider the portfolio as a whole in deciding whether and to what extent to exercise the power to adjust, a trustee may apply different criteria in considering the portion of the portfolio that is composed of marketable securities and the portion whose market value cannot be determined readily, and may take into account a beneficiary's use or possession of a trust asset.

Under the prudent investor rule, a trustee is to incur costs that are appropriate and reasonable in relation to the assets and the purposes of the trust, and the same consideration applies in determining whether and to what extent to exercise the power to adjust. In making investment decisions under the prudent investor rule, the trustee will have considered the purposes, terms, distribution requirements, and other circumstances of the trust for the purpose of adopting an overall investment strategy having risk and return objectives reasonably suited to the trust. A trustee is not required to duplicate that work for principal and income purposes, and in many cases the decision about whether and to what extent to exercise the power to adjust may be made at the same time as the investment decisions. To help achieve the objective of reasonable investment costs, a trustee may also adopt policies that apply to all trusts or to individual trusts or classes of trusts, based on their size or other criteria, stating whether and under what circumstances the power to adjust will be exercised and the method of making adjustments; no inference of abuse is to be drawn if a trustee adopts such policies.

General rule. The first sentence of Section 105(a) is from Restatement (Second) of Trusts § 187 and Restatement (Third) of Trusts (Tentative Draft No. 2, 1999) § 50(1). The second sentence of Section 105(a) derives from Comment *e* to § 187 of the Second Restatement and Comment *b* to § 50 of the Third Restatement.

The reference in Section 105(a) to a fiduciary's decision to exercise or not to exercise a discretionary power underscores a fundamental precept, which is that a fiduciary has a duty to make a conscious decision about exercising or not exercising a discretionary power. Comment *b* to § 50 of the Third Restatement states:

> [A] court will intervene where the exercise of a power is left to the judgment of a trustee who improperly fails to exercise that judgment. Thus, even where a trustee has discretion whether or not to make any payments to a particular beneficiary, the court will interpose if the trustee, arbitrarily or without knowledge of or inquiry into relevant circumstances, fails to exercise the discretion.

Section 105(b) makes clear that the rule of subsection (a) applies not only to the power conferred by Section 104(a) but also to the evaluation process required by Section 104(b) in deciding whether and to what extent to exercise the power to adjust. Under Section 104(b), a trustee is to consider all of the factors that are relevant to the trust and its beneficiaries, including, to the extent the trustee determines they are relevant, the nine factors enumerated in Section 104(b). Section 104(b) derives from Section 2(c) of the Uniform Prudent Investor Act, which lists eight circumstances that a trustee shall consider, to the extent they are relevant, in investing and managing assets. The trustee's decisions about what factors are relevant for purposes of Section 104(b) and the weight to be accorded each of the relevant factors are part of the discretionary decision-making process. As such, these decisions are not subject to change for the purpose of changing the trustee's ultimate decision unless the court determines that there has been an abuse of discretion in determining the relevancy and weight of these factors.

Remedy. The exercise or nonexercise of a discretionary power under the Act normally affects the amount or timing of a distribution to the income or remainder beneficiaries. The primary remedy under Section 105(c) for abuse of discretion is the restoration of the beneficiaries and the trust to the positions they would have occupied if the abuse had not occurred. It draws on a basic principle of restitution that if a person pays money to someone who is not intended to receive it (and in a case to which this Act applies, not intended by the settlor to receive it in the absence of an abuse of discretion by the trustee), that person is entitled to restitution on the ground that the payee would be unjustly enriched if he were permitted to retain the payment. See Restatement of Restitution § 22 (1937). The objective is

to accomplish the restoration initially by making adjustments between the beneficiaries and the trust to the extent possible; to the extent that restoration is not possible by such adjustments, a court may order the trustee to pay an amount to one or more of the beneficiaries, the trust, or both the beneficiaries and the trust. If the court determines that it is not possible in the circumstances to restore them to the their appropriate positions, the court may provide other remedies appropriate to the circumstances. The approach of Section 105(c) is supported by Comment *b* to § 50 of the Third Restatement of Trusts:

> When judicial intervention is required, a court may direct the trustee to make or refrain from making certain payments; issue instructions to clarify the standards or guidelines applicable to the exercise of the power; or rescind the trustee's payment decisions, usually directing the trustee to recover amounts improperly distributed and holding the trustee liable for failure or inability to do so....

Advance determinations. Section 105(d) employs the familiar remedy of the trustee's petition to the court for instructions. It requires the court to determine, upon a petition by the fiduciary, whether a proposed exercise or nonexercise of a discretionary power by the fiduciary of a power conferred by the Act would be an abuse of discretion under the general rule of Section 105(a). If the petition contains the information prescribed in the second sentence of subsection (d), the proposed action or inaction is presumed not to result in an abuse, and a beneficiary who challenges the proposal must establish that it will.

Subsection (d) is intended to provide a fiduciary the opportunity to obtain an assurance of finality in a judicial proceeding before proceeding with a proposed exercise or nonexercise of a discretionary power. Its purpose is not, however, to have the court instruct the fiduciary how to exercise the discretion.

A fiduciary may also obtain the consent of the beneficiaries to a proposed act or an omission to act, and a beneficiary cannot hold the fiduciary liable for that act or omission unless:

> (a) the beneficiary was under an incapacity at the time of such consent or of such act or omission; or
>
> (b) the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew; or
>
> (c) the consent of the beneficiary was induced by improper conduct of the trustee.

Restatement (Second) of Trusts § 216.

If there are many beneficiaries, including some who are incapacitated or unascertained, the fiduciary may prefer the greater assurance of finality provided by a judicial proceeding that will bind all persons who have an interest in the trust.

[Article] 2

Decendant's estate or

terminating income interest

Section 201. Determination and Distribution of Net Income. After a decedent dies, in the case of an estate, or after an income interest in a trust ends, the following rules apply:

(1) A fiduciary of an estate or of a terminating income interest shall determine the amount of net income and net principal receipts received from property specifically given to a beneficiary under the rules in [Articles] 3 through 5 which apply to trustees and the rules in paragraph (5). The fiduciary shall distribute the net income and net principal receipts to the beneficiary who is to receive the specific property.

(2) A fiduciary shall determine the remaining net income of a decedent's estate or a terminating income interest under the rules in [Articles] 3 through 5 which apply to trustees and by:

(A) including in net income all income from property used to discharge liabilities;

(B) paying from income or principal, in the fiduciary's discretion, fees of attorneys, accountants, and fiduciaries; court costs and other expenses of administration; and interest on death taxes, but the fiduciary may pay those expenses from income of property passing to a trust for which the fiduciary claims an estate tax marital or charitable deduction only to the extent that the payment of those expenses from income will not cause the reduction or loss of the deduction; and

(C) paying from principal all other disbursements made or incurred in connection with the settlement of a decedent's estate or the winding up of a terminating income interest, including debts, funeral expenses, disposition of remains, family allowances, and death taxes and related penalties that are apportioned to the estate or terminating income interest by the will, the terms of the trust, or applicable law.

(3) A fiduciary shall distribute to a beneficiary who receives a pecuniary amount outright the interest or any other amount provided by the will, the terms of the trust, or applicable law from net income determined under paragraph (2) or from principal to the extent that net income is insufficient. If a beneficiary is to receive a pecuniary amount outright from a trust after an income interest ends and no interest or other amount is provided for by the terms of the trust or applicable law, the fiduciary shall distribute the interest or other amount to which the beneficiary would be entitled under applicable law if the pecuniary amount were required to be paid under a will.

(4) A fiduciary shall distribute the net income remaining after distributions required by paragraph (3) in the manner described in Section 202 to all other beneficiaries, including a beneficiary who receives a pecuniary amount in trust, even if the beneficiary holds an unqualified power to withdraw assets from the trust or other presently exercisable general power of appointment over the trust.

(5) A fiduciary may not reduce principal or income receipts from property described in paragraph (1) because of a payment described in Section 501 or 502 to the extent that the will, the terms of the trust, or applicable law requires the fiduciary to make the payment from assets other than the property or to the extent that the fiduciary recovers or expects to recover the payment from a third party. The net income and principal receipts from the property are determined by including all of the amounts the fiduciary receives or pays with respect to the property, whether those amounts accrued or became due before, on, or after the date of a decedent's death or an income interest's terminating event, and by making a reasonable provision for amounts that the fiduciary believes the estate or terminating income interest may become obligated to pay after the property is distributed.

Comment

Terminating income interests and successive income interests. A trust that provides for a single income beneficiary and an outright distribution of the remainder ends when the income interest ends. A more complex trust may have a number of income interests, either concurrent or successive, and the trust will not necessarily end when one of the income interests ends. For that reason, the Act speaks in terms of income interests ending and beginning rather than trusts ending and beginning. When an income interest in a trust ends, the trustee's powers continue during the winding up period required to complete its administration. A terminating income interest is one that has ended but whose administration is not complete.

If two or more people are given the right to receive specified percentages or fractions of the income from a trust concurrently and one of the concurrent interests ends, e.g., when a beneficiary dies, the beneficiary's income interest ends but the trust does not. Similarly, when a trust with only one income beneficiary ends upon the beneficiary's death, the trust instrument may provide that part or all of the trust assets shall continue in trust for another income beneficiary. While it is common to think and speak of this (and even to characterize it in a trust instrument) as a "new" trust, it is a continuation of the original trust for a remainder beneficiary who has an income interest in the trust assets instead of the right to receive them outright. For purposes of this Act, this is a successive income interest in the same trust. The fact that a trust may or may not end when an income interest ends is not significant for

purposes of this Act.

If the assets that are subject to a terminating income interest pass to another trust because the income beneficiary exercises a general power of appointment over the trust assets, the recipient trust would be a new trust; and if they pass to another trust because the beneficiary exercises a nongeneral power of appointment over the trust assets, the recipient trust might be a new trust in some States (see 5A Austin W. Scott & William F. Fratcher, The Law of Trusts § 640, at 483 (4th ed. 1989)); but for purposes of this Act a new trust created in these circumstances is also a successive income interest.

Gift of a pecuniary amount. Section 201(3) and (4) provide different rules for an outright gift of a pecuniary amount and a gift in trust of a pecuniary amount; this is the same approach used in Section 5(b)(2) of the 1962 Act.

Interest on pecuniary amounts. Section 201(3) provides that the beneficiary of an outright pecuniary amount is to receive the interest or other amount provided by applicable law if there is no provision in the will or the terms of the trust. Many States have no applicable law that provides for interest or some other amount to be paid on an outright pecuniary gift under an inter vivos trust; this section provides that in such a case the interest or other amount to be paid shall be the same as the interest or other amount required to be paid on testamentary pecuniary gifts. This provision is intended to accord gifts under inter vivos instruments the same treatment as testamentary gifts. The various state authorities that provide for the amount that a beneficiary of an outright pecuniary amount is entitled to receive are collected in Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions, App. B (4th ed. 1997).

Administration expenses and interest on death taxes. Under Section 201(2)(B) a fiduciary may pay administration expenses and interest on death taxes from either income or principal. An advantage of permitting the fiduciary to choose the source of the payment is that, if the fiduciary's decision is consistent with the decision to deduct these expenses for income tax purposes or estate tax purposes, it eliminates the need to adjust between principal and income that may arise when, for example, an expense that is paid from principal is deducted for income tax purposes or an expense that is paid from income is deducted for estate tax purposes.

The United States Supreme Court has considered the question of whether an estate tax marital deduction or charitable deduction should be reduced when administration expenses are paid from income produced by property passing in trust for a surviving spouse or for charity and deducted for income tax purposes. The Court rejected the IRS position that administration expenses properly paid from income under the terms of the trust or state law must reduce the amount of a marital or charitable transfer, and held that the value of the transferred property is not reduced for estate tax purposes unless the administration expenses are material in light of the income the trust corpus could have been expected to generate. *Commissioner v. Estate of Otis C. Hubert*, 117 S.Ct. 1124 (1997). The provision in Section 201(2)(B) permits a fiduciary to pay and deduct administration expenses from income only to the extent that it will not cause the reduction or loss of an estate tax marital or charitable contributions deduction, which means that the limit on the amount payable from income will be established eventually by Treasury Regulations.

Interest on estate taxes. The IRS agrees that interest on estate and inheritance taxes may be deducted for income tax purposes without having to reduce the estate tax deduction for amounts passing to a charity or surviving spouse, whether the interest is paid from principal or income. Rev. Rul. 93-48, 93-2 C.B. 270. For estates of persons who died before 1998, a fiduciary may not want to deduct for income tax purposes interest on estate tax that is deferred under Section 6166 or 6163 because deducting that interest for estate tax purposes may produce more beneficial results, especially if the estate has little or no income or the income tax bracket is significantly lower than the estate tax bracket. For estates of persons who die after 1997, no estate tax or income tax deduction will be allowed for interest paid on estate tax that is deferred under Section 6166. However, interest on estate tax deferred under Section 6163 will continue to be deductible for both purposes, and interest on estate tax deficiencies will continue to be deductible for estate tax purposes if an election under Section 6166 is not in effect.

Under the 1962 Act, Section 13(c)(5) charges interest on estate and inheritance taxes to principal. The 1931 Act has no provision. Section 501(3) of this Act provides that, except to the extent provided in Section 201(2)(B) or (C), all interest must be paid from income.

Section 202. Distribution to Residuary and Remainder Beneficiaries.

(a) Each beneficiary described in Section 201(4) is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in undistributed principal assets, using values as of the distribution date. If a fiduciary makes more than one distribution of assets to beneficiaries to whom this section applies, each beneficiary, including one who does not receive part of the distribution, is entitled, as of each distribution date, to the net income the fiduciary has received after the date of death or terminating event or earlier distribution date but has not distributed as of the current distribution date.

(b) In determining a beneficiary's share of net income, the following rules apply:

(1) The beneficiary is entitled to receive a portion of the net income equal to the beneficiary's fractional interest in the undistributed principal assets immediately before the distribution date, including assets that later may be sold to meet principal obligations.

(2) The beneficiary's fractional interest in the undistributed principal assets must be calculated without regard to property specifically given to a beneficiary and property required to pay pecuniary amounts not in trust.

(3) The beneficiary's fractional interest in the undistributed principal assets must be calculated on the basis of the aggregate value of those assets as of the distribution date without reducing the value by any unpaid principal obligation.

(4) The distribution date for purposes of this section may be the date as of which the fiduciary calculates the value of the assets if that date is reasonably near the date on which assets are actually distributed.

(c) If a fiduciary does not distribute all of the collected but undistributed net income to each person as of a distribution date, the fiduciary shall maintain appropriate records showing the interest of each beneficiary in that net income.

(d) A fiduciary may apply the rules in this section, to the extent that the fiduciary considers it appropriate, to net gain or loss realized after the date of death or terminating event or earlier distribution date from the disposition of a principal asset if this section applies to the income from the asset.

Comment

Relationship to prior Acts. Section 202 retains the concept in Section 5(b)(2) of the 1962 Act that the residuary legatees of estates are to receive net income earned during the period of administration on the basis of their proportionate interests in the undistributed assets when distributions are made. It changes the basis for determining their proportionate interests by using asset values as of a date reasonably near the time of distribution instead of inventory values; it extends the application of these rules to distributions from terminating trusts; and it extends these rules to gain or loss realized from the disposition of assets during administration, an omission in the 1962 Act that has been noted by several commentators. See, e.g., Richard B. Covey, Marital Deduction and Credit Shelter Dispositions and the Use of Formula Provisions 91 (4th ed. 1998); Thomas H. Cantrill, Fractional or Percentage Residuary Bequests: Allocation of Postmortem Income, Gain and Unrealized Appreciation, 10 Prob. Notes 322, 327 (1985).

[Article] 3

Apportionment at beginning

and end of income interest

Section 301. When Right to Income Begins and Ends.

(a) An income beneficiary is entitled to net income from the date on which the income

interest begins. An income interest begins on the date specified in the terms of the trust or, if no date is specified, on the date an asset becomes subject to a trust or successive income interest.

(b) An asset becomes subject to a trust:

(1) on the date it is transferred to the trust in the case of an asset that is transferred to a trust during the transferor's life;

(2) on the date of a testator's death in the case of an asset that becomes subject to a trust by reason of a will, even if there is an intervening period of administration of the testator's estate; or

(3) on the date of an individual's death in the case of an asset that is transferred to a fiduciary by a third party because of the individual's death.

(c) An asset becomes subject to a successive income interest on the day after the preceding income interest ends, as determined under subsection (d), even if there is an intervening period of administration to wind up the preceding income interest.

(d) An income interest ends on the day before an income beneficiary dies or another terminating event occurs, or on the last day of a period during which there is no beneficiary to whom a trustee may distribute income.

Comment

Period during which there is no beneficiary. The purpose of the second part of subsection (d) is to provide that, at the end of a period during which there is no beneficiary to whom a trustee may distribute income, the trustee must apply the same apportionment rules that apply when a mandatory income interest ends. This provision would apply, for example, if a settlor creates a trust for grandchildren before any grandchildren are born. When the first grandchild is born, the period preceding the date of birth is treated as having ended, followed by a successive income interest, and the apportionment rules in Sections 302 and 303 apply accordingly if the terms of the trust do not contain different provisions.

Section 302. Apportionment of Receipts and Disbursements When Decedent Dies or Income Interest Begins.

(a) A trustee shall allocate an income receipt or disbursement other than one to which Section 201(1) applies to principal if its due date occurs before a decedent dies in the case of an estate or before an income interest begins in the case of a trust or successive income interest.

(b) A trustee shall allocate an income receipt or disbursement to income if its due date occurs on or after the date on which a decedent dies or an income interest begins and it is a periodic due date. An income receipt or disbursement must be treated as accruing from day to day if its due date is not periodic or it has no due date. The portion of the receipt or disbursement accruing before the date on which a decedent dies or an income interest begins must be allocated to principal and the balance must be allocated to income.

(c) An item of income or an obligation is due on the date the payer is required to make a payment. If a payment date is not stated, there is no due date for the purposes of this [Act]. Distributions to shareholders or other owners from an entity to which Section 401 applies are deemed to be due on the date fixed by the entity for determining who is entitled to receive the distribution or, if no date is fixed, on the declaration date for the distribution. A due date is periodic for receipts or disbursements that must be paid at regular intervals under a lease or an obligation to pay interest or if an entity customarily makes distributions at regular intervals.

Comment

Prior Acts. Professor Bogert stated that "Section 4 of the [1962] Act makes a change with respect to the apportionment of the income of trust property not due until after the trust began but which accrued in part before the commencement of the trust. It treats such income

as to be credited entirely to the income account in the case of a living trust, but to be apportioned between capital and income in the case of a testamentary trust. The [1931] Act apportions such income in the case of both types of trusts, except in the case of corporate dividends." George G. Bogert, The Revised Uniform Principal and Income Act, 38 Notre Dame Law. 50, 52 (1962). The 1962 Act also provides that an asset passing to an inter vivos trust by a bequest in the settlor's will is governed by the rule that applies to a testamentary trust, so that different rules apply to assets passing to an inter vivos trust depending upon whether they were transferred to the trust during the settlor's life or by his will.

Having several different rules that apply to similar transactions is confusing. In order to simplify administration, Section 302 applies the same rule to inter vivos trusts (revocable and irrevocable), testamentary trusts, and assets that become subject to an inter vivos trust by a testamentary bequest.

Periodic payments. Under Section 302, a periodic payment is principal if it is due but unpaid before a decedent dies or before an asset becomes subject to a trust, but the next payment is allocated entirely to income and is not apportioned. Thus, periodic receipts such as rents, dividends, interest, and annuities, and disbursements such as the interest portion of a mortgage payment, are not apportioned. This is the original common law rule. Edwin A. Howes, Jr., The American Law Relating to Income and Principal 70 (1905). In trusts in which a surviving spouse is dependent upon a regular flow of cash from the decedent's securities portfolio, this rule will help to maintain payments to the spouse at the same level as before the settlor's death. Under the 1962 Act, the pre-death portion of the first periodic payment due after death is apportioned to principal in the case of a testamentary trust or securities bequeathed by will to an inter vivos trust.

Nonperiodic payments. Under the second sentence of Section 302(b), interest on an obligation that does not provide a due date for the interest payment, such as interest on an income tax refund, would be apportioned to principal to the extent it accrues before a person dies or an income interest begins unless the obligation is specifically given to a devisee or remainder beneficiary, in which case all of the accrued interest passes under Section 201(1) to the person who receives the obligation. The same rule applies to interest on an obligation that has a due date but does not provide for periodic payments. If there is no stated interest on the obligation, such as a zero coupon bond, and the proceeds from the obligation are received more than one year after it is purchased or acquired by the trustee, the entire amount received is principal under Section 406.

Section 303. Apportionment When Income Interest Ends.

(a) In this section, "undistributed income" means net income received before the date on which an income interest ends. The term does not include an item of income or expense that is due or accrued or net income that has been added or is required to be added to principal under the terms of the trust.

(b) When a mandatory income interest ends, the trustee shall pay to a mandatory income beneficiary who survives that date, or the estate of a deceased mandatory income beneficiary whose death causes the interest to end, the beneficiary's share of the undistributed income that is not disposed of under the terms of the trust unless the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. In the latter case, the undistributed income from the portion of the trust that may be revoked must be added to principal.

(c) When a trustee's obligation to pay a fixed annuity or a fixed fraction of the value of the trust's assets ends, the trustee shall prorate the final payment if and to the extent required by applicable law to accomplish a purpose of the trust or its settlor relating to income, gift, estate, or other tax requirements.

Comment

Prior Acts. Both the 1931 Act (Section 4) and the 1962 Act (Section 4(d)) provide that a deceased income beneficiary's estate is entitled to the undistributed income. The Drafting Committee concluded that this is probably not what most settlors would want, and that, with respect to undistributed income, most settlors would favor the income beneficiary first, the remainder beneficiaries second, and the income beneficiary's heirs last, if at all. However, it

decided not to eliminate this provision to avoid causing disputes about whether the trustee should have distributed collected cash before the income beneficiary died.

Accrued periodic payments. Under the prior Acts, an income beneficiary or his estate is entitled to receive a portion of any payments, other than dividends, that are due or that have accrued when the income interest terminates. The last sentence of subsection (a) changes that rule by providing that such items are not included in undistributed income. The items affected include periodic payments of interest, rent, and dividends, as well as items of income that accrue over a longer period of time; the rule also applies to expenses that are due or accrued.

Example - accrued periodic payments. The rules in Section 302 and Section 303 work in the following manner: Assume that a periodic payment of rent that is due on July 20 has not been paid when an income interest ends on July 30; the successive income interest begins on July 31, and the rent payment that was due on July 20 is paid on August 3. Under Section 302(a), the July 20 payment is added to the principal of the successive income interest when received. Under Section 302(b), the entire periodic payment of rent that is due on August 20 is income when received by the successive income interest. Under Section 303, neither the income beneficiary of the terminated income interest nor the beneficiary's estate is entitled to any part of either the July 20 or the August 20 payments because neither one was received before the income interest ended on July 30. The same principles apply to expenses of the trust.

Beneficiary with an unqualified power to revoke. The requirement in subsection (b) to pay undistributed income to a mandatory income beneficiary or her estate does not apply to the extent the beneficiary has an unqualified power to revoke more than five percent of the trust immediately before the income interest ends. Without this exception, subsection (b) would apply to a revocable living trust whose settlor is the mandatory income beneficiary during her lifetime, even if her will provides that all of the assets in the probate estate are to be distributed to the trust.

If a trust permits the beneficiary to withdraw all or a part of the trust principal after attaining a specified age and the beneficiary attains that age but fails to withdraw all of the principal that she is permitted to withdraw, a trustee is not required to pay her or her estate the undistributed income attributable to the portion of the principal that she left in the trust. The assumption underlying this rule is that the beneficiary has either provided for the disposition of the trust assets (including the undistributed income) by exercising a power of appointment that she has been given or has not withdrawn the assets because she is willing to have the principal and undistributed income be distributed under the terms of the trust. If the beneficiary has the power to withdraw 25% of the trust principal, the trustee must pay to her or her estate the undistributed income from the 75% that she cannot withdraw.

[Article] 4

Allocation of receipts during

administration of trust

[Part 1

Receipts from entities]

Section 401. Character of Receipts.

(a) In this section, "entity" means a corporation, partnership, limited liability company, regulated investment company, real estate investment trust, common trust fund, or any other organization in which a trustee has an interest other than a trust or estate to which Section 402 applies, a business or activity to which Section 403 applies, or an asset-backed security to which Section 415 applies.

(b) Except as otherwise provided in this section, a trustee shall allocate to income money received from an entity.

(c) A trustee shall allocate the following receipts from an entity to principal:

(1) property other than money;

(2) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity;

(3) money received in total or partial liquidation of the entity; and

(4) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a capital gain dividend for federal income tax purposes.

(d) Money is received in partial liquidation:

(1) to the extent that the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation; or

(2) if the total amount of money and property received in a distribution or series of related distributions is greater than 20 percent of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.

(e) Money is not received in partial liquidation, nor may it be taken into account under subsection (d)(2), to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

(f) A trustee may rely upon a statement made by an entity about the source or character of a distribution if the statement is made at or near the time of distribution by the entity's board of directors or other person or group of persons authorized to exercise powers to pay money or transfer property comparable to those of a corporation's board of directors.

Comment

Entities to which Section 401 applies. The reference to partnerships in Section 401(a) is intended to include all forms of partnerships, including limited partnerships, limited liability partnerships, and variants that have slightly different names and characteristics from State to State. The section does not apply, however, to receipts from an interest in property that a trust owns as a tenant in common with one or more co-owners, nor would it apply to an interest in a joint venture if, under applicable law, the trust's interest is regarded as that of a tenant in common.

Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

Reinvested dividends. If a trustee elects (or continues an election made by its predecessor) to reinvest dividends in shares of stock of a distributing corporation or fund, whether evidenced by new certificates or entries on the books of the distributing entity, the new shares would be principal. Making or continuing such an election would be equivalent to deciding under Section 104 to transfer income to principal in order to comply with Section 103(b). However, if the trustee makes or continues the election for a reason other than to comply with Section 103(b), e.g., to make an investment without incurring brokerage commissions, the trustee should transfer cash from principal to income in an amount equal to the reinvested dividends.

Distribution of property. The 1962 Act describes a number of types of property that would be principal if distributed by a corporation. This becomes unwieldy in a section that applies to both corporations and all other entities. By stating that principal includes the distribution of any property other than money, Section 401 embraces all of the items enumerated in Section 6 of the 1962 Act as well as any other form of nonmonetary distribution not specifically mentioned in that Act.

Partial liquidations. Under subsection (d)(1), any distribution designated by the entity

as a partial liquidating distribution is principal regardless of the percentage of total assets that it represents. If a distribution exceeds 20% of the entity's gross assets, the entire distribution is a partial liquidation under subsection (d)(2) whether or not the entity describes it as a partial liquidation. In determining whether a distribution is greater than 20% of the gross assets, the portion of the distribution that does not exceed the amount of income tax that the trustee or a beneficiary must pay on the entity's taxable income is ignored.

Other large distributions. A cash distribution may be quite large (for example, more than 10% but not more than 20% of the entity's gross assets) and have characteristics that suggest it should be treated as principal rather than income. For example, an entity may have received cash from a source other than the conduct of its normal business operations because it sold an investment asset; or because it sold a business asset other than one held for sale to customers in the normal course of its business and did not replace it; or it borrowed a large sum of money and secured the repayment of the loan with a substantial asset; or a principal source of its cash was from assets such as mineral interests, 90% of which would have been allocated to principal if the trust had owned the assets directly. In such a case the trustee, after considering the total return from the portfolio as a whole and the income component of that return, may decide to exercise the power under Section 104(a) to make an adjustment between income and principal, subject to the limitations in Section 104(c).

Section 402. Distribution From Trust or Estate. A trustee shall allocate to income an amount received as a distribution of income from a trust or an estate in which the trust has an interest other than a purchased interest, and shall allocate to principal an amount received as a distribution of principal from such a trust or estate. If a trustee purchases an interest in a trust that is an investment entity, or a decedent or donor transfers an interest in such a trust to a trustee, Section 401 or 415 applies to a receipt from the trust.

Comment

Terms of the distributing trust or estate. Under Section 103(a), a trustee is to allocate receipts in accordance with the terms of the recipient trust or, if there is no provision, in accordance with this Act. However, in determining whether a distribution from another trust or an estate is income or principal, the trustee should also determine what the terms of the distributing trust or estate say about the distribution - for example, whether they direct that the distribution, even though made from the income of the distributing trust or estate, is to be added to principal of the recipient trust. Such a provision should override the terms of this Act, but if the terms of the recipient trust contain a provision requiring such a distribution to be allocated to income, the trustee may have to obtain a judicial resolution of the conflict between the terms of the two documents.

Investment trusts. An investment entity to which the second sentence of this section applies includes a mutual fund, a common trust fund, a business trust or other entity organized as a trust for the purpose of receiving capital contributed by investors, investing that capital, and managing investment assets, including asset-backed security arrangements to which Section 415 applies. See John H. Langbein, The Secret Life of the Trust: The Trust as an Instrument of Commerce, 107 Yale L.J. 165 (1997).

Section 403. Business and Other Activities Conducted By Trustee.

(a) If a trustee who conducts a business or other activity determines that it is in the best interest of all the beneficiaries to account separately for the business or activity instead of accounting for it as part of the trust's general accounting records, the trustee may maintain separate accounting records for its transactions, whether or not its assets are segregated from other trust assets.

(b) A trustee who accounts separately for a business or other activity may determine the extent to which its net cash receipts must be retained for working capital, the acquisition or replacement of fixed assets, and other reasonably foreseeable needs of the business or activity, and the extent to which the remaining net cash receipts are accounted for as principal or income in the trust's general accounting records. If a trustee sells assets of the business or other activity, other than in the ordinary course of the business or activity, the trustee shall account for the net amount received as principal in the trust's general accounting records to the extent the trustee determines that the amount received is no longer required in the

conduct of the business.

(c) Activities for which a trustee may maintain separate accounting records include:

(1) retail, manufacturing, service, and other traditional business activities;

(2) farming;

(3) raising and selling livestock and other animals;

(4) management of rental properties;

(5) extraction of minerals and other natural resources;

(6) timber operations; and

(7) activities to which Section 414 applies.

Comment

Purpose and scope. The provisions in Section 403 are intended to give greater flexibility to a trustee who operates a business or other activity in proprietorship form rather than in a wholly-owned corporation (or, where permitted by state law, a single-member limited liability company), and to facilitate the trustee's ability to decide the extent to which the net receipts from the activity should be allocated to income, just as the board of directors of a corporation owned entirely by the trust would decide the amount of the annual dividend to be paid to the trust. It permits a trustee to account for farming or livestock operations, rental properties, oil and gas properties, timber operations, and activities in derivatives and options as though they were held by a separate entity. It is not intended, however, to permit a trustee to account separately for a traditional securities portfolio to avoid the provisions of this Act that apply to such securities.

Section 403 permits the trustee to account separately for each business or activity for which the trustee determines separate accounting is appropriate. A trustee with a computerized accounting system may account for these activities in a "subtrust"; an individual trustee may continue to use the business and record-keeping methods employed by the decedent or transferor who may have conducted the business under an assumed name. The intent of this section is to give the trustee broad authority to select business record-keeping methods that best suit the activity in which the trustee is engaged.

If a fiduciary liquidates a sole proprietorship or other activity to which Section 403 applies, the proceeds would be added to principal, even though derived from the liquidation of accounts receivable, because the proceeds would no longer be needed in the conduct of the business. If the liquidation occurs during probate or during an income interest's winding up period, none of the proceeds would be income for purposes of Section 201.

Separate accounts. A trustee may or may not maintain separate bank accounts for business activities that are accounted for under Section 403. A professional trustee may decide not to maintain separate bank accounts, but an individual trustee, especially one who has continued a decedent's business practices, may continue the same banking arrangements that were used during the decedent's lifetime. In either case, the trustee is authorized to decide to what extent cash is to be retained as part of the business assets and to what extent it is to be transferred to the trust's general accounts, either as income or principal.

[Part 2

Receipts not normally apportioned]

Section 404. Principal Receipts. A trustee shall allocate to principal:

(1) to the extent not allocated to income under this [Act], assets received from a transferor during the transferor's lifetime, a decedent's estate, a trust with a terminating income interest, or a payer under a contract naming the trust or its trustee as beneficiary;

(2) money or other property received from the sale, exchange, liquidation, or change in form of a principal asset, including realized profit, subject to this [article];

(3) amounts recovered from third parties to reimburse the trust because of disbursements described in Section 502(a)(7) or for other reasons to the extent not based on the loss of income;

(4) proceeds of property taken by eminent domain, but a separate award made for the loss of income with respect to an accounting period during which a current income beneficiary had a mandatory income interest is income;

(5) net income received in an accounting period during which there is no beneficiary to whom a trustee may or must distribute income; and

(6) other receipts as provided in [Part 3].

Comment

Eminent domain awards. Even though the award in an eminent domain proceeding may include an amount for the loss of future rent on a lease, if that amount is not separately stated the entire award is principal. The rule is the same in the 1931 and 1962 Acts.

Section 405. Rental Property. To the extent that a trustee accounts for receipts from rental property pursuant to this section, the trustee shall allocate to income an amount received as rent of real or personal property, including an amount received for cancellation or renewal of a lease. An amount received as a refundable deposit, including a security deposit or a deposit that is to be applied as rent for future periods, must be added to principal and held subject to the terms of the lease and is not available for distribution to a beneficiary until the trustee's contractual obligations have been satisfied with respect to that amount.

Comment

Application of Section 403. This section applies to the extent that the trustee does not account separately under Section 403 for the management of rental properties owned by the trust.

Receipts that are capital in nature. A portion of the payment under a lease may be a reimbursement of principal expenditures for improvements to the leased property that is characterized as rent for purposes of invoking contractual or statutory remedies for nonpayment. If the trustee is accounting for rental income under Section 405, a transfer from income to reimburse principal may be appropriate under Section 504 to the extent that some of the "rent" is really a reimbursement for improvements. This set of facts could also be a relevant factor for a trustee to consider under Section 104(b) in deciding whether and to what extent to make an adjustment between principal and income under Section 104(a) after considering the return from the portfolio as a whole.

Section 406. Obligation to Pay Money.

(a) An amount received as interest, whether determined at a fixed, variable, or floating rate, on an obligation to pay money to the trustee, including an amount received as consideration for prepaying principal, must be allocated to income without any provision for amortization of premium.

(b) A trustee shall allocate to principal an amount received from the sale, redemption, or other disposition of an obligation to pay money to the trustee more than one year after it is purchased or acquired by the trustee, including an obligation whose purchase price or value when it is acquired is less than its value at maturity. If the obligation matures within one year after it is purchased or acquired by the trustee, an amount received in excess of its purchase price or its value when acquired by the trust must be allocated to income.

(c) This section does not apply to an obligation to which Section 409, 410, 411, 412, 414, or 415 applies.

Comment

Variable or floating interest rates. The reference in subsection (a) to variable or floating interest rate obligations is intended to clarify that, even though an obligation's interest rate may change from time to time based upon changes in an index or other market indicator, an obligation to pay money containing a variable or floating rate provision is subject to this section and is not to be treated as a derivative financial instrument under Section 414.

Discount obligations. Subsection (b) applies to all obligations acquired at a discount, including short-term obligations such as U.S. Treasury Bills, long-term obligations such as U.S. Savings Bonds, zero-coupon bonds, and discount bonds that pay interest during part, but not all, of the period before maturity. Under subsection (b), the entire increase in value of these obligations is principal when the trustee receives the proceeds from the disposition unless the obligation, when acquired, has a maturity of less than one year. In order to have one rule that applies to all discount obligations, the Act eliminates the provision in the 1962 Act for the payment from principal of an amount equal to the increase in the value of U.S. Series E bonds. The provision for bonds that mature within one year after acquisition by the trustee is derived from the Illinois act. 760 ILCS 15/8 (1996).

Subsection (b) also applies to inflation-indexed bonds - any increase in principal due to inflation after issuance is principal upon redemption if the bond matures more than one year after the trustee acquires it; if it matures within one year, all of the increase, including any attributable to an inflation adjustment, is income.

Effect of Section 104. In deciding whether and to what extent to exercise the power to adjust between principal and income granted by Section 104(a), a relevant factor for the trustee to consider is the effect on the portfolio as a whole of having a portion of the assets invested in bonds that do not pay interest currently.

Section 407. Insurance Policies and Similar Contracts.

(a) Except as otherwise provided in subsection (b), a trustee shall allocate to principal the proceeds of a life insurance policy or other contract in which the trust or its trustee is named as beneficiary, including a contract that insures the trust or its trustee against loss for damage to, destruction of, or loss of title to a trust asset. The trustee shall allocate dividends on an insurance policy to income if the premiums on the policy are paid from income, and to principal if the premiums are paid from principal.

(b) A trustee shall allocate to income proceeds of a contract that insures the trustee against loss of occupancy or other use by an income beneficiary, loss of income, or, subject to Section 403, loss of profits from a business.

(c) This section does not apply to a contract to which Section 409 applies.

[Part 3

Receipts normally apportioned]

Section 408. Insubstantial Allocations Not Required. If a trustee determines that an allocation between principal and income required by Section 409, 410, 411, 412, or 415 is insubstantial, the trustee may allocate the entire amount to principal unless one of the circumstances described in Section 104(c) applies to the allocation. This power may be exercised by a cotrustee in the circumstances described in Section 104(d) and may be released for the reasons and in the manner described in Section 104(e). An allocation is presumed to be insubstantial if:

(1) the amount of the allocation would increase or decrease net income in an accounting period, as determined before the allocation, by less than 10 percent; or

(2) the value of the asset producing the receipt for which the allocation would be made is less than 10 percent of the total value of the trust's assets at the beginning of the accounting period.

Comment

This section is intended to relieve a trustee from making relatively small allocations while preserving the trustee's right to do so if an allocation is large in terms of absolute dollars.

For example, assume that a trust's assets, which include a working interest in an oil well, have a value of $1,000,000; the net income from the assets other than the working interest is $40,000; and the net receipts from the working interest are $400. The trustee may allocate all of the net receipts from the working interest to principal instead of allocating 10%, or $40, to income under Section 411. If the net receipts from the working interest are $35,000, so that the amount allocated to income under Section 411 would be $3,500, the trustee may decide that this amount is sufficiently significant to the income beneficiary that the allocation provided for by Section 411 should be made, even though the trustee is still permitted under Section 408 to allocate all of the net receipts to principal because the $3,500 would increase the net income of $40,000, as determined before making an allocation under Section 411, by less than 10%. Section 408 will also relieve a trustee from having to allocate net receipts from the sale of trees in a small woodlot between principal and income.

While the allocation to principal of small amounts under this section should not be a cause for concern for tax purposes, allocations are not permitted under this section in circumstances described in Section 104(c) to eliminate claims that the power in this section has adverse tax consequences.

Section 409. Deferred Compensation, Annuities, and Similar Payments.

(a) In this section, "payment" means a payment that a trustee may receive over a fixed number of years or during the life of one or more individuals because of services rendered or property transferred to the payer in exchange for future payments. The term includes a payment made in money or property from the payer's general assets or from a separate fund created by the payer, including a private or commercial annuity, an individual retirement account, and a pension, profit-sharing, stock-bonus, or stock-ownership plan.

(b) To the extent that a payment is characterized as interest or a dividend or a payment made in lieu of interest or a dividend, a trustee shall allocate it to income. The trustee shall allocate to principal the balance of the payment and any other payment received in the same accounting period that is not characterized as interest, a dividend, or an equivalent payment.

(c) If no part of a payment is characterized as interest, a dividend, or an equivalent payment, and all or part of the payment is required to be made, a trustee shall allocate to income 10 percent of the part that is required to be made during the accounting period and the balance to principal. If no part of a payment is required to be made or the payment received is the entire amount to which the trustee is entitled, the trustee shall allocate the entire payment to principal. For purposes of this subsection, a payment is not "required to be made" to the extent that it is made because the trustee exercises a right of withdrawal.

(d) If, to obtain an estate tax marital deduction for a trust, a trustee must allocate more of a payment to income than provided for by this section, the trustee shall allocate to income the additional amount necessary to obtain the marital deduction.

(e) This section does not apply to payments to which Section 410 applies.

Comment

Scope. Section 409 applies to amounts received under contractual arrangements that provide for payments to a third party beneficiary as a result of services rendered or property transferred to the payer. While the right to receive such payments is a liquidating asset of the kind described in Section 410 (i.e., "an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration"), these payment rights are covered separately in Section 409 because of their special characteristics.

Section 409 applies to receipts from all forms of annuities and deferred compensation arrangements, whether the payment will be received by the trust in a lump sum or in installments over a period of years. It applies to bonuses that may be received over two or three years and payments that may last for much longer periods, including payments from an individual retirement account (IRA), deferred compensation plan (whether qualified or not

qualified for special federal income tax treatment), and insurance renewal commissions. It applies to a retirement plan to which the settlor has made contributions, just as it applies to an annuity policy that the settlor may have purchased individually, and it applies to variable annuities, deferred annuities, annuities issued by commercial insurance companies, and "private annuities" arising from the sale of property to another individual or entity in exchange for payments that are to be made for the life of one or more individuals. The section applies whether the payments begin when the payment right becomes subject to the trust or are deferred until a future date, and it applies whether payments are made in cash or in kind, such as employer stock (in-kind payments usually will be made in a single distribution that will be allocated to principal under the second sentence of subsection (c)).

The 1962 Act. Under Section 12 of the 1962 Act, receipts from "rights to receive payments on a contract for deferred compensation" are allocated to income each year in an amount "not in excess of 5% per year" of the property's inventory value. While "not in excess of 5%" suggests that the annual allocation may range from zero to 5% of the inventory value, in practice the rule is usually treated as prescribing a 5% allocation. The inventory value is usually the present value of all the future payments, and since the inventory value is determined as of the date on which the payment right becomes subject to the trust, the inventory value, and thus the amount of the annual income allocation, depends significantly on the applicable interest rate on the decedent's date of death. That rate may be much higher or lower than the average long-term interest rate. The amount determined under the 5% formula tends to become fixed and remain unchanged even though the amount received by the trust increases or decreases.

Allocations Under Section 409(b). Section 409(b) applies to plans whose terms characterize payments made under the plan as dividends, interest, or payments in lieu of dividends or interest. For example, some deferred compensation plans that hold debt obligations or stock of the plan's sponsor in an account for future delivery to the person rendering the services provide for the annual payment to that person of dividends received on the stock or interest received on the debt obligations. Other plans provide that the account of the person rendering the services shall be credited with "phantom" shares of stock and require an annual payment that is equivalent to the dividends that would be received on that number of shares if they were actually issued; or a plan may entitle the person rendering the services to receive a fixed dollar amount in the future and provide for the annual payment of interest on the deferred amount during the period prior to its payment. Under Section 409(b), payments of dividends, interest or payments in lieu of dividends or interest under plans of this type are allocated to income; all other payments received under these plans are allocated to principal.

Section 409(b) does not apply to an IRA or an arrangement with payment provisions similar to an IRA. IRAs and similar arrangements are subject to the provisions in Section 409(c).

Allocations Under Section 409(c). The focus of Section 409, for purposes of allocating payments received by a trust to or between principal and income, is on the payment right rather than on assets that may be held in a fund from which the payments are made. Thus, if an IRA holds a portfolio of marketable stocks and bonds, the amount received by the IRA as dividends and interest is not taken into account in determining the principal and income allocation except to the extent that the Internal Revenue Service may require them to be taken into account when the payment is received by a trust that qualifies for the estate tax marital deduction (a situation that is provided for in Section 409(d)). An IRA is subject to federal income tax rules that require payments to begin by a particular date and be made over a specific number of years or a period measured by the lives of one or more persons. The payment right of a trust that is named as a beneficiary of an IRA is not a right to receive particular items that are paid to the IRA, but is instead the right to receive an amount determined by dividing the value of the IRA by the remaining number of years in the payment period. This payment right is similar to the right to receive a unitrust amount, which is normally expressed as an amount equal to a percentage of the value of the unitrust assets without regard to dividends or interest that may be received by the unitrust.

An amount received from an IRA or a plan with a payment provision similar to that of an IRA is allocated under Section 409(c), which differentiates between payments that are required to be made and all other payments. To the extent that a payment is required to be

made (either under federal income tax rules or, in the case of a plan that is not subject to those rules, under the terms of the plan), 10% of the amount received is allocated to income and the balance is allocated to principal. All other payments are allocated to principal because they represent a change in the form of a principal asset; Section 409 follows the rule in Section 404(2), which provides that money or property received from a change in the form of a principal asset be allocated to principal.

Section 409(c) produces an allocation to income that is similar to the allocation under the 1962 Act formula if the annual payments are the same throughout the payment period, and it is simpler to administer. The amount allocated to income under Section 409 is not dependent upon the interest rate that is used for valuation purposes when the decedent dies, and if the payments received by the trust increase or decrease from year to year because the fund from which the payment is made increases or decreases in value, the amount allocated to income will also increase or decrease.

Marital deduction requirements. When an IRA is payable to a QTIP marital deduction trust, the IRS treats the IRA as separate terminable interest property and requires that a QTIP election be made for it. In order to qualify for QTIP treatment, an IRS ruling states that all of the IRA's income must be distributed annually to the QTIP marital deduction trust and then must be allocated to trust income for distribution to the spouse. Rev. Rul. 89-89, 1989-2 C.B. 231. If an allocation to income under this Act of 10% of the required distribution from the IRA does not meet the requirement that all of the IRA's income be distributed from the trust to the spouse, the provision in subsection (d) requires the trustee to make a larger allocation to income to the extent necessary to qualify for the marital deduction. The requirement of Rev. Rul. 89-89 should also be satisfied if the IRA beneficiary designation permits the spouse to require the trustee to withdraw the necessary amount from the IRA and distribute it to her, even though the spouse never actually requires the trustee to do so. If such a provision is in the beneficiary designation, a distribution under subsection (d) should not be necessary.

Application of Section 104. Section 104(a) of this Act gives a trustee who is acting under the prudent investor rule the power to adjust from principal to income if, considering the portfolio as a whole and not just receipts from deferred compensation, the trustee determines that an adjustment is necessary. See Example (5) in the Comment following Section 104.

Section 410. Liquidating Asset.

(a) In this section, "liquidating asset" means an asset whose value will diminish or terminate because the asset is expected to produce receipts for a period of limited duration. The term includes a leasehold, patent, copyright, royalty right, and right to receive payments during a period of more than one year under an arrangement that does not provide for the payment of interest on the unpaid balance. The term does not include a payment subject to Section 409, resources subject to Section 411, timber subject to Section 412, an activity subject to Section 414, an asset subject to Section 415, or any asset for which the trustee establishes a reserve for depreciation under Section 503.

(b) A trustee shall allocate to income 10 percent of the receipts from a liquidating asset and the balance to principal.

Comment

Prior Acts. Section 11 of the 1962 Act allocates receipts from "property subject to depletion" to income in an amount "not in excess of 5%" of the asset's inventory value. The 1931 Act has a similar 5% rule that applies when the trustee is under a duty to change the form of the investment. The 5% rule imposes on a trust the obligation to pay a fixed annuity to the income beneficiary until the asset is exhausted. Under both the 1931 and 1962 Acts the balance of each year's receipts is added to principal. A fixed payment can produce unfair results. The remainder beneficiary receives all of the receipts from unexpected growth in the asset, e.g., if royalties on a patent or copyright increase significantly. Conversely, if the receipts diminish more rapidly than expected, most of the amount received by the trust will be allocated to income and little to principal. Moreover, if the annual payments remain the same for the life of the asset, the amount allocated to principal will usually be less than the original inventory value. For these reasons, Section 410 abandons the annuity approach under the

5% rule.

Lottery payments. The reference in subsection (a) to rights to receive payments under an arrangement that does not provide for the payment of interest includes state lottery prizes and similar fixed amounts payable over time that are not deferred compensation arrangements covered by Section 409.

Section 411. Minerals, Water, and Other Natural Resources.

(a) To the extent that a trustee accounts for receipts from an interest in minerals or other natural resources pursuant to this section, the trustee shall allocate them as follows:

(1) If received as nominal delay rental or nominal annual rent on a lease, a receipt must be allocated to income.

(2) If received from a production payment, a receipt must be allocated to income if and to the extent that the agreement creating the production payment provides a factor for interest or its equivalent. The balance must be allocated to principal.

(3) If an amount received as a royalty, shut-in-well payment, take-or-pay payment, bonus, or delay rental is more than nominal, 90 percent must be allocated to principal and the balance to income.

(4) If an amount is received from a working interest or any other interest not provided for in paragraph (1), (2), or (3), 90 percent of the net amount received must be allocated to principal and the balance to income.

(b) An amount received on account of an interest in water that is renewable must be allocated to income. If the water is not renewable, 90 percent of the amount must be allocated to principal and the balance to income.

(c) This [Act] applies whether or not a decedent or donor was extracting minerals, water, or other natural resources before the interest became subject to the trust.

(d) If a trust owns an interest in minerals, water, or other natural resources on [the effective date of this [Act]], the trustee may allocate receipts from the interest as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in minerals, water, or other natural resources after [the effective date of this [Act]], the trustee shall allocate receipts from the interest as provided in this [Act].

Comment

Prior Acts. The 1962 Act allocates to principal as a depletion allowance, 27-1/2% of the gross receipts, but not more than 50% of the net receipts after paying expenses. The Internal Revenue Code no longer provides for a 27-1/2% depletion allowance, although the major oil-producing States have retained the 27-1/2% provision in their principal and income acts (Texas amended its Act in 1993, but did not change the depletion provision). Section 9 of the 1931 Act allocates all of the net proceeds received as consideration for the "permanent severance of natural resources from the lands" to principal.

Section 411 allocates 90% of the net receipts to principal and 10% to income. A depletion provision that is tied to past or present Code provisions is undesirable because it causes a large portion of the oil and gas receipts to be paid out as income. As wells are depleted, the amount received by the income beneficiary falls drastically. Allocating a larger portion of the receipts to principal enables the trustee to acquire other income producing assets that will continue to produce income when the mineral reserves are exhausted.

Application of Sections 403 and 408. This section applies to the extent that the trustee does not account separately for receipts from minerals and other natural resources under Section 403 or allocate all of the receipts to principal under Section 408.

Open mine doctrine. The purpose of Section 411(c) is to abolish the "open mine doctrine" as it may apply to the rights of an income beneficiary and a remainder beneficiary in receipts from the production of minerals from land owned or leased by a trust. Instead, such receipts are to be allocated to or between principal and income in accordance with the

provisions of this Act. For a discussion of the open mine doctrine, see generally 3A Austin W. Scott & William F. Fratcher, The Law of Trusts § 239.3 (4th ed. 1988), and *Nutter v. Stockton*, 626 P.2d 861 (Okla. 1981).

Effective date provision. Section 9(b) of the 1962 Act provides that the natural resources provision does not apply to property interests held by the trust on the effective date of the Act, which reflects concerns about the constitutionality of applying a retroactive administrative provision to interests in real estate, based on the opinion in the Oklahoma case of *Franklin v. Margay Oil Corporation*, 153 P.2d 486, 501 (Okla. 1944). Section 411(d) permits a trustee to use either the method provided for in this Act or the method used before the Act takes effect. Lawyers in jurisdictions other than Oklahoma may conclude that retroactivity is not a problem as to property situated in their States, and this provision permits trustees to decide, based on advice from counsel in States whose law may be different from that of Oklahoma, whether they may apply this provision retroactively if they conclude that to do so is in the best interests of the beneficiaries.

If the property is in a State other than the State where the trust is administered, the trustee must be aware that the law of the property's situs may control this question. The outcome turns on a variety of questions: whether the terms of the trust specify that the law of a State other than the situs of the property shall govern the administration of the trust, and whether the courts will follow the terms of the trust; whether the trust's asset is the land itself or a leasehold interest in the land (as it frequently is with oil and gas property); whether a leasehold interest or its proceeds should be classified as real property or personal property, and if as personal property, whether applicable state law treats it as a movable or an immovable for conflict of laws purposes. See 5A Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 648, at 531, 533-534; § 657, at 600 (4th ed. 1989).

Section 412. Timber.

(a) To the extent that a trustee accounts for receipts from the sale of timber and related products pursuant to this section, the trustee shall allocate the net receipts:

(1) to income to the extent that the amount of timber removed from the land does not exceed the rate of growth of the timber during the accounting periods in which a beneficiary has a mandatory income interest;

(2) to principal to the extent that the amount of timber removed from the land exceeds the rate of growth of the timber or the net receipts are from the sale of standing timber;

(3) to or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber from land owned by a trust, by determining the amount of timber removed from the land under the lease or contract and applying the rules in paragraphs (1) and (2); or

(4) to principal to the extent that advance payments, bonuses, and other payments are not allocated pursuant to paragraph (1), (2), or (3).

(b) In determining net receipts to be allocated pursuant to subsection (a), a trustee shall deduct and transfer to principal a reasonable amount for depletion.

(c) This [Act] applies whether or not a decedent or transferor was harvesting timber from the property before it became subject to the trust.

(d) If a trust owns an interest in timberland on [the effective date of this [Act]], the trustee may allocate net receipts from the sale of timber and related products as provided in this [Act] or in the manner used by the trustee before [the effective date of this [Act]]. If the trust acquires an interest in timberland after [the effective date of this [Act]], the trustee shall allocate net receipts from the sale of timber and related products as provided in this [Act].

Comment

Scope of section. The rules in Section 412 are intended to apply to net receipts from the sale of trees and by-products from harvesting and processing trees without regard to the

kind of trees that are cut or whether the trees are cut before or after a particular number of years of growth. The rules apply to the sale of trees that are expected to produce lumber for building purposes, trees sold as pulpwood, and Christmas and other ornamental trees. Subsection (a) applies to net receipts from property owned by the trustee and property leased by the trustee. The Act is not intended to prevent a tenant in possession of the property from using wood that he cuts on the property for personal, noncommercial purposes, such as a Christmas tree, firewood, mending old fences or building new fences, or making repairs to structures on the property.

Under subsection (a), the amount of net receipts allocated to income depends upon whether the amount of timber removed is more or less than the rate of growth. The method of determining the amount of timber removed and the rate of growth is up to the trustee, based on methods customarily used for the kind of timber involved.

Application of Sections 403 and 408. This section applies to the extent that the trustee does not account separately for net receipts from the sale of timber and related products under Section 403 or allocate all of the receipts to principal under Section 408. The option to account for net receipts separately under Section 403 takes into consideration the possibility that timber harvesting operations may have been conducted before the timber property became subject to the trust, and that it may make sense to continue using accounting methods previously established for the property. It also permits a trustee to use customary accounting practices for timber operations even if no harvesting occurred on the property before it became subject to the trust.

Section 413. Property Not Productive of Income.

(a) If a marital deduction is allowed for all or part of a trust whose assets consist substantially of property that does not provide the spouse with sufficient income from or use of the trust assets, and if the amounts that the trustee transfers from principal to income under Section 104 and distributes to the spouse from principal pursuant to the terms of the trust are insufficient to provide the spouse with the beneficial enjoyment required to obtain the marital deduction, the spouse may require the trustee to make property productive of income, convert property within a reasonable time, or exercise the power conferred by Section 104(a). The trustee may decide which action or combination of actions to take.

(b) In cases not governed by subsection (a), proceeds from the sale or other disposition of an asset are principal without regard to the amount of income the asset produces during any accounting period.

Comment

Prior Acts' Conflict with Uniform Prudent Investor Act. Section 2(b) of the Uniform Prudent Investor Act provides that "[a] trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole ... ." The underproductive property provisions in Section 12 of the 1962 Act and Section 11 of the 1931 Act give the income beneficiary a right to receive a portion of the proceeds from the sale of underproductive property as "delayed income." In each Act the provision applies on an asset by asset basis and not by taking into consideration the trust portfolio as a whole, which conflicts with the basic precept in Section 2(b) of the Prudent Investor Act. Moreover, in determining the amount of delayed income, the prior Acts do not permit a trustee to take into account the extent to which the trustee may have distributed principal to the income beneficiary, under principal invasion provisions in the terms of the trust, to compensate for insufficient income from the unproductive asset. Under Section 104(b)(7) of this Act, a trustee must consider prior distributions of principal to the income beneficiary in deciding whether and to what extent to exercise the power to adjust conferred by Section 104(a).

Duty to make property productive of income. In order to implement the Uniform Prudent Investor Act, this Act abolishes the right to receive delayed income from the sale proceeds of an asset that produces little or no income, but it does not alter existing state law regarding the income beneficiary's right to compel the trustee to make property productive of income. As the law continues to develop in this area, the duty to make property productive of current income in a particular situation should be determined by taking into consideration the performance of

the portfolio as a whole and the extent to which a trustee makes principal distributions to the income beneficiary under the terms of the trust and adjustments between principal and income under Section 104 of this Act.

Trusts for which the value of the right to receive income is important for tax reasons may be affected by Reg. § 1.7520-3(b)(2)(v) *Example (1)*, § 20.7520-3(b)(2)(v) *Examples (1)* and *(2)*, and § 25.7520-3(b)(2)(v) *Examples (1)* and *(2)*, which provide that if the income beneficiary does not have the right to compel the trustee to make the property productive, the income interest is considered unproductive and may not be valued actuarially under those sections.

Marital deduction trusts. Subsection (a) draws on language in Reg. § 20.2056(b)-5(f)(4) and (5) to enable a trust for a spouse to qualify for a marital deduction if applicable state law is unclear about the spouse's right to compel the trustee to make property productive of income. The trustee should also consider the application of Section 104 of this Act and the provisions of Restatement of Trusts 3d: Prudent Investor Rule § 240, at 186, app. § 240, at 252 (1992). Example (6) in the Comment to Section 104 describes a situation involving the payment from income of carrying charges on unproductive real estate in which Section 104 may apply.

Once the two conditions have occurred - insufficient beneficial enjoyment from the property and the spouse's demand that the trustee take action under this section - the trustee must act; but instead of the formulaic approach of the 1962 Act, which is triggered only if the trustee sells the property, this Act permits the trustee to decide whether to make the property productive of income, convert it, transfer funds from principal to income, or to take some combination of those actions. The trustee may rely on the power conferred by Section 104(a) to adjust from principal to income if the trustee decides that it is not feasible or appropriate to make the property productive of income or to convert the property. Given the purpose of Section 413, the power under Section 104(a) would be exercised to transfer principal to income and not to transfer income to principal.

Section 413 does not apply to a so-called "estate" trust, which will qualify for the marital deduction, even though the income may be accumulated for a term of years or for the life of the surviving spouse, if the terms of the trust require the principal and undistributed income to be paid to the surviving spouse's estate when the spouse dies. Reg. § 20.2056(c)-2(b)(1)(iii).

Section 414. Derivatives and Options.

(a) In this section, "derivative" means a contract or financial instrument or a combination of contracts and financial instruments which gives a trust the right or obligation to participate in some or all changes in the price of a tangible or intangible asset or group of assets, or changes in a rate, an index of prices or rates, or other market indicator for an asset or a group of assets.

(b) To the extent that a trustee does not account under Section 403 for transactions in derivatives, the trustee shall allocate to principal receipts from and disbursements made in connection with those transactions.

(c) If a trustee grants an option to buy property from the trust, whether or not the trust owns the property when the option is granted, grants an option that permits another person to sell property to the trust, or acquires an option to buy property for the trust or an option to sell an asset owned by the trust, and the trustee or other owner of the asset is required to deliver the asset if the option is exercised, an amount received for granting the option must be allocated to principal. An amount paid to acquire the option must be paid from principal. A gain or loss realized upon the exercise of an option, including an option granted to a settlor of the trust for services rendered, must be allocated to principal.

Comment

Scope and application. It is difficult to predict how frequently and to what extent trustees will invest directly in derivative financial instruments rather than participating indirectly through investment entities that may utilize these instruments in varying degrees. If the trust participates in derivatives indirectly through an entity, an amount received from the entity will be allocated under Section 401 and not Section 414. If a trustee invests directly in derivatives to a significant extent, the expectation is that receipts and disbursements related to

derivatives will be accounted for under Section 403; if a trustee chooses not to account under Section 403, Section 414(b) provides the default rule. Certain types of option transactions in which trustees may engage are dealt with in subsection (c) to distinguish those transactions from ones involving options that are embedded in derivative financial instruments.

Definition of "derivative." "Derivative" is a difficult term to define because new derivatives are invented daily as dealers tailor their terms to achieve specific financial objectives for particular clients. Since derivatives are typically contract-based, a derivative can probably be devised for almost any set of objectives if another party can be found who is willing to assume the obligations required to meet those objectives.

The most comprehensive definition of derivative is in the Exposure Draft of a Proposed Statement of Financial Accounting Standards titled "Accounting for Derivative and Similar Financial Instruments and for Hedging Activities," which was released by the Financial Accounting Standards Board (FASB) on June 20, 1996 (No. 162-B). The definition in Section 414(a) is derived in part from the FASB definition. The purpose of the definition in subsection (a) is to implement the substantive rule in subsection (b) that provides for all receipts and disbursements to be allocated to principal to the extent the trustee elects not to account for transactions in derivatives under Section 403. As a result, it is much shorter than the FASB definition, which serves much more ambitious objectives.

A derivative is frequently described as including futures, forwards, swaps and options, terms that also require definition, and the definition in this Act avoids these terms. FASB used the same approach, explaining in paragraph 65 of the Exposure Draft:

> The definition of *derivative financial instrument* in this Statement includes those financial instruments generally considered to be derivatives, such as forwards, futures, swaps, options, and similar instruments. The Board considered defining a derivative financial instrument by merely referencing those commonly understood instruments, similar to paragraph 5 of Statement 119, which says that "... a derivative financial instrument is a futures, forward, swap, or option contract, or other financial instrument with similar characteristics." However, the continued development of financial markets and innovative financial instruments could ultimately render a definition based on examples inadequate and obsolete. The Board, therefore, decided to base the definition of a derivative financial instrument on a description of the common characteristics of those instruments in order to accommodate the accounting for newly developed derivatives. (Footnote omitted.)

Marking to market. A gain or loss that occurs because the trustee marks securities to market or to another value during an accounting period is not a transaction in a derivative financial instrument that is income or principal under the Act - only cash receipts and disbursements, and the receipt of property in exchange for a principal asset, affect a trust's principal and income accounts.

Receipt of property other than cash. If a trustee receives property other than cash upon the settlement of a derivatives transaction, that property would be principal under Section 404(2).

Options. Options to which subsection (c) applies include an option to purchase real estate owned by the trustee and a put option purchased by a trustee to guard against a drop in value of a large block of marketable stock that must be liquidated to pay estate taxes. Subsection (c) would also apply to a continuing and regular practice of selling call options on securities owned by the trust if the terms of the option require delivery of the securities. It does not apply if the consideration received or given for the option is something other than cash or property, such as cross-options granted in a buy-sell agreement between owners of an entity.

Section 415. Asset-Backed Securities.

(a) In this section, "asset-backed security" means an asset whose value is based upon the right it gives the owner to receive distributions from the proceeds of financial assets that provide collateral for the security. The term includes an asset that gives the owner the right to receive from the collateral financial assets only the interest or other current return or only the proceeds other than interest or current return. The term does not include an asset to which

Section 401 or 409 applies.

(b) If a trust receives a payment from interest or other current return and from other proceeds of the collateral financial assets, the trustee shall allocate to income the portion of the payment which the payer identifies as being from interest or other current return and shall allocate the balance of the payment to principal.

(c) If a trust receives one or more payments in exchange for the trust's entire interest in an asset-backed security in one accounting period, the trustee shall allocate the payments to principal. If a payment is one of a series of payments that will result in the liquidation of the trust's interest in the security over more than one accounting period, the trustee shall allocate 10 percent of the payment to income and the balance to principal.

Comment

Scope of section. Typical asset-backed securities include arrangements in which debt obligations such as real estate mortgages, credit card receivables and auto loans are acquired by an investment trust and interests in the trust are sold to investors. The source for payments to an investor is the money received from principal and interest payments on the underlying debt. An asset-backed security includes an "interest only" or a "principal only" security that permits the investor to receive only the interest payments received from the bonds, mortgages or other assets that are the collateral for the asset-backed security, or only the principal payments made on those collateral assets. An asset-backed security also includes a security that permits the investor to participate in either the capital appreciation of an underlying security or in the interest or dividend return from such a security, such as the "Primes" and "Scores" issued by Americus Trust. An asset-backed security does not include an interest in a corporation, partnership, or an investment trust described in the Comment to Section 402, whose assets consist significantly or entirely of investment assets. Receipts from an instrument that do not come within the scope of this section or any other section of the Act would be allocated entirely to principal under the rule in Section 103(a)(4), and the trustee may then consider whether and to what extent to exercise the power to adjust in Section 104, taking into account the return from the portfolio as whole and other relevant factors.

[Article] 5

Allocation of disbursements during

administration of trust

Section 501. Disbursements From Income. A trustee shall make the following disbursements from income to the extent that they are not disbursements to which Section 201(2)(B) or (C) applies:

(1) one-half of the regular compensation of the trustee and of any person providing investment advisory or custodial services to the trustee;

(2) one-half of all expenses for accountings, judicial proceedings, or other matters that involve both the income and remainder interests;

(3) all of the other ordinary expenses incurred in connection with the administration, management, or preservation of trust property and the distribution of income, including interest, ordinary repairs, regularly recurring taxes assessed against principal, and expenses of a proceeding or other matter that concerns primarily the income interest; and

(4) recurring premiums on insurance covering the loss of a principal asset or the loss of income from or use of the asset.

Comment

Trustee fees. The regular compensation of a trustee or the trustee's agent includes compensation based on a percentage of either principal or income or both.

Insurance premiums. The reference in paragraph (4) to "recurring" premiums is intended to distinguish premiums paid annually for fire insurance from premiums on title insurance, each of which covers the loss of a principal asset. Title insurance premiums would

be a principal disbursement under Section 502(a)(5).

Regularly recurring taxes. The reference to "regularly recurring taxes assessed against principal" includes all taxes regularly imposed on real property and tangible and intangible personal property.

Section 502. Disbursements From Principal.

(a) A trustee shall make the following disbursements from principal:

(1) the remaining one-half of the disbursements described in Section 501(1) and (2);

(2) all of the trustee's compensation calculated on principal as a fee for acceptance, distribution, or termination, and disbursements made to prepare property for sale;

(3) payments on the principal of a trust debt;

(4) expenses of a proceeding that concerns primarily principal, including a proceeding to construe the trust or to protect the trust or its property;

(5) premiums paid on a policy of insurance not described in Section 501(4) of which the trust is the owner and beneficiary;

(6) estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust; and

(7) disbursements related to environmental matters, including reclamation, assessing environmental conditions, remedying and removing environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, collecting amounts from persons liable or potentially liable for the costs of those activities, penalties imposed under environmental laws or regulations and other payments made to comply with those laws or regulations, statutory or common law claims by third parties, and defending claims based on environmental matters.

(b) If a principal asset is encumbered with an obligation that requires income from that asset to be paid directly to the creditor, the trustee shall transfer from principal to income an amount equal to the income paid to the creditor in reduction of the principal balance of the obligation.

Comment

Environmental expenses. All environmental expenses are payable from principal, subject to the power of the trustee to transfer funds to principal from income under Section 504. However, the Drafting Committee decided that it was not necessary to broaden this provision to cover other expenditures made under compulsion of governmental authority. See generally the annotation at 43 A.L.R.4th 1012 (Duty as Between Life Tenant and Remainderman with Respect to Cost of Improvements or Repairs Made Under Compulsion of Governmental Authority).

Environmental expenses paid by a trust are to be paid from principal under Section 502(a)(7) on the assumption that they will usually be extraordinary in nature. Environmental expenses might be paid from income if the trustee is carrying on a business that uses or sells toxic substances, in which case environmental cleanup costs would be a normal cost of doing business and would be accounted for under Section 403. In accounting under that Section, environmental costs will be a factor in determining how much of the net receipts from the business is trust income. Paying all other environmental expenses from principal is consistent with this Act's approach regarding receipts - when a receipt is not clearly a current return on a principal asset, it should be added to principal because over time both the income and remainder beneficiaries benefit from this treatment. Here, allocating payments required by environmental laws to principal imposes the detriment of those payments over time on both the income and remainder beneficiaries.

Under Sections 504(a) and 504(b)(5), a trustee who makes or expects to make a principal disbursement for an environmental expense described in Section 502(a)(7) is

authorized to transfer an appropriate amount from income to principal to reimburse principal for disbursements made or to provide a reserve for future principal disbursements.

The first part of Section 502(a)(7) is based upon the definition of an "environmental remediation trust" in Treas. Reg. § 301.7701-4(e)(as amended in 1996). This is not because the Act applies to an environmental remediation trust, but because the definition is a useful and thoroughly vetted description of the kinds of expenses that a trustee owning contaminated property might incur. Expenses incurred to comply with environmental laws include the cost of environmental consultants, administrative proceedings and burdens of every kind imposed as the result of an administrative or judicial proceeding, even though the burden is not formally characterized as a penalty.

Title proceedings. Disbursements that are made to protect a trust's property, referred to in Section 502(a)(4), include an "action to assure title" that is mentioned in Section 13(c)(2) of the 1962 Act.

Insurance premiums. Insurance premiums referred to in Section 502(a)(5) include title insurance premiums. They also include premiums on life insurance policies owned by the trust, which represent the trust's periodic investment in the insurance policy. There is no provision in the 1962 Act for life insurance premiums.

Taxes. Generation-skipping transfer taxes are payable from principal under subsection (a)(6).

Section 503. Transfers From Income To Principal For Depreciation.

(a) In this section, "depreciation" means a reduction in value due to wear, tear, decay, corrosion, or gradual obsolescence of a fixed asset having a useful life of more than one year.

(b) A trustee may transfer to principal a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation, but may not transfer any amount for depreciation:

(1) of that portion of real property used or available for use by a beneficiary as a residence or of tangible personal property held or made available for the personal use or enjoyment of a beneficiary;

(2) during the administration of a decedent's estate; or

(3) under this section if the trustee is accounting under Section 403 for the business or activity in which the asset is used.

(c) An amount transferred to principal need not be held as a separate fund.

Comment

Prior Acts. The 1931 Act has no provision for depreciation. Section 13(a)(2) of the 1962 Act provides that a charge shall be made against income for "... a reasonable allowance for depreciation on property subject to depreciation under generally accepted accounting principles ... ." That provision has been resisted by many trustees, who do not provide for any depreciation for a variety of reasons. One reason relied upon is that a charge for depreciation is not needed to protect the remainder beneficiaries if the value of the land is increasing; another is that generally accepted accounting principles may not require depreciation to be taken if the property is not part of a business. The Drafting Committee concluded that the decision to provide for depreciation should be discretionary with the trustee. The power to transfer funds from income to principal that is granted by this section is a discretionary power of administration referred to in Section 103(b), and in exercising the power a trustee must comply with Section 103(b).

One purpose served by transferring cash from income to principal for depreciation is to provide funds to pay the principal of an indebtedness secured by the depreciable property. Section 504(b)(4) permits the trustee to transfer additional cash from income to principal for this purpose to the extent that the amount transferred from income to principal for depreciation is less than the amount of the principal payments.

Section 504. Transfers From Income To Reimburse Principal.

(a) If a trustee makes or expects to make a principal disbursement described in this section, the trustee may transfer an appropriate amount from income to principal in one or more accounting periods to reimburse principal or to provide a reserve for future principal disbursements.

(b) Principal disbursements to which subsection (a) applies include the following, but only to the extent that the trustee has not been and does not expect to be reimbursed by a third party:

(1) an amount chargeable to income but paid from principal because it is unusually large, including extraordinary repairs;

(2) a capital improvement to a principal asset, whether in the form of changes to an existing asset or the construction of a new asset, including special assessments;

(3) disbursements made to prepare property for rental, including tenant allowances, leasehold improvements, and broker's commissions;

(4) periodic payments on an obligation secured by a principal asset to the extent that the amount transferred from income to principal for depreciation is less than the periodic payments; and

(5) disbursements described in Section 502(a)(7).

(c) If the asset whose ownership gives rise to the disbursements becomes subject to a successive income interest after an income interest ends, a trustee may continue to transfer amounts from income to principal as provided in subsection (a).

Comment

Prior Acts. The sources of Section 504 are Section 13(b) of the 1962 Act, which permits a trustee to "regularize distributions," if charges against income are unusually large, by using "reserves or other reasonable means" to withhold sums from income distributions; Section 13(c)(3) of the 1962 Act, which authorizes a trustee to establish an allowance for depreciation out of income if principal is used for extraordinary repairs, capital improvements and special assessments; and Section 12(3) of the 1931 Act, which permits the trustee to spread income expenses of unusual amount "throughout a series of years." Section 504 contains a more detailed enumeration of the circumstances in which this authority may be used, and includes in subsection (b)(4) the express authority to use income to make principal payments on a mortgage if the depreciation charge against income is less than the principal payments on the mortgage.

Section 505. Income Taxes.

(a) A tax required to be paid by a trustee based on receipts allocated to income must be paid from income.

(b) A tax required to be paid by a trustee based on receipts allocated to principal must be paid from principal, even if the tax is called an income tax by the taxing authority.

(c) A tax required to be paid by a trustee on the trust's share of an entity's taxable income must be paid proportionately:

(1) from income to the extent that receipts from the entity are allocated to income; and

(2) from principal to the extent that:

(A) receipts from the entity are allocated to principal; and

(B) the trust's share of the entity's taxable income exceeds the total receipts described in paragraphs (1) and (2)(A).

(d) For purposes of this section, receipts allocated to principal or income must be reduced by the amount distributed to a beneficiary from principal or income for which the trust receives a deduction in calculating the tax.

Comment

Electing Small Business Trusts. An Electing Small Business Trust (ESBT) is a creature created by Congress in the Small Business Job Protection Act of 1996 (P.L. 104-188). For years beginning after 1996, an ESBT may qualify as an S corporation stockholder even if the trustee does not distribute all of the trust's income annually to its beneficiaries. The portion of an ESBT that consists of the S corporation stock is treated as a separate trust for tax purposes (but not for trust accounting purposes), and the S corporation income is taxed directly to that portion of the trust even if some or all of that income is distributed to the beneficiaries.

A trust normally receives a deduction for distributions it makes to its beneficiaries. Subsection (d) takes into account the possibility that an ESBT may not receive a deduction for trust accounting income that is distributed to the beneficiaries. Only limited guidance has been issued by the Internal Revenue Service, and it is too early to anticipate all of the technical questions that may arise, but the powers granted to a trustee in Sections 506 and 104 to make adjustments are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems.

Section 506. Adjustments Between Principal and Income Because Of Taxes.

(a) A fiduciary may make adjustments between principal and income to offset the shifting of economic interests or tax benefits between income beneficiaries and remainder beneficiaries which arise from:

(1) elections and decisions, other than those described in subsection (b), that the fiduciary makes from time to time regarding tax matters;

(2) an income tax or any other tax that is imposed upon the fiduciary or a beneficiary as a result of a transaction involving or a distribution from the estate or trust; or

(3) the ownership by an estate or trust of an interest in an entity whose taxable income, whether or not distributed, is includable in the taxable income of the estate, trust, or a beneficiary.

(b) If the amount of an estate tax marital deduction or charitable contribution deduction is reduced because a fiduciary deducts an amount paid from principal for income tax purposes instead of deducting it for estate tax purposes, and as a result estate taxes paid from principal are increased and income taxes paid by an estate, trust, or beneficiary are decreased, each estate, trust, or beneficiary that benefits from the decrease in income tax shall reimburse the principal from which the increase in estate tax is paid. The total reimbursement must equal the increase in the estate tax to the extent that the principal used to pay the increase would have qualified for a marital deduction or charitable contribution deduction but for the payment. The proportionate share of the reimbursement for each estate, trust, or beneficiary whose income taxes are reduced must be the same as its proportionate share of the total decrease in income tax. An estate or trust shall reimburse principal from income.

Comment

Discretionary adjustments. Section 506(a) permits the fiduciary to make adjustments between income and principal because of tax law provisions. It would permit discretionary adjustments in situations like these: (1) A fiduciary elects to deduct administration expenses that are paid from principal on an income tax return instead of on the estate tax return; (2) a distribution of a principal asset to a trust or other beneficiary causes the taxable income of an estate or trust to be carried out to the distributee and relieves the persons who receive the income of any obligation to pay income tax on the income; or (3) a trustee realizes a capital gain on the sale of a principal asset and pays a large state income tax on the gain, but under

applicable federal income tax rules the trustee may not deduct the state income tax payment from the capital gain in calculating the trust's federal capital gain tax, and the income beneficiary receives the benefit of the deduction for state income tax paid on the capital gain. See generally Joel C. Dobris, Limits on the Doctrine of Equitable Adjustment in Sophisticated Postmortem Tax Planning, 66 Iowa L. Rev. 273 (1981).

Section 506(a)(3) applies to a qualified Subchapter S trust (QSST) whose income beneficiary is required to include a pro rata share of the S corporation's taxable income in his return. If the QSST does not receive a cash distribution from the corporation that is large enough to cover the income beneficiary's tax liability, the trustee may distribute additional cash from principal to the income beneficiary. In this case the retention of cash by the corporation benefits the trust principal. This situation could occur if the corporation's taxable income includes capital gain from the sale of a business asset and the sale proceeds are reinvested in the business instead of being distributed to shareholders.

Mandatory adjustment. Subsection (b) provides for a mandatory adjustment from income to principal to the extent needed to preserve an estate tax marital deduction or charitable contributions deduction. It is derived from New York's EPTL § 11-1.2(A), which requires principal to be reimbursed by those who benefit when a fiduciary elects to deduct administration expenses on an income tax return instead of the estate tax return. Unlike the New York provision, subsection (b) limits a mandatory reimbursement to cases in which a marital deduction or a charitable contributions deduction is reduced by the payment of additional estate taxes because of the fiduciary's income tax election. It is intended to preserve the result reached in *Estate of Britenstool v. Commissioner*, 46 T.C. 711 (1966), in which the Tax Court held that a reimbursement required by the predecessor of EPTL § 11-1.2(A) resulted in the estate receiving the same charitable contributions deduction it would have received if the administration expenses had been deducted for estate tax purposes instead of for income tax purposes. Because a fiduciary will elect to deduct administration expenses for income tax purposes only when the income tax reduction exceeds the estate tax reduction, the effect of this adjustment is that the principal is placed in the same position it would have occupied if the fiduciary had deducted the expenses for estate tax purposes, but the income beneficiaries receive an additional benefit. For example, if the income tax benefit from the deduction is $30,000 and the estate tax benefit would have been $20,000, principal will be reimbursed $20,000 and the net benefit to the income beneficiaries will be $10,000.

Irrevocable grantor trusts. Under Sections 671-679 of the Internal Revenue Code (the "grantor trust" provisions), a person who creates an irrevocable trust for the benefit of another person may be subject to tax on the trust's income or capital gains, or both, even though the settlor is not entitled to receive any income or principal from the trust. Because this is now a well-known tax result, many trusts have been created to produce this result, but there are also trusts that are unintentionally subject to this rule. The Act does not require or authorize a trustee to distribute funds from the trust to the settlor in these cases because it is difficult to establish a rule that applies only to trusts where this tax result is unintended and does not apply to trusts where the tax result is intended. Settlors who intend this tax result rarely state it as an objective in the terms of the trust, but instead rely on the operation of the tax law to produce the desired result. As a result it may not be possible to determine from the terms of the trust if the result was intentional or unintentional. If the drafter of such a trust wants the trustee to have the authority to distribute principal or income to the settlor to reimburse the settlor for taxes paid on the trust's income or capital gains, such a provision should be placed in the terms of the trust. In some situations the Internal Revenue Service may require that such a provision be placed in the terms of the trust as a condition to issuing a private letter ruling.

[Article] 6

Miscellaneous Provisions

Section 601. Uniformity Of Application and Construction. In applying and construing this Uniform Act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among States that enact it.

Section 602. Severability Clause. If any provision of this [Act] or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or

applications of this [Act] which can be given effect without the invalid provision or application, and to this end the provisions of this [Act] are severable.

Section 603. Repeal. The following acts and parts of acts are repealed:

(1) ....

(2) ....

(3) ....

Section 604. Effective Date. This [Act] takes effect on ....

Section 605. Application Of [ACT] To Existing Trusts and Estates. This [Act] applies to every trust or decedent's estate existing on [the effective date of this [Act]] except as otherwise expressly provided in the will or terms of the trust or in this [Act].

List of States Adopting the Uniform Principal and Income Act

(As of August 5, 2004)

The following states have adopted the 1997 revision to the Uniform Principal and Income Act,

1. Alabama
2. Alaska
3. Arizona
4. Arkansas
5. California
6. Colorado
7. Connecticut
8. District of Columbia
9. Florida
10. Hawaii
11. Idaho
12. Indiana
13. Iowa
14. Kansas
15. Maine
16. Maryland
17. Montana
18. Missouri
19. Nebraska
20. Nevada
21. new Jersey

22. new Mexico
23. New York
24. North Carolina
25. North Dakota
26. Ohio
27. Oklahoma
28. Oregon
29. Pennsylvania
30. South Carolina
31. Tennessee
32. Texas
33. Utah
34. Virginia
35. Washington
36. West Virginia
37. Wyoming

The legislation has been introduced in Massachusetts and Michigan.

The following states have adopted the Uniform Principal and Income Acts of 1931 and 1962:

1. Alabama 1931 Code 1975, §§ 19-3-270 to 19-3-382
2. Alaska 1962 AS 13.38.010 to 13.38.140
3. Arizona 1962 A.R.S. §§ 14-7401 to 14-7413
4. Arkansas 1997 ACA §§ 28-70-101 to 28-70-603
5. California 1997 West's Ann. Cal. Civ. Code §§ 16320 to 16375
6. Colorado 1931 West's C.R.S.A. §§ 15-1-401 to 15-1-417
7. Connecticut 1997 PA-164 (no statute number available)
8. Florida 1962 West's F.S.A. §§ 738.01 to 738.15
9. Georgia 1962 OCGA §§ 53-12-210 to 53-12-219
10. Hawaii 1962 HRS §§ 557-1 to 557-16
11. Idaho 1962 I.C. §§ 68-1001 to 68-1016
12. Illinois 1962 S.H.A.760 ILCS 15/1 to 15/17
13. Indiana 1962 West's A.I.C. 30-4-5-1 to 30-4-5-11
14. Iowa 1997 I.C.A. §§637.101 to 637.601
15. Kansas 1962 K.S.A. 58-901 to 58-917
16. Kentucky 1962 K.R.S. §§386.191 to 386.349
17. Maryland 1962 Code, Estates & Trusts, §§ 14-201 to 14-214
18. Michigan 1962 M.L.C.A. §§ 555.51 to 555.68
19. Minnesota 1962 M.S.A. §§ 501B.59 to 501B.76
20. Mississippi 1962 Code 1972, §§ 91-17-1 to 91-17-31
21. Missouri 1962 V.A.M.S §§ 456.700 to 456.820
22. Montana 1962 M.C.A. §§ 72-34-401 to 72-34-416
23. Nebraska 1962 R.R.S.1943, §§ 30-3101 to 30-3115
24. Nevada 1962 N.R.S. 164.140 to 164.370
25. New Jersey 1962 N.J.S.A. §§ 3B:19A-1 to 3B19A-35
26. New Mexico 1962 NMSA 1978 §§ 46-3-1- to 46-3-15
27. New York 1962 McKinney's EPTL 11.2.1
28. North Carolina 1962 G.S. §§ 37-16 to 37-40
29. North Dakota 1997 NDCC 59-04.2-01 to 59-04.2-30

30. Ohio 1962 R.C.§§ 134.01 to 1340.13; 2190.66 to 2109.68
31. Oklahoma 1997 60 Okl.St.Ann. §§ 175.101 to 175.602
32. Oregon 1962 ORS 129.005 to 129.125
33. Pennsylvania 1931 20 Pa.C.S.A. §§ 8101 to 8112
34. South Carolina 1962 Code 1976§§ 62-7-401 to 62-7-421
35. South Dakota 1962 SDCL 55-13-1 to 55-13-17
36. Tennessee 1931 T.C.A. §§ 35-6-101 to 35-6-115
37. Texas 1962 V.T.C.A., Property Code §§ 113.101 to 113.111
38. Utah 1962 U.C.A.1953, 22-3-1- to 22-3-16
39. Vermont 1931 14 V.S.A. §§ 3301 to 3313
40. Virginia 1997 Code 1950, §§ 55-277.1 to 55.277.33
41. Washington 1962 West's RCWA 11.104.010 to 11.104.940
42. West Virginia 1931 Code, 36-6-1 to 36-6-17
43. Wisconsin 1962 W.S.A. 701.20
44. Wyoming 1962 W.S.1977, §§ 2-3-601 to 2-3-614

FDIC Memorandums Regarding Consent to Exercise Trust Powers

Federal Deposit Insurance Corporation

Washington 25

Office of Chief

Division of Examination

June 30, 1958

Memorandum to -

Supervising Examiners

Federal Deposit Insurance Corporation

Subject: Applications to the Federal Deposit Insurance Corporation For Consent to Exercise Trust Powers

On June 25, 1958, the Board of Directors approved a recommendation of the Deputy Chief, Division of Examination, and the General Counsel, pertaining to applications to the Federal Deposit Insurance Corporation for consent to exercise trust powers. This decision by the Board establishes the circumstances under which an application will be required.

The following is excerpted from the recommendation submitted to the Board of Directors:

> "1. That regulation Part 333 is *not applicable*, and this Corporation's written consent is not necessary, when an insured nonmember bank proposes to exercise trust powers which it had, either by statute or by charter, at the time of its admission to Federal deposit insurance, unless the record shows that at the time of its admission it was understood and agreed between the Corporation and the bank that it should not exercise such powers.
>
> > (Application Forms No. 2; No. 84, No. 84 revised December 15, 1948, and the corresponding forms for use by incorporators of proposed banks, do not provide such a contract.)
>
> "However, the regulation *is applicable* to such an insured nonmember bank, and this Corporation's written consent is necessary, if the bank may not exercise trust powers without first obtaining the consent of the State supervisory authority although it has trust powers, either by statute or charter. The term 'consent' should not be construed to include a situation where a bank can as a matter of right exercise trust powers by merely increasing its capital to the prescribed statutory amount, or by complying with the statutory requirements in respect to the filing of bonds or securities.
>
> "2. That regulation Part 333 is *applicable* to such an insured nonmember bank which has executed by itself, or by its incorporators and ratified by the bank, any of the above forms revised December 1, 1950, viz:
>
> > Form 84 revised December 1, 1950 - 'Application for Federal Deposit Insurance'

Form 82 revised December 1, 1950 - 'Application of Proposed Bank for Federal Deposit Insurance'

Form 85 revised December 1, 1950 Application to Establish Branch'

Form 85a revised December 1, 1950 'Application to Move Main Office or Branch'

Or amendments thereof which show the general character of the business exercised by the bank and which contain an agreement that the bank will not engage in any other business without the prior written consent of the Corporation, and such a bank may not exercise trust powers without the prior written consent of this Corporation."

In summary, if inquiry or application relating to the inauguration of the exercise of trust powers is received, the Supervising Examiner, before requiring formal application for consent, must determine by review of the District Office files whether regulation Part 333 is applicable. The review of the files should determine:

(1) If the consent of the State Supervisory Authority is necessary; or

(2) If an agreement that the bank will not engage in trust business without consent of the Corporation as indicated on FDIC Forms 82, 84, 85, or 85a, has been filed by the bank subsequent to December 1, 1950. The agreement referred to is in the form of a paragraph on the application forms placed in use as of December 1, 1950, and revised May 1, 1952, viz:

"It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in Section 6 of the Federal Deposit Insurance Act to this Application, will consider it only with respect to the general character or types of business above stated and that the Bank will not engage in any other business without the prior written consent of the Corporation."

In the event application to the Corporation for consent to exercise trust powers is required from an insured bank, such application must be made on Forms 102, "Application to Federal Deposit Insurance Corporation," and 103, "Supplementary Information to Application to Federal Deposit Insurance Corporation for Consent to Exercise Trust Powers." Form 103 must also be used as a supplement to Form 82, "Application of Proposed New Bank for Federal Deposit Insurance," if applicant desires to exercise trust powers.

Applications at hand, regardless of date of receipt, will be processed in accordance with these instructions.

Edward H. DeHority

Deputy Chief

Division of Examination

June 16, 1958

Memorandum to --

The Special Committee

and

The Board of Directors

Question: Whether under regulation Part 333 banks which had trust powers when they became insured but did not exercise them, must obtain this Corporation's prior consent to the exercise of such powers. The regulation reads as follows:

§ 333.1 Classification of General character of business. State nonmember insured banks are divided into five categories for the purpose of classifying their general character or type of business, viz: commercial banks, banks and trust companies, savings banks (including mutual and stock), industrial banks, and cash depositories.

§ 333.2 Change in general character of business. No State nonmember insured bank (except a District bank) or branch thereof shall hereafter cause or permit any change to be made in the general character or type of business exercised by it after the effective date of this part without the prior written consent of the

Corporation.

§ 333.101 Prior consent not required. The extension by any State nonmember insured bank of its business to include personal, character or instalment loans, or the extension by an industrial bank of its business to include the business of a commercial bank, is not a change in the general character or type of business requiring the prior written consent of the Corporation.

Historical:

The first two sections of the regulation, namely, § 333.1 and § 333.2, were adopted by the Board on August 30, 1946. The memorandum to the Special Committee and the Board recommending its adoption points out that when a bank applies for insurance, the Board gives consideration to the factors prescribed in the Federal Deposit Insurance Act and considers each factor in the light of the bank's powers at that time; that if the bank subsequently enlarges its corporate powers or changes the general character of its business, it may materially affect the basis upon which the Board considered the factors and the bank would be exercising different rights, powers, and types of business from that considered by the Board.

It referred to a memorandum of Mr. Oppegard's to Mr. Sailor dated July 25, 1945, a copy of which was attached to the memorandum, for a more complete discussion of the proposal. The gist of that memorandum was that when an insured nonmember bank changed its type of banking from one of the categories mentioned in the proposed regulation to include one or more of the other categories and the insurance risk was thus enlarged, the Corporation should have the power to determine whether it will accept such additional potential risk. It pointed out that this power was inherent in the statute and was consistent with other provisions therein which prohibited, in certain instances, consolidations, mergers, or assumptions of liabilities and transfer of assets without the prior written consent of the Corporation; the reduction or retirement of common or preferred capital stock, notes, or debentures, without such consent, and other statutory provisions, including the general authority to prescribe regulations, which clearly evidence the intention of Congress to give to the Corporation such powers as its Board of Directors deem necessary to protect the insurance fund.

The memorandum recommended:

1. That our examiners, in their report of examination upon the bank's application for deposit insurance show that the investigation, with respect to the factors set out in subsection (g) was made only for the type of bank shown in the application;
2. That the application form be revised to contain an agreement of the bank that it will not enlarge its powers, change its essential characteristics, convert to any other type or types of banking, or move its main office to another location without the prior written consent of this Corporation;
3. That the following statement be eliminated from the present application form: "The establishment of a trust department (is) (is not) contemplated."

The interpretative provision set out in § 333.101 of the regulation was adopted January 21, 1948. The memorandum in support of its adoption stated that it was consistent with the practice of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System. We quote the following from the memorandum:

> "The Board of Governors of the Federal Reserve System requires of each state bank, as a condition for membership in that system, am agreement that it will not '... except with the permission of the Board of Governors of the Federal Reserve System, cause or permit any change to be made in the general character of its business or in the scope of its corporate powers exercised by it at the time of membership, ...' The Board of Governors has ruled, with respect to commercial banks taking on small loan business of the Morris Plan type, that '... While such extension of activities may to some extent constitute a change in the general character of the bank's business and in some cases) at least, involve a change in the scope of the corporate powers exercised by the bank, the change is not felt to be such as would come within the intent of the general condition of membership. Accordingly, banks desiring to engage in such activity will not be required to obtain the permission of the Board under the general conditions of membership...'"

In this connection it is pointed out that § 9 of the Federal Reserve Act, which relates to applications for membership by State banks in the Federal Reserve System, provides that the Federal Reserve Board may prescribe conditions under which a State bank may become a member of that System; whereas there is no like provision in the Federal Deposit Insurance Act in respect to nonmember banks applying for Federal deposit insurance.

Practice under the regulation:

In a memorandum of October 23, 1946 to the Chief of the Division of Examination, entitled "Administrative Procedure Act--Corporation's Rules and Regulations" various recommendations were made by legal counsel in respect to amending the procedural forms governing applications and memoranda presented to the Board. This memorandum included these recommendations in respect to Part 333, here discussed:

> "No definite standards can clearly be laid down as guides by which to determine when a state nonmember bank must make, and when it need not make, application for consent under Part 333 except such as are implicit in the regulation itself, namely, whether the proposal changes the general character or type of applicant's business. However, it may be said as a general rule that the regulation is applicable:
>
> 1. When the proposed type of business to be conducted requires an amendment of the institution's articles of incorporation; and
>
> 2. When the proposed type of business to be conducted requires the consent of the state supervising authority.
>
> Other applications will have to be handled on a case by case basis. The regulations should not be invoked to require consent when the bank merely takes on some additional functions which do not materially change its general character or type of business. The paramount consideration in each such case should be whether the proposal affects the insurance risk. As a general matter, if the proposal does not come within Ill and '21 above and does not materially affect the insurance risk, the regulation should not be invoked."
>
> In a memorandum of March 2, 1950 to Mr. Sailor, legal counsel referred to the above memorandum of October 23, 1946, and added the following:
>
> "And we will now add that, in our opinion, the regulation is not applicable where an insured nonmember bank merely proposes to exercise a power which it had at the time of its admission to deposit insurance (1) unless the record shows that, at the time of its admission to deposit insurance, it was understood or agreed by and between the bank and this Corporation that any specified power should not be exercised without the prior written consent of the Corporation; or (2) unless the power is one which is inconsistent with the purposes of the Federal deposit insurance law and its exercise is precluded by reason thereof. In my opinion, nonuse of a power for any particular period of time is not a criterion for invoking the provisions of Part 333 unless it can clearly be shown from the record that such nonuse constituted an abandonment of the power and it was the intention of the bank that our Board should disregard the power in passing upon its application for deposit insurance, and our Board did disregard the same in so doing."

This involved the Iowa Trust and Savings Bank, Oskaloosa, Iowa, which had trust powers in its charter but did not exercise them at the time of its admission to Federal deposit insurance.

Corporation forms used by the banks in applying for Federal deposit insurance:

1. Form 2 used by the banks in applying for membership in the temporary Federal deposit insurance fund under the Banking Act of 1933 (a majority of the banks became insured under this Act) contained this statement in respect to the operation of a trust department:

   "This Corporation does operate a trust department."

   The banks were required to insert in the blank space whether or not they were operating a trust department.

2. Form 84 used by banks in making application for Federal deposit insurance under the Banking Act of 1935 contained the same statement.

3. In Form 84 revised December 15, 1948 (being the first revised form in use after the adoption of Part 333) the above-quoted statement was stricken. We quote as follows from that form as pertinent here:

   "The *(Name of Bank) City or Town and State)* hereby makes application to the Federal Deposit Insurance Corporation to become an insured bank under the provisions of Section 12B of the Federal Reserve Act, as amended, hereinafter referred to as the Federal Deposit Insurance law. The general character or types of business now exercised by the Bank are as follows:

   (See Footnote*)

   It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in subsection (g) of the Federal Deposit Insurance Law to this Application, will consider it only with respect to the general character or types of business above stated.

   *Here outline the nature and extent of the banking business conducted by the Bank. Show whether the business is that of a commercial bank, a bank and trust company, a trust company (without banking powers), a savings bank (stock), an industrial bank, or a cash depository."

4. In Form 84 revised December 1, 1950 (being the second revised form in use after the adoption of Part 333) the two paragraphs above quoted from Form 84 revised December 15, 1948, were amended to read as follows:

   "The *(Name of Bank) (Street Address) (City or Town and State)* hereby makes application to the Federal Deposit Insurance Corporation to become an insured bank under the provisions of the Federal Deposit Insurance Act. The general character or types of business now exercised by the Bank are: (Check all appropriate items)
   ( ) Commercial banking; ( ) Savings Banking; ( ) Industrial banking; ( ) Trust business;
   ( ) Cash depository; ( ) Others. Specify

   It is understood that the Board of Directors of the Federal Deposit Insurance Corporation in applying the factors set out in Section 6 of the Federal Deposit Insurance Act to this Application, will consider the Application only with respect to the general character or type of business above stated *and that the Bank will not engage in any other business without the prior written consent of the Corporation*." (Emphasis supplied.)

5. Form 82 revised (1950), being an application form for execution by prospective incorporators of a proposed bank, contains the same above provisions as Form 84 revised (1950), except the necessary modification to show that the incorporators are making the application for the proposed bank, and an additional form (Form 82A revised 12-1-50) for execution by the bank itself after its incorporation containing a resolution in which the board of directors of the bank --

   "hereby approves the said action of the prospective incorporators of the Bank in preparing and presenting to the Federal Deposit Insurance Corporation said Application, and hereby ratifies and confirms the same, with the same force and effect as if said Application had been made in behalf of the Bank by this Board;

6. Form 85 revised December 1, 1950, a form for use in making an "Application to Establish a Branch", and Form 85A revised December 1, 1950, a form for use in making an "Application to Move Main Office or Branch", both contain the same statements and agreement as are contained in Form 84 revised December, 1950, quoted above, in respect to the general character of the business exercised by the bank and the agreement that the bank will not engage in any other business without the prior written consent of the Corporation.

Discussion and Opinion:

We hereby confirm the opinion of the legal Division in its memorandum of October 23, 1946 to Mr. Sailor, Chief, Division of Examination, in which we stated that the regulation is not applicable where an insured nonmember bank merely proposes to exercise a power which it

had at the time of its admission to deposit insurance, unless the record shows that at the time of its admission it was understood and agreed by and between the bank and this Corporation that any of its specified powers should not be exercised without the prior written consent of the Corporation; and that nonuse of a power for any particular period of time is not a criterion for invoking the provisions of the regulation unless it can be clearly shown from the record that such nonuse constituted an abandonment of the power and it was the intention of the bank that our Board should disregard the power in passing upon its application for deposit insurance, and our Board did disregard the same in so doing.

It is quite obvious that Forms 2 and 84 provide no such agreement or understanding between the applicant bank and this Corporation; and we doubt that such an agreement can be predicated upon the provisions contained in application Form 84 revised December 15, 1948. The basis for that doubt is that it contains no affirmative statement by the bank that it will not engage in any other business without the prior consent of the Corporation. On the other hand, it does advise the bank that the Corporation in applying the statutory factors will consider the application only with respect to the general character or types of business stated therein. However, since there is a doubt about its sufficiency as a contract and as it was used for a period of only two years, we believe it should be placed in the same category as Forms 2 and 84.

We believe, however, that under Form 84 revised December 1, 1950. Form 82 revised December 1, 1950, Form 85 revised December 1, 1950, and Form 85A revised December 1, 1950, an enforceable contract exists between the bank and this Corporation whereby the bank has agreed not to exercise trust powers without the prior written consent of the Corporation, unless so indicated on the application.

For the purpose of the question presented, we shall therefore place banks in two categories, namely, those which became insured prior to the use of the above application forms revised December 1, 1950, and those which became insured under forms revised December 1, 1950.

It is our opinion that the banks in the first category which had, at the time of admission to Federal deposit insurance, either by statute or by charter provisions, trust powers but did not exercise the same at the time of their admission, may exercise such powers without first obtaining this Corporation's written consent, in the absence of any collateral agreement with the Corporation that the bank should not execute such powers without the Corporation's consent. We do believe, however, that in any State, where the bank although it has such powers under the statute may not exercise the same without obtaining the consent of the State supervisory authority, the bank should be required to obtain this Corporation's consent, i.e., that the regulation is applicable in such a case.

We believe that all banks in the second category which had the power, either by statute or by charter, to exercise trust powers but did not exercise them at the time of obtaining Federal deposit insurance should be required to obtain this Corporation's prior written consent to the exercise of such powers. As stated, we believe these application forms constitute an adequate contract between the Corporation and a commercial bank, that it "will not engage in any other business without the prior written consent of the Corporation ..." and that such "other business" would embrace the exercise of its trust powers.

Recommendation:

It is recommended that the Board of Directors approve the following interpretation and application of regulation Part 333 relating to the extension of corporate powers by insured nonmember banks, viz:

1. That regulation Part 333 is *not applicable*, and this Corporation's written consent is not necessary, when an insured nonmember bank proposes to exercise trust powers which it had, either by statute or by charter, at the time of its admission to Federal deposit insurance, unless the record shows that at the time of its admission it was understood and agreed between the Corporation and the bank that it should not exercise such powers.

   (Application Forms No. 2, No. 84, No. 84 revised December 15, 1948, and the corresponding forms for use by incorporators of proposed banks, do not provide such a contract.)

However, the regulation is applicable to such an insured nonmember bank, and this Corporation's written consent is necessary, if the bank may not exercise trust powers without first obtaining the consent of the State supervisory authority although it has trust powers, either by statute or charter. The term "consent" should not be construed to include a situation where a bank can as a matter of right exercise trust powers by merely increasing its capital to the prescribed statutory amount, or by complying with the statutory requirements in respect to the filing of bonds or securities.

2. That regulation Part 333 is applicable to such an insured nonmember bank which has executed by itself, or by its incorporators and ratified by the bank, any of the above forms revised December 1, 1950, viz:

Form 84 revised December 1, 1950 - "Application for Federal Deposit Insurance"

Form 82 revised December 1, 1950 - "Application of Proposed Bank for Federal Deposit Insurance"

Form 85 revised December 1, 1950 - "Application to Establish Branch"

Form 85A revised December 1, 1950 - "Application to Move Main Office or Branch"

or amendments thereof which show the general character of the business exercised by the bank and which contain an agreement that the bank will not engage in any other business without the prior written consent of the Corporation, and such a bank may not exercise trust powers without the prior written consent of this Corporation.

Edward H. DeHority

Deputy Chief

Division of Examination

Royal L. Coburn

General Counsel

Recommendation of the Deputy Chief, Division of Examination, and the General Counsel

Approved by the Special Committee

Recommendation of Special Committee

Approved by the Board of Directors, June 25, 1958

FDIC Legal Opinion on FRB Section 23B Fees and Affiliated Employee Benefit Plans

FDIC

Federal Deposit Insurance Corporation

Dallas Regional Office

1601 Bryan Street, Dallas, Texas 75201 (214) 220-3400 Legal Division

March 10, 1995

Memorandum to: Michael M. Sawyer

Review Examiner

From: Terry G. Youngblood

Counsel/Senior Litigator

Subject: * Bank & Trust Company

*, Texas

* Bank & Trust Company is the trustee of its holding company's profit sharing plan, and the trust department has been waiving fees for the profit sharing plan. An opinion has been requested as to whether or not this violates Section 23B(a)(1)(A).

As set forth in Advisory Opinion 93-53, the Federal Reserve has determined that a profit sharing plan is a company within the meaning of Section 23A. If the profit sharing plan is controlled by a person or persons who control the bank, the profit sharing plan is an affiliate of the bank.

Section 23A(b)(1)(C)(i) states that if a company is controlled by a group of shareholders who control the bank or its holding company, that company is an affiliate of the bank. At * Bank & Trust Company, the directors own 34 percent of the holding company, and if they act in concert they are deemed to control the bank pursuant to Section 23A(b)(3)(A)(i). By virtue of their control of the bank, they would also control the profit sharing plan because the bank is the trustee of the plan.

Likewise, Section 23A(b)(1)(C)(ii) states that if a majority of the directors or trustees of a bank constitutes a majority of the directors or trustees of a company, the other company is an affiliate of the bank. In the instant case, the directors of the bank are automatically the directors of the trustee of the profit sharing plan by virtue of the trust department's status as trustee, and the directors thereby control the profit sharing plan.

The profit sharing plan is therefore an affiliate of the bank within the meaning of Section 23A and Section 23B.

The trust department's failure [to] charge the profit sharing plan for services rendered is a violation of Section 23B(a)(1) unless the bank would in good faith waive fees for comparable transactions with nonaffiliated companies.

Page 3-E of the Report of Examination states that the trust department waives fees for a good customer of the commercial department, but this does not appear to be a comparable transaction because the profit sharing plan does not generate income for the commercial department of the bank.

Problems from Customer "Free-Riding" in Custody Accounts

FIL-76-93

November 4, 1993

Trust Accounts

To: Chief Executive Officer

Subject: Problems from Customer "Free-Riding" in Custody Accounts

The FDIC is alerting banks under its supervision to problems and potential risks from customers who are "free-riding" securities in trust department custody accounts. Free-riding occurs when customers buy and sell securities, usually on the same day, in amounts greatly exceeding the amount allowed under margin collateral requirements. Banks, as well as brokerage houses, have incurred losses when these customers failed to pay for their trades. The Securities and Exchange Commission has been investigating several banks and brokerage firms for possible problems in this area.

Free-riding often begins when a custodial account is opened with a bank trust department. The customer also establishes brokerage accounts for directing securities trade. The customer advises the broker-dealer that payment for the trades will be made through the custodial account.

The free-rider attempts to profit from short-term changes in market prices of securities without placing significant personal funds at risk. Free-riders frequently place a buy order for securities, anticipating a near-

term price increase and intending to pay for the securities with the proceeds from the sale of the same securities.

Banks that permit these transactions without requiring adequate margin collateral face significant risks when a customer's custody account does not contain enough money to complete a purchase order or enough securities to complete a sale order. The risks to bank include: (1) enforcement actions for violation of the Federal Reserve Board's margin lending standards in Regulation U (12 CFR221) or for aiding and abetting violations of Regulation X (12 CFR 224) or Regulation T (12 CFR 220); and (2) the loss of bank funds needed to complete the trades of customers who fail to pay.

Although the FDIC does not believe free-riding is a significant problem at FDIC-supervised banks at this time, the agency is recommending that banks review their policies and procedures for accepting custodial agency accounts and clearing securities transactions. These policies and procedures should:

- Set standards for the acceptance of new custodial accounts, including customer background and credit information;
- Require identification of broker-dealers sending securities to, and receiving funds from, customer accounts;
- Establish systems to track accounts involving numerous broker-dealers;
- Reject customer trades where acceptance would result in a violation of Regulation U; and
- Determine that each account has sufficient funds to perform any trade or, if margin credit is extended, that collateral requirements are met.

Banks also may wish to refer to the supervisory letter recently issued by the staff of the Federal Reserve Board discussing the Federal reserve's margin lending requirements as they apply to free-riding (SR93-13, dated March 16, 1993).

For more information, please contact John F. Harvey, the trust review examiner in the FDIC's Division of Supervision at 202-898-6762.

Stanley J. Poling, Director

Distribution: FDIC-Supervised Banks (Commercial and Savings)

FRB Memorandum on "Free Riding"

Board of Governers

of the

Federal Reserve System

Washington, D. C. 20551

SR 93-13 (FIS)

Division of Banking

Supervision and Regulation

March 16, 1993

To the Officer in charge of supervision

at each Federal Reserve Bank

Subject: Violations of Federal Reserve Margin Regulations in Custodial Agency Accounts Resulting From "Free-Riding" Schemes

Federal Reserve examiners should be aware of recent targeted examinations and investigations by the Federal Reserve and the Enforcement Division of the Securities Exchange Commission (SEC), as well as court actions, that have found banks in violation of Regulation U (12 CFR 221) (Credit by Banks for the Purpose of Purchasing or Carrying Margin Stock) in connection with extensions of credit by bank trust departments, using bank or other fiduciary funds, to individuals involved in illegal "day trading" or "free-riding" schemes. These activities also involved the aiding and abetting of violations of two other securities credit regulations: Regulation T (12 CFR 220) (Credit by Brokers and Dealers) and Regulation X (12 CFR 224) (Borrowers of Securities Credit). Day trading and free-riding schemes involve the purchase and sale of stock on the same day (or within a very short period of time) and the funding of the purchases by the sales' proceeds.

Because of the illegal activities described below, banking organizations have been exposed to disciplinary proceedings, as well as to substantial credit risk. To date, several banks have sustained monetary losses in their trust departments as a result of their involvement in these schemes.

In the late 1980's, the SEC started to uncover illegal free-riding schemes and addressed them through injunctive actions filed against broker-dealers and banks in federal district court. In one case, SEC v. Hansen, et al., 726 F.Supp. 74 (S.D.N.Y. 1989), a bank was found to have violated Regulation U by knowingly participating in a free-riding scheme. This was the first case in which the SEC sued a bank for illegal securities clearance activities associated with a free-riding scheme. It appears that over the past several months these illegal schemes have resurfaced. Investigations and examinations by SEC and Federal Reserve staffs have detected similar violations by state member and national banks' trust departments, leading to follow-up enforcement actions. Thus, increased vigilance by Federal Reserve examiners is called for to ensure that state member banks' trust departments, as well as bank holding companies' nonbank subsidiaries and U.S. branches and agencies of foreign banks that conduct trust-related activities, take all steps necessary to prevent their customers from involving them in the customers' attempts at free-riding. Prompt enforcement action may be necessary to accomplish this in some situations.

Summary of Illegal Activities

The free-riding conduct in question typically involves individuals trading large amounts of securities without depositing the necessary money or appropriate collateral in their customer accounts. The customer seeks to free-ride--that is, purchase and sell the same securities and pay for the purchase with the proceeds of the sale. Often, free-riding schemes involve initial public offerings because broker-dealers are prohibited from financing these new issues. If the money to pay for the securities is not in the account when the securities are delivered in a delivery-versus-payment or receive-versus-payment (DVP) transaction, a bank or other financial institution that permits completion of the transaction creates a temporary overdraft in the customer's account. This overdraft is an extension of credit that is subject to Regulation U.

The typical device used by the perpetrators of a free- riding scheme is for a new customer to open a custodial agency account into which a number of broker-dealers will deliver securities or funds on a DVP basis. Although a deposit may be made into the custodial agency account, the amount of trading is greatly in excess of the original deposit causing the bank to extend its own credit to meet the payment and delivery obligations of the account. Thus, while the financial institution may be generating fees based on the activity of these accounts, it is subjecting itself to substantial losses should the market prices for the purchased securities fall or failed transactions otherwise occur. In addition, other liabilities under federal banking and securities laws may be involved.

Securities Credit Regulations

Regulation U. Because there is no exemption in Regulation U for trust activities in a bank or other financial institution,[1] any extension of credit in the course of settling customer securities transactions must comply with all of the provisions of Regulation U.[2] This includes the requirement that all extensions of credit that are secured by marginable stock be within the 50 percent margin limit set by Regulation U.

To avoid violations of the Board's securities credit regulations, the customer's account must hold sufficient funds on settlement date to pay for each transaction and the funds may not include the proceeds of their sale. If a financial institution is relying on the proceeds of the sale

of securities as its source of payment for accepting delivery of the securities, Board staff, the SEC, and the courts have viewed the institution as extending credit secured by the securities to the customer. Because Regulation U limits the amount of credit that can be extended in these cases to 50 percent of the securities' current market value if the securities qualify as margin stock and, generally, in a free-riding scheme a customer's account does not have funds to pay for all such purchases or a customer instructs the institution to pay for the purchase of securities with the proceeds from those securities' sale, a banking organization that has extended credit in a free-riding scheme has violated Regulation U.

Although the proscriptions of Regulation U apply only to transactions in margin stock, free-riding in nonmargin stocks in custodial agency accounts could, as described below, result in aiding and abetting violations by the banking organization of Regulations T and X, other securities laws, and raise financial safety and soundness issues.

Regulations T and X. Because the custodial agency accounts described above are used to settle transactions effected by the customer at broker-dealers, a banking organization that opens this type of account should have some general understanding of how Regulation T restricts the customer's use of the account at the institution. Regulation T requires the use of a cash account for customer purchases or sales on a DVP basis. Section 220.8(a) of Regulation T specifies that cash account transactions are predicated on the customer's agreement that he or she will make full cash payment for securities before selling them and does not intend to sell them before making such payment. Therefore, free-riding is prohibited in a cash account. A customer who instructs his or her agent bank or other financial institution to pay for a security in reliance on the proceeds of its sale in a DVP transaction is causing, or aiding or abetting, the broker-dealer to violate the credit restrictions of Regulation T. Regulation X, which generally prohibits borrowers from willfully causing credit to be extended in contravention of Regulations T or U, also applies to the customer in such cases.

As described above, banking organizations involved in free-riding schemes may be aiding and abetting violations of Regulation T by the broker-dealers delivering securities or funds to the institutions' customers' accounts. As long as the bank or other financial institution uses its funds to complete a customer's transactions, the broker-dealers may not discover that they are selling securities to the customer in violation of their obligations under Regulation T. A similar aiding and abetting violation of Regulation X could occur with respect to violations by the customers who have used the financial institution to induce their broker-dealers to violate Regulation T.

New Customer Inquiries and Warning Signals

Trust examiners, as well as commercial examiners, should make sure that all banking organizations follow appropriate written policies and procedures concerning the establishment of custodial agency accounts or any new account involving customer securities transactions. They should address, among other things, ways an institution can protect against free-riding schemes. One of the ways financial institutions can protect themselves is to obtain adequate background and credit information from new clients, including whether the customer intends to obtain bank credit to use the account for transactions as if it were a margin account at a broker-dealer. This type of activity requires more extensive monitoring than the typical DVP account in which no credit is extended. It would be prudent to inquire why a new customer is not utilizing the margin account services of its broker-dealers. Regulation U Form FR U-1 must be obtained and constantly updated if the account is to be used as a margin account.

It also would be advisable for the financial institution to obtain from the customer a list of broker-dealers that will be sending securities to or receiving funds from the account on a DVP basis. If it appears that a number of broker-dealers may be used on a DVP basis, the banking organization should obtain an undertaking from the customer, as part of the new account agreement, that all transactions with the broker-dealer will be in conformance with Regulations T and X and that the customer is aware that a cash account security is not to be sold until it is paid for. Similarly, in obtaining instructions for settling DVP transactions for a customer, the institution should clarify that it will not pay for the purchase of securities with the proceeds from the sale of those securities.

Examiners should also ensure that banking organizations monitor such accounts closely for an initial period to detect patterns typical of free-riding, including intraday overdrafts, and ensure that sufficient funds or margin collateral are on deposit at all times. Frequent

transactions in securities being offered in an initial public offering may suggest an avoidance of Regulations T and X. In the event it appears that a customer is attempting to free-ride, an institution immediately should alert the broker-dealers involved and take steps to minimize its own credit risk and legal liability.

At a minimum, examiners should also evaluate a trust institution's ability to ensure that it does not extend more credit on behalf of the banking organization to a customer than is permitted under Regulation U. Any overdraft related to a purchase or sale of margin stock is an extension of credit subject to the regulation, including overdrafts that are outstanding for less than a day. Board staff has published a number of opinions discussing the application of Regulation U to various transactions relating to free-riding in the Federal Reserve Regulatory Service. See, for example, Federal Reserve Regulatory Service, at 5-942.2 (1992); 5-942.18 (1990); and 5-942.15 (1989).

SEC and Federal Reserve Sanctions and Enforcement Actions
As noted earlier, the SEC has exercised its broad authority to enforce the Board's securities credit regulations. This has included the initiation of several enforcement actions in federal district court against banks involved in activities similar to those outlined above, as well as the preparation of other cases that are pending. In each completed case, the SEC obtained permanent injunctions against future violations from the banks involved. The SEC also required the banks to establish credit compliance committees to formulate written policies and procedures concerning the extension of purpose credit in their securities clearance business, establish training programs for bank personnel responsible for the conduct of their securities clearance business and submit to outside audits to ascertain whether the banks met their undertakings under the injunctions.

It should be noted that under section 21 of the Securities Exchange Act of 1934, the SEC may, and has stated an intention to, seek civil money penalties in addition to federal district court injunctive actions. Civil penalties and aiding and abetting liability may be assessed by the SEC against a banking organization if the customer or its broker-dealer is found in violation of Regulations X or T, and if the financial institution has knowledge of the facts and assists the scheme -- that is, by extending credit to finance the free-riding.

In addition, the Board may institute enforcement proceedings against the banking organizations supervised by the Federal Reserve and their institution-affiliated parties involved in these activities, including cease and desist, civil money penalty assessment, and removal and permanent prohibition actions.

Notification to State Member Banks
Reserve Bank staff should notify the state member banks, bank holding companies, and the U.S. branches and agencies of foreign banks in their Districts about the potential for violations of the Board's Regulation U and other securities credit regulations. A suggested notification letter is attached.

Please contact Scott Holz, Senior Attorney, or Angela Desmond, Senior Attorney, at (202) 452-2781, with any questions concerning the Board's margin regulations and free-riding arrangements, and Herbert A. Biern, Deputy Associate Director, at (202) 452-2620, for enforcement-related matters.

Stephen C. Schemering

Deputy Director

FFIEC Examination Council Supervisory Policy on Repurchase Agreements Of Depository Institutions With Securities Dealers And Others

Purpose
Depository institutions and others involved with the purchase of United States Government and Agency obligations under agreements to resell (reverse repurchase agreement), have sometimes incurred significant losses. The most important factors causing these heavy losses have been inadequate credit risk management and the failure to exercise effective control over securities collateralizing the transactions.

The following minimum guidelines address the need for managing credit risk exposure to

counterparties under securities repurchase agreements and for controlling the securities in those transactions, and should be followed by depository institutions that enter into repurchase agreements with securities dealers and others.

Depository institutions that actively engage in repurchase agreements are encouraged to have more comprehensive policies and controls to suit their particular circumstances. The examining staffs of the federal bank, thrift and credit union supervisory agencies will review written policies and procedures of depository institutions to determine their adequacy in light of these minimum guidelines and the scope of each depository's operations.

I. Credit Policy Guidelines

The apparent safety of short-term repurchase agreements which are collateralized by highly liquid, U.S. Government and federal agency obligations has contributed to an attitude of complacency. Some portfolio managers have underestimated the credit risk associated with the performance of the counterparty to the transaction, and have not taken adequate steps to assure control of the securities covered by the agreement.

All depository institutions that engage in securities repurchase agreement transactions should establish written credit policies and procedures governing these activities. At a minimum, those policies and procedures should cover the following:

A. Written policies should establish "know your counterparty" principles. Engaging in repurchase agreement transactions in volume and in large dollar amounts frequently requires the services of a counterparty who is a dealer in the underlying securities. Some firms which deal in the markets for U.S. Government and federal agency securities are subsidiaries of, or related to, financially stronger and better known firms. However, these stronger firms may be independent of their U.S. Government securities subsidiaries and affiliates and may not be legally obligated to stand behind the transactions of related companies. Without an express guarantee, the stronger firm's financial position cannot be relied upon in assessing the creditworthiness of a counterparty.

   It is important to know the legal entity that is the actual counterparty to each repurchase agreement transaction. A depository institution should know about the actual counterparty's character, integrity of management, activities, and the financial markets in which it deals. Depository institutions should be particularly careful in conducting repurchase agreements with any firm that offers terms that are significantly more favorable than those currently prevailing in the market.

   In certain situations depository institutions may use, or serve as, brokers or finders in order to locate repurchase agreement counterparties or particular securities. When using or acting as this type of agent the names of each counterparty should be fully disclosed. Depository institutions should not enter into undisclosed agency or "blind brokerage" repurchase transactions in which the counterparty's name is not disclosed.

B. Dealings with unregulated securities dealers. A dealer in U.S. Government and federal agency obligations is not necessarily a federally insured bank or thrift, or a broker/dealer registered with the Securities and Exchange Commission. Therefore, the dealer firm may not be subject to any federal regulatory oversight.

   A depository institution doing business with an unregulated securities dealer should be certain that the dealer voluntarily complies with the Federal Reserve Bank of New York's minimum capital guideline, which currently calls for liquid capital to exceed measured risk by 20 percent (that is, the ratio of a dealer's liquid capital to risk of 1.2: 1). This ratio can be calculated by a dealer using either the Securities and Exchange Commission's Net Capital Rule for Brokers and Dealers (Rule 15c3-1) or the Federal Reserve Bank of New York's Capital Adequacy Guideline for United States Government Securities Dealers. To ensure that an unregulated dealer complies with either of those capital standards, it should certify its compliance with the capital standard and provide the following three forms of certification:

   1. A letter of certification from the dealer that the dealer will adhere on a continuous basis to the capital adequacy standard;
   2. audited financial statements which demonstrate that as of the audit date the

dealer was in compliance with the standard and the amount of liquid capital; and

3. a copy of a letter from the firm's certified public accountant stating that it found no material weaknesses in the dealer's internal systems and controls incident to adherence to the standard.

A. Periodic evaluations of counterparty creditworthiness should be conducted by individuals who routinely make credit decisions and who are not involved in the execution of repurchase agreement transactions.

   Prior to engaging in initial transactions with a new counterparty, depository institutions should obtain audited financial statements and regulatory filings (if any) from its counterparties, and should insist that similar information be provided on a periodic and timely basis in the future. Recent failures of government securities dealers have typically been foreshadowed by delays in producing these statements. Many firms are registered with the Securities and Exchange Commission as broker/dealers and have to file financial statements and should be willing to provide a copy of these filings.

   The counterparty credit analysis should consider the financial statements of the entity that is to be the depository institution's counterparty as well as those of any related companies that could have an impact on the financial condition of the counterparty. When transacting business with a subsidiary, consolidated financial statements of a parent are not adequate. Repurchase agreements should not be entered into with any counterparty that is unwilling to provide complete and timely disclosure of its financial condition. As part of this analysis, the depository institution should make inquiry about the counterparty's general reputation and whether there have been any formal enforcement actions against the counterparty or its affiliates by state or federal securities regulators.

B. Maximum position and temporary exposure limits for each approved counterparty should be established based upon credit analysis performed. Periodic reviews and updates of those limits are necessary.

   Individual repurchase agreement counterparty limits should consider overall exposure to the same or related counterparty throughout the depository institution. Repurchase agreement counterparty limitations should include the overall permissible dollar positions in repurchase agreements, maximum repurchase agreement maturities and limits on temporary exposure that may result from decreases in collateral values or delays in receiving collateral.

C. Lending Limitations. Federally-chartered savings institutions and federal credit unions are subject to all federal regulations in this area. State-chartered banks or savings institutions should consult with their counsel and/or state banking or thrift authorities as to the applicability of state lending restrictions to repurchase transactions.

   Except as otherwise provided in applicable agency regulations and state law, it should be assumed that unless the depository institution's interest in securities held as collateral under a repurchase agreement is assured, a repurchase agreement transaction with any single counterparty will be subject to the lending limitations applicable to that institution. Conversely, the market value of securities sold under a repurchase agreement in excess of the amount of proceeds received by the depository institution could be viewed as an unsecured extension of credit to the repurchase agreement counterparty subject to the depository institution's lending limits.

   The application of lending limitations on loans by national banks to certain types of repurchase transactions is currently under review by the Comptroller of the Currency. Until this review is completed, national banks as a matter of prudent banking should treat repurchase agreements as if they are subject to the lending limit unless the bank has control of the underlying securities.

II. Guidelines for Controlling Repurchase Agreement Collateral

Repurchase agreements can be a useful asset and liability management tool, but repurchase

agreements can expose a depository institution to serious risks if they are not managed appropriately. It is possible to reduce repurchase agreement risk if the depository institution negotiates written agreements with all repurchase agreement counterparties and custodian banks. Compliance with the terms of these written agreements should be monitored on a daily basis. If prudent management control requirements of repurchase agreements are too burdensome for a depository institution, other asset/liability management tools should be used.

The marketplace perceives repurchase agreement transactions as similar to lending transactions collateralized by highly liquid government securities. However, experience has shown that the collateral securities will probably not serve as protection if the counterparty becomes insolvent or fails, and the purchasing institution does not have control over the securities. This policy statement provides general guidance on the steps depository institutions should take to protect their interest in the securities underlying repurchase agreement transactions (see "C. Control of Securities,") However, ultimate responsibility for establishing adequate procedures rests with management of the institution. Management should obtain a written legal opinion as to the adequacy of the procedures utilized to establish and protect the depository institution's interest in the underlying collateral.

General Requirements

A. A written agreement specific to a repurchase agreement transaction or master agreement governing all repurchase agreement transactions should be entered into with each counterparty. The written agreement should specify all the terms of the transaction and the duties of both the buyer and seller. Senior managers of depository institutions should consult legal counsel regarding the content of the repurchase and custodial agreements. The repurchase and custodial agreements should specify, but should not be limited to, the following:

- acceptable types and maturities of collateral securities;
- initial acceptable margin for collateral securities of various types and maturities;
- margin maintenance, call, default and sellout provisions;
- rights to interest and principal payments;
- rights to substitute collateral; and
- the persons authorized to transact business on behalf of the depository institution and its counterparty.

- Confirmations. Some repurchase agreement confirmations may contain terms that attempt to change the depository institution's rights in the transaction. The depository institution should obtain and compare written confirmations for each repurchase agreement transaction to be certain that the information on the confirmation is consistent with the terms of the agreement. The confirmation should identify specific collateral securities.
- Control of Securities. As a general rule, a depository institution should obtain possession or control of the underlying securities and take necessary steps to protect its interest in the securities. The legal steps necessary to protect its interest may vary with applicable facts and law and accordingly should be undertaken with the advice of counsel. Additional prudential management controls may include:
    1. Direct delivery of physical securities to the institution, or of book-entry securities by appropriate entry in an account maintained in the name of the depository institution by a Federal Reserve bank which maintains a book-entry system for U.S. Treasury securities and certain agency obligations (for further information as to the procedures to be followed, contact the Federal Reserve bank for the district in which the depository institution is located);
    2. delivery of either physical securities to, or in the case of book entry securities, making appropriate entries in the books of a third party custodian designated by the depository institution under a written custodial agreement which explicitly recognizes the depository institution's interest in the securities as superior to that of any other person; or
    3. appropriate entries on the books of a third party custodian acting pursuant to a tripartite agreement with the depository institution and the counterparty, ensuring adequate segregation and identification of either physical or book-entry securities.

Where control of the underlying securities is not established, the depository institution may be regarded only as an unsecured general creditor of the insolvent counterparty. In such instance, substantial losses are likely to be incurred. Accordingly, a depository institution should not enter into a repurchase agreement without obtaining control of the securities unless all of the following minimum procedures are observed: (1) it is completely satisfied as to the creditworthiness of the counterparty; (2) the transaction is within credit limitations that have been pre-approved by the board of directors, or a committee of the board, for unsecured transactions with the counterparty; (3) periodic credit evaluations of the counterparty are conducted; and (4) the depository institution has ascertained that collateral segregation procedures of the counterparty are adequate. Unless prudential internal procedures of these types are instituted and observed, the depository institution may be cited by its financial supervisory agency for engaging in unsafe or unsound practices.

All receipts and deliveries of either physical or book-entry securities should be made according to written procedures, and third party deliveries should be confirmed in writing directly by the custodian. It is not acceptable to receive confirmation from the counterparty that the securities are segregated in a depository institution's name with a custodian; the depository institution should, however, obtain a copy of the advice of the counterparty to the custodian requesting transfer of the securities to the depository institution. Where securities are to be delivered, payment for securities should not be made until the securities are actually delivered to the depository institution or its agent. The custodial contract should provide that the custodian takes delivery of the securities subject to the exclusive direction of the depository institution.

Substitution of securities should not be allowed without the prior consent of a depository institution. The depository institution should give its consent before the delivery of the substitute securities to the depository institution or a third party custodian. Any substitution of securities should take into consideration the following discussion of "margin requirements."

D. Margin Requirements. The amount paid by a depository institution under the repurchase agreement should be less than the market value of the securities, including the amount of any accrued interest, with the difference representing a predetermined margin. Factors to be considered in establishing an appropriate margin include the size and maturity of the repurchase transaction, the type and maturity of the underlying securities, and the creditworthiness of the counterparty. Margin requirements on U.S. Government and federal agency obligations underlying repurchase agreements should allow for the anticipated price volatility of the security until the maturity of the repurchase agreement. Less marketable securities may require additional margin to compensate for less liquid market conditions. Written repurchase agreement policies and procedures should require daily mark-to-market of repurchase agreement securities to the bid side of the market. Repurchase agreements should provide for additional securities or cash to be placed with the depository institution or its custodian bank to maintain the margin within the predetermined level.

Margin calculations should also consider accrued interest on underlying securities and the anticipated amount of accrued interest over the term of the repurchase agreement, the date of interest payment and which party is entitled to receive the payment. In the case of pass-through securities, anticipated principal reductions should also be considered when determining margin adequacy.

E. Prudent management procedures should be followed in the administration of any repurchase agreement. Longer term repurchase agreements require management's daily attention to the effects of securities substitutions, margin maintenance requirements (including consideration of any coupon interest or principal payments) and possible changes in the financial condition of the counterparty. Engaging in open repurchase agreement transactions without

maturity dates may be regarded as an unsafe and unsound practice unless the depository institution has retained rights to terminate the transaction quickly to protect itself against changed circumstances. Similarly, automatic renewal of short-term repurchase agreement transactions without reviewing collateral values and adjusting collateral margin may be regarded as an unsafe and unsound practice. If additional margin is not deposited when required, the depository institution's rights to sell securities or otherwise liquidate the repurchase agreement should be exercised without hesitation.

F. Overcollateralization. A depository institution should use current market values, including the amount of any accrued interest, to determine the price of securities that are sold under repurchase agreements. Counterparties should not be provided with excessive margin. Thus, the written repurchase agreement contract should provide that the counterparty must make additional payment or return securities if the margin exceeds agreed upon levels. When acquiring funds under repurchase agreements it is prudent business practice to keep at a reasonable margin the difference between the market value of the securities delivered to the counterparty and the amount borrowed. The excess market value of securities sold by a depository institution may be viewed as an unsecured loan to the counterparty subject to the unsecured prudential limitations for the depository institution and should be treated accordingly for credit policy and control purposes.

By order of the Board of Directors, November 12, 1985.

Source: FDIC bank letter (BL-43-85), dated November 18, 1985

FFIEC Examination Council Supervisory Policy on Securities Lending

Purpose

Financial institutions are lending securities with increasing frequency. In some instances a financial institution may lend its own investment or trading account securities. More and more often, however, financial institutions lend customers' securities held in custody, safekeeping, trust or pension accounts. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand for them, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers has heightened regulatory sensitivity to the potential for problems in this area. Accordingly, we are providing the following discussion of guidelines and regulatory concerns.

Securities Lending Market

Securities brokers and commercial banks are the primary borrowers of securities. They borrow securities to cover securities fails (securities sold but not available for delivery), short sales, and option and arbitrage positions. Securities lending, which used to involve principally corporate equities and debt obligations, increasingly involves loans of large blocks of U.S. government and federal agency securities.

Securities lending is conducted through open-ended "loan" agreements, which may be terminated on short notice by the lender or borrower. The objective of such lending is to receive a safe return in addition to the normal interest or dividends. Securities loans are generally collateralized by U.S. government or federal agency securities, cash, or letters of credit. At the outset, each loan is collateralized at a predetermined margin. If the market value of the collateral falls below an acceptable level during the time a loan is outstanding, a margin call is made by the lender institution. If a loan becomes over-collateralized because of appreciation of collateral or market depreciation of a loaned security, the borrower usually has the opportunity to request the return of any excessive margin.

When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower. Fees received on securities loans are divided between the lender institution and the customer account that owns the securities. In situations involving cash collateral, part of interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

Definitions Of Capacity

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. For the purposes of these guidelines, the relevant capacities are:

Principal: A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

Agent: A lender institution offering securities on behalf of a customer-owner is acting as an agent. For the lender institution to be considered a bona fide or "fully disclosed" agent, it must disclose the names of the borrowers to the customer-owners (or give notice that names are available upon request), and must disclose the names of the customer-owner to borrowers (or give notice that names are available upon request). In all cases the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, i.e. "blind brokerage" transactions in which participants cannot determine the identity of the counterparty, are treated as if the lender institution were the principal. (See definition above.)

Directed Agent: A lender institution which lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

Fiduciary: A lender institution which exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For purposes of these guidelines, the underlying relationship may be as agent, trustee, or custodian.

Finder: A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Securities and collateral are delivered directly by the borrower and the lender without the involvement of the finder. The finder is simply a fully disclosed intermediary.

Guidelines

All financial institutions that participate in securities lending should establish written policies and procedures governing these activities. At a minimum, policies and procedures should cover each of the topics in these guidelines.

Recordkeeping

Before establishing a securities lending program, a financial institution must establish an adequate recordkeeping system. At a minimum, the system should produce daily reports showing which securities are available for lending, and which are currently lent, outstanding loans by borrower, outstanding loans by account, new loans, returns of loaned securities, and transactions by account. These records should be updated as often as necessary to ensure that the lender institution fully accounts for all outstanding loans, that adequate collateral is required and maintained, and that policies and concentration limits are being followed.

Administrative Procedures

All securities lent and all securities standing as collateral must be marked to market daily. Procedures must ensure that any necessary calls for additional margin are made on a timely basis.

In addition, written procedures should outline how to choose the customer account that will be the source of lent securities when they are held in more than one account. Possible methods include: loan volume analysis, automated queue, a lottery, or some combination of these methods. Securities loans should be fairly allocated among all accounts participating in a securities lending program.

Internal controls should include operating procedures designed to segregate duties and timely management reporting systems. Periodic internal audits should assess the accuracy of accounting records, the timeliness of management reports, and the lender institution's overall compliance with established policies and procedures.

Credit Analysis and Approval of Borrowers

In spite of strict standards of collateralization, securities lending activities involve risk of loss. Such risks may arise from malfeasance or failure of the borrowing firm or institution. Therefore, a duly established management or supervisory committee of the lender institution should formally approve, in advance, transactions with any borrower.

Credit and limit approvals should be based upon a credit analysis of the borrower. A review should be performed before establishing such a relationship and reviews should be conducted at regular intervals thereafter. Credit reviews should include an analysis of the borrower's financial statement, and should consider capitalization, management, earnings, business reputation, and any other factors that appear relevant. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person(s) managing the securities lending program are not sufficient.

Credit and Concentration Limits

After the initial credit analysis, management of the lender institution should establish an individual credit limit for the borrower. That limit should be based on the market value of the securities to be borrowed, and should take into account possible temporary (overnight) exposures resulting from a decline in collateral values or from occasional inadvertent delays in transferring collateral. Credit and concentration limits should take into account other extensions of credit by the lender institution to the same borrower or related interests. Such information, if provided to a institution's trust department conducting a securities lending program, would not be considered material inside information and therefore, not violate "Chinese Wall" policies designed to protect against the misuse of material inside information. Violation of securities laws would arise only if material inside information were used in connection with the purchase or sale of securities.

Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

When a lender institution is lending its own securities as principal, statutory lending limits may apply. For national banks and federal savings associations, the limitations in 12 USC 84 apply. For state-chartered institutions, state law and applicable federal law must be considered. Certain exceptions may exist for loans that are fully secured by obligations of the United States government and federal agencies.

Collateral Management

Securities borrowers pledge and maintain collateral at least 100 percent of the value of the securities borrowed. The minimum amount of excess collateral, or "margin", acceptable to the lender institution should relate to price volatility of the loaned securities and the collateral (if other than cash).

Generally, the minimum initial collateral on securities loans is at least 102 percent of the market value of the lent securities plus, for debt securities, any accrued interest.Collateral must be maintained at the agreed margin. A daily "mark-to-market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should take into account the value of accrued interest on debt securities.

Securities should not be lent unless collateral has been received or will be received simultaneously with the loan. As a minimum step toward perfecting the lender's interest, collateral should be delivered directly to the lender institution or an independent third party trustee.

Cash as Collateral

When cash is used as collateral, the lender institution is responsible for making it income productive. Lenders should establish written guidelines for selecting investments for cash collateral. Generally, a lender institution will invest cash collateral in repurchase agreements, master notes, a short term investment fund, U.S. or Eurodollar certificates of deposits, commercial paper or some other type of money market instrument. If the lender institution is acting in any capacity other than as principal, the written agreement authorizing the lending relationship should specify how cash collateral is to be invested.

Investing cash collateral in liabilities of the lender institution or its holding company would be an improper conflict of interest unless that strategy was specifically authorized in writing by the owner of the lent securities. Written authorizations for participating accounts are further discussed later in these guidelines.

Letters of Credit as Collateral

Since May 1982, letters of credit have been permitted as collateral in certain securities lending transactions outlined in Federal Reserve Regulation T. If a lender institution plans to accept letters of credit as collateral, it should establish guidelines for their use. Those guidelines should require a credit analysis of the financial institution issuing the letter of credit before securities are lent against that collateral. Analyses must be periodically updated and reevaluated. The lender institution should also establish concentration limits for the institutions issuing letters of credit and procedures should ensure they are not exceeded. In establishing concentration limits on letters of credit accepted as collateral, the lender institution's total outstanding credit exposures from the issuing institution should be considered.

Written Agreements

Securities should be lent only pursuant to a written agreement between the lender institution and the owner of the securities specifically authorizing the institution to offer the securities for loan. The agreement should outline the lender institution's authority to reinvest cash collateral (if any) and responsibilities with regard to custody and valuation of collateral. In addition, the agreement should detail the fee or compensation that will go to the owner of the securities in the form of a fee schedule or other specific provision. Other items which should be covered in the agreement have been discussed earlier in these guidelines.

A lender institution must also have written agreements with the parties who wish to borrow securities. These agreements should specify the duties and responsibilities of each party. A written agreement may detail: acceptable types of collateral (including letters of credit); standards for collateral custody and control, collateral valuation and initial margin, accrued interest, marking to market, and margin calls; methods for transmitting coupon or dividend payments received if a security is on loan on a payment date; conditions which will trigger the termination of a loan (including events of default); and acceptable methods of delivery for loaned securities and collateral.

Use of Finders

Some lender institutions may use a finder to place securities, and some financial institutions may act as finders. A finder brings together a borrower and a lender for a fee. Finders should not take possession of securities or collateral. The delivery of securities loaned and collateral should be direct between the borrower and the lender. A finder should not be involved in the delivery process.

The finder should act only as a fully disclosed intermediary. The lender institution must always know the name and financial condition of the borrower of any securities it lends. If the lender institution does not have that information it and its customers are exposed to unnecessary risks.

Written policies should be in place concerning the use of finders in a securities lending program. These policies should cover the circumstances in which a finder will be used, which party pays the fee (borrower or lender), and which finders the lender institution will use.

Employee Benefit Plans

The Department of Labor has issued two class exemptions which deal with securities lending programs for employee benefit plans covered by the Employee Retirement Income Security Act (ERISA)--Prohibited Transaction Exemption 81-6 (46 FR 7527 (January 23, 1981), supplemented 52 FR 18754 (May 19, 1987)), and Prohibited Transaction Exemption 82-63 (47 FR 14804 (April 6, 1982) and correction published at 47 FR 16437 (April 16, 1982)). The exemptions authorize transactions which might otherwise constitute unintended "prohibited transactions" under ERISA. Any institution engaged in lending of securities for an employee benefit plan subject to ERISA should take all steps necessary to design and maintain its program to conform with these exemptions. Prohibited Transaction Exemption 81-6 permits the lending of securities owned by employee benefit plans to persons who could be "parties in interest" with respect to such plans, provided certain conditions specified in the exemption are met. Under those conditions neither the borrower nor an affiliate of the borrower can have

discretionary control over the investment of plan assets, or offer investment advice concerning the assets, and the loan must be made pursuant to a written agreement. The exemption also establishes a minimum acceptable level for collateral based on the market value of the loaned securities.

Prohibited Transaction Exemption 82-63 permits compensation of a fiduciary for services rendered in connection with loans of plan assets that are securities. The exemption details certain conditions which must be met.

Indemnification

Certain lender institutions offer participating accounts indemnification against losses in connection with securities lending programs. Such indemnifications may cover a variety of occurrences including all financial loss, losses from a borrower default, or losses from collateral default. Lender institutions that offer such indemnification should obtain a legal opinion from counsel concerning the legality of their specific form of indemnification under federal and/or state law.

A lender institution which offers an indemnity to its customers may, in light of other related factors, be assuming the benefits and, more importantly, the liabilities of a principal. Therefore, lender institutions offering indemnification should also obtain written opinions from their accountants concerning the proper financial statement disclosure of their actual or contingent liabilities.

Regulatory Reporting

Securities borrowing and lending transactions should be reported by commercial banks according to the Instructions for the Consolidated Reports of Condition and Income and by thrifts according to Thrift Financial Report instructions.

By order of the Board of Directors, July 22, 1997.

Source: 62 Fed. Reg. 40816, July 30, 1997, effective July 30, 1997

State Statutes Authorizing Fiduciary Investments in Proprietary Mutual Funds

Revised Through September 1, 2000

State Statutes Authorizing fiduciary investments in proprietary mutual funds				
State	**Citation**	**Fees**	**Disclosure** **To Whom/How/When/What**	**Other**
AL	Ala. Code § 19-3-120.1	Allows fee as investment advisor and as trustee.	To the current income beneficiaries. By prospectus, account statement or otherwise. Requires disclosure of the basis (expressed as a percentage of asset value or otherwise) of fees.	Mutual Fund Investment Restrictions Portfolio of investment trust or company must consist of investments authorized by law or trust agreement.
AK	Alaska Stat. § 13.36.225	Prudent Investor Rule: Fees to be "appropriate and		

		reasonable" in relation to trust investments		
* AZ	Ariz. Rev. Stat. Ann. 6-246		To all persons whose funds are invested in the company or trust. In the statement of the fiduciary account That the bank or trust company provides services for and receives fees from the open-end or closed-end management company or investment trust	Mutual Fund Investment Restrictions Portfolio of investment company must consist of investments permitted by applicable fiduciary instrument
AR	Ark. Stat. Ann § 28-71-104	Allows fees as an investment advisor and a trustee		Mutual Fund Investment Restrictions Portfolio of investment company must consist of investments permitted by applicable fiduciary instrument
CA	Cal. Finance Code § 1561.1	Fees received from trust accounts "reasonably attributable" to investment advisory or investment management services to the trust shall be reduced by any fees that are received for providing "investment advisory" or "investment management" services to the mutual fund.	At least annually by prospectus, the following items must be disclosed to trust account holders: Statement of the trust account and brief description of the fees received by the bank trust department for its investment advisory or investment management services for the mutual fund.	
CO	Colo. Rev. Stat. § 11-10-107 (1990)	Allows fee as investment advisor and as trustee		
* CT	Conn. Gen. Stat 45a-235,-209	Unless specifically permitted by governing instrument, neither investment advisory fee nor trustee fee may be charged	Annually to each current income beneficiary By mailing separate notices Notices shall cover (1) disclosure of provision of services	Limits on Authorization Investment permissible if: Not prohibited by governing

			and compensation and (2) provide prospectus, statement, (and/or?) letter.	instrument Portfolio consists of investments not prohibited Duty of prudence not affected
DE	Del. Code Ann. tit. 12, § 3312	Permits investment advisor fee. Bank may receive fiduciary fees or commissions from account at the same rate bank would be entitled to receive if account was not invested in mutual funds	To all current income beneficiaries Disclose the full amount of fees or commissions received by the bank	
* DC	DC Code Ann. § 21--1721	Fees may not exceed "customary or prevailing amount" charged by bank for providing comparable service to nonfiduciary accounts	To all current income beneficiaries Disclose the rate, formula or other method for which bank receives services to mutual fund	Investment expressly allowed
FL	Fla. Stat. Ann. § 660.417 & § 737.402		To all persons to whom statements of such account are rendered Disclose the basis upon which compensation is calculated	Mutual Fund Investment Restrictions Portfolio of investment company must consist substantially of investments not prohibited by the governing instrument
GA	Ga. Code Ann. § 3-8-3,-4	Allows fee as investment advisor and as trustee		
HI	Haw. Rev. Stat. § 412: 8-400	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
ID	Idaho Code § 68-404A	Allows fee as investment advisor and as trustee		
IL	Ill. Ann. Stat. 5/5.1	Allows fee as investment advisor and as trustee if total compensation paid by trust estate as trustee fees and mutual fund fees, including any advisory or		

		management fees, are reasonable. Trustee may receive 12b-1 fees equal to the amount of those fees that would be paid to any other party		
IN	Ind. Code Ann. § 28-1-12-3 (West Supp. 1992)	Allows fee as investment advisor and as trustee		
IA	Iowa Code Ann. 633.123(2)	Allows fee as investment advisor and as trustee		Mutual Fund Investment Restrictions Portfolio of investment company or trust must consist substantially of investments not prohibited by the governing instrument
* KS	Kan. Stat. Ann. § 17-5005(c)	Allows fee as investment advisor and as trustee Total of all fees, charges and compensation from fiduciary account, and remuneration for services provided by bank to mutual fund, shall be reasonable	To all current income beneficiaries By statement, prospectus, or otherwise Conspicuously disclose the rate, formula, or other method of compensation for services by bank to mutual fund	Fiduciary Standard Investment must be in best interest of fiduciary account beneficiary and must meet Prudent Investor standard
KY	Ky. Rev. Stat. Ann. § 386.020(g)	statute does not specify whether fiduciary may receive reasonable compensation for investment advisor services		
LA	La. Rev. Stat. Ann. § 9:2127	Allows fee as investment advisor and as trustee	To all persons having an ownership, contractual, or beneficial interest in such accounts By prospectus, account statement, or otherwise The basis on which fee is calculated expressed as a percentage of asset value or otherwise	Mutual Fund Investment Restrictions Portfolio of investment company or trust must consist substantially of investments not prohibited by the governing instrument
	Me. Rev. Stat. Ann.	Fees are limited to either the	Disclosure of any	

ME	18-A Section 7-408	investment advisory fee or the trustee fee	affiliated relationship must be given	Limits on Authorization Investment not permitted if prohibited by instrument, judgement, decree or order creating the fiduciary relationship
MD	Md. Est. & Trusts Code Ann. § 15-106	Allows fee as investment advisor and as trustee if disclosures given or beneficiary consent received	To current income beneficiaries Disclose description of services, and the rate, formula or other method by which compensation is paid	Limits on Authorization Investment must be authorized by the agreement or instrument that gives corporate fiduciary investment authority, or by court order Investment Restrictions Investment limited to no-load open-end management type investment company or trust that does not impose a contingent sales charge or distribution charge on investment of fiduciary assets
* MA	Mass. Ann. Laws Chapter 167G section 3(11)	Either: Investment advisory fees to which trustee entitled to receive as trustee shall be reduced by the amount of any investment advisory fees paid to the trustee by the investment company, or Investment advisory fees paid to the trustee by the investment company shall be received in lieu of any investment advisory fees that the trustee would otherwise be entitled to	In any written communication or account statement reflecting such a purchase, bank shall disclose any capacity in which it acts for the issuer of the securities	Limits on Authorization Purchase of any investment company for which bank acts as adviser is allowed unless there is an express provision to the contrary in the instrument creating trust relationship. Miscellaneous

		receive for the investment management of the trust		General standard of prudence required of fiduciaries still applies Any bonds or securities shall have sufficient liquidity to satisfy the principles of fiduciary investment
MI	Mich. Comp. Laws § 700.1508	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
MN	Minn. Stat. § 48A.07	Allows fee as investment advisor and as trustee in the absence of an express prohibition in trust instrument	To all current income beneficiaries Disclose the rate, formula and method of compensation	
MS	Miss. Code Ann. § 81-5-33	Allows fee as investment advisor and as trustee if total compensation is reasonable	To all current income beneficiaries By statement, prospectus or otherwise Disclose the basis, expressed as a percentage of asset value or otherwise, upon which compensation is calculated	
MO	Mo. Rev. Stat. 362.550(11)	Bank entitled to only normal fiduciary fees		
* MT	Mont. Code Ann § 32-1-420	Allows fee as investment advisor and as trustee unless expressly prohibited in trust instrument	To all current income beneficiaries The rate, formula and method of compensation	
NE	1993 Rev. Stat. § 30-3205	Bill allows fee as investment advisor and as trustee if disclosures made	To all persons entitled to receive statements of account activity Initially by prospectus and at least annually thereafter by account statement or any other written means Disclose the basis of the compensation as investment advisor expressed as a	Consents Required Must be consented to in writing by all persons entitled to receive statements of account activity Miscellaneous Portfolio of

			percentage of the asset value, a percentage of the income earned, or the actual amount charged	investment company or trust must substantially consist of investments not prohibited by the governing instrument
NV	Nev. Rev. Stat. Ann. § 669.225	Allows fee as investment advisor and as trustee if disclosures made	To the person currently receiving the benefits of the fiduciary relationship By prospectus, statement of account, or otherwise Disclose the manner in which compensation is calculated	Mutual Fund Investment Restrictions Portfolio of investment company or trust must substantially consist of investments not prohibited by the governing instrument
NH	N.H. Rev. Stat. Ann. § 384:65	Two categories of permissible fees from mutual fund providers: (1) investment advisory fees that the fiduciary is entitled to receive as trustee reduced by the amount of any investment advisory fees paid to the fiduciary by the investment company or investment trust; and (2) investment advisory fees paid to the fiduciary from an investment company in lieu of any investment advisory fees that the fiduciary would otherwise be entitled to receive for the investment management of the trust account.	Written communications to trust account holders must reflect the purchase of such securities, the nature of the relationship, and whether such bank or affiliate received any fee for providing such services.	Fiduciary purchases of proprietary mutual fund stock must be expressly authorized by the trust instrument, a court order, the written consent of the grantor of the trust, or the written consent of the beneficiaries of the trust.
NJ	N.J.S. 3B: 14-23(W)	Allows for either investment advisor or trustee fee		Limits on Authorization No written objection is received prior to the initial investment, after all current income beneficiaries are provided 30 days written notice of the bank's intent to invest fiduciary assets

NM	1993 N.M. Laws 51 § 46-2A-1		Disclosure required	
NY	N.Y. Estate Powers & Trusts Law ("EPTL") § 11-2.2(b)(1)	fiduciary shall elect annually to receive either its fiduciary's commissions or its fee as investment advisor		Limits on Authorization Investment permitted unless trust document, will or order appointing the fiduciary provides otherwise
NC	1993 N.C. Sess. Laws § 32-27 (ratified 6-7-93)	Allows for reasonable fee as investment advisor and as a trustee	To all current income beneficiaries Conspicuously by statement, prospectus or otherwise Disclose the rate, formula or other method by which the remuneration for those services is determined. The trustee fee must also be disclosed.	
ND	N.D. Cent. Code §§ 4-9-105 and -107	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		
OH	Ohio Rev. Code Ann. § 1109.10(H)	Allows fees as investment advisor and as trustee	To all persons entitled to receive statements of account activity By prospectus, account statement, or any other means At least annually Disclosure of fee charged as a percentage of either asset value or income earned or actual amount charged. Disclosure in at least ten-point boldface type, that the mutual fund is not insured or guaranteed by the FDIC or any other governmental agency	In any periodic statements, mutual fund must report the net asset value of the shares comprising the investment of the trust fund in the affiliated investment company
OK	Okl. St. § 175.55	Allows for either trustee or investment advisor fee		

OR	Or. Rev. Stat. § 709.175	Does not specify whether fiduciary may receive reasonable compensation for investment advisor services		
PA	20 Pa. Cons. Stat. § 7314.1	Allows for trustee and investment advisor fees	To all persons to whom statements of the accounts are rendered By prospectus, account statement or otherwise Disclosure of the basis upon which compensation is calculated, expressed as a percentage of asset value or otherwise	Mutual Fund Investment Restrictions Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument
RI	R.I. Gen. Laws § 18-15-5,-7,-9	Consistent with Prudent Investor Rule		
SC	S.C. Code Ann. § 62-7-302	Allows for trustee and investment advisor fees		
SD	S.D. Codified Laws Ann. Section 55-1A-9	Allows for trustee and investment advisor fees	To all current income beneficiaries Disclose the rate, formula and method of the compensation	
TN	Tenn Code Ann. § 35-3-117(h)	Allows for trustee and investment advisor fees		
TX	Tex. Property Code Ann. Section 113.053(g) (Vernon)	Allows for trustee and investment advisor fees	Disclose compensation by prospectus, account statement, or otherwise	Limits on Authorization Executor or administrator may not invest unless authorized by court Miscellaneous Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument

UT	Utah Code Ann. § 75-7-402	Allows for trustee and investment advisor fees		
VA	Va. Code Ann. § 26-44.1	Cannot take fee as investment advisor and as trustee unless expressly agreed to in writing by creator of trust or affected beneficiary Compensation for such advice and services shall not exceed the customary or prevailing amount that is charged by a fiduciary for providing comparable advice and services for the benefit of nonfiduciary accounts	To all current income beneficiaries of an account By prospectus, statement of the account, or otherwise Disclose the rate, formula, or other method by which compensation is received or to be received	
* WA	Wash. Rev. Code § 11.100.35	Allows for investment advisor and trustee fees	To each person to whom a regular periodic accounting would ordinarily be rendered under trust instrument, or upon request Prospectus must be furnished to above	
WV	W.Va. § 44-6-9	Allows for fee as investment advisor and as trustee		Mutual Fund Investment Restrictions Portfolio of investment company must substantially consist of investments not prohibited by the governing instrument.
WI	Wis. Stat. 881.01	Allows for fee as either advisor or as trustee. Bank or trust company must waive its fiduciary fee for the assets that it invests in proprietary mutual fund or its investment advisory fee.		
WY	Wyo. Stat. Ann §§ 4-9-105, 4-9-107	Prudent Investor Rule: Fees to be "appropriate and reasonable" in relation to trust investments		

The Board of Governers of the

Federal Reserve System

Washington, D. C. 20551

Division of Banking

Supervision and Regulation

SR 99-7 (SPE)

March 26, 1999

to the officer in charge of supervision and appropriate

supervisory and examination staff at each federal

Reserve Bank and to each domestic and foreign

banking organization supervised by the

Federal Reserve

Subject: Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest

Summary

Increasingly, banks and trust institutions are encountering various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to the financial benefits arising from the use of mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and record-keeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. In the case of other financial incentives, guidance under applicable law may be less clear. In all cases, however, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

The primary supervisory concern is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may expose itself to an increased risk of legal action by account beneficiaries, as well as to potential violations of law or regulation. The Federal Reserve is issuing this guidance to help institutions minimize these risks and to help ensure that their activities meet fiduciary standards.

Background

Certain mutual fund providers offer compensation in the form of "service" fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, sub-accounting or administrative service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis point amount of the dollar value of assets invested, or on transaction volume.

In recent years, nearly every state legislature has modified its laws explicitly to allow the acceptance of such fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality and appropriateness for the account,

and a determination of the "reasonableness" of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) has also adopted these general standards for national banks.[1] However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

While there has been no comprehensive review of the extent to which these types of incentive payments are presently being offered by mutual fund providers, the practice appears to have become more common in recent years. In addition to the service fees cited above, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict of interest concerns are raised by the investment of fiduciary account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as "proprietary" funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments. This activity can be expected to become more prevalent as banking organizations become more active in offering proprietary mutual funds.[3]

Supervisory Guidance

Although many state laws now explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Even in the case of investments where the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or placing fiduciary assets in proprietary mutual funds. The following measures should be included in this process:

- Reasoned Legal Opinion - The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.

- Establishment of Policies and Procedures - The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.

- Analysis and Documentation of Investment Decisions - Where fees or other compensation are received in connection with fiduciary account investments over which the institution has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with the provisions of the Prudent Investor or Prudent Man Rules, as appropriate.

Please distribute this letter to the appropriate supervision staff, particularly all examiners of fiduciary and securities activities, and to all domestic and foreign banking organizations with fiduciary activities supervised by the Federal Reserve. A suggested transmittal letter is attached. To the extent that examiners identify issues and concerns pertaining to the acceptance of fees from mutual fund providers or investments in proprietary mutual funds, please forward such information to the Manager, Specialized Activities Section, Mail Stop 182, at the Federal Reserve Board. Any matters of significant concern should be noted in examination reports and corrective action pursued as appropriate.

Questions concerning this letter may be addressed to Michael G. Martinson, Deputy Associate Director, at (202) 452-3640 or Heidi Richards, Manager, at (202) 452-2598.

Richard Spillenkothen

Director

Attachment

Supersedes: "Trust Services - Extra Fees in Connection with 12b-1 Funds or Cash Sweep Systems," FRRS 3-1596

Notes:

1. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with established state law fiduciary requirements. This includes a "reasonableness" test for any fees received by the institution. OCC Interpretive Letter No. 704, February 1996.

2. ERISA section 406(b)(3); Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Federal Reserve Regulation Y addresses investment of fiduciary account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. FRRS 4-177.

FDIC General Counsel's Opinion No. 12: "Engaged in the Business of Receiving Deposits Other Than Trust Funds"

February 17, 2000

Memorandum TO: The Board of Directors

From: William F. Kroener, III

General Counsel

Subject:

General Counsel's Opinion No. 12:"Engaged in the Business of Receiving Deposits Other Than Trust Funds"

Background

In recent years, the FDIC has received applications for deposit insurance from an increasing number of non-traditional depository institutions. Some of these applicants have been credit card banks; others have been trust companies. These applications have raised the issue of whether these institutions would be "engaged in the business of receiving deposits other than trust funds" as required by section 5 of the FDI Act. *See* 12 U.S.C. § 1815(a)(1). The purpose of this General Counsel's opinion is to clarify the agency's interpretation of the statutory phrase.

Summary and Recommendation

The FDIC has approved applications from a number of institutions that planned to maintain a single non-trust deposit account. Typically in recent years the amount of this deposit account

has been $500,000. The FDIC thus has found that institutions holding this amount of deposited funds in one or more non-trust deposit accounts are "engaged in the business of receiving deposits other than trust funds." The FDIC in acting on deposit insurance applications has not required the acceptance of non-trust deposits from the general public. This interpretation of the statutory phrase by the FDIC is confirmed by this General Counsel's opinion. I recommend that the Board of Directors approve the publication of this General Counsel's opinion in the Federal Register.

Staff member knowledgeable about this case:

Christopher Hencke, Legal Division (898-8839)

Discussion

Section 5 of the FDI Act provides that an applicant for deposit insurance must be "engaged in the business of receiving deposits other than trust funds." 12 U.S.C. § 1815(a)(1). The corollary to section 5 is section 8. Under the latter section, the FDIC must terminate the insured status of any depository institution "not engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1818(p).

For many years the FDIC has approved applications from institutions that did not plan to accept deposits from the general public. The FDIC has determined that being "engaged in the business of receiving [non-trust] deposits" does not require the acceptance of non-trust deposits from the general public. Rather, the acceptance of non-trust deposits from a particular group (such as trust customers or affiliates) has been regarded by the FDIC as sufficient to satisfy the threshold requirement of the statute.

The FDIC's long-standing interpretation is consistent with the language of the FDI Act. Although the Act refers to the "receiving" of deposits, the Act also defines "deposit" in such a way as to equate "receiving" and "holding." *See* 12 U.S.C. § 1813(l)(1). This is appropriate because the "holding" of a single deposit account involves a continuing business relationship with periodic withdrawals, deposits, rollovers and the accrual of interest. In other words, the opening of a deposit account is not a completed, isolated transaction. Also, the FDIC is mindful that a single deposit account can be divided into portions. If the FDIC required the periodic receipt of a particular number of non-trust deposits, institutions holding one deposit account would simply arrange for the account to be divided into portions. At periodic intervals, funds would be withdrawn and redeposited. Under these circumstances, the FDIC has regarded one non-trust deposit account in the amount of $500,000 as sufficient.

The FDIC's interpretation of "engaged in the business of receiving [non-trust] deposits" also is consistent with the past practice of the Office of the Comptroller of the Currency (OCC). Prior to 1991 the OCC was responsible for determining whether a new national bank would be "engaged in the business of receiving deposits other than trust funds." (Since the enactment of FDICIA in 1991 that responsibility has rested with the FDIC for national as well as State banks.) By chartering national banks with limited deposit-taking functions, the OCC effectively found that being "engaged in the business" did not require the acceptance of non-trust deposits from the general public.

The FDIC's interpretation is also consistent with other federal banking law as well as State banking laws. The Bank Holding Company Act (BHCA) as amended by the Competitive Equality Banking Act (CEBA) contemplates that an institution could be insured by the FDIC even though substantially all of the institution's deposits are trust funds. *See* 12 U.S.C. § 1841(c)(2)(D). Similarly, a Virginia statute defines a "credit card bank" in such a way that the bank must be insured by the FDIC even though the bank may accept deposits only from affiliates. *See* Va. Code §§ 6.1-391; 6.1-392.1.A. A number of other States have statutes to similar effect. These federal and State statutes presume that an institution may be "engaged in the business of receiving [non-trust] deposits" even though the institution accepts no such deposits from the general public.

The leading case on being "engaged in the business of receiving [non-trust] deposits" is *Meriden Trust and Safe Deposit Company v. FDIC,* 62 F.3d 449 (2d Cir. 1995). In that case, the court found that a particular bank was "engaged in the business" even though the bank held only two non-trust deposit accounts in the aggregate amount of $200,000. This case supports the FDIC's interpretation.

Recently a contrary ruling was issued on a preliminary jurisdictional motion by a federal district court in Louisiana. The litigation was initiated by a group of credit card holders in Louisiana against a credit card bank chartered in Georgia. The cardholders charged the bank with violating Louisiana restrictions on fees and interest rates. In its defense, the bank cited 12 U.S.C. § 1831d. That section of the FDI Act allows a "State bank" to avoid State restrictions on fees and interest rates when operating outside its State of incorporation. The issue before the federal district court was whether the Georgia bank was a "State bank" as defined at 12 U.S.C. § 1813(a)(2). Under the statutory definition, an institution cannot be a "State bank" unless it is "engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1813(a)(2)(A).

In its recent ruling, the federal district court found that the Georgia bank insured by the FDIC was not "engaged in the business of receiving [non-trust] deposits" because it held only two deposits owned by affiliates. This ruling is inconsistent with the factors noted above supporting a broader, less restrictive interpretation of being "engaged in the business of receiving [non-trust] deposits." Also, the court's ruling is inconsistent with section 8 of the FDI Act. Under that section, the FDIC is authorized to make "conclusive" findings that an insured institution is "not engaged in the business of receiving deposits, other than trust funds." 12 U.S.C. § 1818(p). The FDIC has made no such determination in the case of the Georgia credit card bank. In any event, the district court's ruling has been appealed by the Georgia bank to the United States Court of Appeals for the Fifth Circuit. The case is pending before the Court of Appeals.

Conclusion

For the reasons summarized above, in my opinion the holding of one or more non-trust deposits in the aggregate amount of $500,000 is sufficient to satisfy the threshold requirement of being "engaged in the business of receiving deposits other than trust funds." I recommend that the Board authorize the publication of this General Counsel's opinion in the Federal Register. The publication of the opinion would be beneficial to future applicants for deposit insurance.

Financial Institution Letters

Alert Regarding Bank Investment Securities and Custodial Accounts Held At Securities Broker-Dealers

FIL-38-2002
April 25, 2002

To:	Chief Executive Officer
Subject:	*Credit Risks Arising From Bank Investment Securities and Custodial Accounts Held at Securities Broker-Dealers*

The Federal Deposit Insurance Corporation (FDIC) is alerting you to concerns it has identified regarding bank custodial relationships with failed broker-dealers. These concerns have arisen following the failure of a large regional securities broker-dealer and its liquidation by the Securities Investor Protection Corporation (SIPC). For this liquidation (which was the largest in SIPC history), the bankruptcy trustee has informed banks with securities held in safekeeping that they will incur a loss. This alert provides banks basic information regarding SIPC coverage and reminds banks of the credit risks associated with custodial relationships. Bank management is advised to review existing custodial relationships, evaluate the creditworthiness and reputation of custodians, and ensure that the bank maintains properly diversified custodial relationships.

The Securities Investor Protection Act of 1970 (SIPA) created SIPC to provide certain protections to customers against losses from the failure of a securities broker-dealer. Under SIPA, only customers of a SIPC-member firm qualify for SIPC protection and only "customer property" as defined in SIPA and determined to be in the member firm's custody are covered. Although SIPC coverage allows a bank, for its own account, to share in "customer property," banks cannot receive advances from SIPC. In the event that a bank demonstrates that it is acting as an agent for an investor, that investor is entitled to separate

status as a "customer" and is eligible to receive advances from SIPC.

In general, during a liquidation proceeding, the trustee for the failed broker-dealer will (1) return to customers property that is registered in a specific customer's name, (2) pay those customers their pro rata share of "customer property," and (3) provide customers (other than banks and broker-dealers for their own accounts) SIPC advances up to the $500,000 limit. Customers not subject to SIPC protection, such as banks, will receive a pro rata distribution of "customer property." Banks should be aware of SIPC's coverage and claims procedures and be able to differentiate between bank-owned and bank customer-owned accounts and securities held at failed broker-dealers.

These events serve as an opportunity to remind banks of their obligation under existing supervisory policy to exercise due diligence when selecting broker-dealers and establishing a custodial relationship. Banks should establish and periodically review broker-dealer selection criteria that would include a review of the broker-dealer's financial statements and an assessment of the firm's ability to honor its commitments. An inquiry into the broker-dealer's reputation should be conducted. Such information can be obtained from state and federal securities regulators and industry self-regulatory organizations such as the National Association of Securities Dealers (NASD). The custodian's reputation and creditworthiness should be periodically reviewed. Banks should review their existing custodial relationships and underlying documentation and practices so that bank management can fully understand the nature and extent of potential credit risks that can arise from existing custodial relationships. Where needed, banks should consult with their attorneys and independently review their agreements and business practices with broker-dealers.

These events also instruct that even sound due diligence practices may not adequately minimize banks' exposure. In order to avoid unforeseen credit exposure in similar circumstances, banks should ensure that their custodial relationships are properly diversified. Maintaining relationships with different custodians can minimize the bank's exposure in this area.

Michael J. Zamorski
Director

Distribution: FDIC-Supervised Banks (Commercial and Savings)

Note: Paper copies of FDIC financial institution letters may be obtained through the FDIC's Public Information Center, 801 17th Street, NW, Room 100, Washington, DC 20434 (800-276-6003 or 202-416-6940).

supervision@fdic.gov

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Appendix D- Securities Law

Table of Contents

General Information

Glass-Steagall Act as Modified By Gramm-Leach-Bliley Act

Applicability of Federal Securities Laws to Banks and Bank Sponsored Securities Activities

Registration of Bank Securities

Bank as Broker

Bank as Dealer

Bank as Underwriter

Bank as Principal Underwriter

Bank as Municipal Bond Underwriter

Bank as Clearing Agency

Bank as Municipal Securities Dealer

Bank as Municipal Securities Broker

Bank as Investment Advisor

Bank as Investment Company

Collective Trust Funds (general)

Collective Trust Funds (for Qualified Plans)

Other Collective Trust Funds

Securities and Exchange Commission

SEC Staff Compliance Guide to Banks	Dealer Statutory Exceptions and Rules
Securities Exchange Act Release No. 34-23170	Section 28(e) and Soft Dollars
SEC No-Action Letter	Waiver of 12b-1 Fees for ERISA Plans
SEC Rule 3a-4 ICA of 1940 Release IC-22579 17 CFR Parts 270 and 274	Status of Investment Advisory Programs

SEC Rule 3a-4 Safe Harbor for Wrap Accounts
SEC Regulation 270.3a-4

17 CFR 270.3a-4

SEC Rule 206(4)-6 Disclosure of Proxy Voting Policies and Records

SEC Rule 204-2

SEC Rule 14a-1 Solicitation of Proxies Definitions

SEC Regulation 240.14a-1 *

SEC Rule 14a-13 Shareholder Communications - Beneficial Owners

SEC Regulation 240.14a-13 *

S EC Rule 14b-1 Shareholder Communications - Brokers and Dealers

SEC Regulation 240.14b-1 *

SEC Rule 14b-2 Shareholder Communications - B anks and Fiduciaries

SEC Regulation 240.14b-2 *

SEC Rule 14c-1 Shareholder Communications - Section 14(C) Definitions

SEC Regulation 240.14c-1 *

SEC Rule 14c-7 Shareholder Communications - Copies of Materials

SEC Regu lation 240.14c-7 *

* codified at 17 CFR Part 240 -- General Rules and Regulations -- Securities Exchange Act of 1934.

NASD Rule 2711 Research Analysts and Research Reports

Links to Securities Law, Regulations, and Miscellaneous Statutes

The following items can be found in the three volume FDIC Rules and Regulations.

Securities Act of 1933: To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Securities Exchange Act of 1934: To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

Investment Company Act of 1940: To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Investment Advisers Act of 1940: To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

FDIC Part 344: Recordkeeping and Confirmation Requirements for Securities Transactions.

SEC Rule 240.10b-5: Employment of manipulative and deceptive devices

SEC Rule 240.13f-1: Reporting by institutional investment managers of information with respect to accounts over which they exercise investment discretion

SEC Rule 249.325: Form 13F, report of institutional investment manager pursuant to Section 13(f)

SEC Rule 240.14e-3: Transactions in securities on the basis of material, nonpublic information in the context of tender offers (Insider information)

SEC Rule 240.17f-1: Requirements for reporting and inquiry with respect to missing, lost, counterfeit or stolen securities.

* codified at 17 CFR Part 240 -- General Rules and Regulations -- Securities Exchange Act of 1934 .

Glass-Steagall Act As Modified By Gramm-Leach-Bliley Act

Historical Perspective

The Banking Act of 1933 (Act), in particular Sections 16, 20, 21, and 32, are often called the Glass-Steagall Act, was enacted to address questionable banking industry practices during the 1920's and 1930's.. The primary purpose of the Act is to separate commercial banking from investment banking. This separation was designed to promote the financial stability of commercial banks, create public confidence in the banking system, and prevent conflicts of interest which might develop from the performance of both commercial and investment banking.

Sections 16, 20, 21, and 32 of the Act established certain restrictions regarding commercial banks engaging in securities related activities. In general, these Sections prohibited banks from underwriting or making a market in stocks and municipal revenue debt instruments. They also prohibited banks from maintaining financial or personnel ties with investment banks. Specifically, Section 32 of the Banking Act of 1933 prohibited any employee of a member bank from concurrently being employed by any firm engaged in the issuance of securities. In the case of a State nonmember bank, this would result in a conflict of interest situation and would, if proper safeguards were not taken, result in a deficiency in the bank's operation and action by the Corporation to remedy the situation.

Gramm-Leach-Bliley Act (GLBA): enacted November 12, 1999

The GLBA repealed Sections 20 and 32 of the Banking Act of 1933 [Section 101 of GLBA]. The GLBA also modified several other securities laws which are applicable to banks and bank securities activities. Those issues are discussed in the following sub-section.

Section 20 Repealed

Prior to GLBA, Section 20 had prohibited bank affiliations with organizations dealing in the issuance of securities. It prohibited a bank from affiliation with any corporation, association, business trust, or other similar organization engaged principally in the issuance, flotation, underwriting, public sale, or distribution, whether through wholesale or retail channels or through participation in a syndicate, of stocks, bonds, debentures, notes, or other securities.

With the repeal of Section 20, banks have more flexibility to engage in securities underwriting and dealer activities. These activities will need to be conducted through a Financial Holding Company or f inancial subsidiary (at the bank level). This will be of particular interest to banks with proprietary mutual funds, as they are now allowed to underwrite and distribute both proprietary and third-party mutual funds.

Section 32 Repealed

Prior to GLBA, Section 32 had prohibited interlocking management between entities that issue securities and banks. The language describing these entities was similar to that noted above.

With the repeal of Section 32, banks can have common officers, directors, and employees with registered investment companies (mutual funds). This allows interlocks and poses a new conflict of interest situation. Though the interlock is limited to some degree by the Investment Company Act of 1940, it still exists. Examiners should be mindful of the potentially abusive situations this interlock may present.

Section 10(c) of the Investment Company Act of 1940 prohibits a majority of the directors of a mutual fund from being officers, directors, or employees of any one bank. The GLBA expanded this prohibition to affiliates and subsidiaries of the bank. Basically, a mutual fund may not have a majority of its directorate comprised of individuals of a single bank and its associated affiliates and subsidiaries.

In addition, the SEC strengthened its general rules for director independence of investment companies by amending certain exemptive rules under the Investment Company Act of 1940. For investment companies that rely on these rules: independent directors must constitute a majority of their board of directors; independent directors must select and nominate other independent directors; and any legal counsel for the independent directors must be an independent legal counsel. [Section 10 of Investment Company Act of 1940 and SEC Release Nos. 33-7932 & 34-43786 Final Rule: Role of Independent Directors of Investment Companies; effective May 12, 2001.]

Applicability of Federal Securities Laws to Banks and Bank Sponsored Securities Activities

The Gramm-Leach-Bliley Act (GLBA) modified aspects of certain Federal securities laws that are applicable to banks and bank sponsored securities activities. The GLBA was enacted November 12, 1999. GLBA provisions were phased-in during an eighteen month period after November 12, 1999. The following discussion of rules and exemptions are post- GLBA .

1. **Registration of Bank Securities**
   Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

   The Act exempts any security issued or guaranteed by a bank from all Sections except Section 17 fraud provisions. (§ 3(a)(2)).

   Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   Bank securities must be registered with the appropriate bank regulatory agency which administers and enforces §§ 12, 13, 14(a), (c), (d), (f), and 16 in a manner substantially similar to the SEC (§ 12(i)).

2. **Bank as Broker**
   a. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

      §3(a)(4) : The GLBA Section 201, Definition of Broker, amended §3(a)(4) of the Securities Exchange Act of 1934.

      There is an exemption for banks engaging in traditional trust and fiduciary activity, provided a few key points are followed. These include how compensation is received, how the activity is marketed, and how transactions are directed. A further explanation of these concepts is found in subsections (B)(ii) and (C). Fiduciary activity is defined in subsection (D).

      An exemption has also been afforded to certain stock purchase plans (subsection B(iv)) and safekeeping and custodial activity (subsection B(viii). Again, these are subject to how transactions are directed. There is also a "catch-all" de minimis exemption for isolated transactions that fall outside of the items specifically exempted (subsection B(xi)). It is expected that this will help with incidental

transactions.

There is no specific recordkeeping requirement set-forth in this section; however, management will need sufficient records to demonstrate that the institution qualifies for the exemption. If an activity does not meet any of the exemptions detailed below the bank must register with the SEC. Either the SEC or the NASD will provide regulatory oversight. Management may decide to move the activity to a subsidiary or affiliate. In that case, the subsidiary or affiliate must register with the SEC.

On October 3, 2007, the Federal Reserve and SEC published Regulation R, "Definitions of Terms and Exemptions Relating to the 'Broker' Exceptions for Banks and Exemptions for Banks Under Section 3(a)(5) of The Securities Exchange Act and Related Rules; Final Rule," which sets forth requirements for satisfying the conditions for the Trust & Fiduciary exceptions, the Custody & Safekeeping exemptions, as well as the Networking exception and other exemptions for banks from the definition of "Broker." See SEC Release No. 34-56501: File No. S7-22-0 (353KB PDF file - PDF Help). Also refer to Section 10.F for a detailed discussion of Regulation R.

The revised definition of a broker in Section §3(a)(4) states, in part,

Broker:

A. In General - The term `broker' means any person engaged in the business of effecting transactions in securities for the account of others.
B. Exception for certain bank activities - A bank shall not be considered to be a broker because the bank engages in any one or more of the following activities under the conditions described:

i. Third party brokerage arrangements - "text not included"
ii. Trust Activities - The bank effects transactions in a trustee capacity, or effects transactions in a fiduciary capacity in its trust department or other department that is regularly examined by bank examiners for compliance with fiduciary principles and standards, and
    I. is chiefly compensated for such transactions, consistent with fiduciary principles and standards, on the basis of an administration or annual fee (payable on a monthly, quarterly, or other basis), a percentage of assets under management, or a flat or capped per order processing fee equal to not more than the cost incurred by the bank in connection with executing securities transactions for trustee and fiduciary customers, or any combination of such fees; and
    II. does not publicly solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.
iii. Permissible Securities Transactions - "text not included"
iv. Certain Stock Purchase Plans
    I. Employee Benefit Plans - The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of any pension, retirement, profit-sharing, bonus, thrift, savings, incentive, or other similar benefit plan for the employees of that issuer or its affiliates (as defined in Section 2 of the Bank Holding Company Act of 1956), if the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan.

II. Dividend Reinvestment Plans - The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of that issuer's dividend reinvestment plan, if
    a. the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan; and
    b. the bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the Commission.

III. Issuer Plans - The bank effects transactions, as part of its transfer agency activities, in the securities of an issuer as part of a plan or program for the purchase or sale of that issuer's shares, if
    a. the bank does not solicit transactions or provide investment advice with respect to the purchase or sale of securities in connection with the plan or program; and
    b. the bank does not net shareholders' buy and sell orders, other than for programs for odd-lot holders or plans registered with the Commission.

IV. Permissible Delivery of Materials - The exception to being considered a broker for a bank engaged in activities described in sub clauses (I), (II), and (III) will not be affected by delivery of written or electronic plan materials by a bank to employees of the issuer, shareholders of the issuer, or members of affinity groups of the issuer, so long as such materials are
    a. comparable in scope or nature to that permitted by the Commission as of the date of the enactment of the Gramm-Leach-Bliley Act; or
    b. otherwise permitted by the Commission.

v. Sweep Accounts .--The bank effects transactions as part of a program for the investment or reinvestment of deposit funds into any no-load, open-end management investment company registered under the Investment Company Act of 1940 that holds out as a money market fund.

vi. Affiliate Transactions - "text not included"

vii. Private Securities Offerings - "text not included"

viii. Safekeeping and Custody Activities

I. In General- The bank, as part of customary banking activities
    a. provides safekeeping or custody services with respect to securities, including the exercise of warrants and other rights on behalf of customers;
    b. facilitates the transfer of funds or securities, as a custodian or a clearing agency, in connection with the clearance and settlement of its customers' transactions in securities;
    c. effects securities lending or borrowing transactions with or on behalf of customers as part of services provided to customers pursuant to division (a) or (b) or invests cash collateral pledged in connection with such transactions;
    d. holds securities pledged by a customer to another person or securities subject to purchase or resale agreements involving a customer, or facilitates the pledging or transfer of such securities by book entry or as otherwise provided under applicable law, if the bank maintains records separately identifying the securities and the customer; or
    e. serves as a custodian or provider of other related administrative services to any individual retirement account, pension, retirement, profit sharing, bonus, thrift savings, incentive, or other similar benefit plan.

II. Exception for Carrying Broker Activities - "text not included"

ix. Identified Banking Products -- The bank effects transactions in identified banking products as defined in Section 206 of the Gramm-Leach-Bliley Act.
x. Municipal Securities - The bank effects transactions in municipal securities.
xi. De Minimis Exception - The bank effects, other than in transactions referred to in clauses (i) through (x), not more than 500 transactions in securities in any calendar year, and such transactions are not effected by an employee of the bank who is also an employee of a broker or dealer.

C. Execution by Broker or Dealer- The exception to being considered a broker for a bank engaged in activities described in clauses (ii), (iv), and (viii) of subparagraph (B) shall not apply if the activities described in such provisions result in the trade in the United States of any security that is a publicly traded security in the United States, unless

i. the bank directs such trade to a registered broker or dealer for execution;

ii. the trade is a cross trade or other substantially similar trade of a security that
   I. is made by the bank or between the bank and an affiliated fiduciary; and
   II. is not in contravention of fiduciary principles established under applicable Federal or State law; or
iii. the trade is conducted in some other manner permitted under rules, regulations, or orders as the Commission may prescribe or issue.

D. Fiduciary Capacity - For purposes of subparagraph (B)(ii), the term `fiduciary capacity' means
   i. in the capacity as trustee, executor, administrator, registrar of stocks and bonds, transfer agent, guardian, assignee, receiver, or custodian under a uniform gift to minor act, or as an investment adviser if the bank receives a fee for its investment advice;
   ii. in any capacity in which the bank possesses investment discretion on behalf of another; or
   iii. in any other similar capacity.
E. Exception for Entities Subject to Section 15(e) - "text not included"

b. Investment Company Act of 1940: To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

   The GLBA in Section 215, Definition of Broker Under the Investment Company Act of 1940, amended Section 2(a)(6) of the Investment Company Act of 1940.

   The term `broker' has the same meaning as given in Section 3 of the Securities Exchange Act of 1934, except that such term does not include any person solely by reason of the fact that such person is an underwriter for one or more investment companies.

c. Investment Advisers Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

   The GLBA in Section 218, Definition of Broker Under the Investment Advisers Act of 1940 amended Section 202(a)(3).

   The term `broker' has the same meaning as given in Section 3 of the

Securities Exchange Act of 1934.

3. **Bank as Dealer**
   a. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   §3 (a)(5) : The GLBA Section 202, Definition of Dealer, amended Section 3(a)(5) of the Securities Exchange Act of 1934.

   There is an exception for trustee and fiduciary transactions and asset-backed activity. However, the Securities Exchange Act of 1934 does not define what is considered a trustee or fiduciary as it pertains to dealer activity. It does define fiduciary activity in the revised Section 3(a)(4)(D).

   The revised **definition of a dealer** in Section 3(a)(5) states, in part,

   Dealer:

   A. In General - The term `dealer' means any person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise.
   B. Exception for person not engaged in the business of Dealing - "text not included"
   C. Exception for Certain Bank Activities - A bank shall not be considered to be a dealer because the bank engages in any of the following activities under the conditions described:
      i. Permissible Securities Transactions - "text not included"
      ii. Investment, Trustee, and Fiduciary Transactions - The bank buys or sells securities for investment purposes
         I. for the bank; or
         II. for accounts for which the bank acts as a trustee or fiduciary.
      iii. Asset-Backed Transactions - The bank engages in the issuance or sale to qualified investors, through a grantor trust or other separate entity, of securities backed by or representing an interest in notes, drafts, acceptances, loans, leases, receivables, other obligations (other than securities of which the bank is not the issuer), or pools of any such obligations predominantly originated by
         I. the bank;
         II. an affiliate of any such bank other than a broker or dealer; or
         III. a syndicate of banks of which the bank is a member, if the obligations or pool of obligations consists of mortgage obligations or consumer-related receivables.
      iv. Identified Banking Products - The bank buys or sells identified banking products, as defined in Section 206 of the Gramm-Leach-Bliley Act.

   Furthermore, the SEC issued a Final Rule (below) and separate Staff Commentary in 2003 to clarify the requirements for bank exemptions for broker and dealer rules. The new guidance finalizes dealer rules, but separate broker rules are to be issued separately at a later date. Broker rules definitions had not been issued as of this printing. The revised sections of the Securities Exchange Act of 1934 are quoted below. For preamble and endnotes to the SEC's final rule, refer to either SEC Release No. 34-47364 or 68 Federal Register 8686.

   SEC Final Rule: Definition of Terms in and Specific Exemptions for

Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934 Securities and Exchange Commission 17 CFR Part 240 [Release No. 34-47364; File No. S7-41-02]

Excerpt:

Summary: The Securities and Exchange Commission is adopting amendments to its rule granting an exemption to banks from dealer registration for a de minimis number of riskless principal transactions, and to its rule that defines terms used in the bank exception to dealer registration for asset-backed transactions. The Commission also is adopting a new exemption for banks to the definition of broker and dealer under the Securities Exchange Act of 1934 for certain securities lending transactions. In addition, the Commission is extending the exemption from rescission liability under Exchange Act Section 29 to contracts entered into by banks acting in a dealer capacity before March 31, 2005. These rules address certain of the exceptions for banks from the definitions of "broker" and "dealer" that were added to the Securities Exchange Act of 1934 by the Gramm-Leach-Bliley Act.

Compliance Date: September 30, 2003.

Section 240.3a5-1 is revised to read as follows:

§ 240.3a5-1 Exemption from the definition of "dealer" for a bank engaged in riskless principal transactions.

(a) A bank is exempt from the definition of the term "dealer" to the extent that it engages in or effects riskless principal transactions if the number of such riskless principal transactions during a calendar year combined with transactions in which the bank is acting as an agent for a customer pursuant to Section 3(a)(4)(B)(xi) of the Act (15 U.S.C. 78c(a)(4)(B)(xi)) during that same year does not exceed 500.

(b) For purposes of this section, the term riskless principal transaction means a transaction in which, after having received an order to buy from a customer, the bank purchased the security from another person to offset a contemporaneous sale to such customer or, after having received an order to sell from a customer, the bank sold the security to another person to offset a contemporaneous purchase from such customer.

Section 240.3b-18 is revised to read as follows:

§ 240.3b-18 Definitions of terms used in Section 3(a)(5) of the Act.

For the purposes of Section 3(a)(5)(C) of the Act (15 U.S.C. 78c(a)(5)(C):

(a) The term affiliate means any company that controls, is controlled by, or is under common control with another company.

(b) The term consumer-related receivable means any obligation incurred by any natural person to pay money arising out of a transaction in which the money, property, insurance, or services (being purchased) are primarily for personal, family, or household purposes.

(c) The term member as it relates to the term "syndicate of banks" means a bank that is a participant in a syndicate of banks and together with its affiliates, other than its broker or dealer affiliates, originates no less than 10% of the value of the obligations in a pool of obligations used to back the securities issued through a grantor trust or other separate entity.

(d) The term obligation means any note, draft, acceptance, loan, lease, receivable, or other evidence of indebtedness that is not a security issued by a person other than the bank.

(e) The term originated means:

> (1) Funding an obligation at the time that the obligation is created; or
>
> (2) Initially approving and underwriting the obligation, or initially agreeing to purchase the obligation, provided that:
>
>> (i) The obligation conforms to the underwriting standards or is evidenced by the loan documents of the bank or its affiliates, other than its broker or dealer affiliates; and
>>
>> (ii) The bank or its affiliates, other than its broker or dealer affiliates, fund the obligation in a timely manner, not to exceed six months after the obligation is created.

(f) The term pool means more than one obligation or type of obligation grouped together to provide collateral for a securities offering.

(g) The term predominantly originated_means that no less than 85% of the value of the obligations in any pool were originated by:

> (1) The bank or its affiliates, other than its broker or dealer affiliates; or
>
> (2) Banks that are members of a syndicate of banks and affiliates of such banks, other than their broker or dealer affiliates, if the obligations or pool of obligations consist of mortgage obligations or consumer-related receivables.
>
> (3) For this purpose, the bank and its affiliates include any financial institution with which the bank or its affiliates have merged but does not include the purchase of a pool of obligations or the purchase of a line of business.

(h) The term syndicate of banks means a group of banks that acts jointly, on a temporary basis, to issue through a grantor trust or other separate entity, securities backed by obligations originated by each of the individual banks or their affiliates, other than their broker or dealer affiliates.

Section 240.15a-8 is revised to read as follows:

§ 240.15a-8 Exemption for banks from Section 29 liability.

(a) No contract entered into before January 1, 2003 shall be void or considered voidable by reason of Section 29 of the Act (15 U.S.C. 78cc) because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Act (15 U.S.C. 78o(a)) or any applicable provision of the Act (15 U.S.C. 78a et seq.) and the rules and regulations thereunder based solely on the bank's status as a broker or dealer when the contract was created.

(b) No contract entered into before March 31, 2005, shall be void or considered voidable by reason of Section 29 of the Act (15 U.S.C. 78cc) because any bank that is a party to the contract violated the registration requirements of Section 15(a) of the Act (15 U.S.C. 78o(a)) or any applicable provision of the Act (15 U.S.C. 78a et seq.) and the rules and regulations thereunder based solely on the bank's status as a dealer when the contract was created.

Section 240.15a-11 is added to read as follows:

§ 240.15a-11 Exemption from the definitions of "broker" and "dealer" for banks engaging in securities lending transactions.
(a) A bank is exempt from the definitions of the terms "broker" and "dealer" under Sections 3(a)(4) and 3(a)(5) of the Act (15 U.S.C. 78c(a)(4) and (a)(5)), to the extent that, as a conduit lender, or as an agent, it engages in or effects securities lending transactions, and any securities lending services in connection with such transactions, with or on behalf of a person the bank reasonably believes to be:

(1) A qualified investor as defined in Section 3(a)(54)(A) of the Act (15 U.S.C. 78c(a)(54)(A)); or

(2) Any employee benefit plan that owns and invests on a discretionary basis, not less than $25,000,000 in investments.

(b) Securities lending transaction means a transaction in which the owner of a security lends the security temporarily to another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such securities, and has the right to terminate the transaction and to recall the loaned securities on terms agreed by the parties.

(c) Securities lending services means:

(1) Selecting and negotiating with a borrower and executing, or directing the execution of the loan with the borrower;

(2) Receiving, delivering, or directing the receipt or delivery of loaned securities;

(3) Receiving, delivering, or directing the receipt or delivery of collateral;

(4) Providing mark-to-market, corporate action, recordkeeping or other

services incidental to the administration of the securities lending transaction;

(5) Investing, or directing the investment of, cash collateral; or

(6) Indemnifying the lender of securities with respect to various matters.

(d) For the purposes of this section, the term conduit lender means a bank that borrows or loans securities, as principal, for its own account, and contemporaneously loans or borrows the same securities, as principal, for its own account. A bank that qualifies under this definition as a conduit lender at the commencement of a transaction will continue to qualify, notwithstanding whether:

(1) The lending or borrowing transaction terminates and so long as the transaction is replaced within one business day by another lending or borrowing transaction involving the same securities; and

(2) Any substitutions of collateral occur.

b. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

The GLBA in Section 216, Definition of Dealer Under the Investment Company Act of 1940, amended Section 2(a)(11) of the Investment Company Act of 1940 to read as follows.

The term `dealer' has the same meaning as given in the Securities Exchange Act of 1934, but does not include an insurance company or investment company.

c. Investment Advisers Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

The GLBA in Section 219, Definition of Dealer Under the Investment Advisers Act of 1940 amended Section 202(a)(7) to read as follows.

The term `dealer' has the same meaning as given in Section 3 of the Securities Exchange Act of 1934, but does not include an insurance company or investment company.

4. **Bank as Underwriter**
   a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

   No exemption from definition of "underwriter" (§ 2(11)). The provisions of the Act are applicable to banks.

   b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   Not exempt from definition (§ 3(a)(20)). The provisions of the act are applicable to banks.

   c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

   Not exempt from definition of "underwriter" (§ 2(a)(40)). The provisions of the act are applicable to banks.

5. **Bank as Principal Underwriter**
   Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

   No exemption from definition (§ 2(a)(29)).

6. **Bank as a Municipal Bond Underwriter**
   The GLBA amends the corporate powers of National banks. They now have the authority to underwrite municipal revenue bonds. This activity may be performed within the bank. State banks may also engage in this activity to the extent permitted by the respective State's laws. This activity may be at the holding company, the bank, or the bank subsidiary level.

   Section 151 of the GLBA amends the paragraph designating the Seventh of Section 5136 of the Revised Statutes of the United States (12 U.S.C. 24(7)). It adds the following sentence.

   In addition to the provisions in this paragraph for dealing in, underwriting, or purchasing securities, the limitations and restrictions contained in this paragraph as to dealing in, underwriting, and purchasing investment securities for the national bank's own account shall not apply to obligations (including limited obligation bonds, revenue bonds, and obligations that satisfy the requirements of Section 142(b)(1) of the Internal Revenue Code of 1986) issued by or on behalf of any State or political

subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or any public agency or authority of any State or political subdivision of a State, if the national bank is well capitalized (as defined in Section 38 of the Federal Deposit Insurance Act).

7. **Bank as Clearing Agency**
   Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   No exemption from definition (§ 3(a)(23)(A); however, a bank is not to be deemed a clearing agency if it only performs customary bank functions or acts as agent for a clearing agency or participant in a clearing agency (§ 3(a)(23)(B)).

8. **Bank as Municipal Securities Dealer**
   Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   No exemption from "municipal securities dealer" definition for banks (§ 3(a)(30)); however, § 3(a)(30)(B) allows a separately identifiable department or division and not the bank itself to register as a municipal securities dealer

9. **Bank as Municipal Securities Broker**
   Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

   Exempts banks from definition of broker (§3(a)(4)(B)(ix))

10. **Bank as Investment Adviser**
    a. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

       Incorporates Investment Advisers, as defined in the Investment Advisers Act of 1940. (§3(a)(20))

    b. Investment Advisers Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

       Banks, bank holding companies, or their SIDDs (separately identifiable department or division) are required to register and comply with the Investment Advisers Act of 1940 if the bank, bank holding company, or SIDD serves or acts as an investment adviser to a registered investment company. A registered investment company is defined in the Investment Company Act of 1940 Section 3(a)(1) and includes mutual funds and other similar issuers.

       An "investment adviser" under the Investment Advisers Act of 1940 is subject to SEC jurisdiction, recordkeeping requirements, advertising and solicitation rules, rules on receipt of performance fees, and limits on use of nonpublic information.

       If the bank or bank holding company does not advise a registered investment company - the bank or bank holding company is exempt from the Act. This is explained below in an excerpt from Section 202(a)(11).

(§202(a)(11)) : "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser. "

If management elects to provide investment advice to a registered investment company, they will need to register the bank with the SEC or establish a "separately identifiable department or division" (SIDD) that will provide the advisory service. The SIDD must meet the provisions of 202(a)(26) below and register with the SEC.

(§ 202(a)(26)) : " The term "separately identifiable department or division" of a bank means a unit--
(A) that is under the direct supervision of an officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's investment adviser activities for one or more investment companies, including the supervision of all bank employees engaged in the performance of such activities; and
(B) for which all of the records relating to its investment adviser activities are separately maintained in or extractable from such unit's own facilities or the facilities of the bank, and such records are so maintained or otherwise accessible as to permit independent examination and enforcement by the Commission of this Act or the Investment Company Act of 1940 and rules and regulations promulgated under this Act or the Investment Company Act of 1940. "

(§210(A) Consultation) : This section of the Investment Advisors Act was added in 1999 through the GLBA . It allows for the sharing of information, between the SEC and the appropriate federal banking agency, regarding the investment advisory activities of any bank, bank holding company, or SIDD that is registered under Section 203 of the Act.

11. **Banks as Investment Company**
    a. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

    Incorporates Investment Company Act definition of "investment company". (§ 3(a)(19)).

    b. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

    Banks are exempt from definition of investment company for the Act (§ 3(c)(3)).

    c. Investment Advisers Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other

purposes.

Incorporates Investment Company Act definition of investment company (§ 202(a)(12)).

12. **Collective Trust Fund Treatment**
    a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

       Exempts any interest or participation in any common trust fund or similar fund that is excluded from the definition of the term 'investment company' under Section 3(c)(3) of the Investment Company Act of 1940 from all except fraud provisions under Section 17 of the Securities Act of 1933. (§ 3(a)(2)).

    b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

       Exempts any interest or participation in any common trust fund or similar fund that is excluded from the definition of the term `investment company' under Section 3(c)(3) of the Investment Company Act of 1940. (§ 3(a)(12))

    c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

       The GLBA codified the SEC's position on common trust funds and collective pooled investment funds. An exemption under Section 3(c)(3) of the Investment Company Act of 1940 is available for common trust fund or similar fund if:

       a. such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose;
       b. except in connection with the ordinary advertising of the bank's fiduciary services, interests in such fund are not-
          i. advertised; or
          ii. offered for sale to the general public; and
       c. fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable Federal or State law. (§ 3(c)(3))

Collective Trust Funds (for Qualified Plans)

13. **Single and Collective Trust Fund for IRC § 401 "Qualified" Retirement Plans Which Do Not Contain Voluntary Employment Contributions**
    a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

       Exempts interests or participations in a single or collective trust fund maintained by a bank . . . issued in connection with (a) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954" from all except fraud provisions (§ 3(a)(2)).

    b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

Includes in definition of exempted security "interests or participations in a collective trust fund maintained by a bank . . . issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954" (§ 3(a)(12)). Exempts from registration "interests or participations in any collective trust fund maintained by a bank . . . issued in connection with (i) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954" (§ 12(g)(2)(H)).

c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Exempts from definition of investment company "employees, stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954; or any collective trust fund maintained by a bank consisting solely of assets of such trusts" (§ 3(c)(11)).

14. **Single and Collective Trust Fund for IRC § 401 "Qualified" Retirement Plans Which Contain Voluntary Employee Contributions**

a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Contains no exemption for interests or participants in a single or collective trust fund maintained by a bank if "an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participants in the trust or separate account itself) issued by the employer or by any company indirectly or indirectly controlling, controlling by or under common control with the employer" (§ 3(a)(2)).

b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

Includes in definition of exempted security "interests or participations in a collective trust fund maintained by a bank . . . issued connection with . . . a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954" from all but fraud provisions (§ 3(a)(12)). Exempts from registration "interests or participations in any collective trust fund maintained by a bank . . . (which) are issued connection with . . . a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954" (§ 12(g)(2)(H)).

c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Exempts from definition of investment company "employees' stock bonus, pension, or profit-sharing trust which meet the requirements for qualification under Section 401 of the Internal Revenue Code of 1954; or any collective trust fund consisting solely of assets of such trusts": (§ 3(c)(11)).

15. **Single and Collective Trust Fund for H.R. 10 or Keogh Plans**

a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Contains no exemption since only interests or participations in single or collective trust funds maintained by a bank which cover employees some or all of whom are employees within the meaning of Section 401 of Internal Revenue Code of 1954 are exempted (§ 3(a)(2)).

b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through

the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

Contains no exemption because the definition of exempted security expressly excludes "interests or participations in collective trust funds maintained by a bank . . . which cover employees some or all of whom are employees within the meaning of Section 401(c)(1) of the Internal Revenue Code of 1954" (§ 3(a)(12)).. However, interests in Keogh Plans are exempt from registration under (§ 12(g)(2)(H)) which exempts "any interest or participation in any collective trust funds maintained by a bank . . . (which) is issued in connection with (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualifications under Section 401 of the Internal Revenue Code of 1954" (§ 12(g)(2)(H)).

c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Exempts from definition of investment company "employees' stock bonus, pension, or profit-sharing trusts which meet the requirements for qualification under Section 401 of the Internal Revenue Code of 1954; or any collective trust fund consisting solely of assets of such trusts": (§ 3(c)(11)).

16. **Collective Trust Funds, Including "Commingled Agency Accounts"**

a. Securities Act of 1933 : To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

No exemption.

b. Securities Exchange Act of 1934 : To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes.

No exemption.

c. Investment Company Act of 1940 : To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

No general exemption; however, there is a limited exemption excepting from the definition of investment company "any common trust fund, or similar fund, established before the effective date of the Revenue Act of 1936 (June 22, 1936) by a corporation which is supervised or examined by State or Federal authority having supervision over banks, if a majority of the units of beneficial ownership in such fund, other than units owned by charitable or educational institutions, are held under instruments providing for payment of income to one or more persons and of principal to another or others" (§ 3(c)(3)).

Securities and Exchange Commission

Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules
September 16, 2003

Division of Market Regulation

This Staff Compliance Guide to Banks on Dealer Statutory Exceptions and Rules was prepared by and represents the views of the staff of the Division of Market Regulation and does not constitute rules, regulations, or statements of the Securities and Exchange Commission ("Commission"). The Commission has neither approved nor disapproved its contents.

Beginning October 1, 2003, banks that buy and sell securities need to consider whether they are "dealers" under the federal securities laws.

Dealer activity is not interpreted the same way under securities law and banking law.

Banks need to be aware that "dealer" activity under the federal securities laws is not necessarily the same thing as "dealer" activity under banking law. For example, so-called "riskless principal" transactions are dealer activity for securities law purposes, even though they are agency activity for banking law purposes. Similarly, repurchase agreement transactions are treated as purchases and sales of securities for securities law purposes. Generally, these transactions would also be characterized for securities law purposes as transactions in the underlying security.

Although this Staff Compliance Guide highlights some of the significant provisions of the Securities Exchange Act of 1934 ("Exchange Act") and the Commission's rules, it is not comprehensive. We urge banks that need more information about particular exceptions and exemptions to consult the applicable law, including Section 3(a)(5) of the Exchange Act and the rules cited below. Banks can also obtain additional information by reading Exchange Act Release No. 47364 (February 14, 2003) (which can be found at http://www.sec.gov/rules/final/34-47364.htm) and Exchange Act Release No. 44291 (May 11, 2001) (which can be found at http://www.sec.gov/rules/final/34-44291.htm).

Banks that have additional questions may contact SEC staff for guidance at 202-942-0069 or at marketreg@sec.gov. Banks may also wish to consult with private counsel.

What is a "dealer" under the federal securities laws?

Section 3(a)(5) of the Exchange Act generally defines a "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." All transactions that go through a bank's own accounting books are potential dealer transactions.

The securities laws and rules, however, distinguish "dealers" (which buy and sell securities as part of a regular business) from "traders" (which buy and sell securities for investment and not as part of a regular business). For additional information on distinguishing "dealers" from "traders," see http://www.sec.gov/rules/proposed/34-46745.htm and http://www.sec.gov/rules/final/34-47364.htm at "Dealer Activities and the Dealer/Trader Distinction."

Typical dealer functions include:

- Providing two-sided quotations, or otherwise indicating an ongoing willingness to buy and sell particular securities; or
- Issuing or originating securities that the person also buys and sells.

If you are trying to determine whether a particular bank is acting as a dealer, you might want to consider the following questions:

- Does the bank hold itself out as being in the business of buying and selling securities?
- Does the bank engage in transactions with the public?
- Does the bank make a market in, or quote prices for both purchases and sales of, one or more securities?
- Does the bank participate in a "selling group" or otherwise underwrite securities?
- Does the bank hold a dealer inventory or does it trade with an affiliate that is a dealer?

A "yes" answer to any of these questions indicates that the bank may be a dealer.

Special Rules for Banks and FDIC-Insured Savings Associations

If a bank - or an FDIC-insured savings association or savings bank (which we will refer to as "savings banks") - is engaging in dealer activity, it does not necessarily have to register as a dealer with the Commission. Rather, Section 3(a)(5) of the Exchange Act and certain Commission rules provide transaction-specific exceptions and exemptions from the definition of "dealer" for banks and savings banks. These exceptions and exemptions are outlined below.

Exceptions From the Definition of "Dealer" Under Exchange Act Section 3(a)(5)

The Exchange Act provides four exceptions from the definition of "dealer." While the statute only makes these exceptions available to "banks" as defined in Section 3(a)(6) of the Exchange Act, the Commission has extended the scope of these exceptions to include savings banks. The four exceptions cover permissible securities transactions, investment transactions, asset-backed transactions, and identified banking products.

1. Permissible securities transactions . This exception permits banks to buy and sell commercial paper, bankers acceptances or commercial bills, certain Canadian government obligations, Brady bonds, and "exempted securities." "Exempted securities" include government securities, municipal securities, and interests or participations in common or collective trust funds.

   Note: Banks that deal in municipal securities, government securities, and Canadian government obligations have other registration requirements under the Exchange Act. These requirements are discussed below in the question and answer section of this guide.

2. Investment transactions. This exception permits banks to buy and sell securities for investment purposes. It applies to transactions both for the bank itself and for its trustee and fiduciary accounts. It does not apply to transactions between the bank and its customers. This exception is analogous to the "trader" distinction discussed above.

3. Asset-backed transactions. This exception permits banks - through a grantor trust or other separate entity - to issue and sell certain asset-backed securities to "qualified investors." These securities must represent obligations predominantly (85% or more) originated by the bank, or an affiliate of the bank other than a broker-dealer. If the underlying assets are mortgage obligations or consumer-related receivables, a syndicate of banks that includes the bank issuing and selling the securities must have originated 85% or more of the obligations, and the bank issuing and selling the securities must have originated at least 10% of the value of the pool of obligations backing the securities. The term "qualified investor" is defined in Exchange Act Section 3(a)(54) to include other banks, broker-dealers, savings associations, and other parties that meet specified criteria. The exception is limited to the original placement of securities. It does not permit a bank to repurchase and re-sell securities in the secondary market. For additional information, see Exchange Act Rule 3b-18, which defines terms used in the asset-backed transaction exception.

4. Identified banking products. This exception permits banks to buy and sell certain "identified banking products," which include deposit accounts, savings accounts, certificates of deposit, other deposit instruments issued by a bank, banker's acceptances, bank issued letters of credit, bank loans, and debit accounts. "Identified banking products" also include loan participations if they are sold to "qualified investors," or to other persons who have the opportunity to review and assess any material information. In addition, "identified banking products" include (i) credit swaps and (ii) equity swaps that are sold directly to "qualified investors." (As noted above, "qualified investors" include other banks, broker-dealers, savings associations, and

other parties that meet specified criteria.)

Exemptions from the Definition of "Dealer"

In addition to the four exceptions from the definition of "dealer" outlined above, banks and savings banks should also consider two exemptions adopted by the Commission by rule. These exemptions pertain to riskless principal transactions and securities lending transactions.

1. Riskless principal transactions. [17 CFR 240.3a5-1.] This exemption, under Exchange Act Rule 3a5-1, permits banks to engage in a limited number (up to 500) of "riskless principal" transactions per calendar year without registering with the Commission as dealers. A "riskless principal" transaction is one in which, after having received an order to buy from a customer, a bank purchases the security from another person to offset that contemporaneous sale. Alternatively, a riskless principal transaction is one in which after having received an order to sell from a customer, a bank sells the security to another person to offset that contemporaneous purchase.

How to count transactions for purposes of this exemption: Transactions with two customers where the bank acts as a riskless principal between them count as one transaction. However, if a bank acts as a riskless principal between one counterparty and multiple counterparties by arranging multiple transactions, each of the transactions on the side that involves the largest number of transactions would count as separate transactions against the annual transaction-limit.

How counting will be affected by banks' brokerage activities: The Exchange Act also permits banks to engage in certain "broker" activities without registering with the Commission. At the time the "dealer" provisions become effective, however, the "broker" provisions still will be subject to a Commission order delaying their effectiveness. See Exchange Act Release No. 47649 (April 8, 2003) (which can be found at http://www.sec.gov/rules/other/34-47649.htm).

One of the "broker" exceptions - known as the de minimis exception - permits banks to engage in no more than 500 brokerage transactions per year that are not otherwise exempt without registering with the Commission. When banks utilize this exception after the compliance date is set for the broker rules, banks' riskless principal transactions and brokerage transactions effected under the de minimis exception will count toward the same 500-transaction limit. In other words, banks may be able to engage in any combination of brokerage transactions under the de minimis exception and riskless principal transactions under Rule 3a5-1, so long as the total number of these transactions does not exceed 500 per year. Until the broker rules are effective, however, banks may use the entire 500-transaction limit for riskless principal transactions.

A final note about this interim period: Banks will have additional flexibility initially, during the period when the dealer exceptions are effective but the broker rules are not. Until the broker rules become effective, banks may also choose to accommodate customers by executing securities transactions as agent for a commission, rather than assuming the role of a principal without risk.

2. Securities lending transactions. [17 CFR 240.15a-11.] This exemption, under Rule 15a-11, permits banks to engage in, or effect, securities lending transactions with certain counterparties. A "securities lending transaction" is a transaction in which the owner of a security lends the security temporarily to another party under a written securities lending agreement. Through this agreement, the lender retains the economic interests of an owner of the securities. Subject to any terms agreed upon by the parties, including an agreement to loan the securities for a fixed term, the lender also has the right to terminate the transaction and to recall the loaned securities.

Who can be a counterparty under this exemption? The counterparty to these securities lending transactions must be either a person the bank reasonably believes is a "qualified investor," or any employee benefit plan that owns and invests on a discretionary basis, at least $25,000,000 in investments. (As noted above, "qualified investors" include other banks, broker-dealers, savings associations, and other parties that that meet specified criteria.) See Exchange Act Section 3(a)(54).

In what capacities may a bank act under this exemption? A bank may act as a conduit lender, or as an agent. A bank is a "conduit lender" if, as principal for its own account, it borrows or loans securities, and contemporaneously loans or borrows the same securities. A bank that qualifies as a conduit lender at the commencement of a transaction will continue to qualify if the lending or borrowing transaction terminates so long as it is replaced within one business day by another lending or borrowing transaction involving the same securities. It will also continue to qualify if substitutions of collateral occur.

Securities lending services are included within this exemption. Banks may also provide securities lending services in connection with securities lending transactions. "Securities lending services" encompass (1) selecting and negotiating with a borrower, and executing, or directing the execution of the loan with the borrower; (2) receiving, delivering, or directing the receipt or delivery of loaned securities; (3) receiving, delivering, or directing the receipt or delivery of collateral; (4) providing mark-to-market, corporate action, recordkeeping or other services incidental to the administration of the securities lending transaction; (5) investing, or directing the investment of, cash collateral; and (6) indemnifying the lender of securities with respect to various matters.

A final note about safekeeping and custody activities: Banks also have a conditional exception under Section 3(a)(4)(B)(viii) from the Exchange Act definition of "broker" for safekeeping and custody activities. Under that exception, banks may engage in securities lending services for custody customers without meeting the requirements of this exemption. For example, the safekeeping and custody exception permits a bank to engage in securities lending transactions for custody customers that are not "qualified investors." Of course, because the custody exception is only an exception from the definition of "broker," it does not cover "dealer" transactions.

Reminder: If your bank is doing, or may do, any of the activities of a dealer, you should find out if the bank needs to register with the SEC or stop engaging in dealer transactions. We want to underscore that similar topics may be analyzed differently under the securities laws and interpretations than under banking law and interpretations. If you are not certain, you may want to review SEC laws, rules, interpretations, consult with private counsel, or ask for Commission staff advice.

* * * * *

Frequently Asked Questions

Question #1: May a bank holding company, subsidiary of a bank, or affiliate of a bank use the bank exceptions in the Exchange Act?

Answer #1: No. The exceptions in the Exchange Act only exclude *banks'* securities activities from broker-dealer regulation, and then only in certain specified circumstances. ***Only the bank itself*** may claim an exception or exemption. The exceptions and exemptions are not available to a subsidiary or affiliate of a bank (unless the subsidiary or affiliate is itself a bank).

Question #2: May a bank conduct securities transactions with its subsidiaries or affiliates without registering as a broker-dealer?

Answer #2: Each of a bank's securities transactions with a subsidiary or affiliate of the bank must qualify for an exception or exemption.

Question #3: May a bank use more than one exception or exemption?

Answer #3: Yes, if the bank meets all of the conditions of any exception or exemption on which it is relying. For example, a bank may engage in securities lending transactions in accordance with Exchange Act Rule 15a-1, or if the security lent is an exempted security, in accordance with Exchange Act Section 3(a)(5)(C)(i)(II).

Question #4: What can a bank do if it needs additional time to bring its activities into conformity with the bank dealer exceptions and exemptions?

Answer #4: As the Commission noted in adopting the final dealer rules, individual banks may have specific transactions in progress for which they may need an extension of the implementation date of these rules. Banks in this situation should contact SEC's staff to determine if specific relief may be available to them. Each bank's situation will be considered on a case-by-case basis for specified transactions for which a demonstrated burden could be avoided or alleviated through a reasonably short extension of the compliance date, or during any period when additional specific exemption requests are being considered.

Question #5: What kinds of issues will the Commission staff address by telephone?

Answer #5: The Commission staff is available to discuss any legal issue under the federal securities laws. However, banks should understand that this guidance is highly informal and, while intended to be helpful to the persons making the inquiries, not binding on the Commission. A bank seeking more formal assurance with respect to particular proposed activities should submit a written request to the Office of Chief Counsel of the Division of Market Regulation.

Question #6: If my bank has a program where it sweeps deposit accounts into government securities subject to repurchase agreements, will the bank have to change or end that program when the bank "broker" and "dealer" rules go into effect?

Answer #6: As explained above, repurchase agreement transactions ("repos") are treated as purchases and sales of securities for securities law purposes. Generally, these transactions would also be characterized for securities law purposes as transactions in the underlying security. Therefore, the bank would need to consider whether it is acting as a broker (that is, if the bank forwards the money to another entity which enters into the repo as principal) or as a dealer (that is, if the bank itself enters into the repo as principal). Under the bank exception to the definition of broker, banks are permitted to effect transactions in "exempted securities." Under the bank exception to the definition of dealer, banks are permitted to buy and sell exempted securities as defined in Section 3(a)(12) of the Exchange Act. Exempted securities include government securities. Thus, a bank has an exception from the definition of broker for transactions in government securities and an exception from the definition of dealer for buying and selling government securities. Banks must also, however, comply with the requirements of the Government Securities Act of 1986 and the related regulations. An analysis of those requirements is beyond the scope of this guide.

Question #7: If my bank was doing riskless principal transactions as a service to our customers when banks had a complete exemption from broker-dealer registration under the federal securities laws, how many riskless principal transactions may the bank engage in from October 1, 2003 until December 31, 2003, after the more limited exemption takes effect?

Answer #7: During the period before the broker rules become effective, a bank is exempt from the definition of "dealer" for 500 riskless principal transactions during a calendar year. To make it easy for banks to comply during this calendar year, a bank may utilize the entire 500 transactions between October 1, 2003 and December 31, 2003. The Commission extended the blanket bank broker exemption until November 12, 2004. During calendar year 2004, the bank also may use the entire 500 transactions for riskless principal transactions. Once the revised broker rules become effective, the bank will have to combine its riskless principal transactions with the transactions in which the bank is acting as an agent for a customer under the statutory exception for de minimis transactions during each calendar year. The combined number of transactions may not exceed 500 per calendar year. [17 CFR 240.3a5-1.] The calculation for combining the de minimis broker transactions with the riskless principal transactions will be more fully addressed when the broker rules become effective.

Question #8: If my bank wants to act as a riskless principal to fill a securities order as a service to a customer, how does the bank count the order when the bank transacts with several broker-dealers to get best execution?

Answer #8: The bank would count the order as one transaction, assuming the customer only placed one order with the bank. In other words, multiple transactions with broker-dealers to fill a single customer order would only count as one transaction for the purpose of this exemption. Moreover, if the bank routes an order to a single broker-dealer, and the broker-dealer splits the order among several of its customers, the bank would still count the transaction as one transaction. In contrast, if the bank acts as an intermediary between one customer and multiple customers by arranging multiple transactions, the bank must count each of the transactions on the side of the intermediation that involves the largest number of transactions against the annual 500-transaction limit.

Question #9: What does it mean for a bank to act as a fiduciary for purposes of Exchange Act Section 3(a)(5)(C)(ii)?

Answer #9: The exception for trustee and fiduciary transactions applies when the bank buys or sells securities for investment purposes for accounts for which the bank acts as a trustee or fiduciary. In giving meaning to the term "fiduciary" in Section 3(a)(5)(C)(ii), we look to the legislative history, which states that Exchange Act Section 3(a)(5) "excepts a bank from the definition of 'dealer' when it buys and sells securities for investment purposes for the bank or for accounts for which the bank acts as trustee or fiduciary. This mirrors existing law distinguishing between investors and dealers, and is limited to the portfolio trading of the bank and accounts for which it makes investment decisions." H.R. Rep. No. 106-74, pt. 3, at 170-71(1999).

Question #11: What does it mean to underwrite securities?

Answer #11: Confusion about what it means to be a dealer sometimes is caused by the belief that dealers only underwrite securities, although in general the determination of broker or dealer status under the Exchange Act primarily depends on the broader definitions of 'purchase' and 'sale.' See Exchange Act Section 3(a)(13) and 3(a)(14) [15 USC 78c(a)(13) and 78c(a)(14)]. As the Commission stated in footnote 21 of Exchange Act Release No 47364 (February 14, 2003): "The term 'underwriter' is defined in Section 2(a)(11) of the Securities Act of 1933 [15 USC 77b(a)(11)]. In determining whether a bank is acting as an underwriter when it undertakes particular securities activities, the Commission is not expressing any views on whether those activities would constitute 'underwriting' for purposes of Section 16 of the Glass-Steagall Act. The Commission wishes to emphasize that the determination of dealer status with respect to securities transactions, including those that do not involve a public offering, must be made by

reference to the federal securities laws. It is the Commission's view, however, that the fact that an offering is exempt from registration under the Securities Act of 1933 ("Securities Act") [15 USC 77a, et seq.] does not necessarily affect the status of a participant in that offering as an 'underwriter' as defined in Securities Act Section 2(a)(11)." [68 FR 8686 at 8688, note 21.]

Question #12: May a bank register itself as a broker-dealer?

Answer #12: While this is possible as a theoretical matter, it may not be practical for most banks (except in the case of banks that do not make loans). As the Commission noted in Exchange Act Release No. 44291 (May 11, 2001) http://www.sec.gov/rules/final/34-44291.htm at note 266 and the sources cited therein, banks have traditionally had varying reasons for choosing to conduct securities activities through a separate entity.

Question #13: Why is the definition of "dealer" for purposes of broker-dealer registration different from the analysis under the Commission's net capital rule of when a registered broker-dealer must maintain the required minimum capital as a "dealer"?

Answer #13: The analysis is different because the purpose of the analysis is different. All registered broker-dealers, including any bank that registered with the Commission, are subject to the net capital rule. The net capital rule sets forth appropriate capital levels to comply with the financial responsibility requirements for a registered broker-dealer based on its business model. Exchange Act Rule 15c3-1(a)(2)(iii)(B) establishes minimum net capital requirements for broker-dealers that are designated as "dealers" because they engage in a certain level of proprietary trading. Under that rule, a "dealer" includes "any broker or dealer that effects more than ten transactions in any one calendar year for its own investment account." In contrast, determining when a person meets the initial threshold that requires registration as a broker-dealer is subject to the analysis of the factors set forth at the beginning of this special notice as well as the broker factors set forth in the Compliance Guide to the Registration and Regulation of Brokers and Dealers.

Question #14: If a bank acts only as a municipal securities dealer, must it register as a broker-dealer?

Answer #14: No, it has an exception from broker-dealer registration. It, or its separately identified department or division, must, however, register as a municipal securities dealer under Exchange Act Section 15B. A bank should use Form MSD to register with the Commission. The bank, or its separately identified department or division, must follow the rules governing municipal securities dealers, including the rules of the Municipal Securities Rulemaking Board ("MSRB").

Question #15: If a bank is registered as a municipal securities dealer, must it also register as a municipal securities broker?

Answer #15: No, there is no separate registration for municipal securities brokers. However, if a bank has a separately identified department or division registered as a municipal securities dealer, the bank must conduct its municipal brokerage business in that separately identifiable department or division. For additional information on this subject, see MSRB Rule G-1, which defines the separately identifiable department or division of a bank.

Question #16: Do a bank's transactions in municipal fund securities have to comply with Commission and MSRB rules?

Answer #16: Banks must register as municipal securities dealers to deal in municipal securities that States issue to provide tax-favored vehicles for educational savings, such as 529 plans. All those banks' municipal securities

activities - including municipal fund securities transactions in which the bank acts solely as an agent - must conform with MSRB rules and all Commission rules that apply to municipal securities dealers. On the other hand, if a bank does not act as a dealer in municipal securities, then the bank may engage in agency transactions involving municipal fund securities without registering with the Commission and registering with the MSRB.

Question #17: If a bank acts as a dealer of U.S. government or Canadian government securities, must it register as a broker-dealer?

Answer #17: No, because banks are exempted from broker-dealer registration for "permissible securities transactions." Permissible securities transactions include "exempt securities," which include government securities and Canadian securities and are defined in Exchange Act Section 3(a)(12). Banks, however, must also comply with the requirements of the Government Securities Act of 1986 [15 USC § 78o-5] as well as the legal requirements of the implementing regulations promulgated by Treasury, 17 C.F.R. Parts 400 to 450 when they effect transactions in or buy or sell government securities and Canadian securities. For hold-in-custody repurchase transactions, 17 C.F.R. § 450 also is applicable. Banks that are dealing in government securities also should review the Federal Financial Institutions Examination Council ("FFIEC") Modification of Policy Statement, 63 F.R. 6935 (February 11, 1998).

Question # 18: If a bank may deal only with "qualified investors" to meet the terms of an exemption or exception, who can be its customers or counterparties?

Answer #18: The term "qualified investor" is defined in Exchange Act Section 3(a)(54). [15 USC 78c(a)(54).] Qualified investors include investment companies, banks, small business investment companies, any State sponsored employee benefit plan, institutional trusts, market intermediaries, and individuals, corporations or partnerships that own and invest on a discretionary basis more than $25,000,000.

How to Contact Us

For general questions regarding broker-dealer registration and regulation:

Office of Interpretation and Guidance
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
(202) 942-0069
E-mail address: marketreg@sec.gov

Where to Get Further Information

For copies of SEC forms and recent SEC releases:

Publications Section
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0011
(202) 942-4046

Other useful telephone numbers, and Web sites:

- SEC's website: http://www.sec.gov/
- National Association of Securities Dealers' website: http://www.sec.gov/cgi-bin/goodbye.cgi?www.nasdr.com
- National Association of Securities Dealers' telephone number: (800) 289-9999 or (301) 590-6500

References:

Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of Exchange Act Release No. 34-47364, 68 FR 8686 (February 24, 2003).

Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of Exchange Act Release No. 34-46745, 67 FR 67495 (November 5, 2002).

Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of Exchange Act Release No. 34-44291, 66 FR 27760 (May 18, 2001).

Division of Market Regulation: Compliance Guide to the Registration and Regulation of Brokers and Dealers, http://www.sec.gov/divisions/marketreg/bdguide.htm

http://www.sec.gov/divisions/marketreg/bankdealerguide.htm

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Appendix E — Employee Benefit Law

Reference	Topic
	Interagency Agreement to Refer Violations of ERISA to the Department of Labor

ERISA (Statute)

§§	
3	Definitions (Selected)
206	[Excerpt] Pledging by Participant of Vested Interest
401	Coverage
402	Establishment of Plan
403	Establishment of Trust
404	Fiduciary Duties
405	Co-Fiduciary Liability
406	Prohibited Transactions
407	Investment in Sponsor Securities and Real Estate
408	Statutory Exemptions to Prohibited Transactions
408(b)(1)	Loans to Plan Participants
408(b)(2)	Ancillary Services
408(b)(3)	Loans to ESOPs
408(b)(4)	Deposits With Fiduciary Banks and Thrifts
408(b)(8)	Collective Investment Funds
408(c)(2)	Fiduciary Fees & Expenses
409	Liability for Breach of Fiduciary Duty
410	Exculpatory Provisions
411	Prohibition Against Certain Persons Holding Certain Positions
412	Bonding of Fiduciaries
502	Civil Money Penalties

Cross References Between ERISA and Internal Revenue Code

Summary of ERISA Regulations, Opinions, and Court Decisions

§§

3	Definitions (Selected)
4	Plans Covered
404	Fiduciary Duties
405	Co-Fiduciary Liability
406	Prohibited Transactions
407	Investment in Sponsor Securities and Real Estate
408	Statutory Exemptions to Prohibited Transactions
408(b)(1)	Loans to Plan Participants
408(b)(2)	Ancillary Services
408(b)(3)	Loans to ESOPs
408(b)(4)	Deposits With Fiduciary Banks and Thrifts
408(b)(5)	Insurance Company Fiduciaries
408(b)(7)	Conversion of Securities
408(b)(8)	Collective Investment Funds
408(c)(2)	Fiduciary Fees & Expenses
410	Exculpatory Provisions
412	Bonding of Fiduciaries

Internal Revenue Code

§§

72(p)	Loans to Plan Participants Treated as Distributions
72(p)-1	Loans to Plan Participants Treated as Distributions – IRS Guidelines
408(h)	Custodial Accounts
408(m)	Investment in Collectibles by IRA and Self-Directed Accounts
408(q)	Deemed Individual Retirement Accounts
409(e)	Qualifications for Tax Credit ESOPs – Voting Rights
417	Special Rules for Survivor Annuity Requirements
4975	Tax on Prohibited Transactions

Regulations

54.4975-11	IRS	ESOP Requirements
54.4975-12	IRS	"Qualified Employer Security" Defined
2510.3-101	DOL	Plan Assets (Pension and Welfare Benefits Administration Regulation)
2520.103-5	DOL	CIF Reports to Plan Administrators
2550.404a-1	DOL	Investment Duties (Prudence Regulation)
2550.404b-1	DOL	Indicia of ownership
2550.404c-1	DOL	ERISA Section 404(c) Plans
2550.404c-5	DOL	Default Investment Alternatives Under Participant Directed Individual Account Plans (306KB PDF file - PDF Help)

Employer Securities and Real Property

2550.407a-1	DOL	General
2550.407a-2	DOL	Acquisition
2550.407d-5	DOL	"Qualifying" Defined
2550.407d-6	DOL	"Employee Stock Ownership Plan" Defined
2550.408b-1	DOL	Loans to Plan Participants and Beneficiaries
2550.408b-2	DOL	Services or Office Space
2550.408b-3	DOL	Loans to ESOPs
2550.408b-4	DOL	Investment in Own-Bank Interest-Bearing Deposits
2550.408b-6	DOL	Ancillary Services by Banks
2550.408c-2	DOL	Compensation for Services
2550.408e	DOL	Qualifying Employer Securities and Real Estate
2570.30 -.52	DOL	Individual and Class Prohibited Transaction Exemption Requests (Replaces ERISA Procedure 75-1)

IRS Revenue Rulings

59-60	Valuation of Non-Traded Assets
	IRS Rev Bulletin 2003-37
	IRS Revenue Procedure 2003-13 Deemed IRAs
	IRS Revenue Ruling 2004-67-Roth & Deemed IRA Group Trust Participation
	IRS Self Correction Program FAQ Guidance

IRS Voluntary Compliance Program FAQ Guidance

IRS Interpretive Letter

EP:R:9	IRA Annual Valuations: Partnership Valuations, Inc.

PTE	**Prohibited Transaction Class Exemptions**
75-1	Securities Transactions (67KB PDF file - PDF Help) Also See 86-128
77-3	Investment in Mutual Funds by In-House Employee Benefit Plans
77-4	Investment in Mutual Funds advised by fiduciary bank or affiliated with fiduciary bank (proprietary mutual funds).
80-26	Interest-free loans (including overdrafts) between plans and parties in interest.
80-51	Collective Investment Funds [Replaced by PTE 91-38].
80-83	Investment of plan assets in a securities issue of plan sponsor used to reduce debt at fiduciary bank or its affiliates.
81-6	Securities lending between plans and banks, broker-dealers, and government securities dealers.
81-8	Covers four types of short-term investments: banker's acceptances, commercial paper, repurchase agreements, and certificates of deposit.
82-63	Securities lending: permits payment of compensation to fiduciary providing service.
82-87	Residential Mortgage Loans. First- and second-lien loans and participations on 1-to-4 family homes, townhouses, condominiums, and cooperative apartments.
84-14	QPAM: Qualified Professional Asset Managers. Permits certain transactions between independent QPAMs and (1) parties in interest, and (2) employers, subject to conditions. Amendment to PTE-84-14 (80KB PDF file - PDF Help)
86-128	Securities Transactions With Broker-Dealers: Permits use of affiliated brokers, including for collective investment funds.
91-38	Collective Investment Funds [Formerly PTE 80-51].
91-55	Gold Coins: American Eagle gold coins permitted as IRA investment.
93-33	Receipt of Services by IRA and Self-Retirement Plan Beneficiaries [Formerly PTE 93-2]
94-20	Foreign exchange: use of fiduciary bank, and its affiliates, to invest in foreign exchange and foreign currency options.

96-23	In-House Professional Asset Managers
97-11	Relationship Brokerage (25KB PDF file - PDF Help) Amendment #1 Amendment #2 (28KB and 44KB PDF files - PDF Help)
97-41	Collective Investment Fund Conversions to Mutual Funds
98-54	Foreign Exchange Transactions Executed Pursuant to Standing Instructions
2000-14	Temporary Amendment to PTE 80-26 for Certain Interest Free Loans
2002-12	Cross-Trading of Securities (201KB PDF file - PDF Help)
2002-13	Amendment to Clarify the Term "Plan" (42KB PDF file - PDF Help)
2002-51	Voluntary Fiduciary Correction Program (58KB PDF file - PDF Help) Amendment to 2002-51 (66KB PDF file - PDF Help)
2003-39	Release of Claims and Extenstions of Credit in Connection with Litigation (72KB PDF file - PDF Help)
2004-16	Mandatory Distributions (108KB PDF file - PDF Help)
2006-06	Abandoned Individual Account Plans (116KB PDF file - PDF Help)
2006-16	Loans of Securities by Plans (108KB PDF file - PDF Help)
IB	**Interpretive Bulletins**
75-2	Interpretive Bulletins Relating to the Employee Retirement Income Security Act of 1974
75-3	Interpretive bulletin relating to investments by employee benefit plans in securities of registered investment companies.
75-4	Interpretive bulletin relating to indemnification of fiduciaries
75-6	Guidelines for determining when a party in interest with respect to an employee benefit plan may receive an advance for expenses to be incurred on behalf of the plan without engaging in a transaction prohibited by section 406 of the Employee Retirement Income Security Act of 1974
75-8	Questions and answers relating to fiduciary responsibility under the Employee Retirement Income Security Act of 1974
94-1	ETIs: Economically Targeted Investments (Social Investing)
94-2	Proxy Voting and Investment Policies
94-3	In-Kind Contributions to Plans
95-1	Interpretive bulletin relating to the fiduciary standard under ERISA when selecting an annuity provider

96-1	Participant Investment Education for 404(c) Individual Account Plans
TB	**Technical Bulletins**
86-1	Soft Dollars and Directed Commissions for Securities Transactions
AO	**Advisory Opinions/Individual Exemptions**
77-46	Insured/Uninsured Deposits: Indicates diversification requirements do not apply to insured deposits, and that uninsured deposits will not violate diversification requirements if depository bank's assets are "diversified."
79-49	Own-bank plans: Prohibits fee for fiduciary services when bank acts as fiduciary for own-bank plan.
80-OCC	Own-bank stock: Prohibits discretionary purchases, sales, and retention of stock of a fiduciary bank. Non-discretionary purchases, sales, retention permitted. Indicates discretionary purchases and retention would be imprudent.
85-36	Loan(s) that primarily generate jobs for union members/employers.
86-FRB	Cash sweeps and related fees ("Plotkin Letter").
88-2	Cash sweeps for non-discretionary accounts into non-affiliated mutual funds.
88-9	Own-bank stock: Purchases of stock (including treasury stock) of the fiduciary bank (or its parent holding company) by self-directed IRA accounts.
88-18	Self-directed IRA account loans to a company in which the grantor/customer has a substantial interest.
88-28	Own-bank stock: Purchases of an initial public offering ("IPO") of stock of the fiduciary bank (or its parent holding company) by self-directed IRA accounts by a mutual savings bank converting to a stock institution.
89-03	Self-directed IRA account investments in stock of the customer's employer, including stock purchased directly from the employer company.
92-23	Own-bank stock: Permits non-discretionary purchase and retention of own-bank (or holding company) stock.
93-13	Mutual funds, proprietary: Provides guidance on how PTE 77-4 applies to purchase of affiliated mutual funds.
93-24	Float management involving demand deposit accounts.
93-26	Mutual funds, proprietary: Provides guidance on applicability of PTE 77-4 to use of affiliated mutual funds by IRA and Keogh accounts.
94-41A	Escheating
94-OCC	Collective investment funds conversions to mutual funds.
96-OCC	Investment in derivatives.
97-15A	Acceptance of Mutual Fund 12b-1 Fees; Letter to Frost National Bank; Discretionary and Non-Discretionary Accounts.
97-16A	Acceptance of Mutual Fund 12b-1 Fees; Letter to Aetna Life Insurance and

Annuity Company; Non-Discretionary Accounts.

98-06A	Applicability of PTE-97-4 and PTE 77-3 to Investment of In-House Bank Employee Benefit Plans into Proprietary Mutual Funds
1999-03A	Purchase of Mortgage-Backed Securities Representing Interests in a Trust Fund for which an Affliate of the Fiduciary Serves as a Sub-Servicer
1999-05A	Application of Plan Assets Regulation to Certain Mortgage Pool Certificates Offered by Freddie Mac
1999-13A	Treatment of QDROs Believed to be Questionable
2000-10A	Whether allowing the owner of an IRA to direct the IRA to invest in a limited partnership, in which relatives and the IRA owner in his individual capacity are partners, will violate section 4975 of the Code
2001-01A	The application of Title I of ERISA to the payment by plans of expenses relating to tax-qualification. See hypothetical examples. (www.dol.gov)
2001-10A	Application of ERISA Secs. 408(b)(2) and 408(b)(6) to the provision of trustee services by Laurel Trust Company to two defined benefit plans which it sponsors and the payment by the plans of trustee fees in connection with those services
2002-04A	Application of Sec. 408(e) of ERISA to certain transactions between a plan and various personal trusts and estates sharing a common trustee with the plan
2002-05A	Whether the prohibition in PTE 77-4 (42 FR 18732, April 8, 1977) on sales commission payments would apply to commissions paid by a plan to an independent broker who executes the plan's purchase or sale of shares of open-end investment companies registered under the Investment Company Act of 1940 through a securities exchange
2002-08A	Whether indemnification and limitation of liability provisions in a plan's service provider contract would violate the fiduciary provisions of ERISA
2002-14A	Guidance concerning the selection of annuity providers in connection with distributions from defined contribution plans. Specifically, the application of specific requirements of Interpretive Bulletin 95-1
2003-02A	Regarding the application of ERISA to the provision of overdraft protection services, including any inherent extension of credit incident to such services, by banks, whether or not the bank exercises investment discretion over plan assets
2003-09A	Whether a trust company's receipt of 12b-1 and subtransfer fees from mutual funds, the investment advisers of which are affiliates of the trust company, for services in connection with investment by employee benefit plans in the mutual funds, would violate ERISA when the decision to invest in such funds is made by an employee benefit plan fiduciary or participant who is independent of the trust company and its affiliates
2003-11A	Whether delivery of a Profile (as described in Rule 498 under the Securities Act of 1933) would satisfy the prospectus delivery requirements under ERISA section 404(c) regulations
2003-15A	Whether a limited partnership in which employee benefit plans invest would be deemed a party in interest with respect to the plans under section 3(14)(G) of ERISA where the plan trustee would hold more than fifty percent of the interests in the limited partnership on behalf of the plans
2004-02A	Time and Order of Issuance of Domestic Relations Orders

2004-05A	Whether the execution of a securities transaction between a plan and party in interest through an alternative trading system constitutes a prohibited transaction under ERISA
2004-07A	Non-depository, state chartered trust company that is a wholly-owned subsidiary of a bank holding company and is subject to regular examination and supervision by the Federal Reserve System, is exempt from certain bonding requirements in section 412 of ERISA
2004-09A	Concerning the application of the prohibited transaction provisions under section 4975(c) of the IRC, to certain contributions to health savings accounts
2005-04A	Whether a plan may invest in a mutual fund when one of the plan's trustees is the president, CEO, and significant shareholder of the mutual fund's investment advisor
2005-09A	Whether in-kind investments in a bank collective investment fund are covered by ERISA section 408(b)(8), if the stated conditions are met
2006-01A	Whether a lease by a company (LLC) 49% owned by an IRA to a company (S) which is a disqualified person with respect to that IRA is a prohibited transaction where the manager of the LLC is an officer of S. Whether 29 CFR 2509.75-2 makes the transaction an indirect prohibited transaction and whether it makes the transaction a violation of the Internal Revenue Code's exclusive benefit rule
2006-06A	Whether the prohibition on the payment of sales commissions in PTE 77-3 applies to the payment of 12b-1 Fees by a proprietary mutual fund to an unrelated broker
2006-08A	Whether a fiduciary of a defined benefit plan may, consistent with the requirements of section 404 of ERISA, consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan
2006-09A	This advisory opinion concludes that a self-directed IRA's investment in notes of a corporation, a majority of whose stock is owned by the son-in-law of the IRA owner, would be a prohibited transaction under the Internal Revenue Code
2007-01A	Whether transactions between a broker-dealer and a separate account managed by a QPAM under a 401(k) plan fail to satisfy section I(a) of PTE 84-14 where plan participants investing in such account receive investment allocation advice from a subsidiary of the broker-dealer
2007-02A	Whether the 10% test applicable to pooled investment vehicles under the QPAM class exemption (84-14) does not require consideration of any underlying plan investors in a pooled fund investing in another pooled fund (47KB PDF file - PDF Help)
FAB	**DOL Field Assistance Bulletins**
2002-01	ESOP Refinance Transactions
2002-02	Plan Amendments Made by Multiemployer Trustees
2002-03	Disclosure and Other Obligations Relating to "Float"
2003-01	Participant Loans to Corporate Directors and Officers
2003-02	Application of Participant Contribution Requirements to Multiemployer Defined Contribution Pension Plans

2003-03	Allocation of Expenses in a Defined Contribution Plan
2004-01	Health Savings Accounts
2004-02	Fiduciary Duties and Missing Participants in Terminated Defined Contribution Plans
2004-03	Fiduciary Responsibilities of Directed Trustees
2006-01	The Distribution to Plans of Settlement Proceeds Relating to Late Trading and Market Timing
2006-02	Health Savings Accounts - Q&As
2006-03	Periodic Benefit Statements - Pension Protection Act of 2006
2007-01	Statutory Exemption for Investment Advice
2007-02	ERISA Coverage of IRC§403(b) Tax-Sheltered Annuity Programs
2007-03	Periodic Pension Benefit Statements For Non-Participant Directed Individual Account Plans
2007-04	Supplemental health insurance coverage as excepted benefits under HIPAA and related legislation excepted benefits under sections 732(c)(3) and 733(c)(4) of ERISA?
2008-01	Fiduciary Responsibility for Collection of Delinquent Contributions

DOL Interpretive Letter

	Receipt of Fees from Mutual Fund Distributors and Investment Advisors

ERISA Procedures

76-1	Advisory Opinion Requests: Establishes procedures for requesting ERISA opinions from Labor Department.
	Voluntary Correction Programs
	Voluntary Fiduciary Correction Program FAQs
	Participant Notice Voluntary Correction Program
	Prohibited Transaction Class Exemption 2002-51

Publications

794	IRS Determination Letters
	Example Determination Letter
	US Treasury Notice 2004-8 - Abusive Roth IRA Transaction

Miscellaneous Laws

	Pension Protection Act of 2006

Economic Growth and Tax Relief Reconciliation Act of 2001

Tax Relief and Health Care Act of 2006

Medicare Prescription Drug Improvement Act of 2003

Table of Contents

Trust Examination Manual

Appendix F- Corporate Trust Law

Table of Contents

Trust Indenture Act of 1939

(Revised through November 15, 1990)

Codified to 15 USC 77aaa through 15 USC 77bbbb
Section 402 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2722)
Effective November 15, 1990

Trust Indenture Act of 1939

Section 301 Short Title

Section 302 Necessity for Regulation

Section 303 Definitions

Section 304 Exempted Securities and Transactions

Section 305 Securities Required to be Registered Under Securities Act

Section 306 Securities Not Registered Under Securities Act

Section 307 Qualification of Indentures Covering Securities Not Required to be Registered

Section 308 Integration of Procedure With Securities Act and Other Acts

Section 309 When Qualification Becomes Effective; Effect of Qualification

Section 310 Eligibility and Disqualification of Trustee

Section 311 Preferential Collection of Claims Against Obligor

Section 312 Bondholders Lists

Section 313 Reports by Indenture Trustee

Section 314 Reports by Obligor; Evidence of Compliance With Indenture Provisions

Section 315 Duties and Responsibility of the Trustee

Section 316 Direction and Waivers by Bondholders; Prohibition of Impairment of Holder's Right to Payment

Section 317 Special Powers of Trustee; Duties of Paying Agents

Section 318 Effect of Prescribed Indenture Provisions

Section 319 Rules, Regulations, and Orders

Section 320 Hearings by Commission

Section 321 Special Powers of the Commission

Section 322 Court Review of Orders; Jurisdiction of Offenses and Suits

Section 323 Liability for Misleading Statements

Section 324 Unlawful Representations

Section 325 Penalties

Section 326 Effect on Existing Law

Section 327 Contrary Stipulations Void

Section 328 Separability of Provisions

SEC Rules Under Section 304 Of The Trust Indenture Act Of 1939

SEC Regulation A - Conditional Small Issues Exemption

Trust Indenture Act Of 1939

As Amended

AN ACT To provide for the regulation of the sale of certain securities in interstate and foreign commerce and through the mails, and the regulation of the trust indentures under which the same are issued, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, the Act entitled "An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes", approved May 27, 1933, as amended, is amended by adding at the end thereof the following:

TITLE III[1]

[1] Title I of this act is the Securities Act of 1933. Title II is the Corporation of Foreign Security Holders Act.

Section 301 Short Title

This title, divided into sections as follows, may be cited as the "Trust Indenture Act of 1939". [Codified to 15 USC 77aaa]

[Source: Section 301 of title III of the Act of May 27, 1933 (Pub. L. No. 22, 48 Stat. 74), effective May 27, 1933, as added by section 301 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1149), effective August 3, 1939]

Section 302 Necessity for Regulation

(a) Upon the basis of facts disclosed by the reports of the Securities and Exchange Commission made to the Congress pursuant to section 211 of the Securities Exchange Act of 1934 and otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors in notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, which are offered to the public, are adversely affected -

(1) when the obligor fails to provide a trustee to protect and enforce the rights and to represent the interests of such investors, notwithstanding the fact that -

(A) individual action by such investors for the purpose of protecting and enforcing their rights is rendered impracticable by reason of the disproportionate expense of taking such action, and

(B) concerted action by such investors in their common interest through representatives of their own selection is impeded by reason of the wide dispersion of such investors through many States, and by reason of the fact that information as to the names and addresses of such investors generally is not available to such investors;

(2) when the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures -

(A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and

(B) generally relieve the trustee from liability even for its own negligent action or failure to act;

(3) when the trustee does not have resources commensurate with its responsibilities, or has any relationship to or connection with the obligor or any underwriter of any securities of the obligor, or holds, beneficially or otherwise, any interest in the obligor or any such underwriter, which relationship, connection, or interest involves a material conflict with the interests of such investors;

(4) when the obligor is not obligated to furnish to the trustee under the indenture and to such investors adequate current information as to its financial condition, and as to the performance of its obligations with respect to the securities outstanding under such indenture; or when the communication of such information to such investors is impeded by the fact that information as to the names and addresses of such investors generally is not available to the trustee and to such investors;

(5) when the indenture contains provisions which are misleading or deceptive, or when full and fair disclosure is not made to prospective investors of the effect of important indenture provisions; or

(6) when, by reason of the fact that trust indentures are commonly prepared by the obligor or underwriter in advance of the public offering of the securities to be issued thereunder, such investors are unable to participate in the preparation thereof, and, by reason of their lack of understanding of the situation, such investors would in any event be unable to procure the correction of the defects enumerated in this subsection.

(b) Practices of the character above enumerated have existed to such an extent that, unless regulated, the public offering of notes, bonds, debentures, evidences of indebtedness, and certificates of interest or participation therein, by the use of means and instruments of transportation and communication in interstate commerce and of the mails, is injurious to the capital markets, to investors, and to the general public; and it is hereby

declared to be the policy of this title, in accordance with which policy all the provisions of this title shall be interpreted, to meet the problems and eliminate the practices, enumerated in this section, connected with such public offerings. [Codified to 15 USC 77bbb]

[Source: Section 302 of title III of the Act of May 27, 1933 (Pub. L. No. 22, 48 Stat. 74), effective May 27, 1933, as added by section 302 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1150), effective August 3, 1939]

Section 303 Definitions

When used in this title, unless the context otherwise requires -

(1) Any term defined in section 2 of the Securities Act of 1933, and not otherwise defined in this section, shall have the meaning assigned to such term in such section 2.

(2) The terms "sale", "sell", "offer to sell", "offer for sale", and "offer" shall include all transactions included in such terms as provided in paragraph (3) of section 2 of the Securities Act of 1933, except that an offer or sale of a certificate of interest or participation shall be deemed an offer or sale of the security or securities in which such certificate evidences an interest or participation if and only if such certificate gives the holder thereof the right to convert the same into such security or securities.

(3) The term "prospectus" shall have the meaning assigned to such term in paragraph (10) of section 2 of the Securities Act of 1933, except that in the case of securities which are not registered under the Securities Act of 1933, such term shall not include any communication -

(A) if it is proved that prior to or at the same time with such communication a written statement if any required by section 306 was sent or given to the persons to whom the communication was made, or

(B) if such communication states from whom such statement may be obtained (if such statement is required by rules or regulations under paragraphs (1) or (2) of subsection (b) of section 306) and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

(4) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission.

(5) The term "director" means any director of a corporation, or any individual performing similar functions with respect to any organization whether incorporated or unincorporated.

(6) The term "executive officer" means the president, every vice president, every trust officer, the cashier, the secretary, and the treasurer of a corporation, and any individual customarily performing similar functions with respect to any organization whether incorporated or unincorporated, but shall not include the chairman of the board of directors.

(7) The term "indenture" means any mortgage, deed of trust, trust or other indenture, or similar instrument or agreement (including any supplement or amendment to any of the foregoing), under which securities are outstanding or are to be issued, whether or not any property, real or personal, is, or is to be, pledged, mortgaged, assigned, or conveyed thereunder.

(8) The term "application" or "application for qualification" means the application provided for in section 305 or 307, and includes any amendment thereto and any report, document,

or memorandum accompanying such application or incorporated therein by reference.

(9) The term "indenture to be qualified" means -

(A) the indenture under which there has been or is to be issued a security in respect of which a particular registration statement has been filed, or

(B) the indenture in respect of which a particular application has been filed.

(10) The term "indenture trustee" means each trustee under the indenture to be qualified, and each successor trustee.

(11) The term "indenture security" means any security issued or issuable under the indenture to be qualified

(12) The term "obligor", when used with respect to any such indenture security, means every person (including a guarantor) who is liable thereon, and, if such security is a certificate of interest or participation, such term means also every person (including a guarantor) which such certificate evidences an interest or participation; but such term shall not include the trustee under an indenture under which certificates of interest or participation, equipment trust certificates, or like securities are outstanding.

(13) The term "paying agent", when used with respect to any such indenture security, means any person authorized by an obligor thereon -

(A) to pay the principal of or interest on such security on behalf of such obligor, or

(B) if such security is a certificate of interest or participation, equipment trust certificate, or like security, to make such payment on behalf of the trustee.

(14) The term "State" means any State of the United States.

(15) The term "Commission" means the Securities and Exchange Commission.

(16) The term "voting security" means any security presently entitling the owner or holder thereof to vote in the direction or management of the affairs of a person, or any security issued under or pursuant to any trust, agreement, or arrangement whereby a trustee or trustees or agent or agents for the owner or holder of such security are presently entitled to vote in the direction or management of the affairs of a person; and a specified percentage of the voting securities of a person means such amount of the outstanding voting securities of such person as entitled the holder or holders thereof to cast such specified percentage of the aggregate votes which the holders of all the outstanding voting securities of such person are entitled to cast in the direction or management of the affairs of such person.

(17) The terms "Securities Act of 1933", "Securities Exchange Act of 1934", and "Public Utility Holding Company Act of 1935" shall be deemed to refer, respectively, to such Acts, as amended, whether amended prior to or after the enactment of this title.

(18) The term "Bankruptcy Act" means the Bankruptcy Act or title 11.

[Codified to 15 USC 77ccc]

[Source: Section 303 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 303 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1151), effective August 3, 1939; as amended by section 301 of title III of the Act of August 10, 1954 (Pub. L. No. 577; 68 Stat. 687), effective October 9, 1954; section 307 of title III of the Act of November 6, 1978 (Pub. L. (No. 95-598; 92 Stat. 2674), effective October 1, 1979; sections 501 and 502 of title V of the Act of December 4, 1987 (Pub. L. No. 100-181; 101 Stat. 1260), effective December 4, 1987; and section 402 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2722), effective November 15, 1990]

Section 304 Exempted Securities and Transactions

(a) The provisions of this title shall not apply to any of the following securities:

(1) any security other than -

(A) a note, bond, debenture, or evidence of indebtedness, whether or not secured, or

(B) a certificate of interest or participation in any such note, bond, debenture, or evidence of indebtedness, or

(C) a temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate;

(2) any certificate of interest or participation in two or more securities having substantially different rights and privileges, or a temporary certificate for any such certificate;

(3) Reserved.

(4) (A) any security exempted from the provisions of the Securities Act of 1933 by paragraph (2), (3), (4), (5), (6), (7), (8), or (11) of subsection 3(a) thereof;

(B) any security exempted from the provisions of the Securities Act of 1933, as amended, by paragraph (2) of subsection 3(a) thereof, as amended by section 401 of the Employment Securities Amendments of 1970.

(5) any security issued under a mortgage indenture as to which a contract of insurance under the National Housing Act is in effect; and any such security shall be deemed to be exempt from the provisions of the Securities Act of 1933 to the same extent as though such security were specifically enumerated in section 3(a)(2) of such Act;

(6) any note, bond, debenture, or evidence of indebtedness issued or guaranteed by a foreign government or by a subdivision, department, municipality, agency, or instrumentality thereof;

(7) any guarantee of any security which is exempted by this subsection;

(8) any security which has been or is to be issued otherwise than under an indenture, but this exemption shall not be applied within a period of twelve consecutive months to an aggregate principal amount of securities of the same issuer greater than the figure stated in section 3(b) of the Securities Act of 1933 [15 USC 77c(b)] limiting exemptions thereunder, or such lesser amount as the Commission may establish by its rules and regulations;

(9) any security which has been or is to be issued under an indenture which limits the aggregate principal amount of securities at any time outstanding thereunder to $10,000,000, or such lesser amount as the Commission may establish by its rules and regulations, but this exemption shall not be applied within a period of thirty-six consecutive months to more than $10,000,000 aggregate principal amount of securities of the same issuer, or such lesser amount as the Commission may establish by its rules and regulations; or

(10) any security issued under a mortgage or trust deed indenture as to which a contract of insurance under title XI of the National Housing Act is in effect: and any such security shall be deemed to be exempt from the provisions of the Securities Act of 1933 to the same extent as though such security were specifically enumerated in section 3(a)(2), as amended, of the Securities Act of 1933.

In computing the aggregate principal amount of securities to which the exemptions provided by paragraphs (8) and (9) may be applied, securities to which the provisions of sections 305 and 306 would not have applied, irrespective of the provisions of those paragraphs, shall be disregarded.

(b) The provisions of sections 305 and 306 shall not apply -

(1) to any of the transactions exempted from the provisions of section 5 of the Securities Act of 1933 by section 4 thereof, or

(2) to any transaction which would be so exempted but for the last sentence of paragraph (11) of section 2 of such Act.

(c) The Commission shall, on application by the issuer and after opportunity for hearing thereon, by order exempt from any one or more provisions of this title any security issued or proposed to be issued under any indenture under which, at the time such application is filed, securities referred to in paragraph (3) of subsection (a) of this section are outstanding or on January 1, 1959, such securities were outstanding, if and to the extent that the Commission finds that compliance with such provision or provisions, through the execution of a supplemental indenture or otherwise -

(1) would require, by reason of the provisions of such indenture, or the provisions of any other indenture or agreement made prior to the enactment of this title, or the provisions of any applicable law, the consent of the holders of securities outstanding under any such indenture or agreement; or

(2) would impose an undue burden on the issuer, having due regard to the public interest and the interests of investors.

(d) The Commission may, by rules or regulations upon its own motion, or by order on application by an interested person, exempt conditionally or unconditionally any person, registration statement, indenture, security or transaction, or any class or classes of persons, registration statements, indentures, securities, or transactions, from any one or more of the provisions of this title, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by this title. The Commission shall by rules and regulations determine the procedures under which an exemption under this subsection shall be granted, and may, in its sole discretion, decline to entertain any application for an order of exemption under this subsection.

(e) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed herein, add to the securities exempted as provided in this section any class of securities issued by a small business investment company under the Small Business Investment Act of 1958 if it finds, having regard to the purposes of that Act, that the enforcement of this Act with respect to such securities is not necessary in the public interest and for the protection of investors.

[Codified to 15 USC 77ddd]

[Source: Section 304 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 304 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1153), effective August 3, 1939; as amended by section 302 of title III of the Act of August 10, 1954 (Pub. L. No. 577; 68 Stat. 687), effective October 9, 1954; section 307(b) of title III of the Act of August 21, 1958 (Pub. L. No. 85-699; 72 Stat. 689), effective-August 21, 1958; the Act of September 13, 1960 (Pub. L. No. 86-760; 74 Stat. 902), effective-September 13, 1960; section 504(b) of title V of the Act of November 3, 1966 (Pub. L. No. 89-754; 80 Stat. 1278), effective November 3, 1966; section 6(c) of the Act of December 22, 1970 (Pub . L. No. 91-567; 84 Stat. 1499), effective with respect to securities sold after January 1, 1970; section 302 of title III of the Act of October 21, 1980 (Pub. L. No. 96-477; 94 Stat. 2291), effective October 21, 1980; and section 403 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2722), effective November 15, 1990]

Section 305 Securities Required to be Registered Under Securities Act

(a) Subject to the provisions of section 304, a registration statement relating to a security shall include the following information and documents, as though such inclusion were required by the provisions of section 7 of the Securities Act of 1933 -

(1) such information and documents as the Commission may by rules and regulations prescribe in order to enable the Commission to determine whether any person designated to act as trustee under the indenture under which such security has been or is to be is eligible to act as such under subsection (a) of section 310; and

(2) an analysis of any provisions of such indenture with respect to -

(A) the definition of what shall constitute a default under such indenture, and the withholding of notice to the indenture security holders of any such default,

(B) the authentication and delivery of the indenture securities and the application of the proceeds thereof,

(C) the release or the release and substitution of any property subject to the lien of the indenture,

(D) the satisfaction and discharge of the indenture, and

(E) the evidence required to be furnished by the obligor upon the indenture securities to the trustee as to compliance with the conditions and covenants provided for in such indenture.

The information and documents required by paragraph (1) of this subsection with respect to the person designated to act as indenture trustee shall be contained in a separate part of such registration statement, which part shall be signed by such person. Such part of the registration statement shall be deemed to be a document filed pursuant to this title, and the provisions of sections 11, 12, 17, and 24 of the Securities Act of 1933 shall not apply to statements therein or omissions therefrom.

(b) (1) Except as may be permitted by paragraph (2) of this subsection, the Commission shall issue an order prior to the effective date of registration refusing to permit such a registration statement to become effective, if it finds that -

(A) the security to which such registration statement relates has not been or is not to be issued under an indenture; or

(B) any person designated as trustee under such indenture is not eligible to act as such under subsection (a) of section 310; but no such order shall be issued except after notice and opportunity for hearing within the periods and in the manner required with respect to refusal orders pursuant to section 8(b) of the Securities Act of 1933. If and when the Commission deems that the objections on which such order was based have been met, the Commission shall enter an order rescinding such refusal order, and the registration shall become effective at the time provided in section 8(a) of the Securities Act of 1933, or upon the date of such rescission, whichever shall be later.

(2) In the case of securities registered under the Securities Act of 1933, which securities are eligible to be issued, offered, or sold on a delayed basis by or on behalf of the registrant, the Commission shall not be required to issue an order pursuant to paragraph (1) of subsection (b) of section 305 for failure to designate a trustee eligible to act under subsection (a) of section 310 if, in accordance with such rules and regulations as may be prescribed by the Commission, the issuer of such securities files an application for the purpose of determining such trustee's eligibility under subsection (a) of section 310. The Commission shall issue an order prior to the effective date of such application refusing to permit the application to become effective, if it finds that any person designated as trustee under such indenture is not eligible to act as such under subsection (a) of section 310, but no order shall be issued except after notice and opportunity for hearing

within the periods and in the manner required with respect to refusal orders pursuant to section 8(b) of the Securities Act of 1933. If after notice and opportunity for hearing the Commission issues an order under this provision, the obligor shall within 5 calendar days appoint a trustee meeting the requirements of subsection (a) of section 310. No such appointment shall be effective and such refusal order shall be rescinded by the Commission until a person eligible to act as trustee under subsection (a) of section 310 has been appointed. If no order is issued, an application filed pursuant to this paragraph shall be effective the tenth day after filing thereof or such earlier date as the Commission may determine, having due regard to the adequacy of information provided therein, the public interest, and the protection of investors.

(c) A prospectus relating to any such security shall include to the extent the Commission may prescribe by rules and regulations as necessary and appropriate in the public interest or for the protection of investors, as though such inclusion were required by section 10 of the Securities Act of 1933, a written statement containing the analysis set forth in the registration statement, of any indenture provisions with respect to the matters specified in paragraph (2) of subsection (a) of this section, together with a supplementary analysis, prepared by the Commission, of such provisions and of the effect thereof, if, in the opinion of the Commission, the inclusion of such supplementary analysis is necessary or appropriate in the public interest or for the protection of investors, and the Commission so declares by order after notice and, if demanded by the issuer, opportunity for hearing thereon. Such order shall be entered prior to the effective date of registration, except that if opportunity for hearing thereon is demanded by the issuer such order shall be entered within a reasonable time after such opportunity for hearing.

(d) The provisions of sections 11, 12, 17, and 24 of the Securities Act of 1933, and the provisions of sections 323 and 325 of this title, shall not apply to statements in or omissions from any analysis required under the provisions of this section or section 306 or 307.

[Codified to 15 USC 77eee]

[Source: Section 305 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 305 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1154), effective August 3, 1939; as amended by section 303 of title III of the Act of August 10, 1954 (Pub. L. No. 577; 68 Stat. 687), effective October 11, 1954; section 404 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2722), effective November 15, 1990]

Section 306 Securities Not Registered Under Securities Act

(a) In the case of any security which is not registered under the Securities Act of 1933 and to which this subsection is applicable notwithstanding the provisions of section 304, unless such security has been or is to be issued under an indenture and an application for qualification is effective as to such indenture, it shall be unlawful for any person, directly or indirectly -

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) In case of any security which is not registered under the Securities Act of 1933, but which has been or is to be issued under an indenture as to which an application for qualification is effective, it shall be unlawful for any person, directly, or indirectly -

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any such security, unless such prospectus, to the

extent the Commission may prescribe by rules and regulations as necessary and appropriate in the public interest or for the protection of investors, includes or is accompanied by a written statement that contains the information specified in subsection (c) of section 305; or

(2) to carry or to cause to be carried through the mails or interstate commerce any such security for the purpose of sale or for delivery after sale, unless, to the extent the Commission may prescribe by rules and regulations as necessary or appropriate in the public interest or for the protection of investors, accompanied or preceded by a written statement that contains the information specified in subsection (c) of section 305.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell through the use or medium of any prospectus or otherwise any security which is not registered under the Securities Act of 1933 and to which this subsection is applicable notwithstanding the provisions of section 304, unless such security has been or is to be issued under an indenture and an application for qualification has been filed as to such indenture, or while the application is the subject of a refusal order or stop order or (prior to qualification) any public proceeding or examination under section 307(c).

[Codified to 15 USC 77fff]

[Source: Section 306 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 306 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1155), effective August 3, 1939; as amended by section 304 of title III of the Act of August 10, 1954 (Pub. L. No. 577; 68 Stat. 687), effective October 9, 1954]

Section 307 Qualification of Indentures Covering Securities Not Required to be Registered

(a) In the case of any security which is not required to be registered under the Securities Act of 1933 and to which subsection (a) of section 306 is applicable notwithstanding the provisions of section 304, an application for qualification of the indenture under which such security has been or is to be issued shall be filed with the Commission by the issuer of such security. Each such application shall be in such form, and shall be signed in such manner, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. Each such application shall include the information and documents required by subsection (a) of section 305. The information and documents required by paragraph (1) of such subsection with respect to the person designated to act as indenture trustee shall be contained in a separate part of such application, which part shall be signed by such person. Each such application shall also include such of the other information and documents which would be required to be filed in order to register such indenture security under the Securities Act of 1933 as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. An application may be withdrawn by the applicant at any time prior to the effective date thereof. Subject to the provisions of section 321, the information and documents contained in or filed with any application shall be made available to the public under such regulations as the Commission may prescribe, and copies thereof, photostatic or otherwise, shall be furnished to every applicant therefore at such reasonable charge as the Commission may prescribe.

(b) The filing with the Commission of an application, or of an amendment to an application, shall be deemed to have taken place upon the receipt thereof by the Commission, but, in the case of an application, only if it is accompanied or preceded by payment to the Commissioner of a filing fee in the amount of $100, such payment to be made in cash of by United States postal money order or certified or bank check, or in such other medium of payment as the Commission may authorize by rule and regulation.

(c) The provisions of section 8 of the Securities Act of 1933 and the provisions of subsection (b) of section 305 of this title shall apply with respect to every such application, as though such application were a registration statement filed pursuant to the provisions of such Act.

[Codified to 15 U.S.C 77ggg]

[Source: Section 307 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 307 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1156), effective August 3, 1939]

Section 308 Integration of Procedure With Securities Act and Other Acts

(a) The Commission, by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, shall authorize the filing of any information or documents required to be filed with the Commission under this title, or under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935, by incorporating by reference any information or documents on file with the Commission under this title or under any such Act.

(b) The Commission, by such rules and regulations or orders as it deems necessary or appropriate in the public interest or for the protection of investors, shall provide for the consolidation of applications, reports, and proceedings under this title with registration statements, applications, reports, and proceedings under the Securities Act of 1933, the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935.

[Codified to 15 USC 77hhh]

[Source: Section 308 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 308 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1156), effective August 3, 1939]

Section 309 When Qualification Becomes Effective; Effect of Qualification

(a) The indenture under which a security has been or is to be issued shall be deemed to have been qualified under this title -

(1) when registration becomes effective as to such security; or

(2) when an application for the qualification of such indenture becomes effective, pursuant to section 307.

(b) After qualification has become effective as to the indenture under which a security has been or is to be issued, no stop order shall be issued pursuant to section 8(d) of the Securities Act of 1933, suspending the effectiveness of the registration statement relating to such security or of the application for qualification of such indenture, except on one or more of the grounds specified in section 8 of such Act, or the failure of the issuer to file an application as provided for by section 305(b)(2).

(c) The making, amendment, or rescission of a rule, regulation, or order under the provisions of this title (except to the extent authorized by subsection (a) of section 314 with respect to rules and regulations prescribed pursuant to such subsection) shall not affect the qualification, form, or interpretation of any indenture as to which qualification became effective prior to the making, amendment, or rescission of such rule, regulation, or order.

(d) No trustee under an indenture which has been qualified under this title shall be subject to any liability because of any failure of such indenture to comply with any of the provisions of this title, or any rule, regulation, or order thereunder.

(e) Nothing in this title shall be construed as empowering the Commission to conduct an investigation or other proceeding for the purpose of determining whether the provisions of an indenture which has been qualified under this title are being complied with, or to enforce such provisions.

[Codified to 15 USC 77iii]

[Source: Section 309 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 309 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1157), effective August 3, 1939; as amended by section 405 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2723), effective

November 15, 1990]

Section 310 Eligibility and Disqualification of Trustee

(a) Persons Eligible for Appointment as Trustee

(1) There shall at all times be one or more trustees under every indenture qualified or to be qualified pursuant to this title, at least one of whom shall at all times be a corporation organized and doing business under the laws of the United States or of any State or Territory or of the District of Columbia or a corporation or other person permitted to act as trustee by the Commission (referred to in this title as the institutional trustee), which -

(A) is authorized under such laws to exercise corporate trust powers, and

(B) is subject to supervision or examination by Federal, State, Territorial, or District of Columbia authority.

The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as sole trustee under an indenture qualified or to be qualified pursuant to this title, if such corporation or other person –

(A) is authorized under such laws to exercise corporate trust powers, and

(B) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional trustees.

In prescribing such rules and regulations or making such order, the Commission shall consider whether under such laws, a United States institutional trustee is eligible to act as sole trustee under an indenture relating to securities sold within the jurisdiction of such foreign government.

(2) Such institution* trustee shall have at all times a combined capital and surplus of a specified minimum amount, which shall not be less than $150,000. If such institutional trustee publishes reports of condition at least annually, pursuant to law or to the requirements of said supervising or examining authority, the indenture may provide that, for the purposes of this paragraph, the combined capital and surplus of such trustee shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published.

* So in statute. Should probably be "institutional."

(3) If the indenture to be qualified requires or permits the appointment of one or more co-trustees in addition to such institutional trustee, the rights, powers, duties, and obligations conferred or imposed upon the trustees or any of them shall be conferred or imposed upon and exercised or performed by such institutional trustee, or such institutional trustee and such co-trustees jointly, except to the extent that under any law of any jurisdiction in which any particular act or acts are to be performed, such institutional trustee shall be incompetent or unqualified to perform such act or acts, in which event such rights, powers, duties and obligations shall be exercised and performed by such co-trustees.

(4) In the case of certificates of interest or participation, the indenture trustee or trustees shall have the legal power to exercise all of the rights, powers, and privileges of a holder of the security or securities in which such certificates evidence an interest or participation.

(5) No obligor upon the indenture securities or person directly or indirectly controlling, controlled by, or under common control with such obligor shall serve as trustee upon such indenture securities.

(b) Disqualification of Trustee. If any indenture trustee has or shall acquire any conflicting interest as hereinafter defined -

(i) then, within 90 days after ascertaining that it has such conflicting interest, and if the default (as defined in the next sentence) to which such conflicting interest relates has not been cured or duly waived or otherwise eliminated before the end of such 90-day period, such trustee shall either eliminate such conflicting interest or, except as otherwise provided below in this subsection, resign, and the obligor upon the indenture securities shall take prompt steps to have a successor appointed in the manner provided in the indenture;

(ii) in the event that such trustee shall fail to comply with the provisions of clause (i) of this subsection, such trustee shall, within 10 days after the expiration of such 90-day period, transmit notice of such failure to the indenture security holders in the manner and to the extent provided in subsection (c) of section 313; and

(iii) subject to the provisions of subsection (e) of section 315, unless such trustee's duty to resign is stayed as provided below in this subsection, any security holder who has been a bona fide holder of indenture securities for at least six months may, on behalf of himself and all others similarly situated, petition any court of competent jurisdiction for the removal of such trustee, and the appointment of a successor, if such trustee fails, after written request thereof by such holder to comply with the provisions of clause (i) of this subsection.

For the purposes of this subsection, an indenture trustee shall be deemed to have a conflicting interest if the indenture securities are in default (as such term is defined in such indenture, but exclusive of any period of grace or requirement of notice) and -

(1) such trustee is trustee under another indenture under which any other securities, or certificates of interest or participation in any other securities, of an obligor upon the indenture securities are outstanding or is trustee for more than one outstanding series of securities, as hereafter defined, under a single indenture of an obligor, unless -

(A) the indenture securities are collateral trust notes under which the only collateral consists of securities issued under such other indenture,

(B) such other indenture is a collateral trust indenture under which the only collateral consists of indenture securities, or

(C) such obligor has no substantial unmortgaged assets and is engaged primarily in the business of owning, or of owning and developing and/or operating, real estate, and the indenture to be qualified and such other indenture are secured by wholly separate and distinct parcels of real estate:

Provided, That the indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that such provision is excluded) to contain a provision excluding from the operation of this paragraph other series under such indenture, and any other indenture or indentures under which other securities, or certificates of interest or participation in other securities, of such an obligor are outstanding, if -

(i) the indenture to be qualified and any such

other indenture or indentures (and all series of securities issuable thereunder) are wholly unsecured and rank equally, and such other indenture or indentures (and such series) are specifically described in the indenture to be qualified or are thereafter qualified under this title, unless the Commission shall have found and declared by order pursuant to subsection (b) of section 305 or subsection (c) of section 307 that differences exist between the provisions of the indenture (or such series) to be qualified and the provisions of such other indenture or indentures (or such series) which are so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify such trustee from acting as such under one of such indentures, or

(ii) the issuer shall have sustained the burden of proving, on application to the Commission and after opportunity for hearing thereon, that trusteeship under the indenture to be qualified and such other indenture or under more than one outstanding series under a single indenture is not so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify such trustee from acting as such under one of such indentures or with respect to such series;

(2) such trustee or any of its directors or executive officers is an underwriter for an obligor upon the indenture securities;

(3) such trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with an underwriter for an obligor upon the indenture securities;

(4) such trustee or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative of an obligor upon the indenture securities, or of an underwriter (other than the trustee itself) for such an obligor who is currently engaged in the business of underwriting, except that -

(A) one individual may be a director and/or an executive officer of the trustee and a director and/or an executive officer of such obligor, but may not be at the same time an executive officer of both the trustee and of such obligor,

(B) if and so long as the number of directors of the trustee in office is more than nine, one additional individual may be a director and/or an executive officer of the trustee and a director of such obligor, and

(C) such trustee may be designated by any such obligor or by any underwriter for any such obligor, to act in the capacity of transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, or depositary, or in any other similar capacity, or, subject to the provisions of paragraph (1) of this subsection, to act as trustee, whether under an indenture or otherwise;

(5) 10 per centum or more of the voting securities of such trustee is beneficially owned either by an obligor upon the indenture securities or by

any director, partner or executive officer thereof, or 20 per centum or more of such voting securities is beneficially owned, collectively by any two or more of such persons; or 10 per centum or more of the voting securities of such trustee is beneficially owned either by an underwriter for any such obligor or by any director, partner, or executive officer thereof, or is beneficially owned, collectively, by any two or more such persons;

(6) such trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default as hereinafter defined -

(A) 5 per centum or more of the voting securities, or 10 per centum or more of any other class of security, of an obligor upon the indenture securities, not including indentures securities and securities issued under any other indenture under which such trustee is also trustee, or

(B) 10 per centum or more of any class of security of an underwriter for any such obligor;

(7) such trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default as hereafter defined, 5 per centum or more of the voting securities of any person who, to the knowledge of the trustee, owns 10 per centum or more of the voting securities of, or controls directly or indirectly or is under direct or indirect common control with, an obligor upon the indenture securities;

(8) such trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default as hereinafter defined, 10 per centum or more of any class of security of any person who, to the knowledge of the trustee, owns 50 per centum or more of the voting securities of an obligor upon the indenture securities;

(9) such trustee owns, on the date of default upon the indenture securities (as such term is defined in such indenture but exclusive of any period of grace or requirement of notice) or any anniversary of such default while such default upon the indenture securities remains outstanding, in the capacity of executor, administrator, testamentary or inter vivos trustee, guardian, committee or conservator, or in any other similar capacity, an aggregate of 25 per centum or more of the voting securities, or of any class of security, of any person, the beneficial ownership of a specified percentage of which would have constituted a conflicting interest under paragraph (6), (7), or (8) of this subsection. As to any such securities of which the indenture trustee acquired ownership through becoming executor, administrator or testamentary trustee of an estate which include them, the provisions of the preceding sentence shall not apply for a period of not more than 2 years from the date of such acquisition, to the extent that such securities included in such estate do not exceed 25 per centum of such voting securities or 25 per centum of any such class of security. Promptly after the dates of any such default upon the indenture securities and annually in each succeeding year that the indenture securities remain in default the trustee shall make a check of its holding of such securities in any of the above-mentioned capacities as of such dates. If the obligor upon the indenture securities fails to make payment in full of principal or interest under such indenture when and as the same becomes due and payable, and such failure continues for 30 days thereafter, the trustee shall make a prompt check of its holdings of such securities in any of the above-mentioned capacities as of the date of the expiration of such 30-day period, and after such date, notwithstanding the foregoing provisions of this paragraph, all such securities so held by the trustee, with sole or joint control over such securities vested in it, shall be considered as though beneficially owned by such trustee, for the purposes of paragraphs (6), (7), and (8) of this subsection; or

(10) except under the circumstances described in paragraphs (1), (3), (4), (5)

or (6) of section 311(b) of this title, the trustee shall be or shall become a creditor of the obligor.

For purposes of paragraph (1) of this subsection, and of section 316(a) of this title, the term "series of securities" or "series" means a series, class or group of securities issuable under an indenture pursuant to whose terms holders of one such series may vote to direct the indenture trustee, or otherwise take action pursuant to a vote of such holders, separately from holders of another such series:

Provided, That "series of securities" or "series" shall not include any series of securities issuable under an indenture if all such series rank equally and are wholly unsecured.

The specification of percentages in paragraphs (5) to (9), inclusive, of this subsection shall not be construed as indicating that the ownership of such percentages of the securities of a person is or is not necessary or sufficient to constitute direct or indirect control for the purposes of paragraph (3) or (7) of this subsection.

For the purposes of paragraphs (6), (7), (8), and (9) of this subsection -

(A) the terms "security" and "securities" shall include only such securities as are generally known as corporate securities, but shall not include any note or other evidence of indebtedness issued to evidence an obligation to repay moneys lent to a person by one or more banks, trust companies, or banking firms, or any certificate of interest or participation in any such note or evidence of indebtedness;

(B) an obligation shall be deemed to be in default when a default in payment of principal shall have continued for thirty days or more, and shall not have been cured; and

(C) the indenture trustee shall not be deemed the owner or holder of -

(i) any security which it holds as collateral security (as trustee or otherwise) for any obligation which is not in default as above defined, or

(ii) any security which it holds as collateral security under the indenture to be qualified, irrespective of any default thereunder, or

(iii) any security which it holds as agent for collection, or as custodian, escrow agent or depositary, or in any similar representative capacity.

For the purposes of this subsection, the term "underwriter" when used with reference to an obligor upon the indenture securities means every person who, within one year prior to the time as of which the determination is made, was an underwriter of any security of such obligor outstanding at the time of the determination.

Except in the case of a default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the indenture trustee shall not be required to resign as provided by this subsection if such trustee shall have sustained the burden of proving, on application to the Commission and after opportunity for hearing thereon, that -

(i) the default under the indenture may be cured or waived during a reasonable period and under the procedures described in such application, and

(ii) a stay of the trustee's duty to resign will not be inconsistent with the interests of holders of the indenture securities. The filing of such an application shall automatically stay the performance of the duty to resign until the Commission orders otherwise.

Any resignation of an indenture trustee shall become effective only upon the appointment

of a successor trustee and such successor's acceptance of such an appointment.

(c) Applicability of Section. The Public Utility Holding Company Act of 1935 shall not be held to establish or authorize the establishment of any standards regarding the eligibility and qualifications of any trustee or prospective trustee under an indenture to be qualified under this title, or regarding the provisions to be included in any such indenture with respect to the eligibility and qualifications of the trustee thereunder, other than those established by the provisions of this section.

[Codified to 15 USC 77jjj]

[Source: Section 310 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 310 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1157), effective August 3, 1939; as amended by sections 406, 407, and 408 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2723), effective November 15, 1990]

Section 311 Preferential Collection of Claims Against Obligor

(a) Subject to the provisions of subsection (b) of this section, if the indenture trustee shall be, or shall become, a creditor, directly or indirectly, secured or unsecured, of an obligor upon the indenture securities, within three months prior to a default as defined in the last paragraph of this subsection, or subsequent to such a default, then, unless and until such a default shall be cured, such trustee shall set apart and hold in a special account for the benefit of the trustee individually and the indenture security holders -

(1) an amount equal to any and all reductions in the amount due and owing upon any claim as such creditor in respect of principal or interest, effected after the beginning of such three months' period and valid as against such obligor and its other creditors, except any such reduction resulting from the receipt or disposition of any property described in paragraph (2) of this subsection, or from the exercise of any right of set-off which the trustee could have exercised if a petition in bankruptcy had been filed by or against such obligor upon the date of such default; and

(2) all property received in respect of any claim as such creditor, either as security therefore, or in satisfaction or composition thereof, or otherwise, after the beginning of such three months' period, or an amount equal to the proceeds of any such property, if disposed of, subject, however, to the rights, if any, of such obligor and its other creditors in such property or such proceeds.

Nothing herein contained shall affect the right of the indenture trustee -

(A) to retain for its own account -

(i) payments made on account of any such claim by any person (other than such obligor) who is liable thereon, and

(ii) the proceeds of the bona fide sale of any such claim by the trustee to a third person, and

(iii) distributions made in cash, securities, or other property in respect of claims filed against such obligor in bankruptcy or receivership or in proceedings for reorganization pursuant to the Bankruptcy Act or applicable State law;

(B) to realize, for its own account, upon any property held by it as security for any such claim, if such property was so held prior to the beginning of such three months' period;

(C) to realize, for its own account, but only to the extent of the claim hereinafter mentioned, upon any property held by it as security for any such claim, if such claim was created after the beginning of such three months' period and such property period was received as security therefor

simultaneously with the creation thereof, and if the trustee shall sustain the burden of proving that at the time such property was so received the trustee had no reasonable cause to believe that a default as defined in the last paragraph of this subsection would occur within three months; or

(D) to receive payment on any claim referred to in paragraph (B) or (C), against the release of any property held as security for such claim as provided in paragraph (B) or (C), as the case may be, to the extent of the fair value of such property.

For the purposes of paragraphs (B), (C), and (D), property substituted after the beginning of such three months' period for property held as security at the time of such substitution shall, to the extent of the fair value of the property released, have the same status as the property released, and, to the extent that any claim referred to in any of such paragraphs is created in renewal of or in substitution for or for the purpose of repaying or refunding any preexisting claim of the indenture trustee as such creditor, such claim shall have the same status as such preexisting claim.

If the trustee shall be required to account, the funds and property held in such special account and the proceeds thereof shall be apportioned between the trustee and the indenture security holders in such manner that the trustee and the indenture security holders realize, as a result of payments from such special account and payments of dividends on claims filed against such obligor in bankruptcy or receivership or in proceedings for reorganization pursuant to the Bankruptcy Act or applicable State law, the same percentage of their respective claims, figured before crediting to the claim of the trustee anything on account of the receipt by it from such obligor of the funds and property in such special account and before crediting to the respective claims of the trustee and the indenture security holders dividends on claims filed against such obligor in bankruptcy or receivership or in proceedings for reorganization pursuant to the Bankruptcy Act or applicable State law, but after crediting thereon receipts on account of the indebtedness represented by their respective claims from all sources other than from such dividends and from the funds and property so held in such special account. As used in this paragraph, with respect to any claim, the term "dividends" shall include any distribution with respect to such claim, in bankruptcy or receivership or in proceedings for reorganization pursuant to the Bankruptcy Act or applicable State law, whether such distribution is made in cash, securities, or other property, but shall not include any such distribution with respect to the secured portion, if any, of such claim. The court in which such bankruptcy, receivership, or proceeding for reorganization is pending shall have jurisdiction -

(i) to apportion between the indenture trustee and the indenture security holders, in accordance with the provisions of this paragraph, the funds and property held in such special account and the proceeds thereof, or

(ii) in lieu of such apportionment, in whole or in part, to give to the provisions of this paragraph due consideration in determining the fairness of the distributions to be made to the indenture trustee and the indenture security holders with respect to their respective claims, in which event it shall not be necessary to liquidate or to appraise the value of any securities or other property held in such special account or as security for any such claim, or to make a specific allocation of such distributions as between the secured and unsecured portions of such claims, or otherwise to apply the provisions of this paragraph as a mathematical formula.

Any indenture trustee who has resigned or been removed after the beginning of such three months' period shall be subject to the provisions of this subsection as though such resignation or removal had not occurred. Any indenture trustee who has resigned or been removed prior to the beginning of such three months' period shall be subject to the provisions of this subsection if and only if the following conditions exist -

(i) the receipt of property or reduction of claim which would have given rise to the obligation to account, if such indenture trustee had continued as trustee, occurred after the beginning of such three months' period; and

(ii) such receipt of property or reduction of claim occurred within three months after such resignation or removal.

As used in this subsection, the term "default" means any failure to make payment in full of principal or interest, when and as the same becomes due and payable, under any indenture which has been qualified under this title, and under which the indenture trustee is trustee and the person of whom the indenture trustee is directly or indirectly a creditor is an obligor; and the term "indenture security holder" means all holders of securities outstanding under any such indenture under which any such default exists. In any case commenced under the Bankruptcy Act of July 1, 1898, or any amendment thereto enacted prior to November 6, 1978, all references to periods of three months shall be deemed to be references to periods of four months.

(b) The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions excluding from the operation of subsection (a) of this section a creditor relationship arising from -

(1) the ownership or acquisition of securities issued under any indenture, or any security or securities having a maturity of one year or more at the time of acquisition by the indenture trustee;

(2) advances authorized by a receivership or bankruptcy court of competent jurisdiction, or by the indenture, for the purpose of preserving the property subject to the lien of the indenture or of discharging tax liens or other prior liens or encumbrances on the trust estate, if notice of such advance and of the circumstances surrounding the making thereof is given to the indenture security holders at the time and in the manner provided in the indenture;

(3) disbursements made in the ordinary course of business in the capacity of trustee under an indenture, transfer agent, registrar, custodian, paying agent, fiscal agent or depositary, or other similar capacity.

(4) an indebtedness created as a result of services rendered or premises rented; or an indebtedness created as a result of goods or securities sold in a cash transaction as defined in the indenture;

(5) the ownership of stock or of other securities of a corporation organized under the provisions of section 25(a) of the Federal Reserve Act, as amended, which is directly or indirectly a creditor of an obligor upon the indenture securities; or

(6) the acquisition, ownership, acceptance, or negotiation of any drafts, bills of exchange, acceptances, or obligations which fall within the classification of self-liquidating paper as defined in the indenture.

(c) In the exercise by the Commission of any jurisdiction under the Public Utility Holding Company Act of 1935 regarding the issue or sale, by any registered holding company or a subsidiary company thereof, of any security of such issuer or seller or of any other company to a person which is trustee under an indenture or indentures of such issuer or seller or other company, or of a subsidiary or associate company or affiliate of such issuer or seller or other company (whether or not such indenture or indentures are qualified or to be qualified under this title), the fact that such trustee will thereby become a creditor, directly or indirectly, of any of the foregoing shall not constitute a ground for the Commission taking adverse action with respect to any application or declaration, or limiting the scope of any rule or regulation which would otherwise permit such transaction to take effect; but in any case in which such trustee is trustee under an indenture of the company of which it will thereby become a creditor, or of any subsidiary company thereof, this subsection shall not prevent the Commission from requiring (if such requirement would be authorized under the provisions of the Public Utility Holding Company Act of 1935) that such trustee, as such, shall effectively and irrevocably agree in writing, for the benefit of the holders from time to time of the securities from time to time outstanding under such indenture, to be bound by the provisions of this section, subsection (c) of section 315, and, in case of default (as such term is defined in such indenture), subsection (d) of section 315, as fully as though such provisions were included in such indenture. For the

purposes of this subsection the terms "registered holding company", "subsidiary company", "associate company", and "affiliate" shall have the respective meanings assigned to such terms in section 2(a) of the Public Utility Holding Company Act of 1935.

[Codified to 15 USC 77kkk]

[Source: Section 311 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 311 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1161), effective August 3, 1939; as amended by section 409 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2728), effective November 15, 1990]

Section 312 Bondholders Lists

(a) Each obligor upon the indenture securities shall furnish or cause to be furnished to the institutional trustee thereunder at stated intervals of not more than six months, and at such other times as such trustee may request in writing, all information in the possession or control of such obligor, or of any of its paying agents, as to the names and addresses of the indenture security holders, and requiring such trustee to preserve, in as current a form as is reasonably practicable, all such information so furnished to it or received by it in the capacity of paying agent.

(b) Within five business days after the receipt by the institutional trustee of a written application by any three or more indenture holders stating that the applicants desire to communicate with other indenture security holders with respect to their rights under such indenture or under the indenture securities, and accompanied by a copy of the form of proxy or other communication which such applicants propose to transmit, and by reasonable proof that each such applicant has owned an indenture security for a period of at least six months preceding the date of such application, such institutional trustee shall, at its election, either -

(1) afford to such applicants access to all information so furnished to or received by such trustee; or

(2) inform such applicants as to the approximate number of indenture security holders according to the most recent information so furnished to or received by such trustee, and as to the approximate cost of mailing to such indenture security holders the form of proxy or other communication, if any, specified in such application.

If such trustee shall elect not to afford to such applicants access to such information, such trustee shall, upon the written request of such applicants, mail to all such indenture security holders copies of the form of proxy or other communication which is specified in such request, with reasonable promptness after a tender to such trustee of the material to be mailed and of payment, or provision for the payment, of the reasonable expenses of such mailing, unless within five days after such tender, such trustee shall mail to such applicants, and file with the Commission together with a copy of the material to be mailed, a written statement to the effect that, in the opinion of such trustee, such mailing would be contrary to the best interests of the indenture security holders or would be in violation of applicable law. Such written statement shall specify the basis of such opinion. After opportunity for hearing upon the objections specified in the written statement so filed , the Commission may, and if demanded by such trustee or by such applicants shall, enter an order either sustaining one or more of such objections or refusing to sustain any of them. If the Commission shall enter an order refusing to sustain any of such objections, or if, after the entry of an order sustaining one or more of such objections, the Commission shall find, after notice and opportunity for hearing, that all objections so sustained have been met, and shall enter an order so declaring, such trustee shall mail copies of such material to all such indenture security holders with reasonable promptness after the entry of such order and the renewal of such tender.

(c) The disclosure of any such information as to the names and addresses of the indenture security holders in accordance with the provisions of this section, regardless of the source from which such information was derived, shall not be deemed to be a violation of any

existing law, or of any law hereafter enacted which does not specifically refer to this section, nor shall such trustee be held accountable by reason of mailing any material pursuant to a request made under subsection (b) of this section.

[Codified to 15 USC 77lll]

[Source: Section 312 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 312 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1164), effective August 3, 1939; as amended by section 410 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2728), effective November 15, 1990]

Section 313 Reports by Indenture Trustee

(a) The indenture trustee shall transmit to the indenture security holders as hereinafter provided, at stated intervals of not more than 12 months, a brief report with respect to any of the following events which may have occurred within the previous 12 months (but if no such event has occurred within such period no report need be transmitted):

(1) any change to its eligibility and its qualifications under section 310;

(2) the creation of or any material change to a relationship specified in paragraph (1) through (10) of section 310(b);

(3) the character and amount of any advances made by it, as indenture trustee, which remain unpaid on the date of such report, and for the reimbursement of which it claims or may claim a lien or charge, prior to that of the indenture securities, on the trust estate or on property or funds held or collected by it as such trustee, if such advances so remaining unpaid aggregate more than one-half of 1 per centum of the principal amount of the indenture securities outstanding on such date;

(4) the amount, interest rate, and maturity date of all other indebtedness owing to it in its individual capacity, on the date of such report, by the obligor upon the indenture securities, with a brief description of any property held as collateral security therefor, except an indebtedness based upon a creditor relationship arising in any manner described in paragraphs (2), (3), (4), or (6) of subsection (b) of section 311;

(5) any change to the property and funds physically in its possession as indenture trustee on the date of such report;

(6) any change to any release, or release and substitution, of property subject to the lien of the indenture (and the consideration therefor, if any) which it has not previously reported;

(7) any additional issue of indenture securities which it has not previously reported; and

(8) any action taken by it in the performance of its duties under the indenture which it has not previously reported and which in its opinion materially affects the indenture securities or the trust estate, except action in respect of a default, notice of which has been or is to be withheld by it in accordance with an indenture provision authorized by subsection (b) of section 315.

(b) The indenture trustee shall transmit to the indenture security holders as hereinafter provided, within the times hereinafter specified, a brief report with respect to -

(1) the release, or release and substitution, of property subject to the lien of the indenture (and the consideration therefor, if any) unless the fair value of such property, as set forth in the certificate or opinion required by paragraph (1) of subsection (d) of section 314, is less than 10 per centum of the principal amount of indenture securities outstanding at the time of such release, or such release and substitution, such report to be so transmitted

within 90 days after such time; and

(2) the character and amount of any advances made by it as such since the date of the last report transmitted pursuant to the provisions of subsection (a) (or if no such report has yet been so transmitted, since the date of execution of the indenture), for the reimbursement of which it claims or may claim a lien or charge, prior to that of the indenture securities, on the trust estate or on property or funds held or collected by it as such trustee, and which it has not previously reported pursuant to this paragraph, if such advances remaining unpaid at any time aggregate more than 10 per centum of the principal amount of indenture securities outstanding at such time, such report to be so transmitted within 90 days after such time.

(c) Reports pursuant to this section shall be transmitted by mail -

(1) to all registered holders of indenture securities, as the names and addresses of such holders appear upon the registration books of the obligor upon the indenture securities;

(2) to such holders of indenture securities as have, within the two years preceding such transmission, filed their names and addresses with the indenture trustee for that purpose; and

(3) except in the case of reports pursuant to subsection (b) of this section, to all holders of indenture securities whose names and addresses have been furnished to or received by the indenture trustee pursuant to section 312.

(d) A copy of each such report shall, at the time of such transmission to indenture security holders, be filed with each stock exchange upon which the indenture securities are listed, and also with the Commission.

[Codified to 15 USC 77mmm]

[Source: Section 313 of title III of the Act of May 27, 1933 (Pub L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 313 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1165), effective August 3, 1939; as amended by sections 411 and 412 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2729), effective November 15, 1990]

Section 314 Reports by Obligor; Evidence of Compliance With Indenture Provisions

(a) Periodic Reports. Each person who, as set forth in the registration statement or application, is or is to be an obligor upon the indenture securities covered thereby shall -

(1) file with the indenture trustee copies of the annual reports and of the information, documents, and other reports (or copies of such portions of any of the foregoing as the Commission may by rules and regulations prescribe) which such obligor is required to file with the Commission pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934; or, if the obligor is not required to file information, documents, or reports pursuant to either of such sections, then to file with the indenture trustee and the Commission, in accordance with rules and regulations prescribed by the Commission, such of the supplementary and periodic information, documents, and reports which may be required pursuant to section 13 of the Securities Exchange Act of 1934, in respect of a security listed and registered on a national securities exchange as may be prescribed in such rules and regulations;

(2) file with the indenture trustee and the Commission, in accordance with rules and regulations prescribed by the Commission, such additional information, documents, and reports with respect to compliance by such obligor with the conditions and covenants provided for in the indenture, as may be required by such rules and regulations, including, in the case of annual reports, if required by such rules and regulations, certificates or

opinions of independent public accountants, conforming to the requirements of subsection (e) of this section, as to compliance with conditions or covenants, compliance with which is subject to verification by accountants, but no such certificate or opinion shall be required as to any matter specified in clauses (A), (B), or (C) of paragraph (3) of subsection (c);

(3) transmit to the holders of the indenture securities upon which such person is an obligor, in the manner and to the extent provided in subsection (c) of section 313, such summaries of any information, documents, and reports required to be filed by such obligor pursuant to the provisions of paragraph (1) or (2) of this subsection as may be required by rules and regulations prescribed by the Commission; and

(4) furnish to the indenture trustee, not less often than annually, a brief certificate from the principal executive officer, principal financial officer or principal accounting officer as to his or her knowledge of such obligor's compliance with all conditions and covenants under the indenture. For purposes of this paragraph, such compliance shall be determined without regard to any period of grace or requirement of notice provided under the indenture.

The rules and regulations prescribed under this subsection shall be such as are necessary or appropriate in the public interest or for the protection of investors, having due regard to the types of indentures, and the nature of business of the class of obligors affected thereby, and the amount of indenture securities outstanding under such indentures, and, in the case of any such rules and regulations prescribed after the indentures to which they apply have been qualified under this title, the additional expense, if any, of complying with such rules and regulations. Such rules and regulations may be prescribed either before or after qualification becomes effective as to any such indenture.

(b) Evidence of Recording Indenture. If the indenture to be qualified is or is to be secured by the mortgage or pledge of property, the obligor upon the indenture securities shall furnish to the indenture trustee -

(1) promptly after the execution and delivery of the indenture, an opinion of counsel (who may be of counsel for such obligor) either stating that in the opinion of such counsel the indenture has been properly recorded and filed so as to make effective the lien intended to be created thereby, and reciting the details of such action, or stating that in the opinion of such counsel no such action is necessary to make such lien effective; and

(2) at least annually after the execution and delivery of the indenture, an opinion of counsel (who may be of counsel for such obligor) either stating that in the opinion of such counsel such action has been taken with respect to the recording, filing, rerecording, and refiling of the indenture as is necessary to maintain the lien of such indenture, and reciting the details of such action, or stating that in the opinion of such counsel no such action is necessary to maintain such lien.

(c) Evidence of Compliance With Conditions Precedent. The obligor upon the indenture securities shall furnish to the indenture trustee evidence of compliance with the conditions precedent, if any, provided for in the indenture (including any covenants compliance with which constitutes a condition precedent) which relate to the authentication and delivery of the indenture securities, to the release or the release and substitution of property subject to the lien of the indenture, to the satisfaction and discharge of the indenture, or to any other action to be taken by the indenture trustee at the request or upon the application of such obligor. Such evidence shall consist of the following:

(1) certificates or opinions made by officers of such obligor who are specified in the indenture, stating that such conditions precedent have been complied with;

(2) an opinion of counsel (who may be of counsel for such obligor) stating that in his opinion such conditions precedent have been complied with; and

(3) in the case of conditions precedent compliance with which is subject to verification by accountants (such as conditions with respect to the preservation of specified ratios, the amount of net quick assets, negative-pledge clauses, and other similar specific conditions), a certificate or opinion of an accountant, who, in the case of any such conditions precedent to the authentication and delivery of indenture securities, and not otherwise, shall be an independent public accountant selected or approved by the indenture trustee in the exercise of reasonable care, if the aggregate principal amount of such indenture securities and of other indenture securities authenticated and delivered since the commencement of the then current calendar year (other than those with respect to which a certificate or opinion of an accountant is not required or with respect to which a certificate or opinion of an independent public accountant has previously been furnished) is 10 per centum o r more of the aggregate amount of the indenture securities at the time outstanding; but no certificate or opinion need be made by any person other than an officer or employee of such obligor who is specified in the indenture, as to -

(A) dates or periods not covered by annual reports required to be filed by the obligor, in the case of conditions precedent which depend upon a state of facts as of a date or dates or for a period or periods different from that required to be covered by such annual reports, or

(B) the amount and value of property additions, except as provided in paragraph (3) of subsection (d), or (C) the adequacy of depreciation, maintenance, or repairs.

(d) Certificates of Fair Value. If the indenture to be qualified is or is to be secured by the mortgage or pledge of property or securities, the obligor upon the indenture securities shall furnish to the indenture trustee a certificate or opinion of an engineer, appraiser, or other expert as to the fair value -

(1) of any property or securities to be released from the lien of the indenture, which certificate or opinion shall state that in the opinion of the person making the same the proposed release will not impair the security under such indenture in contravention of the provisions thereof, and requiring further that such certificate or opinion shall be made by an independent engineer, appraiser, or other expert, if the fair value of such property or securities and of all other property or securities released since the commencement of the then current calendar year, as set forth in the certificates or opinions required by this paragraph, is 10 per centum or more of the aggregate principal amount of the indenture securities at the time outstanding; but such a certificate or opinion of an independent engineer, appraiser, or other expert shall not be required in the case of any release of property or securities, if the fair value thereof as set forth in the certificate or opinion required by this paragraph is less than $25,000 or less than 1 per centum of the aggregate principal amount of the indenture securities at the time outstanding;

(2) to such obligor of any securities (other than indenture securities and securities secured by a lien prior to the lien of the indenture upon property subject to the lien of the indenture), the deposit of which with the trustee is to be made the basis for the authentication and delivery of indenture securities, the withdrawal of cash constituting a part of the trust estate or the release of property or securities subject to the lien of the indenture, and requiring further that if the fair value to such obligor of such securities and of all other such securities made the basis of any such authentication and delivery, withdrawal, or release since the commencement of the then current calendar year, as set forth in the certificates or opinions required by this paragraph, is 10 per centum or more of the aggregate principal amount of the indenture securities at the time outstanding, such certificate or opinion shall be made

by an independent engineer, appraiser, or other expert and, in the case of the authentication and delivery of indenture securities, shall cover the fair value to such obligor of all other such securities so deposited since the commencement of the current calendar year as to which a certificate or opinion of an independent engineer, appraiser, or other expert has not previously been furnished; but such a certificate of an independent engineer, appraiser, or other expert shall not be required with respect to any securities so deposited, if the fair value thereof to such obligor as set forth in the certificate or opinion required by this paragraph is less than $25,000 or less than 1 per centum of the aggregate principal amount of the indenture securities at the time outstanding; and

(3) to such obligor of any property the subjection of which to the lien of the indenture is to be made the basis for the authentication and delivery of indenture securities, the withdrawal of cash constituting a part of the trust estate, or the release of property or securities subject to the lien of the indenture, and requiring further that if

(A) within six months prior to the date of acquisition thereof by such obligor, such property has been used or operated, by a person or persons other than such obligor, in a business similar to that in which it has been or is to be used or operated by such obligor, and

(B) the fair value to such obligor of such property as set forth in such certificate or opinion is not less than $25,000 and not less than 1 per centum of the aggregate principal amount of the indenture securities at the time outstanding, such certificate or opinion shall be made by an independent engineer, appraiser, or other expert and, in the case of the authentication and delivery of indenture securities, shall cover the fair value to the obligor of any property so used or operated which has been so subjected to the lien of the indenture since the commencement of the then current calendar year, and as to which a certificate or opinion of an independent engineer, appraiser, or other expert has not previously been furnished.

The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that such provision is excluded) to provide that any such certificate or opinion may be made by an officer or employee of the obligor upon the indenture securities who is duly authorized to make such certificate or opinion by the obligor from time to time, except in cases in which this subsection requires that such certificate or opinion be made by an independent person. In such cases, such certificate or opinion shall be made by an independent engineer, appraiser, or other expert selected or approved by the indenture trustee in the exercise of reasonable care.

(e) Recitals as to Basis of Certificate or Opinion. Each certificate or opinion with respect to compliance with a condition or covenant provided for in the indenture (other than certificates provided pursuant to subsection (a)(4) of this section) shall include -

(1) a statement that the person making such certificate or opinion has read such covenant or condition;

(2) a brief statement as to the nature and scope of the examination or investigation upon which the statements or opinions contained in such certificate or opinion are based;

(3) a statement that, in the opinion of such person, he has made such examination or investigation as is necessary to enable him to express an informed opinion as to whether or not such covenant or condition has been complied with; and

(4) a statement as to whether or not, in the opinion of such person, such condition or covenant has been complied with.

(f) Parties May Provide for Additional Evidence. Nothing in this section shall be construed either as requiring the inclusion in the indenture to be qualified of provisions that the obligor upon the indenture securities shall furnish to the indenture trustee any other evidence of compliance with the conditions and covenants provided for in the indenture than the evidence specified in this section, or as preventing the inclusion of such provisions in such indenture, if the parties so agree.

[Codified to 15 USC 77nnn]

[Source: Section 314 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 314 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1167), effective August 3, 1939; as amended by section 413 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2729), effective November 15, 1990]

Section 315 Duties and Responsibility of the Trustee

(a) Duties Prior to Default. The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to provide that, prior to default (as such term is defined in such indenture) -

> (1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and
>
> (2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;

but the indenture trustee shall examine the evidence furnished to it pursuant to section 314 to determine whether or not such evidence conforms to the requirements of the indenture.

(b) Notice of Defaults. The indenture trustee shall give to the indenture security holders, in the manner and the extent provided in subsection (c) of section 313, notice of all defaults known to the trustee, within ninety days after the occurrence thereof; Provided That such indenture shall automatically be deemed (unless it is expressly provided therein that such provision is excluded) to provide that, except in the case of default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the trustee shall be protected in withholding such notice if and so long as the board of directors, the executive committee, or a trust committee of directors and/or responsible officers, of the trustee in good faith determine that the withholding of such notice is in the interests of the indenture security holders.

(c) Duties of the Trustee in Case of Default. The indenture trustee shall exercise in case of default (as such term is defined in such indenture) such of the rights and powers vested in it by such indenture, and to use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs.

(d) Responsibility of the Trustee. The indenture to be qualified shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own willful misconduct, except that -

> (1) such indenture shall automatically be deemed (unless it expressly provided therein that any such provision is excluded) to contain the provisions authorized by paragraphs (1) and (2) of subsection (a) of this section;
>
> (2) such indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee from liability for any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts;

and

(3) such indenture shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions protecting the indenture trustee with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the holders of not less than a majority in principal amount of the indenture securities at the time outstanding (determined as provided in subsection (a) of section 316) relating to the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture.

(e) Undertaking for Costs. The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions to the effect that all parties thereto, including the indenture security holders, agree that the court may in its discretion require, in any suit for the enforcement of any right or remedy under such indenture, or in any suit against the trustee for any action taken or omitted by it as trustee, the filing by any party litigant in such suit of an undertaking to pay the costs of such suit, and that such court may in its discretion assess reasonable costs, including reasonable attorneys' fees, against any party litigant in such suit, having due regard to the merits and good faith of the claims or defenses made by such party litigant: Provided, That the provisions of this subsection shall not apply to any suit instituted by such trustee, to any suit instituted by any indenture security holder, or group of indenture security holders, holding in the aggregate more than 10 per centum in principal amount of the indenture securities outstanding, or to any suit instituted by any indenture security holder for the enforcement of the payment of the principal of or interest on any indenture security, on or after the respective due dates expressed in such indenture security.

[Codified to 15 USC 77ooo]

[Source: Section 315 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933), as added by section 315 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1171), effective August 3, 1939; as amended by section 414 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2730), effective November 15, 1990]

Section 316 Direction and Waivers by Bondholders; Prohibition of Impairment of Holder's Right to Payment

(a) The indenture to be qualified -

(1) shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to contain provisions authorizing the holders of not less than a majority in principal amount of the indenture securities or if expressly specified in such indenture, of any series of securities at the time outstanding -

(A) to direct the time, method, and place of conducting any proceeding for any remedy available to such trustee, or exercising any trust or power conferred upon such trustee, under such indenture, or

(B) on behalf of the holders of all such indenture securities, to consent to the waiver of any past default and its consequences; or

(2) may contain provisions authorizing the holders of not less than 75 per centum in principal amount of the indenture securities or if expressly specified in such indenture, of any series of securities at the time outstanding to consent on behalf of the holders of all such indenture securities to the postponement of any interest payment for a period not exceeding three years from its due date.

For the purposes of this subsection and paragraph (3) of subsection (d) of section 315, in determining whether the holders of the required principal amount of indenture securities have concurred in any such direction or consent, indenture securities owned by any obligor upon the indenture securities, or by any person directly or indirectly controlling or controlled by or under direct or indirect common control with any such obligor, shall be disregarded, except that for the purpose of determining whether the indenture trustee shall be protected in relying on any such direction or consent, only indenture securities which such trustee knows are so owned shall be so disregarded.

(b) Notwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, except as to a postponement of an interest payment consented to as provided in paragraph (2) of subsection (a), and except that such indenture may contain provisions limiting or denying the right of any such holder to institute any such suit, if and to the extent that the institution or prosecution thereof or the entry of judgment therein would, under applicable law, result in the surrender, impairment, waiver, or loss of the lien of such indenture upon any property subject to such lien.

(c) The obligor upon any indenture qualified under this title may set a record date for purposes of determining the identity of indenture security holders entitled to vote or consent to any action by vote or consent authorized or permitted by subsection (a) of this section. Unless the indenture provides otherwise, such record date shall be the later of 30 days prior to the first solicitation of such consent or the date of the most recent list of holders furnished to the trustee pursuant to section 312 of this title prior to such solicitation.

[Codified to 15 USC 77ppp]

[Source: Section 316 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933), as added by section 316 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1172), effective August 3, 1939; as amended by section 415 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2731), effective November 15, 1990]

Section 317 Special Powers of Trustee; Duties of Paying Agents

(a) The indenture trustee shall be authorized -

(1) in the case of a default in payment of the principal of any indenture security, when and as the same shall become due and payable, or in the case of a default in payment of the interest on any such security, when and as the same shall become due and payable and the continuance of such default for such period as may be prescribed in such indenture, to recover judgment, in its own name and as trustee of an express trust, against the obligor upon the indenture securities for the whole amount of such principal and interest remaining unpaid; and

(2) to file such proofs of claim and other papers or documents as may be necessary or advisable in order to have the claims of such trustee and of the indenture security holders allowed in any judicial proceedings relative to the obligor upon the indenture securities, its creditors, or its property.

(b) Each paying agent shall hold in trust for the benefit of the indenture security holders or the indenture trustee all sums held by such paying agent for the payment of the principal of or interest on the indenture securities, and shall give to such trustee notice of any default by an obligor upon the indenture securities in the making of any such payment.

[Codified to 15 USC 77qqq]

[Source: Section 317 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 317 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1173), effective August 3, 1939; as amended by section 416 of

title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2731), effective November 15, 1990]

Section 318 Effect of Prescribed Indenture Provisions

(a) if any provision of the indenture to be qualified limits, qualifies, or conflicts with the duties impose by operation of subsection (c) of this section, the imposed duties shall control.

(b) The indenture to be qualified may contain, in addition to provision specifically authorized under this title to be included therein, any other provisions the inclusion of which is not in contravention of any provision of this title.

(c) The provisions of sections 310 to and including 317 that impose duties on any person (including provisions automatically deemed included in an indenture unless the indenture provides that such provisions are excluded) are a part of and govern every qualified indenture, whether or not physically contained therein, shall be deemed retroactively to govern each indenture heretofore qualified, and prospectively to govern each indenture hereafter qualified under this title and shall be deemed retroactively to amend and supersede inconsistent provisions in each such indenture heretofore qualified. The foregoing provisions of this subsection shall not be deemed to effect the inclusion (by retroactive amendment or otherwise) in the text of any indenture heretofore qualified of any of the optional provisions contemplated by section 310(b)(1), 311(b), 314(d), 315(a), 315(b), 315(d), 315(e), or 316(a)(1).

[Codified to 15 USC 77rrr]

[Source: Section 318 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 318 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1173), effective August 3, 1939; as amended by section 417 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2731), effective November 15, 1990]

Section 319 Rules, Regulations, and Orders

(a) The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as it may deem necessary or appropriate in the public interest or for the protection of investors to carry out the provisions of this title, including rules and regulations defining accounting, technical, and trade terms used in this title. Among other things, the Commission shall have authority -

(1) by rules and regulations, to prescribe for the purposes of section 310(b) the method (to be fixed in indentures to be qualified under this title) of calculating percentages of voting securities and other securities;

(2) by the rules and regulations, to prescribe the definitions of the terms "cash transaction" and "self-liquidating paper" which shall be included in indentures to be qualified under this title, which definitions shall include such of the creditor relationships referred to in paragraphs (4) and (6) of subsection (b) of section 311 as to which the Commission determines that the application of subsection (a) of such section is not necessary in the public interest or for the protection of investors, having due regard for the purposes of such subsection; and

(3) for the purposes of this title, to prescribe the form or forms in which information required in any statement, application, report, or other document filed with the Commission shall be set forth.

For the purpose of its rules or regulations the Commission may classify persons, securities, indentures, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, indentures, or matters.

(b) Subject to the provisions of the Federal Register Act and regulations prescribed under the authority thereof, the rules and regulations of the Commission under this title shall be

effective upon publication in the manner which the Commission shall prescribe, or upon such later date as may be provided in such rules and regulations.

(c) No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule, regulation, or order of the Commission, notwithstanding that such rule, regulation, or order may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

[Codified to 15 USC 77sss]

[Source: Section 319 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 319 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1173), effective August 3, 1939]

Section 320 Hearings by Commission

Hearings may be public and may be held before the Commission, any member or members thereof, or any officer or officers of the Commission designated by it, and appropriate records thereof shall be kept.

[Codified to 15 USC 77ttt]

[Source: Section 320 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 320 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1174), effective August 3, 1939]

Section 321 Special Powers of the Commission

(a) For the purpose of any investigation or any other proceeding which, in the opinion of the Commission, is necessary and proper for the enforcement of this title, any member of the Commission, or any officer thereof designated by it, is empowered to administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, contracts, agreements, or other records which the Commission deems relevant or material to the inquiry. Such attendance of witnesses and the production of any such books, papers, correspondence, memoranda, contracts, agreements, or other records may be required from any place in the United States or in any Territory at any designated place of investigation or hearing. In addition, the Commission shall have the powers with respect to investigations and hearings, and with respect to the enforcement of, and offenses and violations under, this title and rules and regulations and orders prescribed under the authority thereof, provided in sections 20, 22(b), and 22(c) of the Securities Act of 1933.

(b) The Treasury Department, the Comptroller of the Currency, the Board of Governors of the Federal Reserve system, the Federal Reserve Banks, and the Federal Deposit Insurance Corporation are hereby authorized, under such conditions as they may prescribe, to make available to the Commission such reports, records, or other information as they may have available with respect to trustees or prospective trustees under indentures qualified or to be qualified under this title, and to make through their examiners or other employees for the use of the Commission, examinations of such trustees or prospective trustees. Every such trustee or prospective trustee shall, as a condition precedent to qualification of such indenture, consent that reports of examinations by Federal, State, Territorial, or District authorities may be furnished by such authorities to the Commission upon request therefore.

Notwithstanding any provision of this title, no report, record, or other information made available to the Commission under this subsection, no report of an examination made under this subsection for the use of the Commission, no report of an examination made of any trustee or prospective trustee by any Federal, State, Territorial, or District authority having jurisdiction to examine or supervise such trustee, no report made by any such trustee or prospective trustee to any such authority, and no correspondence between any such authority and any such trustee or prospective trustee, shall be divulged or made known or available by the Commission or any member, officer, agent, or employee thereof, to any person other than a member, officer, agent, or employee of the Commission: Provided, That the Commission may make available to the Attorney General of the United

States, in confidence, any information obtained from such records, reports of examination, other reports, or correspondence , and deemed necessary by the Commission, or requested by him, for the purpose of enabling him to perform his duties under this title.

(c) Any investigation of a prospective trustee, or any proceeding or requirement for the purpose of obtaining information regarding a prospective trustee, under any provision of this title, shall be limited -

> (1) to determining whether such prospective trustee is qualified to act as trustee under the provisions of subsection (b) of section 310;
>
> (2) to requiring the inclusion in the registration statement or application of information with respect to the eligibility of such prospective trustee under paragraph (1) of subsection (a) of such section 310; and statement or application of the most recent published report of condition of such prospective trustee, as described in paragraph (2) of such subsection (a), or, if the indenture does not contain the provision with respect to combined capital and surplus authorized by the last sentence of paragraph (2) of subsection (a) of such section 310, to determining whether such prospective trustee is eligible to act as such under such paragraph (2).

(d) The provisions of section 4(b) of the Securities Exchange Act of 1934 shall be applicable with respect to the power of the Commission -

> (1) to appoint and fix the compensation of such employees as may be necessary for carrying out its functions under this title, and
>
> (2) to lease and allocate such real property as may be necessary for carrying out its functions under this title.

[Codified to 15 USC 77uuu]

[Source: Section 321 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 321 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1174), effective August 3, 1939; as amended by section 104(b) of title I of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2714), effective November 15, 1990]

Section 322 Court Review of Orders; Jurisdiction of Offenses and Suits

(a) Orders of the Commission under this title (including orders pursuant to the provisions of sections 305(b) and 307(c)) shall be subject to review in the same manner, upon the same conditions, and to the same extent, as provided in section 9 of the Securities Act of 1933, with respect to orders of the Commission under such Act.

(b) Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability or duty created by, this title, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 22(a) of the Securities Act of 1933.

[Codified to 15 USC 77vvv]

[Source: Section 322 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 322 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1175), effective August 3, 1939; as amended by section 418 of title IV of the Act of November 15, 1990 (Pub. L. No. 101-550; 104 Stat. 2732), effective November 15, 1990]

Section 323 Liability for Misleading Statements

(a) Any person who shall make or cause to be made any statement in any application, report, or document filed with the Commission pursuant to any provisions of this title, or any rule, regulation, or order thereunder, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or who shall omit to state any material fact required to be stated therein or

necessary to make the statements therein not misleading, shall be liable to any person (not knowing that such statement was false or misleading or of such omission) who, in reliance upon such statement or omission, shall have purchased or sold a security issued under the indenture to which such application, report, or document relates, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading or of such omission. A person seeking to enforce such liability may sue at law or in equity in any court of competent jurisdiction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit and assess reasonable costs, including reasonable attorney's fees, against either party litigant, having due regard to the merits and good faith of the suit or defense. No action shall be maintained to enforce any liability created under this section unless brought within one year after the discovery of the facts constituting the cause of action and within three years after such cause of action accrued.

(b) The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist under the Securities Act of 1933, or the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935, or otherwise at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

[Codified to 15 USC 77www]

[Source: Section 323 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 323 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1176), effective August 3, 1939]

Section 324 Unlawful Representations

It shall be unlawful for any person in offering, selling, or issuing any security to represent or imply in any manner whatsoever that any action or failure to act by the Commission in the administration of this title means that the Commission has in any way passed upon the merits of, or given approval to, any trustee, indenture or security, or any transaction or transactions therein, or that any such action or failure to act with regard to any statement or report filed with or examined by the Commission pursuant to this title or any rule, regulation, or order thereunder, has the effect of a finding by the Commission that such statement or report is true and accurate on its face or that it is not false or misleading.

[Codified to 15 USC 77xxx]

[Source: Section 324 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 324 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1176), effective August 3, 1939; as amended by section 305 of title III of the Act of August 10, 1954 (Pub. L. No. 577; 68 Stat. 688), effective October 9, 1954]

Section 325 Penalties

Any person who willfully violates any provision of this title or any rule, regulation, or order thereunder, or any person who willfully, in any application, report, or document filed or required to be filed under the provisions of this title or any rule, regulation, or order thereunder, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.

[Codified to 15 USC 77yyy]

[Source: Section 325 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 325 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1177), effective August 3, 1939; as amended by section 27(d) of the Act of June 4, 1975 (Pub. L. No. 94-29; 89 Stat. 163), effective June 5, 1975]

Section 326 Effect on Existing Law

Except as otherwise expressly provided, nothing in this title shall affect -

(1) the jurisdiction of the Commission under the Securities Act of 1933, or the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935, over any person, security, or contract, or

(2) the rights, obligations, duties, or liabilities of any person under such Acts; nor shall anything in this title affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person or security, insofar as such jurisdiction does not conflict with any provision of this title or any rule, regulation, or order thereunder.

[Codified to 15 USC 77zzz]

[Source: Section 326 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 326 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1177), effective August 3, 1939]

Section 327 Contrary Stipulations Void

Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or with any rule, regulation, or order thereunder shall be void.

[Codified to 15 USC 77aaaa]

[Source: Section 327 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 327 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1177), effective August 3, 1939]

Section 328 Separability of Provisions

If any provision of this title or the application of such provision to any person or circumstance shall be held invalid, the remainder of the title and the application of such provision to persons or circumstances other than those as to which it is held invalid shall not be affected thereby.

[Codified to 15 USC 77bbbb]

[Source: Section 328 of title III of the Act of May 27, 1933 (Pub. L. No. 22; 48 Stat. 74), effective May 27, 1933, as added by section 328 of title III of the Act of August 3, 1939 (Pub. L. No. 253; 53 Stat. 1177), effective August 3, 1939]

SEC Rules Under Section 304 Of The Trust Indenture Act Of 1939

(17 CFR 260.4a-1 and -2)

Section 260.4a-1 Exempted securities under section 304(a)(8).

The provisions of the Trust Indenture Act of 1939 shall not apply to any security which has been or is to be issued otherwise than under an indenture. The same issuer may not claim this exemption within a period of twelve consecutive months for more than $5,000,000 aggregate principal amount of any securities of the same issuer. [Codified to 17 CFR 260.4a-1] (Issued 12-31-81 at 46 FR 63256, Revised 8-13-92 at 57 FR 36501.)

Section 260.4a-2 Exempted securities under section 304(d).

The provisions of the Trust Indenture Act of 1939 shall not apply to any security that has been issued or will be issued in accordance with the provisions of Regulation A (17 CFR 230.251 et seq.) under the Securities Act of 1933. [Codified to 17 CFR 260.4a-2] (Issued 8-13-92 at 57 FR 36501.)

Section 260.4a-3 Exempted securities under section 304(a)(9).

The provisions of the Trust Indenture Act of 1939 shall not apply to any security which has been or is to be issued under an indenture which limits the aggregate principal amount of securities at any time outstanding thereunder to $10,000,000 or less, but this exemption shall not be applied within a period of thirty-six consecutive months to more than $10,000,000 aggregate principal amount of securities of the

same issuer. [Codified to 17 CFR 260.4a-3, formerly 17 CFR 260.4a-2] (Issued 12-31-81 at 46 FR 63256, Revised 8-13-92 at 57 FR 36501.)

SEC Regulation A - Conditional Small Issues Exemption

Codified to 17 CFR 230.251

(Issued 8-13-92 at 57 FR 36468)

Section 230.251 Scope of Exemption.

A public offer or sale of securities that meets the following terms and conditions shall be exempt under section 3(b) from the registration requirements of the Securities Act of 1933 (the "Securities Act"):

(a) Issuer. The issuer of the securities:

(1) is an entity organized under the laws of the United States or Canada, or any State, Province, Territory or possession thereof, or the District of Columbia, with its principal place of business in the United States or Canada;

(2) is not subject to section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (15 USC 78a et seq.) immediately before the offering;

(3) is not a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company or companies;

(4) is not an investment company registered or required to be registered under the Investment Company Act of 1940 (15 USC 80a-1 et seq.);

(5) is not issuing fractional undivided interests in oil or gas rights as defined in oil or gas rights as defined in § 230.300, or a similar interest in other mineral rights; and

(6) is not disqualified because of § 230.262.

* * *

Note: The balance of the regulation has been omitted.

* * *

Appendix G — Collective Investment Fund Law

Table of Contents

OCC and IRS Regulations

Section 9.12 of OCC Regulation 9

Section 9.18 of OCC Regulation 9

Excepts from OCC Bulletin 97-22

IRS - Revenue Ruling 81-100

Internal Revenue Code Section 581

Internal Revenue Code Section 584

Internal Revenue Code Section 584 [1996 Tax-Free Conversion Amendment]

OCC Interpretive Letters 12 C.F.R. 9.18

Collective Fund Limited to Funds Awaiting Investment or Distribution: Self-Deposits in a STIF [Interpretive Letter # 969, July 2003]

Admission and Withdrawal Rules and Frequency [OCC Interpretive Letter # 936, June 2002 and OCC Interpretive Letter #920, December 2001]

Expense Recovery for Model-Driven Funds [OCC Interpretive Letter # 919, December 2001]

Applying Different Fund Management Fees Commensurate with Amount and Type of Participant Services Provided [OCC Interpretive Letter # 829, May 1998]

SEC Interpretations and Regulations Dealing With Collective Investment Funds (CIFs):

Recaps of Various SEC Positions

IRA Accounts in CIFs [3-1-96 SEC Letter of Admonishment]

IRA Accounts in CIFs [The Commercial Bank 12-6-94]

IRA Accounts in CIFs [Santa Barbara Bank and Trust, 11-1-91]

Personal and Employee Benefit Accounts in Personal Common Trust Fund [Santa Barbara Bank and Trust, 11-1-91]

Multi-affiliated-bank CIFs [Old Kent Financial Corporation, 7-25-89] [SEC Releases dated 1-10-78]

"Mini-trusts" not acceptable for CIFs [First Jersey National Bank, November 13, 1987]

CIF investing in another CIF [United Virginia Bankshares, 7-15-87]

Keogh Account use of CIF [National Bank of Fairfax, 12-29-76]

Keogh Account use of CIF [Citizens and Southern National Bank, 9-25-81]

Corporate and Government Plan use of CIF [The Provident Bank 9-24-91]

Corporate and Government Plan use of CIF [The Idaho First National Bank 10-11-88]

Government Plan use of CIF [Fidelity Management Trust Company 11-2-89]

Investing in non-affiliated bank CIFs - not permissible [Northern Trust Corporation 3-3-89]

Investing in non-affiliated bank CIFs - not permissible [Northern Trust Corporation II 7-21-89]

Keogh Account use of CIF [17 CFR Section 230.180 "Sophisticated Investor Rule"]

Merger Rules for Mutual Funds and CIFs [SEC Rule 17a-8 17 CFR 270.17a-8]

Private Investment Companies (Private Collective Funds) under the ICA of 1940 [American Bar Association 4-22-99]

Regulation D Summary [Rules Governing the Offer and Sale of Securities Without Registration]

Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates [Bank Regulatory Agencies 2003]

Comptroller of the currency Self-Dealing and Conflicts of interest

Section 9.12 of OCC Regulation 9

9.12 (a) Investments for Fiduciary Accounts
- (b) Loans, Sales, or Other Transfers from Fiduciary Accounts
- (c) Loans to Fiduciary Accounts
- (d) Sales Between Fiduciary Accounts
- (e) Loans Between Fiduciary Accounts

Office of the comptroller of the currency

Regulation § 9.12 Self-Dealing and Conflicts of Interest

Codified to 12 CFR 9.12

Federal Register December 30, 1996 (61 FR 68543)

§ Section 9.12 Self-Dealing and Conflicts of Interest

(a) for fiduciary accounts

(1) In general. Unless authorized by applicable law, a national bank may not invest funds of a fiduciary account for which a national bank has investment discretion in the stock or obligations of, or in assets acquired from: the bank or any of its directors, officers, or employees; affiliates of the bank or any of their directors, officers, or employees; or individuals or organizations with whom there exists an interest that might affect the exercise of the best judgment of the bank.

(2) Additional securities investments. If retention of stock or obligations of the bank or its affiliates in a fiduciary account is consistent with applicable law, the bank may:

(i) Exercise rights to purchase additional stock (or securities convertible into additional stock) when offered pro rata to stockholders; and

(ii) Purchase fractional shares to complement fractional shares acquired through the exercise of rights or the receipt of a stock dividend resulting in fractional share holdings.

(b) Loans, sales, or other transfers from fiduciary accounts

(1) In general. A national bank may not lend, sell, or otherwise transfer assets of a fiduciary account for which a national bank has investment discretion to the bank or any of its directors, officers, or employees, or to affiliates of the bank or any of their directors, officers, or employees, or to individuals or organizations with whom there exists an interest that might affect the exercise of the best judgment of the bank, unless:

(i) The transaction is authorized by applicable law;

(ii) Legal counsel advises the bank in writing that the bank has incurred, in its fiduciary capacity, a contingent or potential liability, in which case the bank, upon the sale or transfer of assets, shall reimburse the fiduciary account in cash at the greater of book or market value of the assets;

(iii) As provided in §9.18(b)(8)(iii) for defaulted investments; or

(iv) Required in writing by the OCC.

(2) Loans of funds held as trustee. Notwithstanding paragraph (b)(1) of this section, a national bank may not lend to any of its directors, officers, or employees any funds held in trust, except with respect to employee benefit plans in accordance with the exemptions found in section 408 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1108).

(c) Loans to fiduciary accounts.

A national bank may make a loan to a fiduciary account and may hold a security interest in assets of the account if the transaction is fair to the account and is not prohibited by applicable law.

(d) Sales between fiduciary accounts.

A national bank may sell assets between any of its fiduciary accounts if the transaction is fair to both accounts and is not prohibited by applicable law.

(e) Loans between fiduciary accounts.

A national bank may make a loan between any of its fiduciary accounts if the transaction is fair to both accounts and is not prohibited by applicable law.

Comptroller of the currency

Collective Investment Funds

Section 9.18 of OCC Regulation 9

9.18 (a) Types of Common Trust Funds and Investments Permitted

(1) Funds for Personal Trust Accounts

(2) Funds for Employee Benefit Accounts

(b) Administration of Collective Investment Funds

(1) Establishment & Contents of Plan

(2) Exclusive Management Requirement

(3) Proportionate Representation for Participating Accounts

(4) Valuation Frequency and Methods

(5) Admission and Withdrawals

(6) Audits and Financial Reports

(i) Annual Audit

(ii) Financial Report

(iii) Limitations on Representations

(iv) Availability of Reports

(7) Advertising of CIF

(8) Self Dealing and Conflicts of Interest

(i) Bank Interests

(ii) Loans to Participating Accounts

(iii) Purchase of Defaulted Investments

(9) Management Fees

(10) Expenses

(11) Prohibition Against Certificates

(12) Correction of Good Faith Mistakes

(c)Other Collective Investments

(1) Single Loans or Obligations

(2) Mini-funds

(3) Trust Funds of Corporations and Closely-related Settlors

(4) Other Authorized Funds

(5) Special Exemption Funds

Office of the comptroller of the currency

Regulation § 9.18 Collective Investment Funds

Codified to 12 CFR 9.18

Federal Register December 30, 1996 (61 FR 68543)

§ Section 9.18 Collective Investment Funds

(a) In general. Where consistent with applicable law, a national bank may invest assets that it holds as fiduciary in the following collective investment funds: [foot note 1]

(1) A fund maintained by the bank, or by one or more affiliated banks , [foot note 2] exclusively for the collective investment and reinvestment of money contributed to the fund by the bank, or by one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act.

(2) A fund consisting solely of assets of retirement, pension, profit sharing, stock bonus or other trusts that are exempt from Federal income tax.

(i) A national bank may invest assets of retirement, pension, profit sharing, stock bonus, or other trusts exempt from Federal income tax and that the bank holds in its capacity as trustee in a collective investment fund established under paragraph (a)(1) or (a)(2) of this section.

(ii) A national bank may invest assets of retirement, pension, profit sharing, stock bonus, or other employee benefit trusts exempt from Federal income tax and that the bank holds in any capacity (including agent), in a collective investment fund established under this paragraph (a)(2) if the fund itself qualifies for exemption from Federal income tax.

(b) Requirements. A national bank administering a collective investment fund authorized under paragraph (a) of this section shall comply with the following requirements:

(1) Written plan. The bank shall establish and maintain each collective investment fund in accordance with a written plan (Plan) approved by a resolution of the bank's board of directors or by a committee authorized by the board. The bank shall make a copy of the Plan available for public inspection at its main office during all banking hours, and shall provide a copy of the Plan to any person who requests it. The Plan must contain appropriate provisions, not inconsistent with this part, regarding the manner in which the bank will operate the fund, including provisions relating to:

(i) Investment powers and policies with respect to the fund;

(ii) Allocation of income, profits, and losses;

(iii) Fees and expenses that will be charged to the fund and to participating accounts;

(iv) Terms and conditions governing the admission and withdrawal of participating accounts;

(v) Audits of participating accounts;

(vi) Basis and method of valuing assets in the fund;

(vii) Expected frequency for income distribution to participating accounts;

(viii) Minimum frequency for valuation of fund assets;

(ix) Amount of time following a valuation date during which the valuation must be made;

(x) Bases upon which the bank may terminate the fund; and

(xi) Any other matters necessary to define clearly the rights of participating accounts.

(2) Fund management. A bank administering a collective investment fund shall have exclusive management thereof, except as a prudent person might delegate responsibilities to others . [foot note 3]

(3) Proportionate interests. Each participating account in a collective investment fund must have a proportionate interest in all the fund's assets.

(4) Valuation

(i) Frequency of valuation. A bank administering a collective investment fund shall determine the value of the fund's assets at least once every three months. However, in the case of a fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, the bank shall determine the value of the fund's assets at least once each year.

(ii) Method of valuation

(A) In general. Except as provided in paragraph (b)(4)(ii)(B) of this section, a bank shall value each fund asset at market value as of the date set for valuation, unless the bank cannot readily ascertain market value, in which case the bank shall use a fair value determined in good faith.

(B) Short-term investment funds. A bank may value a fund's assets on a cost, rather than market value, basis for purposes of admissions and withdrawals, if the Plan requires the bank to:

(1) Maintain a dollar-weighted average portfolio maturity of 90 days or less;

(2) Accrue on a straight-line basis the difference between the cost and anticipated principal receipt on maturity; and

(3) Hold the fund's assets until maturity under usual circumstances.

(5) Admission and withdrawal of accounts

(i) In general. A bank administering a collective investment fund shall admit an account to or withdraw an account from the fund only on the basis of the valuation described in paragraph (b)(4) of this section.

(ii) Prior request or notice. A bank administering a collective investment fund may admit an account to or withdraw an account from a collective investment fund only if the bank has approved a request for or a notice of intention of taking that action on or before the valuation date on which the admission or withdrawal is based. No requests or notices may be canceled or countermanded after the valuation date.

(iii) Prior notice period for withdrawals from funds with assets not readily marketable. A bank administering a collective investment fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, may require a prior notice period, not to exceed one year, for withdrawals.

(iv) Method of distributions. A bank administering a collective investment fund shall make distributions to accounts withdrawing from the fund in cash, ratably in kind, a combination of cash and ratably in kind, or in any other manner consistent with applicable law in the state in which the bank maintains the fund.

(v) Segregation of investments. If an investment is withdrawn in kind from a collective investment fund for the benefit of all participants in the fund at the time of the withdrawal but the investment is not distributed ratably in kind, the bank shall segregate and administer it for the benefit ratably of all participants in the collective investment fund at the time of withdrawal.

(6) Audits and financial reports

(i) Annual audit. At least once during each 12-month period, a bank administering a collective investment fund shall arrange for an audit of the collective investment fund by auditors responsible only to the board of directors of the bank. [foot note 4]

(ii) Financial report. At least once during each 12-month period, a bank administering a collective investment fund shall prepare a financial report of the fund based on the audit required by paragraph (b)(6)(i) of this section. The report must disclose the fund's fees and expenses in a manner consistent with applicable law in the state in which the bank maintains the fund. This report must contain a list of investments in the fund showing the cost and current market value of each investment, and a statement covering the period after the previous report showing the following (organized by type of investment):

(A) A summary of purchases (with costs);

(B) A summary of sales (with profit or loss and any other investment changes);

(C) Income and disbursements; and

(D) An appropriate notation of any investments in default.

(iii) Limitation on representations. A bank may include in the financial report a description of the fund's value on previous dates, as well as its income and disbursements during previous accounting periods. A bank may not publish in the financial report any predictions or representations as to future performance. In addition, with respect to funds described in paragraph (a)(1) of this section, a bank may not publish the performance of individual funds other than those administered by the bank or its affiliates.

(iv) Availability of the report. A bank administering a collective investment fund shall provide a copy of the financial report, or shall provide notice that a copy of the report is available upon request without charge, to each person who ordinarily would receive a regular periodic accounting with respect to each participating account. The bank may provide a copy of the financial report to prospective customers. In addition, the bank shall provide a copy of the report upon request to any person for a reasonable charge.

(7) Advertising restriction. A bank may not advertise or publicize any fund authorized under paragraph (a)(1) of this section, except in connection with the advertisement of the general fiduciary services of the bank.

(8) Self-dealing and conflicts of interest. A national bank administering a collective investment fund must comply with the following (in addition to § 9.12):

(i) Bank interests. A bank administering a collective investment fund may not have an interest in that fund other than in its fiduciary capacity. If, because of a creditor relationship or otherwise, the bank acquires an interest in a participating account, the participating account must be withdrawn on the next withdrawal date. However, a bank may invest assets that it holds as fiduciary for its own employees in a collective investment fund.

(ii) Loans to participating accounts. A bank administering a collective investment fund may not make any loan on the security of a participant's interest in the fund. An unsecured advance to a fiduciary account participating in the fund until the time of the next valuation date does not constitute the acquisition of an interest in a participating account by the bank.

(iii) Purchase of defaulted investments. A bank administering a collective investment fund may purchase for its own account any defaulted investment held by the fund (in lieu of segregating the investment in accordance with paragraph (b)(5)(v) of this section) if, in the judgment of the bank, the cost of segregating the investment is excessive in light of the market value of the investment. If a bank elects to purchase a defaulted investment, it shall do so at the greater of market value or the sum of cost and accrued unpaid interest.

(9) Management fees. A bank administering a collective investment fund may charge a reasonable fund management fee only if:

(i) The fee is permitted under applicable law (and complies with fee disclosure requirements, if any) in the state in which the bank maintains the fund; and

(ii) The amount of the fee does not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary accounts that would not have been provided to the accounts were they not invested in the fund.

(10) Expenses. A bank administering a collective investment fund may charge reasonable expenses incurred in operating the collective investment fund, to the extent not prohibited by applicable law in the state in which the bank maintains the fund. However, a bank shall absorb the expenses of establishing or reorganizing a collective investment fund.

(11) Prohibition against certificates. A bank administering a collective investment fund may not issue any certificate or other document representing a direct or indirect interest in the

fund, except to provide a withdrawing account with an interest in a segregated investment.

(12) Good faith mistakes. The OCC will not deem a bank's mistake made in good faith and in the exercise of due care in connection with the administration of a collective investment fund to be a violation of this part if, promptly after the discovery of the mistake, the bank takes whatever action is practicable under the circumstances to remedy the mistake.

(c) Other collective investments. In addition to the collective investment funds authorized under paragraph (a) of this section, a national bank may collectively invest assets that it holds as fiduciary, to the extent not prohibited by applicable law, as follows:

(1) Single loans or obligations. In the following loans or obligations, if the bank's only interest in the loans or obligations is its capacity as fiduciary:

(i) A single real estate loan, a direct obligation of the United States, or an obligation fully guaranteed by the United States, or a single fixed amount security, obligation, or other property, either real, personal, or mixed, of a single issuer; or

(ii) A variable amount note of a borrower of prime credit, if the bank uses the note solely for investment of funds held in its fiduciary accounts.

(2) Mini-funds. In a fund maintained by the bank for the collective investment of cash balances received or held by a bank in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act, that the bank considers too small to be invested separately to advantage. The total assets in the fund must not exceed $1,000,000 and the number of participating accounts must not exceed 100.

(3) Trust funds of corporations and closely-related settlors. In any investment specifically authorized by the instrument creating the fiduciary account or a court order, in the case of trusts created by a corporation, including its affiliates and subsidiaries, or by several individual settlors who are closely related.

(4) Other authorized funds. In any collective investment authorized by applicable law, such as investments pursuant to a state pre-need funeral statute.

(5) Special exemption funds. In any other manner described by the bank in a written plan approved by the OCC. [foot note 5] In order to obtain a special exemption, a bank shall submit to the OCC a written plan that sets forth:

(i) The reason that the proposed fund requires a special exemption;

(ii) The provisions of the proposed fund that are inconsistent with paragraphs (a) and (b) of this section;

(iii) The provisions of paragraph (b) of this section for which the bank seeks an exemption; and

(iv) The manner in which the proposed fund addresses the rights and interests of participating accounts.

Footnotes

[1] In determining whether investing fiduciary assets in a collective investment fund is proper, the bank may consider the fund as a whole and, for example, shall not be prohibited from making that investment because any particular asset is non-income producing.

[2] A fund established pursuant to this paragraph (a)(1) that includes money contributed by entities that are affiliates under 12 U.S.C. 221a(b), but are not members of the same affiliated group, as defined at 26 U.S.C. 1504, may fail to qualify for tax-exempt status under the Internal Revenue Code. See 26 U.S.C. 584.

[3] If a fund, the assets of which consist solely of Individual Retirement Accounts, Keogh Accounts, or other employee benefit accounts that are exempt from taxation, is registered under the Investment Company

Act of 1940 (15 U.S.C. 80a-1 et seq.), the fund will not be deemed in violation of this paragraph (b)(2) as a result of its compliance with section 10(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-10(c)).

[4] If a fund, the assets of which consist solely of Individual Retirement Accounts, Keogh Accounts, or other employee benefit accounts that are exempt from taxation, is registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), the fund will not be deemed in violation of this paragraph (b)(6)(i) as a result of its compliance with section 10(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-10(c)), if the bank has access to the audit reports of the fund.

[5] Any institution that must comply with this section in order to receive favorable tax treatment under 26 U.S.C. 584 (namely, any corporate fiduciary) may seek OCC approval of special exemption funds in accordance with this paragraph (c)(5).

Excerpts from OCC Bullein 97-22

Subject: Fiduciary Activities of National Banks

Pertaining to Revisions to Section 9.18

9.18 Collective investment funds

14) Do banks need to amend their collective investment fund plans?

Whether a bank needs to amend its collective investment fund plan document (plan) depends on the language in the plan. If the plan specifically states the requirements of the former regulation, such as the 10 percent limitations, the bank should continue operating the funds in compliance with the plan provisions unless the plan is amended. If the plan merely makes general reference to 12 CFR 9.18, amendment of the plan may not be necessary. However, a bank operating a short-term investment fund should amend its plans to reflect the new valuation provision in the revised regulation.

Collective investment fund plan amendments should be approved by the bank's board of directors or its designee. Expenses incurred in amending the plan are considered a cost of establishing or reorganizing a collective investment fund, and therefore may not be charged to the fund. The revised regulation eliminated the requirement that collective investment fund plans be filed with the OCC; consequently, there is no need to file plan amendments with the OCC.

15) If a bank delegates collective investment fund (CIF) investment responsibilities under the new prudent delegation standard, will the CIF lose its exemption from Federal securities laws (Section 3(a)(2) of the 1933 Act) and from Federal taxation (IRC 584, for common trust funds)?

It is the OCC's position that a bank may delegate CIF investment responsibilities if the delegation is prudent. The bank should conduct a due diligence review of the investment advisor prior to the delegation. The board of directors, or its designee, should approve the delegation and ensure an agreement setting forth duties and responsibilities is in place. In addition, the bank should closely monitor the performance of the investment adviser. We recommend that a bank review the securities law and tax implications of delegation with their attorney prior to any delegation of investment responsibility.

16) Why were the short term investment fund provisions changed?

The short-term investment fund provisions were amended to align them more closely with the Securities and Exchange Commission's Rule 2a-7, which governs money market mutual funds. For purposes of calculating the dollar-weighted average portfolio as required in 12 CFR 9.18(b)(4)(ii)(B), the bank should refer to the SEC definition used for Rule 2a-7.

17) What constitutes a summary of purchases and sales for purposes of the collective investment fund financial reports?

For purposes of the collective investment fund financial reports, acceptable reporting of "a summary of purchases (with costs)" would include the aggregating of purchases by investment type. Acceptable reporting of "a summary of sales (with profit or loss and any other investment changes)" would include the aggregating of sales by investment type, and would result in the netting of realized gains and losses. Examples of investment types include equity securities, convertible bonds, U.S. government and agency securities, corporate debt, and municipal securities.

Miscellaneous

18) What happens to the Fiduciary Precedents and Trust Interpretive Letters?

The fiduciary precedents and trust interpretive letters are interpretations of the former regulation. However, they still may have persuasive effect on interpretations of the new language. Additionally, in many instances, the precedents and interpretations have become industry practice or simply articulate sound fiduciary principles. The OCC is including these, where appropriate, in the narrative sections of the revised version of the *Comptroller's Handbook for Fiduciary Activitie*s, due out later this year.

Internal Revenue Service - Revenue Ruling 81-100

This revenue ruling dated March 30, 1981, restates and consolidates the positions stated under Rev. Rul. 56-267, 1956-1 C.B. 206 and Rev. Rul. 75-530, 1975-2 C.B. 146, under current law.

The revenue rulings concern the effect on the tax exempt status of trusts forming parts of qualified retirement plans and individual retirement accounts of an arrangement under which the individual trusts pool their assets in a group trust (usually created for the purpose of providing diversification of investments), where the group trust is declared to be part of the qualified plan or individual retirement account and the trust instruments creating both the participating and group trusts provide that amounts shall be transferred from one trust to the other at the direction of the trustee of the participating trust.

Section 501(a) of the Internal Revenue Code provides, in part, that a trust described in section 401(a) shall be exempt from income tax.

Section 401(a)(1) of the Code provides, in effect, that a trust or trusts created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries shall be qualified under this section if contributions are made to the trust or trusts by such employer, or employees for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated in accordance with such plan.

By making contributions to a participating trust, which provides that from time to time amounts so contributed may be transferred to and from a specified group trust, the employer and any participating employees, in effect, make contributions to the group trust for purposes of section 401(a)(1).

Section 401(a)(2) of the Code provides that under each trust instrument it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the plan and the trust or trusts, for any part of the corpus or income to be used for, or disbursed to, purposes other than for the exclusive benefit of the employees or their beneficiaries.

Section 408(e)(1) of the Code provides for the exemption from taxation of individual retirement accounts which meet the requirements of section 408. Section 408(a)(5) provides that the assets of the trust (individual retirement account) may not be commingled with other property except in a common trust fund or common investment fund. With regard to section 408(a)(5), the Conference Committee stated that the conferees intend that the assets of qualified individual retirement accounts may be pooled with the assets of qualified section 401(a) trusts. The conferees intended that the group trust itself will be entitled to exemption from tax under the Code. See Conference Report No. 93-1280, 93rd Cong., 2nd Sess. 337 (1974), 1974-3 C.B. 415, 498.

Held, if the requirements below are satisfied, a group trust is exempt from taxation under section 501(a) of the Code with respect to its funds which equitably belong to participating trusts described in section 401(a) and is exempt from taxation under section 408(e) with respect to its funds which equitable belong to individual retirement accounts, which satisfy the requirements of section 408. Also, the status of individual trusts as qualified under section 401(a) or meeting the requirements of section 408 of the Code and exempt from tax under section 501(a) or 408(e), respectively, will not be affected by the pooling of their funds in a group trust if the following requirements are satisfied.

(1) The group trust is itself adopted as a part of each individual retirement account or employer's pension or profit-sharing plan.

(2) The group trust instrument expressly limits participation to individual retirement accounts which are exempt under section 408(e) of the Code and employer's pension and profit-sharing trusts which are exempt under section 501(a) of the Code by qualifying under section 401(a).

(3) The group trust instrument prohibits that part of its corpus or income which equitably belongs to any individual retirement account or employer's trust from being used for or diverted to any purposes other than for the exclusive benefit of the individual or the employees, respectively, or their beneficiaries who are entitled to benefits under such participating individual retirement account or employer's trust.

(4) The group trust instrument prohibits assignment by a participating individual retirement account or employer's trust of any part of its equity or interest in the group trust.

(5) The group trust is created or organized in the United States and is maintained at all times as a domestic trust in the United States.

Rev. Rul. 56-267 and Rev. Rul. 75-530 are superseded because the positions stated therein are restated under current law in this revenue ruling.

Internal Revenue Code Section 581

26 USC 581

Current through P.L. 104-18, approved 7-7-95

§ 581. Definition of bank

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

(Aug. 16, 1954, c. 736, 68A Stat. 202; Sept. 28, 1962, Pub.L. 87-722, s 5, 76 Stat. 670; Oct. 4, 1976, Pub.L. 94-455, Title XIX, s 1901(c) (5), 90 Stat. 1803.)

Historical and Statutory Notes

Amendments

1976 Amendment. Pub.L. 94-455 substituted "or of any State" for "of any State, or of any Territory" following "District of Columbia" and struck out "Territorial" following "examination by State".

1962 Amendment. Pub.L. 87-722 substituted "authority of the Comptroller of the Currency" for "section 11(k) of the Federal Reserve Act (38 Stat. 262; 12 U.S.C. 248(k))."

Cross References

Individual retirement account bank trustee requirement, see 26 USC 408.

Mutual savings banks, see 26 USC 593.

Returns of banks with respect to common trust funds, see 26 USC 6032.

Notes of decisions

1. Law governing

Peculiarities in individual state laws are not controlling on the Court of Appeals in the interpretation of the provision of Revenue Act of 1936, § 104, defining a bank. Staunton Industrial Loan Corporation v. C.I.R., C.A.4, 1941, 120 F.2d 930.

2. Reception of deposits

An industrial loan corporation which engaged in receiving deposits termed "investments" and made loans and discounts was a "bank". Staunton Industrial Loan Corporation v. C.I.R., C.A.4, 1941, 120 F.2d 930.

A personal loan company was not a "bank" within the definition of the term "bank" contained

in the Revenue Code, nor within the statutes of Ohio distinguishing between banks and building and loan companies, when it engaged in the personal loan and finance business by receiving funds from others, including financial institutions, for which it issued certificates of deposit, even though such funds were an outstanding indebtedness of the organization to the holder of the certificates. City Loan & Sav. Co. v. U.S., D.C.Ohio 1959, 177 F.Supp. 843, affirmed 287 F.2d 612.

A bank which was chartered and supervised by the State of Indiana was a bank under this section. It was noted that at least 65% of deposits were from general public. The fact that only 2-4% of deposits were invested in loans and that all borrowers had some business relationship was understandable considering town's small population. On balance, it was decided that a substantial part of the institution's business was receiving deposits and making loans. Austin State Bank v. C.I.R., 1971, 57 T.C. 180.

3. Fiduciary powers

A Morris Plan Bank corporation classified by Connecticut state law as an industrial bank, which was not authorized to receive deposits but was authorized to sell certificates of indebtedness, and which did a substantial business in making loans and discounts, was as a "bank" and not a "corporation," even though payments to bank for certificates which were in fact "deposits" were designated as "investments," and that it did not exercise any fiduciary powers similar to those permitted to a national bank. Morris Plan Bank of New Haven v. Smith, C.A.Conn.1942, 125 F.2d 440.

Internal Revenue Code Section 584

26 USC 584

§ 584. Common trust funds

(a) Definitions . For purposes of this subtitle, the term "common trust fund" means a fund maintained by a bank --

(1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and

(2) in conformity with the rules and regulations, prevailing from time to time, of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks.

(b) Taxation of common trust funds . A common trust fund shall not be subject to taxation under this chapter and for purposes of this chapter shall not be considered a corporation.

(c) Income of participants in fund .

(1) Inclusions in taxable income. Each participant in the common trust fund in computing its taxable income shall include, whether or not distributed and whether or not distributable --

(A) as part of its gains and losses from sales or exchanges of capital assets held for not more than six months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for not more than six months;

(B) as part of its gains and losses from sales or exchanges of capital assets held for more than six months, its proportionate share of the gains and losses of the common trust fund from sales or exchanges of capital assets held for more than six months;

(C) its proportionate share of the ordinary taxable income or the ordinary net loss of the common trust fund, computed as provided in subsection (d).

(2) Dividends and partially tax exempt interest. The proportionate share of each participant in the amount of dividends to which section 116 applies, and in the amount of partially tax exempt interest on obligations described in section 35 or section 242, received by the common trust fund shall be considered for purposes of such sections as having been received by such participant. If the common trust fund elects under section 171 (relating to

amortizable bond premiums) to amortize the premium on such obligations, for purposes of the preceding sentence the proportionate share of the participant of such interest received by the common trust fund shall be his proportionate share of such interest (determined without regard to this sentence) reduced by so much of the deduction under section 171 as is attributable to such share.

(d) Computation of common trust fund income . The taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except that --

(1) there shall be segregated the gains and losses from sales or exchanges of capital assets;

(2) after excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed --

(A) an ordinary taxable income which shall consist of the excess of the gross income over deductions; or

(B) an ordinary net loss which shall consist of the excess of the deductions over the gross income;

(3) the deduction provided by section 170 (relating to charitable, etc., contributions and gifts) shall not be allowed; and

(4) the standard deduction provided in section 141 shall not be allowed.

(e) Admission and withdrawal . No gain or loss shall be realized by the common trust fund by the admission or withdrawal of a participant. The withdrawal of any participating interest by a participant shall be treated as a sale or exchange of such interest by the participant.

(f) Different taxable years of common trust fund participant . If the taxable year of the common trust fund is different from that of a participant, the inclusions with respect to the taxable income of the common trust fund, in computing the taxable income of the participant for its taxable year, shall be based upon the taxable income of the common trust fund for any taxable year of the common trust fund ending within or with the taxable year of the participant.

(g) Net operating loss deduction . The benefit of the deduction for net operating losses provided by section 172 shall not be allowed to a common trust fund, but shall be allowed to the participants in the common trust fund under regulations prescribed by the Secretary or his delegate.

Internal Revenue Code Section 584 [1996 Tax-Free Conversion Amendment]

26 USC 584

The "Small Business Job Protection Act of 1996" amended IRC Section 584 to permit the tax-free conversion of common trust funds into mutual funds. The text of the amendment follows:

SEC. 1805. Nonrecognition treatment for certain transfers by common trust funds to regulated investment companies.

(a) General rule- Section 584 (relating to common trust funds) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

(h) Nonrecognition treatment for certain transfers to regulated investment companies-

(1) In General- If--

(A) a common trust fund transfers substantially all of its assets to one or more regulated investment companies in exchange solely for stock in the company or companies to which such assets are so transferred, and

(B) such stock is distributed by such common trust fund to participants in such common trust fund in exchange solely for their interests in such common trust fund, no gain or loss shall be recognized by such common trust fund by reason of such transfer or distribution, and no gain or loss shall be recognized by any participant in such common trust fund by reason of such exchange.

(2) Basis Rules-

(A) Regulated Investment Company - The basis of any asset received by a regulated investment company in a transfer referred to in paragraph (1)(A) shall be the same as it would be in the hands of the common trust fund.

(B) Participants - The basis of the stock which is received in an exchange referred to in paragraph (1)(B) shall be the same as that of the property exchanged. If stock in more than one regulated investment company is received in such exchange, the basis determined under the preceding sentence shall be allocated among the stock in each such company on the basis of respective fair market values.

(3) Treatment of assumptions of liability-

(A) In General - In determining whether the transfer referred to in paragraph (1)(A) is in exchange solely for stock in one or more regulated investment companies, the assumption by any such company of a liability of the common trust fund, and the fact that any property transferred by the common trust fund is subject to a liability, shall be disregarded.

(B) Special rule where assumed liabilities exceed basis-

(i) In General - If, in any transfer referred to in paragraph (1)(A), the assumed liabilities exceed the aggregate adjusted bases (in the hands of the common trust fund) of the assets transferred to the regulated investment company or companies--

(I) notwithstanding paragraph (1), gain shall be recognized to the common trust fund on such transfer in an amount equal to such excess,

(II) the basis of the assets received by the regulated investment company or companies in such transfer shall be increased by the amount so recognized, and

(III) any adjustment to the basis of a participant's interest in the common trust fund as a result of the gain so recognized shall be treated as occurring immediately before the exchange referred to in paragraph (1)(B). If the transfer referred to in paragraph (1)(A) is to two or more regulated investment companies, the basis increase under subclause (II) shall be allocated among such companies on the basis of the respective fair market values of the assets received by each of such companies.

(ii) Assumed Liabilities - For purposes of clause (i), the term "assumed liabilities" means the aggregate of--

(I) any liability of the common trust fund assumed by any regulated investment company in connection with the transfer referred to in paragraph (1)(A), and

(II) any liability to which property so transferred is subject.

(4) Common trust fund must meet diversification rules -

This subsection shall not apply to any common trust fund which would not meet the requirements of section 368(a)(2)(F)(ii) if it were a corporation. For purposes of the preceding sentence, Government securities shall not be treated as securities of an issuer in applying the 25-percent and 50-percent test and such securities shall not be excluded for purposes of determining total assets under clause (iv) of section 368(a)(2)(F).

(b) Effective Date- The amendment made by subsection (a) shall apply to transfers after December 31, 1995.

OCC Interpretive Letters 12 C.F.R. 9.18

Collective Fund Limited to Funds Awaiting Investment or Distribution: Self-Deposits in a STIF

OCC Interpretive Letter #969, July 2003

12 C.F.R. 9.18

12 C.F.R. 9.12

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

April 28, 2003

RE: Collective Fund Limited to Funds Awaiting Investment or Distribution

Dear [ ] :

This is in response to your February 5, 2003 letter, and subsequent discussions with Joel Miller, concerning [ ] 's (the "Bank's") desire to pool the funds of individual fiduciary accounts and self-deposit **(1)** them collectively in a 12 C.F.R. § 9.18(a)(1) short-term investment fund ("STIF"). The STIF would consist exclusively of funds awaiting investment or distribution and would operate in accordance with all applicable provisions of 12 C.F.R. § 9.18. Based on your representations, and for the reasons set forth below, we conclude that the Bank may pool the individual fiduciary accounts and self-deposit them in the STIF.

Discussion

The Bank currently serves as trustee, executor, administrator, guardian, and in other fiduciary capacities for thousands of its trust customers. As fiduciary, the Bank receives and invests fiduciary cash and other assets and makes distributions to beneficiaries.

The Bank seeks to pool and self-deposit fiduciary funds awaiting investment or distribution and to manage them collectively through a STIF. The assets of the STIF will consist of short-term CDs of varying maturities, similar to assets of a money market fund, except that a portion (e.g., 10%) of the STIF assets may consist of checking or other "transaction" deposits that are needed to meet anticipated liquidity needs. The Bank believes collective investment will enable customers to receive higher yields on funds awaiting distribution or investment without materially increasing the administrative burden on the Bank. Each trust customer's account will reflect ownership of units in the STIF equivalent to the customer's proportionate share of the STIF net assets.

Analysis

National banks are generally authorized to pool fiduciary funds and invest them collectively, including investment through STIFs. **(2)** Investing these fiduciary funds in the bank's own deposits, however, raises conflict of interest issues for the STIF. Twelve C.F.R. § 9.18(b)(8) requires a national bank administering a STIF to comply with the conflict of interest requirements of 12 C.F.R. § 9.12, which provides as follows -

> *(a) Investments for fiduciary accounts.*
> (1) *In general.* ***Unless authorized by applicable law*** , a national bank may not invest funds of a fiduciary account for which a national bank has investment discretion in the stock or obligations of, or in assets acquired from: the bank or any of its directors, officers, or employees; affiliates of the bank or any of their directors, officers, or employees; or individuals or organizations with whom there exists an interest that might affect the exercise of the best judgment of the bank. (Emphasis added.)

Applicable law authorizes the Bank to invest the STIF in the Bank's own deposit obligations. Twelve C.F.R. § 9.2(b) defines applicable law to include, "any applicable Federal law governing [fiduciary] relationships." Federal law includes OCC regulations, 12 C.F.R. § 9.10(b), which read in part as follows -

> (b) *Self-deposits* - (1) *In general*. A national bank may deposit funds of a fiduciary account that are awaiting investment or distribution in the commercial, savings, or another department of the bank, ***unless prohibited by applicable law*** . (Emphasis added.)

Part 9 was restructured and streamlined in 1995. The regulatory history of Part 9 clearly shows that national banks have been permitted to self-deposit funds awaiting investment or distribution both before and after Part 9 was revised.

Before its revision, Part 9 dealt with self-deposits of trust funds in three sections. Twelve C.F.R. § 9.18(b)(8)(i) (1993) expressly permitted STIFs to self-deposit funds awaiting investment or distribution; 12 C.F.R. § 9.12(a) (1993) prohibited conflicts of interest such as self-deposits of fiduciary funds unless "lawfully authorized by the instrument creating the relationship, or by court order or by local law"; and 12 C.F.R. § 9.10(b) (1993) permitted self-deposit of funds awaiting investment or distribution "unless *prohibited* by the instrument creating the trust or by local law." OCC precedents (described below) made it clear that in addition to the specific authorization for STIFs to self-deposit under 12 C.F.R. § 9.18(b)(8)(i) (1993), STIFs were subject to the provisions of 12 C.F.R. § 9.12 and 12 C.F.R. § 9.10(b). *See* Trust Interpretation 218 (May 24, 1989) and Trust Interpretation 258 (April 10, 1991) *infra* .

In 1995 the OCC deleted the express authorization for self-deposits of STIF funds in 12 C.F.R. § 9.18(b)(8)(i), and instead inserted a cross reference to 12 C.F.R. § 9.12. *See* 61 *Fed. Reg* . 68543, at 68550 (Dec. 30, 1996). Adding the cross-reference to 12 C.F.R. § 9.12 effectively preserved the ability of STIFs to self-deposit subject to the same requirement under old Part 9 that they comply with 12 C.F.R. § 9.12 and 12 C.F.R. § 9.10(b).

The OCC issued two letters under old Part 9 confirming the ability of STIFs to self-deposit . In Trust Interpretation No. 218 (May 24, 1989), the OCC permitted a bank to self-deposit in a STIF provided that the STIF's investment objective was to, "provide a temporary investment for funds awaiting investment or distribution." The Interpretation also included the qualification that, "it must be permissible for all accounts participating in the STIF to maintain funds in deposits of the Bank, *see* 12 C.F.R. § 9.10(b) and 12 C.F.R. § 9.12," demonstrating that the ability of the STIF to self-deposit was subject to those two regulations. Interpretation No. 218 was clarified by Trust Interpretation No. 258 (April 10, 1991) which noted that under 12 C.F.R. § 9.12, the exception for self-deposits of trust funds applied only when "lawfully authorized by the instrument creating the relationship, or by court order or by local law." As described above, that standard contained in 12 C.F.R.§ 9.12 was changed in 1995 to permit self-deposits "if authorized by applicable law."

The Bank represents that applicable law in those states in which it does business and plans to self-deposit fiduciary funds does not prohibit such self-deposits. As a result, 12 C.F.R. § 9.10(b) provides the applicable authority required by 12 C.F.R. § 9.12 for the Bank to self-deposit fiduciary funds awaiting investment or distribution or to deposit such funds with affiliates, and this practice is not prohibited by applicable law.

Conclusion

Based on the foregoing, the Bank may self-deposit fiduciary assets awaiting investment or distribution collectively in a STIF administered by the Bank. The Bank confirms that it will comply with the requirements as to collateral for self-deposits imposed by 12 C.F.R. § 9.10 and with all other applicable requirements under Part 9.

Sincerely,
/s/ *Lisa Lintecum*

Lisa Lintecum
Director
Asset Management Division

Footnotes

(1) Any deposits the Bank makes of fiduciary funds in the commercial, savings, or other department of the Bank are considered "self-deposits. 12 C.F.R. § 9.10(b).

(2) *See* 12 C.F.R. § 9.18(a)(1) and 9.18(b)(4)(ii)(b). Twelve C.F.R. § 9.18(a)(1) states -

> *Where consistent with applicable law* **,** a national bank may invest assets that it holds as fiduciary in the following collective investment funds:
> (1) A fund maintained by the bank, or by one or more affiliated banks, exclusively for the collective investment and reinvestment of money contributed to the fund by the bank, or by one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act. [Footnotes omitted, emphasis added.]
>
> The Bank represents that it is consistent with applicable law for it to invest fiduciary assets in collective investment funds in those states in which it does business and plans to so invest fiduciary assets.

Admission and Withdrawal Rules and Frequency
[OCC Interpretive Letter #936 and #920]

OCC Interpretive Letter #936, June 2002

12 C.F.R. 9.18

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

May 22, 2002

Re: Proposed Creation of the "[ ] Fund"

Dear [ ]:

This letter confirms our February 13, 2002 teleconference, and responds to your letter dated March 5, 2002, regarding the establishment by [ ] ("Bank"), as trustee, of the [ ] ("Fund"). You have inquired whether the OCC would object to an aspect of the Fund's operations under the OCC's rules governing collective investment funds at 12 C.F.R. § 9.18. Specifically, you have inquired whether the Bank, as trustee, may allow participant withdrawals from the Fund at the sole discretion of the Bank, or when a participant becomes ineligible to continue as a participant in the Fund. Based on your representations, and for the reasons described below, the OCC does not object to this aspect of the Fund's operations under the OCC's rules governing collective investment funds at 12 C.F.R. § 9.18.[1]

I. Proposal

The Bank seeks to establish the Fund for the collective investment of money contributed to the Fund by the Bank in its capacity as trustee of certain tax-exempt charitable trusts. The Bank is forming the Fund in order to enable several small trusts for which it serves as trustee to invest in private equity limited partnerships ("PELP"). However, the trusts cannot invest in the PELP directly because an appropriate private equity investment for these trusts would not satisfy the minimum investment requirement of the limited partnership. The Fund will pool the investments of several tax-exempt trusts that are "qualified purchasers," [2] allowing the Fund to satisfy the minimum requirement of the limited partnership.

Under the Bank's proposal, Fund participants will be unable to make discretionary withdrawals from the Fund. [3] Sections 6.2(a), (b), (c) and (e) of the Declaration of Trust provide:

(a) Unless otherwise limited hereunder, the decision on when to allow, the form of, and the timing of all Fund withdrawals shall be within the sole discretion of the Trustee;

(b) Participants will not have the right to withdraw from the Fund at any particular time or interval;

(c) At the time of the creation of a Fund, the Trustee does not anticipate allowing any withdrawals from the Fund prior to the termination and liquidation of the [private equity investments] of the Fund; and

(d) Upon the occurrence of an event that renders a participant ineligible to continue as a participant in the Fund, [4] within one year of such event the Trustee shall redeem such participant's units in the Fund, in kind, with a proportionate share of the [private equity investments] and the other assets of the Fund; subject, however, to any liens for incurred and unpaid capital contributions, debts, fees and expenses.

You represented during our February 13, 2002 teleconference that the Fund will be valued semi-annually on April 1 and October 1. The Bank will use the valuation reports provided by the PELP's general partner to determine the Fund's fair value. To comply with 12 C.F.R. § 9.18(b)(4)(ii), and as provided in § 5.3(f) of the Declaration of Trust, the Bank will determine whether the valuation provided by the PELP's general partner represents the fair value of the Fund's assets as of the date of the valuation.

II. Discussion

The OCC's regulation governing collective investment funds does not mandate the frequency of admissions and withdrawals from collective investment funds. The regulation requires that the written plan governing the administration of the collective investment fund include appropriate provisions related to the terms and conditions governing the admission and withdrawal of participating accounts. [5]

In addition, the regulation provides that admissions and withdrawals may only be "on the basis of the valuation described in paragraph (b)(4)." Section 9.18(b)(4), in turn, provides in part that,

> A bank administering a collective investment fund shall determine the value of the fund's assets at least once **every three months**. However, in the case of a fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, the bank shall determine the value of the fund's assets **at least once a year**. [6]

These provisions require that bank trustees use the valuation derived under section 9.18(b)(4) to determine the amount participants are entitled to when they are admitted to or withdraw from a fund. It does not mandate the frequency of admissions and withdrawals . [7] National banks and institutions that must comply with this regulation to receive favorable tax treatment should have valid reasons for limiting admissions and withdrawals, however. In addition, the admissions and withdrawal policies must be consistent with fiduciary duties.

In this case, the Bank does not anticipate allowing any withdrawals from the Fund prior to the termination and liquidation of the underlying trust investments because the Fund might fail to satisfy the minimum investment requirement of the PELP if the Fund permitted discretionary withdrawals from the Fund. In addition, you represent that the Bank will limit admissions to, and withdrawals from the Fund, because the Fund's private equity investments will be in limited partnerships that will be illiquid over their projected ten to fifteen year business cycles. Specifically, the limited partnership interests are not transferable without the permission of the General Partner. You have also represented that the amount of the investment that each participating trust will make in the Fund will not impair the liquidity of the participating trusts. The Fund is designed as, and will be used as, only one part of an overall investment strategy for the participating trusts.

Based on your representations and consistent with applicable law, the Bank may permit a participant to withdraw from the Fund solely at the Bank's discretion, or when a participant becomes ineligible to continue as a participant in the Fund. [8]

I trust this is responsive to your inquiry. Please do not hesitate to contact me if you have any questions.

Sincerely,

-signed-

Asa L. Chamberlayne
Counsel
Securities and Corporate
Practices Division

Footnotes

[1] We limit our no-objection to the Bank's proposal to allow participant withdrawals from the Fund at the sole discretion of the Bank, or when a participant becomes ineligible to continue as a participant in the Fund. We offer no views on whether other aspects of the Fund's operations comply with the provisions of 12 C.F.R. § 9.18 or with applicable fiduciary law.

[2] While the Investment Company Act of 1940 ("1940 Act") is not applicable to the Bank's proposal, the Bank represents that if the 1940 Act were applicable to the Bank's proposal, the tax-exempt trusts for which the Bank is trustee would meet the definition of "qualified purchasers" under § 2(a)(51) of the 1940 Act.

[3] The Bank represents that it will provide appropriate disclosures to the board of directors or the trustee(s) of the beneficiaries of each Fund participant with respect to the nature of the Fund's investments and capital calls, and that Fund participants will not have the right to withdraw from the Fund at any particular time or time interval.

[4] The Bank represents that the only way a participant would cease to be eligible to continue as a participant in the Fund would be if the Bank was removed, for cause, as trustee of the participating account.

[5] The regulation also provides that certain funds may require a prior notice period of up to one year for withdrawals. 12 C.F.R. § 9.18(b)(5)(iii).

[6] 12 C.F.R. § 9.18(b)(4)(i). Section 9.18(b)(4) also establishes the method of valuation. In general, bank trustees are required to value fund assets at market value as of the date set for valuation, unless the bank cannot readily ascertain market value, in which case the bank shall use a fair value determined in good faith. *See* 12 C.F.R. § 9.18(b)(4)(ii)(A). Different valuation methods apply to short term investment funds. *See* 12 C.F.R. § 9.18(b)(4)(ii)(B).

[7] OCC Trust Interpretive Letters interpreting the prior version of 12 C.F.R. § 9.18 concluded that admissions and withdrawals must occur as frequently as valuations. *See e.g.*, Trust Interpretive Letter #13 (February 14, 1986). Upon closer examination of the regulation, however, we have concluded that the regulation does not mandate the frequency of admissions and withdrawals. *See* Interpretive Letter #920 (December 6, 2001).

[8] *See* footnote 4, *supra.*

OCC Interpretive Letter #920, December 2001

12 C.F.R. 9.18

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

December 6, 2001

Subject:**[ ]** Trust Company -- **[ ]**Fund

Dear [ ]:

This is in response to your request for an exemption under 12 C.F.R. § 9.18(c)(5) to permit annual admissions to and withdrawals from a collective investment fund established by **[ ]**Trust Company. For the reasons discussed below, we have concluded that annual admissions and withdrawals are permitted under 12 C.F.R. § 9.18 and, therefore an exemption from 12 C.F.R. § 9.18 is not required.

Proposal

[ ] ("Trust Company"), a **[ ]** trust company, seeks to establish a collective investment fund, **[ ]** ("CIF"), exclusively for the collective investment and reinvestment of money contributed to the fund by the Trust Company in its capacity as trustee of certain trusts. The Trust Company is forming the CIF in order to enable several small trusts for which it serves as trustee to invest in **[ ]** ("Limited Partnership"), a limited partnership formed by the Trust Company. Those trusts are not qualified to invest directly in the Limited Partnership because of their size.

The Limited Partnership invests in third party investment partnerships engaged in hedge fund investing. The Limited Partnership will receive cash flow from its partnership investments once a year. As a result, the Limited Partnership will only allow annual admissions and withdrawals. Because the Limited Partnership only permits annual admissions and withdrawals, the Trust Company has proposed that the CIF only allow annual admissions and withdrawals.

The CIF will be valued quarterly. The Trust Company will use the valuation reports provided to it from the third-party investment partnerships that constitute the underlying investments of the Limited Partnership to determine the fund's fair value. To comply with 12 C.F.R. § 9.18(b)(4)(ii), the Trust Company must determine that the valuation provided by the limited partnerships represents the fair value of the fund's assets as of the date of the valuation.

Discussion

The OCC's regulation governing collective investment funds does not mandate the frequency of admissions and withdrawals from collective investment funds. The regulation requires that the written plan governing the administration of the CIF include appropriate provisions related to the terms and conditions governing the admission and withdrawal of participating accounts . [1]

In addition, the regulation provides that admissions and withdrawals may only be "on the basis of the valuation described in paragraph (b)(4)." Section 9.18(b)(4), in turn, provides in part that,

> A bank administering a CIF shall determine the value of the fund's assets at least once **every three months**. However, in the case of a fund described in paragraph (a)(2) of this section that is invested primarily in real estate or other assets that are not readily marketable, the bank shall determine the value of the fund's assets **at least once a year**. [2]

These provisions require that bank trustees use the valuation derived under section 9.18(b)(4) to determine the amount participants are entitled to when they are admitted to or withdraw from a fund. It does not mandate the frequency of admissions and withdrawals. [3] National banks and institutions that must comply with this regulation to receive favorable tax treatment should have valid reasons for limiting admissions and withdrawals, however. In addition, the admissions and withdrawal policies must be consistent with fiduciary duties.

In this case, you have represented that the CIF will not have sufficient liquidity to permit admissions and withdrawals more than once a year because the CIF is invested in a Limited Partnership that only permits annual admissions and withdrawals. You also have represented that the amount of the investment that each participating trust will make in the CIF will not impair the liquidity of the participating trusts. The CIF is designed as, and will be used as, only one part of an overall investment strategy for the participating trusts.

Based on these representations and consistent with applicable law, the Trust Company may permit annual admissions and withdrawals from the CIF. The proposed schedule of admissions and withdrawals must be disclosed to fund participants in the CIF's written plan.

I trust this is responsive to your inquiry. Please do not hesitant to contact me if you have any questions.

Sincerely,

-signed-

Beth Kirby
Special Counsel
Securities and Corporate Practices

Footnotes
[1] The regulation also provides that certain funds may require a prior notice period of up to one year for withdrawals. 12 C.F.R. § 9.18(b)(5)(iii).

[2] 12 C.F.R. § 9.18(b)(4)(i). Section 9.18(b)(4) also establishes the method of valuation. In general, bank trustees are required to value fund assets at market value as of the date set for valuation, unless the bank cannot readily ascertain market value, in which case the bank shall use a fair value determined in good faith. *See* 12 C.F.R. § 9.18(b)(4)(ii)(A). Different valuation methods apply to short term investment funds. *See* 12 C.F.R. § 9.18(b)(4)(ii)(B).

[3] OCC Trust Interpretive Letters interpreting the prior version of 12 C.F.R. § 9.18 concluded that admissions and withdrawals must occur as frequently as valuations. *See e.g.*, Trust Interpretive Letter #13 (February 14, 1986). Upon closer examination of the regulation, however, we have concluded that the regulation does not mandate the frequency of admissions and withdrawals.

Expense Recovery for Model-Driven Funds

OCC Interpretive Letter #919, December 2001

12 C.F.R. 9.18

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

November 9, 2001

RE: Model-Driven Funds

Dear [ ]:

This is in response to your request for confirmation that the OCC permits model-driven funds, established pursuant to 12 C.F.R. § 9.18, to allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds. Based on your representations and for the reasons set forth below, we conclude that model-driven funds, as defined below, may allocate costs to individual participants in the manner described below. [1]

Background

You represent a national bank that administers index funds and model-driven funds, established pursuant to 12 C.F.R. § 9.18. [2] The index funds are collective investment funds that seek to replicate the performance of a specified index, such as the Standard and Poor's 500 Index. Trading decisions are made according to a formula that tracks the rate of return of the index by replicating the entire portfolio of the index or by investing in a representative sample of that portfolio.

The model-driven funds are collective investment funds that seek to outperform a specified index or benchmark based on a pre-determined investment strategy. [3] In the model-driven funds, a computer model selects the identity and amount of securities contained in the funds. The model is based on prescribed objective criteria, using independent third party data that is not within the control of the fund manager.

Proposal

The Bank has proposed to charge or credit fund participants who are admitted to, or withdraw from its model-driven funds with the costs, expenses and related adjustments (collectively, the "Costs") involved in the acquisition of securities when the participants are admitted to the funds, and the disposition of securities upon the participants' withdrawal from the funds. [4] The Bank currently charges or credits fund participants who are admitted to, or withdraw from its index funds in this manner. With respect to domestic model-driven funds, these Costs would include:

> (1) commissions paid by the fund to broker/dealers on purchases or sales, as applicable, of portfolio investments relating to the participant's contribution or redemption, respectively;
>
> (2) Securities and Exchange Commission fees on sales of portfolio investments of U.S. listed and traded securities by the fund relating to the participant's redemption; and
>
> (3) the net difference (positive or negative) between:
>
>> (a) the market value of the portfolio investments purchased or sold by the funds, relating to the participant's contribution or redemption, on the date the fund's investments are valued for purposes of determining the number of units in the fund to be issued to or redeemed for the participant, and
>>
>> (b) the fund's execution price for such portfolio investments. [5]

The Bank has represented that it will inform all participants in the model-driven funds it manages that these Costs will be allocated to contributing and redeeming participants.

You contend on behalf of the Bank that allocating costs in this manner is appropriate for two reasons. First, you believe that allocating costs to individual participants entering or exiting the fund will be fair and equitable to all the participants in the fund. You believe that a procedure that did not allocate costs to a contributing or withdrawing participant could be unfair to other participants in the fund because these other participants would bear the expenses and charges attributable to the contributing or withdrawing participant.

Second, you note that the OCC has previously permitted section 9.18 index funds to charge brokerage fees and expenses to accounts that are purchasing or selling units of the index fund. You believe that model-driven funds should be treated in the same manner as index funds for purposes of allocating costs, given the similarities between these types of funds. You note that both index funds and model driven funds limit the discretion of fund managers, are based upon certain pre-specified formulae or algorithms, and are quantitative in nature.

For these reasons, you believe the OCC should permit model-driven funds, established pursuant to 12 C.F.R. § 9.18, to allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds.

Discussion

Collective Investment Funds, established pursuant to 12 C.F.R. § 9.18, generally are not permitted to charge individual participants with the cost of entering or exiting a fund. [6] The OCC has determined, however, that funds with certain characteristics may charge individual participants the costs associated with being admitted to or withdrawing from a fund. In particular, the OCC has permitted a section 9.18 index fund to charge brokerage fees and expenses to accounts that are purchasing or selling units of the index fund provided that the fund document authorizes such charges. [7]

Model-driven funds, established pursuant to 12 C.F.R. § 9.18(a)(2), have characteristics similar to section 9.18 index funds. In particular, both index funds and model-driven funds do not involve any significant exercise of investment discretion by investment managers managing the funds. For example, an investment manager of an index fund makes investments according to a formula that tracks the rate of return, risk profile, or other characteristics of an independently maintained index by either replicating the entire portfolio of the index or by investing in a representative sample of such portfolio designed to match the projected risk/return profile of that index.

Similarly, an investment manager of a model-driven fund makes investments based upon a formula by which an "optimal" portfolio is created to implement a pre-determined investment strategy that is either based upon or measured by an independently maintained index of securities. A computer model must select the identity and the amount of the securities contained in a model-driven fund. Although managers may use their discretion to design the computer model, the model must be based on prescribed objective criteria using third party data, not within the control of the managers, to transform an independently maintained index. [8]

This limited management discretion helps ensure that all fund participants, including those entering or exiting a fund, will be treated fairly and equitably. For example, the Bank has committed that fund participants being admitted to or withdrawing from a fund will have the same access to and benefit from cross-trading opportunities and other low cost trading mechanisms as other fund participants. [9] For these reasons, we conclude that model-driven funds, as defined in this letter, should be permitted to allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as index funds. [10]

Model Validation and Testing

As noted above, trading decisions in model-driven funds are made by computer models, based on pre-determined investment strategies and prescribed objective criteria. These computer models are designed to systematically control risk and costs and achieve above benchmark returns. Computer models that are improperly validated or tested, however, may expose the bank to risks from erroneous model input or output or incorrect interpretation of model results. To mitigate those risks, the bank should ensure that its computer models are frequently verified, validated and reviewed. To ensure proper validation and testing, the bank should develop formal written policies and procedures consistent with the guidance provided in OCC Bulletin 2000-16 on Risk Modeling and Model Validation.

Conclusion

Model-driven funds, established pursuant to 12 C.F.R. § 9.18(a)(2), may allocate costs to individual participants being admitted to or withdrawing from such funds in the same manner and to the same extent as section 9.18 index funds, provided the fund document authorizes such charges. If you have any questions, please do not hesitate to contact me at (202) 874-5210.

Sincerely,

-signed-

Beth Kirby
Special Counsel
Securities and Corporate Practices

Footnotes

[1] You have represented that the proposed allocation, if properly disclosed, complies with applicable law, including the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), to the extent that the model-driven funds have assets of clients subject to ERISA. The OCC has not addressed and does not opine whether the proposed allocation complies with ERISA or applicable federal securities law and state law.

[2] Section 9.18 collective investment funds include funds maintained by the bank, exclusively for the collective investment or reinvestment of money contributed to the fund by

the bank, or one or more affiliated banks, in its capacity as trustee, executor, administrator, guardian, or custodian under a uniform gifts to minors act. 12 C.F.R. § 9.18(a)(1). Section 9.18 collective investment funds also include funds consisting solely of assets of retirement, pension, profit sharing stock bonus or other trusts that are exempt from Federal income tax. 12 C.F.R. § 9.18(a)(2).

[3] The index or benchmark must represent the investment performance of a specific segment of the public market for debt or equity securities. In addition, the index or benchmark must be established and maintained by an independent organization that is in the business of providing financial information or brokerage services to institutional clients, a publisher of financial news or information or a public stock exchange or association of securities dealers. The index or benchmark must be a standardized index of securities that is not specifically tailored for the use of the manager.

[4] The Bank has represented that trades would be effected in a prudent and expeditious manner. The Bank has committed that the fund would not engage in any "market timing" (i.e., the fund would not seek to "time" the transactions in anticipation of broad market movements).

[5] With respect to international model-driven funds investing in foreign securities, these Costs would include items (1) and (3) listed above, as well as the following: (1) transaction-related charges to convert, as applicable, the participant's contribution of U.S. dollars to the relevant foreign currencies or the proceeds on sales relating to the participant's redemption to U.S. dollars from the relevant foreign currencies, and any applicable stamp taxes or other types of transfer fees imposed by a foreign jurisdiction or a foreign exchange; and (2) bank custodian charges paid by the fund representing fees levied on a per-portfolio transaction basis relating to the participant's contribution or redemption, as applicable. In general, you state that the charges to contributing and redeeming participants are higher in foreign markets than in U.S. markets because the costs associated with purchases and sales of securities are higher in foreign markets.

[6] Section 9.18(b)(10) permits a bank that manages a collective investment fund to charge reasonable expenses (except expenses incurred in establishing or reorganizing a collective investment fund) to the fund as long as those expenses are permissible under state law and are fully disclosed to fund participants. 12 C.F.R. § 9.18(b)(10).

[7] OCC Fiduciary Precedent 9.5980, which interpreted the former Part 9, stated, among other things, that the OCC will not object to an index fund charging brokerage fees and expenses to accounts that are purchasing or selling units of an index fund provided the fund document authorizes such charges. *See* OCC Fiduciary Precedent 9.5980, *Comptroller's Handbook for Fiduciary Activities* (September 1990). *See also* OCC Trust Interpretive Letter No. 228 (August 8, 1989), where the OCC permitted an index fund to charge individual participants with brokerage expenses and certain trading or market gains or losses. Part 9, including 12 C.F.R. 9.18, was amended effective January 29, 1997. 61 *Fed. Reg.* 68,543 (1996). The fiduciary precedents and trust interpretive letters preceding the January 29, 1997 effective date of 12 C.F.R. Part 9 are interpretations of the former regulation. Those precedents and interpretations can still be persuasive in interpreting the language in the new Part 9, however. Furthermore, in many instances the precedents and interpretations have become industry practice or simply articulate sound fiduciary principles.

[8] Fund managers do not have discretion to override trading decisions made by the computer model. Fund managers may, however, verify the data the computer model is relying on and make adjustments to the model output to correct inaccuracies or outdated information. Fund managers may not make such adjustments for arbitrary reasons or to benefit the fund manager, its affiliates, of any party in which the manager or its affiliates have an interest. In addition, any adjustment must be made in compliance with written policies and procedures.

[9] Cross-trading refers to a practice where an investment manager offsets an order to buy a particular security with an order to sell a particular security between two or more accounts under its management without a broker acting as intermediary. The Department of Labor has granted the Bank exemptive authority to engage in cross-trading securities with regard

to its index funds and model-driven funds.

[10] The Department of Labor has recognized these similarities in its proposed class exemption for Model-Driven Funds and Index Funds under ERISA. The proposed class exemption would treat Model-Driven Funds and Index Funds identically for purposes of allowing certain cross-trades of securities under ERISA. The proposed class exemption is based on the limited management discretion associated with these types of funds. *See* 64 *Fed. Reg.* 70057, 70069 (December 15, 1999). The DOL has adopted this same approach for many years with respect to numerous individual prohibited transaction exemptions relating to cross-trading. *See, e.g.*, PTE 95-96, Mellon Bank, N.A., 60 *Fed. Reg.* 35,933 (July 12, 1995) ; PTE 94-47, Bank of America National Trust and Savings Association, 59 *Fed. Reg.* 32,021 (June 21, 1994); and PTE 94-43, Fidelity Management Trust Company, 59 *Fed. Reg.* 30,041 (June 10, 1994).

Applying Different Fund Management Fees Commensurate with Amount and Type of Participant Services Provided

OCC Interpretive Letter #829, May 1998

12 C.F.R. 9.18

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

April 9, 1998

Dear [ ]:

This responds to your request on behalf of [ ], [*City, State*] (Bank), that the Office of the Comptroller of the Currency (OCC) express its views, consistent with the requirements of 12 C.F.R. Part 9, concerning the ability of a national bank to charge different fund management fees to participants in a collective investment fund (CIF) commensurate with the amount and types of services the bank provides to the CIF participants. Based on the representations you made on behalf of the Bank, and subject to the conditions below, we believe that a national bank may, in the manner described, charge CIF participants different fund management fees commensurate with the amount and types of services the bank provides to each participant, consistent with the requirements of 12 C.F.R. Part 9.

I. Background

The Bank is contemplating the establishment of a fluctuating net asset collective investment fund ( ) for employee benefit plans that would invest primarily in guaranteed investment contracts (GICs). **(1)** The GICs are issued primarily by insurance companies. Generally, the bank intends to maintain a 10% cash position in [ ].

At present, the Bank (together with its affiliate banks) offers to 401(k) employee benefit plans and certain other employee benefit plans, choices of different retirement programs designed to meet the investment and administrative needs of the plans. Plan sponsors initially choose a retirement program offered by the Bank, then select from the investment alternatives available under the program (usually no more than eight) those alternatives it will make available to plan participants as investment options under its plan. **(2)** The investment alternatives offered in this type of 401(k) product include certain mutual funds and [ ]. Before a sponsor decides to offer [ ] as an investment alternative to its plan participants, the Bank proposes to provide the plan sponsor with a Disclosure Statement describing how [ ] works and a

copy of the [ ] Declaration of Trust. The Bank also would provide the plan sponsor with information concerning the management fees applicable to its plan prior to the sponsor's decision whether to offer [ ] as an investment option.

Under the Bank's proposal, the management fee structure varies the fees charged to [ ] participants depending on the services they receive. For example, the Bank intends to charge a lower fee to plan participants investing in [ ] that contract directly with a third party for participant accounting or if the size of the plan allows for more cost-efficient

servicing. The Bank would charge a higher fee to plan participants who take advantage of the full range of services the Bank offers for managing and administering the [ ], including [ ]'s portion of participant accounting. The Bank's CIF presently has a single in-fund management fee. As a result, plans that would require fewer services or allow for more cost efficient services tend not to participate in the CIF. Indeed, if such plans invested in the CIF and were to pay for services they did not receive or to pay more than warranted for the plan's services they did receive, the Bank and the plan trustee(s) could potentially breach the fiduciary duty they owe to the plans and plan participants. Conversely, the Bank does not believe a waiver of the entire management fee is appropriate, because it provides all CIF participants some level of customary services, including investment management, and they should pay a reasonable fee for those services.

The Bank has proposed a management fee structure for [ ] so that plan participants (or their employers) pay only for those services participants receive and only those plan participants whose assets are actually invested in [ ] (or their employers) pay the management fees associated with [ ]. The proposed fees generally fall within one of the three following areas:

1. No Fee. The Bank would not charge a fund management fee where the employer

pays the Bank's fees in one of the following three situations:

(a) where a plan and its participants otherwise would pay either the base service

or full service fees but the employer decides instead to pay the appropriate fee

directly; **(3)**

(b) where a plan, rather than employing the Bank for administrative services,

instead opens a so-called "Invest Only" custody or investment advisory account

for the sole purpose of investing in [ ]. The employer would pay a graduated fee that varies inversely with the amount of assets invested in [ ]. The Bank would have no responsibilities with respect to participant accounts; and

(c) where certain existing customers (mainly Bank customers) previously

negotiated various plan level fees that the employer pays, these arrangements

would remain unchanged.

2. Base Fee. The Bank charges a base service management fee for certain general

management and administrative services. The Bank anticipates that, based on the CIF

fees it currently charges, the base service management fee will range from [#] to [#]

basis points. **(4)**

3. Full Fee. The Bank charges a full service management fee for the full range of

management and administrative services that a trustee usually and customarily renders

to a CIF. The Bank would charge that fee in exchange for providing all administrative

services to the plan and its participants' accounts. The Bank anticipates that, based on

the CIF fees it currently charges, a full service management fee will be approximately [#] basis points.

The Bank believes that this fee structure would provide national banks a tool to price fiduciary services competitively and allow it to offer [ ] as a viable and competitive product to other investment alternatives. The Bank believes that if it cannot offer multiple pricing flexibility, it cannot present a viable alternative to other, more attractive investment options, *e.g.*, where the sponsor of a 401(k) plan that qualifies for a lower expense ratio may select from a "menu" of more favorably priced investment options for plan participants (such as the purchase of institutional shares of a mutual fund).

The Bank would charge all CIF plans annual fees for trustee and custodian services. The annual fee would vary, depending upon other administrative services the Bank provides that are not directly related to investment services that the plans contract for, such as testing required under ERISA, filing the Form 5500, making contributions, issuing participant statements, and administering participant loans.

You represented on behalf of the Bank that each unit has a proportionate interest in [ ]'s assets. No unit would have any right, title, or interest in [ ] superior to, or different from, the right, title, or interest of any other [ ] unit. Due to the charging of fund management fees corresponding to the services the Bank would provide plan participants, unit values may vary. As the Bank deducts management fees at the [ ] fund level, the unit value of units held by plan participants who pay the full service fee will of necessity be lower than the unit value of units of plan participants subject only to the base service fee. Where a plan sponsor pays all fees directly, that plan's participants' units would have the largest per unit value since the Bank would not charge fees at the [ ] fund level.

Participants will always purchase [ ] units at their then fair market value. If one participant buys units subject to the full service fee and another participant purchases units subject only to the base service fee and each participant invests $1,000, both participants will receive units worth $1,000. The participant buying the full service fee units will receive more units, however, since units subject to a full service fee will have a lower fair market value, due to the larger fund management fee that the Bank periodically will deduct from those units. The value of the units will vary only to reflect the different fund management fees. You represent on behalf of the Bank that appropriate Bank systems and procedures will accurately account for, calculate, and report those value differences.

II. Discussion

As fiduciaries, national banks may invest funds held on behalf of retirement, pension, profit sharing, stock bonus or other trusts that are exempt from Federal income taxation under the Internal Revenue Code in CIFs.

(5) CIFs may invest in various assets, including GICs.

(6) GICs are individually negotiated investment contracts between insurance companies and investors that resemble debt instruments and provide for fixed returns over a period of time, typically less than ten years.

(7) The OCC previously has approved the use of CIFs for employee benefit accounts that invest primarily in GICs.

(8) OCC regulations govern the administration of CIFs by national bank trustees.
(9) National banks may charge fees for the management of CIFs consistent with the limitations in 12 C.F.R. §9.18(b)(9) (1997). The management fees national bank may charge for administering CIFs are subject to an overall "reasonableness" standard. Accordingly, national banks may charge management fees for CIFs that are reasonable
(10) , consistent with applicable state law requirements, and commensurate with the services the bank trustee is providing to the CIF.
(11) A bank must also disclose the management fees to be charged to a CIF and to participating accounts in the bank's written plan
(12) and at least annually in a manner consistent with applicable law in the state where the bank maintains the CIF.
(13) Part 9's reasonableness standard replaces a quantitative management fee limitation formerly applicable to CIF management fees.
(14) The quantitative management fee limitation permitted a national bank trustee to charge a CIF a management fee only if the fractional part of such fee proportionate to the interest of each participant would not exceed the total fees that the participant would be charged if the participant had not invested assets in the CIF.
(15) The OCC replaced the more restrictive quantitative management fee limitation with the reasonableness standard, in order to provide "updated operating standards for national bank fiduciary activities" and "sufficient protections for bank's fiduciary customers."
(16) Under the new standard, national banks may charge CIF management fees provided that the fees are reasonable under the particular facts and circumstances. OCC regulations do not address the ability of national banks to charge different fees to different classes of CIF participating accounts. The OCC determined under the former quantitative limitation that national banks may charge different management fees to different classes of participant accounts.
(17) In OCC Interpretive Letter No. 300,
(18) the OCC permitted a bank trustee to charge a reduced management fee to large dollar employee benefit CIF participants because the bank made available reduced fees for individually invested large dollar accounts.
(19) The fee concession conformed with the quantitative management fee restrictions then applicable under section 9.18(b)(12) because, while the bank charged different management fees to different classes of CIF participants, the total fees charged did not exceed the total fees the bank charged accounts receiving individual investment management. Similarly, Part 9 does not address the issue of whether national banks may accept management fees from other than CIF participants and plans as the Bank proposes under its no fee option, or how the reasonableness standard applies when a bank chooses to do so. The OCC concluded that a national bank may receive fees in a similar circumstance under the quantitative standard. In OCC Interpretive Letter No. 722
(20) , a national bank inquired about the permissibility of assessing management fees to CIF participants where the CIF simultaneously received fee payments from nonparticipants. The OCC concluded that a national bank CIF could receive both the participant and nonparticipant fee payments provided the bank concluded, based on a reasoned opinion of trust counsel, that applicable state law, the governing trust instrument, and the management fee restrictions contained in 12 C.F.R. § 9.18 permitted the fees. Provided the Bank's management fee structure, including the trustee/custodian fee, meets the reasonableness standard and the Bank complies with appropriate disclosure requirements, the Bank can proceed with its proposal. Although OCC has reviewed the ability of national banks to charge different classes of management fees and accept fees from other than the CIF participants and plans under the old quantitative test, those former precedents support the position that a national bank may also do so under the current reasonableness standard. Indeed, the Bank's ability to charge different management fees based on employer fee payments, previously negotiated fees, and services the Bank provides to participants, furthers the OCC's goal of updating the operating standards for national banks fiduciary activities, as envisioned by the OCC when drafting the new Part 9. In addition, allowing the Bank to offer CIF units incorporating the proposed fee structure will enable the Bank to offer an investment product that can effectively compete with other investment alternatives, including similarly structured mutual funds.
(21) Equally important, the Bank's proposed fee structure enables the Bank to establish one CIF that offers a variety of fee options as opposed to multiple CIFs that accomplish that same result, saving the Bank the expense associated with establishing and administering numerous CIFs. Therefore, consistent with the OCC's desire to provide sufficient

protections for Bank's fiduciary customers, the Bank may charge the proposed CIF management fees to CIF participants if, based on the relevant facts and supported by a well reasoned opinion of trust counsel, the Bank concludes that: (1) the fees are reasonable; (2) applicable law permits the fees (and the bank complies with fee disclosure requirements, if any) in the state where the Bank maintains the fund; (3) the amount of the fees do not exceed an amount commensurate with the value of legitimate services of tangible benefit to the participating fiduciary accounts that would not have been provided to accounts were they not invested in the fund; (4) the management fees to be charged to the fund and to participating accounts are disclosed in the Bank's written plan; and (5) the Bank discloses the management fees, along with other fees and expenses charged to the plan, at least annually in a manner consistent with applicable law in the state where the Bank maintains the CIF.Finally, 12 C.F.R. § 9.18(b)(3) requires that all participating accounts in a CIF have a proportionate interest in all of the CIF's assets. Under the Bank's proposal, the value of the [ ] units will vary depending, in part, on the services the Bank provides in connection with the units. Under the Bank's proposal, the Bank will subtract all fees from the value of a participant's [ ] units so that the unit value of units held by plan participants that incur the full service fees will be lower than the unit value of units subject to base service fees and no service fees, and the unit value of units subject to base service fees will be lower than the unit value of units subject to no service fees. The Bank will provide participants buying full service units with more units for the same dollar investment as participants buying base service units or no service fee units and participants buying base service units will receive more units than participants purchasing no service fee units. Under these circumstances, the Bank's increase in the number of units provided to purchasers of full service units over base service units and to purchasers of base service units over no fee units permits all unit purchasers to

retain a proportionate interest in [ ]'s assets. Despite the fact that the value of the units will vary due to the different fund management fees, each [ ] participant will have a proportionate interest in [ ]'s underlying assets as required under 12 C.F.R. §9.18(b)(3).

III. Conclusion

Based on the representations made by the Bank, the Bank may charge different management fees to FCCIF participants, commensurate with the amount and types of services it provides to the participants, where the fees meet the requirements of the reasonableness standard of 12C.F.R. § 9.18(b)(9) and each participant retains a proportionate interest in [ ]'s underlying assets as required by 12 C.F.R. § 9.18(b)(3).

I trust this letter responds to your inquiry. If you have any further questions, please contact Tena M. Alexander, a Senior Attorney with the Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

/s/

Dean E. Miller

Senior Advisor for Fiduciary Activities

Footnotes

(1) One of the Bank's investment objectives will be to keep the [ ] units at a constant unit value to avoid administering fractional shares and for ease of transfer.

(2) Although any defined benefit or defined contribution plan may invest in [ ], the Bank anticipates that the primary source of growth for the [ ] will come from 401(k)defined benefit plans in which the sponsor may select [ ] as one of several investment alternatives available to participants under the plan and in which the investments are participant-directed.

(3) [ ] could rebate the payments. The Bank, however, believes that a rebate procedure would unnecessarily add to the administrative structure and expenses of [ ], and be cumbersome, costly, and confusing to participants.

(4) The Bank's fee proposal would allow both small and large plans to benefit. While some bond and equity mutual funds allow only the largest plans ($100 million or more) to

purchase their institutional shares, the Bank would allow plans to participate in [ ] regardless of size, similar to certain other GIC commingled funds and institutional money market mutual funds.

(5) 12 C.F.R. § 9.18(a).

(6) See OCC Interpretive Letter No. 716 (December 21, 1996), *reprinted in* [1995-1996 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 81-031; OCC Trust Interpretive Letter No.173 (August 31, 1988), *reprinted in* [1987-1988 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,940; OCC Trust Interpretive Letter No. 128 (November 17, 1987).

(7) *See* OCC Interpretive Letter No. 716, *supra*.

(8) *See* OCC Trust Interpretation No. 194 (January 13, 1989), *reprinted in* [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,961.

(9) *See* 12 C.F.R. § 9.18 (1997). Part 9, including 12 C.F.R. § 9.18, was amended effective January 29, 1997. 61 *Fed. Reg*. 68,543 (1996). The fiduciary precedents and trust interpretive letters preceding the January 29, 1997 effective date of 12 C.F.R. Part 9 are interpretations of the former regulation. Even so, those precedents and interpretations can still be persuasive in interpreting the language in the new Part 9. Furthermore, in many instances the precedents and interpretations have become industry practice or simply articulate sound fiduciary principles. *See* OCC Bulletin 97-22 (May 15, 1997).

(10) Banks may charge "management" fees for any services that assist the bank in fulfilling its management role. *See* Investment Securities Letter No. 48 (May 3, 1990) ,

reprinted in [1990-1991 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,261. The reasonableness of a fee depends in part on the services obtained for the fee. *See* OCC

Interpretive Letter No. 722 (March 12, 1996), *reprinted in* [1995-1996 Transfer Binder] Fed.Banking L. Rep. (CCH) ¶ 81-031.

(11) The OCC's regulation on CIF management fees provides:

Management fees. A bank administering a collective investment fund may charge a reasonable fund management fee only if: (i) The fee is permitted under applicable law

(and complies with fee disclosure requirements, if any) in the state in which the bank maintains the fund; and (ii) The amount of the fee does not exceed an amount

commensurate with the value of legitimate services of tangible benefit to the participating fiduciary account that would not have been provided to the accounts were

they not invested in the fund. 12 C.F.R. § 9.18(b)(9)(i) and (ii) (1997).

(12) National banks are required to establish and maintain each CIF in accordance with a written plan approved by a resolution of the bank's board of directors or by a committee authorized by the bank's board of directors. 12 C.F.R. § 9.18(b)(1)(iii).

(13) 12 C.F.R. § 9.18(b)(6)(ii). Alternatively, if the Bank concludes that the proposed management fees do not conform with the overall reasonableness standard in Part 9, the Bank must request an exemption to Part 9 management fee requirements, by submitting to the OCC a written plan that identifies: (i) The reasons that the CIF requires a special exemption; (ii) The provisions of the proposed CIF that are inconsistent with 12 C.F.R. § 9.18; (iii) The provisions of 12 C.F.R. § 9.18 for which the bank seeks an exemption; and the manner in which the proposed CIF addresses the rights and interest of participating accounts; and (v) The manner in which the proposed fund addresses the rights and interests of the participating accounts. The OCC will grant the Bank an exemption if the written proposal is consistent with the Bank's fiduciary duties and with safe and sound banking practices.

(14) 12 C.F.R. § 9.18(b)(12) (1996).

(15) 12 C.F.R. § 9.18(b)(12) (1996).

(16) *See* 61 *Fed. Reg.* 68,543, 68,550 (1996).

(17) *See* OCC Trust and Securities Letter No. 300 (April 26, 1984), *reprinted in* [1985-1987 Transfer Binder] (CCH) ¶ 85,470.

(18) OCC Trust and Securities Letter No. 300, *supra*.

(19) The Bank reduced its management fees when it rebated a portion of its management fee to purchase additional fund units for its large dollar CIF participants. OCC Trust and Securities Letter No. 300, *supra*.

(20) *See* OCC Interpretive Letter No. 722, *supra.*

(21) A mutual fund may issue multiple class shares under Rule18f-3 of the Investment Company Act of 1940. 12 C.F.R. § 270.18f-3.

SEC Interpretations and regulations dealing with collective investment funds (CIFs):

Recaps of various SEC positions

Revised as of March 1994

Exclusive Management

Investment Advisor, Unaffiliated . Bank proposes to contract with an outside investment advisor for two CIFs. The bank's investment and securities committee will meet biweekly to review the advisor's recommendations and ensure they are in compliance with the bank's investment policies. The Advisor may not effect transactions; the bank will select brokers and place investment orders. The committee will also monitor investments on at least a monthly basis. SEC responds that CIF exemptions under Section 3(a)(2) of the Securities Act of 1933, Section 3(a)(12) of the Securities Exchange Act of 1934 and Section 3(c)(11) of the Investment Company Act of 1940 will be available under such an arrangement. 2-12-88 No-Action Letter to Citytrust, Bridgeport, CT. Also note 1980 SEC Release 33-6188.

Permissible Participating Accounts

Funeral Trusts . CIF exemptions under Section 3(a)(2) of the Securities Act of 1933, Section 3(a)(12) of the Securities Exchange Act of 1934 and Section 3(c)(3) of the Investment Company Act of 1940 will be available if assets of funeral trusts are invested in CIF. 9-5-90 No-Action Letter to Fleet National Bank, Providence, RI.

Rabbi Trusts . CIF exemptions under Section 3(a)(2) of the Securities Act of 1933, Section 3(a)(12) of the Securities Exchange Act of 1934 and Section 3(c)(3) of the Investment Company Act of 1940 will *not* be available if assets of rabbi trusts are invested in CIF. 8-17-94 No-Action Letter to Boatmen's Trust Company, St. Louis, MO.

Investment in Other CIFs

Affiliates, Out-of-State . Trust accounts and CIFs of a Michigan bank may invest in CIFs operated by Illinois banks owned by the same multi-bank holding company without the loss of CIF exemptions under Section 3(a)(2) and Rule 132 of the Securities Act of 1933, Sections 3(a)(12) and (12)(G)(2)(H) and Rules 3a12-6 and 12h-1 of the Securities Exchange Act of 1934 and Sections 3(c)(3) and 3(c)(11) and Rule 3c-4 of the Investment Company Act of 1940. 7-25-89 No-Action Letter to Old Kent Financial Corporation, Grand Rapids, MI.

Sponsorship of CIFs

Non-insured Trust Companies . A non-insured trust company, unaffiliated with any insured bank or bank holding company, was chartered under the banking laws of a state. The SEC indicated that it may operate common trust funds without violating the registration requirements of federal securities laws. 4-20-89 No-Action Letter to Trust Company of Knoxville, Knoxville, TN. [Also see Section 581, Internal Revenue Code.]

Collective Investment Funds
SEC Letter of Admonishment

Recap
IRA Accounts in CIFs IRA Accounts may not participate in a collective investment fund unless the CIF is registered with the SEC as a security and as a mutual fund.

United States

Securities and Exchange Commission

Washington, D.C. 20549

Office of Compliance

Inspections and

Examinations

March 1, 1996

Board of Directors

-- Bank

Post Office Box --

--, --

Members of the Board:

It has come to our attention that Individual Retirement Accounts ("IRAs") are invested in interests in Collective Investment Funds ("CIF") which are described as publicly offered and administered by -- Bank ("Bank"). This practice appears to violate both the Securities Act of 1933 ("1933 Act") and the Investment Company Act of 1940 ("1940 Act") to the extent the CIFs are being publicly offered and interests in them are held by more than 100 investors.

A pooled securities fund in which interests are offered to the public as investments, is an investment company as defined in Section 3(a) of the 1940 Act and, absent an exclusion or exemption from registration, are subject to the registration and substantive requirements of the 1940 Act. Section 3(c) provides certain exclusions from this definition. These exclusions do not appear to be available, however, to a CIF when IRAs invest in the publicly offered interests of the CIF.

Specifically, while Section 3(c)(3) of the 1940 Act excludes bank common trust funds from the definition of an investment company, the Commission and its staff have interpreted this exclusion narrowly. The exclusion offered by Section 3(c) (3) has been interpreted as only applying to a common trust fund where a bank has received monies for bona fide fiduciary purposes and the fund is not offered to the public.[1] The staff has further stated that the Section 3(c)(3) exclusion is not available where a fund is operated as an investment service to IRA customers and not iii a manner incidental to the performance of its traditional trust activities.[2] [3]

Similarly, Section 3(c)(11) of the 1940 Act provides that a collective trust fund maintained by a bank consisting solely of the assets of employee benefit plan trusts qualified under Section 401 of the Internal Revenue Code and government plans is not an investment company. Because IRAs are not qualified under Section 401 of the Internal Revenue Code, however, and IRA assets are invested in the CIFs, the CIFs would not meet the requirements of Section 3(c)(11). In addition, based on the information provided to us, the interests in the CIFs were publicly offered. As a result, the CIFs also would not meet the conditions of Section 3(c)(1) of the 1940 Act, which excludes from the definition of investment company issuers that have less than 100 beneficial owners **and** which have not and are not making a public

offering of their securities. Thus, a publicly offered common trust fund which pools assets of IRAs, alone or with bona fide trust assets, would be subject to registration and regulation under the 1940 Act and interests in the fund would be subject to the registration provisions of the 1933 Act.

The Commission recently settled enforcement proceedings where IRA accounts invested in publicly offered common trust funds operated without registration of the funds or the interests therein.[4] In anticipation of an administrative proceeding charging the bank with willfully violating Sections 5(a) and (c) of the 1933 Act and Section 34(b) of the 1940 Act and causing violations by the common trust fund of Sections 7(a), 22(c), 22(e) and 24(b) of the 1940 Act and Rule 22c-1 thereunder, the bank consented to a Commission order requiring it to cease and desist from committing or causing any violation or future violations of such provisions of the 1933 Act and the 1940 Act and imposing other sanctions.

It is our understanding that you have been notified either to withdraw IRA assets from the CIFs that the Bank administers or register the CIFs, and the interests therein, under the 1933 and 1940 Acts. It is our further understanding that the Bank has terminated its CIF for IRAs. Please be advised that continuation or renewal of the IRA asset investment practices discussed in this letter will result in our taking appropriate regulatory action.

If you have any questions or concerns regarding this matter, please feel free to contact me at (202) 942-0540.

Sincerely,

Gene A. Gohlke

Associate Director

- Footnotes -

1. See, e.g., Santa Barbara Bank & Trust (pub. avail. November 1991); Union Bank & Trust (pub. avail. July 8, 1987); Owensboro National Bank (pub. avail. July 29, 1981); Citytrust (pub. avail. Mar. 9, 1980); Howard Savings Bank (pub. avail. Aug. 13, 1979) Genessee Merchants Bank & Trust (pub. avail. Jan. 8, 1979).

2. See Commercial Bank (pub. avail. Feb. 24, 1988), *reconsideration denied* (pub. avail. July 13, 1988), *Commission review* denied (pub. avail. Jan. 11, 1989).

3. Santa Barbara Bank & Trust, supra.

4. In re The Commercial Bank and Marvin C. Abeene, 1940 Act Rel. No. 20757 (Dec. 6, 1994).

Collective Investment Funds

SEC Administrative Proceedings Order

Recap
IRA Accounts in CIFs IRA Accounts may not participate in a collective investment fund unless the CIF is registered with the SEC as a security and as a mutual fund.

United States

Securities and Exchange Commission

Washington, D.C. 20549

For immediate release 94-170

Administrative proceedings against the commercial bank and Marvin Abeene

Washington, D.C., December 7, 1994 -- The Securities and Exchange Commission today announced the institution of public administrative proceedings as to The Commercial Bank of Salem, Oregon ("Commercial") and Marvin C. Abeene, a senior vice-president at Commercial.

The Commission's Order finds that Commercial violated, or caused violations of, the registration provisions of the Securities Act of 1933 and the Investment Company Act of 1940 and the reporting, pricing and other provisions of the Investment Company Act in connection with its operation of a fund currently known as the "Common Trust Fund R of The Commercial Bank Combined Capital Trust (Individual Retirement Account Fund)" (the "IRA Fund"). The Order also finds that Abeene aided and abetted and caused these violations.

According to the Order, Commercial's Trust Department created the IRA Fund as an investment vehicle for customers seeking investment opportunities for their individual retirement accounts. The IRA Fund invests in stock, bonds and cash instruments. In late 1987, Commercial sought no-action relief from the staff of the Commission's Division of Investment Management regarding whether it could operate the IRA Fund without registering it and the interests therein pursuant to the Investment Company Act and the Securities Act. After being denied no-action relief, Commercial continued to operate the IRA Fund without registration under the federal securities laws and offered and sold interests in the IRA Fund to the public. In April 1993, Commercial filed an initial registration statement for the IRA Fund with the Commission. Abeene was the Commercial officer primarily responsible for overseeing the operation of the IRA Fund, including compliance with applicable regulations.

The Order finds that, in addition to failing to register the IRA Fund and the interests therein, Commercial offered and sold interests in the IRA-Fund to the public by means of materially misleading sales brochures and other materials. These materials were misleading because, among other things, they failed to disclose that investments in the IRA Fund were not subject to federal deposit insurance. Some of the investors in the IRA Fund were under the impression that their investments were federally insured because their accounts were with a bank. The Order also finds that commercial caused, and Abeene aided and abetted and caused, violations of the reporting, pricing and redemption provisions of the Investment Company Act.

The Order orders Commercial and Abeene to cease and desist from violating or causing violations of Sections 5(a) and (c) of the Securities Act and Sections 7(a), 22(c), 22(e), 24(b) and 34(b) of the Investment Company Act and Rule 22c-I thereunder. It also imposes a civil penalty on Commercial in the amount of $75,000 and suspends Abeene from association with any broker, dealer, municipal securities dealer, investment adviser or investment company for a period of six months. Pursuant to the Order, Commercial must retain an independent consultant to, among other things, conduct a review of the policies and procedures of Commercial with respect to its investment company operations, including the operation of the IRA Fund, and recommend policies and procedures, to be adopted by Commercial, designed to prevent and detect violations of the federal securities laws.

Commercial and Abeene, without admitting or denying the findings specified therein, have each consented to the entry of the Order and the above-referenced sanctions.

United States of America

Before the

Securities and Exchange Commission

Securities Act of 1933

Release No. 7116 / December 6, 1994

Investment Company Act of 1940

Release No. 20757 December 6, 1994

Administrative Proceedings

File No. 3-8567

: Order Instituting

: Public Proceedings

: Pursuant to Section 8A

in the Matter of : of the securities

: ACT OF 1933 AND

The Commercial Bank and : Sections 9(b) and 9(f)

Marvin C. Abeene : of the investment

: Company Act of 1940,

Respondents. : Imposing Remedial

: Sanctions and ordering

: Respondents to

: cease and desist

I.

The Commission deems it appropriate and in the public interest that proceedings be, and they hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") to determine whether The Commercial Bank ("Commercial" or "Bank") willfully violated Sections 5 (a) and (a) of the Securities Act and Section 34 (b) of the Investment Company Act and caused violations by the "Common Trust Fund R of The Commercial Bank Combined Capital Trust (Individual Retirement Account Fund)" (the "IRA Fund") of Sections 7(a), 22(c), 22(e) and 24(b) of the Investment Company Act and Rule 22c-I thereunder; and whether Marvin C. Abeene ("Abeene") willfully aided and abetted and caused Commercial's and the IRA Fund's violations.

II

In anticipation of the institution of these proceedings, Respondents Commercial and Abeene have each submitted an Offer of Settlement which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission or to which the commission is a party, prior to a hearing pursuant to the Commission's Rules of Practice, 17 C.F.R. § 201.1 *et seq.*, Respondents Commercial and Abeene, without admitting or denying the findings set forth herein, except that Respondents admit the jurisdiction of the Commission over them and over the subject matter of these proceedings, each consent to the issuance of this Order Instituting Public Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 9(b) and 9(f) of the Investment Company Act of 1940, Making Findings, Imposing Remedial Sanctions and Ordering Respondents to Cease and Desist ("Order"), and to the entry of the findings and imposition of the sanctions set forth below.

III

On the basis of this Order and Respondents' Offers of Settlement, the Commission makes the following findings:

_Respondents

A. The Commercial Bank

Commercial is a bank chartered under the laws of the State of Oregon with its main office in Salem, Oregon. Commercial provides general banking and trust services primarily to residents of Oregon. Commercial has ten branches, all of which are located in Oregon. Commercial is the larger of two wholly owned subsidiaries of Commercial Bancorp, a bank holding company and an Oregon corporation whose common stock is registered with the commission pursuant to Section 12(g) of the Securities Exchange Act of 1934.

B. Marvin C. Abeene

Abeene, age 49, is a resident of Salem, Oregon. Abeene has served as Manager of Commercial's Trust Department from 1974 through the present and currently holds the title of senior vice-president of the Bank. The Trust Department consists of approximately twelve

employees. Abeene is the Commercial officer primarily responsible for the Bank's operation of the IRA Fund which purports to be a common trust fund.

IV. Statement of facts

A. Introduction

This matter involves violations, and aiding and abetting and causing violations, of the registration, reporting, pricing and other provisions of the federal securities laws by Commercial and Abeene. These violations occurred in connection with Commercial's operation of the IRA Fund.

In addition to traditional trust services such as estate planning, Commercial's Trust Department offers accounts under its management the opportunity to invest in several common trust funds under the rubric of the Combined Capital Trust.[1] Commercial's Trust Department created the IRA Fund as an investment vehicle for customers seeking investment, opportunities for their individual retirement accounts ("IRAs")[2] In many cases, these customers' employers had established corporate retirement plans which invested their monies in one of the Trust Department's common trust funds. Based on the performance of these corporate retirement funds, these customers were seeking similar investment results for their IRAs.

Around the time of the IRA Fund's inception, Commercial sought no-action relief from the staff of the Commission's Division of Investment Management regarding whether it could operate the IRA Fund without registering it and the interests therein pursuant to the Investment Company Act and the Securities Act. After being denied no-action relief, Commercial continued to operate the IRA Fund without registration under the federal securities laws and offered and sold interests in the IRA Fund to the public.[3] Abeene was the Commercial officer primarily responsible for the Bank's request for no-action relief and the subsequent process leading to the filing of the IRA Fund's initial registration statement with the Commission, all as more fully described below.

In addition to failing to register the IRA Fund and the interests therein, Commercial offered and sold interests in the IRA Fund to the public by means of materially misleading sales brochures and other materials. These materials were misleading because, among other things, they failed to disclose that investments in the IRA Fund were not subject to federal deposit insurance.

B. Commercial's Operation of the IRA Fund

1. The Request for No-Action Relief

On December 7, 1987, Commercial wrote to the Commission's staff seeking no-action relief in order to operate the IRA Fund without registration under the Securities Act and the Investment Company Act. Commercial's letter explained that it sought to rely upon the exemptions contained in Sections 3(a)(2) and 3(a)(11) of the Securities Act[4] and Section 3(c)(3) of the Investment Company Act.[5] The letter stated that the Bank was seeking to offer and sell interests in the IRA Fund to certain customers of the Trust Department who had IRAs funded by rollover distributions.

The staff of the Division of Investment Management wrote to Commercial on January 25, 1988, refusing to grant no-action relief. Commercial requested a reconsideration of the refusal and, on July 13, 1988, the staff affirmed its original response. On August 25, 1988, Commercial appealed the staff's decision. On January 11, 1989, the staff informed the Bank that the Commission had exercised its discretion to decline to review the staff's position and declined to issue an informal statement on the matter. See Commercial Bank (pub. avail. Feb. 24, 1988) (initial denial of no-action relief); Commercial-Bank (pub. avail. July 13, 1988) (Commercial Bank's appeal; staff's refusal to reconsider initial denial); and Commercial Bank Appeal (pub. avail. Jan. II, 1989) (Commission declined to review staff's position or to issue informal statement).

The staff's refusal to grant Commercial no action relief was based primarily on its position that the exemptions contained in Section 3(a)(2) of the Securities Act and Section 3(c)(3) of the Investment Company Act apply only to a common trust fund which is operated for the

administrative convenience of a bank in a manner incidental to the bank's traditional trust department activities and not where the fund is established as an investment vehicle for individual members of the public. The staff determined that commercial operated the IRA Fund primarily as an investment service to its IRA customers and not in a manner incidental to the performance of its traditional trust activities on behalf of Trust Department customers.[6] In addition, the staff determined that the exemptions are only available if the common trust fund holds funds from individual trust accounts created by customers for bona fide fiduciary purposes, and the staff concluded that this was not the case as to the IRA Fund.[7]

Despite the staff's refusal to grant no-action relief, Commercial continued to operate the IRA Fund on an unregistered basis from January 10, 1989 through October 1993.[8] During this period, the Bank took steps in preparation for registration of the IRA Fund.[9] On April 6, 1993, Commercial filed a Form N-IA registration statement with the Commission for registration of the IRA Fund and its securities under both the Investment Company Act and the Securities Act.

During the period in which the Bank has operated the IRA Fund, the profile of investors in the fund changed significantly. The initial investors in the IRA Fund consisted of individuals who already had either a personal trust account with the Trust Department, e.g., a living trust, or whose employers maintained a corporate retirement or pension account with the Trust Department. Sometime after 1987, and possibly as early as 1988, the Trust Department began to allow investments in the IRA Fund by individuals with no such prior relationship with the Trust Department. As of October 1993, at least twenty-five percent of the investors in the IRA Fund had no relationship with the Trust Department apart from their accounts in the IRA Fund.

1. Commercial's omissions in its Disclosure to Investors Regarding The IRA Fund

In sales brochures provided to prospective investors in the IRA Fund, the Bank did not disclose that an investment in the fund was not subject to federal deposit insurance. The Trust Department did not have a policy or practice of informing Trust Department customers that an investment in the IRA Fund was not federally insured.[10] Some of the sales brochures which contained performance information about the IRA Fund also omitted disclosure indicating that information regarding the IRA Fund's past performance was no indication of its future performance and that both the investment return and principal value of an investment in the fund may fluctuate.

3. Calculation of the IRA Fund's Net Asset Value

Commercial calculated the IRA Fund's net asset value ("NAV") on a monthly basis only. Because it was the Trust Department's procedure to calculate the IRA fund's NAV on a monthly basis, any purchases, redemptions or withdrawals by investors in the fund that were received by the fund on any day that the fund did not calculate its NAV would not have been priced with an appropriate NAV.

V. Legal Discussion

A. Commercial Caused and Abeene Aided and Abetted And Caused

Violations of Section 7(a) of the Investment Company Act

Section 7(a) of the Investment Company Act prohibits an investment company that has a board of directors[11] from offering or selling any security unless the investment company is registered under Section 8 of the Investment Company Act. The IRA Fund meets the definition of an investment company under both Section 3(a)(1) and Section 3(a)(3) of the Investment Company Act because: (1) it is and has been primarily engaged in the business of investing in securities; and (2) more than forty percent of its assets were and are invested in investment securities. *See* Sections 3(a)(1) and (3) of the Investment Company Act.

The IRA Fund does not qualify for the exclusion under Section 3(c)(3) of the Investment Company Act for "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in

its capacity as a trustee, executor, administrator, or guardian." This exclusion does not apply to the IRA Fund because Commercial offered the IRA Fund primarily as an investment service to its customers, and not in a manner incidental to the performance of its traditional trust activities on behalf of Trust Department customers. In addition, the change in the profile of the IRA Fund's investors supports the argument that, assuming *arguendo* that the operation of the IRA Fund was initially incidental to the trust services offered by the Trust Department to its customers, the fund, at some subsequent time, clearly became ineligible for the section 3(c)(3) exclusion.

Thus, because Commercial, through its Trust Department, sold interests in the IRA Fund to its customers between January 1987 through October 1993 while the IRA Fund was not registered as an investment company, Commercial caused violations of Section 7(a).

Abeene was the central figure in creating and then managing the IRA Fund on behalf of Commercial. He assumed responsibility for ensuring that the operation of the IRA Fund complied with the federal securities laws and knew that the Commission would require the fund and the interests therein be registered with the commission before interests therein could be offered or sold. As a result, Abeene willfully aided and abetted and caused violations of Section 7(a).

B. Commercial Violated Sections 5(a) and (c) of the Securities Act, and Abeene Aided and Abetted And Caused Commercial's Violations of Section 5 In Connection With Offers and Sales of Unregistered Interests in the IRA Fund

Section 5 of the Securities Act prohibits, among other things, the offer and sale of a security unless a registration statement is in effect for such security. See Sections 5(a) and (e) of the Securities Act. The interests in the IRA Fund offered to, and purchased by, Commercial's customers constitute "securities" as defined under Section 2(1) of the Securities Act. The interests in the IRA Fund do not qualify for the exemption under Section 3(a)(2) of the Securities Act because Commercial offered the IRA Fund primarily as an investment service to its customers.[12] Because the IRA Fund did not have a registration statement in effect, or filed with the Commission, between January 1987 through October 1993, Commercial willfully Violated Sections 5(a) and (c) of the Securities Act.

Abeene was responsible for Commercial's operation of the IRA Fund and the filing of the IRA Fund's initial registration statement in a timely manner. As a result of his conduct, Abeene willfully aided and abetted and caused Commercial's violations of Sections 5(a) and (c) of the Securities Act.

C. Commercial Violated Section 34(b) of the Investment Company Act, and Abeene Aided and Abetted and Caused Commercial's Violations, by Omitting

Certain Material Facts from the IRA Fund's Sales-Materials[13]

Section 34(b) of the Investment Company Act prohibits the making of any untrue statement of a material fact in, among other things, any document the keeping of which is required pursuant to Section 31(a) of the Act. Rule 31a-2(a)(3), promulgated under Section 31(a) of the Investment Company Act, requires registered investment companies to "[p]reserve for a period not less than 6 years from the end of the fiscal year last used . . . any advertisement, pamphlet, circular, form letter or other sales literature addressed to or intended for distribution to prospective investors." The "keeping" of documents required pursuant to Section 31(a) encompasses those documents, such as advertisements and other sales literature, which an investment company must "preserve" pursuant to Rule 31a-2(a)(3). Thus, Rule 31a-2(a)(3) of the Investment Company Act required Commercial to "Preserve" its sales brochures, and Section 34(b) of the Act applied to the sales brochures.

Commercial used certain sales brochures describing the IRA Fund in presentations to prospective investors. These materials, which qualify as sales literature under Rule 31a-2(a)(3), omitted to state that an investment in the IRA Fund was not federally insured. Commercial employees, under Abeene's supervision, did not necessarily correct this omission in oral presentations to certain prospective investors. Commercial did not have a practice of informing prospective investors in the IRA Fund that an investment in the fund was not federally insured. Some of the investors in the IRA Fund were under the impression that their investments were federally insured because their accounts were with a bank. Such information is material because an investor's decision whether or not to make a

particular investment will depend to a significant extent on the safety of the investment. In addition, certain sales materials used by Commercial disclosed historical investment results for the IRA Fund. The materials failed to include a legend disclosing that (1) this performance data represented past performance of the IRA Fund; (2) such investment returns and the principal value of an investment in the IRA Fund may vary; and (3) upon redemption, an investment may be worth more or less than the original cost of the investment. Commercial's failure to include these caveats in these sales materials resulted in a material omission. See Rule 482(a)(6) under the Securities Act; Rule 34b-I under the Investment Company Act. As a result, Commercial willfully violated section 34(b) of the Investment Company Act.

Abeene generally oversaw the drafting and production of the sales brochures which discussed the IRA Fund. He also reviewed several versions of the sales brochures before they were used in presentations with Trust Department customers. After the law firm suggested to Abeene that written disclosure as to lack of federal deposit insurance should be provided to Trust Department customers, Abeene failed to require that Trust Department employees provide such disclosure for investors in the IRA Fund until the fall of 1993. As a result, Abeene willfully aided and abetted and caused Commercial's violations of Section 34(b) of the Investment Company Act.

D. Commercial Caused and Abeene Aided and Abetted and Caused Violations of Section 24(b) of the Investment Company Act By Failing To File Certain Sales Materials

Section 24(b) of the Investment Company Act makes it unlawful for any registered open-end company, in connection with a public offering of any security of which such company is an issuer, to transmit, among other things, sales literature addressed to or intended for distribution to prospective investors unless the sales literature is filed with the Commission. The IRA Fund qualifies an "open-end company" and Commercial failed to file the sales literature with the commission which was transmitted by Commercial to prospective investors in the IRA Fund. For the reasons stated above, Commercial caused and Abeene willfully aided and abetted and caused violations of Section 24(h) of the Investment Company Act.

E. Commercial Caused and Abeene Aided and Abetted and Caused Violations of Sections 22(c) and 22(e) of the Investment Company Act and Rule 22c-I Promulgated Under Section 22(c) of the Act

Rule 22c-I(a) under the Investment Company Act requires a registered investment company to sell, redeem or repurchase the redeemable securities which it issues at a price based on the current net asset value of the security. The net asset value of the security generally must be computed no less frequently than once daily except on, among others, any day on which no security is tendered for redemption and on which no order to purchase or sell such security is received by the investment company.

Commercial calculated the IRA Fund's NAV on a monthly basis only. As a result, any purchases, redemptions or withdrawals by investors in the IRA Fund that were received by the fund on any day that the fund did not calculate its NAV would not have been priced with an appropriate NAV. As a result, Commercial caused and Abeene willfully aided and abetted and caused violations of Section 22(c) of the Investment company Act and Rule 22c-I thereunder.

Section 22(e) of the Investment company Act generally prohibits any registered investment company from suspending the right of redemption, or Postponing the date of payment or satisfaction upon redemption of any redeemable security for more than seven days after the tender of such security to the company. The Trust Department's practice for redemptions was as follows: if an investor in the IRA Fund sought to redeem his investment in the beginning or middle of the month, the valuation of the redemption would not occur until the end of that month, and the investor would not receive the redemption proceeds until after the valuation took place. Therefore, Commercial failed to satisfy redemption requests within seven days of investors' requests for redemption. As a result, commercial caused and Abeene willfully aided and abetted and caused violations of Section 22(e) of the Investment Company Act.

VI.Findings

Based on the foregoing, the Commission finds that:

A. Commercial willfully violated Sections 5(a) and (c) of the Securities Act and Section 34(b) of the Investment Company Act;

B. Abeene willfully aided and abetted and caused Commercial's violations of Sections 5(a) and (c) of the Securities Act and Section 34(b) of the Investment Company Act;

C. Commercial caused violations of Sections 7(a), 22(c), 22(e) and 24(b) of the Investment Company Act and Rule 22c-I thereunder; and

D. Abeene willfully aided and abetted and caused violations of Sections 7(a), 22(c), 22(e) and 24(b) of the Investment Company Act and Rule 22c-I thereunder.

VII. Order

In view of the foregoing, the Commission deems it appropriate and in the public interest to accept the Respondents' Offers of Settlement, and impose the sanctions specified therein.

Accordingly, the Commission ORDERS that:

A. Commercial cease and desist from committing or causing any violation, and from committing or causing any future violation, of Sections 5(a) and (c) of the Securities Act and Sections 7(a), 22(c), 22(e), 24(b) and 34(b) of the Investment Company Act and Rule 22c-I thereunder;

B. Commercial shall, within ten days of the issuance of this Order, pursuant to Section 9(d)(1) of the Investment Company Act, pay a civil money penalty in the amount of $75,000 to the United States Treasury. Such payment shall be (1) made by United States postal money order, certified check, bank cashier's cheek or bank money order; (2) made payable to the Securities and Exchange Commission; (3) hand-delivered to the Comptroller, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549; and (4) submitted under cover letter which identifies Commercial as a Respondent in these proceedings, the file number of these proceedings (3-_) and the Commission case number (HO-2816), a copy of which cover letter and form of payment shall be sent to Gary N. Sundick, Associate Director, Division of Enforcement, Securities and Exchange Commission, Mailstop 4-1, 450 Fifth Street, N.W., Washington, D.C. 20549; and

C. Commercial comply with its undertakings to:

1. retain; at Commercial's expense, an Independent Consultant ("Consultant"), not unacceptable to the Commission's staff, within 30 days of the date of this Order and for a period of time which Commercial and the Consultant reasonably agree to be necessary to, among other things: (1) conduct a comprehensive review of the policies and procedures of Commercial with respect to investment company operations, including, but not limited to, the operation of the IRA Fund since its inception, (2) recommend policies and procedures designed reasonably to prevent and detect violations of the federal securities laws, including, but not limited to, the violations alleged in this order, and (3) prepare a written report to Commercial's board of directors of its findings and recommendations. Such recommended policies and procedures shall include, but not be limited to, training programs, manuals and other measures reasonably designed to ensure that Commercial employees, officers and agents understand and are capable of performing their obligations and responsibilities with respect to investment company operations consistent with the requirements of the federal securities laws;

2. adopt and implement, by no later than 30 days after receipt of the report, such policies and procedures as recommended by the Consultant which Commercial reasonably determines do not constitute an undue burden on Commercial;

3. retain the Consultant (or another Independent Consultant not unacceptable to the Commission's staff) on or about the one year anniversary of the

Consultant's completion of its report, to conduct a review of Commercial's implementation of the policies and procedures recommended by the Consultant, to make additional recommendations as necessary and to prepare a written report to Commercial's board of directors of its findings and recommendations;

4. authorize the Consultant(s) to promptly provide copies of the written reports referenced above to the Commission's staff of the Divisions of Enforcement and of Investment Management and to discuss the findings therein with the Commission's staff;

5. authorize the Consultant(s) to promptly report to the Commission's staff: (1) any failure by Commercial to comply with this Order and (2) any violations of the federal securities laws by Commercial which the Consultant(s) may discover in the course of its engagement;

6. cooperate fully with the Consultant(s); and

7. retain a successor Consultant, not unacceptable to the Commission's staff, within 30 days, if the Consultant resigns or is otherwise unable to serve. All provisions in the Order that apply to the Consultant shall apply to any successor Consultant.

The Commission also Orders that:

A. Abeene cease and desist from committing or causing any violation, and from committing or causing any future violation, of Sections 5(a) and (c) of the Securities Act and Sections 7(a), 22(C), 22(e), 24(b) and 34(b) of the Investment Company Act and Rule 22c-I thereunder;

B. Effective on the second Monday following the date of this order, Abeene be, and hereby is, suspended from association with any broker, dealer, municipal securities dealer, investment adviser or investment company for a period of six months; and

C. Abeene shall deliver an affidavit of compliance to the Commission within ten days following his period of suspension stating that he has complied with the terms of the suspension.

By the commission.

Jonathan G. Katz

Secretary

1 Each of the common trust funds pools for collective investment monies contributed by its investors. For example, investments in the common trust funds are offered to Keogh accounts and corporate retirement plans.

2 The fund is a balanced fund consisting of investments in stocks, bonds and cash. The market value of the IRA Fund increased from approximately $846,000 as of December 31, 1987 to $12.6 million as of December 31, 1993. Currently, there are approximately 200 accounts in the IRA Fund.

Commercial is the principal underwriter for the IRA Fund as that term is defined in Section 2(a)(29) of the Investment Company Act.

3 In April 1993, Commercial filed with the Commission a registration statement, seeking to register the IRA Fund and the interests therein. As of the date of this order, the IRA Fund's registration is still pending.

4 Section 3(a)(2) exempts from the Securities Act:

[A)ny interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian....

Section 3(a)(11) exempts from the Securities Act any security sold wholly intrastate where an issue is sold

only to persons resident within a single State and where the issuer in a resident of such State.

5 Section 3(c)(3) of the Investment Company Act excludes from the definition of investment company "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."

6 Initial investors in the IRA Fund were attracted to the Trust Department because of its investment services. For example, in the sales brochures used in presentations to potential investors, the Trust Department emphasized the "professional investment management" being offered and the "consistently superior investment results" achieved by the Bank's other common trust funds and the investment adviser to those funds and to the IRA Fund.

7 In response to Commercial's request for reconsideration of the staff's position, the staff noted that bona fide fiduciary purposes include those situations in which a bank is providing traditional estate planning and other fiduciary services, but not primarily money management.

8 The IRA Fund ceased accepting new accounts for investment in the IRA Fund, as well as additional deposits to existing accounts, as of October 1, 1993 in response to the staff's inquiries into the unregistered operation of the IRA Fund.

9 Commercial engaged a law firm to assist it in the registration of the IRA Fund (the "law firm"). The law firm considered the availability of other exemptions under the federal securities laws and, in July 1989, without opining on the correctness of the Commission's staff position, advised Commercial that the Bank had no other alternative but to register the IRA Fund with the Commission.

In November 1992, approximately six months prior to the filing of the IRA Fund's initial registration Statement, the law firm communicated its concerns to Commercial that "there may have been an inadequate appreciation [on Commercial's part] of the serious risks involved in the continuing operation of the [IRA Fund] without registration."

10 During the time period relevant to this Order, the Trust Department never directed its employees to disclose to potential investors in the IRA Fund that their investments in the fund were not federally insured. The Trust Department did not direct its employees to provide such disclosure until the fall of 1993, despite explicit suggestions from the law firm that such disclosure would be required for the IRA Fund's sales brochures.

11 Commercial's Trust Committee constitutes the IRA Fund's board of directors for purposes of Section 7(a) of the Investment Company Act. The Trust Committee, among other things, decided to seek no-action relief on behalf of the IRA Fund, approved the decision to hire the IRA Fund's investment adviser, and determined to register the fund with the commission.

12 In addition, Section 3 (a) (11) of the Securities Act (the "intrastate exemption") is inapplicable to securities issued by registered investment companies by virtue of Section 24(d) of the Investment Company Act. As discussed below, because the IRA Fund should have been registered with the Commission, it cannot take advantage of the intrastate exemption.

13 Several of the provisions and rules of the Investment Company Act discussed in this Order proscribe conduct by registered investment companies. However, the fact that Commercial was unlawfully operating the IRA Fund on an unregistered basis does not insulate it from the requirements of the Investment Company Act which apply to registered investment companies. *See Krome v. Merrill Lynch & Co., Inc.*, 637 F. Supp. 910, 917 n.4 (S.D.N.Y. 1986), *vacated in part*, 110 F.R.D. 693 (S.D.N.Y. 1986) ("Failure to register...does not insulate a company from the other provisions of the [Investment company Act]. To hold otherwise would subject firms who do not register to less stringent regulation than those who do register.") (citing *In re Mownsend Corp. of America*, 42 S.E.C. 282, 316-17 (1964)); *Goldman v. McMahan, Brafman, Morgan & Co.*, (1987 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 93,354 (S.D.N.Y. 1987) (holding that Section 36(b) of the Investment Company Act applies to companies which should have been, but were not, registered under the Act).

Collective Investment Funds

SEC No-Action Letter

Santa Barbara Bank and Trust

Publicly Available November 1, 1991

Fed. Sec. L. Rep. P 76,422

(Cite as: 1991 WL 243172 (S.E.C.))

Recap
IRA Accounts may not participate in a collective investment fund unless the CIF is registered with the SEC as a security and as a mutual fund.
Personal and employee benefit accounts may not be commingled in the same collective investment fund unless the CIF is registered with the SEC as a security and as a mutual fund.

Letter to SEC

June 19, 1991

Ms. Nancy M. Morris

Associate Chief Counsel

Securities and Exchange Commission

Washington, DC 20219

RE: Banks Common Trust Funds

Dear Ms. Morris:

Santa Barbara Bank & Trust is a state chartered bank and trust company located in Santa Barbara, California. We presently are operating two common trust funds exclusively for our personal trust clients. We would like to be able to commingle funds held in employee benefit accounts, both qualified plans and IRA accounts, into these personal trust funds.

Our bank's legal counsel has checked with the California Financial Codes, the Comptroller's regulations, and the Internal Revenue regulations and has not been able to find any restrictions on using our current common trust funds for employee benefit accounts. Could you please let me know if the Securities and Exchange Commission would have any restrictions or problems with the Bank commingling personal trust and employee benefit trust accounts.

Your prompt attention to this question would be greatly appreciated.

Yours very truly,

Paulette Posch

Vice President

Employee Benefits Manager

SEC Letter

1940 Act / s 3(c)(3)

November 1, 1991

Publicly Available November 1, 1991

Paulette Posch, Vice President

Santa Barbara Bank & Trust

Trust Division

820 State St.

P.O. Box 2340

Santa Barbara, CA 93120-2340

Dear Ms. Posch:

Your letter of June 19, 1991, asks whether there are any restrictions under the federal securities laws on Santa Barbara Bank & Trust (the "Bank") commingling the assets of qualified employee benefit plan accounts and individual retirement accounts ("IRAs") with the assets of personal trust accounts in its common trust funds.

A pooled securities fund in which interests are offered to the public as investments is an investment company as defined in Section 3(a) of the Investment Company Act of 1940 ("1940 Act"). Section 3(c) provides certain exclusions from this definition.

Section 3(c)(3) excludes bank common trust funds from the 1940 Act.[1] The staff has interpreted this exclusion as applying only to a common trust fund, for moneys which a bank has received for bona fide fiduciary purposes, that is not offered to the public.[2] Such a common trust fund serves as an administrative convenience of the bank incidental to its traditional trust department activities.[3]

The Commission and its staff have stated that this exception is not available for common trust funds holding assets of IRAs.[4] Thus, a common trust fund which pools assets of IRAs, alone or with bona fide trust assets, would be subject to registration and regulation under the 1940 Act and interests in the fund would be subject to the registration provisions of the Securities Act of 1933 ("1933 Act"). A number of banks have organized funds consisting exclusively of IRA assets and have registered them under the 1940 Act.

The staff further takes the position that a common trust fund that commingles the assets of employee benefit plans meeting the requirements for qualification under Section 401 of the Internal Revenue Code with Section 3(c)(3) trust assets must register under the 1940 Act, and interests in that fund must be registered under the 1933 Act.[5] The staff does not believe that the Section 3(c)(3) exclusion extends to employee benefit plan funds held by a bank as trustee because a separate provision of the 1940 Act, Section 3(c)(11), already excludes certain employee benefit plans.[6]

Section 3(c)(11) provides that a collective trust fund maintained by a bank consisting solely of the assets of employee benefit plan trusts qualified under Section 401 of the Internal Revenue Code and government plans is not an investment company. Thus, the Bank could commingle its qualified plan trusts in a collective trust fund consisting solely of assets of such trusts without registering either the fund or interests in the fund.[7] However, since IRAs are qualified under Section 408 of the Internal Revenue Code, and not Section 401, the collective trust fund would not meet the requirements of Section 3(c)(11) if it included assets of IRAs and would, therefore, be required to register as an investment company.[8] Finally, the interests in such a fund must be registered under the 1933 Act.

I hope this information will be helpful to you. Please contact this Office if you have any additional questions or concerns.

Sincerely,

Richard F. Jackson

Attorney

Office of Chief Counsel

Securities and Exchange Commission (S.E.C.)

- Footnotes -

1 Section 3(c)(3) excepts from the definition of investment company "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian." For a discussion of the legislative and administrative history with respect to common trust funds, see United Missouri Bank of Kansas City, N.A. (pub. avail. Dec. 31, 1981).

2 See, e.g., Union Bank & Trust (pub. avail. July 8, 1987); Owensboro National Bank (pub. avail. July 29, 1981); Citytrust (pub. avail. Mar. 9, 1980); Howard Savings Bank (pub. avail. Aug. 13, 1979); Genessee Merchants Bank & Trust (pub. avail. Jan. 8, 1979).

3 See Commercial Bank (pub. avail. Feb. 24, 1988), reconsideration denied (pub. avail. July 13, 1988), Commission review denied (pub. avail. Jan. 11, 1989); First National Bank of Peoria (pub. avail. Aug. 4, 1979); Millikin National Bank of Decatur (pub. avail. Mar. 31, 1979).

4 See Testimony of Richard C. Breeden Before the Subcommittee on Telecommunications & Finance of the House Committee on Energy and Commerce, Concerning Proposed Revisions to Rules Governing Bank Common Trust Funds, at n. 8 (Oct. 4, 1990) (discussing registration of common trust funds for IRA assets). See also Commercial Bank, supra note 3; Hibernia National Bank of New Orleans (pub. avail. Sept. 24, 1986); United Missouri Bank of Kansas City, N.A., supra note 1; Owensboro National Bank, supra note 2; Citytrust, supra note 2; First National Bank of Peoria, supra note 3; Millikin National Bank of Decatur, supra note 3; Continental Illinois National Bank and Trust Company of Chicago (pub. avail. Apr. 28, 1975).

5 See Millikin National Bank of Decatur, supra note 3; First National Bank of Peoria, supra note 3; National Boulevard Bank of Chicago (pub. avail. Mar. 22, 1974), reconsideration denied (pub. avail. Oct. 18, 1974).

6 See Millikin National Bank of Decatur, supra note 3; First National Bank of Peoria, supra note 3; National Boulevard Bank of Chicago, supra note 5.

7 A collective trust fund consisting solely of the assets of qualified plans, including assets of Keogh plans, is excepted by Section 3(c)(11). However, interests in a collective trust fund which includes Keogh plan assets are securities that must be registered under the 1933 Act unless the plan meets the requirements of Rule 180 thereunder.

8 See, e.g., United Missouri Bank of Kansas City, N.A., supra note 1; Owensboro National Bank, supra note 2; Citytrust, supra note 2; First National Bank of Peoria, supra note 3; Millikin National Bank of Decatur, supra note 3; Continental Illinois National Bank and Trust Company of Chicago, supra note 4.

Collective Investment Funds

SEC No-Action Letter

Old Kent Financial Corporation

Publicly Available July 25, 1989

(Cite as: 1989 WL 246145 (S.E.C.))

Recap
Multi-affiliated-bank CIFs Bona fide fiduciary accounts in one institution may participate in a collective investment fund operated by an affiliated institution, even if the two institutions are in different states.

Letter to SEC

March 17, 1989

Office of Chief Counsel

Division of Corporate Finance

Securities and Exchange Commission

450 Fifth Street

Washington, D.C. 20549

Office of Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street

Washington, D.C. 20549

Re: Request for No-Action Letter by Old Kent Financial Corporation Under the Following Statutes and Rules: Section 3(a)(2) of the Securities Act and Rule 132, Sections 3(a)(12) and 12(g)(2)(H) of the Exchange Act and Rules 3a12-6 and 12h-1(b), Sections 3(c)(3) and 3(c)(11) of the Investment Company Act and Rule 3c-4

Dear Sirs:

We are writing on behalf of Old Kent Bank and Trust Company ("Old Kent Bank"), a state banking corporation organized under the laws of and having its principal place of business in the state of Michigan, Old Kent Financial Corporation, a bank holding company incorporated under the laws of and having its principal place of business in the state of Michigan, and Unibanc Trust Company, a state banking corporation incorporated under the laws of and having its principal business in the state of Illinois.

Old Kent Financial Corporation is a bank holding company registered with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended. Old Kent Bank is a subsidiary of Old Kent Financial Corporation. Unibanc Trust Company and seven other banks having their principal place of business in Illinois, which are organized as national banking associations under the laws of the United States or state banking corporations under the laws of Illinois (the "Illinois Banks"), are also subsidiaries of Old Kent Financial Corporation. Old Kent Bank, Unibanc Trust Company, the Illinois banks, and Old Kent Financial Corporation are members of an "affiliated group," as that term is defined in § 1504(a) of the Internal Revenue Code of 1986, as amended (the "Code"). Old Kent Bank, Unibanc Trust Company, and the Illinois Banks (as well as any other affiliated banks hereafter acquired which maintain common and collective trust funds substantially in the manner described herein) are sometimes referred to collectively as "the Banks" in this letter.

Old Kent Financial Corporation's subsidiary banks operate a system of interbank common and collective trust funds for the collective investment and reinvestment of funds held in fiduciary capacities by the Banks. In reliance upon earlier letters from the Division of Corporate Finance and from the Division of Investment Management, several Old Kent Financial Corporation affiliate banks (listed on Exhibit A to the letter to Old Kent Financial Corporation, available February 29, 1988) are permitted to invest funds those banks hold in a fiduciary capacity into the common trust funds and collective trust funds maintained by Old Kent Bank.

Old Kent Financial Corporation would now like to allow Old Kent Bank to invest assets it holds in a fiduciary capacity into common and collective trust funds maintained by Unibanc Trust Company and the other Illinois Banks.

We hereby request your confirmation that the staff of the Division of Corporate Finance and the staff of the Division of Investment Management will not recommend that the Securities and Exchange Commission take any enforcement action if Old Kent Financial Corporation and its subsidiaries conduct the activities described below without effecting any registration under the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act"), and the Investment Company Act of 1940 (the "Investment Company Act").

Facts

The trust department of Old Kent Bank currently maintains certain common trust funds for the commingled investment of assets that Old Kent Bank holds in its capacity as trustee, executor, administrator, or guardian of personal fiduciary accounts, and certain collective investment funds for assets which Old Kent Bank holds in its capacity as trustee or agent for employee benefit trusts. The trust departments of Unibanc Trust Company and the other Illinois Banks also currently maintain certain common trust funds for the commingled investment of assets which Unibanc Trust Company and the Illinois Banks hold in their capacities as trustee, executor, administrator, or guardian of personal fiduciary accounts, and certain collective investment funds for assets which Unibanc Trust Company and the Illinois Banks hold in their capacities as trustee or agent for employee benefit trusts. Both types of funds are sometimes referred to generically as common trust funds or the "Funds."

In order to qualify for tax exemption under Section 584 of the Code, all of the common trust funds maintained by the Banks are maintained in conformity with the rules and regulations of the Comptroller of the Currency. All of the collective investment funds maintained by the Banks are operated either in conformity with the rules and regulations of the Comptroller of the Currency or in conformity with the conditions for tax exemption set forth in Section 401(a) of the Code and Rev.Rul. 81-100, 1981-1 C.B. 326 (superseding Rev.Rul. 56-267, 1956-1 C.B. 206 and Rev.Rul. 75-530, 1975-2 C.B. 146). Both the common trust and collective investment funds maintained by the Banks are in all cases maintained in conformity with a version of the Uniform Common Trust Fund Act, the Michigan Common Trust Fund Act, or the Illinois Common Trust Fund Act, as appropriate. The Banks exercise ultimate investment and management discretion over the respective common and collective trust funds they maintain.

Old Kent Financial Corporation wishes to expand its system of interbank common trust and collective investment funds in order to achieve certain operational efficiencies and economies of scale by eliminating the unnecessary duplication of common and collective trust funds having substantially identical investment characteristics, to assure the availability throughout the entire bank system of high quality investment management service, and to make available greater opportunities for diversification of trust assets and for participation in collective investment funds with specialized objectives.

Currently Unibanc Trust Company and the other Illinois Banks are able to invest assets which those Banks hold as trustee, executor, administrator, or guardian in common trust funds maintained by Old Kent Bank, and assets of employee benefit trusts which those Banks hold as trustee in collective trust funds maintained by Old Kent Bank. Any common or collective trust fund maintained by Unibanc Trust Company or another Illinois Bank can invest all or part of its assets in common and collective trust funds maintained by Old Kent Bank having compatible investment characteristics; subject, in each case, to the provisions of the governing trust or plan instruments and any applicable state laws. These investments are permitted in reliance on a letter from the Division of Corporation Finance and a letter from the Division of Investment Management to Old Kent Financial Corporation (available February 29, 1988), stating that neither division would recommend enforcement action under the Securities Act, the Exchange Act, or the Investment Company Act if such investments were allowed. In all cases, such investment transactions are undertaken in accordance with applicable state laws which permit such transactions.

Old Kent Financial Corporation would now like to permit personal fiduciary accounts for which Old Kent Bank serves as trustee, and common trust funds maintained by Old Kent, to participate in common trust funds maintained by Unibanc Trust Company. Old Kent Financial Corporation would also like to enable employee benefit trusts for which Old Kent Bank serves as Trustee, and collective trust funds maintained by Old Kent Bank, to participate in collective trust funds maintained by Unibanc Trust Company. It is possible that in the future Old Kent Financial Corporation will wish to permit similar participations by Old Kent Bank and Trust Company in common and collective trust funds maintained by the other Illinois Banks.

Each common trust fund in the interbank system would continue to be operated in compliance with substantially the same state and federal regulatory requirements as would apply if the Bank contributing funds thereto (the "contributing Bank") were the same entity as the bank maintaining the common or collective trust fund (the "maintaining Bank"). Michigan has adopted the Michigan Common Trust Funds Act, MCLA s 555.101, et seq., MSA s 23.1141, et seq. Illinois has adopted the Illinois Common Trust Fund Act, Ill.Rev.Stat. Ch.17, P 2101, et seq., S.H.A. Ch.17, P 2101, et seq. Funds maintained by Old Kent will continue to be operated in accordance with the Michigan Common Trust Funds Act, and funds maintained by Unibanc Trust Company and any other Illinois Banks that are Illinois state banks will continue to be operated in accordance with the Illinois Common Trust Fund Act. While there are minor variations between these two acts, they are substantially the same. Similarly, while we recognize that the

supervision and regulation of banks and trust departments varies somewhat in different states, we believe that the regulation of banks and trust companies by the states of Michigan and Illinois is closely comparable. In any event, the fiduciary duties owed to customers by Old Kent, Unibanc Trust Company, or any of the other Illinois Banks will remain the responsibility of the contributing Bank, and thus will be unaffected by the proposed interbank investments.

The rights of the beneficiaries of the contributing Bank's personal fiduciary accounts and the rights of the beneficiaries of the contributing Bank's employee benefit trusts investing in the maintaining Bank's common and collective trust funds, either directly or through the intermediary of the contributing Bank's own common and collective trust funds, would not be diminished by reason of such investment. The fees charged for services in the management of the interbank system would be no greater than those that would have been charged each participating personal fiduciary account and employee benefit trust had they been individually invested by the contributing Bank as trustee. The records maintained by the maintaining Bank and the contributing Bank would reflect the participation in each common and collective trust fund of all trusts and other accounts which participate in such fund, either directly or indirectly through intermediary Contributing Banks. The contributing Bank and the maintaining Bank would adhere to the various reporting requirements and percentage limitations on participations for the common and collective trust funds as required by the regulations of the Comptroller of the Currency.

Request for Commission Action

Based upon the foregoing facts, upon the prior no-action position taken by the Staff of the Commission regarding the ability of Illinois subsidiaries of Old Kent Financial Corporation to invest assets they hold and funds they maintain in a fiduciary capacity into the common and collective trust funds of Old Kent Bank, upon prior no-action positions taken by the Staff of the Commission concerning other companies, (in particular, First Wachovia Corporation (available May 18, 1988), United Virginia Bankshares, Inc. (available June 15, 1987), and SunTrust Banks, Inc. (available June 18, 1986)), and upon our analysis of the statutes, regulations, and policy considerations involved, we request that the staff of the Commission confirm our opinion that:

1. Participations in Unibanc Trust Company's common or collective trust funds may be issued to Old Kent Bank, as Trustee, without registration under the Securities Act of 1933 by virtue of the exemption provided by Section 3(a)(2) of such Act and Rule 132 thereunder;

2. Participations in Unibanc Trust Company's common or collective trust funds will be exempt from registration under the Securities Exchange Act of 1934 by virtue of the exemptions provided by Sections 3(a)(12) and 12(g)(2)(H) of such Act, and Rules 3a12-6 and 12h-1(b) thereunder; and

3. The common and collective trust funds of Unibanc Trust Company may exist and operate without registration under the Investment Company Act of 1940 by virtue of the exemptions provided by Sections 3(c)(3) and 3(c)(11) of such Act and Rule 3c-4 thereunder.

Copies of Old Kent Financial Corporation (available February 29, 1988), the prior letter in which the Staff of the Commission took a no-action position concerning interbank common and collective trust funds that Old Kent Financial Corporation sought to establish are enclosed with this letter.

Applicable Law

Section 3(a)(2) of the Securities Act exempts from registration any interest or participation in any common trust fund maintained by a bank for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian. That section also exempts any interest or participation in a collective trust fund maintained by a bank when such interest or participation is issued in connection with a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code. Rule 132 of the General Rules and Regulations under the Securities Act defines common trust fund, as used in section 3(a)(2) of the Act, as including a common trust fund maintained by a bank which is a member of an affiliated group (as defined by section 1504(a) of the Code) which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of the affiliated group in the capacity of trustee, executor, administrator, or guardian. There are two conditions to this expanded definition: The common trust fund must be operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such a fund and any other contributing banks were the same entity; and the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian must not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group.

Section 3(a)(12) of the Exchange Act includes in its definition of exempted security any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, and any interest or participation in a collective trust fund maintained by a bank which interest or participation is issued in connection with a stock bonus, pension, or profit sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954. Section 12(g)(2)(H) specifically exempts from the registration requirements of subsection (g) any interest or participation in collective trust funds maintained by a bank, which interest or participation is issued in connection with a stock bonus, pension, or profit sharing plan that meets the requirements for qualification under section 401 of the Code. Rule 12(h)-1(b) states that issuer shall be exempt from the provisions of 12(g) of the Act with respect to any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of the monies contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian. That Rule goes on to state that for its purposes, the term "common trust fund" includes a common trust fund which is a member of an affiliated group, as defined in section 1504(a) of the Code, and which is maintained exclusively for the investment and reinvestment of monies contributed thereto by one or more bank members of the affiliated group in the capacity of trustee, executor, administrator, or guardian. This definition assumes the same two conditions as does Rule 132 under the Securities Act.

Section 3(c)(3) of the Investment Company Act excludes from the definition of an "investment company" any common trust fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian. Similarly, Section 3(c)(11) excludes from the definition of investment company any collective trust fund maintained by a bank consisting solely of the assets of employees stock bonus, pension, or profit sharing trusts which meet the requirements for qualification under Section 401 of the Code. Rule 3c-4 states that the term common trust fund, as used in Section 3(c)(3) of the Investment Company Act, includes a common trust fund maintained by a bank which is a member of an affiliated group and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of the affiliated group, in the capacity of trustee, executor, administrator, or guardian. Again, the same two conditions are imposed: the common trust fund must be operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian, must not be diminished by the reason of the maintenance of such common trust fund by another bank member of the affiliated group.

We note that, while the Commission has extended the exemptions from the registration requirements of the Securities Act, the Exchange Act, and the Investment Company Act by enacting the Rules cited above, the Commission has not specifically included in such Rules a reference to common trust funds maintained by out-of-state affiliates of a bank serving as trustee, executor, administrator, or guardian. However, we can find no reason why there should be any additional restrictions on an interstate common trust fund system operated as proposed by Old Kent Financial Corporation. In enacting these rules, the Commission noted that it would appear appropriate to view banks in an affiliated group as a single economic unit. Securities Act Release No. 5875, October 21, 1977. It seems appropriate, therefore, for the Commission to confirm that the above-cited statutes and Rules apply to interstate common and collective trust fund systems. With the amendments to the Bank Holding Company Act and state banking laws to allow interstate ownership of banks, there appears to be little policy concern against interstate banking affiliate operations, including common trust funds.

In SunTrust Banks, Inc., the staff of the Commission took a no-action position, finding that a regional bank holding company could implement a system of interbank common and collective trust funds for the collective investment and reinvestment of funds held in fiduciary capacities by subsidiary banks without registration under the Securities Act, the Exchange Act or the Investment Company Act, so long as the exceptions in Section 3(c)(3) and 3(c)(11) of the Investment Company Act were otherwise available to the common trust funds and collective trust funds maintained by the subsidiary banks. The staff emphasized that (a) all the SunTrust banks were members of an "affiliated group" as defined in the Code, (b) each fund would continue to be operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining the fund and the bank contributing assets thereto were the same entity, and (c) investment by a contributing bank in the maintaining bank's common trust fund would not diminish the rights of the beneficiaries of the contributing bank's personal fiduciary accounts.

Similarly, in United Virginia BankShares, Inc., the staff of the Commission took a no-action position. The staff stated that it would not recommend enforcement action based on counsel's opinion that participating in a maintaining Bank's common or collective trust funds, including funds of those banks that act as intermediaries, are exempt from registration under the Securities Act and the Exchange Act. Additionally, the staff said that it would not recommend any enforcement action under the Investment Company Act. The staff emphasized the same factors as it did in SunTrust Banks, Inc.

In First Wachovia Corporation, the staff again took a no-action position, stating that it would not recommend any enforcement action under the Securities Act, the Exchange Act or the Investment Company Act if a regional bank holding company implemented a system of interbank common and collective trust funds for the subsidiary banks of its two subsidiary bank holding companies. The staff again stressed the factors emphasized in SunTrust Banks, Inc., along with the fact that the subsidiary banks currently maintained the funds in question in their capacity as trustee, executor, administrator or guardian of personal fiduciary accounts, and in their capacity as trustee, co-trustee or managing agent of certain employee benefit trusts.

Like the facts presented in these prior no-action letters, the present situation justifies the issuance of a no-action letter. In particular, the following facts are true:

(i) Old Kent Bank, Unibanc Trust Company and the other Illinois Banks are members of an "affiliated group" as that term is defined in Section 1540(a) of the Code;

(ii) all funds maintained by the Banks would continue to be operated in compliance with substantially the same state and federal regulatory requirements as would apply if Old Kent Bank and the maintaining Bank were the same entity; and

(iii) investment by Old Kent Bank into a common trust fund maintained by Unibanc Trust Company or another Illinois Bank would not diminish the rights of the beneficiaries of Old Kent Bank's personal fiduciary accounts, nor would investment by Old Kent Bank into a collective trust fund maintained by Unibanc Trust Company or another Illinois Bank diminish the rights of the persons for whose benefit Old Kent Bank acts as agent or trustee.

As required by Securities Act Release No. 6269, seven copies of this letter are enclosed herewith. By sending this letter to the Division of Corporation Finance and to the Division of Investment Management simultaneously, we are requesting both divisions to confirm that they will not recommend that the Commission take any enforcement action if Old Kent Financial Corporation and its subsidiaries conduct the activities described herein.

Should you determine that you are unable to take the action requested in this letter, we request the opportunity to consult further with the staff prior to any written response to this letter. If you have any questions regarding the requested ruling or desire further information, please do not hesitate to call me, or, in my absence, M. Gayle Robinson of this firm, by telephone at (616) 459-6121.

Very truly yours,

Gordon R. Lewis

SEC Letter

(Cite as: 1989 WL 246145, (S.E.C.))

1933 Act / s 3(a)(2)

July 25, 1989

Publicly Available July 25, 1989

We would not recommend that the Commission take any enforcement action against Old Kent Bank and Trust Company ("Old Kent Bank"), Old Kent Financial Corporation, or Unibanc Trust Company ("Unibanc Trust"), under the Investment Company Act of 1940 ("1940 Act"), if assets held by Old Kent Bank or the common and collective trust funds maintained by Old Kent Bank are invested in the common and collective trust funds ("Funds") maintained by Unibanc Trust, without registration of the Funds under the 1940 Act. As we noted in our earlier response to Old Kent Financial Corporation (pub. avail. Feb. 29, 1988),[1] our position is based on the facts and representations in your letter, including that:

(1) Old Kent Bank and Unibanc Trust are members of an "affiliated group" as that term is defined in section 1504(a) of the Internal Revenue Code of 1986;

(2) Old Kent Bank and Unibanc Trust currently maintain their common and collective trust funds pursuant to the exceptions in section 3(c)(3) and section 3(c)(11), respectively, of the 1940 Act in their capacity as trustee, executor, administrator, or guardian of personal fiduciary accounts and in their capacity as trustee or agent for employee benefit trusts;

(3) all funds maintained by Old Kent Bank and Unibanc Trust would continue to be operated in compliance with the same state and federal regulatory requirements as would apply if Old Kent Bank maintained the funds it contributes to Unibanc Trust; and

(4) neither the rights of the beneficiaries of Old Kent Bank's personal fiduciary accounts nor the rights of the persons for whose benefit Old Kent Bank acts as agent or trustee would be diminished by reason of their investment in the Funds.

The Division of Corporation Finance has asked us to advise you that, based on the facts presented, that Division will not recommend any enforcement action to the Commission if Old Kent Financial Corporation, in reliance on your opinion that participations in Unibanc Trust Company's common or collective trust funds are exempt from registration under section 3(a)(2) and Rule 132 of the Securities Act of 1933 and from registration under section 3(a)(12) and 12(g)(2)(H) and Rule 3a12-6 and Rule 12h-1 of the Securities Exchange Act of 1934, permits funds maintained by Old Kent Bank to participate in Unibanc Trust Company's common and collective trust funds as proposed without registration of the interests in the funds under the 1933 Act or the 1934 Act.

Because these positions are based on the representations made to our Divisions it should be noted that any different facts or representations might require different conclusions. Moreover, this response only expresses the Divisions' positions on enforcement action and does not purport to express any legal conclusions on the questions presented.

Carol A. Peebles

Attorney

Securities and Exchange Commission (S.E.C.)

- Footnote -

1 See also First Wachovia Corporation (pub. avail. May 18, 1988); United Virginia Bankshares, Inc. (pub. avail. June 15, 1987); SunTrust Banks, Inc. (pub. avail. June 18, 1986).

Definitions concerning multi-bank common trust funds

Securities and Exchange Commission

Securities Act of 1933

Release No. 5896

Securities Exchange Act of 1934

Release No. 14363

Investment Company Act OF 1940

Release No. 10089

January 10, 1978

Summary: These rules have the effect, provided certain conditions are met, of treating common trust funds for several banks in the same affiliated group ("multi-bank common trust funds") in the same manner as traditional single bank common trust funds which are ordinarily exempt from regulation as investment companies, and from the registration and reporting requirements normally applicable to publicly held companies and other issuers of securities. Some state laws permit multi-bank common trust funds, which may operate as non-taxable entities. In the absence of these rules, multi-bank common trust funds might be treated differently under the federal securities laws from single bank common trust funds.

Common trust funds maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian, and interests or participations therein, are exempted or excluded from provisions of the federal securities laws by section 3(a)(2) [15 USC 77c(a)(2)] of the Securities Act of 1933 [15 USC 77a et seq.) ("Securities Act"), section 3(a)(12) [15 USC 78c(a)(12)] and rule 12h-2 [17 CFR 240.12h-2] of the Securities Exchange Act of 1934 [15 USC 78a et seq.) (Exchange Act"), and section 3(c)(3) [15 USC 80a-3(c)(3)] of the Investment Company Act of 1940 [15 USC 80a-1 et seq.] ("Investment Company Act").

These provisions apply only to common trust funds for assets contributed by a bank in a bona fide fiduciary capacity and incidental to the bank's traditional trust department activities.

These rules define the term "common trust fund" to include multi-bank common trust funds, and thus have the effect of exempting them from the provisions of the Investment Company Act. Also, under these rules interests or participations therein would be exempt from the registration requirements in section 5 [15 USC 77e] of the Securities Act and section 12(g) of the Exchange Act [15 USC 781(g)], and be "exempted securities" under section 3(a)(12) of the Exchange Act.

Part 230 - General Rules and Regulations, Securities Act of 1933

230.132 Definition of "common trust fund" as used in section 3(a)(2) of the Act.

The term "common trust fund" as used in section 3(a)(2) of the Act [15 USC 77c(a)(2)] shall include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in section 1504(a) of the Internal Revenue Code of 1954 (26 USC 1504(a)], and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group in the capacity of trustee, executor, administrator, or guardian, provided that:

(a) the common trust fund is operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and

(b) the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian would not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group.

Codified to 15 USC 77s(a).

Part 240 - General rules and regulations, Securities Exchange Act of 1934

240.12h-2 Exemptions from registration under section 12(g) of the act.

* * *

(b) Any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian. For purposes of this paragraph (b), the term "common trust fund" shall include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in section 1504(a) of the Internal Revenue Code of 1954 [26 USC 1504(a)], and which is maintained exclusively for the investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group in the capacity of trustee, executor, administrator, or guardian, provided that:

> (1) the common trust fund is operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and
>
> (2) the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator or guardian would not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group; and

* * *

240.3a12-6 Definition of "common trust fund" as used in section 3(a)(12) of the act.

The term "common trust fund" as used in section 3(a)(12) of the Act [15 USC 78c(a)(12)) shall include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in section 1504(a) of the Internal Revenue Code of 1954 [26 USC 1504(a)], and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group in the capacity of trustee, executor, administrator, or guardian, provided that:

(a) the common trust fund is operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and

(b) the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian would not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group.

Codified to 15 USC 78c(b).

Part 270 - Rules and Regulations, Investment Company Act of 1940

270.3c-4 Definition of "common trust fund" as used in section 3(c)(3) of the Act.

The term "common trust fund, as used in section 3(c)(3) of the Act [15 USC 80a-3(c)(3)] shall include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in section 1504(a) of the Internal Revenue Code of 1954 [26 USC 1504(a)], and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group in the capacity of trustee, executor, administrator, or guardian, provided that:

(a) the common trust fund is operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining such fund and any other contributing banks were the same entity; and

(b) the rights of persons for whose benefit a contributing bank acts as trustee, executor, administrator, or guardian would not be diminished by reason of the maintenance of such common trust fund by another bank member of the affiliated group.

Codified to 15 USC 80a-6(c), 8Oa-37(a).

Collective Investment Funds

SEC No-Action Letter

First Jersey National Bank

Publicly Available November 13, 1987

(Cite as: 1987 WL 108740 (S.E.C.))

Recap
"Mini-trusts" are not bona fide fiduciary accounts for purposes of federal securities laws, and so may not participate in a collective investment fund unless the CIF is registered with the SEC as a security and as a mutual fund.

Letter to SEC

July 10, 1987

Office of Chief Counsel

Division of Corporation Finance

Securities and Exchange Commission

Washington, D.C. 20549

Office of Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

Gentlemen:

We are writing on behalf of First Jersey National Bank (the "Bank"), a national banking association organized under the laws of the United States of America, to request that the staff of the Securities and Exchange Commission (the "Staff" and the "Commission") advise us that it will not recommend any action to the Commission if the Bank, through its Trust Department, maintains common trust funds without compliance with the registration requirements of Section 3(a)(2) of the Securities Act of 1933 (the "1933 Act"), Section 3(a)(12) of the Securities Exchange Act of 1934 (the "1934 Act") and Section 3(c)(3) of the Investment Company Act of 1940 (the "1940 Act") (collectively the "Acts").

I. Statement of Facts

The Bank is a national banking association located in New Jersey, which had total assets as of March 31, 1987 of 4.9 billion. The Bank is a qualified bank under the provisions of state law and is authorized to act in various fiduciary capacities, including administrator, executor and/or trustee under a decedent's Last Will and Testament, a trustee under an intervivos trust and as a guardian of an incompetent or a minor. The Bank presently administers assets exceeding 1.25 billion, including approximately 900 million for personal trust services and 350 million for employee benefit trust services. The assets administered in this capacity include approximately 525 trusts and estates ranging in size from $20,000 to $8,800,000.

In connection with the administration of its Trust Department, the Bank maintains three common trust funds. The first, which was established in 1965, is called The First Jersey National Bank Commingled Trust Fund For Employee Benefit Plans (the "Commingled Fund"). The Commingled Fund is used exclusively for the administration of employee benefit plan assets. The Commingled Fund has assets of approximately 145 million. At all times since the Commingled Fund was established and at the present time, the Commingled Fund was and is subject to all applicable New Jersey trust and banking laws, Comptroller of the Currency rules and regulations and is qualified as a common trust fund under Section 584 of the Internal Revenue Code of 1986.

Unlike the Commingled Fund, the other two common trust funds are not limited to use for employee benefit plans. Rather, The First Jersey National Bank Plan of Common Trust Equity Fund "I" (the "Equity Fund") and the First Jersey National Bank Plan of Common Trust Fixed Income Fund "I" (the "Fixed Income Fund") were established in 1985 for personal assets. The Equity Fund and Fixed Income Fund are designed so that the Bank can contribute to such Funds provided that the underlying trust or Last Will and Testament, as the case may be, allow for such an investment and the Bank is appropriately designated as a trustee, executor or guardian. The Equity Fund has assets of approximately 11.3 million and the Fixed Income Fund has assets of approximately 19.3 million. At all times since the Equity Fund and the Fixed Income Fund were established and at the present time, the Equity Fund and the Fixed Income Fund were and are subject to all applicable New Jersey trust and banking laws, Comptroller of the Currency rules and regulations and are qualified as common trust funds under Section 584 of the Internal Revenue Code of 1986.

Through its Trust Department, the Bank is proposing to continue and expand its existing common trust funds pursuant to the First Jersey National Bank Plan of Common Trust Funds (the "Common Trust Fund") (see attached). The Common Trust Fund will allow the Bank, while acting as a fiduciary, to contribute monies to the Common Trust Fund that it holds as trustee, executor, administrator or guardian. The Bank will at all times act as trustee of the Common Trust Fund. After the participant designates the type of common trust fund in which the underlying corpus is to be placed, the trustee shall have the

exclusive management and control of the common trust fund including the authority to invest and reinvest the principal and/or the undistributed income of the trust's or estate's assets in any such class or classes of property as the trustee determines are appropriate for the participation and in accordance with the common trust fund's investment powers.

The Common Trust Fund will be administered as part of and incidental to the Trust Department's regular trust activities. The Bank will not utilize any general advertising or solicitation for the Common Trust Fund and will continue to offer the Common Trust Fund as one of the many trust services provided by the Bank. The Common Trust Fund will be administered in compliance with all applicable trust and banking statutes, rules and regulations existing in New Jersey, regulations of the Comptroller of the Currency and the Internal Revenue Code of 1986, as amended, and regulations of the Internal Revenue Service.

Interests could be deposited into the Common Trust Fund in anyone of three (3) ways. First, the interests currently being administered in the Equity Fund and Fixed Income Fund would be transferred to the Common Trust Fund and such interests would continue to be administered in the equity fund and fixed income fund. As stated above, the Equity Fund and Fixed Income Fund were previously established and are currently administered to allow the Bank, when acting in the capacity of a trustee, executor or guardian, to invest in a common trust fund. This transfer of funds will in no way adversely affect the rights of persons who have an interest in the Equity Fund and the Fixed Income Fund. Further, all of the statutes, rules and regulations that are applicable to the Equity Fund and Fixed Income Fund are also applicable to the Common Trust Fund.

Once the transfer of interests to the Common Trust Fund is made, the Bank may contribute assets to the Common Trust Fund where the Bank has been designated as a trustee or co-trustee under the terms of a trust agreement prepared outside the Bank's auspices. Interests accepted by the Bank in this manner will continue to be incidental to the Bank's regular Trust Department activities.

Second, the Bank is proposing to utilize a Participating Trust Agreement (see attached) to provide clients of the Trust Department with a trust document under which assets are deposited with the Bank as a trustee with complete fiduciary authority including the right and obligation to invest all trust assets. The Participating Trust Agreement will be evaluated, accepted or rejected and administered by the Trust Department in the same manner and with the same degree of scrutiny as every other trust agreement in which the Bank is either a trustee or co-trustee. It is envisioned that the minimum interest that a grantor could invest would be $50,000 Dollars. As trustee, the Bank will have all of the fiduciary duties, responsibilities and liabilities as provided for under New Jersey statutes (N.J.S.A. 3B:14-1 et seq.; 3B:10-1 et seq.) and common law.

During the lifetime of the grantor, the Participating Trust Agreement provides the trustee with the ability to determine whether or not to make payments to or for the benefit of the grantor in instances in which the trustee deems it advisable for the care, maintenance and support of the grantor or when the grantor becomes disabled. In carrying out this provision, the Bank is subject to the standard of care imposed upon fiduciaries by the laws of the State of New Jersey. Additionally, the Participating Trust Agreement provides for the grantor to designate his spouse or his estate as a beneficiary of the trust upon the death of the grantor. In the instance in which the spouse is designated as a beneficiary, the trust could continue, as would the Bank's obligations as trustee, until the death of the spouse or upon the earlier termination of the trust by the spouse. Under certain circumstances, the Bank may allow the grantor to choose additional dispositive provisions that best meets the grantor's needs.

Other fiduciary responsibilities imposed on the trustee include the obligation to determine and settle any federal estate and gift tax liability imposed on the trust, which tax liability potentially increases at any time in which the trustee makes a discretionary payment. Furthermore, there is the obligation to render a statement to both grantor and beneficiary which shall serve as an accounting to properly inform such parties of activities within the trust account.

Third, the Bank would accept interests into the Common Trust Fund if the Bank is appointed as a conservator, a guardian for a minor or mental incompetent, as administrator or as an executor of the estate of a decedent. To serve in the capacity of a conservator, the Bank would need the consent of the conservatee and the appointment as such by the Superior Court of New Jersey upon a finding that a conservatee, by reason of advanced age, illness or physical infirmity, is unable to provide for himself or others dependent upon him for support. N.J.S.A. 3B:13A-1 et seq; N.J.Ct.R. 4:83-1 et seq. The court proceeding may be initiated by the conservatee or some other person in his behalf. A conservator has both formal and informal accounting requirements and may have to post a bond.

To serve in the capacity of a guardian for a minor, the Bank must be appointed by a court and act in a fiduciary manner with an obligation to preserve and manage the property and rights of a minor. N.J.S.A. 3B:12-1 et seq. To serve in the capacity of a guardian for a mental incompetent, the Bank must be appointed by the Superior Court of New Jersey following a declaration of incompetency by such court pursuant to New Jersey statutes and court rules. N.J.S.A. 3B:12-1 et seq.; N.J.Ct.R. 4:83-1 et seq.

To serve in the capacity of an executor, the Bank would have to be designated as such under a testator's will. As an executor, the Bank must act in a fiduciary manner as set forth by New Jersey statutes and common law.

II. Requested No-Action Position.

On the basis of the foregoing facts, we request that the Staff advise us that it will not recommend any action to the Commission if the Common Trust Fund is not registered under the 1940 Act and the interests in the Common Trust Fund are not registered under the 1933 Act and 1934 Act.

III. Discussion.

Subject to the concurrence of the Staff as requested herein, it is our belief that the continuation and expansion of the Common Trust Fund will not require registration under the 1940 Act by virtue of Section 3(c)(3) which excepts from the definition of investment company "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of money contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian ..." Similar exemptions from registration are available for interests in the Common Trust Fund under Section 3(a)(2) of the 1933 Act and Section 3(a)(12) of the 1934 Act.

In prior No-Action Letters, both the Division of Corporate Finance and Division of Investment Management have stressed that moneys contributed to a common trust fund must be received by a bank acting in a bona fide fiduciary capacity rather than serving as a mere vehicle for the general investment by the public. We believe that the interests in the Common Trust Fund will be received by the Bank while acting in a bona fide fiduciary capacity and will not be utilized by the public as a vehicle for investment.

In the case where interests are admitted into the Common Trust Fund from the existing Equity Fund and Fixed Income Fund, such a transfer is very similar to the transfers that were described in the Allied Trust Company No-Action Letter (available April 25, 1984) ("Allied") and Sun Trust Banks, Inc. No-Action Letter (available June 18, 1986) ("Sun Trust"). Allied and Sun Trust involved existing common trust funds with respect to which either Allied or Sun Trust, or their subsidiaries, maintained a common fund in which such entities held interests in their capacity as trustee, executor, administrator or guardian. In addition, in both cases the rights of the beneficiaries were not diminished by the transfer of existing trust assets, the fees charged were not increased by reason of such a transfer and the resulting common fund agreed to comply with the same statutes, rules and regulations of the particular state and of the Comptroller of the Currency and the Internal Revenue Service. The staff granted Allied's and Sun Trust's request for a no-action determination.

The transfer of interests from the Equity Fund and the Fixed Income Fund to the Common Trust Fund will involve all of the same characteristics found in Allied and Sun Trust. Prior to and after the transfer, the interests are and will be maintained by the Bank as a trustee, executor, administrator or guardian. The proposed transfer will not adversely affect the rights of any persons who have an interest in the Equity Fund or Fixed Income Fund; nor will the proposed transfer increase fees, vary the applicability or change the required compliance with any applicable statutes, rules and regulations. Not only are the investment characteristics virtually the same between the Equity Fund and Fixed Income Fund when compared to the Common Trust Fund, but all of the Bank's reporting obligations and virtually all of the mechanics involved in administering the trusts are the same.

In the case where interests are admitted into the Common Trust Fund by grantors utilizing the Participating Trust Agreement, the moneys will be received by the Bank while acting in a bona fide fiduciary capacity. The Bank will become a fiduciary subject to the duties, responsibilities and liabilities imposed by New Jersey statutes and common law. N.J.S.A. 3B:11-1 et seq. Since the Acts specifically use the term "trustee" and under New Jersey law the Bank would be acting as a trustee, we believe, absent a determination that the interests would be used by the public for general investment, that the clear language used in such Acts would exempt interests admitted to the Common Trust Fund in this manner.

As in the case of interests admitted into the Common Trust Fund from the existing Equity Fund and Fixed Income Fund, the interests admitted by virtue of a Participating Trust Agreement will not be used by the

public for general investment. The Participating Trust Agreement is substantially different than a general investment money market or mutual fund account. Under the investment agreements used for money market or mutual fund accounts, the investment manager does not trigger any of the duties, responsibilities or liabilities of a trustee. Rather, acting as an investment manager simply imposes the obligation to invest assets in accordance with the investment agreement, upon the death of the customer, to distribute the principal and proceeds of the assets to the customer's estate and to render a financial report to all the customers. A money market or mutual fund account is fully subject to the federal and state securities laws and most allow a relatively small dollar amount of approximately $1,000 or $2,500 dollars to open an account. Finally, the procedures used in executing a money market or mutual fund investment agreement and depositing and withdrawing from such an account are very informal and can even include instructions over the telephone.

In almost complete contrast, the Participating Trust Agreement appoints the Bank as a trustee, under state law, with complete fiduciary authority including the right and obligation to invest all trust assets. The duties, responsibilities and liabilities of the Bank, as trustee, are much more substantial and onerous than that of an investment manager of a money market or mutual fund account. For instance, the Bank, as trustee, has the responsibility for determining whether or not to make payments to or for the benefit of the grantor in instances in which the Bank deems it advisable for the care, maintenance and support of the grantor or when the grantor is deemed disabled. The investment manager for a money market or mutual fund account is not so responsible, but simply must follow the customer's instructions to either deposit or withdraw the deposited assets or portions thereof.

The Participating Trust Agreement allows the grantor to designate his spouse or his estate as a beneficiary of the trust upon the death of the grantor. In the instance in which the spouse is designated as a beneficiary, the trust could continue, as would the Bank's obligations as trustee, until the death of the spouse or upon the earlier termination of the trust by the spouse. Under certain circumstances, the Bank may allow the grantor to choose additional dispositive provisions. By allowing the grantor, in consultation with a representative of the Trust Department, to choose a dispositive provision which would encompass estate planning decisions and tax implications, the Bank is acting far beyond an investment manager who simply remits the balance of the account to the estate of the customer without the ability to consider any estate planning decisions and tax implications at the outset or conclusion of the customer-investment manager relationship.

Another contrast between the Participating Trust Agreement and a money market or mutual fund account is that the grantor may not receive the net income of the trust estate more frequently than once a month. This same restriction, relating to the ability to receive the net income of the trust estate, is also found for all interests admitted and distributions made to the Common Trust Fund. In most money market or mutual fund accounts, deposits and withdrawals can be made on a daily basis.

As a trustee, the Bank has certain other fiduciary duties that are not imposed on an investment manager. There is an obligation to render a statement to both grantor and beneficiary which shall serve as an accounting to properly inform such parties of activities within the trust account. In addition, upon the death of the grantor, the Bank has a clear obligation under state law to settle the tax obligations of the trust with a view toward the care and preservation of the corpus of the trust. In fact, under Section 6324 of the Internal Revenue Code of 1986, if the Bank does not act in such a fiduciary manner, the Bank can be held liable. An investment manager does not provide any accounting, but instead distributes a quarterly financial summary that is also used for general advertising purposes. Upon the death of a customer, there is no obligation, nor is there any possibility of liability, imposed on the investment manager except to remit the balance of the account to the customer's estate.

Lastly, the Participating Trust Agreement is designed for interests of at least $50,000 Dollars. While there may be extremely limited circumstances in which the Bank may accept an interest of less than $50,000, but never any less than $25,000, even $25,000 is substantially greater than the $1,000-$2,500 Dollar minimums being used by money market or mutual fund accounts. The greater minimum amount under the Participating Trust Agreement limits the availability of this fiduciary instrument to grantors with, not only greater financial wherewithal and presumably greater financial acumen, but also to grantors desiring a more individualized and personal relationship.

In the case where interests are admitted into the Common Trust Fund pursuant to an appointment of the Bank as a conservator, a guardian for a minor or mental incompetent, an administrator or a designation under a testator's Last Will and Testament as an executor, will clearly impose traditional fiduciary duties, responsibilities and liabilities on the Bank. In instances in which the Bank is acting as a conservator or guardian, there will be court supervision and scrutiny over such proceedings. Once again, since the Acts

specifically use the term "executor" and "guardian" and under New Jersey law the Bank would be acting as an executor or guardian, the clear language used in such acts would exempt interests admitted to the Common Trust Fund in this manner.

In the instance of the Bank acting as a conservator, the Staff has previously issued a no-action determination to Wells Fargo Bank National Assoc. (available January 15, 1978) ("Wells Fargo"). In Wells Fargo, the staff was asked to determine whether a bank acting as a conservator under California law would be exempt from registration under the Acts because of the similarity in fiduciary responsibility imposed on the bank between its role as a conservator and guardian. In granting the no-action determination, the Staff simply wrote that they would not recommend that the Commission take any action under the 1940 Act (the Division of Corporate Finance did not opine in Wells Fargo) provided that solicitation of clients for this service would not be by advertisements in the mass media. Rather, solicitation of clients would be accomplished only through brochures describing trust department services.

In instances when the Bank contributes interests to the Common Trust Fund while acting as a conservator, the Bank will be acting in an analogous manner to Wells Fargo. The Bank will be acting as a conservator under the applicable state law (New Jersey) and will be performing similar fiduciary responsibilities as a guardian would under New Jersey law. Also, the Bank will not utilize any advertising through the mass media. Therefore, while the Acts do not specifically list the term "conservator", the Staff should issue a no-action determination for interests admitted to the Common First Fund while the Bank is acting in the capacity of a conservator.

In addition to the interests admitted to the Common Trust Fund being exempt from registration under the 1933 Act and the 1934 Act, the Common Trust Fund's formation and operation by the Bank is also exempt from registration under the 1940 Act. Since the Common Trust fund is being maintained by the Bank exclusively for the collective investment and reinvestment of money contributed thereto by the Bank in its capacity as a trustee executor, administrator or guardian, registration under the 1940 Act is not required. The Bank will administer the Common Trust Fund in compliance with all applicable trust and banking statutes, rules and regulations existing in New Jersey, of the Comptroller of the Currency and the Internal Revenue Code. These rules and regulations include 12 C.F.R. 9.18 and the precedent and opinions of the Comptroller of the Currency issued thereunder. Concurrently with the submission of this no-action request, the Bank has submitted the Common Trust Fund to the Internal Revenue Service for a determination that the same is in compliance with Internal Revenue Code Section 584.

As previously written, the Bank will not solicit any participants to the Common Trust Fund through advertisements aimed at the mass media. Instead, any publicity about the Common Trust Fund and copies of the annual financial report shall be made solely in connection with the promotion of the fiduciary services of the Bank. Lastly, the Common Trust Fund will be maintained as incidental to the Trust Department's regular activities.

IV. Conclusion

As a result of the fact that the Bank will maintain the Common Trust Fund for the collective investment and reinvestment of money contributed thereto by the Bank in its capacity as trustee, executor, guardian or conservator, and based on the fact that the Common Trust Fund will not serve as a mere vehicle for the general investment by the public, we believe that the Common Trust Fund is exempt from registration under Section 3(c)(3) of the 1940 Act and the interests in the Common Trust Fund are exempt from Section 3(a)(2) of the 1933 Act and Section 3(a)(12) the 1934 Act.

Hannoch Weisman

A Professional Corporation

By Ellen B. Kulka

A Member of the Firm

SEC Letter

1940 Act / s 3(c)(3)

October 14, 1987

Publicly Available November 13, 1987

Re: First Jersey National Bank

Incoming letter dated July 10, 1987

On the basis of the facts presented, and particularly noting that the Division of Investment Management has determined that it is unable to assure you that it would not recommend any enforcement action to the Commission if the Bank maintains the Funds as proposed in your letter without registering the Funds under the Investment Company Act of 1940, we are unable to advise you that this Division would not recommend enforcement action to the Commission should the Bank offer and maintain the Funds as described in your letter without registration of interests therein under the Securities Act of 1933 and the Securities Exchange Act of 1934.

The Division of Investment Management has asked us to inform you of their position as follows.

Your letter of July 10, 1987, requests our assurance that we would not recommend any enforcement action to the Commission under the Investment Company Act of 1940 ("1940") if the Bank implements the proposed expansion of its existing common trust funds (namely, the Equity Fund and the Fixed Income Fund; collectively, "Funds") without registering them under the 1940 Act. The proposal contemplates that the Bank will solicit participations in the Funds by offering to its customers its services as trustee under participating trust agreements ("mini-trusts") that are standardized and revocable and can be set up generally with a $50,000 minimum initial investment, except in limited cases where the Bank may accept a lesser amount not less than $25,000. The grantor designates which of the Funds his money should be invested in. Also, the grantor may withdraw any sum or sums from the principal as often as once a month and, with the Bank's consent, add to the principal from time to time. The grantor is entitled to a monthly distribution of the net income unless he shall have instructed the Bank otherwise. The Bank has discretionary authority to provide out of the principal for the grantor's support and, in the event of the grantor's illness or disability, for expenses related thereto. In the event of the grantor's death, the Bank, after payment of the obligations of the grantor's estate, must distribute the principal and accrued net income to the grantor's estate or spouse, as the grantor may designate. If the spouse is designated as beneficiary, the mini-trust could continue until the earlier of the spouse's death or the spouse's revocation of the trust.

You argue that investment of mini-trust moneys in the Funds should not make section 3(c)(3) of the 1940 Act[1] unavailable to the Funds because section 3(c)(3) specifically uses the term "trustee," the Bank would be acting as a "trustee" under New Jersey law, and you believe that the public will not use the mini-trusts for general investment in the Funds. Where, as in this case, a bank makes a public offer of mini-trusts the assets of which are to be invested in such of the bank's common trust funds as the grantors may designate, the offer could involve an offer of participations in the common trust funds for investment unless the grantors are likely to create and use the mini-trusts primarily to avail of the bank's fiduciary functions in addition to money management. This view is supported, among other things, by statements of the Federal Reserve Board ("Board") regarding the proper scope of activities of bank common trust funds, which formed the basis for the common trust fund exception under the 1940 Act. In May 1940, the Board stated

In amending Regulation F to permit the operation of Common Trust Funds, the Board intended that a Common Trust Fund should be used merely to aid in the administration of trusts by a trust institution through the commingled investment of funds of various trusts. While the operation of a Common Trust Fund might thus enable a trust institution to accept small trusts which it otherwise would be unwilling to handle, it was contemplated that trust guise or form should not be used to enable a trust institution to operate a Common Trust Fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a Common Trust Fund to the public as investments.... In determining whether a particular trust is created and used for "bona fide fiduciary purposes," it is necessary to consider, in the light of such intent and purposes, not only the terms of the trust instrument but also other facts and circumstances concerning the creation and use of the trust.[2]

Under the mini-trust, the grantor designates which of the Funds his money should be invested in, will receive the monthly net income thereof unless he instructs the Bank otherwise, and may add to, withdraw from, and revoke the mini-trust. Although the Bank also stands ready to provide, in addition to money management, such traditional fiduciary services as providing for the grantor's support from the trust corpus, paying for expenses related to the grantor's illness, disability, death, etc., and continuing the mini-trust for the benefit of the grantor's spouse at the spouse's option, we are unable to conclude that grantors

of the mini-trusts would create and use the mini-trusts primarily to avail of the Bank's fiduciary services.[3] Thus, we cannot conclude that the Bank's proposal would not involve an offer of participations in the Funds to the public as investments.[4] Accordingly, we cannot assure you that we would not recommend any enforcement action to the Commission under the 1940 Act if the Bank implements its proposal without registering the Funds under that Act.

Because these positions are based upon the representations made to the Division in your letter, it should be noted that any different facts or conditions might require different conclusions. Moreover, this letter merely expresses the Divisions' positions regarding enforcement action, and does not purport to express any legal conclusion with respect to the questions presented.

Sincerely,

Cecilia D. Blye

Special Counsel

Securities and Exchange Commission (S.E.C.)

- Footnotes -

1 Section 3(c)(3), in relevant part, excepts from the definition of an investment company any common trust fund "maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian." (emphasis added)

2 26 Fed.Reserve Bull. 393-394 (1940) (emphasis added).

3 See, generally, Provident National Bank (pub. avail. Feb. 17, 1982); Mechanics Bank (pub. avail. Jan. 5, 1981); The Howard Savings Bank of Newark, New Jersey (pub. avail. May 1, 1980); Genesee Merchants Bank & Trust (pub. avail. Jan. 8, 1979).

4 The fact that the Bank will not solicit participants to the Funds through advertisements in the mass media does not necessarily mean that the mini-trusts would not be publicly offered as a means of participating in the Funds. See, e.g., Howard Savings Banks, supra.

Collective Investment Funds

SEC No-Action Letter

United Virginia Bankshares Incorporated

Publicly Available June 15, 1987

(Cite as: 1987 WL 108274 (S.E.C.))

Recap
CIF investing in another CIF A common trust fund or a collective investment fund may invest in a similar fund operated by an affiliated institution if the two funds have compatible investment characteristics subject to governing trust or plan instruments and any applicable state laws.

Letter to SEC

January 26, 1987

Office of the Chief Counsel

Division of Corporate Finance

Securities and Exchange Commission

450 Fifth Street

Washington, D.C. 20549

Dear Sirs:

We are writing on behalf of United Virginia Bankshares, Incorporated ("Bankshares"), a regional bank holding company incorporated under the law of Virginia and having its principal place of business in Richmond, Virginia. Bankshares's principal subsidiaries are United Virginia Bank ("UVB"), a banking corporation incorporated under the laws of and having its principal place of business in the state of Virginia, NS & T Bank, N.A. ("NS & T"), a national banking association having its principal place of business in the District of Columbia, and Bank of Bethesda ("Bethesda"), a banking corporation incorporated under the laws of and having its principal place of business in the state of Maryland (UVB, NS & T and Bethesda are sometimes hereinafter referred to as the "Banks"). Bankshares is a bank holding company registered with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended (the "Bank Holding Company Act"). All of the Banks and Bankshares are members of an "affiliated group" as that term is defined in Section 1504(a) of the Internal Revenue Code of 1986, as amended (the "Code").

Bankshares proposes to implement a system of interbank common and collective trust funds for the collective investment and reinvestment of funds held in fiduciary capacities by the Banks. We hereby request your confirmation that the staff of the Division of Corporate Finance will not recommend that the Securities and Exchange Commission take any enforcement action if Bankshares and its subsidiaries conduct the activities described below without effecting any registration under the Securities Act of 1933 (the "Securities Act"), the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Company Act of 1940 (the "Investment Company Act").

Facts:

The trust departments of certain of the Banks currently maintain certain common trust funds for the commingled investment of assets which such Banks hold in their capacity as trustee, executor, administrator or guardian of personal fiduciary accounts and certain collective investment funds for assets which such Banks hold in their capacity as trustee or agent for employee benefit trusts. Both types of funds are sometimes referred to generically as common trust funds. In order to qualify for tax exemption under Section 584 of the Code, all of the common trust funds maintained by the Banks, including those maintained by state Banks, are maintained in conformity with the rules and regulations of the Comptroller of the Currency. All of the collective investment funds maintained by the Banks are operated either in conformity with the rules and regulations of the Comptroller of the Currency or in conformity with the conditions for tax exemption set forth in Section 401(a) of the Code and Rev.Rul. 81-100, 1981-1 C.B. 326 (superseding Rev.Rul. 56-267, 1956-1 C.B. 206 and Rev.Rul. 75-530, 1975-2 C.B. 146). Both the common trust and collective investment funds are in all cases maintained in conformity with a version of the Uniform Common Trust Fund Act or a similar law in force in the respective state or jurisdiction of the Bank which maintains them. The Banks exercise ultimate investment and management discretion over the respective common and collective trust funds they maintain.

In order to achieve certain operational efficiencies and economies of scale, to assure the availability throughout the Bankshares bank system of high quality investment management service, and to make available greater opportunities for diversification of trust assets and for participation in collective investment funds with specialized objectives, Bankshares wishes to establish a system of interbank common trust and collective investment funds in which all the Banks could participate. Initially, employee benefit trusts for which certain Banks serve as trustee and collective investment funds maintained by those Banks will be permitted to participate in collective investment funds maintained by UVB, and personal fiduciary accounts for which certain Banks serve as trustee and common trust funds maintained by those Banks will be permitted to participate in common trust funds maintained by UVB. It is anticipated, however, that ultimately (1) any Bank would be able to invest assets which it holds in its capacity as trustee, executor, administrator or guardian in common trust funds maintained by other Banks and assets of employee benefit trusts which it holds as trustee in collective investment funds maintained by other Banks, and (2) any common or collective trust fund maintained by a Bank would be able to invest all or

part of its assets in common and collective trust funds maintained by other Banks having compatible investment characteristics, subject, in each case, to the provisions of the governing trust or plan instruments and any applicable state laws. In all cases, the proposed investment transactions would be undertaken in accordance with applicable state laws which permit such transactions.

Each common trust fund in the Bankshares interbank common trust fund system would continue to be operated in compliance with the same state and federal regulatory requirements as would apply if the Bank contributing funds thereto (the "contributing Bank") were the same entity as the Bank maintaining the common trust fund (the "maintaining Bank"). The rights of the beneficiaries of the contributing Bank's personal fiduciary accounts investing in the maintaining Bank's common trust funds, either directly or through the intermediary of the contributing Bank's own common trust funds, would not be diminished by reason of such investment. The fees charged for services in the management of the Bankshares interbank system would be no greater than those that would have been charged each participating personal fiduciary account had it been individually invested by the contributing Bank as trustee in the contributing Bank's common trust fund. The records maintained by the maintaining Bank and the contributing Bank would reflect the participation in each common trust fund of all trusts and other accounts which participate in such fund, either directly or indirectly through intermediary contributing Banks. The contributing Bank and the maintaining Bank would adhere to the various reporting requirements and percentage limitations on participations for the common trust funds as required by the regulations of the Comptroller of the Currency.

Request for Commission Action:

Based upon the foregoing facts, upon prior no-action positions taken by the staff of the Commission, in particular, Western Bancorporation (available May 22, 1980) and SunTrust Banks, Inc. (available June 18, 1986), copies of which are enclosed with this letter, and upon our analysis of the statutes, regulations and policy considerations involved, we request that the staff of the Commission confirm that:

(1) Participations in a maintaining Bank's common or collective trust funds, including funds of those Banks which act as intermediaries by investing in the common or collective trust funds of another Bank, may be issued without registration under the Securities Act by virtue of the exemption provided by Section 3(a)(2) of such Act and Rule 132 thereunder;

(2) Participations in a maintaining Bank's common or collective trust funds, including funds of those Banks which act as intermediaries by investing in the common or collective trust funds of another Bank, will be exempt from registration under the Securities Exchange Act by virtue of the exemptions provided by Sections 3(a)(12) and 12(g)(2)(H) of such Act and Rules 3a12-6 and 12h-1(b) thereunder; and

(3) The common and collective trust funds of a maintaining Bank, including funds of those Banks which act as intermediaries by investing in the common or collective trust funds of another Bank, may exist and operate without registration under the Investment Company Act by virtue of the exemptions provided by Sections 3(c)(3) and 3(c)(11) of such Act and Rule 3c-4 thereunder.

We note that, while the Commission has extended the exemptions from the registration requirements of the Securities Act, the Securities Exchange Act and the Investment Company Act by enacting the Rules cited above, the Commission has not specifically included in such Rules a reference to common trust funds maintained by out-of-state affiliates of a bank serving as trustee, executor, administrator or guardian. However, we can find no reason why there should be any additional restrictions on an interstate common trust fund system operated as proposed by Bankshares. In enacting these Rules, the Commission noted that it would appear appropriate to view banks in an affiliated group as a single economic unit. Securities Act Release No. 5875, October 21, 1977. It seems appropriate, therefore, for the Commission to confirm that the above cited statutes and Rules apply to interstate common and collective trust fund systems. With the amendments of the Bank Holding Company Act and state banking laws to allow interstate ownership of banks, there appears to be little policy concern against interstate banking affiliate operations, including common trust funds.

In Western Bancorporation, the staff of the Commission took a "no-action" position under the exemptions referred to above with respect to an interstate common trust fund system to be implemented and operated by a multi-state bank holding company. Western Bancorporation, which had been grandfathered out of compliance with Section 3(d) of the Bank Holding Company Act, had 22 subsidiary banks, operating in 11 states and consisting of a combination of national and state banks. As in the case of the Bankshares system, those subsidiary banks were governed by the requirements of various federal and state laws.

In SunTrust Banks, Inc., based on facts very similar to Bankshare's proposal, the staff of the Commission

took a "no-action" position, finding that a regional bank holding company could implement a system of interbank common and collective trust funds for the collective investment and reinvestment of funds held in fiduciary capacities by subsidiary banks so long as the exceptions in Sections 3(c)(3) and 3(c)(11) of the 1940 Act were otherwise available to the common trust funds and collective trust funds maintained by the subsidiary banks. The staff emphasized that (i) all the SunTrust banks were members of an "affiliated group" as defined in the Code, (ii) each fund would continue to be operated in compliance with the same state and federal regulatory requirements as would apply if the bank maintaining the fund and the bank contributing assets thereto were the same entity and (iii) investment by a contributing bank in the maintaining bank's common trust fund would not diminish the rights of the beneficiaries of the contributing bank's personal fiduciary accounts.

As required by Securities Act Release No. 6269, seven copies of this letter are enclosed herewith. By a separate letter, we have simultaneously requested that the Division of Investment Management confirm that it will not recommend that the Commission take any enforcement action if Bankshares or its subsidiaries conduct the activities described herein. A copy of that letter is enclosed as an attachment to each copy of this letter.

If you have any questions regarding the requested ruling or desire further information, please do not hesitate to call the undersigned at (804) 783-6419 or Robert L. Musick, Jr., at (804) 783-6414.

Sincerely yours,

R. Hart Lee

SEC Letter

1934 Act / s 12(g)(2)(H)

May 14, 1987

Publicly Available June 15, 1987

Re: United Virginia Bankshares, Inc.

Incoming letter dated January 26, 1987

On the basis of the facts presented, the Division of Corporation Finance will not recommend any enforcement action to the Commission if United Virginia Bankshares, Inc., in reliance upon your opinion as counsel that participations in a maintaining Bank's common or collective trust funds, including funds of those Banks that act as intermediaries by investing in the common or collective trust funds of another Bank, are exempt from registration under the Securities Act of 1933 ("Securities Act") by virtue of the exemptions provided by Section 3(a)(2) of the Act and Rule 132 thereunder, and also from registration under the Securities Exchange Act of 1934 ("Exchange Act") by virtue of the exemptions provided by Sections 3(a)(12) and 12(g)(2)(H) of that Act and Rules 3a12-6 and 12h-1(b) thereunder, implements and operates the common and collective trust funds as proposed without registration of interests therein under the Securities Act or the Exchange Act.

In addition, the Division of Investment Management has asked us to inform you that, on the basis of the facts and representations in your letter, and as long as the exceptions in Section 3(c)(3) and Section 3(c)(11) of the Investment Company Act of 1940 ("1940 Act") are otherwise available to the common trust funds and collective trust funds (collectively, "Funds") maintained by each subsidiary bank of Bankshares ("Bank"), that Division would not recommend any enforcement action to the Commission if, without registration of the Funds under the 1940 Act:

(1) a Bank contributes assets, which it holds in its capacity as trustee, executor, administrator or guardian, to common trust funds maintained by other Banks;

(2) a Bank invests assets, which it holds as trustee or agent of any employee's stock bonus, pension, or profit-sharing trust that meets the requirements for qualification under Section 401 ("Section 401 assets") of the Internal Revenue Code of 1986 ("Code") in collective trust funds maintained by other Banks for Section 401 assets held by them;

(3) any common trust fund maintained by a Bank invests all of part of its assets in common trust funds

maintained by other Banks having compatible investment characteristics subject to governing trust instruments and any applicable state laws; or

(4) any collective trust fund maintained by a Bank invests all or part of its assets in collective trust funds maintained by other Banks having compatible investment characteristics subject to governing trust or plan instruments and any applicable state laws.

The position of the Division of Investment Management is based on the facts presented in your letter and your oral representations to Elizabeth Tsai of the staff on February 11, 1987, including the following: (a) all the Banks are members of an "affiliated group" as that term is defined in Section 1504(a) of the Code; (b) the Funds would continue to be operated in compliance with the same state and federal regulatory requirements as would apply if the Bank maintaining the Funds ("maintaining Bank") and the Bank contributing assets thereto ("contributing Bank") were the same entity; and (c) investment by a contributing Bank in the maintaining Bank's common trust fund would not diminish the rights of the beneficiaries of the contributing Bank's personal fiduciary accounts, nor would investment by a contributing Bank in the maintaining Bank's collective trust fund diminish the rights of the persons for whose benefit the contributing Bank acts as agent or trustee.

Because these positions are based upon the representations made to the Division in your letter, it should be noted that any different facts or conditions might require a different conclusion or conclusions. Further, this response only expresses the Divisions' positions on enforcement action and does not purport to express any legal conclusion on the questions presented.

Sincerely,

William H. Carter Special Counsel

Securities and Exchange Commission (S.E.C.)

Collective Investment Funds

SEC No-Action Letter

The National Bank of Fairfax

Publicly Available December 29, 1976

(Cite as: 1976 WL 12983 (S.E.C.))

Recap
Restricts Keogh (H.R. 10) account usage of ***common trust funds*** (as opposed to collective investment funds).

Letter to SEC

October 15, 1976

Chief Counsel

Division of Corporation Finance

Securities and Exchange Commission

500 North Capitol Street

Washington, D. C. 20549

Re: The National Bank of Fairfax Self-Employed Retirement Plan and Trust Agreement--Amended and Restated as of January 1, 1975

The National Bank of Fairfax

P. O. Box 278

Fairfax, Virginia 22030

Request for a "no-action letter" under Section 3(a)11 and 3(a)(2) of the Securities Act of 1933

Dear Sir:

The request herein for a "no-action letter" relates to Section 3(a)(11) of the Securities Act of 1933 (the "Act"), involving a security offered and sold only to persons resident within a single State, and to Section 3(a)(2) of the Act involving the establishment of separate trust accounts for retirement plans of self-employed individuals where the intrastate exemption of Section 3(a)(11) of the Act is not available.

The undersigned counsel for The National Bank of Fairfax, P. O. Box 278, Fairfax, Virginia 22030 (the "Bank") respectfully requests that the Division of Corporation Finance indicate that it will not recommend any action to the Commission if the Bank publicly offers for sale or sells participations in The National Bank of Fairfax Self-Employed Retirement Plan and Trust Agreement-- Amended and Restated as of January 1, 1975 (the "Plan"), in the manner set forth in the Plan. In support of this request, the following representations are made:

1. The National Bank of Fairfax is a national bank doing business in Fairfax, Virginia.

2. The Bank on December 12, 1975, adopted the Plan, and a copy thereof is attached hereto and incorporated herein by reference.

3. A copy of the Adoption Agreement relative to the Plan is attached hereto and incorporated hereby reference.

4. The Plan has been submitted to the Commissioner of Internal Revenue for approval but no determination letter has as of this date been issued by the Commissioner.

5. The Plan is restricted to self-employed individuals and their employees.

6. Under the Plan, the Bank is the Trustee (Section 1.21 of Plan).

7. The pertinent provisions of the Plan relative to who may become a Member thereof (as "Member" is defined in the Plan), from whom voluntary contributions shall be accepted, and to the establishment of separate trusts, are as follows:

"Section 2.6. Residence. No individual may become a Member who is not a bona fide resident of the Commonwealth of Virginia; provided, however, that a Hired Employee who is a non-resident but who is in the employ of an Employer who is a bona fide resident of Virginia may become a Member if he makes no contributions under the Plan. For this purpose, if the Employer is a partnership, such partnership shall be considered a bona fide resident of Virginia only if its principal place of business is in Virginia and all partners are bona fide residents of Virginia.

The restrictions of the foregoing provisions shall be inapplicable where the Employer has made an election pursuant to Section 10.5(a) to have his participation in the Plan segregated from the Trust Fund and held by the Trustee upon a separate trust. Such election shall be mandatory if the Employer is not a resident of Virginia, as defined above, at the time the Plan is adopted by the Employer.

If a sole proprietor or a partner (in case the Employer is a partnership) ceases to be a resident of the Commonwealth of Virginia (or if a partnership, the partnership shall remove its offices from within the Commonwealth of Virginia, or if the personal representative of a deceased sole proprietor or a member of the partnership, as the case may be, shall be or become a non-resident of Virginia) subsequent to the date on which the Plan is adopted by the Employer, the Employer shall forthwith give notice of such fact to the Trustee. Unless or until the Employer has given notice of his intention to transfer his participation in the Plan to a new Trustee pursuant to Section 7.4, effective as of the date that the Employer ceases to be a resident of Virginia, the Employer shall be deemed to have made the election pursuant to Section 10.5(a). Within a reasonable time after the Trustee receives notice that such Employer has ceased to be a resident of Virginia, the Trustee shall provide for the segregation of such Employer's participation in the Plan as a separate trust, pursuant to Section 10.5(a).

The Trustee shall not accept any contributions to the Plan by the Employer unless (1) such contribution or contributions are accompanied by a statement signed by the Employer acknowledging that the Employer is a resident of Virginia, as defined above, or (2) the Employer has made an election pursuant to Section 10.5(a). Further, the Trustee shall not accept any voluntary contributions to the Plan by any Member unless (1) such contribution or contributions are accompanied by a statement signed by such Member acknowledging that he is a resident of Virginia, as defined above, or (2) the Employer of such Member has made an election pursuant to Section 10.5(a)."

"Section 10.5(a) Separate Trusts. Notwithstanding the foregoing provisions of this Article with respect to the collective investment of the Trust Fund, the Employer may elect to have the contributions and assets allocable to the Plan of such Employer segregated from the Trust Fund and held by the Trustee upon a separate trust containing the same terms and conditions as the Plan. The Employer's Plan shall not be otherwise affected by such separation. Such election shall be made either in the Adoption Agreement or in writing in a form acceptable to the Trustee.

Section 10.5(b) Employer-Directed Investments. If the Employer has made the election specified in Section 10.5(a), then notwithstanding the foregoing provisions of this Article X, the Employer shall have the right to direct the investment of any or all of the funds constituting the Participating Interests of each of its Employees who are Members under the Plan, either by directing the Trustee with respect to investments (including reinvestments, disposals and exchanges) or by disapproving proposed investments by the Trustee (including reinvestments, disposals and exchanges). Any such direction by an Employer to the Trustee shall be in writing signed by the Employer and in a form acceptable to the Trustee. The Trustee shall comply with the investment directions of an Employer as promptly as possible; provided, however, that the Trustee may review each such investment direction and it may decline to follow any direction determined by it to be in violation of the terms of the Plan or the provisions of the Employee Retirement Income Security Act of 1974. The Trustee shall assume no liability and shall be fully protected in carrying out the directions of an Employer with respect to any such Employer- directed investments or disapproval of proposed investments. In the absence of any directions pursuant to the foregoing, the funds constituting the separate trust of the Employer shall be invested and reinvested as the Trustee, in its sole discretion, shall determine."

8. The pertinent provisions in the Adoption Agreement relative to who may become a Member of the Plan (as "Member" is defined in the Plan), from whom voluntary contributions shall be accepted, and to the establishment of separate trusts, are as follows:

Fifth

The Trustee shall not accept any contributions to the Plan by the Employer unless (1) such contribution or contributions are accompanied by a statement signed by the Employer acknowledging that the Employer is a resident of Virginia, as defined in the Plan, or (2) the Employer has made an election pursuant to Section (B) of Article Eighth below."

Sixth

Each Member (check one) ( ) shall ( ) shall not be entitled to make annual voluntary contributions of per cent (not to exceed 10) of such Member's Aggregate Compensation. In the case of Owner Employees, such Contributions shall not exceed $2,500 for each year of Service with the Employer. Each Member (check one) ( ) shall ( ) shall not be entitled to withdraw his voluntary contributions. The Trustee shall not accept any voluntary contributions to the Plan by any Member unless (1) such contribution or contributions are accompanied by a statement signed by such Member acknowledging that he is a resident of Virginia, or (2) the Employer of such Member has made an election pursuant to Section (B) of Article Eighth below."

Eighth

The Trustee hereby agrees to hold all contributions made to the Trust Fund by the Employer and his Employees as set forth above in trust in accordance with the terms of the Plan and Trust, and to distribute or pay out the same only as therein provided. (Check one):

(A) The Trustee shall allocate all such contributions % to the Common Stock Fund, % to the Fixed Income Fund, and % to the Insurance Fund established pursuant to the Trust. Changes in the allocation of contributions between the Common Stock Fund, the Fixed Income Fund, and the Insurance Fund shall be made by the Trustee only upon written request of the Employer and shall become effective as of the next Valuation Date following receipt of such notice from the Employer.

(B) In lieu of collective investment and pursuant to Section 10.5(a) of the Plan, the Employer elects to have the contributions and assets allocable to its Plan segregated from the Trust Fund and held by the Trustee upon a separate trust containing the same terms and conditions as the Plan. The election under this paragraph (B) shall be mandatory if the Employer is not a resident of Virginia, as defined in the Plan, at the time the Plan is adopted by the Employer."

9. The pertinent provision of the Plan relative to the Trustee terminating an Employer's interest in the Plan (as "Employer" is defined in the Plan), and to an Employer transferring his participation in the Plan to another Trustee is as follows:

"Section 7.2 Disqualified Plan. If at any time it shall be determined by the Internal Revenue Service that the Plan of any Employer fails to qualify under Sections 401 and 501(a) of the Internal Revenue Code, the Trustee, upon receiving notice of such disqualification, shall exercise its termination right under Section 7.4 below. The Plan of any Employer shall not be considered disqualified within the meaning of this Section merely because, pursuant to Section 401(e) of the Internal Revenue Code, the Plan is to be considered not qualified with respect to one or more particular Members."

4 "Section 7.3 Termination by Trustee. The Trustee, at any time, by written notice to any Employer may terminate that Employer's participation in the Plan effective as of a specified future Valuation Date. Upon such termination or upon revocation of the Plan pursuant to Section 6.4, every Employee of that Employer who is then a Member shall be entitled to receive his Participating Interest as provided in Section 7.1."

"Section 7.4 Transfer to New Trustee. An Employer, at any time, by written notice to the Trustee, in such form as is acceptable to the Trustee, and provided that transfer may be effected without adversely affecting the qualification of the Employer's participation in the Plan under Section 401 of the Internal Revenue Code of 1954, as amended (or corresponding provision of any subsequent Federal revenue law at the time in effect), may transfer his participation in the Plan to any other trustee eligible to act as trustee. As soon as practicable after the Valuation Date next following receipt of such notice, the Trustee shall transfer the assets of that part of the Trust Fund representing the Participating Interests of the Employees of that Employer on that Valuation Date, to the other trustee named in the notice. Upon such transfer, the Trustee shall have a right to have its accounts settled as provided in Section 10.9 of the Plan. When such assets All have been transferred and delivered to the other trustee and the relevant accounts of the Trustee have been settled as provided in Section 10.9 of the Plan, the Trustee shall be released and discharged from all further accountability of liability respecting such assets and shall not be responsible in any way for the further disposition of such assets or any part thereof."

10. The pertinent provisions of the Plan relative to the investment of the Trust Fund (as "Trust Fund" is defined in the Plan) are as follows:

"Article X--Investment of Trust Fund

Section 10.1 General. Subject to Section 10.5 below, the investment of the Trust Fund shall be made by the Trustee. All investments and reinvestments shall be made at such times and in such stocks, bonds, or other securities or property of any kind, including interest bearing savings accounts with its own banking department or with any other bank, which shall seem suitable and appropriate to the Trustee. The Trustee is specifically given the right to invest the assets of the Trust Fund in any common trust fund or funds operated by it. The Trustee shall not be confined to the class or type of investments prescribed by statute, by rule of court or otherwise, as legal investments for trustees or fiduciaries generally.

The assets of the Trust Fund shall be invested collectively for the accounts of all Members in the Plan; however, records shall be kept for each Member which shall reflect not only the contributions made on his behalf but also his pro rata share of the net income of the Trust Fund and of the net gains or losses thereof. The reflection of said items shall occur once each year upon the Valuation Date and shall be distributed among the accounts of the Members in the same ratio as the balance of each such account at the close of business on the last preceding Valuation Date bears to the aggregate of such balances at the close of business on such preceding Valuation Date."

"Section 10.2 Allocations. The Trustee is authorized: (a) Employer's Instructions. To allocate contributions pursuant to the Plan from each Employer and for his Employees to the Fixed Income Fund, and/or the Common Stock Fund, and/or the Insurance Fund, in accordance with the most recent instructions received by the Trustee from that Employer as to the allocation of such contributions.

(b) Fixed Income Fund. To invest and reinvest the Fixed Income Fund, without distinction between

principal and income, in shares of stock (preferred, preference or guaranteed) or other evidences of ownership, bonds, debentures, equipment or collateral trust certificates, notes or other evidences of indebtedness, unsecured or secured by mortgages on real or personal property wherever situated (including any part interest in a bond and mortgage or note and mortgage whether insured or uninsured) and any other property, or part interest in property, real or personal, foreign or domestic, the rate of return from which is fixed by the instruments evidencing the investments, without regard to any restriction placed upon fiduciaries by any present or future applicable law, administrative regulation, rule of court or court decision. The Trustee's determination as to whether or not an investment is one the rate of return from which is fixed by the instrument evidencing it shall be conclusive and binding upon all persons interested in the Fixed Income Fund; and it may retain any otherwise ineligible property received by way of dividend, exchange, conversion, liquidation or otherwise than by purchase for as long as the Trustee in its discretion deems desirable for advantageous realization thereon.

(c) Common Stock Fund. To invest and reinvest the Common Stock Fund, without distinction between principal and income, in shares of common stock or other evidences of ownership and any other property, or part interest in property, real or personal, foreign or domestic, the rate of return from which is not fixed by the instruments evidencing the investments, whether or not productive of income or consisting of wasting assets; and to the extent the Trustee in its discretion deems desirable, or pending selection and purchase of other suitable investments, or to provide for current cash requirements, in investments the rate of return from which is fixed by the instruments evidencing the investments; without regard to any restriction placed upon fiduciaries by any present of future applicable law, administrative regulation, rule of court or court decision.

(d) Insurance Fund. To invest and reinvest the Insurance Fund, without distinction between principal and income, by payment of premiums on individual endowment contracts without an element of life insurance, and annuity policies on the lives of Participants purchased from such insurance companies and in such forms and amounts as the Employer shall designate (or as the Trustee may select in the absence of such designation). Such contracts shall be restricted to forms approved for retirement plans qualified under Section 401 of the Internal Revenue Code of 1954, as amended. Any dividends payable under such contracts shall be applied to reduce premiums. In no event shall the life insurance issued on any one Member's life exceed the amount of ordinary life insurance which may be purchased with less than 50% of the aggregate of all contributions credited to such Member's account, provided, however, if a Member so elects and Employee contributions are permitted under the Plan, life insurance contracts may be purchased for the Member in excess of this limitation. The Trustee on behalf of the individual Participant's Participating Interest, shall be owner, applicant and beneficiary on each such contract which shall be allocated to the individual Participant's account. On termination of a Participant's participation other than by reason of death, the Trustee shall cause any such contract for such Participant to be endorsed as a paid-up policy in accordance with its terms and distributed to the former Participant (subject to the provisions of Article V). On death of a Participant while in the employ of an Employer, the Trustee shall assign any proceeds payable under any such contracts on the Participant's life to the Participant's Beneficiary as designated in accordance with Section 5.4."

11. In the opinion of the undersigned counsel for The National Bank of Fairfax, the public offer and sale by the Bank of participations in the Plan in the manner set forth in the Plan would not make the Section 3(a)(11) exemption of the Act unavailable, and, further, that the provisions of the Plan relative to the establishment of separate trusts in those cases where initially an Employer is not a resident of Virginia, or where a Member ceases to be a resident of Virginia, would not violate the provisions of Section 3(a)(2) of the Act, which Section 3(a)(2) does not exempt interests or participations in a single or collective trust fund maintained by a bank, by a pension or profit-sharing plan which covers employees some or all of whom are employees within the meaning of Section 401(c)(1) of the Internal Revenue Code of 1954.

On the basis of the foregoing, it is respectfully requested that the Division of Corporation Finance indicate, as expeditiously as is convenient to it, that it will not recommend any action to the Commission if the Bank publicly offers for sale or sells participations in the Plan, in the manner set forth in the Plan, without compliance with the registration requirements of the Securities Act of 1933, as amended.

Respectfully submitted,

Boothe, Prichard & Dudley

Arthur P. Scibelli

SEC Letter

1933 Act / s 3(a)(2); 3(a)(11)

Publicly Available December 29, 1976

Arthur P. Scibelli, Esq.

Boothe, Princhard & Dudley

4085 University Drive

Fairfax, Virginia 22030

Re: The National Bank of Fairfax

Dear Mr. Scibelli:

This is in response to your letter dated October 15, 1976, concerning the establishment of the National Bank of Fairfax Self-Employed Retirement Plan & Trust (the "Plan") without compliance with the registration requirements of the Securities Act of 1933 (the "Act") in reliance upon the exemptions contained in Sections 3(a)(11) and 3(a)(2) of the Act.

You have requested our views with respect to the applicability of Section 3(a)(11) of the Act to the offer and sale of participations in the Plan only to persons resident within a single state. In Securities Act Release No. 33-5450, dated January 7, 1974, the Commission stated that the Staff would consider requests for "no-action" letters in reliance upon Section 3(a)(11) for transactions outside Rule 147, "only on an infrequent basis and in the most compelling circumstances." The Staff is of the opinion that the transaction proposed in your letter does not meet this requirement and, accordingly, we are not in a position to issue a no-action letter in this regard.

Furthermore, you request the Division's concurrence in your opinion that, in situations where the intrastate exemption of 3(a)(11) is unavailable, the Bank could rely upon the exemption provided by Section 3(a)(2) of the Act for the establishment of separate trust accounts.

The issue raised deals with the extent to which an exemption might be available under Section 3(a)(2) of the Act for interests and participations in H.R. 10 ("Keogh") Plans. The view of this Division is that the 1970 amendments to that Section, including the legislative history and the language of the statute, evidence a clear intent that no specific exemption was intended to be created for interests in H.R. 10 Plans. Accordingly, we are unable to concur in your opinion that the exemption provided by Section 3(a)(2) of the Act would be available to the Bank for the establishment of the separate interest accounts.

Please contact Mr. Thomas C. Lauerman of the Division of Investment Management (202-755-0217) if you have any questions regarding the Keogh Plan exception in Section 3(a)(2).

Sincerely,

Consuela M. Washington

Attorney Adviser

Securities and Exchange Commission (S.E.C.)

Collective Investment Funds

SEC No-Action Letter

Citizens and Southern National Bank

Publicly Available October 26, 1981

Recap
Requires securities registration of *Intrastate* Keogh (H.R. 10) accounts if Keoghs are commingled with

Interstate Employee Benefit Plans.

Letter to SEC

This firm represents the Citizens and Southern National Bank, a national banking association having an office and place of business in Atlanta, Fulton County, Georgia, (hereinafter called "C&S"); the C&S Pooled Profit Sharing and Pension Trust (hereinafter called the "Pooled Trust") and the C&S Commingled Retirement Trust Fund, (hereinafter called the "H.R. 10 Trust"). C&S is the trustee for both the Pooled Trust and the H.R. 10 Trust, both of which serve as the collective investment vehicles of various pension or profit sharing plans which meet the requirements for qualification under section 401 of the Internal Revenue Code of 1954 (hereinafter called "Qualified Plans").

The Pooled Trust holds only funds of Qualified Plans which do not cover persons who are employees within the meaning of section 401(c)(1) of the Internal Revenue Code of 1954 (hereinafter called the "Code"). Assets contributed to Qualified Plans sponsored by both Georgia and foreign employers are so held. The Pooled Trust relies on section 3(a)(2) of the Securities Act of 1933, as amended (hereinafter called the "1933 Act"), for exemption form the registration provisions of the 1933 Act.

The H.R. 10 Trust holds only funds of Qualified Plans sponsored by sole proprietors and partnerships. All partnerships, sole proprietors, partners owning more than a 10% interest in the capital or profits of a partnership, and members of the plan making voluntary contributions to the H.R. 10 Trust are residents of Georgia. The H.R. 10 Trust relies on section 3(a)(11) of the 1933 Act for exemption from the registration provisions of the 1933 Act.

In order to increase operating efficiency, C&S desires to commingle the funds of the Pooled Trust and the H.R. 10 Trust (the resulting entity hereinafter called the "Commingled Trust"). No funds contributed to a Qualified Plan which covers persons who are employees within the meaning of the Code section 401(c)(1) will be accepted by the Commingled Trust from any non-resident of Georgia, in accordance with the current policy of the H.R. 10 Trust. In our opinion, such a Commingled Trust will be exempt from the registration provisions of the 1933 Act by virtue of the principles stated in Release No. 33-6281, 17 C.F.R. 281 6281 (January 15, 1981).

Discussion of Law

Until recently, the Securities and Exchange Commission (hereinafter called the "Commission") has taken the position that the commingling of the assets of a retirement trust otherwise exempt under section 3(a)(2) of the 1933 Act with an H.R. 10 retirement trust exempt under section 3(a)(11) of the 1933 Act would result in neither exemption being available for the resultant commingled trust and, therefore, registration under the 1933 Act being required. *Commercial National Bank in Shreveport*, Federal Securities Law Reporter Transfer Binder 71-72, Paragraph 78,384 (1971); Release No. 33-6185, 17 C.F.R. 231. 6188 (February 1, 1980) at III(B)(1)(c).

However, on January 15, 1981, in Release No. 33-6281 at II(B)(2), the Commission announced a change in its position. Release No. 33-6281 set out four reasons for the change:

> (1) "Read literally, this language [of section 3(a)(2) of the 1933 Act] does not preclude commingling of Keogh plan assets with corporate plan assets."
>
> (2) "[T]he legislative history of section 3(a)(2) suggests that a literal interpretation is not inappropriate in this regard."
>
> (3) "[T]here does not appear to be any substantial reason why commingling of the assets of corporate and Keogh plans should be prohibited."
>
> (4) "A number of insurance companies have been commingling corporate and Keogh funds anyway."

Accordingly, the Commission declared that "the availability of the section 3(a)(2) exemption no longer will be deemed by the staff to depend in part on whether the assets of Keogh plans are commingled with the assets of tax qualified corporate plans." The Commission noted, however, that interests or participations sold to plans not subject to the section 3(a)(2) exemption would still be subject to registration under the 1933 Act, absent some other exemption.

Under Release No. 33-6281, section 3(a)(2) of the 1933 Act will clearly exempt from registration the interests or participations in the proposed Commingled Trust which would otherwise be the interests or participations in the Pooled Trust. Release No. 33-6281 implies that interests or participations in the proposed Commingled Trust which would otherwise be the interests or participations in the H.R. 10 Trust will be exempt from registration as long as such interests or participations are offered or sold only to residents of Georgia in accordance with section 3(a)(11) of the 1933 Act. Indeed, if the portion of the Commingled Trust represented by the current H.R. 10 Trust loses its exemption under section 3(a)(11) of the 1933 Act merely by virtue of the commingling, the Commission's change of position announced in Release No. 33-6281 would be of very little practical significance. Thus, it is our opinion that in accordance with Release No. 33-6281, a Commingled Trust of the type described herein will not be subject to registration under the 1933 Act.

In view of the foregoing, we respectfully request your confirmation that the staff will not recommend any action to the Commission if C&S commingles the Pooled Trust and the H.R. 10 Trust and offers and sells interests or participations in the resultant Commingled Trust under the terms stated herein without registration under section 5 of the 1933 Act.

SEC Letter

1933 Act / s 3(a)(2); 3(a)(11)

1981

September 25, 1981

Publicly Available October 26, 1981

After consideration of the facts presented, we are unable to agree with your view that the Section 3(a)(11) exemption would be available for interests in the proposed Commingled Trust sold exclusively to H.R. 10 plans who are Georgia residents. The Section 3(a)(11) exemption is by its terms unavailable where an offering of securities is extended to non-residents of the state in which the issuer resides and conducts its business. In the case of the proposed Commingled Trust, a Georgia resident, interests therein would be issued not only to H.R. 10 plans resident in Georgia, but also to tax-qualified corporate plans sponsored by employers who are non-residents of Georgia. The offer and sale of interests to these nonresident plans would, in our view, render the Section 3(a)(11) exemption unavailable for the offer and sale of interests to resident H.R. 10 plans.

The Statements in Release 33-6281 which you believe support your view regarding the availability of the Section 3(a)(11) exemption for the H.R. 10 portion of the Commingled Trust were intended to indicate simply that the Section 3(a)(2) exemption for trust interests sold to tax-qualified corporate plans would not be lost merely because assets of H.R. 10 plans were commingled with the assets of the corporate plans. The statements reflected the longstanding views of many insurance companies that they could commingle corporate and H.R. 10 plan monies in the same fund and register only the H.R. 10 interests, while relying on the Section 3(a)(2) exemption for the corporate plan interests. The statements were not designed to convey the impression that it is possible in a single trust to rely on the Section 3(a)(2) exemption for interests sold to non-resident corporate plans and on the Section 3(a)(11) exemption for interests sold to resident H.R. 10 plans. We recognize, however, that the statements in the release regarding this issue are ambiguous and could therefore be misconstrued. Accordingly, this Division, as a matter of policy, will not recommend any enforcement action to the Commission with respect to past transactions by commingled trusts who in good faith have been selling interests to resident H.R. 10 plans in reliance upon their belief that the statements in the release permitted Section 3(a)(11) to be available for such sales at the same time that Section 3(a)(2) was available for sales to non-resident corporate plans. This no-action position will also apply for the reasonable time after publication of this letter necessary for the taking of corrective action to conform to the interpretation herein.

Collective Investment Funds

SEC No-Action Letter

[The Provident Bank]

Publicly Available September 24, 1991

Recap
Permits the collective investment of Corporate and Government Employee Benefit Plans without Registration of either CIFs or Interests (*participant plans*) in the CIFs

Letter to SEC

June 4, 1990

Office of Chief Counsel

Division of Corporate Finance

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

Office of Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

RE: Request for No Action Letter Regarding The Provident Bank

Section 3(a)(2) of the Securities Act of 1933

Section 3(a)(12) of the Securities Act of 1934

Section 3(c)(11) of the Investment Company Act of 1940

Gentlemen:

We are writing on behalf of The Provident Bank ("Provident"). Provident proposes to form a collective trust fund for the investment of funds held on behalf of employee benefit plans qualified under Section 401(a) of the Internal Revenue Code (the "Code") and exempt from tax under Section 501(a) of the Code, governmental plans under Section 414(d) of the Code and group trusts consisting entirely of assets of such plans.

We respectfully request a determination that the Staff will not recommend any enforcement action to the Commission if Provident maintains and operates the fund:

(i) without registering the interests in the fund under the Securities Act of 1933 (the "1933 Act"), in reliance upon the exemption provided by Section 3(a)(2);

(ii) without registering the interests in the fund under the Securities Exchange Act of 1934 (the "1934 Act"), in reliance upon the exemption provided by Section 3(a)(12) of such Act; and

(iii) without registering the fund as an investment company under the Investment Company Act of 1940 (the "1940 Act"), in reliance upon the exclusion set forth in Section 3(c)(11) of such Act.

I. Statement of Facts

A. General

Provident is an Ohio banking corporation authorized to engage in the banking business and to conduct trust activities. A substantial portion of Provident's business consists of receiving deposits and exercising fiduciary powers similar to those permitted to national banks under the authority of the Office of the Comptroller of the Currency ("OCC"). On December 31, 1989 it had total assets of approximately $2 billion and deposits of approximately $1.6 billion. Provident is a member of the Federal Reserve System and of the Federal Deposit Insurance Corporation.

Provident proposes to establish a collective trust fund to be known as the Provident Investment Contract Fund (the "Fund"). The Fund's assets would be invested primarily in guaranteed investment contracts ("GICs") issued by insurance companies and bank investment contracts ("BICs") issued by commercial banks and trust companies. GICs and BICs are contracts issued on a negotiated basis, guaranteed by the issuer, having specific terms governing yield, payment of interest, benefit and withdrawal rights and length of commitment, and are generally carried at book value. Under the Fund's plan of operation, the trustees of a qualified employee benefit plan or other prospective participant (the "Participating Trust") may elect to participate in the Fund by satisfying the eligibility criteria, by providing appropriate evidence of authority to invest in the Fund and by establishing a qualifying relationship with the Bank.

B. Participation in the Fund

Provident proposes to limit participation in the Fund to the following trusts:

> (i) retirement, pension, profit-sharing, stock bonus and other trusts forming a part of a plan or plans qualified under the provisions of Section 401(a) and exempt from federal income taxation under Sections 501(a) of the Code;
>
> (ii) trusts maintained in connection with a governmental plan within the meaning of Section 414(d) of the Code; and
>
> (iii) group trusts maintained by a bank the assets of which consist entirely of assets of trusts described in (i) or (ii) above.

Certain qualified plans are not eligible, however, such as a plan covering employees described by Section 401(c)(1) of the Code or a plan funded by an annuity contract described in Section 403(b) of the Code, except to the extent by rule or regulation of the SEC the participation of such plans would be permissible without requiring registration of the interests in the Fund under the 1933 Act or the 1934 Act or the registration of the Fund as an investment company under the 1940 Act. This provision is intended to permit H.R. 10 (Keogh) plans or Individual Retirement Accounts (IRAs) to participate at such time as the legal effects of including those types of plans become clearer, particularly the application of the 1940 Act.

Provident intends to limit investment in the Fund to plans satisfying the requirements of your March 18, 1977 letter re Guaranteed Investment Contracts, i.e. a plan may not participate unless it (a) covers at least fifteen persons, (b) has annual contributions of more than $10,000 or (c) is established by a corporate employer with a net worth of at least $100,000 on the last day of its prior fiscal year. Provident would also deliver to each prospective Participating Trust and include in any printed sales literature an offer by Provident to provide, upon request and without cost, financial statements and other material information about the issuer(s) of the GICs and BICs and would direct any advertising to employers that may adopt qualified plans or to the trustees of such plans and not to individual employees.

In addition, investment in the Fund would be permissible only if Provident serves in one of the following capacities:

> (i) Provident is a trustee of the Participating Trust;
>
> (ii) Provident is an investment manager, within the meaning of Section 3(38) of Employee Retirement Income Security Act of 1974, as amended ("ERISA"), with respect to all or a portion of the assets of such trust; or

(iii) Provident has been appointed by the trustees of the Participating Trust to render investment advice with respect to all or a portion of the assets of such trust.

The Fund would also prohibit Provident from participating in the Fund, directly or indirectly (e.g., by taking participations as security for a debt).

C. Investment Policy

The Fund would be invested in fixed income securities, primarily GICs and BICs, with staggered maturities to provide a predictable cash flow from interest income and contract maturities. The Fund could also invest in certificates of deposit issued by banks and savings and loan associations, obligations of the U.S. Treasury and U.S. agencies, commercial paper and similar corporate obligations, other short-term cash equivalent instruments and variable rate contracts to provide liquidity for monthly benefit withdrawals.

D. Administration

Provident will have sole authority to select the GICs and BICs into which the Fund's assets will be invested. Although Provident intends to solicit advice and recommendations from firms which are knowledgeable as to the available contracts, Provident will make the final decision as to specific contracts to be purchased. In making investment decisions, Provident will consider, among other factors, the quality of the various issuers, the effective yield after expenses, the period of the guaranteed interest and other terms of the contracts.

Provident intends to enter into a marketing agreement with The New York GIC Exchange, Inc. which among other things is engaged in the business of marketing GICs, and to employ NYGIC Capital, Inc., a registered investment advisor, as an investment advisor to the Fund. Provident would pay all of the fees and expenses incurred for these services, separately and not from the assets of the Fund. The investment advisor would make recommendations to Provident concerning the purchase and disposition of GICs for the Fund, but Provident would be free to accept or reject any recommendation without justification or explanation. The proposed investment advisor is not affiliated with Provident but Provident is not precluded from using an affiliate or from performing these services itself.

E. Valuation

The units would be valued by valuing each asset and liability in the Fund's portfolio at fair market value. Accordingly, the plan of operation for the Fund will specify valuation techniques which will result in a determination of fair market values.

F. Admissions and Withdrawals

Admissions and withdrawals from the Fund would be permitted only on a valuation date and would require advance notice to the Fund. Because of the long-term nature of the GICs in the Fund, withdrawals may require a waiting period. Provident proposes to allow for a waiting period of up to one year, while making a good faith effort to permit withdrawals sooner if possible. Interests in the Fund would be nonassignable.

G. Coordination with other Regulatory Requirements.

Provident presently maintains several common trust funds in compliance with the Ohio Revised Code and applicable regulations of the Internal Revenue Service and of the OCC. These common trust funds are utilized by Provident to administer funds held by it in applicable fiduciary roles incident to performing its trust services.

The Provident Investment Contract Fund will be established and administered in a similar manner as existing common trust funds, in accordance with the provisions of applicable state law and regulatory requirements.

One difference with existing common trust funds, however, is that Provident is not required to be a "trustee, executor, administrator or guardian" of each Participating Trust in the Fund. Provident may be an investment manager with respect to the Participating Trust, or appointed to render investment advice with respect to the plan assets.

Provident, as trustee of the Fund, has sought, but not yet received, a determination letter from the Internal Revenue Service to the effect that the Fund is a qualified trust under section 401(a) of the Code and is exempt from income tax under section 501(a) of the

Code, pursuant to the requirements detailed in Rev.Rul. 81-100, 1981-1 C.B. 326. For purposes of this letter, we assume that the Fund would so qualify.

Another difference with existing common trust funds relates to the application of OCC regulations. Unlike Section 584 of the Internal Revenue Code, RR 81-100 does not require compliance with OCC regulations as a condition of the tax exemption under Section 501(a) of the Code. Because Provident is a state bank, the OCC regulations do not apply to the Fund. Furthermore, it is our understanding that the OCC as a matter of policy will only review the collective investment funds of national banks. Because Provident is a state-chartered bank, we would in any event be unable to obtain assurance of compliance with these regulations.

Nonetheless, in accordance with the policy of the Federal Reserve Board, Provident intends as a matter of prudence to operate and maintain the Fund in accordance with OCC regulations. We believe that the Fund complies with the specific requirements of Part 9 of such regulations (Section 9.18) relating to collective investment of trust funds.

II. Discussion

A. General

Based upon the facts set forth above, it is our opinion that the proposed Fund and the interests or participations therein comply with statutory provisions which permit the operation of the Fund without registration of interests or participations under the 1933 Act and the 1934 Act and without the registration of the Fund as an investment company under the 1940 Act.

Section 3(a)(2) of the 1933 Act provides an exemption for the following securities:

> ... any interest or participation in a single trust fund, or in a collective trust fund maintained by a bank, ..., which interest, participation, or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (B) an annuity plan which meets the requirements for the deduction of the employer's contributions under section 404(a)(2) of such Code, or (C) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph (i) the contributions under which are held in a single trust fund or in a separate account maintained by an insurance company ..., which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code, or (iii) which is a plan, funded by an annuity contract described in section 403(b) of such Code.

Section 3(a)(12)(A)(iv) of the 1934 Act provides a similar exemption for the following securities:

> (iv) any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, ..., which interest, participation, or security is issued in connection with a qualified plan as defined in subparagraph (C) of this paragraph; ....
> (C) For purposes of subparagraph (A)(iv) ..., the term "qualified plan" means (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (ii) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, or (iii) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the

> satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (i), (ii), or (iii) of this subparagraph which (I) covers employees some or all of whom are employees within the meaning of section 401(c) of such Code or (II) is a plan funded by an annuity contract described in section 403(b) of such Code. See also Section 12(g)(2)(H) of the 1934 Act.

Section 3(c)(11) of the 1940 Act excludes from the definition of an investment company the following:

> (11) Any employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1986; or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts or governmental plans, or both;

The plan of operation for the Fund explicitly restricts participation in the Fund to those trusts and plans permitted by the foregoing provisions of the 1933 Act, the 1934 Act and the 1940 Act.

B. Provident as "Bank"

Provident is a "bank" for the purposes of Section 3(a)(2) of the 1933 Act, Section 3(a)(6) of the 1934 Act and Section 3(c)(11) of the 1940 Act by reason of the definition of "bank" in Section 2(a)(5) of the 1940 Act, since it is a state-chartered bank, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the OCC, supervised by the Ohio Superintendent of Banks and the Federal Reserve Board and not operated for the purposes of evading the provisions of the 1940 Act.

C. "Maintained by a Bank" Requirement

The Fund will be "maintained" by Provident because Provident, as trustee of the Fund, will exercise "substantial investment responsibility." See, generally, Securities Act Release No. 33-6188, 38 F.R. 8962 (Part IV(A)(3)(a)) (February 1, 1980), Bank of America (December 8, 1971) and Sterling National Bank and Trust Company of New York (February 10, 1976). Section 3(c)(11) of the 1940 Act is interpreted similarly. See Bank of Delaware (November 15, 1972). The use of an investment advisor as contemplated by Provident is not inconsistent with exercising substantial investment responsibility. See Lincoln First Bank, N.A. (October 24, 1983). Provident will have full and complete authority to determine the specific securities purchased, retaining discretion to accept or reject the advice of any investment advisor and will have officers and appropriate staff to make such decisions. See Frank Russell Trust Company (July 11, 1980), Frank Russell Trust Company (September 2, 1982) and First Liberty Real Estate Fund (July 14, 1975).

A separate copy of this letter has been submitted to the Division of Investment Management for consideration of the 1940 Act issues. If you have any questions with regard to the foregoing, please contact the undersigned at (513)579-6595.

Timothy B. Matthews

Keating, Muething & Klekamp

Keating, Muething & Klekamp

1800 Provident Tower

One East Fourth Street

Post Office Box 1800

Cincinnati, Ohio 45202

(513)579-6400

Letter to SEC

September 26, 1990

Office of Chief Counsel

Division of Corporate Finance

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

Attn: Ms. Laurie Green, Esq.

RE: Request for No Action Letter Regarding The Provident Bank

Section 3(a)(2) of the Securities Act of 1933

Section 3(a)(12) of the Securities Act of 1934

Section 3(c)(11) of the Investment Company Act of 1940

Dear Ms. Green:

Reference is made to our letter dated June 4, 1990 on behalf of The Provident Bank ("Provident") and to our subsequent telephone conversations concerning Provident's request. You have asked questions or requested clarification of our letter in four respects.

1. Participation in the Fund by Group Trusts

You have asked us to discuss further the aspect of participation in the Provident Investment Contract Fund (the "Fund") by "group trusts."

In Section I. B of our June 4, 1990 letter, we indicated that participation in the Fund was limited to trusts falling into one of three general categories. The third category is "group trusts maintained by a bank the assets of which consist entirely of assets of trusts described in [the first two categories]."

A group trust is a trust in which individual trusts have pooled their assets (often for diversifying their investments) where the group trust is declared to be part of the qualified plans of which it is comprised. Revenue Ruling 81-100, 81-13 I.R. B 32 describes the conditions under which a group trust may qualify for an exemption from taxation under Section 501(a) of the Internal Revenue Code (the "Code") and under which the tax qualification of its respective constituent trusts will not be affected by the pooling of their funds in a group trust.

The Provident Investment Contract Fund is an example of a group trust which qualifies under Rev.Rul. 81-100 and we have obtained a determination letter dated July 9, 1990 from the Internal Revenue Service to that effect. A group trust could be eligible to participate in the Fund only if it were maintained by a bank and only if its assets consisted entirely of assets of trusts which otherwise would be eligible to participate directly in the Fund, i.e., either (i) retirement, pension, profit-sharing, stock bonus and other trusts forming a part of a plan or plans qualified under the provisions of Section 401(a) and exempt from federal income taxation under Section 501(a) of the Code or (ii) trusts maintained in connection with a governmental plan within the meaning of Section 414(d) of the Code.

Participation in the Fund by a group trust meeting these conditions is substantively no different than participation by a qualified trust directly. Section 3(a)(2) of the 1933 Act provides an exception for "any interest or participation in ... a collective trust fund ... which interest, participation or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code." Since a group trust qualifies under Section 401 of the Code, Section 3(a)(2) of the 1933 Act describes an exemption for participation in the Fund by a group trust meeting Provident's conditions.

The language in Section 3(a)(12)(A)(iv) of the 1934 Act is similar. The 1940 Act describes a similar exclusion from the definition of an investment company. Since the assets comprising the Fund will consist

solely of the type of assets described in Section 3(c)(11) of the 1940 Act (whether contributed directly from a qualified retirement plan, for example, or indirectly from a group trust comprised of assets of qualified plans), the Fund as a collective trust fund comprised of these assets is excluded from the definition of an investment company.

2. Application of the 1982 Frank Russell Letter

You have asked for clarification from us as to the relevance of the September 2, 1982 letter concerning the Frank Russell Trust Company cited by us at page 4 of our June 4 no-action letter request.

A part of the concept that a collective trust fund is "maintained by a bank" is that the bank exercises substantial investment responsibility. Where a bank proposes to retain the services of an investment advisor, a question may arise as to whether the nature of such services is inconsistent with the bank's continued exercise of investment responsibility.

In the Frank Russell Trust Company situation, the Trust Company proposed to use the consulting and advisory services of a third party, which would provide certain recommendations concerning the investments to be purchased and sold. However, the Trust Company retained final and complete authority to accept or reject such recommendations, reviewed and evaluated such recommendations independently, and represented that it had adequate staff to do so.

We have made similar representations on behalf of Provident in our letter of June 4 and therefore believe that the favorable position of the staff in the Frank Russell Trust Company situation supports our request in this respect.

3. Appointment of Provident to Render Investment Advice

You have requested clarification of our position on item (iii) appearing at page 3 of our June 4 letter, regarding the capacities in which Provident must serve vis-a-vis a prospective participant in order to make an investment in the Fund permissible.

Our letter states that investment in the Fund would be permissible only if Provident serves in one of three capacities: (i) Provident is a trustee of the Participating Trust; (ii) Provident is an investment manager with respect to the assets of such trust; or (iii) Provident has been appointed by the trustees of the Participating Trust to render investment advice with respect to all or a portion of the assets of such trust.

As we discussed, because of Ohio law concerning collective investment trusts, Provident has decided to delete the third qualifying relationship from the plan of operation of the Fund. Accordingly, Provident must be either a trustee or an investment manager in order to permit the prospective participant to invest in the Fund. Thus, it is now unnecessary to address your questions about this aspect of the Fund.

4. Application of Rule 180

You have asked us to clarify our request regarding the application of Rule 180 to the Fund.

We have not asked in our June 4 letter for the SEC to take a specific no-action position with respect to the application of Rule 180 to the Fund. However, the Fund does permit participation of certain types of plans (Keoghs) under the conditions described in Rule 180 and Provident reserves the right to permit participation on those terms. If this is inconsistent with our other requests or if you believe that the Rule 180 conditions could not be satisfied, we would appreciate the opportunity to discuss this further with you.

If you have any further questions with regard to the foregoing, please contact the undersigned at (513)579-6595.

Timothy B. Matthews

Keating, Muething & Klekamp

Letter to SEC

May 2, 1991

Office of Chief Counsel

Division of Corporate Finance

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

Office of Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20519

Re: Request for No Action Letter Regarding The Provident Bank

Section 3(a)(2) of the Securities Act of 1933

Section 3(a)(12) of the Securities Act of 1934

Section 3(c)(11) of the Investment Company Act of 1940

Gentlemen:

This letter is to follow up my discussions with Cecelia Blye and Larry Stadulis concerning our no action letter request dated June 4, 1990 submitted on behalf of The Provident Bank.

We requested that the Staff take a "no action" position with respect to The Provident Investment Contract Fund. You have indicated that you would not be in a position to take a "no action" position because one of the eligible participants in the proposed fund could be a "group trust" maintained by a bank the assets of which consist entirely of assets of trusts described in paragraphs (i) and (ii), page 2, of our June 4, 1990 letter.

Provident has decided not to permit the "group trusts" described in our letter to participate in the fund. In these circumstances, we believe that Provident may maintain and operate the fund without registering the interests in the fund under the Securities Act of 1933, in reliance upon the exemption provided by Section 3(a)(2), without registering the interests in the fund under the Securities Act of 1934, in reliance upon the exemption provided by Section 3(a)(12), and without registering the fund as an investment company under the Investment Company Act of 1940, in reliance upon the exemption provided by Section 3(a)(11). Therefore, on behalf of Provident, we hereby request that the Staff advise us that it would not recommend to the Commission that it take any action if Provident, on the basis of our opinion, maintains and operates the fund without registration under the Acts set forth above in reliance upon the exemptions so cited.

We will appreciate your expedited consideration of this request given the length of time since the date of our original request.

Sincerely,

Timothy B. Matthews

Keating, Muething & Klekamp

SEC Letter

1934 Act / s 3(a)(12)

September 24, 1991

Publicly Available September 24, 1991

On the basis of the facts presented in your letters of June 4, 1990, September 26, 1990, and May 2, 1991, we would not recommend that the Commission take any enforcement action under the Investment Company Act of 1940 ("1940 Act") if The Provident Bank (the "Bank") establishes and operates the

Provident Investment Contract Fund (the "Fund") without registering the Fund under the 1940 Act in reliance upon the exclusion in Section 3(c)(11) of the 1940 Act. Our response is conditioned, among other things, upon the following: (1) your representation that although the Bank intends to solicit advice and recommendations from firms which are knowledgeable as to the available contracts, it will make the final decision as to specific contracts to be purchased and will have the sole authority to select the GICs and BICs in which the Fund's assets will be invested;[1] (2) the Bank's receipt of a letter from the Internal Revenue Service stating that the Fund is a Qualified Trust under Section 401(a) of the Internal Revenue Code of 1986, as amended;[2] and (3) the representation in your letter of May 2, 1991, that "group trusts" will not participate in the Fund.

The Division of Corporation Finance has asked us to advise you that, on the basis of the facts presented, that Division will not recommend any enforcement action to the Commission if the Bank, in reliance upon your opinion as counsel that the exemptions provided by Section 3(a)(2) of the Securities Act of 1933 and Section 12(g)(2)(H) of the Securities Exchange Act of 1934 are available, operates the described fund without compliance with the registration requirements of the 1933 and 1934 Acts. This position is based on the representations made in your letters, particularly your representation that the Bank will retain full investment authority for, and exclusive management of, the fund.

The Division of Market Regulation concurs in the position of the Divisions of Corporation Finance and Investment Management in reliance on your opinion of counsel and in particular your representations that The Provident Bank is a member of the Federal Deposit Insurance Corporation and the Federal Reserve System and that, in accordance with the policy of the Federal Reserve Board, Provident intends to operate and maintain the Fund in accordance with regulations of the Office of the Comptroller of the Currency.

Because these positions are based on the facts and representations made to the Divisions, you should note that any different facts or representations may require different conclusions. Moreover, this response only expresses the Division's positions on enforcement action and does not purport to express any legal conclusions on the questions presented.

Lawrence P. Stadulis

Attorney

Securities and Exchange Commission (S.E.C.)

[1] See Securities Act Rel. No. 6188 (Feb. 1, 1980); Citytrust (pub. avail. Feb. 12, 1988); Union Bank & Trust (pub. avail. July 8, 1987); National Bank of Commerce Investment Fund (pub. avail. Oct. 10, 1986); Frank Russell Trust Company (pub. avail. Sept. 2, 1982); Frank Russell Trust Company (pub. avail. Aug. 25, 1980); First Liberty Real Estate Fund (pub. avail. July 14, 1975).

[2] In a telephone conversation with the undersigned on July 25, 1990, Timothy B. Matthews represented that the assets of the Fund will not be commingled with the assets of trusts that are qualified under Section 408 of the Internal Revenue Code of 1986, as amended.

Collective Investment Funds

SEC No-Action Letter

The Idaho First National Bank

Publicly Available October 11, 1988

Recap
Permits the collective investment of Corporate and Government Employee Benefit Plans without Registration of either CIFs or Interests (*participant plans*) in the CIFs

Letter to SEC

July 25, 1988

Division of Investment Management

Stop 5-2

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

Attention: Ms. Carol Peebles

Subject: The Idaho First National Bank

Gentlemen:

We are special counsel to The Idaho First National Bank ("Idaho First"), a national banking association which is a wholly owned subsidiary of Moore Financial Group Incorporated ("Moore"), a regional bank holding company. On behalf of Idaho First, we request that you advise us whether the staff of the Division of Investment Management will recommend any enforcement action to the Securities and Exchange Commission ("Commission") regarding the question set forth below.

Facts

Idaho First presently operates a collective investment fund ("Trust") maintained exclusively for assets of employee benefit plans qualified under section 401 of the Internal Revenue Code of 1986, as amended ("Code"). Presently, no funds of plans covering employees within the meaning of Code s 401(c)(1) are held in the Trust and, except as permitted pursuant to Rule 180 under the Securities Act of 1933 ("1933 Act"), no such funds will be permitted in the Trust.

Idaho First proposes to amend and restate the declaration of trust related to the Trust ("Amendment"). The Amendment will make the Trust a group trust pursuant to the provisions of 12 CFR 9.18(a)(2) and Revenue Ruling 81-100 and allow the participation or inclusion in the Trust of the moneys of certain plans or governmental units described in Code section 818(a)(6), as permitted by Code section 401(a)(24).

Code section 401(a)(24) provides that the tax-exempt status of a group trust will not be adversely affected merely because of the participation or inclusion in the trust of moneys of any plan or governmental unit described in Code section 818(a)(6). Code section 818(a)(6) includes

"(A) a governmental plan (within the meaning of Code section 414(d) or an eligible State deferred compensation plan (within the meaning of Code section 457(b)), or

"(B) the Government of the United States, the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing, for use in satisfying an obligation of such government, political subdivision, or agency or instrumentality to provide a benefit under a plan described in subparagraph (A)."

Code section 414(d) defines a governmental plan as

> "a plan established and maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. The term 'Governmental Plan' also includes any plan to which the Railroad Retirement Act of 1935 or 1937 applies and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation by reason of the International Organizations Immunities Act (59 Stat. 669)."

Pursuant to the Amendment, the Trust proposes to receive moneys from any governmental plan (other than a Code section 457 state deferred compensation plan) whether or not the plan is qualified under Code section 401(a) and whether or not the assets of the plan are held in trust, as well as moneys from any federal, state, or local government or agency (a "governmental unit") held for use in satisfying an obligation of the government or agency to provide a retirement benefit under a governmental plan.

Before investing in the Trust, the administrator or trustee of each governmental plan or governmental unit will be required to represent in writing to Idaho First the following:

1. The plan is for the exclusive benefit of the government employer's employees or their beneficiaries;

2. The purpose of the plan is the distribution of corpus and income of funds, if any, accumulated under such plan to the employees or the employees' beneficiaries;

3. It is impossible under the plan for any part of the corpus or income of the plan to be used or diverted to any purpose other than the exclusive benefit of the employees or the employees' beneficiaries prior to the satisfaction of all the plan's liabilities to such employees and employees' beneficiaries;

4. The plan is not funded in part by an annuity contract described in Code section 403(b); and

5. If the plan purchases any securities issued by the government employer or any government entity controlling, controlled by, or under common control with the government employer in an amount in excess of contributions made by the government employer, the securities must be exempt from registration under the 1933 Act.

The approval of the Amendment by the Comptroller of the Currency and a favorable determination letter from the Internal Revenue Service with regard to the tax-exempt status of the Trust will be obtained.

Discussion

A discussion of the applicable provisions of the 1933 Act, the Securities Exchange Act of 1934 ("1934 Act"), and the Investment Company Act of 1940 ("1940 Act") follows.

1933 Act. The exemption from registration afforded by section 3(a)(2) of the 1933 Act applies to:

> "any interest or participation * * * in a collective trust fund maintained by a bank * * * which interest, participation, or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954 * * * or (C) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph (i) the contributions under which are held in a single trust fund * * * and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust * * * itself) issued by the employer or any company directly or indirectly controlling, controlled by, or under common control with the employer, (ii) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code, or (iii) which is a plan funded by an annuity contract described in section 403(b) of such Code." (Emphasis added.)

1934 Act. The exemption from registration under section 3(a)(12)(A)(iv) of the 1934 Act applies to:

> "any interest or participation in a * * * collective trust fund maintained by a bank * * * which interest, participation, or security is issued in connection with a qualified plan as defined in subparagraph (C) of this paragraph * * *.
>
> "(C) For purposes of subparagraph (A)(iv) of this paragraph, the term "qualified plan" means (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954 * * * or (iii) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described

in clause (i), (ii), or (iii) of this subparagraph which (I) covers employees some or all of whom are employees within the meaning of section 401(c) of such Code, or (II) is a plan funded by an annuity contract described in section 403(b) of such Code."

1940 Act. Section 3(c)(11) of the 1940 Act provides an exemption from investment company status for:

"[a]ny employee's stock bonus, pension, or profit-sharing trust which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1986; or any governmental plan described in section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts or governmental plans, or both * * *."

The exemptions afforded by section 3(a)(2) of the 1933 Act, section 3(a)(12) of the 1934 Act, and section 3(c)(11) of the 1940 Act would encompass the receipt of moneys by the Trust directly from governmental plans which are qualified under Code section 401 as well as certain nonqualified governmental plans.

However, two specific aspects of the Trust with respect to governmental plans require further discussion:

Governmental Units. Under the Amendment, the Trust will be permitted to receive moneys directly from governmental units as well as from governmental plans. The lead-in phrase to the exemptions under sections 3(a)(2) and 3(a)(12) states that the exemption is available for any interest or participation issued in connection with a governmental plan. Since the moneys are being invested in the Trust to satisfy an obligation of the governmental unit under a governmental plan, we believe interests or participations issued to governmental units in this situation are issued in connection with governmental plans and should likewise be exempt under sections 3(a)(2) and 3(a)(12).

The exemption under section 3(c)(11) of the 1940 Act does not specifically refer to trust funds containing assets of governmental units. However, under the Amendment, a governmental unit will be able to invest in the Trust only to satisfy an obligation to provide a benefit under a governmental plan. Thus, when the Trust receives money from a governmental unit, the money will in effect become part of the assets of a governmental plan. Accordingly, in our view the Trust is exempt under section 3(c)(11) because it is a collective trust fund maintained by a bank consisting solely of assets of qualified employee benefit trusts or governmental plans, or both.

Investment by a Governmental Plan in the Securities of the Government Employer. It is possible that contributions to a governmental plan may be invested both in the Trust and directly by the governmental plan itself in securities of the government employer ("Employer") or of another state, federal, or local government or agency, or instrumentality thereof. For example, a governmental plan for a particular county in a state might invest in the securities of such state and its other instrumentalities. Such investment could exceed the contributions made by the county to the governmental plan.

Section 3(a)(2) of the 1933 Act, unlike sections 3(a)(12) of the 1934 Act and 3(c)(11) of the 1940 Act, disallows the exemption provided by the section for any plan "the contributions under which are held in a single trust fund * * * for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust * * * itself) issued by the employer or any company directly or indirectly controlling, controlled by, or under common control with the employer." (Emphasis added.)

This statutory language predated the addition of the governmental plan exemption under section 3(a)(2) and could be read to prohibit the purchase by a governmental plan of securities of which the Employer, or its controlled or commonly controlled entities, is the issuer if employee contributions under such plan are held in a single trust fund and such purchases exceed the Employer's contribution to the governmental plan. However, it does not seem likely that Congress intended the underlined language to apply to government entities because of its use of the word "company." A governmental entity is not ordinarily referred to as a "company."

In addition, in the event that all of the assets of a governmental plan are not committed to the Trust and the noncommitted assets are used by such plan to purchase securities of the Employer or its controlled or commonly controlled entities in excess of the amount contributed by the Employer, such a reading of s 3(a)(2) would seem not only to require the registration of interests in such governmental plan, but also interests in the Trust. Registration of the interests in the Trust would be required because the interests would be issued in connection with a governmental plan which does not fit within the exemption. We do not believe that the investment by the governmental plan of assets not committed to the Trust should affect the availability of the s 3(a)(2) exemption for interests in the Trust, because the investment of noncommitted funds is beyond the control of the Trust. Requiring registration of interests in the Trust

would not provide disclosure of investments outside the Trust.

Further, a governmental plan that invests in securities issued by the government employer or any government entity controlling, controlled by, or under common control with the government employer will be investing in securities that are exempt from registration under the 1933 Act. Congress could not have intended to require registration of plan interests based on the indirect acquisition of government securities with employee contributions (through a plan) where the securities could be offered and sold to employees directly without registration pursuant to section 3(a)(2) of the 1933 Act.

Conclusion

Based upon the foregoing facts, upon the no-action position taken by the staff in InterFirst Bank Dallas, N.A. (available April 4, 1983), and upon the analysis discussed above, it is our opinion that the interests in the Trust to be issued pursuant to the Amendment outlined above are exempt securities under section 3(a)(2) of the 1933 Act and under section 3(a)(12) of the 1934 Act and would not require the Trust to register as an investment company under the 1940 Act by virtue of the exemption afforded by section 3(c)(11) thereof.

Request

We request that you advise us whether the staff of the Division of Investment Management will recommend any enforcement action to the Commission if the Amendment as described herein is undertaken without compliance with the various registration requirements of the 1933 Act, the 1934 Act, and the 1940 Act.

Very truly yours,

Rebecca S. Wilson

Letter to SEC

September 9, 1988

Division of Corporation Finance

Stop 7-2

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

Attention: Ms. Felicia Smith

Subject: The Idaho First National Bank

Gentlemen:

Pursuant to our telephone conversations of August 22, 1988, and September 8, 1988, and on behalf of The Idaho First National Bank, we submit the following information to supplement our no-action letter request dated July 25, 1988. Item 5 on page 3 of the July 25 letter should read as follows:

> 5. If the plan purchases any securities issued by the government employer or any other governmental entity controlling, controlled by, or under common control with the government employer in an amount in excess of contributions made by the government employer, the securities must be exempt from registration under the 1933 Act and must be municipal securities as defined in section 3(a)(29) of the Securities Exchange Act of 1934 ("1934 Act") (and thus would be exempted securities under section 3(a)(12)(A)(ii) of the 1934 Act).

Very truly yours,

Rebecca S. Wilson

SEC LETTER

ICA 1940 Act / s 3(c)(11)

October 11, 1988

Publicly Available October 11, 1988

We would not recommend that the Commission take any enforcement action under the Investment Company Act of 1940 if The Idaho First National Bank ("Company") implements the proposed amendment to the declaration of trust related to the collective trust fund ("Trust") without registration of the Trust, under the 1940 Act in reliance upon Section 3(c)(11) thereof. See Interfirst Bank Dallas (pub. avail. Jan. 11, 1983) and e.g. Wachovia Bank and Trust Company, N.A. (pub. avail. Nov. 21, 1983).

The Division of Corporation Finance has requested us to advise you that, based on the facts presented, but without necessarily concurring in your analysis, that Division will not recommend enforcement action to the Commission if the Company, in reliance on your opinion that interests in the Company's collective investment fund by any governmental plan or unit are exempt from registration under Section 3(a)(2) of the Securities Act of 1933 ("1933 Act") and Section 3(a)(12) of the Securities Exchange Act of 1934 ("1934 Act"), implements and operates the Trust as proposed without registration under the 1933 Act or the 1934 Act. In arriving at this position, we have noted particularly that (1) the Company will require certain representations from the administrator or trustee of each governmental plan or governmental unit from which it receives monies for investment; and (2) in the event that a governmental plan or governmental unit invests in securities of the employer or a related entity, such securities must be exempt from registration under the 1933 Act and the 1934 Act.

Because these positions are based on representations made in your letters, it should be noted that any different facts may require a different conclusion. Furthermore, this response only expresses the Divisions' positions on enforcement action and does not express any legal conclusion on the questions presented.

Carol A. Peebles

Attorney

Securities and Exchange Commission (S.E.C.)

Collective Investment Funds

SEC No-Action Letter

Fidelity Management Trust Company

Publicly Available November 2, 1989

Recap
Permits the collective investment of Government Employee Benefit Plans without Registration of either CIFs or Interests (*participant plans*) in the CIFs

Letter to SEC

September 26, 1989

Office of Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

Attn.: Elizabeth T. Tsai

Re: Fidelity Management Trust Company Request for No-Action Letter under 1933 Act Section 3(a)(2), 1934 Act Section 3(a)(12) and 1940 Act Section 3(c)(11)

Dear Ms. Tsai:

This letter is intended to respond to the questions you raised during our recent telephone conversations with regard to our no-action request dated February 3, 1989 and, as you requested, to restate that request so that this letter could be reviewed as a request complete in itself.

On behalf of Fidelity Management Trust Company, an FDIC-insured Massachusetts chartered bank and trust company ("FMTC"), we respectfully request a determination that the Staff (the "Staff") of the Securities and Exchange Commission (the "Commission") will not recommend that the Commission take any enforcement action if the offering of the Fidelity Group Trust for Employee Benefit Plans (the "Trust") to deferred compensation plans maintained by state and local governmental units under Section 457 of the Internal Revenue Code of 1986, as amended (the "Code"), is undertaken without registration under the Securities Act of 1933 (the "1933 Act"), the Securities Exchange Act of 1934 (the "1934 Act") and the Investment Company Act of 1940 (the "1940 Act").

This request should be granted because it is consistent with both prior no-action positions of the Commission and the legislative history to the Acts and because no public policy interest would be served by requiring registration in this situation.

I. Statement of Facts

FMTC was organized in 1981 as a subsidiary of FMR Corp., a Massachusetts holding company. Despite its name, FMTC is not merely a trust company. Rather, FMTC is a bank engaged in a wide variety of banking activities, including the taking of deposits and the exercising of fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency. These activities may be summarized as follows:

A. With respect to its depository activities, FMTC has accepted various types of deposits withdrawable by check, as well as time deposits and savings deposits. Deposits as of the end of each of the last 6 calendar years were as follows: 1983, $10,607; 1984, $21,347,590; 1985, $17,095,523; 1986, $14,496,551; 1987, $11,007,529; and 1988, $7,970,032. These depository activities represent 56% of FMTC's liabilities during such 6-year period. Furthermore, FMTC has been approved by the Federal Reserve System to participate in its automated clearing ("ACH") system, thereby enabling FMTC to wire funds, and to receive wired funds, through the Federal Reserve Bank of Boston.

B. FMTC invests the deposits it receives in a broad variety of investments and loans. The investments encompass money market instruments such as Treasury notes and commercial paper. The loans include consumer loans but not commercial loans. FMTC is also qualified to make student loans.

C. With respect to its fiduciary activities, FMTC acts, among other things, as (i) the trustee of over 100 large Code Section 401(a) pension and profit sharing plans maintained by non-affiliate corporate sponsors, (ii) the trustee or custodian of a variety of "prototype" or "prototype-like" Code Section 408 individual retirement accounts, Code Section 403(b) custodial accounts and Code Section 401(a) pension and profit sharing plans which are marketed through various affiliates of FMTC, the number of which accounts and plans exceed 1 million, and (iii) the investment manager for plan assets of approximately 50 large Code Section 401(a) pension and profit sharing plans (principally of the defined benefit type). FMTC's rapid growth in this area in recent years corresponds to the dramatic increase in retirement plan assets generally during this period.

D. FMTC acts as custodian to several registered investment companies. FMTC also operates a personal trust department, which serves as investment manager to wealthy individuals, foundations and educational institutions.

E. As indicated above, FMTC's fiduciary services fall into three categories. First, FMTC acts as the trustee or custodian for retirement accounts and plans. Second, FMTC acts as the investment manager under retirement plans. Third, FMTC acts as trustee of the Trust. The overwhelming majority of the total fees for fiduciary services are for services in the first two categories, that is, services other than services with

respect to the Trust. In fact, the average annual percentage of total fiduciary fees represented by fiduciary fees other than Trust fees during the last 6 calendar years is as follows; 1983, 81.9%; 1984, 80.7%; 1985, 71.6%; 1986, 84.7%; 1987, 86.9%; and 1988, 86.7%. Accordingly, the average annual percentage of total fiduciary fees represented by fiduciary fees other than Trust fees is greater than 80%. All of the fiduciary fees other than those for the Trust are for services similar to those permitted to national banks. These non-Trust fiduciary services do not involve any "pooling" of investments and therefore do not require exemption under 1933, 1934 or 1940 Acts.

F. FMTC's ability to continue to engage in this wide variety of banking activities has been legislatively preserved by the Competitive Equality Banking Act of 1987 ("CEBA"). CEBA allows FMTC to continue to engage in any activity it engaged in prior to March 5, 1987.

As a bank FMTC is regulated by the Commonwealth of Massachusetts, just like any other bank. As a bank whose deposits are insured by the FDIC, FMTC is similarly regulated, and subject to examination, by the FDIC. The Commonwealth of Massachusetts and FDIC have conducted joint examinations and have also conducted independent examinations of FMTC.

Most recently, the Commonwealth of Massachusetts conducted two separate examinations of FMTC this year; one examined the banking department of FMTC (exclusive of trust operations), and the second examined the EDP systems utilized by FMTC.

In addition to periodic examinations, FMTC files reports at least annually with both the FDIC and the Commonwealth. These reports include, among others, the following:

Commonwealth of Massachusetts

Call Reports

Statement of the Trust Department--Schedule H

Indebtedness of Directors and Officers

Indebtedness of Interests of Directors and Officers

Subsidiary Activities Report

Consolidated Report of Total Assets

Publication Form of Report of Condition

FDIC

Call Reports

Certified Statement of Assets (for assessments)

FMTC has established the Trust as a collective investment fund, consisting of a series of investment portfolios including equity and bond portfolios. The Trust, as most recently amended and restated, is presently maintained exclusively for pension, profit sharing, stock bonus or other employee benefit plans which either (i) are qualified plans within the meaning of Section 401 of the Code and for which there is maintained a trust fund which is tax exempt pursuant to Section 501(a) of the Code, or (ii) are governmental plans as defined in Section 414(d) of the Code which have been established by employers for the exclusive benefit of their employees or their beneficiaries.

Accordingly, FMTC does not and will not offer interests in the Trust to (i) individual retirement accounts as defined in Section 408(a) of the Code, (ii) plans funded by annuity contracts described in Section 403(b) of the Code, or (iii) non-governmental Section 457 plans. Furthermore, FMTC does not offer the Trust to plans covering self-employed individuals as defined in Section 401(c)(1) of the Code. The Trust qualifies as a "group trust" under Internal Revenue Service Revenue Ruling 81-100.

A "governmental plan" is defined in Section 414(d) of the Code to include a plan established and maintained for its employees by the government of the United States, by any state or political subdivision thereof, or by any agency or instrumentality of any of the foregoing.[1]

In connection with the offering of the Trust to any governmental Section 457 plan, FMTC will require the

administrator of such plan to represent in writing that: (1) the plan is for the exclusive benefit of its participants or their beneficiaries, (2) the purpose of the plan is the distribution of corpus and income of the funds, if any, accumulated under such plan to the plan's participants or their beneficiaries, (3) no part of the corpus or income of the plan shall be used or diverted to any purpose other than the exclusive benefit of its participants or their beneficiaries prior to the satisfaction of all the plan's liabilities to such participants and beneficiaries, except that, solely to the extent necessary to retain qualification under Section 457 of the Code, such assets shall remain subject to the claims of the general creditors of the plan sponsor, (4) the plan does not cover self-employed individuals as defined in Section 401(c)(1) of the Code, (5) the plan is not funded by an annuity contract described in Section 403(b) of the Code, and (6) no employee contributions under the plan will be invested by the plan in securities of the governmental employer sponsoring the plan or its commonly controlled entities.

II. Discussion

A. Statutory Authority

The exemption from registration afforded by Section 3(a)(2) of the 1933 Act applies to:

> "any interest or participation ... in a collective trust fund maintained by a bank ..., which interest, participation, or security is issued in connection with (A) a stock bonus, pension or profit-sharing plan which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954, ... or (C) a governmental plan as defined in Section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A) ... or (C) of this paragraph (i) the contributions under which are held in a single trust fund ... and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust ... itself) issued by the employer or any company directly or indirectly controlling, controlled by, or under common control with the employer, (ii) which covers employees some or all of whom are employees within the meaning of Section 401(c)(1) of such Code, or (iii) which is a plan funded by an annuity contract described in Section 403(b) of such Code."

Identical language, except for clause (i) above, makes such interests and participations an exempt security under Section 3(a)(12) of the 1934 Act. Section 3(c)(11) of the 1940 Act also provides an exemption from investment company status for "any employee's stock bonus, pension, or profit sharing trust which meets the requirements for qualification under Section 401 of the Internal Revenue Code of 1954 or which holds only assets of governmental plans described in Section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts."

B. Applicability of Sections 3(a)(2), 3(a)(12) and 3(c)(11) to Section 457 Plans

In the no-action letter issued to Wells Fargo Bank, N.A. (available September 7, 1988), the Staff recognized, and it is the opinion of the undersigned, that Section 457 plans which are maintained by state or local governmental units qualify as governmental plans under Sections 3(a)(2), 3(a)(12) and 3(c)(11). See also the no-action letter issued to InterFirst Bank of Dallas (available April 4, 1983), which exempts certain other types of non-trusteed governmental plans. Moreover, as explained below, reference to the legislative history of Sections 3(a)(2), 3(a)(12) and 3(c)(11) indicates an intent to include Section 457 plans within the scope of the exemptions. Finally, no public policy interest would be served by requiring registration of interests offered to Section 457 plans in this situation.

1. Background

Governmental plans generally fall into three categories: those qualified under Section 401 of the Code; those qualified under Section 403 of the Code; and those qualified under Section 457 of the Code. In each case, the purpose of qualification is to avoid immediate taxation to employees of amounts deferred under the plans. Thus, if a governmental plan were to fail to qualify under Section 401, 403, or 457 of the Code, government employees would be subject to taxation on benefits as they vest under

the plan. See, Code Section 457(f).

The assets of plans qualified under Section 401(a) of the Code must be maintained in trust and must, among other things, satisfy the requirement of Section 401(a)(2) of the Code that it is impossible, prior to satisfaction of all liabilities to participants and beneficiaries, for assets to be used, or diverted to, purposes other than the exclusive benefit of participants and beneficiaries.

Section 403(a) plans are funded by insurance company annuity contracts; 403(b) plans are funded either by such annuity contracts or under custodial agreements that invest exclusively in mutual funds. Section 403(b) plans, which may be sponsored by a state or local government for certain of its educational employees, are specifically excluded from the exemptions provided by Section 3(a)(2) of the 1933 Act and 3(a)(12) of the 1934 Act. As a consequence, FMTC will not permit 403(b) plans to participate in the Trust.

Section 457 plans generally permit employees of state and local governments to defer a portion of their current compensation until separation from service and, as such, are the counterpart to Section 401(k) arrangements maintained by private employers. Among the requirements to qualify as a Section 457 plan, Section 457(b)(6) of the Code provides that the plan must be "unfunded," in that all assets of the plan must remain the property of the employer subject only to the claims of the employer's general creditors.[2]

> The legislative history of Section 457 states that "assets may not be segregated for [the] benefit [of participants] in any manner which would put an interest therein beyond the reach of the general creditors of the sponsoring entity." (Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, p. 71.) This we believe, indicates the statute's intent only to insulate the deferral income and investment property of the Section 457 plan from access to, or receipt by, participants prior to their eligibility for benefits under the plan. The basis for this limitation is in the history of state and local government deferred compensation plans for employees. For years these plans had sought and obtained favorable rulings from the Internal Revenue Service allowing employees, under certain conditions, to postpone their tax liability on deferred compensation until actual receipt under the plan. The conditions necessary for this allowance were rooted in the "constructive receipt" of income doctrine which dictated that employees, in order to be considered as not having received current income under a deferred compensation plan, could not acquire a present interest "in either the amounts deferred or the assets used as the employer's funding medium." (Id. at 67 (footnote omitted)). In devising Section 457, Congress codified, in essence, this constructive receipt doctrine. This appears to be the sole aim of Section 457(b)(6).

Nonetheless, Treasury Regulation 1.457-2(j) expressly permits a participant to direct investment of assets of the plan attributable to his or her benefits, if the plan so provides. Consequently, assets under a Section 457 plan can be "dedicated" to provide benefits so long as they remain subject to the claims of the government's general creditors.

2. No-Action Positions

In the Wells Fargo letter, the Staff permitted the bank to rely on the Section 3(a)(2), 3(a)(12) and 3(c)(11) exemptions for its offerings of collective investment funds to Section 457 plans. The Staff thereby recognized that the unfunded status of such plans did not cause them to fail the "impossibility of diversion" requirements of Sections 3(a)(2) and 3(a)(12) merely because such plans were complying with applicable requirements for qualification under Section 457. We believe that the issues raised by the proposed offering by FMTC to Section 457 plans are identical to those raised in the Wells Fargo letter.[3]

3. Legislative History

As pointed out in the request for the Wells Fargo letter, the governmental plan

exemptions contained in Sections 3(a)(2) and 3(a)(12), along with a corresponding change to Section 3(c)(11) of the 1940 Act, were added by the Small Business Incentive Act of 1980 (the "1980 Amendments"). In support of the 1980 Amendments, the Securities Exchange Commission issued a Memorandum to the United States Senate which provides, in pertinent part, that:

> "Section 1 also adds government plans, as defined in Section 414(d) of the Internal Revenue Code, to the category of plans to which interests ... may be offered and sold without registration under the Securities Act ... Section 414(d) of the Internal Revenue code provides special tax treatment for state and local employee benefit plans, and was added to the Code in 1978 in recognition of the fact that it is often difficult if not impossible for such plans to meet all the qualification requirements of Section 401, particularly the antidiscrimination requirements of Section 401(a), because the states establishing such plans prescribe a shorter vesting period for elected and appointed officials than for other covered employees in recognition of the reality of political life. Section 1 of the Bill would make exemption from registration for bank and insurance company funding of public pension plans turn upon the plans' compliance with the substance of Section 401 as it is material to the operation of the securities laws, rather than on their compliance with all the technical requirements of that Section. Thus, it would provide an exemption from registration for bank and insurance company funding of Section 414(d) plans which have been established for the exclusive purpose of providing retirement benefits to employees or their beneficiaries and whose funds are segregated and cannot be diverted to other purposes. The two requirements contained in the amendment are based upon Section 401(a)(1) and Section 401(a)(2) respectively, which are two of the three central provisions of Section 401."[4]

Contrary to the above Memorandum, Section 414(d) was actually added to the Code by ERISA in 1974, and together with parallel provisions in Title 1 of ERISA, merely exempts governmental plans from certain of the requirements necessary for qualification under Section 401(a) of the Code. The amendment to the Code in 1978 that provided for special tax treatment for state and local government plans was the addition of Section 457.

Moreover, in his remarks before the Senate, Senator Sarbanes, the sponsor of the 1980 Amendments, stated that the purpose of the bill was to "exempt from registration bank and insurance company funding of certain public employee retirement plans without regard to their qualification under Section 401 of the IRS Code."[5]

Although the legislative history does not specifically reference Section 457 plans, it would seem anomalous to conclude that the 1980 Amendments were intended to cover only Section 401(a) governmental plans, since by virtue of enactment of ERISA in 1974, such plans should already have been covered under the existing provisions of Sections 3(a)(2), 3(a)(12) and 3(c)(11) that exempt securities listed in connection with Section 401(a) plans. The context of the Memorandum and Senator Sarbanes' remarks make sense only if the 1980 Amendments were intended to encompass Section 457 plans.

4. Policy Basis

There is no policy reason to exclude Section 457 plans from the Section 3(a)(2), 3(a)(12) and 3(c)(11) exemptions. In particular, the legislative history to Section 457 that permits segregation of plan assets and the Section 457 regulations that permit participant direction of plan investments provide a sufficient basis to satisfy the intent of the requirements of those assets by a government's creditors. Were the Staff to take the position that registration is required in this situation, it would obviously place Section 457 plan sponsors at a disadvantage as compared to both public and private employers that sponsor trusteed plans in terms of the investment options which may be offered to plan participants.

III. Requested Staff Position

Based upon the foregoing facts and analysis discussed above, it is our opinion that the interests in the Trust to be issued to Section 457 plans as described above are exempt securities under Section 3(a)(2) of the 1933 Act and under Section 3(a)(12) of the 1934 Act and would not require the Trust to register as an investment company under the 1940 Act by virtue of the exemption afforded by Section 3(c)(11) thereof. We would appreciate your advice that the Staff will not recommend to the Commission that any action be taken if FMTC proceeds with its proposed offering without compliance with the various registration requirements of the 1933, 1934 and 1940 Acts. If, however, the Staff contemplates recommending against a no-action position, we request that a conference be arranged to discuss these issues.

If you require additional information, please contact the undersigned at (617) 570-7924.

Very truly yours,

John M. Kimpel

1 Section 401(a)(24) of the Code provides that the tax-exempt status of a group trust will not be adversely affected merely because the trust accepts monies from a governmental plan or governmental unit as defined in Section 818(a)(6) of the Code. The legislative history under Section 401(a)(24) makes clear that this provision applies if the trust accepts monies (a) from a retirement plan of a state or local government, whether or not the plan is qualified under Section 401(a) of the Code and whether or not the assets are held in trust, or (b) directly from such state or local government, if such monies are intended for use in satisfying an obligation of such governmental unit to provide a retirement benefit under a governmental plan. See, Joint Committee on Taxation, General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982, p. 339.

2 Code Section 457(b)(6) provides that:

"(A) all amounts of compensation deferred under the plan, (B) all property and rights purchased with such amounts, and (C) all income attributable to such amounts, property, or rights, shall remain (until made available to the participant or beneficiary) solely the property and rights of the employer (without being restricted to the provision of benefits under the plan) subject only to the claims of the employer's general creditors."

3 In addition, on previous occasions, the Commission has granted exemption from registration for interests issued to Section 457 plans in analogous circumstances. See, e.g., ICMA Retirement Trust (available February 7, 1983) (offering of interests in a trust for commingled investment of Section 457 plans exempt under Section 3(a)(2) of the 1933 Act and Section 2(b) of the 1940 Act as an "instrumentality" of the government); Equitable Life Assurance Society (available December 12, 1980) (offering of interests in a group annuity contract held in trust to Section 457 plans not subject to registration under the 1933 and 1940 Acts.)

4 126 Cong.Rec. S 27272-74 (cum. ed. Sept. 25, 1980). SEC Release 33-6281 (January 23, 1981) largely reiterates the legislative history to the 1980 Amendments.

5 126 Cong.Rec. S 27273 (cum. ed. Sept. 25, 1980).

SEC LETTER

1933 Act / s3(a)(2)

November 2, 1989

Publicly Available November 2, 1989

RESPONSE OF THE OFFICE OF CHIEF COUNSEL DIVISION OF INVESTMENT MANAGEMENT

We would not recommend that the Commission take any enforcement action under the Investment Company Act of 1940 ("1940 Act") if Fidelity Management Trust Company ("FMTC") relies upon your opinion as counsel that deferred compensation plans maintained by state and local governmental units under section 457 of the Internal Revenue Code of 1986, as amended ("Code") ("section 457 plans"), qualify as governmental plans under section 3(c)(11) of the 1940 Act,[1] and FMTC offers interests in the Fidelity Group Trust for Employee Benefit Plans ("Trust") to the section 457 plans without registering the

Trust under the 1940 Act.[2] This position is based on the facts and representations in your letter of September 26, 1989, particularly that:

(1) FMTC does not and will not offer the Trust to individual retirement accounts as defined in section 408(a) of the Code; and

(2) in connection with the offering of the Trust to any section 457 plan, FMTC will require the administrator of the plan to represent in writing that no part of the corpus or income of the plan shall be diverted to any purpose other than the exclusive benefit of its participants and beneficiaries, except that, solely to the extent necessary to retain qualification under section 457 of the Code, those assets shall remain subject to the claims of the general creditors of the plan sponsor.

The Division of Corporation Finance has asked us to inform you that, based on the facts presented, but without necessarily concurring in your analysis, that Division will not recommend any enforcement action to the Commission if FMTC, in reliance upon your opinion as counsel that the exemptions provided by section 3(a)(2) of the Securities Act of 1933 and section 3(a)(12) of the Securities Exchange Act of 1934 are available, offers interests in the Trust to section 457 plans without compliance with the registration provisions of these Acts. In reaching this position, that Division has noted particularly that FMTC will require certain described representations of the section 457 plan administrators. The Division of Market Regulation has advised us that they concur in this position.

Because the Divisions' position is based upon the representations made in your letter, it should be noted that any different facts or conditions might require different conclusions. Further, this letter expresses only the Divisions' position on enforcement action and does not express legal conclusions on the questions presented.

Elizabeth T. Tsai

Special Counsel

Securities and Exchange Commission (S.E.C.)

1 Section 3(c)(11), in part, excepts from the definition of an investment company, "Any employee's stock bonus, pension, or profit-sharing trusts which meet the requirements for qualification under section 401 of the [Code] or which holds only assets of governmental plans described in section 3(a)(2)(C) of the Securities Act of 1933; or any collective trust fund maintained by a bank consisting solely of assets of such trusts.

2 See Wells Fargo Bank, N.A. (pub. avail. Sept. 7, 1988); InterFirst Bank Dallas, N.A. (pub. avail. April 4, 1983) (Congress intended section 3(c)(11) of the 1940 Act to be available to a collective trust fund maintained by a bank consisting solely of assets of employee's stock bonus, pension, or profit-sharing trusts which meet the requirements for qualification under section 401 of the Code and assets of governmental plans). See also Aetna Life Insurance Company (pub. avail. Oct. 18, 1989); Nationwide Life Insurance Company (pub. avail. May 12, 1989).

Collective Investment Funds

SEC No-Action Letter

Northern Trust Corporation

Publicly Available March 3, 1989

Recap
Investing in non-affiliated bank CIFs was deemed not permissible in this case, despite an earlier favorable opinion by the OCC. SEC did not concur with Northern Trust Corporation's position.

Companion SEC No-Action Letter of July 21, 1989 follows. (Northern Trust II)

Letter to SEC

January 10, 1989

William E. Morley

Chief Counsel

Division of Corporation Finance

Robert L.D. Colby

Chief Counsel

Division of Market Regulation

Thomas S. Harman

Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Washington, D.C. 20549

Re: No-Action Request: Securities Act of 1933, Section 3(a)(2); Securities Exchange Act of 1934, Section 3(a)(12); Investment Company Act of 1940, Section 3(c)(3).

Gentlemen:

On behalf of Northern Trust Corporation, a bank holding company whose principal banking subsidiary is The Northern Trust Company ("Northern"), [FN1] we hereby request your confirmation that you will not recommend that the Securities and Exchange Commission (the "Commission") take enforcement action against Northern in the event Northern, in its capacity as trustee of moneys received by Northern from common trust funds maintained by unaffiliated banks (individually, an "Originating Bank" and collectively, the "Originating Banks"), contributes such moneys to one or more of the common trust funds (the "Funds") maintained by Northern, in the manner described herein, without registering interests or participations in the Funds under the Securities Act of 1933 (the "1933 Act") or the Securities Exchange Act of 1934 (the "1934 Act"), and without registering the Funds as investment companies under the Investment Company Act of 1940 (the "1940 Act").

- FN1 Northern Trust Corporation, a Delaware corporation with its executive offices located in Chicago, Illinois, is a bank holding company registered with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended. Except for directors' qualifying shares, Northern Trust Corporation owns all of the capital stock of Northern, a banking corporation organized under the laws of the State of Illinois and a member bank of the Federal Reserve System. As a state member bank, Northern is subject to the supervision and examination of the Board of Governors of the Federal Reserve System and the Illinois Commissioner of Banks and Trust Companies.

Northern currently maintains 27 Funds for the collective investment and reinvestment of moneys contributed thereto by Northern in its capacity as trustee, executor, administrator or guardian. The Funds invest in a broad array of financial instruments, and include actively-managed domestic and foreign equity and fixed income funds, passively-managed domestic and foreign equity index funds, and taxable and tax-exempt money-market funds. All of the Funds are maintained in accordance with the Comptroller of the Currency's (the "Comptroller") Regulation 9, 12 C.F.R. § 9.1 et seq. In addition, interests or participations in the Funds are exempt from registration under Sections 3(a)(2) and 3(a)(12), respectively, of the 1933 Act and the 1934 Act, and the Funds themselves are excepted from the definition of investment company under Section 3(c)(3) of the 1940 Act. Under the Declaration of Trust establishing

the Funds, Northern has exclusive management and control of each of the Funds in accordance with the investment objectives applicable thereto.

Like Northern, many Originating Banks maintain (or may wish to establish) common trust funds for the collective investment and reinvestment of moneys received by them for a bona fide fiduciary purpose. In managing the assets of these common trust funds, however, the Originating Banks may be unable--primarily because of the relatively small size of such funds--to utilize or implement the wide range of diversified, specialized investment strategies and techniques employed by Northern in the management of the Funds. Many Originating Banks have indicated an interest in expanding the range of investment strategies and techniques they may utilize for the benefit of their trust customers by establishing one or more trust accounts at Northern whereby an Originating Bank may direct Northern, as trustee for all or a portion of the assets of the Originating Bank's common trust fund or funds, to contribute such assets to one or more of the Funds maintained by Northern.

Prior to permitting an Originating Bank to establish such a trust account at Northern, Northern would obtain specific representations from the Originating Bank that (1) moneys received in trust (or some other fiduciary capacity) by the Originating Bank from its customers and contributed by the Originating Bank to its common trust fund were received by the Originating Bank for a bona fide fiduciary purpose, in accordance with long-standing interpretations that a bank common trust fund may not serve as a vehicle for general investment by the public (see, e.g., H.R.Rep. No. 1382, 91st Cong., 2d Sess. 43 (1970); (2) the Originating Bank has complied and will comply with all restrictions on the operation of its common trust funds contained in the Comptroller's Regulation 9, including the restrictions on advertising respecting common trust funds contained in 12 C.F.R. § 9.18(b)(5)(v); [FN2] and (3) the Originating Bank is not prohibited by local fiduciary law from investing its common trust funds in common trust funds maintained by another bank.

- FN2 Under Section 9.18(b)(5)(ii) of the Comptroller's Regulation 9, the trustee of a common trust fund is required to prepare, at least annually, a financial report relating to the fund that includes, among other things, a list of investments held by the fund showing the cost and current market value of each investment. In addition, under Section 9.18(b)(iv), the trustee is required to furnish the financial report to all participants in the common trust fund (or to notify participants of the availability of the report). While Section 9.18(b)(5)(iv) permits the trustee to furnish a copy of the financial report to prospective customers, it also provides, in conjunction with Section 9.18(b)(5)(v), that a bank may not advertise or publicize its common trust fund services except by way of noting the availability of the financial report in connection with the promotion of the bank's fiduciary services.

- Like the Originating Banks, Northern will comply with the restrictions on advertising contained in Regulation 9 in connection with the operation of the Funds. Northern has, however, obtained approval from the Comptroller to advertise the availability of its proposed services to Originating Banks by direct mailings to such Banks and through advertisements in publications with an intended audience of corporate fiduciaries. See letter dated July 16, 1987 from Dean E. Miller, Deputy Comptroller for Trust and Compliance, to J. Timothy Ritchie of the Northern (the "Comptroller's Letter"), a copy of which is attached hereto. (Enclosure)

Section 3(a)(2) of the 1933 Act, Section 3(a)(12) of the 1934 Act and Section 3(c)(3) of the 1940 Act

Section 3(a)(2) of the 1933 Act and Section 3(a)(12) of the 1934 Act (together with Rule 12h-1 thereunder) provide, in identical terms, registration exemptions from the respective Acts for interests or participations in a common trust fund, provided the fund is maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator or guardian. Section 3(c)(3) of the 1940 Act excepts from the definition of investment company any common trust fund maintained in such a manner and for such purposes. [FN3]

- FN3 It is evident that Sections 3(a)(2), 3(a)(12) and 3(c)(3) are to given identical interpretations. In adopting the Section 3(a)(2) exemption for common trust funds, for example, Congress noted that the exemption "is identical to the exemption for a 'common trust fund or similar fund' in Section 3(c)(3) of the Investment Company Act." S.Rep. No. 184, 91st Cong. 1st Sess. (1969), 27.

Thus, in order for an interest or participation in a common trust fund to be exempt from registration under the 1933 and 1934 Acts and for the common trust fund itself to be excepted from the definition of investment company under the 1940 Act, three criteria must be satisfied: (1) the entity maintaining the

common trust fund must be a statutorily defined "bank;" (2) the common trust fund must be "maintained" by the bank; and (3) the common trust fund must be maintained exclusively for the collective investment and reinvestment of assets contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian.

We submit that Northern's proposal satisfies each of these three criteria. First, Northern is a "bank" for purposes of all three of the relevant sections. Under Section 3(a)(2) of the 1933 Act, the term "bank," in the context of a common trust fund, has the same meaning ascribed to that term in Section 2(a)(5) of the 1940 Act. Under that section, a "bank" is defined to include, among other things, a "member bank of the Federal Reserve System." Similarly, Section 3(a)(6) of the 1934 Act defines bank to include, among other things, a member bank of the Federal Reserve System. As noted above, Northern is a member bank of the Federal Reserve System.

Second, the Funds managed by Northern are funds "maintained" by Northern, since, as noted above, under the terms of the Declaration of Trust establishing and governing the Funds, Northern exercises "substantial investment responsibility" with respect to the Funds by virtue of its exclusive management and control of the Funds in accordance with the investment objectives applicable thereto. [FN4] Bank of Delaware, [72-73 Transfer Binder] Fed.Sec.L. (CCH) Rep. ¶ 79,292 (avail. January 7, 1973).

- FN4 In this connection, it is important to note that the various common trust funds managed by the Originating Banks will also be "maintained" by such Banks, notwithstanding the fact that such Banks may contribute all or a portion of the assets of such funds to trust accounts at Northern for the ultimate contribution by Northern of such assets to the Funds. The Comptroller's Letter opines that the "maintenance" requirement is met as long as the Originating Banks establish "directed" trusts at Northern whereby such Banks give specific directions to Northern as to the amount of moneys that are to be contributed to each of the Funds. Once such a direction is given and moneys are contributed by Northern to one or more of the Funds, Northern will then have complete discretion in managing such moneys in accordance with the investment objectives applicable to each Fund.

Third, the only moneys that Northern will contribute to the Funds are moneys that Northern has received in its capacity as trustee, executor, administrator or guardian. In Bank of Delaware, supra, the staff explained the meaning of this last requirement:

[s]ection 3(c)(3) of the Act excepts from the definition of investment company in Section 3(a) of the Act any common trust fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank acting in one of its traditional fiduciary capacities and not as a vehicle for general investment by the public.

We believe that, under Bank of Delaware, Northern is entitled to rely on the registration exemptions provided by Section 3(a)(2) of the 1933 Act and Section 3(a)(12) of the 1934 Act, as well as the exception from the definition of investment company described in Section 3(c)(3) of the 1940 Act, in implementing its proposal to permit common trust funds maintained by Originating Banks to participate in Northern's Funds. First, as noted above, no Originating Bank will be permitted to contribute the moneys of any of its common trust funds to Funds maintained by Northern unless the Originating Bank first establishes a trust account at Northern with respect to such moneys. Thus, all of the moneys received from the Originating Banks to be contributed by Northern to the Funds will be contributed by Northern in a traditional fiduciary capacity, namely, as trustee for each of the trust accounts established by the Originating Banks. Further, Northern's Funds will not be used as a vehicle for general investment by the public because of all of the moneys contributed by Northern thereto--whether received in trust (or some other fiduciary capacity) by Northern from its trust customers, or by the Originating Banks from their trust customers--will in the first instance have been received by Northern or the Originating Banks, as the case may be, for a bona fide fiduciary purpose. See H.R.Rep. No. 1382, supra. Neither interests in the Funds maintained by Northern nor in the common trust funds maintained by the Originating Banks will be offered as "investments" to the general public.

We are aware of certain no-action letters in which the staff appears to have taken the position that in order for the common trust fund exemption to be available, the bank that contributes moneys to such fund must not only have received such moneys from customers in trust (or some other fiduciary capacity), but for a "bona fide fiduciary purpose" as well (i.e., for a purpose other than, or in addition to, that of money management). See, e.g., Howard Savings Bank, [79-80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 82,320 (avail. August 13, 1979). Under a literal reading of these letters, Northern would be precluded from contributing moneys received from the various Originating Banks to one or more of Northern's Funds

if Northern is deemed to receive such moneys primarily for money management purposes, notwithstanding the fact that Northern received such moneys in trust. We believe, however, that the trusts to be established by the Originating Banks at Northern should be viewed as being established for a bona fide fiduciary purpose and not simply for purposes of money management. Moreover, we believe that even if Northern were viewed as acting primarily as a money manager with respect to moneys received by Northern from the Originating Banks, no regulatory purpose would be served by applying the "bona fide fiduciary purpose" test to such moneys since, as noted above, the test will be applied to moneys received by the Originating Banks and, consequently, Northern's proposal will not be used as a vehicle for general investment by the public. There is, in short, no regulatory justification for applying the "bona fide fiduciary purpose" test to Northern when it has already been applied to the Originating Banks.

A. Northern Should Be Viewed As Receiving Funds From the Originating Banks For A Bona Fide Fiduciary Purpose

One of the principal duties of a trustee is to insure adequate diversification of trust investments. See Restatement (Second) of Trusts, § 228. In furtherance of this duty, and in recognition of its inability to provide to its trust customers the wide range of common trust funds--and potential opportunities for diversification--provided by Northern, an Originating Bank might wish to turn to Northern to assist it in providing the highest possible degree of diversification. While an Originating Bank could turn to other sources to diversify its common trust fund portfolio, the Originating Bank may deem it more appropriate to entrust moneys to an entity that, like the Originating Bank itself, is charged with certain fiduciary responsibilities with respect to the management of these moneys. An Originating Bank, in short, might prefer to seek the services of a fiduciary in light of its own fiduciary obligations to its customers. By entrusting funds to Northern, the Originating Bank would not only be looking to Northern's money management expertise, but to the fiduciary framework within which Northern applies that expertise. [FN5]

- FN5 In this connection, it is important to note that the description of a permissible common trust fund contained in Regulation 9 is virtually identical to the descriptions contained in Sections 3(a)(2), 3(a)(12) and 3(c)(3), and that a common trust fund is permissible under Regulation 9 only if the funds contributed thereto were received for a bona fide fiduciary purpose. Investment Company Institute v. Camp, 401 U.S. 617 (1971). Consequently, in approving Northern's proposal, the Comptroller implicitly concluded either that the trust accounts to be established by the Originating Banks at Northern will be established for a bona fide fiduciary purpose, or that Northern's proposal is otherwise in harmony with the policies underlying the operation of a common trust fund. See the Comptroller's Letter.

B. Northern's Proposal Is Fully Consistent With the Policies Underlying the "Bona Fide Fiduciary Purpose" Letters

The requirement that a bank may only commingle moneys that it has received for a bona fide fiduciary purpose was designed, in our view, to insure that a common trust fund would not be used as a vehicle for general investment by the public, and was not intended to constitute a flat prohibition on arrangements that, though not literally meeting the requirement, pose no danger of being used as a general investment vehicle. Indeed, in InterFirst Corporation, [82- 83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,324 (avail. November 24,1982) and Dauphin Deposit Bank & Trust Co., [83-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,547 (avail. October 1, 1983), the staff concluded that where the grantor of a trust appoints two banks as co-trustees, one of which is to exercise money management functions and the other of which is to exercise fiduciary functions other than, or in addition to, those incident to money management, the money managing co-trustee may, consistently with Section 3(c)(3), contribute the moneys it is managing to one or more of its common trust funds:

[the Section 3(c)(3) exception] applies only to those common trust funds which are operated in a manner incidental to a bank's traditional trust department activities under circumstances in which the trust whose assets would be contributed to the common trust funds are not offered to the public as vehicles for investment in the common trust funds ... A bank may not offer to the public standardized trusts which do not require of the bank any fiduciary functions other than those incident to money management with the intent of managing collectively the assets thereof in a fund not registered as an investment company. However, though a bank, as a co-trustee, may have only fiduciary functions incident to money management with respect to the assets of a trust, it may contribute assets of the trust to its common trust fund if the trust requires of the bank's co-trustee fiduciary functions other than, or in addition to, those incident to money management.

Dauphin, supra, at p. 78,766. As is the case in Dauphin--and in distinction wit h no-action letters such as

Howard Savings Bank--in Northern's proposal, neither Northern nor any Originating Bank will be offering to the public "standardized trusts" which do not require any fiduciary functions other than those incident to money management. Even if the trust accounts established by the Originating Banks at Northern were to be viewed as "standardized," they are clearly not being offered to the public. Further, while the customer of an Originating Bank will not literally appoint the Originating Bank and Northern as co-trustees--with the Originating Bank to perform fiduciary functions and Northern to provide money management services--the customer will name the Originating Bank as trustee, which will in turn effectively appoint Northern as co-trustee by establishing a trust account at Northern. Thus, even if we assume that Northern will act primarily as a money manager with respect to moneys received from the various originating Banks, [FN6] the end result of Northern's proposal is identical to t hat described in the proposals endorsed in InterFirst and Dauphin: one bank--Northern--will provide money management services (as well as fiduciary services incident thereto), while the Originating Bank will perform the more traditional fiduciary services vis-a-vis its customer. In neither scenario is there a danger that the common trust fund will be used as a vehicle for general investment by the public, since in both scenarios the only moneys that may be commingled are those that were received in the first instance from customers for a bona fide fiduciary purpose.

- FN6 As discussed above, however, we believe that Northern should be viewed as having received funds from the various Originating Banks for a bona fide fiduciary purpose.

In addition, we believe that Northern's proposal is closely analogous to a proposal approved by the staff in State Street Bank and Trust Co., [1987 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 78,434 (avail. May 26, 1987). In that letter, the staff indicated that it would not recommend any enforcement action if the assets of certain qualified stock bonus, pension and profit-sharing plans and governmental plans ("Qualified Plans") which were held in separate accounts of certain insurance companies were to be pooled in one or more collective trust funds maintained by an unaffiliated bank. The staff took this position notwithstanding the fact that the arrangements in question did not literally meet the requirements of Sections 3(a)(2) of the 1933 Act, Section 3(a)(12) of the 1934 Act and Section 3(c)(11) of the 1940 Act. Since the arrangements in question were consistent with the policies underlying these sections, the staff gave substance precedence over form, particularly in light of the facts that (1) the separate accounts were "sophisticated investors" that did require the protections afforded by the federal securities laws (as well as the fact the bank maintaining the collective trust fund in which the separate accounts would invest was subject to strict regulation by Federal and state banking authorities) and (2) to deny the exemptions would deny the Qualified Plans that comprised the separate accounts the opportunity and ability to diversify their investments by investing in investments such as the collective trust funds maintained by the bank. See also InterFirst Corporation (avail. November 9, 1984) and Frank Russell Trust Company (avail. September 2, 1982).

Similarly, the Originating Banks that retain Northern to manage the assets of the common trust funds maintained by the Originating Banks will be sophisticated investors with sufficient knowledge regarding investments for them to make decisions with respect to investing in Northern's Funds, and will not need the protection afforded by registration of interests in Northern's Funds.[FN7] In addition, to deny the Originating Banks the opportunity to invest funds held in their common trust funds in the Funds maintained by Northern would deny the Originating Banks--and, more importantly, their customers--the opportunity to take advantage of the diversification and other benefits provided by the Northern.

- FN7 Northern expects that each of the Originating Banks will be an "accredited investor" within the meaning of Rule 501(a) of Regulation D by virtue of being a "bank" within the meaning of Rule 501(a)(1) or otherwise falling within the definition of accredited investor (or will otherwise be the type of investor to whom a valid offering of securities may be made under Section 4(2) of the 1933 Act).

We are aware that under Rule 3c-4 under the 1940 Act (as well as Rule 132 under the 1933 Act and Rules 3a12-6 and 12h-1 under the 1934 Act) and various no-action letters (see, e.g., Sun Trust Banks, Inc. (avail. June 18, 1986)), banks that are members of an affiliated group may contribute assets they hold in a fiduciary capacity directly to a common trust fund maintained by another bank in that group. For the reasons set forth below, however, we believe that Rule 3c-4 should not be construed, by negative implication, to preclude multi-bank common trust funds involving unaffiliated banks.

Rule 3c-4 is a technical rule which was designed to enable multi-bank common trust funds to avail themselves of the favorable tax treatment provided by a 1976 amendment to Section 584 of the Internal Revenue Code (the "Amendment") and yet remain exempt from the registration requirements of the federal securities laws. The Amendment, which provides that banks that are members of an affiliated

group may contribute moneys they hold in a fiduciary capacity directly to a common trust fund maintained by another bank in that group, was enacted in response to a 1970 Internal Revenue Service Revenue Ruling that had concluded that if a bank does not act as fiduciary with respect to all the funds contributed to its common trust fund, but allows the common trust fund to accept as contributions moneys held by affiliated banks in their capacities as fiduciaries, the bank cannot be said to "maintain" its common trust fund. Revenue Ruling 70-302, 70 I.R.B. 140 (1970) (the "Ruling"). See Securities Act Release No. 5896, [77-78 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 81,409 (January 10, 1978) (the "Release"). The Service based its holding on the literal language of pre-Amendment Section 584, which defined a common trust fund as a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as fiduciary. Rev.Rul. 70-302.

Presumably, the bank in Revenue Ruling 70-302 could have avoided the Service's holding by the simple expedient of requiring its affiliated banks to establish trust accounts at the bank, the assets of which accounts could then be contributed by the bank, as trustee, to its common trust fund. In situations where banks are members of an affiliated group, however, such a procedure apparently seemed unnecessary--and therefore unduly burdensome--to Congress, which moved to nullify the Ruling by enacting the Amendment. See S.Rep. No. 1183, 94th Cong., 2nd Sess. 2 (1976). Since favorable tax treatment had historically been provided to a common trust maintained by a bank in situations where various branches of the bank contributed funds directly to the bank's common trust fund, Congress could see no objection to allowing affiliated banks--which, by virtue of their common ownership, effectively comprise one economic unit--to contribute funds they hold in a fiduciary capacity directly to a common trust fund maintained by a bank in their affiliated group. Id.

As the Commission explained in adopting Rule 3c-4, the same literal language that precluded favorable tax treatment for a multi-bank common trust fund under pre-Amendment Section 584 also precluded the fund from taking advantage of the exemptions provided by the federal securities laws. Thus, the Commission moved to close the gap created by the Amendment by promulgating a rule which would effectively conform the federal securities laws to the Amendment:

Bank holding companies and representatives of the banking industry have recently indicated an interest in using "multi-bank common trust funds," i.e., common trust funds maintained by one constituent bank of a bank holding company for assets contributed thereto by the bank or by other constituent banks in the same holding company in their capacity as trustee, executor, administrator or guardian. Some state laws allow such common trust funds, and recent federal legislation permits such funds to be operated as non-taxable entities.

At present, common trust funds maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator or guardian, and interests or participations therein, are exempted or excluded from the provisions of the federal securities laws ...

Because the present definition of "common trust fund" in the federal securities laws refers to a fund maintained by a "bank" for assets contributed to the fund by "such bank," it appears that, as presently drafted, the exclusionary and exemptive provisions of the federal securities laws would not be available if one bank in a bank holding company maintained a common trust fund which included assets contributed by other bank members in the same holding company.

Since Rule 3c-4 was designed simply to conform the federal securities laws to the Amendment, it is evident that the rule is inapposite to Northern's proposal. If Northern were asking the staff to permit unaffiliated banks, in their fiduciary capacities, to contribute moneys directly to Northern's Funds, Rule 3c-4 might arguably be construed to have a preclusive effect. [FN8] As described earlier, however, each Originating Bank will be required to establish a trust account at Northern (and to make the representations described in the second full paragraph on page 2 of this letter), and Northern will then contribute the assets of such accounts, in its capacity as trustee, to Northern's funds. Unlike the situation contemplated by Rule 3c-4, Northern will be in literal compliance with the exemptive provisions of the federal securities laws by virtue of contributing all moneys to the Funds in its capacity as trustee.

- FN8 On the other hand, if the tax laws were to be further amended to afford favorable tax treatment to a multi-bank common trust fund that receives moneys directly from unaffiliated banks in their fiduciary capacities, it would seem to follow that Rule 3c-4 should also be amended to permit such an arrangement. If the banks contributing such moneys received them for a bona fide fiduciary purpose, such an arrangement would be consistent with the policies underlying the common trust fund exemption.

Further, we believe that in situations where multi-bank common trust funds are not being used as vehicles for investment by the general public, it would be counterproductive--and contrary to the very policies underlying Rule 3c-4--to conclude that Rule 3c-4 is the sole avenue of relief for multi-bank funds. To so conclude would put small and medium-sized banks that wish to retain their independence at a competitive disadvantage vis-a-vis larger institutions. More importantly, such a conclusion would effectively penalize the customers of small and medium-sized banks, by prohibiting such banks from taking advantage of the diversification and other opportunities they might otherwise be in a position to afford their customers. [FN9]

- FN9 It is worth noting that in the release proposing Rule 3c-4, the Commission expressly recognized that Rule 3c-4 would have the salutary affect of "making a more diverse selection of investment alternatives available" to trust customers. 42 F.R. 56754, 56755 (October 28, 1977). To the extent that a multi-bank common trust fund is not being used as a vehicle for general investment by the public, Rule 3c-4 should not be interpreted or applied in a manner that would undercut the goal of investment diversification.

Conclusion

In conclusion, it is our opinion that Northern's proposal is fully consistent with the policies underlying the various common trust fund exemptions. The common trust funds maintained by the various Originating Banks will be composed of funds received by those banks for a bona fide fiduciary purpose, and, consequently, Northern's proposal will not be used as a vehicle for general investment by the public. We accordingly respectfully request that the staff concur in our opinion that Northern may engage in the proposed collective investment and reinvestment of moneys received in trust (or some other fiduciary capacity) by Northern--both from its customers and from the Originating Banks--without compliance with the registration provisions of either the 1933 or the 1934 Acts pursuant to Sections 3(a)(2) and 3(a)(12) thereof, respectively, and that the proposed activities will not require registration of Northern's common trust funds as investment companies under the 1940 Act, by virtue of Section 3(c)(3) thereof.

Please call the undersigned, Andrew M. Klein or Joseph H. Nesler of this firm if you have any questions or need additional information. If the staff does have questions or concerns regarding this letter, we would appreciate conferring with the staff before it issues its response.

Very truly yours,

Michael L. Meyer

Enclosure

July 16, 1987

Mr. J. Timothy Ritchie

The Northern Trust Company

Fifty South LaSalle Street

Chicago, Illinois 60675

Dear Mr. Ritchie:

This is in reply to your letter concerning allowing participation in the Bank's common trust funds by common trust funds administered by other nonaffiliated banks.

The Bank wishes to make available to the trust departments of other banks and trust companies the ability to invest some portion or all of common funds administered under 12 CFR § 9.18(a)(1) in one or more of the Bank's common trust funds administered under that section. Since it would be necessary for the Bank to be trustee with respect to assets invested in its common funds, the participating common trust fund agreement would permit the trustee of the fund to appoint the Bank as "investment trustee" under an "investment trust agreement." The Bank proposes that the investment trust agreement would permit the trustee of the participating common trust fund to establish investment guidelines regarding the manner in which assets will be invested, although the particular investment program would be determined by the Bank as investment trustee.

It is our opinion that it is the responsibility of a bank as trustee to evaluate the soundness of

management for any type of investment being considered as an asset in a fiduciary account. This includes reviewing the prudence and the appropriateness of a potential asset for a common trust fund. It is this investment analysis and decision-making process that is required by the exclusive management provision of 12 CFR § 9.18(b)(12). At all times, the investment responsibility for a common trust fund and its administration remains with the trustee of the fund and cannot be delegated.

A bank, as trustee of a common trust fund, may make the management decision to acquire units of a common trust fund trusteed by an unrelated institution. This would not be considered an undue delegation of investment responsibility under 12 CFR § 9.18(b)(12). The investing bank will continue to have the responsibility periodically to ascertain that the investment is suitable for the common trust fund and to determine that the investment continues to be of trust quality.

Under the proposed arrangement, the investment trustee would determine the investment program for the participating common trust fund. This we see to be a delegation of investment discretion even if the program is subject to investment guidelines of the trustee of the participating common trust fund. Rather than being an investment trustee the Bank should be appointed a "directed" trustee. As a directed trustee the Bank would be directed to purchase units of a specific common trust fund by the trustee of the participating common trust fund. Also, the trustee of the participating common trust fund would be delegating exclusive management if the directed trust agreement can not be terminated at anytime, in whole or in part, or there are restrictions or conditions imposed on withdrawing from the common trust funds. Such limitations on withdrawals would be perceived by us as restricting the investment management of the participating fund.

As stated above, the investing national bank will continue to have the responsibility periodically to ascertain that the investment is meeting the needs of the common trust fund, and to determine that the investment continues to be of trust quality. These determinations cannot be made unless the directed trustee provides sufficient information as to the investment composition of the common fund in a timely manner. We believe that 12 CFR § 9.18(b)(5)(ii) states the type of information that would be necessary in the usual case to make the determinations. Such information should be provided as frequently as the facts and circumstances warrant, but no less frequently than quarterly. The providing of the relevant information is one of the provisions that could be addressed in the instrument establishing the directed trust fund agreement.

The foregoing favorable opinion will no longer stand if:

1) An investing bank's common trust fund's tax exempt status is jeopardized by its participation; the Bank's common trust fund's tax exempt status is jeopardized; or

2) Either bank's common trust fund would be subject to the Investment Company Act of 1940, or required to be registered under the Securities Act of 1933 because of the arrangement.

In your letter you request our views on a series of matters which are incidental to the arrangement.

The first item concerns paragraph 9.6700 as stated on page E-12 in the Comptroller's Handbook for National Trust Examiners. You wish us to opine that if the terms of the common trust fund agreement authorizes the creation of an "investment trust" as described in your letter, and there is no specific prohibition under local law for such an arrangement, then the limitations imposed by the Comptroller's Handbook would be inapplicable. We do not concur with your recommended finding. Although it is our opinion that the arrangement is in compliance with 12 CFR § 9.18(b)(12), such a finding is not dispositive of the issue of an unauthorized delegation under local fiduciary law. If under local law a trustee would be found to have violated its fiduciary duty by placing the funds it received in trust with another trustee, then the proposed arrangement would be an unauthorized delegation of fiduciary responsibility. Under such situation the delegation issue may be adequately addressed if the governing instrument of each trust account investing in the participating common trust fund specifically authorized the arrangement. In any event, it remains our opinion that the arrangement should be found to be authorized under local law before it is entered into by a corporate trustee. Further, as to this, we would note the lack of a prohibition under local law to the specific arrangement would appear not to address the general issue of an improper delegation.

The next item is a waiver request concerning the limitation of 12 CFR § 9.18(b)(9)(i) and (ii). During telephone discussions of your ruling request you were in agreement that a waiver of 12 CFR § 9.18(b)(9)(i) would not be necessary at this time. It is highly unlikely that any one participating common trust fund would exceed 10 percent of the market value of any one of your common trust funds. A supervisory concern which is especially relevant here is the increased possibility that large concentrations will result in

the imposition of withdrawal restrictions.

We do concur with your recommendation that the 10 percent limitation of 12 CFR § 9.18(b)(9)(ii) be waived. It is our opinion that investment diversification will be met even if a participating common trust fund invests all of its funds in another common trust fund, since that common trust fund is diversified. We reach this result because of the provisions of 12 CFR § 9.18(b)(3) and (6), which establish that participants in a common trust fund have an interest in the investments of the fund, and are not, merely possessors of fund units.

The last item of 12 CFR § 9.18 for which you believe a waiver is appropriate is the prohibition of advertising or publicizing funds described in sub-paragraph (a)(1) found in (b)(5) of the Regulation. You informed us that the advertising or marketing of the arrangement would be primarily in the form of direct mailing. There is also a possibility that the availability of the arrangement would be publicized in publications with an intended audience of corporate fiduciaries. Since banks are considered sophisticated investors, the staff would recommend that the limited marketing of common trust funds in the form of direct mailings or publications intended for the banking industry be authorized under 12 CFR § 9.18(c)(5). However, at this time it is also our opinion that such marketing efforts should not make reference to the performance of funds other than those administered by the Bank.

There is one item that your comprehensive request did not address and that is the matter of compensation. We would expect that as a result of the arrangement the fees charged to a trust participating in the investing common trust fund would not exceed the amount allowable by 12 CFR § 9.18(b)(12). Also, all fees charged directly or indirectly to a participating trust should be disclosed fully in periodic statements issued to parties in interest to the trust.

We trust that this is fully responsive to your letter.

Sincerely,

Dean E. Miller

Deputy Comptroller for Trust and Compliance

SEC Letter

1933 Act/s 3(a)(2)

1934 Act/s 3(a)(12)

March 3, 1989

Publicly Available March 3, 1989

Re: Northern Trust Corporation

Incoming letter dated January 10, 1989

Based on the facts presented, the Division is **unable to concur** that the proposed funds are common trust funds within the meaning of section 3(a)(2) of the Securities Act of 1933 and section 3(a)(12) of the Securities Exchange Act of 1934.

Because this position is based on the representations made to the Division, it should be noted that any different facts or conditions might require a different result.

The Division of Investment Management will respond separately to your questions under the Investment Company Act of 1940.

Sincerely,

Michael Hyatte

Special Counsel

Securities and Exchange Commission (S.E.C.)

Collective Investment Funds

SEC No-Action Letter

Northern Trust Corporation II

Publicly Available July 21, 1989

Recap
This letter follows-up on the SEC's decision in the first Northern Trust No-Action Letter. Investing in non-affiliated bank CIFs was deemed not permissible in this case, despite an earlier favorable opinion by the OCC. SEC did not concur with Northern Trust Corporation's position.

Letter to SEC

April 26, 1989

Thomas S. Harman
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: Staff Response, Dated March 1, 1989, to No-Action Request of The Northern Trust Company, Dated January 10, 1989 (as supplemented on February 10 and 22, 1989); Your File No. 132-3

Dear Mr. Harman:

On behalf of The Northern Trust Company ("Northern"), we hereby seek reconsideration of the staff's response (the "Response") to Northern's request for no-action regarding the availability of the common trust fund exception.

As is discussed in greater detail below, we believe reconsideration is merited here for three reasons. First, the Response cannot be reconciled with prior staff no-action letters that raise no objection to arrangements substantially identical to Northern's proposal. Second, Northern's proposal does not involve the use of a trust "guise" of the type proscribed by the Federal Reserve Board (the "Board") in the Board pronouncement cited in the Response-- i.e., Northern will not use the trust form in an effort to attract public investors to its common trust funds. As we attempted to make clear in Northern's initial request, the proposal does no more than make available to smaller banks the opportunity to convey to Northern, for contribution by Northern to its specialized common trust funds, moneys such banks have received for bona fide fiduciary purposes. The effect of the staff's denial of Northern's request is to place smaller banks that are not affiliated with larger institutions at a competitive disadvantage and--more importantly--to deny their fiduciary customers the benefit of common trust services afforded to customers of their larger competitors, in spite of the fact that there is no danger of the proposal being used as a vehicle for attracting investment moneys from the public. **[FN1]** Third, the Response assumes--incorrectly--that Northern intends to advertise its proposal to the full extent permitted by the Comptroller of the Currency (the "Comptroller") in its letter to Northern dated July 16, 1987. Northern, however, does not intend to advertise its proposed services in trade publications, and will direct any informational materials it may develop solely to the Originating Banks (as hereinafter defined) in a manner that does not involve any "general advertising or solicitation" (as that term is defined in Regulation D promulgated under the Securities Act of 1933 (the "1933 Act")).

FN1 Smaller banks that are affiliated with larger institutions are, of course, permitted by rule to contribute moneys they have received for bona fide fiduciary purposes directly to common trust funds maintained by their larger affiliates.

As stated in Northern's initial request, Northern, in its capacity as trustee of moneys received by it from common trust funds maintained by unaffiliated banks (individually, an "Originating Bank" and collectively, the "Originating Banks"), wishes to contribute such moneys to one or more of the common trust funds (the "Funds") maintained by Northern. Under Northern's proposal, an Originating Bank would be permitted to establish a trust account at Northern whereby the Originating Bank may direct Northern, as trustee for all or a portion of the assets of the Originating Bank's common trust fund or funds, to contribute such assets to one or more of the Funds maintained by Northern. Prior to permitting an Originating Bank to establish such a trust account at Northern, Northern would obtain specific representations from the Originating Bank that (1) moneys received in trust (or some other fiduciary capacity) by the Originating Bank from its customers and contributed by the Originating Bank to its common trust fund were received by the Originating Bank for bona fide fiduciary purposes, in accordance with long-standing interpretations that a bank common trust fund may not serve as a vehicle for general investment by the public (see, e.g., H.R.Rep. No. 1382, 91st Cong., 2d Sess. 43 (1970); (2) the Originating Bank has complied and will comply with all restrictions on the operation of its common trust funds contained in the Comptroller's Regulation 9, including the restrictions on advertising respecting common trust funds contained in 12 C.F.R. § 9.18(b)(5)(v); and (3) the Originating Bank is not prohibited by local fiduciary law from investing its common trust funds in common trust funds maintained by another bank.

The staff based its rejection of Northern's request for no-action on three premises:

1. "The exception provided by Section 3(c)(3) of the Investment Company Act of 1940 [the "1940 Act"] applies only to a common trust fund for moneys which a bank has received for bona fide fiduciary purposes" (Response at p. 1);

2. "It appears that Northern may be using a trust 'guise' to 'attract moneys seeking investment alone' in its Funds," in contravention of a Federal Reserve Board pronouncement regarding the availability of the common trust fund exception (Response at p. 2); and

3. Northern's perceived intention "to advertise the availability of its proposed services to Originating Banks by direct mailings to such Banks and through advertisements in publications with an intended audience of corporate fiduciaries" falls outside the exception provided by Section 3(c)(3) (Response at p. 2).

We do not believe that the staff's first premise can be reconciled with the position taken in InterFirst Corporation, [82-83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,324 (avail. November 24, 1982) and Dauphin Deposit Bank & Trust Co., [83-84 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,547 (avail. October 1, 1983). In those letters--cited in Northern's no-action request but not discussed in the Response-- **[FN2]** the staff concluded that a bank may contribute moneys to its common trust fund notwithstanding that it received such moneys for money management purposes, as long as another bank performs bona fide fiduciary functions with respect to such moneys:

FN2 To our knowledge, the InterFirst and Dauphin letters have not been disaffirmed by the staff.

A bank may not offer to the public standardized trusts which do not require of the bank any fiduciary functions other than those incident to money management with the intent of managing collectively the assets thereof in a fund not registered as an investment company. However, though a bank, as a co-trustee, may have only fiduciary functions incident to money management with respect to the assets of a trust, it may contribute assets of the trust to its common trust fund if the trust requires of the bank's co-trustee fiduciary functions other than, or in addition to, those incident to money management.

Dauphin, supra, at p. 78,766. To be sure, the factual situation in InterFirst and Dauphin is facially different from that in Northern's proposal. In those letters, a bona fide trust customer appointed two banks as co-trustees, one to perform money management services (as well as fiduciary services incident thereto) and the other to perform fiduciary services other than those incident to money management. Nonetheless, the end result of Northern's proposal is identical to that described in the proposals endorsed in InterFirst and Dauphin: one bank, Northern, will provide money management services (as well as fiduciary services incident thereto), **[FN3]** while the Originating Banks will perform the more traditional fiduciary services vis-a-vis their customers. The only difference between Northern's proposal and the proposals endorsed in

InterFirst and Dauphin is that, in Northern's proposal, the customer will appoint the Originating Bank as trustee and the Originating Bank will then effectively appoint Northern as co-trustee, whereas in InterFirst and Dauphin, the customer appointed both the money managing trustee and the fiduciary trustee. In both Northern's proposal and the InterFirst/Dauphin proposals, however, the only moneys that may be commingled in a common trust fund are moneys that were received in the first instance by a bank for bona fide fiduciary purposes. For this reason, Northern's proposal should be accorded the same treatment that was accorded the proposals in InterFirst and Dauphin.

FN3 As noted in its initial request, however, Northern also believes that it will be receiving funds from the Originating Banks for a bona fide fiduciary purpose.

The principal point made in the InterFirst and Dauphin letters is that a determination regarding the availability of the common trust fund exception should not turn on whether one bank alone performs both money management and fiduciary services; rather, what matters is that "the trusts whose assets would be contributed to [Northern's] common trust funds [not be] offered to the public as vehicles for investment in [Northern's] common trust funds." Dauphin at p. 78,766. In the Response, however, the staff appears to have lost sight of this principle, and takes the position that, simply because Northern will receive moneys from the Originating Banks for money management purposes, Section 3(c)(3) will not be available--even though neither Northern nor the Originating Banks will be offering standardized investment trusts to the public, and even though the Originating Banks will in all cases be conveying to Northern moneys such banks received from their customers for bona fide fiduciary purposes. The staff, in other words, appears to have focused on the relationship between Northern and the Originating Banks, when--in keeping with InterFirst and Dauphin--the proper focus should be on the relationship of the Originating Banks with their customers.

The Response is also inconsistent with the position taken by the staff in State Street Bank and Trust Co., [1987 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 78,434 (avail. May 26, 1987) and Frank Russell Trust Company, [1982 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 77,247 (avail. September 2, 1982). In those letters, the staff raised no objection to arrangements under which insurance company separate accounts and bank collective trust funds (in each case consisting solely of the assets of qualified employee plans) invested their assets in the collective trust fund of an unaffiliated bank. The staff apparently concurred with counsel's contention that since the qualified plans could invest directly in the collective trust fund maintained by the unaffiliated bank under Section 3(a)(2) of the 1933 Act and Section 3(c)(11) of the 1940 Act, no objection could be seen to allowing them to invest indirectly in such collective trust fund by way of insurance company separate accounts or other collective trust funds. Similarly, under Northern's proposal, there can be no doubt that if the moneys received by the Originating Banks from their customers for bona fide fiduciary purposes were received instead directly by Northern for such purposes, Northern could legitimately contribute such moneys to its common trust funds. Thus, Northern should be permitted to contribute bona fide fiduciary moneys to its common trust funds in situations where such moneys are received indirectly by way of the Originating Banks.

The staff's second premise appears to be based on a misconstruction of the Federal Reserve Board's pronouncement concerning the proper use of trusts:

"... the trust guise or form should not be used to enable a trust institution to operate a common trust fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a common trust fund to the public as investments."

26 Fed.Reserve Bull. 393-394 (1940) (emphasis added). **[FN4]** The staff--apparently disregarding the language emphasized above--has concluded that "Northern may be using a trust guise to attract moneys seeking investment alone" in its common trust funds. Even if it can be said that Northern proposes to use the trust form to attract moneys from the Originating Banks, such an activity is fully consistent with the Board's pronouncement in the context of Northern's proposal. This is so because the pronouncement, when read in its entirety, makes the same point made in InterFirst and Dauphin: the focus should be on whether a trust arrangement is consistent with bona fide fiduciary purposes, or whether it is merely a sham to cover the sale of participations in common trust funds to the public as investments. In short, what is relevant is whether Northern is seeking to attract investment moneys from the public--something Northern manifestly does not propose to do.

FN4 As the staff itself acknowledges, in 1962, supervision over common trust funds passed from the Federal Reserve Board to the Comptroller of the Currency. As Northern noted in its request for no-action, the Comptroller has found Northern's proposal to be consistent with the description of a permissible common trust fund contained in Regulation 9, which

description is virtually identical to the description contained in Section 3(c)(3).

As noted in Northern's original request and as reiterated above, the only moneys that Originating Banks will be permitted to convey to Northern are moneys those banks receive from their customers for bona fide fiduciary purposes. Consequently, as a factual matter, Northern will not be attempting to reach the investing public. **[FN5]**

FN5 The numerous safeguards described on pages 1-2 of this letter were expressly designed to prohibit such a practice. The staff has not, to date, indicated to us that it considers these safeguards to be ineffective. Northern would, however, be willing to reconsider these (or establish additional) safeguards in light of any concerns the staff may have. In addition, as noted below, while Northern will provide informational materials with respect to its proposed services to the Originating Banks, such materials will not be distributed to the public.

With respect to the staff's third premise, while Northern has received permission from the Comptroller to advertise its proposed services in a manner somewhat broader than Regulation 9 contemplates, Northern does not intend to advertise such services in publications with an intended audience of corporate fiduciaries. In all cases, Northern will direct any informational materials it may develop solely to the Originating Banks in a manner that does not involve any "general advertising or solicitation" (as that term is defined in Regulation D promulgated under the 1933 Act). Northern would explicitly require that these materials not be redistributed by the Originating Banks to their customers or any other parties (except counsel, accountants, etc.). Upon the request of the staff, Northern will submit such materials to the staff for review prior to directing them to the Originating Banks. **[FN6]**

FN6 Under these circumstances, the staff's concerns regarding common trust fund advertising appear to us to be inapposite. The prohibition against common trust fund advertising--like the requirement that only moneys received for bona fide fiduciary purposes may be contributed to a common trust fund--was designed in large part to ensure that trusts will not be offered to the public as a vehicle for investment in common trust funds. Since Northern's informational materials will be directed solely to the Originating Banks for their internal use, there is no danger that such materials will be used to induce the public to invest either in the common trust funds maintained by the Originating Banks or in Northern's Funds.

In conclusion, when the relationship between the Originating Banks and their customers and the proposed relationship between the Originating Banks and Northern is viewed in proper perspective, it is evident that no legitimate regulatory purpose would be served if Northern were required to register its Funds in order to permit the common trust funds of Originating Banks to participate therein.

We hope that we have established sufficient grounds not only for seeking reconsideration of the staff's Response, but for obtaining a resolution of this issue that is favorable to Northern. We would, of course, be pleased to make any additional submission that the staff may deem appropriate. If the staff is unable to concur with the conclusions set forth herein, we would appreciate the opportunity to discuss these matters with the staff prior to the issuance of its response.

We are simultaneously transmitting seven copies of this letter to the Division of Corporation Finance, and we hereby request that that division also reconsider its position in this matter.

If the staff requires additional information or has any questions concerning this letter, the undersigned or Michael L. Meyer of this firm will be available at the staff's convenience.

Very truly yours,

Joseph H. Nesler

SEC Letter

1940 Act / s 3(C)(3)

July 21, 1989

Publicly Available July 21, 1989

In your letter of April 26, 1989, you ask us to reconsider our response **[FN1]** to your request, dated

January 20, 1989 and supplemented on Feb. 10 and 22, 1989, that no enforcement action be recommended to the Commission against Northern Trust Company ("Northern") if Northern receives moneys from common trust funds maintained by unaffiliated banks ("Originating Banks") and contributes such moneys to one or more of Northern's common trust funds ("Funds"), as described in your earlier letters, without registration of such Funds under the Investment Company Act of 1940 ("1940 Act"). After considering your request for reconsideration, we believe that our response to your initial request is correct. While we do not intend to restate here the analysis provided in our previous response, we will address the issues raised in your April 26, 1989 letter.

FN1 See Northern Trust Company (pub. avail. Mar. 1, 1989).

You state that the only difference between Northern's request and the requests of InterFirst Corporation (pub. avail. Nov. 24, 1982) ("InterFirst") and Dauphin Deposit Bank & Trust Co. (pub. avail. Oct. 1, 1983) ("Dauphin") is that, in Northern's proposal, the customer will appoint the Originating Bank as trustee and the Originating Bank will effectively appoint Northern as co- trustee, whereas in InterFirst and Dauphin, the customer appointed both the money managing trustee and the fiduciary trustee. We believe there are other differences which distinguish Northern from InterFirst and Dauphin.

InterFirst involved a bank holding company which owned 100% of the capital stock of 48 subsidiary banks and 56% of the capital stock of another bank subsidiary. Because the 56% owned subsidiary did not qualify as an "affiliate" as defined in section 1504(a) of the Internal Revenue Code, InterFirst could not avail itself of Rule 3c-4 under the 1940 Act. **[FN2]** Northern proposes to establish a multi-bank common trust fund comprised solely of unaffiliated banks whereas InterFirst proposed to establish a multi-bank common trust fund comprised of approximately 50 banks, only one of which did not meet the definition of affiliated under the Internal Revenue Code.

FN2 Rule 3c-4 defines the term "common trust fund" as used in Section 3(c)(3) of the 1940 Act to include a common trust fund which is maintained by a bank which is a member of an affiliated group, as defined in section 1504(a) of the Internal Revenue Code, and which is maintained exclusively for the collective investment and reinvestment of monies contributed thereto by one or more bank members of such affiliated group. See InterFirst Corporation (pub. avail. May 20, 1982).

Dauphin proposed to deposit certain assets for which it was either the trustee or co-trustee under a will, deed, or agreement into its common trust funds. The only eligible participants were charitable and other non-profit trusts and foundations which appointed Dauphin as either the trustee or co-trustee. In the response to Dauphin, the staff noted that Dauphin's common trust funds would be excepted under Section 3(c)(3) if the trust assets contributed to the funds required of Dauphin, as trustee, or of Dauphin's co- trustee, fiduciary functions other than those incident to money management. You argue that, in Northern's proposal, the customer will appoint the Originating Bank as trustee and the Originating Bank will then effectively appoint Northern as co-trustee. First, we do not believe that the staff has ever extended the analysis in Dauphin to permit "effective" appointment of a co-trustee. Second, we do not see how Dauphin's acting as a trustee or co- trustee of certain assets and contributing those assets to its common trust funds requires us, or even leads us, to conclude that Northern acting as an "effective" co-trustee should be permitted to contribute to its Funds assets of unaffiliated bank customers with whom it has no relationship. In any event, we believe the facts in Dauphin to be wholly inapposite to your situation.

You state that our response was inconsistent with the staff response in State Street Bank and Trust Co. (pub. avail. May 26, 1987) and Frank Russell Trust Company (pub. avail. Sept. 2, 1982). We cannot agree. The staff's response in both of those letters did not involve Section 3(c)(3), but rather Section 3(c)(11). These two provisions obviously involve materially different issues.

Lastly, with respect to Northern's proposed advertising of its common trust funds, we continue to believe that your proposal, as modified in your letter of April 26, 1989 **[FN3]** would cause the Funds to fall outside the exception in Section 3(c)(3). You state in footnote 6 of your April 26 letter that "since Northern's informational materials will be directed solely to the Originating Banks for their internal use, there is no danger that such materials will be used to induce the public to invest either in the common trust funds maintained by the Originating Banks or in Northern's Funds." However, we cannot reconcile this statement with a parenthetical in the text of your April 26 letter which states that Northern's advertising materials may be redistributed by an Originating Bank to "counsel, accountants, etc." Further, while you state that Northern will direct any informational materials to Originating Banks in a manner that does not involve any "general advertising or solicitation (as that term is defined in Regulation D under the 1933 Act)," the staff has, to our knowledge, never applied those standards to advertising issues under Section

3(c)(3).

> **FN3** You state that our response of March 1, 1989 incorrectly assumed that Northern would advertise its Funds to the full extent permitted by the Comptroller of the Currency, i.e. in publications with an intended audience of fiduciaries. We fail to see how we could have made any other assumption when your letter of January 10, 1989 stated that Northern would "comply with the restrictions on advertising contained in Regulation 9 [regulations of the Comptroller] in connection with the operation of the Funds," and "Northern has, however, obtained approval from the Comptroller to advertise the availability of its proposed services ... through advertisements in publications with an intended audience of corporate fiduciaries."

The Division of Corporation Finance has asked us to advise you that it continues to hold the views expressed in its letter of March 3, 1989.

Carol A. Peebles
Attorney

Securities and Exchange Commission (S.E.C.)

Fed. Sec. L. Rep. P 79,333, 1989 WL 246097 (S.E.C. No - Action Letter)

End of Document

Securities and Exchange Commission

17 CFR Section 230.180

"Sophisticated Investor Rule"

Securities Act of 1933

Recap
Keogh Account use of CIF Conditions under which Keogh plans of certain "sophisticated" employers may be exempted from securities registration when invested in Collective Investment Funds

17 CFR Section 230.180

Title 17

Chapter II

PART 230

Sec. 230.180 Exemption from registration of interests and participations issued in connection with certain H.R. 10 plans.

(a) Any interest or participation in a single trust fund or in a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, issued to an employee benefit plan shall be exempt from the provisions of section 5 of the Act if the following terms and conditions are met:

(1) The plan covers employees, some or all of whom are employees within the meaning of section 401(c)(1) of the Internal Revenue Code of 1954, and is either: (i) A pension or profit-sharing plan which meets the requirements for qualification under section 401 of such Code, or (ii) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code;

(2) The plan covers only employees of a single employer or employees of interrelated partnerships; and

(3) The issuer of such interest, participation or security shall have reasonable grounds to believe and, after making reasonable inquiry, shall believe immediately prior to any issuance that:

(i) The employer is a law firm, accounting firm, investment banking firm, pension consulting firm or investment advisory firm that is engaged in furnishing services of a type that involve such knowledge and experience in financial and business matters that the employer is able to represent adequately its interests and those of its employees; or

(ii) In connection with the plan, the employer prior to adopting the plan obtains the advice of a person or entity that (A) is not a financial institution providing any funding vehicle for the plan, and is neither an affiliated person as defined in section 2(a)(3) of the Investment Company Act of 1940 of, nor a person who has a material business relationship with, a financial institution providing a funding vehicle for the plan; and (B) is, by virtue of knowledge and experience in financial and business matters, able to represent adequately the interests of the employer and its employees.

(b) Any interest or participation issued to a participant in either a pension or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954 or an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, and which covers employees, some or all of whom are employees within the meaning of section 401(c)(1) of such Code, shall be exempt from the provisions of section 5 of the Act.

(46 FR 58291, Dec. 1, 1981)

Collective Investment Funds

Securities and Exchange Commission

Merger Rules for Mutual Funds and CIFs

Recap
SEC Rule 17a-8, cited below, defines the merger requirements for registered mutual funds with other affiliated mutual funds or affiliated non-registered CIFs.

Section 270.17a-8 is revised (July 26, 2002) to read as follows:

§ 270.17a-8 Mergers of affiliated companies.

(a) Exemption of affiliated mergers. A Merger of a registered investment company (or a series thereof) and one or more other registered investment companies (or series thereof) or Eligible Unregistered Funds is exempt from sections 17(a)(1) and (2) of the Act (15 U.S.C. 80a-17(a)(1)-(2)) if:

(1) Surviving company. The Surviving Company is a registered investment company (or a series thereof).

(2) Board determinations. As to any registered investment company (or series thereof) participating in the Merger ("Merging Company"):

(i) The board of directors, including a majority of the directors who are not interested persons of the Merging Company or of any other company or series participating in the Merger, determines that:

(A) Participation in the Merger is in the best interests of the Merging Company; and

(B) The interests of the Merging Company's existing

shareholders will not be diluted as a result of the Merger.

(ii) The directors have requested and evaluated such information as may reasonably be necessary to their determinations in paragraph (a)(2)(i) of this section, and have considered and given appropriate weight to all pertinent factors.

Note to paragraph (a)(2)(i): For a discussion of factors that may be relevant to the determinations in paragraph (a)(2)(i) of this section, see Investment Company Act Release No. 25666, July 18, 2002.

(iii) The directors, in making the determination in paragraph (a)(2)(i)(B) of this section, have approved procedures for the valuation of assets to be conveyed by each Eligible Unregistered Fund participating in the Merger. The approved procedures provide for the preparation of a report by an Independent Evaluator, to be considered in assessing the value of any securities (or other assets) for which market quotations are not readily available, that sets forth the fair value of each such asset as of the date of the Merger.

(iv) The determinations required in paragraph (a)(2)(i) of this section and the bases thereof, including the factors considered by the directors pursuant to paragraph (a)(2)(ii) of this section, are recorded fully in the minute books of the Merging Company.

(3) Shareholder approval. Participation in the Merger is approved by the vote of a majority of the outstanding voting securities (as provided in section 2(a)(42) of the Act (15 U.S.C. 80a-2(a)(42))) of any Merging Company that is not a Surviving Company, unless -

(i) No policy of the Merging Company that under section 13 of the Act (15 U.S.C. 80a-13) could not be changed without a vote of a majority of its outstanding voting securities, is materially different from a policy of the Surviving Company;

(ii) No advisory contract between the Merging Company and any investment adviser thereof is materially different from an advisory contract between the Surviving Company and any investment adviser thereof, except for the identity of the investment companies as a party to the contract;

(iii) Directors of the Merging Company who are not interested persons of the Merging Company and who were elected by its shareholders, will comprise a majority of the directors of the Surviving Company who are not interested persons of the Surviving Company; and

(iv) Any distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the Surviving Company pursuant to a plan adopted in accordance with § 270.12b-1 are no greater than the distribution fees (as a percentage of the fund's average net assets) authorized to be paid by the Merging Company pursuant to such a plan.

(4) Board composition; independent directors.

(i) A majority of the directors are not interested persons of the Merging Company and those directors select and nominate any other disinterested directors.

(ii) Any person who acts as legal counsel for the disinterested directors is an independent legal counsel.

(5) Merger records. Any Surviving Company preserves written records that describe the Merger and its terms for six years after the Merger (and for the first two years in an easily accessible place).

(b) Definitions. For purposes of this section:

(1) Merger means the merger, consolidation, or purchase or sale of substantially all of the

assets between a registered investment company (or a series thereof) and another company;

(2) Eligible Unregistered Fund means:

(i) A collective trust fund, as described in section 3(c)(11) of the Act (15 U.S.C. 80a-3(c)(11));

(ii) A common trust fund or similar fund, as described in section 3(c)(3) of the Act (15 U.S.C. 80a-3(c)(3)); or

(iii) A separate account, as described in section 2(a)(37) of the Act (15 U.S.C. 80a-2(a)(37)), that is neither registered under section 8 of the Act, nor required to be so registered;

(3) IndependentEvaluator means a person who has expertise in the valuation of securities and other financial assets and who is not an interested person, as defined in section 2(a)(19) of the Act (15 U.S.C. 80a-2(a)(19)), of the Eligible Unregistered Fund or any affiliate thereof except the Merging Company; and

(4) Surviving Company means a company in which shareholders of a Merging Company will obtain an interest as a result of a Merger.

By the Commission.

Margaret H. McFarland
Deputy Secretary

Dated: July 18, 2002

Collective Investment Funds

Securities and Exchange Commission

SEC No-Action Letter Regarding Private Investment Companies (Private Collective Funds) under ICA of 1940

American Bar Association Section of Business Law

Publicly Available April 22, 1999

Letter to SEC

December 3, 1997

Douglas J. Scheidt, ESQ., Associate Director and Chief Counsel

Division of Investment Management

Securities and Exchange Commission

450 Fifth Street, N.W.

Mail Stop 10-6

Washington, D.C. 20549

Re: Interpretive Issues Regarding New Rules

For Private Investment Companies Under

the Investment Company Act of 1940 (the

"Act")

Gentlemen:

This letter is submitted by the Subcommittee on Private Investment Entities (the "Subcommittee") of the Federal Regulation of Securities Committee (the "Committee"), Section of Business Law (the "Section") of the American Bar Association with respect to the provisions of the National Securities Markets Improvement Act of 1996 (the "1996 Act") relating to private investment companies and the final rules adopted by the Securities and Exchange Commission (the "Commission") to implement such provisions (Rel. No. 1C- 22597) (the "Rules").

We believe that the Rules have on an overall basis been effective and useful. In short, the experience with the Rules has been favorable. There are, however, certain issues which require interpretation or clarification. We have obtained from members of the Subcommittee and others a list of those issues and recommendations as to their resolution. We hope that this may be of assistance to the Staff. We request that the Staff issue interpretive guidance, in question and answer format or otherwise, which deals with these issues and others of which the Staff may be aware. [FN1]

FN1. A draft of this letter has been circulated for comment among members of the Subcommittee and certain other persons. This letter represents the consensus view of the members of the Subcommittee and others who have submitted comments. It does not necessarily reflect the views of all who have reviewed it nor does it reflect the view of the American Bar Association, the Section or the Committee.

A. Knowledgeable Employees

The issues that have arisen under the Rules frequently involve "knowledgeable employees." Rule 3c-5 permits "knowledgeable employees" of a private investment company and certain of its affiliates to acquire securities issued by the fund without being counted as beneficial owners for purposes of Section 3(c)(1) and without satisfying the qualified purchaser definition under Section 3(c)(7). Knowledgeable employees include executive officers, directors, trustees, general partners and advisory board members of the Section 3(c)(1) fund or Section 3(c)(7) fund (a "Covered Company") or an affiliated person of the Covered Company that manages the investment activities of the fund ("Affiliated Management Person") and other employees of the Covered Company or its Affiliated Management Person who, in connection with their regular functions or duties, participate in the investment activities of the fund or other investment companies managed by the fund's Affiliated Management Person, provided that such employee has been performing such functions or duties for the fund or its Affiliated Management Person or substantially similar functions or duties for another person for at least 12 months. Employees performing solely clerical, secretarial or administrative functions with regard to a fund are not deemed knowledgeable employees.

1. Issue: May certain marketing and investor relations professionals, research analysts, brokers and traders, attorneys, financial, compliance, operational and accounting officers of a Covered Company or an Affiliated Management Person who are non-executive employees of the Covered Company or Affiliated Management Person qualify as knowledgeable employees?

It is our understanding that the Staff does not view the requirement that employees "participate in the investment activities" of the fund as limiting the exception to portfolio managers or others who are directly involved, on a regular basis, with a fund's investment decision-making process. As a result of the information other employees may receive in the course of their regular functions or duties, the nature of their responsibilities for the fund and their evaluative abilities, certain other non-executive employees may be close enough to the investment decision-making function to be viewed as participants in that process. As a result, they may possess a sophisticated knowledge and understanding of the investment objectives, risks and operations of one or more funds and related investment companies offered by their employers. We believe, for example, that the definition of knowledgeable employees should be interpreted to include the following persons who meet such criteria: (i) marketing and investor relations professionals who must explain potential and actual portfolio investments of a fund and the investment decision-making process and strategy being followed to clients and prospective investors and who, from time to time, interface among the fund, the portfolio managers and the fund's clients; (ii) research analysts who investigate the potential investments for the fund; (iii) attorneys who, as part of their duties,

provide advice with respect to, or who participate in, the preparation of offering documents, and the negotiation of related agreements and who also are familiar with investment company management issues and respond to questions or give advice concerning ongoing fund investments, operations and compliance matters; (iv) brokers and traders of a broker-dealer related to the Covered Company or the Affiliated Management Person who are Series 7 registered; and (v) financial, compliance, operational and accounting officers of a fund who have management responsibilities for compliance, accounting and auditing functions of funds or their Management Affiliates. [FN2]

FN2. As noted below in the discussion relating to issue number 3, investment management firms are organized in different forms for a variety of business reasons so that employees of entities related to the Covered Company or an Affiliated Management Person (rather than employees of the Covered Company or an Affiliated Management Person) often perform certain of these functions. For example, a marketing professional may be a broker for a brokerage firm under common control with the Affiliated Management Person. We believe employees of related entities under common control should qualify as knowledgeable employees if they meet the functional criteria, regardless of whether they are technically employed by the Covered Company or the Affiliated Management Person.

2. Issue: May an employee who manages a fund that is not defined as an investment company under the Act pursuant to an exception other than Section 3(c)(1) or Section 3(c)(7) be eligible for knowledgeable employee status?

Under Rule 3c-5(a)(1), the term Affiliated Management Person means an affiliated person that manages the investment activities of a Section 3(c)(1) fund, a Section 3(c)(7) fund or an investment company. There does not appear to be any basis for distinguishing among a manager of a private investment company that is not defined as an investment company under Section 3(c)(1) or Section 3(c)(7) of the Act, a manager of a fund that is not defined as an investment company under another provision of the Act (e.g., commingled trusts excepted under Sections 3(c)(3) or 3(c)(11), or foreign or offshore investment companies excepted from registration under Section 6 of the Act) and a manager who manages only separately managed accounts (e.g., not a fund). They may each have the same investment objectives and responsibilities and perform similar functions and should be treated similarly. Non-executive employees (of the type described in our recommendation to issue number 1 above) of a fund not defined as an investment company under a provision of the Act other than Section 3(c)(1) or Section 3(c)(7) or a separately managed account should also be eligible for knowledgeable employee status.

3. Issue: Investment management complexes often establish, for various business reasons, a number of related entities that are involved in investment activities. May the definition of an "Affiliated Management Person" of a Covered Company include each affiliated entity of a Covered Person (regardless of corporate structure) that participates in the investment activities of the investment management company?

The definition of an "Affiliated Management Person" of a Covered Company should include each related entity of a Covered Person that participates in the investment activities of the investment management company. Such an interpretation would provide consistency in the treatment of employees, irrespective of whether the investment management firm chooses to carry on all of its investment advisory businesses through separate operating divisions of a single legal entity or by dividing such business among related entities. Section 209(d)(3) of the 1996 Act seems to contemplate such an interpretation as it refers to "knowledgeable employees of ... an affiliated person ... ", in a manner that may encompass brother-sister entities. Moreover, such an interpretation is completely consistent with the Staff's long-standing practice of not making significant regulatory distinctions depend on whether a single fund complex operates through multiple divisions or multiple controlled entities.

4. Issue: If a knowledgeable employee invests in a Section 3(c)(1) fund or Section 3(c)(7) fund (i) jointly with a spouse and/or other dependents or (ii) through a family company, trust or other similar estate planning vehicle for which the knowledgeable employee is responsible for investment decisions and the source of the funds invested is individual property or property held jointly with the spouse, will such investment be deemed to have

been made by the knowledgeable employee?

Section 2(a)(51)(A)(i) of the Act defines qualified purchaser as "any natural person (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments." Rule 3c-5 permits knowledgeable employees to invest in a Section 3(c)(7) fund even though they do not meet the definition of qualified purchaser. We believe it would be consistent with the purposes of the Rules to permit a knowledgeable employee to invest in a Section 3(c)(7) fund with his or her spouse through a joint, community property or other similar shared ownership interest or through family-owned or estate planning entities when the knowledgeable employee, alone or with his or her spouse, is the source of the investment funds and the knowledgeable employee, alone or with his or her spouse, directs the investment.

Rule 3c-5 also permits knowledgeable employees to invest in a Section 3(c)(1) fund without being counted for purposes of Section 3(c)(1)'s 100-investor limit. Consistent with the approach described above, we believe that a knowledgeable employee should also be permitted to invest in a Section 3(c)(1) fund with his or her spouse or through family-owned or estate planning entities when the knowledgeable employee, alone or with his or her spouse, is the source of the investment funds and the knowledgeable employee, alone or with his or her spouse, directs the investment without being counted as a beneficial owner. This would also be consistent with the Commission's current view that securities of a Section 3(c)(1) fund jointly owned by both spouses should be considered to be owned by one beneficial owner. (See footnote 69 of Rel. No. IC-22597.)

Rule 3c-5(b)(1) requires that a person be a knowledgeable employee at the time such person acquires securities in the fund. This means, for example, that an investor who (i) acquired securities in a Section 3(c)(1) fund before the effective date of the 1996 Act provisions relating to private investment companies (the "Effective Date") and would have been considered a knowledgeable employee at the time of acquisition (but had been counted as a beneficial owner for purposes of the 100-person limitation because the knowledgeable employee exception did not yet exist) and (ii) was a knowledgeable employee on the Effective Date, should no longer count toward the 100-person limitation of Section 3(c)(1). Additionally, an investor who (iii) acquired securities before the Effective Date and would not have been considered a knowledgeable employee at the time of acquisition and (iv) was not a knowledgeable employee on the Effective Date, would continue to count toward the 100-person limitation. While these situations are straightforward in terms of their application, the following interpretive issues should be resolved.

5. Issue: Does an investor who acquired securities in a Section 3(c)(1) fund before the Effective Date count toward the 100-person limitation if he or she would have been considered a knowledgeable employee at the time of acquisition, but is not one on the Effective Date (due, for example, to termination of employment)?

The investor should no longer count toward the 100-person limitation because he or she was a knowledgeable employee at the time the securities were acquired. As provided in footnote 120 of Rel. No. IC-22597, such investor should not be counted simply because employment with the fund has terminated.

6. Issue: Does an investor who acquired securities in a Section 3(c)(1) fund before the Effective Date count toward the 100-person limitation if he or she would not have been deemed a knowledgeable employee at the time of acquisition but was a knowledgeable employee on the Effective Date?

The investor should not count toward the 100-person limitation because he or she was a knowledgeable employee at the time the Rules went into effect. The purpose of the Rules is to allow sponsors to raise additional capital without sacrificing investor protection, and there is no public interest served by counting an investor who on the Effective Date qualified as a knowledgeable employee.

7. Issue: If an investor who does not qualify as a knowledgeable employee invests in a

Section 3(c)(1) fund, may the fund cease to count such person as a beneficial owner once he or she satisfies the knowledgeable employee test?

At the time the investor qualifies as a knowledgeable employee, either because he or she becomes a general partner, director or executive officer of the Covered Company or because such person has been engaged in the investment activities of the Covered Company or another person for at least 12 months, he or she should no longer count toward the 100-person limitation. At such time, the standard is satisfied and the fund should be entitled to reevaluate such employee's status. This would not have any adverse impact on investor protection and would be consistent with the purpose of the Rules. If the fund were not entitled to reevaluate the employee's status, it could result in the employee-investor withdrawing from the fund and then reinvesting immediately so that such employee's securities are acquired at the time he or she was a knowledgeable employee. This does not seem to make sense and would create unnecessary burdens for the fund and the employees and overly emphasize form over substance.

8. Issue: May a knowledgeable employee invest in a Covered Company through an IRA, trust or other entity for which he or she is responsible for investment decisions and where the source of funds invested in the Covered Company was individual property or property held jointly with the knowledgeable employee's spouse (without being counted toward the fund's 100- person limit or without being a qualified purchaser)?

Under Rule 3c-5, a knowledgeable employee may invest in a private investment company without being counted as a beneficial owner for purposes of Section 3(c)(1) and without satisfying the qualified purchaser definition under Section 3(c)(7). Rule 3c-5 also allows certain transferees of a knowledgeable employee to acquire securities of (i) a Section 3(c)(1) fund without counting as a beneficial owner and (ii) a Section 3(c)(7) fund without the transferee satisfying the qualified purchaser or knowledgeable employee standard. It would be consistent with the purposes of the Rules to permit a knowledgeable employee to invest in such funds directly through an IRA, trust or other entity where he or she is the source of the investment funds and directs the investment. Moreover, because a spouse who is not a qualified purchaser may hold a joint interest in a Section 3(c)(7) fund with such person's qualified purchaser spouse, the knowledgeable employee should, consistent with Section 2(a)(51)(A)(i) of the Act, be able to invest in such funds directly through a trust or other entity that is jointly owned with such knowledgeable employee's spouse and/or other dependents.

B. Individual Retirement Accounts

1. Issue: If an existing Section 3(c)(1) fund elects to convert to a Section 3(c)(7) fund pursuant to Section 3(c)(7)(B) of the Act, may a grandfathered investor, who is not otherwise a qualified purchaser, and whose interest in a 3(c)(7) fund is, and was, prior to conversion, held in such investor's individual name, make additional investments in the fund (following its conversion to a 3(c)(7) fund) through his or her IRA or the self-directed account of a retirement plan?

A grandfathered investor is permitted to make additional investments in the grandfathered fund. (See footnote 82 of Rel. No. IC-22597.) So long as the IRA beneficiary and the grandfathered investor are the same, allowing the investor to make additional investments through such investor's IRA or the self-directed account of a retirement plan would be consistent with footnote 82 of the Release.

2. Issue: For purposes of determining whether or not an IRA or the self- directed account of a retirement plan is a qualified purchaser, may one look through the IRA or account to its creator?

If the IRA or account beneficiary is a qualified purchaser who, alone or with others, determines how the money will be invested, then the IRA or account should also be deemed a qualified purchaser.

C. Trusts

Under the definition of qualified purchaser in Section 2(a)(51)(A) of the Act, trusts may qualify under either clause (ii), (iii) or (iv). Each clause focuses on a different standard: clause (ii) focuses on the value of the trust's investments and its ownership; clause (iii) looks to the qualification of the settlor and each trustee of the trust; and clause (iv) focuses only on the value of the trust's investments. These differing standards raise a number of interpretive issues.

1. Issue: Under Section 2(a)(51)(A)(iii), at what time is the status of each settlor and trustee determined -- at the time of a particular investment or at the formation of the trust?

What is the effect on qualification if the settlor is deceased?

Section 3(c)(7)(A) of the Act excepts any issuer whose outstanding securities are owned exclusively by persons who "at the time of acquisition of such securities" are qualified purchasers. The relevant time, therefore, to test the status of each settlor and trustee of the trust should be at the time of a particular investment. The Staff should clarify that if, at the time of an investment, a settlor is deceased, then such settlor will not be considered for purposes of determining

whether the trust is a qualified purchaser. Instead, if the trustee authorized to make decisions with respect to the trust is a qualified purchaser, then the trust should be a qualified purchaser. If the Staff believes it is appropriate, it would be consistent with the statutory scheme to require that such a trust own not less than $5 million in investments in order to be a qualified purchaser.

2. Issue: Section 2(a)(51)(A)(iii) of the Act provides that a qualified purchaser includes any trust not covered by Section 2(a)(51)(A)(ii) of the Act and that was not formed for the specific purpose of acquiring the securities offered as to which "the trustee or other person authorized to make decisions with respect to the trust and each settlor or other person who has contributed assets to the trust" is a qualified purchaser. Is it sufficient if only the trustee actually making the investment decision to acquire the securities at issue is a qualified purchaser?

Under some trust agreements, there are trustees appointed with different authority (for example, a trustee may be appointed to have only administrative authority). It should not be necessary for a trustee who did not participate in a particular investment decision (and whose consent was not needed to make such investment) to be a qualified purchaser in order to qualify the trust.

3. Issue: If a trust that is not covered by Section 2(a)(51)(A)(ii) of the Act has less than $5,000,000 in investments and not all of the trustees authorized to make investment decisions or settlors of the trust are qualified purchasers, may the trust still be deemed a qualified purchaser if all of the trust's beneficiaries are qualified purchasers? Should the use of a trust format, as opposed to a family company format (where a look-through would clearly be permissible), dictate whether a look-through to the beneficiaries is possible?

Under Rule 2a51-3(b), a company may be deemed a qualified purchaser if each beneficial owner of its securities is a qualified purchaser. As Section 2(a)(8) of the Act defines "company" to include a trust, we believe this same look- through should be permitted to the beneficiaries of a trust.

4. Issue: Under Section 2(a)(51)(A)(ii) of the Act, a qualified purchaser includes any company that owns not less than $5 million in investments and is owned by two or more related persons. For a trust to be a qualified purchaser under this definition, it must therefore be owned by two or more related persons. Who is considered to "own" a trust?

If the beneficiaries of the trust were two or more of the related persons described in Section 2(a)(51)(A)(ii), and the trust owns not less than $5 million in investments, the trust should be deemed a qualified purchaser under that provision.

5. Issue: May a grandfathered investor, who is not otherwise a qualified purchaser (i) transfer his or her investment in the converted Section 3(c)(7) fund to an IRA, trust or other entity and (ii) make additional investments in the converted Section 3(c)(7) fund through the IRA, trust or other entity?

If the grandfathered investor is the settlor of the trust and the trustee who makes the particular investment decision, or the one who is the source of the investment funds and who, alone or with others, directs the investments, then such transfer and additional investments should be permitted.

D. Formed for the Specific Purpose

Under the 1996 Act, in order for a trust to be a qualified purchaser, it must not have been formed "for the specific purpose of acquiring the securities offered." Rule 2a51-3(a) applies this condition to all entities

that propose to become qualified purchasers unless each beneficial owner of an entity's securities is a qualified purchaser. This requirement limits the possibility that non-qualified investors could pool their investments in an entity that satisfied the qualified purchaser test. (See Rel. No. IC-22597 at 47.)

1. Issue: When is an entity deemed to be formed for the specific purpose of acquiring securities in a Section 3(c)(7) fund?

In the context of Section 3(c)(1), the Staff has indicated that if an entity is formed for the specific purpose of acquiring securities in a particular fund, the owners of that entity may be counted in determining the number of beneficial owners of that fund. In a series of no-action letters, the Staff conditioned relief to certain funds from such result on the representation, among other things, that the investing entity would not invest more than 40% of its committed capital in that particular Section 3(c)(1) fund. [FN3] In a 1996 no-action letter, the Staff noted that, because the 40% test is not a statutory requirement, it is not determinative of when the owners of an investing entity would need to be counted. [FN4] Rather, the determination that an entity is formed for the specific purpose under Section 3(c)(1) will depend upon an analysis of all of the surrounding facts and circumstances. It would be helpful if the Staff clarifies its position on "formed for the specific purpose" in the context of Section 3(c)(7) funds. Will the Staff's position, as stated in Cornish & Carey, apply?

FN3. See Risk Arbitrage Partners (1986), CMS Communications Fund L.P. (1987), Tyler Capital Fund, L.P./South Market Capital (1989), Handy Place Investment Partnership (1989) and Six Pack (1989).

FN4. See Cornish & Carey Commercial, Inc. (1996).

E. Involuntary Transfers

Under Rule 3c-6, beneficial ownership by any person who acquires securities of a Section 3(c)(1) fund from a person pursuant to an involuntary transfer (a gift, bequest or agreement relating to a legal separation or divorce) is deemed to be beneficial ownership by the person from whom such transfer was made. Securities of a Section 3(c)(7) fund that are owned by a person who received the securities from a qualified purchaser pursuant to an involuntary transfer are deemed to be owned by a qualified purchaser. In either type of fund, beneficial ownership by any person who acquires securities from a knowledgeable employee pursuant to an involuntary transfer is deemed to be beneficial ownership by a knowledgeable employee. Subsequent transfers by transferees that are in the form of a gift or bequest are also permitted without affecting the Section 3(c)(1) or Section 3(c)(7) exception.

1. Issue: Does the rule on involuntary transfers also include distributions from testamentary or inter vivos trusts or other entities?

So long as the decision to make the distribution is not made by the distributee, such distribution should be deemed an involuntary transfer permitted by Rule 3c-6.

2. Issue: May securities of a Section 3(c)(7) fund be transferred to a person by gift if the fund requires additional contributions of capital in the future and either (i) the transferor agrees to pay the additional contributions as they become due or are called by the fund and the fund agrees not to enforce the obligation to pay the additional contributions against the transferee or (ii) simultaneously with the gift, the transferor provides sufficient assets to the transferee to enable it to satisfy the additional contributions?

Investment funds frequently require their beneficial owners to make additional contributions of capital, either at specified intervals or as determined by the fund's general partner. We do not believe that the Staff intended that Rule 3c-6 be used to shift economic obligations to transferees who might not themselves be deemed qualified purchasers. If, however, a qualified purchaser makes a gift and agrees to pay additional contributions required by the fund (and the fund agrees to look solely to the transferor for payment), there would appear to be no policy reasons to disqualify such a transfer from the benefits of Rule 3c-6. The same result should follow if the qualified purchaser transferor provides sufficient assets to the transferee to satisfy the additional contributions.

3. Issue: May a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees receive securities of a Section 3(c)(7) fund by gift if the fund requires additional contributions of

capital in the future and the contributions are paid out of assets previously held by the company so long as such assets derived exclusively from the qualified purchaser?

Under Rule 3c-6(b)(3), a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees may receive securities of a Section 3(c)(7) fund and be deemed a qualified purchaser even if the company does not otherwise satisfy the definition of qualified purchaser set forth in Sections 2(a)(51)(A)(ii) through (iv) of the Act. If the fund in which the company receives securities requires additional contributions of capital in the future, then so long as the assets that will be used to satisfy such contributions have been previously provided by the qualified purchaser transferor, there is no policy reason why such transfer of securities should not be permitted under Rule 3c-6.

4. Issue: Should an interest owned by a company in a Section 3(c)(7) fund that is received by the holders of the company, either as a distribution or in dissolution of the company, be considered the equivalent of a gift to such holders so long as the company was not specifically formed for the purpose of making the investment in question?

If the company was a qualified purchaser when it made the investment in the Section 3(c)(7) fund and was not formed for the specific purpose of making that particular investment, the company should be able to distribute its interest in the fund to the holders of interests in the company either from time to time or upon dissolution of the company without the holders being required to be qualified purchasers. Such a distribution should be deemed an involuntary transfer permitted by Rule 3c-6.

F. Effect of Section 3(c)(7) Funds on Rule 144A Securities and DTC Procedures

Rule 2a51-1(g)(1) provides that, with two exceptions, if a person seeking to purchase a security of a Section 3(c)(7) fund is, or is reasonably believed to be by a Relying Person (a Section 3(c)(7) fund or a person acting on its behalf), a qualified institutional buyer ("QIB"), as defined under Rule 144A promulgated under the Securities Act of 1933, then such person will be deemed to be a qualified purchaser. Reasonable belief may be established by inquiry directed to a prospective investor or a subsequent transferee before such person acquires securities of the fund. In the Rule 144A trading market, however, it is not a Relying Person who makes the determination that a buyer of securities is a QIB; it is the seller of the securities. Therefore, in order to give effect to Rule 2a51-1(g)(1), it is necessary to establish a different mechanism than the reasonable belief of a Relying Person. We believe that, by analogy to the Rule 144A market, a mechanism that would allow a qualified purchaser that is a QIB to have a reasonable belief that a person to whom it wishes to transfer securities of a Section 3(c)(7) fund is a QIB (subject to the two exceptions included in the Rule), should be sufficient.

Such a mechanism could be established by reference to lists maintained by dealers who, in the case of Rule 144A securities, know that the buyer of the security must be a QIB because the CUSIP number has an "R". Dealers police themselves; they maintain a list of their customers which they believe are QIBs. This list would have to be slightly modified in the case of Section 3(c)(7) to take into account the different standards for dealers and trusts. The Commission has blessed these procedures as being in compliance with Rule 144A even though it is possible that such Rule 144A securities could potentially be held by non-QIBs. If these procedures are followed for qualified purchaser funds, the securities could be accepted into the DTC clearance system, thereby enhancing liquidity.

1. Issue: Would the Commission agree that a modified CUSIP number would be sufficient to comply with Section 3(c)(7) as in the case of Rule 144A?

If the CUSIP number in the case of Section 3(c)(7) securities contained a "QP" designation, a parallel procedure could be implemented. If the Commission orally concurs with the establishment of such a procedure, the relevant personnel in charge of the CUSIP system would need to be consulted to determine if such a change could be easily implemented, and who needs to request such a systems change. As an alternative, DTC acceptance of securities issued by Section 3(c)(7) funds might be confined to securities that were required to be traded in very large blocks, thus assuring the large size of the holders.

The foregoing issue is of increasing importance given the nature of the QIB market. A related issue is whether the Section 3(c)(7) fund may rely upon deemed representations

and warranties of transferees as to qualified purchaser status. This issue arises both in domestic and offshore transactions (where there are issuances outside and into the United States in foreign securities). Customarily there is no certification from the transferee, but the offering materials specify that there will be reliance on the deemed representations and warranties of transferees. The offering materials specify that only QIBs may acquire the securities either initially or on resale. There is generally a provision requiring immediate divestiture by any holder that is an ineligible purchaser. We recommend that, for purposes of determining qualified purchaser status, a Relying Person may establish reasonable belief for purposes of Rule 2a51-1(h) by the use of this mechanism inasmuch as the QIB market is limited to institutional buyers, most of whom would easily meet the $25 million in investments requirement under Section 2(a)(51)(A)(iv) and virtually all of whom can be identified from eligibility lists. It is doubtful that there are many institutions that are QIBs that are not also qualified purchasers. Given the nature of the institutional QIB market and the inclusion of procedures mandating divestiture by QIBs that are not qualified purchasers, we believe it would be appropriate for the Commission to clarify that the use of these or similar procedures would permit a Relying Person to meet the requirements of Rule 2a51-1(h), thereby promoting liquidity in the institutional QIB capital markets.

G. Timing of Qualified Purchaser Determination

Section 3(c)(7)(A) of the Act provides that the outstanding securities of a Section 3(c)(7) fund must be owned "exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers." In Rel. No. IC-22597, the Commission stated that it believes this provision requires a new determination as to whether a person is a qualified purchaser each time the person acquires securities of a Section 3(c)(7) fund. The status of an investor as a qualified purchaser, however, does not need to be reaffirmed each time the investor makes additional capital contributions to a fund pursuant to a binding commitment that was made when the investor was determined to be a qualified purchaser.

1. Issue: Does the fund need to make a new determination of qualified purchaser status for an investor each time the investor elects to reinvest his or her earnings of the fund?

It should not be necessary to reaffirm qualified purchaser status when an investor reinvests earnings of the fund. Funds offer investors varying rights, including automatic reinvestment absent an annual earnings withdrawal decision. There is a distinction between reinvesting (or not withdrawing) earnings and making a new investment decision by contributing additional capital to a fund.

Such a finding would be consistent with Weiss, Global Ltd. Partnership (Nov. 1, 1990). In that letter, the Staff provided that, for purposes of the second 10% test under the prior language of Section 3(c)(1)(A), the crediting of partnership earnings to capital accounts should not be treated as an acquisition of securities. The letter stated that a new acquisition of securities should only be triggered by purchases of securities with "new money" (as distinguished from earnings generated by the issuer). While the Weiss, Global letter dealt with the language of Section 3(c)(1) that has been eliminated in the 1996 Act, we believe that its reasoning should also be applicable to the first (and now only) 10% test of Section 3(c)(1) and also to Section 3(c)(7).

H. Short-Term Paper/Section 3(c)(7)

1. Issue: May holders of short-term paper issued by a Section 3(c)(7) fund be excluded from having to meet the qualified purchaser standard in order to invest in that fund?

For purposes of identifying the number of beneficial holders of a Section 3(c)(1) fund, holders of short-term paper issued by the fund are expressly excluded, presumably because their interests in the fund are sufficiently risk- differentiated from equity or long-term debt holders that they should be viewed more as ordinary creditors than as investors in the fund. The same exclusion should apply when identifying the class of investors that must be qualified purchasers for purposes of Section 3(c)(7).

I. Jointly-Held Investments

In footnote 69 of Rel. No. IC-22597, the Commission departed from an earlier Staff position and, consistent with Rule 2a51-1(g)(2), stated that, for purposes of determining the number of beneficial owners of a Section 3(c)(1) fund, securities of a fund jointly owned by two spouses should be considered

to be owned by one beneficial owner. Previously, husbands and wives were counted as two beneficial owners.

1. Issue: If a husband and wife are separate limited partners in a Section 3(c)(1) fund, should they be counted as one or two beneficial owners?

If the limited partner interests are separately owned, then the husband and wife should be counted separately. If, however, the interest held by each spouse is jointly-owned property, then interests of the spouses should be considered to be owned by one beneficial owner.

2. Issue: If a husband and wife jointly own an entity (such as a limited partnership, a limited liability company or a trust) that invests in a Section 3(c)(1) fund, should that entity be counted as one beneficial owner even if the entity would be subject to a "look through" because it owned more than 10% of the voting securities of the Section 3(c)(1) fund or was formed for the purpose of investing in the particular Section 3(c)(1) fund?

So long as the interests in the entity are jointly owned, then the entity should count as one beneficial owner. This would be consistent with footnote 69 of Rel. No. IC-22597 and should apply regardless of whether the entity itself would be subject to a look-through.

J. Conversion to a Section 3(c)(7) Fund

1. Issue: If a Section 3(c)(1) fund that is a limited partnership converts its status to a fund that relies on the exclusion provided by Section 3(c)(7) and that fund subsequently converts from a limited partnership into a limited liability company (with appropriate limited partner consent as required under state law and the fund's limited partnership agreement), will the fund be allowed to continue to include persons who acquired interests in the limited partnership on or before September 1, 1996, even if such persons are not qualified purchasers?

We believe that such a fund should be allowed to continue to rely on Section 3(c)(7) even though it has changed its form from a limited partnership to a limited liability company; provided that the fund continues its business as previously conducted. Although this may be considered a technical change in the issuer, it is clearly a change of form and not of substance. The Commission has consistently treated the new legislation relating to Sections 3(c)(1) and 3(c)(7) with an approach that does not elevate form over substance.

If a fund that maintains its organization as a limited partnership is able to continue to rely on Section 3(c)(7), we do not believe that any policy is furthered by not allowing that fund to rely on Section 3(c)(7) simply because it changes its form from a limited partnership to a limited liability company. Because the business of the fund will continue as previously conducted, the members who invested in the fund prior to September 1, 1996, are not afforded any additional protection by prohibiting reliance on Section 3(c)(7); state law and the limited partnership agreement govern the appropriate consent of the limited partners to such a transaction.

Limited liability companies are becoming more popular as vehicles for private investment companies. Furthermore, the policy of the Federal Reserve Board with respect to private investment funds affiliated with bank holding companies favors the limited liability company format over the limited partnership format. Many private investment companies that have converted or expect to convert to Section 3(c)(7) status also need to convert to limited liability company status because of this Federal Reserve Board policy. [FN5] If the Commission does not agree with the analysis above, private investment companies affiliated with bank holding companies may be unfairly and inadvertently penalized.

FN5. Many of those funds are managed by firms that were recently acquired by bank holding companies.

We appreciate the opportunity to identify interpretive issues and make recommendations concerning the new Rules. Members of the Subcommittee are available to meet with the Staff of the Commission to review the interpretive issues and recommendations set forth herein.

Respectfully submitted,

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SEC Letter

ICA 1940 Act / s 3(c)(1), 3(c)(7), 2(a)(51)(A) / Rule 2a51-1, 2a51-3, 3c-5, 3c- 6

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American Bar Association

Section of Business Law

File No. 132-3

Your letter of December 3, 1997 requests our views regarding a number of issues under Sections 3(c)(1), 3(c)(7) and 2(a)(51)(A) of the Investment Company Act of 1940 ("Investment Company Act"), and Rules 2a51-1, 2a51-3, 3c-5 and 3c-6 under that Act. Specifically, you ask that we respond to the questions set forth below. [FN1]

FN1. You have not asked, and this letter does not address, issues that your questions may raise under the other federal securities laws.

Background

The National Securities Markets Improvement Act of 1996 (the "1996 Act")

Your questions are prompted by the passage of the 1996 Act, which, among other things, contained a number of provisions that relate to the treatment of certain privately offered investment pools that are excluded from the definition of investment company under the Investment Company Act ("private investment companies"). First, the 1996 Act added Section 3(c)(7) to the Investment Company Act to exclude from the definition of investment company any issuer whose outstanding securities are owned by persons who, at the time of acquisition of the securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of its securities ("Section 3(c)(7) Fund"). The exclusion provided by Section 3(c)(7) reflects Congress's recognition that financially sophisticated investors are in a position to appreciate the risks associated with certain investment pools and do not need the protections of the Investment Company Act. [FN2]

FN2. S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) ("Senate Report") ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption rights").

The 1996 Act added Section 2(a)(51) to the Investment Company Act to define the term "qualified purchaser" for purposes of Section 3(c)(7). That section generally defines a qualified purchaser to be: (i)

any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in a Section 3(c)(7) Fund with that person's qualified purchaser spouse) who owns not less than $5 million in investments; (ii) any family-owned company [FN3] that owns not less than $5 million in investments; (iii) any trust that is not covered by clause (ii) and was not formed for the specific purpose of acquiring the securities, the trustee and settlor of which are qualified purchasers; and (iv) any person, acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than $25 million in investments.

FN3. A family-owned company for purposes of this section is a company "that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons."

The 1996 Act also amended Section 3(c)(1) of the Investment Company Act, which excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are owned by not more than 100 beneficial owners and which is not making and does not propose to make a public offering of its securities ("Section 3(c)(1) Fund"). The 1996 Act simplified the way in which the number of beneficial owners in a Section 3(c)(1) Fund is calculated for purposes of the 100-owner limit by no longer requiring the Fund to "look-through" certain companies (e.g., corporations, partnerships and other investors that are not natural persons) that hold its voting securities and count that company's security holders as beneficial owners of the Fund's securities. As amended, Section 3(c)(1) treats beneficial ownership by a company for purposes of the 100-owner limit as beneficial ownership by one person unless the company (i) owns 10 percent or more of the Section 3(c)(1) Fund's voting securities and (ii) is or, but for the exclusion provided by Section 3(c)(1) or Section 3(c)(7), would be an investment company (the "Look-Through Provision").

Finally, Section 3(c)(7) includes a provision that permits an existing Section 3(c)(1) Fund to convert into a Section 3(c)(7) Fund ("Grandfathered Fund"). Under this provision ("Grandfather Provision"), the outstanding securities of a Grandfathered Fund may be beneficially owned by as many as 100 persons that are not qualified purchasers ("grandfathered investors"), provided that these persons acquired the securities of the Grandfathered Fund on or before September 1, 1996, and certain other requirements, designed to protect the Section 3(c)(1) Fund's existing beneficial owners, are satisfied. [FN4]

FN4. Specifically, the Grandfather Provision requires the Grandfathered Fund, prior to conversion, to provide each beneficial owner of its securities with notice of the Fund's intention to become a Section 3(c)(7) Fund and a reasonable opportunity to redeem the owner's interest in the Fund.

With respect to the treatment of private investment companies, the 1996 Act also contained provisions (i) requiring an existing Section 3(c)(1) Fund that wishes to become a qualified purchaser to obtain the consent of certain beneficial owners of its securities and certain other persons; (ii) imposing the investment restrictions of Sections 12(d)(1)(A)(i) and (B)(i) of the Investment Company Act on all Section 3(c)(1) Funds and Section 3(c)(7) Funds, but only in connection with transactions involving securities issued by registered investment companies; and (iii) prohibiting a Section 3(c)(1) Fund from being integrated with a Section 3(c)(7) Fund for purposes of determining whether either Fund meets its exemption. Your letter does not request our views with respect to these provisions.

Commission Rulemaking

In April 1997, the Commission adopted several rules under the Investment Company Act to implement the provisions of the 1996 Act that relate to private investment companies. [FN5] Rule 2a51-1 defines the term "investments" for purposes of Section 2(a)(51) and clarifies how the value of a qualified purchaser's investments should be calculated. Rule 2a51-2 defines the term "beneficial owner" for purposes of the Grandfather Provision. [FN6] Rule 2a51-3 provides that (i) a company may not be deemed to be a qualified purchaser under Sections 2(a)(51)(A)(ii) and (iv) if it was formed for the specific purpose of acquiring the securities issued by a Section 3(c)(7) Fund unless each beneficial owner of the company's securities is a qualified purchaser, and (ii) a company may be deemed to be a qualified purchaser if each beneficial owner of the company's securities is a qualified purchaser.

FN5. Privately Offered Investment Companies, Investment Company Act Release No. 22597 (Apr. 3, 1997), 62 FR 17512 (Apr. 9, 1997) ("Adopting Release").

FN6. Similarly, the Commission adopted Rule 3c-1 to define the term "beneficial ownership" with respect to certain Section 3(c)(1) Funds, effectively permitting such Funds to rely on the pre-1996 provisions of Section 3(c)(1) rather than restructure their existing relationships with investors. None of your questions, however, relates to either Rule 3c-1 or Rule 2a51-2.

As directed by the 1996 Act, the Commission adopted two other rules that relate to private investment companies. Rule 3c-5 generally permits knowledgeable employees of a Section 3(c)(1) Fund, and a company owned exclusively by such knowledgeable employees, to acquire securities issued by the Fund without being counted as beneficial owners of the Fund for purposes of the Section 3(c)(1) 100-owner limit. The rule also permits knowledgeable employees of a Section 3(c)(7) Fund, and a company owned exclusively by such knowledgeable employees, to acquire securities issued by that Fund without being qualified purchasers. Rule 3c-5 was promulgated pursuant to Congress's directive that the Commission prescribe rules permitting knowledgeable employees of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund to own securities issued by the Fund without the Fund losing its exclusion under Sections 3(c)(1) or 3(c)(7). [FN7]

FN7. Section 209(d)(3) of the 1996 Act.

Rule 3c-6 generally addresses transfers of securities issued by private investment companies for estate planning purposes and in certain other circumstances. The rule provides that beneficial ownership by a person who acquired securities ("Transferee") issued by a Section 3(c)(1) Fund from a person other than the Section 3(c)(1) Fund will be deemed to be beneficial ownership by the person from whom the transfer was made ("Transferor"), provided that the Transferee is the estate of the Transferor, a Donee (as that term is defined in the rule), [FN8] or a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. The rule also provides that the securities issued by a Section 3(c)(7) Fund that are owned by a Transferee who received them from a qualified purchaser other than the Section 3(c)(7) Fund, or a person deemed to be a qualified purchaser under this rule (also "Transferor"), will be deemed to be acquired by a qualified purchaser, regardless of whether the Transferee is a qualified purchaser, provided that the Transferee is the estate of the Transferor, a Donee, or a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. Rule 3c-6 was issued under Sections 3(c)(1)(B) and 3(c)(7)(A), both of which provide the Commission with rulemaking authority with respect to the transfer of securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund when the transfer is the result of a "legal separation, divorce, death or other involuntary event." [FN9]

FN8. See infra note 48.

FN9. Section 209(d)(1) of the 1996 Act directed the Commission to prescribe rules to implement the requirements of Section 3(c)(1)(B) no later than 1 year after the date of enactment of the 1996 Act. Although Section 3(c)(1)(B) was enacted in 1980, the Commission had not promulgated any rules implementing this section until it adopted Rule 3c-6. See also infra, text accompanying notes 56-58.

Questions and Answers [FN10]

FN10. The following questions are answered in the order in which they are asked.

A. Rule 3c-5: Knowledgeable Employees

Question 1: May certain marketing and investor relations professionals, research analysts, brokers and traders, attorneys, financial, compliance, operational and accounting officers of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund or an Affiliated Management Person, who are non-executive employees of the Section 3(c)(1) Fund, the Section 3(c)(7) Fund, or Affiliated Management Person, qualify as knowledgeable employees?

Answer: Rule 3c-5 generally defines a "knowledgeable employee" of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund to include certain executives of the Fund or an Affiliated Management Person of the Fund, [FN11] and non-executive employees of the Fund or an Affiliated Management Person of the Fund (other than clerical, secretarial or administrative employees) who, in connection with their regular functions or duties, participate in the investment activities of the Fund, any other Section 3(c)(1) Fund or Section 3(c)(7) Fund, or investment company the investment activities of which are managed by the Affiliated Management Person, [FN12] provided that the employees have been performing these functions and duties for, or on behalf of, the Fund or the Affiliated

Management Person, or substantially similar functions or duties for, or on behalf of, another company for at least 12 months.

FN11. These persons include any executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the Section 3(c)(1), the Section 3(c)(7) Fund or an Affiliated Management Person of the Fund. See Rule 3c-5(a)(4)(i).

FN12. Rule 3c-5(a)(1) defines "Affiliated Management Person" as an affiliated person of the Fund, as defined in Section 2(a)(3) of the Investment Company Act, that manages the investment activities of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund. Section 2(a)(3) defines the term "affiliated person" to include "any person directly or indirectly controlling, controlled by, or under common control with" another person, and any investment adviser to an investment company. For purposes of determining whether a person is an Affiliated Management Person, Rule 3c-5(a)(1) provides that the term "investment company" in Section 2(a)(3) includes a Section 3(c)(1) Fund or a Section 3(c)(7) Fund. Thus, an investment adviser to a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be considered to be an affiliated person of the Fund for purposes of determining whether the adviser was an Affiliated Management Person of the Fund. See PPM America Special Investments CBO II, L.P. (pub. avail. Apr. 16, 1998) ("PPM Letter"). See also Adopting Release, supra note 5, at n.122 and accompanying text (Commission refers to the Affiliated Management Person as "an affiliated person of the fund that oversees the fund's investments.").

You argue that certain other non-executive employees may be close enough to the investment decision-making function to be viewed as participants in that process as a result of their evaluative abilities, the nature of their responsibilities, and the information that these employees may receive in the course of their regular functions or duties. You describe these employees as follows:

(i) marketing and investor relations professionals who must explain potential and actual portfolio investments of a fund and the investment decision-making process and strategy being followed to clients and prospective investors and who, from time to time, interface among the fund, the portfolio managers and the fund's clients; (ii) research analysts who investigate the potential investments for the fund; (iii) attorneys who, as part of their duties, provide advice with respect to, or who participate in, the preparation of offering documents, and the negotiation of related agreements and who also are familiar with investment company management issues and respond to questions or give advice concerning ongoing fund investments, operations and compliance matters; (iv) brokers and traders of a broker-dealer related to the [Section 3(c)(1) Fund/Section 3(c)(7) Fund] or the Affiliated Management Person who are Series 7 registered; and (v) financial, compliance, operational and accounting officers of a fund who have management responsibilities for compliance, accounting and auditing functions of funds or their Management Affiliates.

Rule 3c-5 is intended to cover non-executive employees only if they actively participate in the investment activities of the Fund, any other Section 3(c)(1) Fund or Section 3(c)(7) Fund, or any investment company the investment activities of which are managed by the Fund's Affiliated Management Person. The rule thus is clearly intended to encompass persons who actively participate in the management of a Fund's investments. [FN13] The rule is not intended to include employees who merely obtain information regarding the investment activities of these Funds. The Commission initially proposed that the definition of knowledgeable employee include persons who, in connection with their regular functions or duties, obtain information regarding the investment activities of the Fund or investment companies managed by the Affiliated Management Person, but did not include such persons in the final rule because of a concern that these persons may not have any investment experience. [FN14]

FN13. Adopting Release, supra note 5, at text following n.127.

FN14. Id., at text following n.123 ("One commenter suggested that including employees who 'obtain information' regarding the investment activities could include employees, such as compliance personnel, who may not have any investment experience. The Commission agrees, and the rule as adopted includes only employees who 'participate in' the investment activities of the fund or other investment companies managed by the fund's Management Affiliate.").

Whether an employee actively participates in the investment activities of a Fund is a factual determination that must be made on a case-by-case basis by the Fund. [FN15] Nevertheless, as a general matter, with the possible exception of some research analysts (e.g., a research analyst who researches all potential portfolio investments and provides recommendations to the portfolio manager), we believe that the types of employees described in your letter would not qualify as knowledgeable employees under Rule 3c-5.

FN15. Consequently, the staff generally will not entertain any requests as to our views with respect to whether a particular employee or type of employee meets this aspect of the knowledgeable employee definition.

Question 2: May an employee who manages a fund that is not defined as an investment company under the Investment Company Act pursuant to an exclusion other than Section 3(c)(1) or Section 3(c)(7) be eligible for knowledgeable employee status?

Answer: Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with the Section 3(c)(1) Fund or the Section 3(c)(7) Fund, do not need the protection of the Investment Company Act. To ensure that a knowledgeable employee has the appropriate level of financial knowledge and sophistication, Rule 3c-5 generally requires that knowledgeable employees participate in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or any investment company the investment activities of which are managed by the Fund's Affiliated Management Person. [FN16]

FN16. As noted above, this requirement does not apply to certain executives of the Fund or the Affiliated Management Person of the Fund. See supra note 11.

The staff recently took the position that a person who participates in the investment activities of a company that would be regulated under the Investment Company Act but for the exclusion provided by Section 3(c)(3) of the Investment Company Act or the exemption provided by Rule 3a-6 under that Act [FN17] is as likely to be financially knowledgeable and sophisticated as a person who participates in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company. [FN18] Therefore, the staff stated that it would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act [FN19] if such a person is considered to be a knowledgeable employee under Rule 3c-5, notwithstanding the fact that the employee does not participate in the investment activities of a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company.

FN17. Section 3(c)(3) excludes banks, insurance companies, and certain other financial institutions from the definition of investment company. Rule 3a-6 exempts foreign banks and insurance companies.

FN18. PPM Letter, supra note 12.

FN19. Section 7 generally prohibits a domestic investment company from using U.S. jurisdictional means to offer or sell its securities unless the company is registered under Section 8 of the Investment Company Act.

In addition, the staff takes the position that it is likely that a person who participates in the investment activities of a company that would be regulated under the Investment Company Act but for the exclusion provided by Section 3(c)(11) of the Act or Section 3(c)(2) of the Act is just as financially sophisticated and knowledgeable as a person who manages a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company. Therefore, the staff would not recommend enforcement action under Section 7 if that person were considered to participate in the investment activities of an eligible entity under Rule 3c-5. [FN20]

FN20. Section 3(c)(11) generally excludes from the definition of investment company certain tax-qualified pension or profit-sharing plans, any collective trust fund maintained by a bank that consists solely of assets of these plans, or any insurance company separate account the assets of which are derived from contributions under certain tax-qualified plans. Section 3(c)(2) generally excludes certain underwriters, brokers and market intermediaries from the definition of investment company. Because Rule 3c-5 refers to persons who participate in the "investment activities of a ... company," our position with respect to Section 3(c)(2) companies is limited to

those persons who participate in the investment activities of the companies' proprietary accounts.

Finally, you suggest that persons who participate in the investment activities of "foreign or offshore investment companies" also should be eligible for knowledgeable employee status. We agree. An investment company formed under the laws of a jurisdiction other than the United States and not registered under the Investment Company Act would nevertheless still be considered to be an "investment company" under the Investment Company Act. Thus, any person who participates in the investment activities of such a company may be considered to be a knowledgeable employee under Rule 3c-5. [FN21]

FN21. You also suggest that any "manager who manages only separately managed accounts (e.g., not a fund)" should also be eligible for knowledgeable employee status. Whether such a person can be considered to be as financially sophisticated and knowledgeable as a person who manages a Section 3(c)(1) Fund, a Section 3(c)(7) Fund, or an investment company, would depend on the particular facts and circumstances. The staff generally will entertain requests as to whether a manager who manages only separately managed accounts could qualify, under a particular set of facts and circumstances, as a knowledgeable employee.

Question 3: May the definition of "Affiliated Management Person" of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund include each affiliated entity of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (regardless of corporate structure) that participates in investment activities of the investment management company?

Answer: In promulgating Rule 3c-5, the Commission intended that knowledgeable employees be limited to persons whose employer managed the Section 3(c)(1) Fund or the Section 3(c)(7) Fund in which the persons wished to invest. This requirement was intended, in part, to ensure that knowledgeable employees have access to information about the management of the Section 3(c)(1) Fund or the Section 3(c)(7) Fund in which they wish to invest. [FN22] Rule 3c-5 therefore provides that an investment adviser to a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be considered to be an affiliated person of the Fund for purposes of determining whether the adviser was an Affiliated Management Person of the Fund.

FN22. See Adopting Release, supra note 5, at n.122 and accompanying text; PPM Letter, supra note 12.

The staff recently took the position that, in certain circumstances, a company that is under common control with the investment adviser to a Section 3(c)(7) Fund may be considered to be an Affiliated Management Person of the Fund because an employee of such an entity generally will have significant access to information about the Fund. [FN23] The staff's position was based particularly on the facts that the company and the Fund's investment adviser were indirect, wholly owned subsidiaries of the same ultimate parent and that the company managed the investment activities of a company that would be an investment company but for the exclusion under Section 3(c)(3). [FN24] Whether an affiliate of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund would be an Affiliated Management Person for purposes of determining whether its employees are knowledgeable employees generally would depend on the particular facts and circumstances.

FN23. See PPM Letter, supra note 12.

FN24. Id.

Question 4: If a knowledgeable employee invests in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (i) jointly with a spouse and/or other dependents or (ii) through a family company trust or similar estate planning vehicle for which the knowledgeable employee is responsible for investment decisions and the source of the funds invested is individual property or property held jointly with the spouse, will such investment be deemed to have been made by the knowledgeable employee?

Answer: (i) In the Adopting Release, the Commission stated that, for purposes of determining the number of beneficial owners of the voting securities of a Section 3(c)(1) Fund, securities issued by the Section 3(c)(1) Fund that are jointly owned by an investor and his or her spouse would be considered to be owned by one beneficial owner. [FN25] Thus, securities issued by a Section 3(c)(1) Fund that are jointly owned by a knowledgeable employee and his or her spouse would be

considered to be owned by one beneficial owner. On this basis, we would not count an investment that is jointly owned by a knowledgeable employee and his or her spouse towards the Fund's 100-owner limit because Rule 3c-5 permits a knowledgeable employee of a Section 3(c)(1) Fund to acquire securities of that Fund without being counted as a beneficial owner.

FN25. Adopting Release, supra note 5, at n.69.

Furthermore, we take the position that a knowledgeable employee and his or her spouse who is not a knowledgeable employee (or a qualified purchaser) may invest jointly in a Section 3(c)(7) Fund. Section 2(a)(51)(A)(i) includes as a qualified purchaser any natural person who owns $5 million in investments and that person's spouse if they invest jointly. Therefore, a spouse who is not a qualified purchaser can hold a joint interest in a Section 3(c)(7) Fund with his or her qualified purchaser spouse. [FN26] Although Section 2(a)(51)(A)(i) and Rule 3c-5 both pertain to persons who have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act, Rule 3c-5, unlike Section 2(a)(51)(A)(i), does not expressly permit a knowledgeable employee to invest in a Section 3(c)(7) Fund with his or her spouse who is not a knowledgeable employee (or qualified purchaser).

FN26. Id., at nn.67-68 and accompanying text.

We believe that it would be consistent with Congress's intent to apply the spousal joint interest position in Section 2(a)(51)(A)(i) to Rule 3c-5. Thus, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a knowledgeable employee and his or her spouse who is not a knowledgeable employee (or a qualified purchaser) invest jointly in a Section 3(c)(7) Fund.

Our positions, however, do not extend to joint interests held by knowledgeable employees and their dependents. The Commission's position with respect to determining the number of beneficial owners of securities issued by a Section 3(c)(1) Fund only pertains to securities jointly owned by both spouses. In addition, under Section 2(a)(51)(A)(i), dependents of a qualified purchaser who are not themselves qualified purchasers may not hold a joint interest in a Section 3(c)(7) Fund with the qualified purchaser.

(ii) We also believe that, consistent with the intent of Section 2(a)(51)(A)(iii) and Rule 3c-5, a family company trust or a similar estate planning vehicle, for which the knowledgeable employee is both responsible for investment decisions and the source of the funds invested, may be able to invest in securities issued by any Section 3(c)(1) Fund or any Section 3(c)(7) Fund in which the knowledgeable employee is eligible to invest individually. Furthermore, we believe that such an investment would be deemed to have been made by the knowledgeable employee.

Section 2(a)(51)(A)(iii) generally defines as a qualified purchaser any trust that is not covered by clause (ii), [FN27] was not formed for the specific purpose of acquiring the securities offered and whose the trustee and settlor are qualified purchasers. We believe that Congress required that both the trustee and the settlor of the trust be qualified purchasers because of its belief that both the person contributing assets to the trust, and the person authorized to make investment decisions with respect to those assets, should have the requisite financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act. [FN28] Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and their relationship with a Section 3(c)(1) Fund or a Section 3(c)(7) Fund, have the financial sophistication to understand the risks associated with purchasing securities of that Fund.

FN27. We assume that the entity that you describe would not be a qualified purchaser under Section 2(a)(51)(A)(ii). Any family company that meets the definition of qualified purchaser in Section 2(a)(51)(A)(ii) also may purchase securities issued by a Section 3(c)(7) Fund, regardless of whether the person who manages the trust's investments or is the source of the trust's assets is a knowledgeable employee of the Fund or a qualified purchaser, provided that the requirements of that section are met.

FN28. See Meadowbrook Real Estate Fund (pub. avail. Aug. 26, 1998) ("Meadowbrook Letter").

We believe that it would be consistent with Congress's intent to permit a family company trust or

similar estate planning entity to invest in securities issued by a Section 3(c)(7) Fund if a knowledgeable employee of that Fund is responsible for the investment decisions and is the source of the funds invested. Therefore, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a family company trust or similar estate planning entity is treated as a knowledgeable employee of a Section 3(c)(7) Fund for purposes of investing in securities issued by that Fund, provided that a knowledgeable employee of the Fund is responsible for investment decisions and is the source of the funds invested. Similarly, given the intent of Rule 3c-5, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if a family company trust or similar estate planning entity is treated as a knowledgeable employee of a Section 3(c)(1) Fund for purposes of investing in securities issued by that Fund, provided that a knowledgeable employee of the Fund is responsible for investment decisions and is the source of the funds invested.

As we discussed in our Answer to Question A.4.(i), we take the position that a knowledgeable employee of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund may invest jointly in that Fund with his or her spouse, and that such an investment would be deemed to have been made by the knowledgeable employee. Accordingly, our positions, discussed immediately above, with respect to a family company trust or similar estate planning entity being treated as a knowledgeable employee, would not be affected if the source of the funds invested is property that was jointly owned by the knowledgeable employee and his or her spouse.

Question 5: Does an investor who acquired securities issued by a Section 3(c)(1) Fund before the effective date of the 1996 Act count toward the 100- owner limit if he or she would have been considered a knowledgeable employee at the time of acquisition, but is not one on the effective date of the 1996 Act (due, for example, to termination of employment)?

Answer: No. Rule 3c-5(b)(1) states, in part, that for purposes of determining the number of beneficial owners of a Section 3(c)(1) Fund, there shall be excluded securities beneficially owned by a person who at the time that the securities were acquired was a knowledgeable employee of the Fund. This provision is based on the belief that persons who are financially knowledgeable and sophisticated with respect to a Section 3(c)(1) Fund at the time that they make decisions to purchase securities issued by that Fund should not be counted toward that section's 100-owner limit. We therefore believe that, if a person was a knowledgeable employee at the time that the securities were purchased, the person is not counted toward the 100-owner limit, regardless of whether the purchase occurred prior to the adoption of the rule or the person ceased to be a knowledgeable employee subsequent to the purchase.

Questions 6 and 7: Does an investor who acquired securities issued by a Section 3(c)(1) Fund before the effective date of the 1996 Act count toward the 100-owner limit if he or she would not have been deemed a knowledgeable employee at the time of acquisition but was a knowledgeable employee on the effective date? If an investor who does not qualify as a knowledgeable employee invests in a Section 3(c)(1) Fund, may the Fund cease to count such a person as a beneficial owner once he or she satisfies the knowledgeable employee test?

Answer: The staff has stated that Rule 3c-5 is premised on the requirements that a knowledgeable employee of a Section 3(c)(1) Fund be financially sophisticated and knowledgeable and have a business relationship with the Fund such that the employee would have access to information about the Fund. [FN29] We believe that it would be consistent with the rule to treat a person as having been a knowledgeable employee at the time of any investments in a Section 3(c)(1) Fund if that person subsequently became a knowledgeable employee of the Fund. We therefore would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act if a person who became a knowledgeable employee of a Section 3(c)(1) Fund after purchasing securities issued by that Fund were treated as having been a knowledgeable employee of the Fund at the time of the prior purchases. [FN30]

FN29. See supra Answers to Questions A.1., A.2., and A.3.

FN30. Such a person would not be required to dispose of these securities (or be counted as beneficial owners for purposes of Section 3(c)(1)'s 100-owner limit) upon termination of employment. Adopting Release, supra note 5, at n.120.

Question 8: May a knowledgeable employee invest in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund through an IRA, trust or other entity for which he or she is responsible for investment

decisions and where the source of funds invested in the securities issued by the Fund was individual property or property held jointly with the knowledgeable employee's spouse (without being counted toward the Fund's 100-owner limit or without being a qualified purchaser)?

Answer: When an entity that invests in securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund is the "alter ego" of a knowledgeable employee (i.e., the entity is wholly owned by the employee, the employee makes all of the decisions with respect to the entity's investments, and the investments are for the benefit of the employee), we would consider the investment to have been made by the employee for purposes of Rule 3c-5. In accordance with our spousal joint interest position discussed in our Answer to Question A.4.(i)., we also would consider such an entity to be an alter ego of the knowledgeable employee notwithstanding the fact that the entity was jointly owned with the employee's spouse and the employee and his or her spouse were joint beneficiaries of the investments. Thus, a knowledgeable employee may invest in a Section 3(c)(1) Fund or a Section 3(c)(7) Fund through an IRA or any other entity which may be considered to be the alter ego of the employee. [FN31]

FN31. Cf. Adopting Release, supra note 5, at text following n.78 ("when an entity that holds investments is the 'alter ego' of a Prospective Qualified Purchaser (as in the case of an entity that is wholly-owned by a Prospective Qualified Purchaser who makes all the decisions with respect to such investments), it would be appropriate to attribute the investments held by such entity to the Prospective Qualified Purchaser.").

As we discussed in our Answer to Question A.4.(ii)., under some circumstances we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if an entity such as the one that you described in your question invested in securities issued by a Section 3(c)(1) Fund without the entity being counted toward the Fund's 100-owner limit. Similarly, we would not recommend that the Commission take any enforcement action under Section 7 of the Investment Company Act if such an entity invested in securities issued by a Section 3(c)(7) Fund even though the entity is not a qualified purchaser.

B. Individual Retirement Accounts

Question 1: If an existing Section 3(c)(1) Fund elects to convert to a Section 3(c)(7) Fund pursuant to the Grandfather Provision, may a grandfathered investor, who is not otherwise a qualified purchaser, and whose interest in a Section 3(c)(7) Fund is, and was, prior to conversion, held in such investor's individual name, make additional investments in the Fund (following its conversion to a Section 3(c)(7) Fund) through his or her IRA or the self- directed account of a retirement plan?

Answer: Yes. The Grandfather Provision was designed to enable a Section 3(c)(1) Fund that converts to a Section 3(c)(7) Fund to preserve its arrangements with its grandfathered investors. Furthermore, the Grandfather Provision does not prevent grandfathered investors from making additional investments in the Grandfathered Fund. [FN32] We take the position that, when an entity that invests in securities issued by a Grandfathered Fund is the alter ego of a grandfathered investor (i.e., the entity is wholly owned by the grandfathered investor, the grandfathered investor makes all the decisions with respect to such investments, and the investments are for the benefit of the grandfathered investor), we would consider the acquisition to have been made by the grandfathered investor. [FN33] Thus, a grandfathered investor may continue to purchase securities in the Grandfathered Fund through an entity, such as an IRA or a self-directed account of a retirement plan, that is the alter ego of the investor.

FN32. See id., at n.82.

FN33. See supra note 31.

Question 2: For purposes of determining whether or not an IRA or the self- directed account of a retirement plan is a qualified purchaser, may one look through the IRA or account to its creator?

Answer: When an entity, such as an IRA or self-directed account of a retirement plan, that acquires securities issued by a Section 3(c)(7) Fund is the alter ego of the investor, we would consider the acquisition to have been made by the investor. Thus, a qualified purchaser may invest in securities issued by a Section 3(c)(7) Fund through any IRA, self-directed account of a retirement plan, or other entity that is the investor's alter ego. [FN34]

FN34. See id.

C. Trusts

Question 1: Under Section 2(a)(51)(A)(iii), at what time is the status of each trustee and settlor determined -- at the time of a particular investment or at the formation of the trust? What is the effect on qualification if the settlor is dead?

Answer: Section 3(c)(7) is premised on Congress's belief that certain persons, at the time of making the investment decision, have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Act. [FN35] Accordingly, under Section 2(a)(51)(A)(iii), a trust is a qualified purchaser if, among other things, its trustee (or other person authorized to make decisions with respect to the trust) is a qualified purchaser under clauses (i), (ii), or (iv) of Section 2(a)(51)(A). Congress intended that the trustee (or other person authorized to make decisions with respect to the trust) have the requisite financial sophistication at the time that the decision to invest is made. The staff therefore has taken the position that the time to determine the qualified purchaser status of the trustee who is responsible for investing the assets of the trust, and thus is the person responsible for understanding and evaluating the risks associated with each investment decision, is when the trustee makes the decision to acquire securities issued by a Section 3(c)(7) Fund. [FN36]

FN35. See supra note 2 and accompanying text.

FN36. Meadowbrook Letter, supra note 28.

The staff also has taken the position that a settlor of a Section 2(a)(51)(A)(iii) trust must be a qualified purchaser at the time that the settlor contributed assets to the trust. [FN37] This position reflects Congress's intent that the person whose assets are at risk -- and not only the person making the investment decision -- should be able to appreciate the risks presented by an investment pool that is not subject to regulation under the Investment Company Act. It would be consistent with this intent to require that the settlor be a qualified purchaser (i.e., financially sophisticated) at the time that the settlor makes the decision to contribute assets [FN38] to the trust. [FN39]

FN37. To meet this requirement, the settlor would have to have been a qualified purchaser at least once when he or she contributed assets to the trust. Thus, a settlor who was a qualified purchaser at the time that he or she initially funded the trust, but was not a qualified purchaser when he or she made subsequent contributions, would still be considered a qualified purchaser for purposes of the settlor requirement. Similarly, a settlor who was not a qualified purchaser at the time that he or she initially funded the trust, but was a qualified purchaser when the settlor made other contributions, would meet the requirement. Id., at n.18 and accompanying text.

FN38. As we stated in the Meadowbrook Letter, however, we believe that there may be other situations in which a settlor would have, at the appropriate time, the requisite financial sophistication to appreciate the risks presented by a Section 3(c)(7) Fund, thereby satisfying the purpose of the settlor requirement. Id., at n.21. The staff, however, has not yet been presented with any of these situations.

FN39. We disagree with your analysis that a trust should be treated as a qualified purchaser under Section 2(a)(51)(A)(iii) solely because the settlor is deceased and the trustee is a qualified purchaser. By analogy, under Section 2(a)(51)(A)(iv), an investment manager who is a qualified purchaser -- even one who invests $25 million on a discretionary basis -- cannot invest a client's assets in a Section 3(c)(7) Fund unless the client also is a qualified purchaser. See Senate Report, supra note 2, at 10 ("An investment adviser managing private accounts would not be permitted to purchase interests in a qualified purchaser pool on behalf of a client unless that client is also a qualified purchaser.").

Question 2: Section 2(a)(51)(A)(iii) of the Investment Company Act provides that a qualified purchaser includes any trust not covered by Section 2(a)(51)(A)(ii) of that Act and that was not formed for the specific purpose of acquiring the securities offered as to which "the trustee or other person authorized to make decisions with respect to the trust" is a qualified purchaser. Is it sufficient if only the trustee actually making the investment decision to acquire the securities at issue is a qualified purchaser?

Answer: As discussed previously, Section 3(c)(7) is premised on Congress's belief that financially sophisticated persons are able to assess the risks of investing in Section 3(c)(7) Funds, and therefore these persons do not need the protections of the Act. [FN40] We believe that if the trust has more than one trustee, only the trustee who is responsible for making investment decisions with respect to the trust, and therefore will be responsible for assessing the risks associated with investing in Section 3(c)(7) Funds, must be a qualified purchaser.

FN40. See supra note 2 and accompanying text; see also supra Answer to Question C.1.

Question 3: If a trust that is not covered by Section 2(a)(51)(A)(ii) has less than $5 million in investments and not all of the trustees authorized to make investment decisions or settlors of the trust are qualified purchasers, may the trust still be deemed a qualified purchaser if all of the trust's beneficiaries are qualified purchasers? Should the use of a trust format, as opposed to a family company format (where a look-through would clearly be permissible), dictate whether a look-through to the beneficiaries is possible?

Answer: Under Rule 2a51-3(b), a company may be deemed to be a qualified purchaser if each beneficial owner of its securities is a qualified purchaser. You argue that, because Section 2(a)(8) of the Investment Company Act defines "company" to include a trust, Rule 2a51-3(b) should be interpreted to permit a trust to be deemed to be a qualified purchaser if all of its beneficiaries are qualified purchasers, even though none of the trust's settlors or trustees is a qualified purchaser.

We disagree. Under Section 2(a)(51)(A)(iii), a trust is a qualified purchaser if, among other things, its trustee (or other person authorized to make decisions with respect to the trust), and each settlor (or other person who has contributed assets to the trust), are qualified purchasers under clauses (i), (ii), or (iv) of Section 2(a)(51)(A). We believe that Congress required that both the trustee and the settlor of the trust be qualified purchasers because of its belief that both the person contributing assets to the trust, and the person authorized to make investment decisions with respect to those assets, should have the requisite financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act. [FN41] Your interpretation would permit a trust to invest in securities issued by a Section 3(c)(7) Fund, even though neither the person contributing assets to the trust nor the persons making investment decisions with respect to the trust's assets would be a qualified purchaser. We therefore believe that interpreting Rule 2a51-3(b) in the manner that you suggest would be inconsistent with Congress's intent in enacting Section 2(a)(51)(A)(iii). [FN42]

FN41. See Meadowbrook Letter, supra note 28.

FN42. Some trusts that are not qualified purchasers, however, may nevertheless invest in securities issued by a Section 3(c)(7) Fund. See, e.g., supra Answers to Questions A.4.(ii)., A.8., and B.1. See infra Answer to Question C.5.

Question 4: Under Section 2(a)(51)(A)(ii) of the Investment Company Act, a qualified purchaser includes any company that owns not less than $5 million in investments and is owned by two or more related persons. For a trust to be a qualified purchaser under this definition, it must therefore be owned by two or more related persons. Who is considered to "own" a trust?

Answer: Section 2(a)(51)(A)(ii) is intended to permit "certain family investment vehicles -- family trusts and other types of companies --" [FN43] that are formed to facilitate estate planning [FN44] to invest in Section 3(c)(7) Funds. According to the legislative history, Congress intended that any company with $5 million in investments and "that is owned by an extended family" be treated as a qualified purchaser. [FN45] Congress did not, however, specifically address what it intended by the use of the term "owned" in the context of trusts.

FN43. Senate Report, supra note 2, at 10.

FN44. See The Securities Investment Promotion Act of 1996: Hearing on S. 1815 before the Senate Committee on Banking, Housing and Urban Affairs, 104th Cong. 2d Sess. 41 (1996) (testimony of Arthur Levitt, Chairman, SEC).

FN45. Senate Report, supra note 2, at 10.

We believe that Congress intended that all economic interests in a company that relies on Section 2(a)(51)(A)(ii) be held exclusively by persons who satisfy the family relationship requirements of that section. [FN46] The staff recently took the position that beneficiaries of certain trusts may be considered to be the "owners" of those trusts for purposes of Section 2(a)(51)(A)(ii). This position was based on the representation that the beneficiaries are the only persons who hold economic interests in the trusts. [FN47]

FN46. In this regard, we believe that a trust generally would be able to rely on that section only if all present or future, vested or contingent, economic interest in its assets are held exclusively by eligible family members. Meadowbrook Letter, supra note 28.

FN47. Id. In this letter, counsel represented that, while the trustee receives fees for services rendered, such fees do not represent an economic interest comparable to an ownership interest in the company.

Question 5: May a grandfathered investor, who is not otherwise a qualified investor, (i) transfer his or her investment in the Grandfathered Fund to an IRA, trust, or other entity and (ii) make additional investments in the converted Section 3(c)(7) Fund through the IRA, trust or other entity?

Answer: (i) As discussed in our Answer to Question B.1., we take the position that when an entity that invests in securities issued by a Grandfathered Fund is the alter ego of a grandfathered investor, we would consider the investment to have been made by the grandfathered investor. Therefore, a grandfathered investor may transfer his or her investment in the Grandfathered Fund to any entity that is an alter ego of that investor, because the grandfathered investor effectively would be transferring the securities to himself or herself.

We also believe that it would be consistent with the intent of Rule 3c- 6 if, when persons who acquire securities issued by a Grandfathered Fund from a grandfathered investor, the securities are treated as being owned by the grandfathered investor, provided that the other requirements of Rule 3c-6 are met. [FN48] Rule 3c-6 provides that beneficial ownership of securities issued by a Section 3(c)(7) Fund that are acquired from a qualified purchaser are treated under certain circumstances as being owned by the qualified purchaser. Rule 3c-6 does not, however, address the transfer by a grandfathered investor of securities issued by a Grandfathered Fund. Therefore, we would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act if a grandfathered investor transfers his or her investments in the Grandfathered Fund to any person or entity and the Transferee were not counted toward the 100-owner limit in the Grandfather Provision, [FN49] provided that the other requirements of Rule 3c-6 are satisfied.

FN48. Rule 3c-6 applies when a Transferor transfers securities to (i) the estate of the Transferor; (ii) a Donee; or (iii) a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor. The rule defines the term "Donee" as a person who acquires a security of a Section 3(c)(1) Fund or a Section 3(c)(7) Fund (or a security or other interest in a company established by the Transferor exclusively for the benefit of (or owned exclusively by) the Transferor and/or a Donee or the estate of the Transferor) as a gift or bequest or pursuant to an agreement relating to a legal separation or divorce.

FN49. As discussed in the Background section, the Grandfather Provision states that the outstanding securities of a Grandfathered Fund may be beneficially owned by as many as 100 persons that are not qualified purchasers, provided that these persons acquired the securities of the Grandfathered Fund on or before September 1, 1996. The requirement that persons who are not qualified purchasers must have acquired the securities on or before September 1, 1996 is intended to define the persons who may be grandfathered investors (i.e., those persons who held securities of the Section 3(c)(1) Fund prior to the enactment of the 1996 Act and who do not meet the definition of qualified purchaser). We interpret this requirement as not prohibiting a grandfathered investor from transferring his or her securities under certain conditions after the Section 3(c)(1) Fund has converted to a Section 3(c)(7) Fund.

(ii) As discussed in our Answer to Question B.1., a grandfathered investor may continue to

purchase securities in the Grandfathered Fund through an entity, such as an IRA, that is the alter ego of the investor. As a general matter, however, we believe that a grandfathered investor, who is making the investment decisions with respect to the assets of a trust or other entity that is not the alter ego of the investor, may not invest that entity's assets in the Grandfathered Fund unless the entity itself is a qualified purchaser. We believe that this type of transaction may be considered to be a new arrangement between the grandfathered investor and the Fund, which would be inconsistent with the intent of the Grandfather Provision. [FN50]

FN50. See supra Answer to Question B.1.

D. Section 2(a)(51)(A)(iii) and Rule 2a51-3: "Formed for the Specific Purpose"

Question: When is an entity deemed to be formed for the specific purpose of acquiring securities in a Section 3(c)(7) Fund?

Answer: Section 2(a)(51)(A)(iii) specifies that a trust that is a qualified purchaser under that section must not have been formed "for the specific purpose of acquiring the securities offered." Rule 2a51-3(a) makes that condition applicable to any prospective qualified purchaser seeking to rely on Section 2(a)(51)(A)(ii) or (iv) unless each beneficial owner of the prospective qualified purchaser's securities is a qualified purchaser. The rule limits the possibility that a company will form an entity for the specific purpose of making an investment in a Section 3(c)(7) Fund available to investors that themselves are not qualified purchasers. [FN51] This conduct also may raise issues under Section 48(a) of the Investment Company Act, which prohibits an entity from doing indirectly what it is prohibited from doing directly, and gives the Commission the authority to "look-through" a transaction if it is a sham or conduit formed or operated for no purpose other than circumventing the requirements of the Act. [FN52]

FN51. Adopting Release, supra note 5, at n.112 and accompanying text.

FN52. See Cornish & Carey (pub. avail. June 21, 1996).

You note that the staff has indicated that, if an entity is formed for the specific purpose of acquiring securities in a particular Section 3(c)(1) Fund, the owners of that entity may be counted in determining the number of beneficial owners of that Fund. You further note that the staff has taken the position that, in the Section 3(c)(1) context, the determination that an entity is formed for the specific purpose of investing in a Section 3(c)(1) Fund will depend upon an analysis of all of the surrounding facts and circumstances, and while the percentage of an entity's assets invested in the Section 3(c)(1) Fund is relevant, exceeding a specified percentage level, by itself, is not determinative. [FN53] You suggest that the staff apply this analysis in the context of entities investing in Section 3(c)(7) Funds.

FN53. Id.

We agree. The staff takes the position that any entity whose investors consist of non-qualified purchasers, that was formed or operated for the purpose of investing in a Section 3(c)(7) Fund, and that subsequently invests in such a Fund, may result in a violation of Section 48(a) and/or Section 7 of the Investment Company Act (because the entity would not be considered a qualified purchaser under Section 2(a)(51)(A) and thus the Fund could not rely on Section 3(c)(7)). [FN54] We agree that our analysis with respect to entities investing in a Section 3(c)(1) Fund also applies with respect to entities investing in a Section 3(c)(7) Fund. Thus, we believe that the determination that an entity is formed for the specific purpose of investing in a Section 3(c)(7) Fund will depend upon an analysis of all of the surrounding facts and circumstances, and while the percentage of an entity's assets invested in the Section 3(c)(7) Fund is relevant, exceeding a specified percentage level, by itself, is not determinative. Of course, any entity that is not formed for the purpose of investing in a Section 3(c)(7) Fund can invest in such a Fund only if the entity itself meets the definition of qualified purchaser under Section 2(a)(51)(A).

FN54. While Section 2(a)(51)(A)(iii) and Rule 2a51-3 only seek to prevent entities from being "formed" for the purpose of circumventing the Investment Company Act, Section 48 applies both to entities that are formed or operated for the purpose of circumventing the Act. Thus, while an entity that is operated for the specific purpose of acquiring securities in a Section 3(c)(7) Fund may nevertheless still be considered a qualified purchaser under Section 2(a)(51)(A), that entity and the Fund may be in violation of Section 48(a).

E. Rule 3c-6: Involuntary Transfers

Question 1: Does the rule on involuntary transfers also include distributions from testamentary or inter vivos trusts or other entities?

Answer: Rule 3c-6 generally pertains to the transfer of securities issued by a Section 3(c)(1) Fund or a Section 3(c)(7) Fund that occurs pursuant to a gift, bequest, or an agreement relating to a legal separation or divorce. The issue raised by your question is whether distributions from testamentary or inter vivos trusts would be considered to be gifts or bequests for purposes of Rule 3c-6. Whether a distribution from a testamentary or inter vivos trust is governed by the rule depends on the particular facts and circumstances.

Question 2: May securities of a Section 3(c)(7) Fund be transferred to a person by gift if the Fund requires additional contributions of capital in the future and either (i) the Transferor agrees to pay the additional contributions as they become due or are called by the Fund and the Fund agrees not to enforce the obligation to pay the additional contributions against the Transferee or (ii) simultaneously with the gift, the Transferor provides sufficient assets to the Transferee to enable it to satisfy the additional contributions?

Answer: (i) In the Adopting Release, the Commission noted that Rule 3c-6 would not apply if a person acquires the securities issued by a Section 3(c)(1) Fund for consideration, and that any person that pays consideration for these securities must be counted toward the 100-owner limit of the Section 3(c)(1) Fund. [FN55] Similarly, we believe that Rule 3c-6 would not apply if a person acquires the securities issued by a Section 3(c)(7) Fund for consideration, and thus any person that pays consideration for these securities must be a qualified purchaser, a knowledgeable employee, or a grandfathered investor. We also believe that any obligation to pay for any additional contributions of capital may be a form of consideration, and thus Rule 3c-6 may not apply if a Transferor transfers securities issued by a Section 3(c)(7) Fund to a Transferee, but the Transferee is obligated to pay additional contributions as they become due or are called by the Fund. We believe that the requirement that additional contributions be made to the Fund after the Transferor transfers securities to the Transferee would not prevent the Fund from relying on Rule 3c-6, however, if the Transferor agrees to pay the additional contributions as they become due or are called by the Fund and the Fund agrees not to enforce the obligation to pay the additional contributions against the Transferee.

FN55. See Adopting Release, supra note 5, at n.132.

(ii) As discussed in our Answer to Question E.2.(i)., we believe that any obligation to pay for any additional contributions of capital may be a form of consideration, and thus Rule 3c-6 may not apply if a Transferor transfers securities issued by a Section 3(c)(7) Fund to a Transferee and the Transferee is obligated to pay additional contributions as they become due or are called by the Fund. Therefore, as a general matter, Rule 3c-6 does not apply if the Transferee is under any obligation to pay additional contributions, even if the Transferor provides the Transferee with sufficient assets to pay those contributions.

Furthermore, Rule 3c-6 as a general matter does not apply if a Transferor transfers assets to a Transferee who is not a qualified purchaser with the intention that the Transferee use the assets to purchase securities issued by a Section 3(c)(7) Fund, even if the assets are a gift. Nonetheless, we believe that it may be consistent with Rule 3c-6, and we would not recommend any enforcement action to the Commission under Section 7 of the Investment Company Act, if a Transferor transferred sufficient assets to enable the Transferee to satisfy any future capital contributions, and the Transferee used the assets to purchase securities issued by the Fund, if there were appropriate procedures in place reasonably designed to ensure that the assets would in fact be available and be of a sufficient amount for the contributions to be paid, and the Transferee is not under any obligation to pay the contributions.

Question 3: May a company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the qualified purchaser and his or her estate or donees receive securities of a Section 3(c)(7) Fund by gift if the Fund requires additional contributions of capital in the future and the contributions are paid out of assets previously held by the company so long as such assets derived exclusively from the qualified purchaser?

Answer: As we discussed in our Answer to Question E.2.(ii)., in accordance with the terms of Rule 3c-6, a Transferor may transfer securities issued by a Section 3(c)(7) Fund, together with sufficient

assets to enable the Transferee to satisfy future additional contributions required by the Fund, if there were appropriate procedures in place reasonably designed to ensure (i) that the assets would be used only to pay the contributions, and (ii) that the assets would in fact be available and be of a sufficient amount for the contributions to be paid. In addition, the Transferee may not be under any obligation to pay the contributions. Therefore, a Transferor may transfer by gift securities issued by a Section 3(c)(7) Fund to a company, such as the one that you describe in your question (and which is a permissible Transferee under Rule 3c- 6(b)(3)), and future capital contributions required by the Fund may be paid out of assets previously held by the company that were derived exclusively from the Transferor, provided that the company had in place the appropriate procedures, described above, and that the company was under no obligation to pay the contributions.

Question 4: Should an interest owned by a company in a Section 3(c)(7) Fund that is received by the holders of the company, either as a distribution or in dissolution of the company, be considered the equivalent of a gift to such holders so long as the company was not specifically formed for the purpose of making the investment in question?

Answer: Rule 3c-6 would not be available for a distribution or a dissolution by a company because none of the company's holders who would receive the securities would be "(1) the estate of the Transferor; (2) a Donee; or (3) a company established by the Transferor exclusively for the benefit or (or owned exclusively by) the Transferor [and/or a Donee or the estate of the Transferor]," as required by Rule 3c-6(b). [FN56] Section 3(c)(7)(A) provides, in part, however, that securities issued by a Section 3(c)(7) Fund that are owned by persons who received them from a qualified purchaser as a gift or bequest, or when the transfer was caused by legal separation, divorce, death, or other involuntary event, will be deemed to be owned by a qualified purchaser, subject to such rules as the Commission may prescribe. The Commission has stated that Rule 3c-6 does not necessarily provide an exclusive list of involuntary events for purposes of Section 3(c)(7). [FN57] Whether distributions or dissolutions by a company would be considered to be "involuntary events" for purposes of Section 3(c)(7)(A) would depend on the particular facts and circumstances. [FN58]

FN56. See supra note 48.

FN57. Adopting Release, supra note 5, at n.133.

FN58. Section 3(c)(1)(B), which was enacted in 1980, contains a similar provision with respect to the involuntary transfers of securities of a Section 3(c)(1) Fund. See supra note 9. The staff previously issued several letters regarding this section, and counsel seeking to determine whether a transfer of securities of a Section 3(c)(7) Fund would be considered involuntary for purposes of Section 3(c)(7)(A) may wish to review these letters. See, e.g., Trivest Special Situations Fund 1985 L.P. (July 13, 1989) (transfer of partnership interests to participants of a pension plan caused by the termination of the plan is not within the intent of Section 3(c)(1)(B) because the pension plan was voluntarily terminated when it was no longer economically advantageous to maintain it).

F. Effect of Section 3(c)(7) Funds on Rule 144A Securities

Question: Would the Commission agree that a modified CUSIP number would be sufficient to comply with Section 3(c)(7) as in the case of Rule 144A?

Answer: Section 3(c)(7) generally requires holders of securities issued by a Section 3(c)(7) Fund to be qualified purchasers. Rule 2a51-1(h) generally defines the term "qualified purchaser" to mean any person that meets the definition of qualified purchaser in Section 2(a)(51)(A) and the rules thereunder, or that the Section 3(c)(7) Fund or a person acting on its behalf (each a "Relying Person") reasonably believes meets the definition. Rule 2a51- 1(g)(1) generally provides that if a person seeking to purchase a security of a Section 3(c)(7) Fund is, or the Fund or other Relying Person reasonably believes is, a qualified institutional buyer as defined in Rule 144A ("QIB") under the Securities Act of 1933, [FN59] with the exception of self-directed employee benefit plans and certain dealers, that person is deemed to be a qualified purchaser ("QP-QIB").

FN59. Rule 144A sets forth a non-exclusive safe harbor from the registration requirements of Section 5 of the Securities Act for the resale of restricted securities to specified institutions by persons other than the issuer of such securities.

You argue that it should not be necessary under Rule 2a51-1(g)(1) for the Fund or other Relying

Person to form a reasonable belief that buyers are QP-QIBs. You state that, in the trading market for securities offered under Rule 144A ("144A Market"), it is the seller of the securities that determines that status of the purchaser, and not the issuer or other Relying Person. You therefore believe that the reasonable belief requirement should be deemed to have been satisfied if the seller of the securities has a reasonable belief that the purchaser is a QP-QIB on the basis of an established procedure for making this determination.

You further believe that one such procedure that would permit a seller to form the requisite reasonable belief would be the use of lists of securities maintained by dealers who participate in the 144A Market. You note that the CUSIP number of securities on these lists that can be purchased only by QIBs ("Rule 144A Securities") includes a special designation. You propose that a special designation be created for securities issued by Section 3(c)(7) Funds that would indicate that they can be purchased only by QP-QIBs. As an alternative, you propose that securities issued by Section 3(c)(7) Funds would be accepted for trading in the 144A Market only in large blocks, thus assuring the large size of the holders.

You also argue that, for purposes of Rule 2a51-1(h), a Section 3(c)(7) Fund should be able to form the requisite reasonable belief on the basis of deemed representations and warranties made by purchasers of the Fund's securities in the 144A Market that such purchasers are QP-QIBs and that any securities held by a purchaser who is not a QP-QIB must be divested. You state that the Fund's offering materials generally provide that there will be reliance on these representations and warranties. You argue that "most" participants in the 144A Market have at least $25 million under management and therefore would be qualified purchasers under Section 2(a)(51)(A)(iv), and that it is "doubtful" that there are many QIBs that are not also QP-QIBs.

We believe that a reasonable belief formed by a person other than the Fund or other Relying Person would satisfy neither the letter nor spirit of Rule 2a51-1. A Fund or other Relying Person may be able to develop procedures for resales in the 144A Market that, if followed, would be sufficient to form the requisite reasonable belief under Rule 2a51-1. [FN60] We generally believe that any procedures developed for resales in the 144A Market for purposes of Rule 2a51-1 must be designed to provide a means by which the Fund or other Relying Person can make a reasonable determination that all of the purchasers of the Fund's securities were qualified purchasers at the time that they acquired the securities. While we agree that the procedures you propose could be components of reasonable compliance procedures, whether a particular set of procedures would be sufficient for a Fund or other Relying Person to form the requisite reasonable belief depends on the facts and circumstances. [FN61] As a result, the staff, as a matter of policy, will not respond to requests to assess whether any particular set of procedures could form the basis of a reasonable belief under Rule 2a51-1.

> FN60. A Relying Person might include, for example, a participant of the Depository Trust Company, provided that the participant is acting on the Fund's behalf.
>
> FN61. The Division of Corporation Finance has advised us that the Division is not expressing any view on whether the procedures outlined in your letter satisfy the requirements of Rule 144A. Persons reselling securities in reliance on Rule 144A must reasonably believe that any offeree or purchaser is a QIB. Rule 144A provides non-exclusive methods for determining whether an offeree or purchaser is a QIB. The Division of Corporation Finance has given guidance in this area as well. See, e.g., Commscan (pub. avail. Feb. 3, 1999).

G. Timing of Qualified Purchaser Determination

Question: Does the Section 3(c)(7) Fund need to make a new determination of qualified purchaser status for an investor each time the investor elects to reinvest its earnings of the Fund?

Answer: No. Section 3(c)(7) excludes from the definition of investment company any issuer whose outstanding securities are owned by persons who, at the time of acquisition of the securities, are qualified purchasers, and which is not making or proposing to make a public offering of its securities. Consistent with prior staff interpretations of Section 3(c)(1), [FN62] the staff does not interpret Section 3(c)(7) as requiring the status of a person as a qualified purchaser to be reaffirmed in connection with the crediting of a Section 3(c)(7) Fund's earnings to an investor's account. Under some circumstances, however, a reinvestment of dividends may be considered to be a public offering of securities, which would preclude a fund from relying on Section 3(c)(7). [FN63]

FN62. Weiss Global Limited Partnership (pub. avail. Nov. 1, 1990)(staff took position that the acquisition of securities would not occur, for purposes of the pre-amended Look Through Provision of Section 3(c)(1), when a limited partner's partnership interests increased due to (i) the crediting of partnership earnings to capital accounts or the effect of their distribution to other limited partners, or (ii) redemptions of partnership interests by the partnership).

FN63. Section 3(c)(7)'s limitation on public offerings has been interpreted to permit offerings that comply with Section 4(2) of the Securities Act. See Adopting Release, supra note 5, at n.5. A reinvestment of earnings in securities may be considered to be a sale of securities for purposes of the Securities Act, and these securities may be subject to the registration provisions of that Act, absent an exemption from those provisions, such as that provided by Section 4(2). See, e.g., Securities Act Release No. 929 (Jul. 29, 1936), 11 FR 10957 (1936); Investment Company Act Release No. 6480 (May 10, 1971) 36 FR 9627 (May 1971).

H. Short-Term Paper

Question: May holders of short-term paper issued by a Section 3(c)(7) Fund be excluded from having to meet the qualified purchaser standard in order to invest in the Fund?

Answer: No. Unlike Section 3(c)(1), Section 3(c)(7) does not specifically exclude short-term paper holders from its requirements.

I. Jointly Held Investments

Question 1: If a husband and wife are separate limited partners of a Section 3(c)(1) Fund, should they be counted as one or two beneficial owners?

Answer: If the husband and wife each owns securities of a Section 3(c)(1) Fund in his or her own name, then the Fund should count the husband and wife as two beneficial owners. If the securities are jointly owned by the husband and wife, then they should be counted as one beneficial owner. [FN64]

FN64. Adopting Release, supra note 5, at n.69.

Question 2: If a husband and wife jointly own an entity that invests in a Section 3(c)(1) Fund, should that entity be counted as one beneficial owner even if the entity would be subject to a "look-through" because it owned more than 10% of the voting securities of the Section 3(c)(1) Fund or was formed for the purpose of investing in the Section 3(c)(1) Fund?

Answer: The entity would be counted as one beneficial owner if the entity's only shareholders are the husband and wife whose interests are jointly owned, regardless of whether the entity was formed for the specific purpose of investing in the Section 3(c)(1) Fund. [FN65]

FN65. Id.

J. Conversion to Section 3(c)(7) Fund

Question: If a Section 3(c)(1) Fund that is a limited partnership converts its status to a Section 3(c)(7) Fund, and that Fund subsequently converts from a limited partnership to a limited liability company (with appropriate partner consent as required by state law and the Fund's partnership agreement), will the Fund be able to continue to include its grandfathered investors?

Answer: A Section 3(c)(7) Fund that seeks to convert from a limited partnership to a limited liability company would be required to exchange the limited partnership interests held by its shareholders with securities issued by the limited liability company. If this exchange were deemed to be an "acquisition" for purposes of Section 3(c)(7), the grandfathered investors would have to be qualified purchasers in order to receive the new securities. We believe, however, that the receipt of new securities resulting from a change in legal form from a limited partnership to a limited liability company would not be such an acquisition, provided that (i) the change in legal form does not result in any material change in the interests of the grandfathered investors of the Fund, and (ii) the limited liability company will represent in all substantial respects the same business and enterprise as that of the limited partnership. Our position is consistent with our views with respect to the conditions under which a registered investment company may reorganize to change its legal form without the new entity either filing a new registration statement or registering its securities. [FN66]

FN66. See, e.g., CIGNA Aggressive Growth Fund (pub. avail. Feb. 15, 1985); Massachusetts Financial Development Fund, Inc. (pub. avail. Jan. 10, 1985); Institutional Liquid Assets, Inc. (pub. avail. May 28, 1978); Kemper Municipal Bond Fund, Inc. (pub. avail. Dec. 22, 1976).

Rochelle Kauffman Plesset

Senior Counsel

Securities and Exchange Commission (S.E.C.)

1999 WL 235450 (S.E.C. No - Action Letter)

END OF DOCUMENT

Regulation D under the Securities Act of 1933

[Summary of Regulation D - Rules Governing the Offer and Sale of Securities Without Registration Under the Securities Act of 1933]

(17 CFR 230.501 to 508)

Title 17

Chapter II

Part 230

Section 230.501(a) - Definition of "Accredited Investor"

(1) - Banks as defined in Section 3(a)(2) of the Act, acting individually or as a fiduciary

- Savings and Loan Associations defined in Section 3(a)(5)A) of the Act, acting individually or as a fiduciary

- Registered Brokers or Dealers registered under Section 15 of the Securities Exchange Act of 1934

- Insurance companies as defined in Section 2(13) of the Act

- Investment companies registered under the Investment Company Act of 1940

- Business development companies as defined in Section 2(a)(48) of the Investment Company Act of 1940

- Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c)(d) of the Small Business Act of 1956

- Any state or local employee benefit plan having assets in excess of $5 million

- Any employee benefit plan subject to ERISA if the investment decision is made by a Plan Fiduciary which is a bank, savings and loan association, insurance company, or registered investment adviser

- An employee benefit plan whose assets exceed $5 million

- A self-directed employee benefit plan, whose investment decisions are made solely by "Accredited Investors"

(2) - A private business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940

(3) - Any:

- Organization described in IRC Section 501(c)(3), (religious, charitable, educational, etc.)

- Corporation,
- Massachusetts or similar business trust,
- Partnership,

which has not been formed for the specific purpose of acquiring the securities offered, and which has assets in excess of $5 million

(4) - Any director, executive officer or general partner of the issuer of the securities being sold

(5) - Any individual whose net worth, *or*

whose joint net worth with that person's spouse,

exceeds $1 million at the time of purchase

(6) - Any individual whose income exceeded $200 thousand in each of the two previous years, *or*

whose joint income with that person's spouse exceeded $300 thousand in each of the two previous years, *and*

has a reasonable expectation of reaching the same income level in the current year

(7) - Any trust having assets in excess of $5 million, which was not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as defined in Section 230.506(b)(2)(ii)

(8) - Any entity in which all the equity owners are "Accredited Investors"

Section 230.501(e) - Calculation of number of purchasers for purposes of Sections 230.505(b) and 230.506(b):

(1) - The following persons are **excluded** from the calculation of number of purchasers:

(i) Any relative of the purchaser having the same principal residence of the purchaser

(ii) Any trust or estate in which the purchaser or relative sharing the purchaser's principal residence have a combined beneficial interest of more than 50 percent

(iii) Any corporation in which the purchaser or relative sharing the purchaser's principal residence have a combined beneficial interest of more than 50 percent

(iv) Any "Accredited Investor"

(2) - A corporation, partnership or other entity shall be counted as one purchaser, however, if the entity was organized for the specific purpose of acquiring the securities offered and is not an "Accredited Investor", each beneficial owner of equity securities or equity interests in the entity shall be counted as a separate purchaser

(3) - Non-contributory employee benefit plans subject to ERISA shall be counted as one purchaser

Section 230.501(g) - The definition of the term "issuer" in Section 2(4) of the Act shall apply, except, in the case of a Federal Bankruptcy, the trustee or debtor in possession shall be considered the issuer.

Section 230.502 - General conditions in regard to offers and sales made under Regulation D

(a) Integration of all offers and sales within the past 6 months

(b) Information to be furnished to purchasers, other than to "Accredited Investors" or with respect to

offerings of $1 million or less under Section 230.504:

(i) if issuer is not subject to reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934:

(A)Non-financial information

(B)Financial information on offerings of up to:

(1) $2 million + information required in Item 310 on Form S-B, 17 CFR Section 228.310 (small business disclosure requirements)

(2) $7.5 million + information required in Form SB-2, 17 CFR Section 228.310 (small business disclosure requirements)

(3) $7.5 million+Information as would be required for securities registration under Section 5 of the Act

(C)Foreign private issuers eligible to use Form 20-F under Section 249.220f (forms prescribed under the Securities Exchange Act of 1934)

(ii) if issuer is subject to reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934:

(A) Issuer's annual report

(B) Issuer's Form 10-K

(C) Information required to filed under Sections 13(a), 14(a), 14(c), and 15(d) of the Securities Exchange Act of 1934

(D) Foreign private issuers may use information contained in its most recent filing of Form 20-F or Form F-1 under Section 239.31 (forms prescribed under the Securities Act of 1933)

(iii) exhibits to filed with the SEC as part of the registration statement, other than an annual report or Form 10-K report, need not be furnished "Non-Accredited Investors"

(iv) at a reasonable time prior to the sale to a "Non-Accredited Investor" under Sections 230.505 or 230.506, at the "Non-Accredited Investor's" written request, a brief description of material written information provided "Accredited Investors"

(v) at a reasonable time prior to the purchase of securities under Sections 230.505 and 230.506, information that is necessary to verify accuracy of information furnished under paragraphs (b)(i) and (ii) above

(vi) for business combinations or exchange offers, written information concerning terms for any purchasers which are materially different from those for all other security holders

(vii) information concerning the limitations on resale contained in paragraph (d) below

(c) Advertising restrictions: *except for securities sold under Section 230.504(b)(1)*, neither the issuer nor any person acting on its behalf shall offer or sell securities through general advertising

(d) Resale restrictions: *except for securities sold under Section 230.504(b)(1)*, securities sold under Regulation D cannot be resold without registration under the Act, or exemption therefrom

Section 230.503 - Filing of notice of sales with the SEC:

Issuers of securities under Sections 230.504, 230.505 or 230.506 are required to file a notice on Form D (17 CFR 239.500 - forms prescribed under the Securities Act of 1933) no later than 15 days after the first sale of securities

Section 230.504 - Exemption for offerings and sales of securities not exceeding $1 million

(a) Securities sold under this section by issuers which are not:

- subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934,
- an investment company, are not subject to the registration requirements of Section 5 of the Act

(b) (1) The requirements for investors, issuers, and information dissemination under Sections 230.501 and 230.502 must be met

(2) The aggregate offering of securities under this section shall not exceed $1 million, less the aggregate for all securities sold within 12 months prior to the current offering of securities

Section 230.505 - Exemption for offerings and sales of securities not exceeding $5 million

(a) Securities sold under this section by issuers which are not investment companies, are not subject to the registration requirements of Section 5 of the Act

(b) (1) The requirements for investors, issuers, and information dissemination under Sections 230.501 and 230.502 must be met

(2) (i) The aggregate offering of securities under this section shall not exceed $5 million, less the aggregate for all securities sold within 12 months prior to the current offering of securities

(ii) There are no more than 35 purchasers of securities in any offering under this section

(iii) No exemption under this section will be available for securities of any issuer described in Section 230.262 of Regulation A

Section 230.506 - Exemption for offerings and sales of securities without regard to dollar amount of offering

(a) Securities sold under this section are not deemed public offerings under Section 4(2) of the Act

(b) (1) The requirements for investors, issuers, and information dissemination under Sections 230.501 and 230.502 must be met

(2) (i) There are no more than 35 purchasers of securities in any offering under this section

(ii) "Sophisticated Person" defined as having knowledge and experience in financial and business matters to permit an evaluation of the risks and merits of the prospective investment, either acting alone or with a purchaser representative

Section 230.507 - Exemptions under Sections 230.504, 230.505, and 230.506 are not available to issuers, their affiliates, or predecessors which have been subject to order or decree enjoining such person for failure to comply with Section 230.503

Section 230.508 - Insignificant deviations from any requirement of Regulation D does not result in the loss of exemption from Section 5 of the Act

Joint Release Office of the Comptroller of the Currency Board of Governors of the Federal Reserve System Federal Deposit Insurance Corporation Office of Thrift Supervision

January 5, 2004

Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or its Affiliates

Purpose and Scope

This interagency policy is issued jointly by the federal banking agencies, including the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve System (Board), and the Office of Thrift Supervision (OTS) (the agencies) to alert banking organizations, including their boards of directors and senior management, of the safety and soundness implications of and the legal impediments to a bank providing financial support to investment funds[1] advised by the bank, its subsidiaries, or affiliates. A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation, and can harm investors, if the associated risks are not effectively controlled. The agencies have concluded that recent market developments, including market volatility, the continued low interest rate environment, and operational and corporate governance weaknesses, warrant the issuance of this guidance.

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and acquisition of fund shares. In very limited circumstances, certain arrangements between banks and funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns.

Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and collateral and market terms requirements on many transactions between a bank and certain of its advised funds. Additionally, the OCC's fiduciary activities regulation (12 CFR 9) may restrict transactions between a bank and its advised funds.[2]

Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank advised investment funds. Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities[3] that include:

- Establishing alternative sources of emergency support from the parent holding company, non-bank affiliates or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to ensure that appropriate policies and procedures were followed.
- Implementing an effective risk management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.
- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with FAS 5, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing Call Report Schedule RC-T - Fiduciary and Related Services.

Notification

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to (or immediately after, in the event of an emergency) the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

[1]Bank advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of this guidance, "banks" includes banks and savings associations regulated by the federal banking or thrift agencies.

[2]Banks should be aware that other legal requirements may also restrict or prohibit transactions between a bank and its advised funds, including the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Employee Retirement Income Security Act of 1974 (ERISA).

[3]The agencies acknowledge the SEC's functional regulatory authority over the investment advisory activities of SEC registered investment advisers. However, the agencies remain responsible for evaluating the consolidated risk profiles of banking organizations, which may include assessing the risks posed to the bank from the activities and obligations of any subsidiary or affiliate.

Implications of the Growth of Hedge Funds

Staff Report to the
United States Securities and Exchange Commission

September 2003

This is a staff report to the Commission. The Commission has expressed no view regarding the analysis, findings or conclusions herein.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 29, 2003

Hedge funds, while representing a relatively small portion of the U.S. financial markets, have grown significantly in size and influence in recent years. In June 2002, the staff of the Commission's Division of Investment Management and Office of Compliance Inspections and Examinations undertook a fact-finding mission aimed at reviewing the operations and practices of hedge funds.

After last spring's two-day roundtable on the hedge fund industry, I asked the staff to summarize its findings in a report to the Commission. I also asked the staff to include recommendations about actions that, in the judgment of the staff, the Commission might consider when addressing issues that the staff raised in its report. The substance and the language of the report represent the views of the staff. They do not represent the views of the Commission or of any individual Commissioner.

I look forward to reviewing the staff's report and accompanying recommendations with my fellow Commissioners. The staff has raised important issues for the Commission's consideration. I anticipate that we will hear strong views both in support of and in opposition to the staff's recommendations. We intend to consider these comments carefully as we continue to deliberate the appropriate extent of Commission oversight of the hedge fund industry.

William H. Donaldson

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TABLE OF CONTENTS

IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS

EXECUTIVE SUMMARY……………………..……………………………..……..vii

I. Investigation by the Staff of the Commission 1

II. Legal Structure and Benefits of Hedge Funds 3

A. What is a Hedge Fund 3

B. Market Benefits of Hedge Funds 4

C. Pooled Investment Vehicles that Are Not Hedge Funds 5

1. Registered Investment Companies 5

2. Private Equity Funds 7

3. Venture Capital Funds 8

4. Commodity Pools 8

D. Domestic and Offshore Hedge Funds 9

1. Domestic Hedge Funds 9

2. Offshore Hedge Funds 10

III. The Regulation of Hedge Funds and Their Advisers 11

A. Hedge Funds and the Investment Company Act of 1940 11

1. Section 3(c)(1) 11

2. Section 3(c)(7) 12

B. Hedge Funds and the Securities Act of 1933 13

1. The Private Offering Exemption of the Securities Act 14

2. Regulation D 14

C. Hedge Funds and the Securities Exchange Act of 1934 18

1. Definition of “Broker” and “Dealer” 18

2. Exchange Act Registration Under Section 12 18

3. Beneficial Ownership Reporting under Sections 13 and 16 of the Exchange Act 19

D. Hedge Fund Advisers and the Investment Advisers Act of 1940 20

E. Certain Other Regulatory Requirements 23

1. Regulation under the CEA 23

2. NASD Regulation 25

3. Regulation under ERISA 28

4. Treasury Department Regulations 29

5. State Regulation 31

IV. Operations of Hedge Funds 33

A. Hedge Fund Investment Strategies 33

1. Overview 33

2. Hedge Funds Strategies 34

3. Hedge Fund Investment Activities Compared to those of Registered Investment Companies 36

4. Leverage 37

5. Short Selling 39

B. Nature of Hedge Fund Investors 43

C. Hedge Fund Marketing 44

D. Disclosure by Hedge Funds to Investors and Prospective Investors 46

1. Private Placement Memoranda 47

2. Limited Partnership Agreements 49

3. Transparency 49

4. Periodic Reporting 50

5. Additional Sources of Hedge Fund Information 51

E. Hedge Fund Service Providers 52

1. Hedge Fund Investment Advisers 52

2. Broker-Dealers/Prime Brokers 53

3. Offshore Administrators 55

4. Auditors 57

5. Consultants and Other Finders 59

F. Hedge Fund Advisory Fees 61

G. Hedge Fund Valuation Practices 64

H. Audit Reports 65

I. Risk Management 66

J. Funds of Hedge Funds 67

1. Background 67

2. Registered FOHFs 68

3. Repurchases 71

4. Content of Registered FOHF Disclosure. 71

V. Hedge Fund Enforcement Actions 72

A. Commission Actions 72

B. State and SRO Enforcement Activities 74

VI. Concerns 76

A. Lack of Commission Regulatory Oversight 76

1. Inability to Detect Fraud and Other Misconduct at Early Stages 76

2. Lack of Meaningful Information about Hedge Funds and Hedge Fund Advisers 77

B. Valuation of Hedge Fund Portfolio Securities 79

C. Retailization 80

1. Direct Investment in Hedge Funds 80

2. Registered Funds of Hedge Funds 81

3. Pension Plan and Other Institutional Investment in Hedge Funds 82

D. Disclosure 83

E. Conflicts of Interests 83

1. Side-by-Side Management of Client Accounts 83

2. Relationships with Prime Brokers 85

F. Concerns about General Solicitation 86

G. Concerns about Whether the Federal Securities Laws and Regulations Are Impairing the Investment Activities of Registered Investment Companies 87

VII. Recommendations 88

A. The Commission Should Consider Requiring Hedge Fund Advisers to Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration 89

1. Benefits of Mandatory Registration 92

2. Concerns about Mandatory Registration 96

B. The Commission Should Consider Revising its Regulations Under the Advisers Act to Require Advisers to Provide a Brochure Specifically Designed for Hedge Funds. 97

C. The Commission Should Consider Requiring Certain Registered Investment Companies to Follow Board Adopted Valuation Procedures 99

D. The Commission Should Consider Requiring Additional Disclosure to be Provided About Layered Fees of "Funds of Funds" 99

E. Regulators Should Continue to Monitor Whether Suitability Obligations Are Being Met 100

F. The Commission Should Consider Permitting General Solicitation in Section 3(c)(7) Hedge Fund Offerings 100

G. Monitor Capital Introduction Services Provided by Prime Brokers 101

H. Encourage the Hedge Fund Industry to Embrace and Further Develop Best Practices 101

I. Investor Education 103

VIII. The Commission Should Consider Issuing a Concept Release for Examining Wider Use of Hedge Fund Investment Strategies in Registered Investment Companies 103

A. Different Registered Investment Company Structures Provide Various Benefits and Challenges in the Deployment of Absolute Return Strategies 104

B. Registered Investment Companies are Subject to Restrictions on Leverage and Short Selling that Hedge Funds Avoid 107

C. Alignment of the Investment Adviser's Interests with Investors......................... 109

D. Absolute Return Strategies May Challenge Traditional Investor Expectations .. 110

Appendix A -- Summary of the Commission's Previous Studies or Investigations of Hedge funds

EXECUTIVE SUMMARY

I. Background on Report of the Implications of the Growth of Hedge Funds

At the request of the Commission, the staff has conducted a study of hedge funds, including their investment advisers and other service providers and their investors. The Commission's decision to study the hedge fund industry was based, in large part, on the growth of hedge fund assets coupled with the Commission's lack of information about these investment pools. The hedge fund industry recently has experienced significant growth in both the number of hedge funds and the amount of assets under management. Based on current estimates, 6,000 to 7,000 hedge funds operate in the United States managing approximately $600 to $650 billion in assets. In the next five to ten years, hedge fund assets have been predicted to exceed $1 trillion.

The growth in hedge funds has been fueled primarily by the increased interest of institutional investors such as pension plans, endowments and foundations seeking to diversify their portfolios with investments in vehicles that feature absolute return strategies – flexible investment strategies which hedge fund advisers use to pursue positive returns in both declining and rising securities markets, while generally attempting to protect investment principal. In addition, funds of hedge funds ("FOHF"), which invest substantially all of their assets in other hedge funds, have also fueled this growth.

The study focused on a number of key areas of staff concern, including the recent increase in the number of hedge fund enforcement cases, the role that hedge funds play in our financial markets and the implications of the Commission's limited ability to obtain basic information about hedge funds. The staff also examined the emergence of registered FOHFs – FOHFs that register under the Investment Company Act of 1940 ("Investment Company Act") so that they may offer and sell their securities to a larger number of investors and FOHFs that register under the Investment Company Act and the Securities Act of 1933 ("Securities Act") so that they may offer and sell their securities in the public market. Finally, the staff reviewed hedge fund disclosure and marketing practices, valuation practices and conflicts of interest.

The study commenced with the staff's review of 65 hedge fund advisers (both registered and unregistered) managing approximately 650 different hedge funds with over $160 billion of assets. This phase of the study included a number of on-site visits to hedge fund advisers, which were selected to provide a representative cross-section of the industry. The staff also visited several broker-dealers offering prime brokerage services to hedge funds and conducted a separate series of on-site examinations focused on the operations of registered FOHFs. In addition, the staff met with hedge fund advisers, investors, regulators and industry observers willing to share information about hedge funds.

Complementing the study, the Commission held a Hedge Fund Roundtable on May 14 and 15, 2003, and invited a broad spectrum of the hedge fund industry and interested persons to participate in a discussion of hedge fund issues. At the close of the Roundtable, Chairman

William H. Donaldson requested that the staff provide the Commission with a report of its findings and recommendations resulting from the hedge fund study. In response, the Division of Investment Management, with the assistance of the Divisions of Corporation Finance, Enforcement and Market Regulation, and the Offices of Compliance Inspections and Examinations, Economic Analysis, International Affairs and Investor Education and Assistance, has prepared this Report. The Chairman also requested public comment on the issues discussed in the Roundtable. The Commission received approximately 80 comment letters in response and those letters have been considered in preparing this Report.

The Report outlines the staff's factual findings, identifies concerns and recommends that the Commission should consider certain regulatory and other measures to improve the current system of hedge fund regulation and oversight. The views expressed in this Report are those of the staff and do not necessarily reflect the views of the Commission or the individual Commissioners.

A. Characteristics of Hedge Funds

Although financial service providers, regulators and the media commonly refer to "hedge funds," the term has no precise legal or universally accepted definition. The term generally identifies an entity that holds a pool of securities and perhaps other assets that does not register its securities offerings under the Securities Act and which is not registered as an investment company under the Investment Company Act. Hedge funds are also characterized by their fee structure, which compensates the adviser based upon a percentage of the hedge fund's capital gains and capital appreciation. Hedge fund advisory personnel often invest significant amounts of their own money into the hedge funds that they manage. As discussed in the Report, although similar to hedge funds, there are other unregistered pools of investments, including venture capital funds, private equity funds and commodity pools that generally are not categorized as hedge funds.

The investment goals of hedge funds vary among funds, but many hedge funds seek to achieve a positive, absolute return rather than measuring their performance against a securities index or other benchmark. Hedge funds utilize a number of different investment styles and strategies and invest in a wide variety of financial instruments. Hedge funds invest in equity and fixed income securities, currencies, over-the-counter derivatives, futures contracts and other assets. Some hedge funds may take on substantial leverage, sell securities short and employ certain hedging and arbitrage strategies. Hedge funds typically engage one or more broker-dealers to provide a variety of services, including trade clearance and settlement, financing and custody services.

Hedge funds often provide markets and investors with substantial benefits. For example, based on our observations, many hedge funds take speculative, value-driven trading positions based on extensive research about the value of a security. These positions can enhance liquidity and contribute to market efficiency. In addition, hedge funds offer investors an important risk management tool by providing valuable portfolio diversification because hedge fund returns in many cases are not correlated to the broader debt and equity markets.

B. Hedge Fund Organization and Operations

Hedge funds are typically organized by professional investment advisers that manage a hedge fund's investments. Hedge funds distribute securities in private offerings, traditionally "marketing" their interests through word of mouth and the personal relationships with the hedge fund's advisory personnel. Broader marketing, including use of the Internet, has become more frequent in recent years. Hedge funds generally do not have limited time horizons, although a number of factors, including an inability to consistently achieve positive returns, often contribute to a relatively shorter life span than that of other investment vehicles. Hedge fund advisers typically receive, as compensation, a management fee based on the amount of hedge fund assets (commonly 1-2 percent), plus a share of the capital gains and capital appreciation (commonly 20 percent) or some other allocation based on the fund's investment performance. Hedge funds typically agree to repurchase their own interests from investors on a limited, periodic basis, such as quarterly, often following an initial "lock-up period" during which time investors are not permitted to liquidate their investments.

Because hedge funds are not registered investment companies, they generally are not required to meet prescribed disclosure requirements. Hedge fund advisers, however, typically provide potential hedge fund investors with a private placement memorandum that discloses information about the investment strategies the hedge fund is permitted to use and an overview of how the hedge fund operates. The private placement memorandum also generally provides the adviser with the maximum flexibility in selecting, shifting and modifying its strategies. In addition, the private placement memorandum often provides the hedge fund adviser with broad discretion in valuing the hedge fund's assets. Hedge fund investors generally receive some ongoing performance information, risk analyses and portfolio profiles from their hedge fund advisers. Although not required, most hedge funds retain an auditor to conduct an annual independent audit, which, if certified, is prepared using generally accepted accounting principles.

For tax and other considerations, some hedge fund advisers create one or more "offshore" hedge funds that are organized in a foreign jurisdiction, in addition to maintaining U.S.-based hedge funds. In many cases, an offshore hedge fund is managed using trading strategies that are substantially similar to those used to manage an onshore hedge fund managed by the same adviser. These hedge funds are offered and sold to certain U.S. investors as well as foreign investors.

C. Principal Exclusions and Exemptions for Hedge Funds and Their Investment Advisers

To avoid registration and substantive regulation under the Investment Company Act, hedge funds rely on one of two exclusions from the definition of investment company. The first exclusion is available to hedge funds that have 100 or fewer investors. The second exclusion applies to hedge funds that sell their interests only to highly sophisticated investors. To rely on either exclusion, the hedge fund must restrict its offerings so that they meet the requirements for non-public offerings.

Hedge funds do not register the offer and sale of their interests under the Securities Act. As such, hedge funds may not offer their securities publicly or engage in a public solicitation. Instead, hedge funds generally sell their interests in private offerings. To meet the most commonly used regulatory "safe harbor" for conducting private offerings, hedge funds may sell their interests to an unlimited number of "accredited investors." Accredited investors include individuals with a minimum annual income of $200,000 ($300,000 with spouse) or $1 million in net worth and most institutions with $5 million in assets. Hedge funds that seek to rely on the sophisticated investor exclusion from Investment Company Act registration may sell their interests only to "qualified purchasers," a standard with significantly higher financial requirements than those necessary for accredited investors. In practice, we understand that most hedge funds sell only to investors whose wealth exceeds that required to meet the standard established for accredited investor status.

Although some hedge fund advisers choose to register voluntarily, or are registered for another reason, most advisers to hedge funds do not register under the Investment Advisers Act of 1940 ("Advisers Act"). They often rely on the "*de minimis*" exemption from registration for investment advisers with 14 or fewer clients. Under Commission rules, each hedge fund counts as one client.

II. Concerns Relating to Hedge Fund Growth

As noted above, our study was, in large part, the result of the Commission's recognition that it lacks information about hedge fund advisers that are not registered under the Advisers Act and the hedge funds that they manage. Although this recognition is not new, the Commission's attention was focused again on the hedge fund industry as a result of the recent growth of the industry and the increase of investments in hedge funds by institutions. Although hedge fund investment advisers are subject to the antifraud provisions of the federal securities laws, they are not subject to any reporting or standardized disclosure requirements, nor are they subject to Commission examination. Consequently, the Commission has only indirect information about these entities and their trading practices and, we believe, is hampered in its ability to develop regulatory policy as hedge funds become more important participants in our financial markets. We are concerned about our inability to examine hedge fund advisers and evaluate the effect of the strategies used in managing hedge funds on our financial markets. We also are concerned about the lack of applicable regulatory measures necessary to ensure that material information to assist investors in making fully informed investment decisions is available.

The Commission's inability to examine hedge fund advisers has the direct effect of putting the Commission in a "wait and see" posture vis-à-vis fraud and other misconduct. The Commission typically is able to take action with respect to such fraud and other misconduct only after it receives relevant information from third parties (for example, investors or service providers), and frequently only after significant losses have occurred. In contrast, we believe that our examination program not only allows the Commission to identify misconduct by registered investment advisers earlier, but it also assists in identifying and possibly preventing certain misconduct from developing into fraud.

We also are concerned that some hedge fund investors may not always receive useful information about the investment adviser and its management of the fund. In addition, we believe that disclosure to some hedge fund investors could be improved to address conflicts of interests of hedge fund advisers.

One of our key concerns relates to the manner by which hedge fund advisers value hedge fund assets. The broad discretion that these advisers have to value assets and the lack of independent review over that activity gives rise to questions about whether some hedge funds' portfolio holdings are accurately valued. Our concern not only reflects our recognition of the incentives that may cause an adviser to inaccurately value hedge fund assets, but it also reflects our concern that registered funds that invest their assets in hedge funds may lack access to information that enables them to "fair value" their interests in hedge funds and therefore accurately calculate their net asset value.

In addition, we have observed various uses of the Internet by hedge fund advisers to communicate with investors. We are taking the opportunity in this Report to reiterate the Commission's statement that the analysis historically applied to determine whether an offering is part of a general solicitation or public offering has not changed in the context of offerings made through electronic sources. Separately, however, we recommend to the Commission that additional consideration be given to whether hedge funds that offer and sell their securities solely to "qualified purchasers," as defined under the Investment Company Act, should be subject to the limitation that such funds only make private offerings of their securities.

III. Staff Recommendations Relating to Hedge Fund Advisers, Funds of Hedge Funds and Hedge Funds

A. The Commission Should Consider Requiring Hedge Fund Advisers To Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration

The staff recommends that the Commission consider revising its rules under the Advisers Act to require hedge fund advisers to register as investment advisers. Amending the rules under the Advisers Act would require hedge fund advisers to "look through" any hedge funds under their management and count each investor in each hedge fund as a separate client of the adviser. In practical terms, this would result in the registration of most large hedge fund advisers. The staff further recommends that the Commission consider amending its rules to require that registered hedge fund advisers file with the Commission, and deliver to investors, a disclosure statement specifically designed for hedge fund investors.

Registration of hedge fund advisers would have several benefits. First, registered hedge fund advisers would become subject to the Commission's regular inspections and examinations program. Effective Commission oversight could lead to earlier detection of actual and potential misconduct, help to deter fraud and encourage a culture of compliance and controls. Second, the Commission would be authorized to collect basic and meaningful information about the activities of hedge fund advisers and hedge funds, which are becoming increasingly influential participants

in the U.S. financial markets. Third, Advisers Act registration would enable the Commission to require hedge fund advisers to disclose information about issues important to investors, such as conflicts arising from side-by-side management of hedge funds and other client accounts and hedge fund advisers' relationships with prime brokers. Fourth, registration of hedge fund advisers under the Advisers Act would effectively increase the minimum investment requirement for direct investments in certain hedge funds because registered advisers are generally prohibited from charging performance fees unless investors have $750,000 invested with the adviser or have a net worth of $1.5 million.

Importantly, Advisers Act registration would not impede the manner in which a hedge fund adviser invests or operates a hedge fund. Registration would not place restrictions on a hedge fund adviser's ability to trade securities, use leverage, sell securities short or enter into derivative transactions. Registration would also not require the disclosure of hedge fund proprietary trading strategies and portfolio positions, nor would it result in the public identification of the hedge fund's investors.

B. The Commission and its Staff Should Consider Addressing Certain Valuation, Suitability and Fee Disclosure Issues Relating to Registered FOHFs

The Commission should consider requiring, through rulemaking, that all registered investment companies that invest their assets in hedge funds, including registered FOHFs, have policies and procedures designed to ensure that funds and their boards value their interests in hedge funds in a manner consistent with the requirements of the Investment Company Act. To address concerns that registered FOHF investors do not understand the impact of multiple layers of fees, the Commission should adopt its proposed rulemaking to require all registered investment companies, including registered FOHFs, to disclose in their prospectus fee tables the estimated expenses of the company's underlying fund interests. To address concerns about registered FOHFs exposing investors to levels and types of risks that are not appropriate for those investors, the Commission should continue to encourage the examination staffs of the Commission and the NASD to be vigilant in identifying violations of broker-dealer suitability obligations with respect to the sale of all registered FOHFs.

C. The Commission Should Consider Permitting General Solicitation in Fund Offerings Limited to Qualified Purchasers

The staff recommends that the Commission consider eliminating the prohibition on general solicitation or advertising in offerings by hedge funds that rely on the exclusion from the definition of an investment company for hedge funds that permit investments only by highly sophisticated investors. Permitting pooled investment vehicles, including hedge funds, which limit their investors to this higher standard to engage in a general solicitation could facilitate capital formation, without raising significant investor protection concerns.

D. The Staffs of the Commission and the NASD Should Monitor Closely Capital Introduction Services Provided by Broker-Dealers

Commission and NASD examiners should continue to monitor prime brokers' capital introduction practices. In addition, the staff should consider whether broker-dealers' suitability and other regulatory obligations are being met in connection with the offering of hedge funds interests.

E. The Commission Should Encourage the Hedge Fund Industry To Embrace and Further Develop Best Practices

The Commission should encourage those involved in the hedge fund industry to embrace existing "best practices" and refine and improve these best practices to supplement current conflict management practices.

F. The Commission Should Continue Its Efforts To Improve Investor Education Regarding Hedge Funds

In light of the publicity surrounding hedge funds, as well as the advent of registered FOHFs, there is a greater need to promote investor education regarding hedge funds, their investment strategies and their operations. In addition to making investors aware of the potential for fraud in hedge funds, we are also concerned that many investors may not realize the correlation between risk and return – that higher risk inevitably accompanies potentially higher returns.

IV. The Commission Should Consider Issuing a Concept Release To Examine the Wider Use of Hedge Fund Investment Strategies in Registered Funds

Some commenters have asserted that retail investors could benefit from greater access to absolute return strategies and hedge fund investment techniques. The Commission should consider issuing a concept release requesting comment on this topic generally and focusing on issues such as whether: (1) current restrictions placed on registered funds' use of leverage and short selling should be relaxed; (2) an absolute return strategy, especially in connection with a performance fee tied to achieving an absolute return, has a positive effect on aligning the interests of hedge fund advisers and investors; and (3) additional investor education initiatives would be necessary to educate investors about absolute return strategies and risks.

Staff Report

I. Investigation by the Staff of the Commission

Over the past 35 years, the Commission and the staff have periodically conducted or participated in a number of studies about hedge funds.[1] While some of these studies were prompted by particular events, others were part of a program of Commission surveillance to review aspects of the securities markets. Previous studies often focused on the impact of hedge fund operations on the stability of the financial markets. These studies examined, among other things, trading and brokerage practices, including the use of short selling and leverage by hedge funds, the systemic risks posed by hedge funds and the exposure of banks and other counterparties to hedge funds and other highly-leveraged institutions.

The considerable growth of the hedge fund industry in recent years prompted the Commission to authorize the staff to examine hedge funds once again.[2] Although hedge funds remain a relatively small portion of the U.S. financial markets,[3] the rate of growth of hedge funds has been substantially greater than that of other sectors.[4] In addition, hedge funds have a growing role in our securities markets as large and frequent traders of securities.

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1 See Appendix A for a chronological discussion of the Commission's major studies or investigations of hedge funds.

2 Consistent with previous hedge fund studies, the staff has no reliable data on the number of hedge funds in existence or the amount of hedge fund assets under management. Participants at the Commission's May 14-15, 2003 Hedge Fund Roundtable ("Roundtable") estimated that there are approximately 6,000 hedge funds currently operating in the United States, with approximately $600 billion in assets under management. Other estimates vary greatly. The Commission estimated in 1992, based on media reports, that there were approximately 400 hedge funds in existence. See Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992) ("Breeden Letter").

3 For example, the total market value of corporate equities in the U.S. stock market at the end of 2002 was $11.8 trillion. Federal Reserve Statistical Release Z.1, *Flow of Funds Accounts of the United States - Flows and Outstanding,* available at http://www.federalreserve.gov/releases/Z1/20030605/.

4 According to a Roundtable participant, hedge fund assets grew from $50 billion in 1993 to $592 billion in 2003, an increase of 1084 percent. Comment submitted by Roundtable Panelist Charles J. Gradante on behalf of the Hennessee Group LLC at 4-5 ("Hennessee Group Comment Letter"). By contrast, over the decade from December 1992 to December 2002, the number of mutual fund portfolios increased by 116 percent, from 3,824 to 8,256, and their assets increased by 289

As more fully discussed below, the concerns that prompted the Commission's current examination of hedge funds involve not simply the growth in the number of hedge funds and their assets under management, but more importantly, the causes and implications of that growth. They also reflect the Commission's interest in determining whether the recent increase in the number of hedge fund frauds is a result of this growth, and whether certain types of offenses are endemic to hedge funds. Finally, the Commission was concerned about the potential impact that the growth in hedge fund assets and activities may have on our financial markets.[5]

Our examination began in June 2002, and included reviews of both registered and unregistered investment advisers that manage hedge funds. The staff also had on-site discussions with a number of hedge fund advisers.[6] In addition, the staff met or spoke with a variety of experts in their respective fields to get their perspectives on the hedge fund industry. This group included legal and accounting experts, chief investment officers, risk managers, prime brokers, trade industry representatives, hedge fund consultants and representatives from foreign and domestic regulators.

In May 2003, the Commission hosted a Roundtable to provide a public forum for discussion and debate about the implications of hedge fund growth. The Roundtable brought together representatives from the hedge fund industry and other interested persons to discuss issues relating to hedge funds, and to offer their recommendations.[7] In addition, the Commission

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percent from $1.6 trillion to $6.4 trillion. See The Investment Company Institute, *2003 Mutual Fund Fact Book: A Guide to Trends and Statistics in the Mutual Fund Industry* 63 (43rd ed. 2003). In that same period, assets of insurance companies increased by 110 percent (from $1.6 trillion to $3.3 trillion), assets of commercial banks grew by 100 percent (from $3.5 trillion to $7 trillion), and deposits of commercial banks increased by 79 percent (from $2.5 trillion to $4.5 trillion). See Federal Reserve Statistical Release Z.1, supra note 3; Federal Reserve Statistical Release H.8, *Assets and Liabilities of Commercial Banks in the United States*, available at http://www.federalreserve.gov/releases/Z1/20030605/; http://www.federalreserve.gov/releases/z1/current/data.htm.

5 The Commission recognized over 30 years ago that hedge fund trading raises special concerns with respect to their impact on the securities markets. See *35th Annual Report*, U.S. Securities and Exchange Commission 18 (1969) ("[b]ecause hedge funds are so strongly performance-oriented, they may have a greater impact on the securities markets than their asset size would indicate").

6 The staff selected hedge fund investment advisers based on their: (1) hedge fund assets under management; (2) number of hedge funds under management; (3) hedge fund investment objectives; (4) status and length of operations; (5) Commission registration status; and (6) additional advisory services provided.

7 A wide range of persons involved in the hedge fund industry participated in the Roundtable, including hedge fund advisers, consultants, service providers (such as prime brokers, auditors and

invited the public to submit written comments to the Commission relating to the growth and investor protection implications of hedge funds. The Commission received approximately 80 comment letters addressing these topics, which the staff considered in connection with the preparation of this Report.[8]

II. Legal Structure and Benefits of Hedge Funds

A. What is a Hedge Fund

Although there is no universally accepted definition of the term "hedge fund,"[9] the term generally is used to refer to an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act. Alfred Winslow Jones is credited with establishing one of the first hedge funds as a private partnership in 1949. That hedge fund invested in equities and used leverage and short selling to "hedge" the portfolio's exposure to movements of the corporate equity markets.[10] Over time, hedge funds began to diversify their investment portfolios to include other financial instruments and engage in a wider variety of investment strategies. Today, in addition to trading equities, hedge funds may trade fixed income securities, convertible securities, currencies, exchange-traded futures, over-the-counter derivatives, futures contracts, commodity options and other non-securities investments. Furthermore, hedge funds today may or may not utilize the hedging and arbitrage strategies that

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attorneys), investment bankers and hedge fund investors. Academics and foreign and U.S. regulators also participated in the Roundtable. A copy of the webcast and a transcript of the Roundtable discussions are available on the Commission's website. See http://www.connectlive.com/events/sechedgefunds/; http://www.sec.gov/spotlight/hedgefunds/hedge1trans.txt and http://www.sec.gov/spotlight/hedgefunds/hedge2trans.txt.

8 See *Notice of Roundtable Discussions; Request for Comment,* Advisers Act Release No. 2117 (Mar. 26, 2003). All comments received in response to the request are available from SEC public reference by calling (202) 942-8090, or by writing to: publicinfo@sec.gov. In addition, comments submitted by Roundtable panelists are available at http://www.sec.gov/spotlight/hedgefunds/hedge-parts.htm.

9 One Roundtable participant submitted a selection of definitions and descriptions of the term "hedge fund" that illustrates the diversity of views about that term. See Comment submitted by Roundtable Panelist David A. Vaughan.

10 Carol Loomis, *Hard Times Come to Hedge Funds* ("Loomis"), Fortune 100, 101 (Jan. 1970). One commenter suggested that the first hedge funds were merely implementing investment strategies first used by the proprietary trading desks of investment banks. See Hennessee Group Comment Letter, supra note 4, at 2.

hedge funds historically employed, and many engage in relatively traditional, long-only equity strategies.

B. Market Benefits of Hedge Funds

Hedge funds seek to achieve positive investment returns, often with less volatility than traditional asset classes such as stocks and bonds. Hedge funds engage in a wide variety of investment strategies, such as investing in distressed securities, illiquid securities, securities of companies in emerging markets and derivatives, as well as pursue arbitrage opportunities, such as those arising from possible mergers or acquisitions. They typically are managed by entrepreneurs who employ more complicated, flexible investment strategies than advisers at mutual funds, brokerage firms and bank trust departments.

Hedge funds can provide benefits to financial markets by contributing to market efficiency and enhancing liquidity. Many hedge fund advisers take speculative trading positions on behalf of their managed hedge funds based on extensive research about the true value or future value of a security. They may also use short-term trading strategies to exploit perceived mispricings of securities. Because securities markets are dynamic, the result of such trading is that market prices of securities will move toward their true value. Trading on behalf of hedge funds can thus bring price information to the securities markets, which can translate into market price efficiencies.[11] Hedge funds also provide liquidity to the capital markets by participating in the market.

Hedge funds play an important role in a financial system where various risks are distributed across a variety of innovative financial instruments. They often assume risks by serving as ready counterparties to entities that wish to hedge risk. For example, hedge funds are buyers and sellers of certain derivatives, such as securitized financial instruments, that provide a mechanism for banks and other creditors to un-bundle the risks involved in real economic activity. By actively participating in the secondary market for these instruments, hedge funds can help such entities to reduce or manage their own risks because a portion of the financial risks are shifted to investors in the form of these tradable financial instruments. By reallocating financial risk, this market activity provides the added benefit of lowering the financing costs

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[11] "[M]any of the things which [hedge funds] do . . . tend to refine the pricing system in the United States and elsewhere. And it is that really exceptionally and increasingly sophisticated pricing system which is one of the reasons why the use of capital in this country is so efficient . . . there is an economic value here which we should not merely dismiss . . . I do think it is important to remember that [hedge funds] . . . , by what they do, they do make a contribution to this country." Testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve, Before the House Committee on Banking and Financial Services (Oct. 1, 1998).

shouldered by other sectors of the economy. The absence of hedge funds from these markets could lead to fewer risk management choices and a higher cost of capital.

Hedge funds also can serve as an important risk management tool for investors by providing valuable portfolio diversification. Hedge fund investment strategies are typically designed to protect investment principal. Hedge funds frequently use financial instruments (e.g., derivatives) and techniques (e.g., short selling) to hedge against market risk and construct a conservative investment portfolio -- one designed to preserve wealth. In addition, hedge fund investment performance can exhibit low correlation to that of traditional investments in the equity and fixed-income markets.[12] Institutional investors have used hedge funds to diversify their investments based on this historic low correlation with overall market activity.

C. Pooled Investment Vehicles that Are Not Hedge Funds

Hedge funds are often compared to registered investment companies. In addition, unregistered investment pools, such as venture capital funds, private equity funds and commodity pools, are sometimes referred to as hedge funds. Although all of these investment vehicles are similar in that they accept investors' money and generally invest it on a collective basis,[13] they also have characteristics that distinguish them from hedge funds.

1. Registered Investment Companies

As a practical matter, hedge funds are similar to registered investment companies in a number of respects. Both are entities that issue securities to investors and hold pools of securities and perhaps other assets through which investors can obtain, among other things, investment diversification and professional asset management by an investment adviser who typically organizes the pool. Hedge funds and registered investment companies may invest in similar types of securities and may even share similar investment strategies.

Registered investment companies, however, also differ from hedge funds in a number of significant respects, including the extent to which they are regulated. Registered investment companies are registered with the Commission and are subject to the provisions of the Investment Company Act. Their securities offerings are almost always registered with the Commission and they are subject to the disclosure and reporting requirements of the federal

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12 See, e.g., Mark J.P. Anson, *Handbook of Alternative Assets* 37-40 (2002) ("*Handbook of Alternative Assets*").

13 But for certain exclusions set forth in the Investment Company Act, all of these vehicles would meet the definition of investment company in Section 3(a) of the Investment Company Act. See infra Part III.A.1. and 2.

securities laws. Finally, investment advisers to registered investment companies are required to register with the Commission under the Advisers Act.

Registered investment companies, which register their securities offerings under the Securities Act, generally may offer and sell their securities to any investor,[14] including investors who are not financially sophisticated. Most registered investment companies have a board of directors, a majority of whom are independent of the investment companies' investment adviser.[15] The board is responsible for selecting and overseeing the activities of the company's investment adviser and other service providers and for generally overseeing the company's operations.

In addition, registered investment companies are subject to extensive operational restrictions designed to prevent the potential for abuse that exists when an investment adviser has control of the assets of other persons who do not actively oversee the management of those assets. For example, registered investment companies are subject to regulations concerning the computation of the fund's net asset value,[16] as well as regulations designed to protect against

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[14] Recently, a number of hedge funds that invest all or substantially all of their assets in other hedge funds have begun registering under the Investment Company Act as closed-end investment companies, and many have also registered their securities offerings under the Securities Act. See infra Part IV.J. (discussing funds of hedge funds).

[15] See *Interpretive Matters Concerning Independent Directors of Investment Companies*, Investment Company Act Release No. 24083 text accompanying n. 4 (Oct. 14, 1999) ("Congress intended to place independent directors in the role of 'independent watchdogs,' who would furnish an independent check upon the management of funds and provide a means for the representation of shareholder interests in fund affairs.")(citations omitted).

[16] Under the Investment Company Act, a registered investment company must value its portfolio securities using market quotations or, if market quotations are not readily available, fair value as determined in good faith by the company's board of directors. See Section 2(a)(41) of the Investment Company Act and Rule 2a-4 thereunder. See also Accounting Series Release No. 118, Financial Reporting Codification (CCH) §404.03 (Dec. 23, 1970) ("ASR No. 118"); Accounting Series Release No. 113, Financial Reporting Codification (CCH) §404.04 (Oct. 21, 1969); Letters to Craig S. Tyle, General Counsel, Investment Company Institute, from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management (Dec. 8, 1999; Apr. 30, 2001). Most boards fulfill their obligations by approving and monitoring the implementation of valuation procedures and methodologies. Boards of registered investment companies are also required to continuously review the appropriateness of their valuation methodologies. See ASR No. 118.

conflicts of interest and limit leverage (and consequently certain trading strategies).[17] They also are subject to regulations requiring shareholder reports.[18]

2. *Private Equity Funds*

A private equity fund, like a hedge fund, is an unregistered investment vehicle in which investors pool money to invest in securities. Private equity funds concentrate their investments in unregistered (and typically illiquid) securities. Both private equity funds and domestic hedge funds are typically organized as limited partnerships.[19] Because these entities rely on an exemption from registration of the offer and sale of their securities, the managers/sponsors of both private equity funds and hedge funds solicit investors directly, or through a registered broker-dealer, rather than through general solicitation, general advertising or a public offering of the securities. The investors in private equity funds and hedge funds typically include high net worth individuals and families, pension funds, endowments, banks and insurance companies.[20] Like hedge funds, many private equity funds establish offshore "mirror" funds that are typically managed by the general partner of the companion U.S. fund and have similar investments.

Private equity funds, however, differ from hedge funds in a number of significant ways. Private equity investors typically commit to invest a certain amount of money with the fund over the life of the fund, and make their contributions in response to "capital calls" from the fund's general partner. Because private equity funds typically do not retain a pool of uninvested capital, their general partners make a capital call when they have identified or expect to identify a portfolio company in which the private equity fund will invest.[21] Private equity funds are long-

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17 See Investment Company Act Sections 10(f); 17 (conflicts of interest) and 18 (leverage).

18 See Investment Company Act Section 30(e) and Rule 30e-1 thereunder.

19 See George W. Fenn, Nellie Lang and Stephen Prowse, *The Economics of the Private Equity Market,* Staff Study of the Board of Governors of the Federal Reserve System 41 (1995). Like domestic hedge funds, some private equity funds are organized as limited liability companies and, occasionally, corporations.

20 "[I]ndividuals and families account for less than 10 percent of the assets invested in private equity funds, pension funds account for about 30 percent, endowments account for about 20 percent, and banks and insurance companies account for about 40 percent." Secretary of the Treasury, Board of Governors of the Federal Reserve System, and Securities and Exchange Commission, *A Report to Congress in Accordance with § 356(c) of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001* n. 95 (Dec. 31, 2002) ("Patriot Act Report").

21 A hedge fund investor, by contrast, generally can decide when and how much to invest in the fund.

term investments, provide for liquidation at the end of the term specified in the fund's governing documents, and offer little, if any, opportunity for investors to redeem their investments.[22] A private equity fund, however, may distribute cash to its investors when it sells its portfolio investment, or it may distribute the securities of a portfolio company (assuming the portfolio company has complied with the registration requirements of the Securities Act in connection with the distribution) to its investors.

3. Venture Capital Funds

Venture capital funds are unregistered investment vehicles, which are structurally similar to hedge funds and attract similar types of investors.[23] Venture capital pools are generally organized, however, to invest in the start-up or early stages of a company.

Venture capital funds have the same features that distinguish private equity funds generally from hedge funds, such as mandatory capital contributions over the life of the fund and the long-term nature of the investment. In addition, unlike hedge fund advisers, general partners of venture capital funds often play an active role in the companies in which the funds invest, either by sitting on the board of directors or becoming involved in the day-to-day management of these companies. In contrast to a hedge fund, which may hold an investment in a portfolio security for an indefinite period based on market events and conditions, a venture capital fund typically seeks to liquidate its investment once the value of the company increases above the value of the investments.

4. Commodity Pools

Commodity pools are investment trusts, syndicates or similar enterprises that are operated for the purpose of trading commodity futures. The investment concentration in commodity futures distinguishes commodity pools from hedge funds and the other investment vehicles

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[22] There is typically no formal secondary market for shares in a private equity fund, although there may be a small informal secondary market comprised of private equity funds that buy interests in other established private equity funds. In 1999, five private equity funds raised $1.6 billion for purchases of secondary interests in other private equity funds. See Patriot Act Report, supra note 20, at n. 99 (citation omitted). See also David M. Toll, *Private Equity Primer*, in *Galante's Venture Capital & Private Equity Directory*.

[23] See National Venture Capital Association, *2003 National Venture Capital Association Yearbook* 9 (2003). The National Venture Capital Association estimates that 1,798 venture capital funds were in existence in 2002, with $253 billion in capital under management. It also estimates that, in 2002, individuals and families accounted for approximately nine percent of the invested assets in venture capital funds; pension funds accounted for 42 percent; endowments accounted for 21 percent; and banks, insurance companies and corporations accounted for 28 percent. Id. at 10.

discussed above.[24] Commodity pool operators, which manage commodity pools, are subject to oversight by the Commodity Futures Trading Commission ("CFTC"). The CFTC has recently adopted rules which sharpen the distinction between hedge funds and commodity pools.[25]

D. Domestic and Offshore Hedge Funds

The corporate structure of a hedge fund depends primarily on whether the fund is organized under U.S. law ("domestic hedge fund") or under foreign law and located outside of the United States ("offshore hedge fund"). The investment adviser of a domestic hedge fund often operates a related offshore hedge fund, either as a separate hedge fund or often by employing a "master-feeder" structure that allows for the unified management of multiple pools of assets for investors in different taxable categories.[26]

1. Domestic Hedge Funds

Domestic hedge funds are usually organized as limited partnerships to accommodate investors that are subject to U.S. income taxation.[27] The fund's sponsor typically is the general partner and investment adviser. The sponsor also typically handles marketing and investor services. Domestic hedge funds typically maintain contractual relationships with one or more broker-dealers, which provide clearance and settlement and financing services and may provide a

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[24] Commodity pools also differ from hedge funds, private equity funds and venture capital funds in that commodity pools frequently rely on Section 3(b)(1) of the Investment Company Act to exclude them from the definition of investment company. Section 3(b)(1) excludes from that definition any issuer that is directly or indirectly primarily engaged in a business other than investing or trading in securities.

[25] See infra Part III.E.1 (discussing the regulation of commodity pools).

[26] The master fund is usually organized as a corporation, such as an international business company, under non-U.S. law. It offers shares to one or more domestic feeder funds and one or more offshore corporate feeder funds, all of which share common investment strategies and objectives. See Gerald T. Lins ("Lins"), *Hedge Fund Organization*, in *Hedge Fund Strategies: A Global Outlook* 98, 100-101 (Brian R. Bruce, ed., 2002).

[27] Hedge funds may also take the form of limited liability companies ("LLCs") or business trusts. Limited partnerships, LLCs and business trusts are generally not separately taxed and, as a result, income is taxed only at the level of the individual investor. Each of the three forms also limits investor liability. LLCs offer the additional benefit of limited liability for fund advisers, but some states and foreign countries tax LLCs as corporations. See David A.Vaughan and Margaret A. Bancroft, *Structuring Issues for Hedge Funds*, in *The Capital Guide to Starting a Hedge Fund – A U.S. Perspective* 31, 32 (2001).

variety of incidental services.[28] A domestic hedge fund also may employ executing brokers, accountants, lawyers, custodians, administrators, placement agents, registrars and transfer agents. Domestic hedge funds typically do not have a board of directors or any oversight body analogous to the board of directors of a registered investment company.

2. *Offshore Hedge Funds*

Offshore hedge funds are typically organized as corporations in countries such as the Cayman Islands, British Virgin Islands, the Bahamas, Panama, the Netherlands Antilles or Bermuda. Offshore funds generally attract investment of U.S. tax-exempt entities, such as pension funds, charitable trusts, foundations and endowments, as well as non-U.S. residents. U.S. tax-exempt investors favor investments in offshore hedge funds because they may be subject to taxation if they invest in domestic limited partnership hedge funds.[29] Offshore hedge funds may be organized by foreign financial institutions or by U.S. financial institutions or their affiliates. Sales of interests in the United States in offshore hedge funds are subject to the registration and antifraud provisions of the federal securities laws.

Offshore hedge funds typically contract with an investment adviser, which may employ a U.S. entity to serve as subadviser.[30] An offshore hedge fund often has an independent fund administrator, also located offshore, that may assist the hedge fund's adviser to value securities and calculate the fund's net asset value, maintain fund records, process investor transactions, handle fund accounting and perform other services.[31] An offshore hedge fund sponsor typically appoints a board of directors to provide oversight activities for the fund. These funds, especially those formed more recently, may have directors who are independent of the investment adviser.

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[28] See Roundtable Transcript, May 14 (statement of Richard Lindsey). See infra Part IV.E.2 (discussing the role of broker-dealers/prime brokers).

[29] Under U.S. income tax laws, a tax-exempt organization (such as an ERISA plan, a foundation or an endowment) engaging in an investment strategy that involves borrowing money is liable for a tax on "unrelated business taxable income" ("UBTI"), notwithstanding its tax-exempt status. The UBTI tax can be avoided by the tax-exempt entity by investing in non-U.S. corporate structures (i.e., offshore hedge funds). See http://www.greencompany.com/HedgeFunds/OffDocOffshore.shtml.

[30] Lins, supra note 26 at 100**.**

[31] According to one Roundtable participant, there is a "trend towards more independent administration for domestic [hedge] funds, which traditionally have handled administration through fund affiliates." Roundtable Transcript, May 14 (statement of William Keunen). See also Roundtable Transcript, May 14 (statement of Joel Press). See infra Part IV.E.3 (discussing the role of offshore administrators).

III. The Regulation of Hedge Funds and Their Advisers

A. Hedge Funds and the Investment Company Act of 1940

Most hedge funds have substantial investments in securities that would cause them to fall within the definition of investment company under the Investment Company Act.[32] Hedge funds, however, typically rely on one of two statutory exclusions from the definition of investment company, which enables them to avoid the regulatory provisions of that Act.

1. Section 3(c)(1)

Section 3(c)(1) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 investors and which is not making and does not presently propose to make a public offering of its securities.[33] In general, ownership by a corporate investor is counted as one investor in testing compliance with the 100-investor limitation of Section 3(c)(1).[34] Section 3(c)(1) reflects Congress's view that privately placed

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[32] Section 3(a)(1)(A) of the Investment Company Act defines an investment company as an issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(C) of that Act defines an investment company as an issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of its total assets (exclusive of government securities and cash items) on an unconsolidated basis. Many hedge funds meet both of these definitions.

[33] Notwithstanding the 100-investor limitation, a hedge fund that is incorporated offshore, but relies on Section 3(c)(1) in order to offer its securities privately to U.S. residents, may have more than 100 investors. The staff of the Division of Investment Management takes the position that an offshore hedge fund that relies on Section 3(c)(1) may exclude non-U.S. investors in determining whether it is in compliance with the 100-investor limitation of Section 3(c)(1). See *Touche, Remnant & Co.* (pub. avail. Aug. 27, 1984); *Investment Funds Institute of Canada* (pub. avail. Mar. 4, 1996) (staff states that it would not recommend enforcement action if an offshore hedge fund relying on Section 3(c)(1) exceeds the 100-investor limit because investors who purchased securities outside the United States have relocated to the United States). In practice, many offshore hedge funds relying on Section 3(c)(1) have more than 100 investors.

[34] If a corporate investor that is a registered investment company, or a company relying on Section 3(c)(1) or Section 3(c)(7), beneficially owns ten percent or more of the outstanding voting securities of the Section 3(c)(1) fund, the Section 3(c)(1) fund must "look-through" that corporate investor and count each of its investors as a beneficial owner of the Section 3(c)(1) fund for purposes of the 100-investor limitation. A hedge fund that relies on Section 3(c)(1) and that accepts investments from registered investment companies or entities relying on Section 3(c)(1)

investment companies owned by a limited number of investors do not rise to the level of federal interest under the Investment Company Act.[35]

Hedge funds relying on Section 3(c)(1) may not be making or proposing to make a public offering. As discussed further below, these hedge funds must comply with Section 4(2) of the Securities Act, and frequently do so by relying on the safe harbor available under Regulation D under that Act, as discussed below.[36] Consequently, hedge funds may offer their securities only to "accredited investors," and may not engage in any general solicitation or general advertising of their shares, as discussed below.

2. Section 3(c)(7)

Section 3(c)(7) of the Investment Company Act excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers,"[37] and which is not

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or Section 3(c)(7), therefore, must ensure that those investors do not acquire more than ten percent of the hedge fund's outstanding voting securities so that the hedge fund may continue to rely on Section 3(c)(1).

[35] See *Investment Trusts and Investment Companies: Hearings on S. 3580 before a Subcomm. of the Senate Comm. on Banking and Currency,* 76th Cong., 3d Sess. 179 (1940).

[36] See infra Part III.B.2 (discussing Regulation D). The staff of the Division of Investment Management generally interprets the non-public offering requirement of Section 3(c)(1) consistently with the non-public offering exemptions under Section 4(2) of the Securities Act and the rules thereunder. See, e.g., *Santa Barbara Securities* (pub. avail. Apr. 8, 1983). See also *Lamp Technologies* (pub. avail. May 29, 1997; May 29, 1998) ("*Lamp*").

[37] Section 2(a)(51) of the Investment Company Act generally defines "qualified purchaser" to be: (1) any natural person who owns not less than $5 million in investments; (2) any family-owned company (as described in that section) that owns not less than $5 million in investments; (3) any other trust the trustee and settlor(s) of which are qualified purchasers that was not formed for the specific purpose of acquiring the securities of the Section 3(c)(7) fund; and (4) any person acting for its own account or the accounts of other qualified purchasers, that owns and invests on a discretionary basis not less than $25 million in investments. Rule 2a51-1 under the Investment Company Act defines the term "investments" for purposes of Section 2(a)(51), and details how the value of a qualified purchaser's investments should be calculated. Rule 2a51-3 under the Investment Company Act provides that any company may be deemed to be a qualified purchaser if each beneficial owner of the company's securities is a qualified purchaser. The staff of the Division of Investment Management takes the position that a hedge fund that is incorporated offshore but relies on Section 3(c)(7) to offer its securities privately in the United States is not subject to the qualified purchaser requirements with respect to its investors who are non-U.S. residents. See *Goodwin Proctor & Hoar* (pub. avail. Feb. 28, 1997).

making and does not at that time propose to make a public offering of its securities.[38] This exclusion reflects Congress's view that certain highly sophisticated investors do not need the protections of the Investment Company Act because those investors are in a position to appreciate the risks associated with pooled investment vehicles.[39]

A hedge fund relying on Section 3(c)(7) may accept an unlimited number of qualified purchasers for investment in the fund. As a practical matter, however, most funds relying on Section 3(c)(7) have no more than 499 investors in order to avoid the registration and reporting requirements of the Securities Exchange Act of 1934 ("Exchange Act").[40] In addition, unlike Section 3(c)(1), Section 3(c)(7) does not have a "look-through" provision in the event that a registered investment company or a private investment company owns ten percent or more of the Section 3(c)(7) fund's outstanding voting securities. A Section 3(c)(7) fund is only required to look through any company (investment company or otherwise) that invests in its shares to determine whether that company's investors are qualified purchasers if the company was "formed for the purpose" of investing in the Section 3(c)(7) fund.[41]

B. Hedge Funds and the Securities Act of 1933

One of the Securities Act's primary objectives is to provide full and fair disclosure in securities transactions. To accomplish this objective, Section 5 of the Securities Act mandates the registration with the Commission of public securities offerings and the delivery to purchasers of a prospectus containing specified categories of information about the issuer and the securities being offered, unless there is an available exemption from the registration requirements. Since limited partnership, LLC and other interests offered to investors in the case of a typical hedge fund fall within the definition of the term "securities" for purposes of the federal securities laws, the hedge funds must either register the offer and sale of the securities or rely on an exemption

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[38] As with respect to a Section 3(c)(1) fund, the Commission has stated that the non-public offering requirement of Section 3(c)(7) should be interpreted consistently with the non-public offering exemptions under Section 4(2) of the Securities Act and the rules thereunder. *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 n. 5 (Apr. 3, 1997). See supra note 36.

[39] S. Rep. No. 293, 104th Cong., 2d. Sess. 10 (1996) ("Generally, these investors can evaluate on their own behalf matters such as the level of a fund's management fees, governance provisions, transactions with affiliates, investment risk, leverage, and redemption rights.").

[40] See infra Part III.C.2 (discussing Exchange Act registration under Section 12).

[41] Rule 2a51-3 generally provides, in relevant part, that an entity may not be deemed to be a qualified purchaser if it was formed for the specific purpose of acquiring the securities offered by a Section 3(c)(7) fund unless each beneficial owner of an entity's securities is a qualified purchaser.

from registration. Offerings of hedge fund securities in the United States generally rely on the private offering exemption in Section 4(2) of the Securities Act or Rule 506 promulgated under that Section to avoid the registration and prospectus delivery requirements of Section 5.

1. *The Private Offering Exemption of the Securities Act*

Section 4(2) of the Securities Act exempts from the registration and prospectus delivery requirements of Section 5 any "transactions by an issuer not involving any public offering." The Section 4(2) exemption, commonly known as the "private offering" or "private placement" exemption, requires no notice or other filing or regulatory approval as a prerequisite for its availability.

The procedures appropriate to establish the availability of an exemption under Section 4(2) have evolved over time based upon judicial decisions, Commission interpretive guidance and shared experience. The Supreme Court in *Ralston Purina* stated that a private offering is an "offering to those who are shown to be able to fend for themselves" and that the availability of the exemption "turns on the knowledge of the offerees" and is limited to situations where the offerees have access to the kind of information afforded by registration under Section 5 of the Securities Act.[42]

2. *Regulation D*

a. *Rule 506*

Rule 506 of Regulation D under the Securities Act is a set of requirements promulgated by the Commission to govern private offerings. Although compliance with the Rule 506 requirements is not required to establish the availability of a private offering exemption, satisfaction of the conditions of the rule entitles an issuer to claim the Section 4(2) exemption. In this sense, Rule 506 establishes "safe harbor" criteria for the private offering exemption, but is not the exclusive means of establishing entitlement to the exemption. Because of a degree of uncertainty as to the availability of the Section 4(2) exemption, many hedge funds tailor their offering and sale procedures to the criteria specified in Rule 506.

b. *Offerings to "Accredited Investors"*

The safe harbor protection most often relied upon by hedge funds under Rule 506 exempts offerings that are made exclusively to "accredited investors."[43] Issuers are permitted

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[42] SEC v. Ralston Purina Co., 346 U.S. 119, 125, 126-27 (1953).

[43] While Rule 506(b)(2)(i) limits the number of purchasers in a Rule 506 transaction to 35, this numerical limitation becomes irrelevant if the offering is made only to "accredited investors"

under these provisions to sell securities to an unlimited number of "accredited investors."[44] In addition, if the offering is made only to accredited investors, no specific information is required to be provided to prospective investors.

The term "accredited investors" is defined to include:

> Individuals who have a net worth, or joint worth with their spouse, above \$1,000,000, or have income above \$200,000 in the last two years (or joint income with their spouse above \$300,000) and a reasonable expectation of reaching the same income level in the year of investment; or are directors, officers or general partners of the hedge fund or its general partner; and
>
> Certain institutional investors, including: banks; savings and loan associations; registered brokers, dealers and investment companies; licensed small business investment companies; corporations, partnerships, limited liability companies and business trusts with more than \$5,000,000 in assets; and many, if not most, employee benefit plans and trusts with more than \$5,000,000 in assets.[45]

Although most of these thresholds were initially established in 1982, the Commission has modified the definition of accredited investor since then and has had the opportunity to reevaluate the thresholds.[46] Most recently, the Commission, in December 2001, proposed that the term "qualified purchaser" be defined under the Securities Act to mean "accredited investor" as defined in Rule 501(a) of Regulation D under the Securities Act.[47] At that time, the

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because Rule 501(e)(1)(iv) provides that "accredited investors" are not counted for purposes of determining whether the issuer has exceeded the 35-purchaser limit.

[44] On its face, Rule 506 appears to permit offerings to hundreds of investors, as long as no more than 35 purchasers are not accredited investors. In the original proposing release for Regulation D, the Commission indicated that it was aware of this potential and issued this warning:

> The Commission cautions issuers . . . that depending on the actual circumstances, offerings made to such large numbers of purchasers may involve a violation of the prohibitions against general solicitation and general advertising.

Proposed Revisions of Certain Exemptions, Securities Act Release No. 6339 n. 30 (Aug. 7, 1981).

[45] See Rule 501 under the Securities Act.

[46] See *Defining the Term "Qualified Purchaser" Under the Securities Act of 1933*, Securities Act Release No. 8041 (Dec. 19, 2001) (history of accredited investor concept).

[47] Id.

Commission stated in the proposing release that the existing "accredited investor" standard struck the appropriate balance between investor protection and capital formation needs and did not propose changes to the definition.

c. General Solicitation and General Advertising

Offers and sales under Rule 506 cannot be made using any form of "general solicitation or general advertising." The current parameters of prohibited and permissible activities are set out in Rule 502(c) under the Securities Act, Commission staff no action letters, Commission releases and enforcement and private actions. The restrictions on general solicitation and general advertising in finding investors for private offerings mean that issuers and persons acting on their behalf cannot find investors through, among other things, advertisements, articles, notices or other communications published in a newspaper, magazine or similar media, cold mass mailings, broadcasts over television or radio, material contained on a web site available to the public or an e-mail message sent to a large number of previously unknown persons.[48] The restrictions also apply to any meeting or seminar where the participants have been invited by general solicitation or general advertising.

One central principle in the interpretations is that general solicitation is not present when there is a pre-existing, substantive relationship between an issuer or its broker-dealer, and the offeree. The relationship must be established at a time prior to the commencement of the private offering or, in the case of a hedge fund, 30 days before the investor can make an investment.[49] The existence of a pre-existing, substantive relationship is not the only way to avoid a general solicitation. The presence or absence of a general solicitation depends on the facts and circumstances of each particular case.

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[48] See Rule 506 under the Securities Act; *SEC v. Inorganic Recycling Corp.*, Litigation Release No. 16322 (Sept. 30, 1999); *In the Matter of CGI Capital, Inc.*, Securities Act Release No. 7904 (Sept. 29, 2000); *In the Matter of Harry Harootunian and Professional Planning & Technologies, Inc. and In the Matter of Robert Testa*, Exchange Act Release No. 32981 (Sept. 29, 1993); *In the Matter of Kenman Corp.*, Exchange Act Release No. 21962 (Apr. 19, 1985); *In the Matter of PriorityAccess, Inc.*, Securities Act Release No. 8021 (Oct. 3, 2001); *Circle Creek Aquaculture V, L.P.* (pub. avail. Mar. 26, 1993); *H.B. Shaine & Co.* (pub. avail. May 1, 1987); *Ovation Cosmetics, Inc.* (pub. avail. Mar. 8, 1976); *Woodtrails-Seattle, Ltd.* (pub. avail. Aug. 9, 1982).

[49] Many of the interpretive letters that the staff of the Division of Corporation Finance has issued address the circumstances under which issuers and broker-dealers can establish the pre-existing substantive relationship without violating the restrictions on general solicitation and advertising. See, e.g., *Bateman Eichler, Hill Richards, Inc.* (pub. avail. Dec. 3, 1985); *E.F. Hutton Co.* (pub. avail. Dec. 3, 1985); *IPONET* (pub. avail. July 26, 1996) ("IPONET"); *Lamp,* supra note 36.

With respect to online private offerings under Regulation D, the Commission has stated that "[b]road use of the Internet for exempt securities offerings under Regulation D is problematic because of the requirement that these offerings not involve a general solicitation or advertising."[50] The Commission and staff, on numerous occasions, have made clear how the Internet can be used in private offerings of securities without running afoul of the prohibitions on general solicitation and general advertising.[51] The staff of the Division of Corporation Finance has granted no action relief where a broker-dealer, on behalf of other issuers, solicited, pre-qualified and made offers to potential investors via the Internet.[52] In a letter involving hedge funds, the staff of the Division of Corporation Finance determined that there was no general solicitation if investors were solicited, pre-qualified and able to access a password protected web site containing information on hedge funds to purchase hedge fund interests 30 days after the investor was qualified.[53]

d. Resale Restrictions

Hedge funds relying on Rule 506 must exercise reasonable care to assure that their investors are not investing with a view to distributing their interests in the fund to the public. Unrestricted resales of the interests can jeopardize the availability of Rule 506 protection even if the original sales qualify for the protection. Rule 506 provides safe harbor protection for issuers against the loss of Rule 506 protection because of resales.[54] The conditions for the safe harbor include "reasonable inquiry to determine if the purchaser is acquiring the securities for himself or for other persons" and "written disclosure . . . that the securities . . . cannot be resold unless they are registered under the [Securities] Act or unless an exemption from registration is available."[55]

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[50] *Use of Electronic Media*, Securities Act Release No. 7856 (Apr. 28, 2000) ("2000 Electronic Release").

[51] *Use of Electronic Media for Delivery Purposes*, Securities Act Release No. 7233 (Oct. 6, 1995); *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Securities Act Release No. 7516 (Mar. 23, 1998); 2000 Electronic Release, supra note 50; *IPONET,* supra note 49; *Lamp,* supra note 36.

[52] *IPONET*, supra note 49.

[53] *Lamp,* supra note 36. The staff of the Division of Corporation Finance also has addressed general solicitation issues in the context of other privately offered funds. See *Royce Exchange Fund, Quest Advisory Corp.* (pub. avail. Aug. 28, 1996).

[54] Rule 502 under the Securities Act is incorporated into Rule 506 under the Securities Act.

[55] Rule 502(d) under the Securities Act.

In addition, the safe harbor is conditioned upon the placement of a legend on the certificate or other document that evidences the securities.

These resale restrictions ordinarily do not present a problem for hedge funds. For a variety of business and legal reasons, the principals of hedge funds normally have no interest in encouraging resale of interests in their funds. In the usual case, therefore, transfers of the interests are prohibited without the written consent of the general partner or other manager, and there is limited liquidity of the interests through sales and redemptions by the hedge funds.

C. Hedge Funds and the Securities Exchange Act of 1934

1. Definition of "Broker" and "Dealer"

Some hedge funds may need to register with the Commission as dealers. Section 3(a)(5) of the Exchange Act generally defines a dealer as a person that is engaged in the business of buying and selling securities for its own account. The Commission historically has distinguished "dealers" from "traders." A trader is a person that buys and sells securities, either individually or in a trustee capacity, but not as part of a regular business. Entities that buy and sell securities for investment generally are considered traders, but not dealers. In contrast to dealers, which must register with the Commission in accordance with Section 15(b) of the Exchange Act, there is no registration requirement for traders.[56]

2. Exchange Act Registration Under Section 12

The Exchange Act contains registration and reporting provisions that may apply to hedge funds. Section 12 of the Exchange Act and the rules promulgated thereunder govern the registration of classes of equity securities traded on an exchange or meeting the holder of record and asset tests of Section 12(g) and related rules. Section 12(g) and Rule 12g-1 thereunder require that an issuer having 500 holders of record of a class of equity security (other than an exempted security) and assets in excess of $10 million at the end of its most recently ended fiscal year register the equity security under the Exchange Act. Registration of a class of equity security subjects domestic registrants to the periodic reporting requirements of Section 13, proxy requirements of Section 14 and insider reporting and short swing profit provisions of Section 16 of the Exchange Act. Although hedge fund interests fall within the definition of equity security

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[56] See generally Testimony of Richard R. Lindsey, Director, Division of Market Regulation, U.S. Securities and Exchange Commission, *Concerning Hedge Fund Activities in the U.S. Financial Markets*, Before the House Committee on Banking and Financial Services (Oct. 1, 1998); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, *Concerning Hedge Fund Activities in the U.S. Financial Markets*, Before the House Committee on Banking, Finance and Urban Affairs (Apr. 13, 1994). See also *Davenport Management, Inc*. (pub. avail. Apr. 13, 1993); *Louis Dreyfus Corp.* (pub. avail. July 23, 1987).

under the Exchange Act, most hedge funds seek to avoid Exchange Act registration by having fewer than 500 holders of record (which in the case of hedge funds are also generally the investors).

3. Beneficial Ownership Reporting under Sections 13 and 16 of the Exchange Act

The beneficial ownership reporting rules under Sections 13(d) and 13(g) of the Exchange Act generally require that any person who, after acquiring beneficial ownership of any equity securities registered under Section 12 of the Exchange Act, beneficially owns greater than five percent of the class of equity securities, file a beneficial ownership statement containing the information required by Schedule 13D or Schedule 13G.[57] Beneficial ownership is broadly defined by Rule 13d-3 under the Exchange Act to include the power to vote or dispose of any equity securities, or the power to direct the voting or disposition of those securities. Due to the power a hedge fund's adviser may exercise over the equity securities held by the fund, both the hedge fund and its adviser generally will be deemed to beneficially own any equity securities owned by the hedge fund.[58] In certain specified circumstances, the hedge fund and its advisers may file a short form Schedule 13G in lieu of filing a Schedule 13D.[59]

In addition to the amount of equity securities beneficially owned by the reporting person and the percentage of the subject class of equity securities this amount represents, Schedule 13D requires disclosure of certain other material information regarding the reporting person (e.g., identity and background) and the acquisition of the securities (e.g., source and amount of funds or other consideration used or to be used in making the purchase; the purpose of the acquisition; contracts, arrangements, understandings or other relationships between the reporting persons with respect to any securities of the issuer, etc.). The information required to be disclosed by Schedule 13G is more limited than the information required to be disclosed by Schedule 13D.[60] Once a hedge fund and its advisers are subject to the reporting obligations of Sections 13(d) or

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57 See Rule 13d-1(a) under the Exchange Act.

58 See Example 11 from *Adoption of Beneficial Ownership Disclosure Requirements*, Exchange Act Release No. 13291 (Feb. 24, 1977) (power over discretionary accounts represents beneficial ownership of the shares held in those accounts).

59 See Rule 13d-1(b) under the Exchange Act.

60 For example, Schedule 13G does not require as much disclosure on the background of the reporting person, does not require any disclosure as to the source of the funds used in the transaction, and does not require a statement as to the purpose of the transaction (other than a certification that the purpose is not to change or influence control over the issuer). See Instructions to Schedule 13G.

13(g), previously filed beneficial ownership statements must be amended as a result of certain changes in the information disclosed.[61]

In addition, hedge fund advisers also may be subject to the quarterly reporting obligations of Section 13(f) of the Exchange Act, which apply to any "institutional investment manager" exercising investment discretion with respect to accounts having an aggregate fair market value of at least $100 million in equity securities. An "institutional investment manager" includes any person (other than a natural person) investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.[62]

Section 16 applies to every person who is the beneficial owner of more than ten percent of any class of equity security registered under Section 12 of the Exchange Act and each officer and director of the issuer of the security (collectively, "reporting persons" or "insiders"). Upon becoming a reporting person, a person is required by Section 16(a) to file an initial report with the Commission disclosing the amount of his or her beneficial ownership of all equity securities of the issuer. Section 16(a) also requires reporting persons to keep this information current by reporting to the Commission changes in ownership of these equity securities, or the purchase or sale of security-based swap agreements involving these securities.[63] Hedge funds are also subject to the short swing profit provisions of Section 16(b) of the Exchange Act.

D. Hedge Fund Advisers and the Investment Advisers Act of 1940

Virtually all hedge fund advisers meet the definition of "investment adviser" under the Advisers Act.[64] Under the Advisers Act, investment advisers must register with the Commission and comply with the provisions of that Act and Commission rules. Registered investment advisers must keep current a Form ADV that is filed with the Commission and provide a

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61 See Rule 13d-2 under the Exchange Act.

62 See Section 13(f)(5)(A) of the Exchange Act.

63 See Section 16(a)(3)(B) of the Exchange Act.

64 Section 202(a)(11) of the Advisers Act generally defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities." The Advisers Act contains certain limited exceptions from this definition for banks, certain professionals, including lawyers and accountants, broker-dealers, publishers and persons giving advice only about U.S. government securities.

disclosure statement that includes the information disclosed on Part II of Form ADV to clients.[65] These disclosures provide both the Commission and investors with current information about the adviser's business practices and disciplinary history, among other things. Registered advisers must maintain required books and records[66] and submit to periodic examinations by the Commission's staff. Advisers registered with the Commission also must comply with other requirements, including those relating to safeguarding client assets that are in the adviser's custody[67] and requiring that clients be told of an adviser's adverse financial condition.[68] Registered investment advisers must also inform clients of the adviser's proxy voting practices.[69] The Advisers Act also prohibits them from defrauding their clients.[70]

Many hedge fund advisers, however, avoid registering with the Commission by relying on the Advisers Act's *de minimis* exemption under Section 203(b) of that Act. That section excludes from registration investment advisers that have had fewer than 15 clients during the preceding 12 months, do not hold themselves out generally to the public as an investment adviser and are not an investment adviser to a registered investment company.[71] For purposes of Section 203(b), current Commission rules provide that investment advisers may count a "legal organization," such as a hedge fund, as a single client.[72] Thus, an adviser may manage up to 14 hedge funds before being required to register with the Commission as an investment adviser, so long as it satisfies the "no holding out" condition. Investment advisers that are exempt from registration nevertheless are subject to the antifraud provisions of the Advisers Act.

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65 See Rule 204-3 under the Advisers Act.

66 See Rule 204-2 under the Advisers Act.

67 See Rule 206(4)-2 under the Advisers Act.

68 See Rule 206(4)-4 under the Advisers Act.

69 See Rule 206(4)-6 under the Advisers Act.

70 Section 206(1) of the Advisers Act prohibits investment advisers from employing "any device, scheme or artifice to defraud any client or prospective client." Section 206(2) of the Advisers Act prohibits and investment adviser from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client."

71 Section 203(b)(3) of the Advisers Act.

72 Rule 203(b)(3)-1 under the Advisers Act provides that an adviser may count a legal organization as a single client if the legal organization receives investment advice based on its investment objectives rather than on the individual investment objectives of its owners.

Registered investment advisers are not required to indicate whether they manage hedge funds. They are also not required to state the amount of hedge fund assets under their management. A recent survey identifying the largest hedge fund firms accounts for slightly under half of the estimated $600 billion in U.S. hedge fund assets.[73] Approximately 52 percent of the domestic advisers in this survey, managing some $158 billion of hedge fund assets, are not registered with the Commission as investment advisers.[74] There is no comprehensive database or survey of the smaller firms managing the other half of U.S. hedge fund assets – approximately another $300 billion. We expect that relatively fewer of these smaller advisers would be registered with the Commission, and that the proportion of hedge fund advisers not registered with us industry-wide may be approximately two-thirds.[75]

A number of hedge fund advisers, however, do register as investment advisers under the Advisers Act. Some are required to register because they have 15 or more advisory clients, or they advise one or more registered investment companies, and therefore are ineligible for the *de minimis* exemption. Others have registered with the Commission voluntarily because their investors demand it or for competitive reasons.[76]

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[73] See Institutional Investor, *The Hedge Fund 100* (June 2002) ("*The Hedge Fund 100*") (The survey lists 86 U.S.-based and U.S.-registered firms managing $298 billion in hedge fund assets. It also covered 14 internationally based firms managing approximately $42 billion in hedge fund assets.).

[74] Forty-eight percent of the domestic hedge fund advisers listed in *The Hedge Fund 100* are registered with the Commission and manage a total of $140 billion in hedge funds.

[75] This expectation is based on our assumption that smaller hedge fund advisers who are not named in *The Hedge Fund 100* are more likely to operate without registering with the Commission than larger hedge fund advisers. Larger hedge fund advisers are more likely to serve investors who demand registration, such as pension plans and many endowments, or to engage in other advisory activities such that the adviser is no longer eligible for the exception under Section 203(b)(3).

[76] Hennessee Group Comment Letter, supra note 4, at 14 ("Due to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from that market."); Roundtable Transcript, May 15 (statement of Sandra Manzke) (institutional investors are requiring that hedge fund advisers register). See also *U.S. Hedge Fund Regulations Might Help Industry in Long Run*, Reuters English News Service (May 24, 2002) ("We registered with the SEC because it was simply easier to say that we were registered. A few fraud cases have gotten attention and when someone writes a $10 million check, they want some assurances." (Quoting Jerry Paul of Quixote Capital Management LLC)).

E. Certain Other Regulatory Requirements

Depending upon their activities, in addition to complying with the federal securities laws, hedge funds and their advisers may have to comply with other laws including the Commodity Exchange Act ("CEA"), rules promulgated by the National Association of Securities Dealers ("NASD") and/or provisions of the Employment Retirement Income Security Act ("ERISA"). In addition, hedge funds may be subject to certain regulations promulgated by the Department of the Treasury, including rules relating to the prevention of money laundering. Moreover, hedge fund advisers are subject to certain state laws.

1. Regulation under the CEA

Generally, a hedge fund that engages in even a single commodity futures transaction will be deemed to be a "commodity pool" by the CFTC.[77] Similarly, the person that organizes and provides futures advice to such a hedge fund will typically fall within the statutory definitions of "Commodity Pool Operator" ("CPO") and "Commodity Trading Advisor" ("CTA"), respectively.[78] An adviser to a hedge fund that uses commodity futures typically acts as both a CPO and a CTA to that hedge fund. However, as noted below, most hedge fund advisers can now claim an exemption from registration as a CPO and CTA pursuant to exemptions that were recently adopted by the CFTC.

Once an adviser falls within the definition of CPO or CTA, it generally must register as such with the CFTC.[79] Registered CPOs and CTAs must comply with CFTC rules that impose disclosure, record keeping and periodic reporting requirements.[80] In addition, registered CPOs and CTAs must complete an annual self-audit and must submit to periodic audits conducted by

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77 See CFTC Interpretive Letter 98-18 (Mar. 12, 1998).

78 See Section 1a(5) of the CEA (defining CPO); Section 1a(6)(A) of the CEA (defining CTA). A hedge fund adviser generally will not fall within the definition of CPO or CTA if it invests only in swaps, forward contracts or synthetic futures. These investments provide the same investment exposure as futures, but generally are not subject to regulation under the CEA.

79 See Section 4m(1) of the CEA. A person generally registers with the CFTC as a CPO or a CTA by filing a completed Form 7-R and certain supporting materials with the National Futures Association ("NFA"), the self-regulatory organization governing the commodities markets. 17 C.F.R. Section 3.10.

80 See Rules 4.21 through 4.26 under the CEA (rules applicable to CPOs), and Rules 4.31 through 4.36 under the CEA (rules applicable to CTAs).

the NFA.[81] All registered CPOs and CTAs are subject to the CEA's general antifraud rules,[82] as well as specific client protection, advertising and position reporting rules.[83]

As a result of recent CFTC rule adoptions, many hedge fund advisers can now qualify for exemptions from CPO and CTA registration. Regulations under the CEA provide an exemption from registration to CPOs operating pools that engage in limited commodity futures activities and sell interests solely to certain qualified individuals.[84] Regulations under the CEA also provide an exemption from registration to CPOs that operate pools that sell interests to certain highly sophisticated pool participants.[85] Investment advisers to hedge funds that operate in reliance upon Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act may be able to rely upon one of these CFTC exemptions.[86] In addition, the CEA provides a *de minimis*

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81 See Interpretive Notice, NFA Compliance Rule 2-9 (July 4, 2000). Audits conducted by the NFA are designed to determine whether a firm is maintaining records in accordance with applicable CFTC and NFA rules, and to ensure that the firm is being operated in a manner that protects investors in the commodity futures markets. Although the NFA's audits may include a review of non-commodities, the emphasis of these audits is on reviewing commodities futures issues. See, e.g., Roundtable Transcript, May 15 (statement of Jane Thorpe) (stating that the NFA conducts its audits using "a risk-based approach [and] is going to focus on those areas that obviously it has the most and we have the most interest in.").

82 See Section 4o of the CEA (general antifraud provision similar to Section 206(1) and Section 206(2) of the Advisers Act) and CFTC Rule 32.9 (prohibiting fraud in connection with commodity option transactions). See also Section 4b of the CEA (prohibiting fraudulent or misleading contracts) and CFTC Rule 4.15 (stating that Section 4o continues to apply to persons that are exempt from registration as a CTA or CPO).

83 See Rules 4.20 and 4.30 under the CEA (governing segregation of pool assets and prohibited CTA activities, respectively); Rule 4.41 under the CEA (governing advertising by CPOs, CTAs and the principals thereof); Rule 18.04 under the CEA (requiring traders who hold or control reportable positions in futures, or options on futures, to file a "Statement of Reporting Trader" on Form 40 with the CFTC upon receipt of a special call by the CFTC).

84 See CFTC Rule 4.13(a)(3) (exempting pools that privately place ownership interests to "accredited investors" as defined in Rule 501 of Regulation D of the Securities Act, and to certain other special groups of purchasers, provided that the pool, among other things, complies with certain limits on margin and notional value of the fund's commodity interests). This rule amendment took effect on August 8, 2003.

85 See CFTC Rule 4.13(a)(4) (exempting pools that privately place ownership interests to certain highly sophisticated persons, including natural persons that are "qualified purchasers," as defined in Section 2(a)(51) of the Investment Company Act). This rule was recently adopted by the CFTC and became effective on August 8, 2003.

86 Approximately 50 percent of the roughly 1,800 registered CPOs are eligible to deregister with the CFTC in reliance upon CFTC Rules 4.13(a)(3)-(4). See Roundtable Transcript, May 15

exemption from CTA registration that is similar to the Investment Advisers Act's *de minimis* exemption from investment adviser registration.[87] Consequently, hedge fund advisers that are exempt from registration as an investment adviser also are usually exempt from registration as a CTA.[88] Hedge fund advisers that meet the definition of CPO or CTA, but that are exempt from registration as such, are required to keep books and records, but are not subject to disclosure, periodic reporting or audit requirements that apply to a registered CPO or a registered CTA.[89]

2. *NASD Regulation*

a. *Suitability Determinations*

Broker-dealers that sell interests in hedge funds are subject to the requirements of NASD rules, which regulates sales practices of its members, including certain suitability matters. The NASD recently issued a Notice to Members to remind them of their obligations when selling hedge funds and funds of hedge funds.[90] The Notice to Members was issued in response to the NASD's recent review of its broker-dealer members when recommending an investment in

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(statement of Jane Thorpe). As of May 2003, the CFTC had received 290 notices claiming the CFTC no action relief that was subsequently codified as CFTC Rule 4.13(a)(3). See id. It is difficult to ascertain whether these CPOs are new participants in the commodity markets or whether they are existing, registered CPOs that deregistered after claiming this relief.

[87] See Section 4m(1) of the CEA (providing exemption from registration for CTAs with 15 or fewer clients). See also CFTC Rule 4.14(a)(10) (counting certain business organizations as a single client for the purposes of the calculation required by Section 4m(1)). This rule amendment took effect on August 8, 2003.

[88] CPOs that are registered, or exempt from registration, as CPOs are specifically exempted from registration as CTAs. See CFTC Rules 4.14(a)(4) and 4.14(a)(5). As a result, only hedge fund advisers that are not CPOs, such as hedge fund sub-advisers, will typically need to rely upon the Section 4m(1) exemption.

[89] Certain CPOs and CTAs, although not exempt from registration, nevertheless enjoy relief from many of the requirements applicable to registered entities. See CFTC Rule 4.7 (exempting certain registered CPOs and CTAs from portions of the CEA's operational requirements). In order to obtain this relief, a CPO must sell interests in its commodity pool, and a CTA must provide advice, only to "qualified eligible persons," as defined in the rule (e.g., qualified purchasers, as defined by Section 2(a)(51) of the Investment Company Act), or individual accredited investors who meet a specific commodity portfolio requirement set forth in CFTC Rule 4.7(a)(1)(v).

[90] NASD Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds* (Feb. 2003).

hedge funds or FOHFs.[91] The NASD found that some broker-dealers may not be fulfilling their sales practice obligations under the NASD Rules, particularly when selling hedge funds and FOHFs to investors.

The Notice to Members reminded broker-dealers of their obligations in the following five areas:

- Promotion of Hedge Funds. Broker-dealers must balance sales material and oral presentations that promote hedge fund investing with disclosure of the risks and potential disadvantages that investing in these products may present.[92] Broker-dealers must give potential investors any prospectus or disclosure document, but providing such a document does not by itself satisfy the member's duty to provide balanced sales materials and oral presentations.

- Reasonable-Basis Suitability. A broker-dealer that recommends a hedge fund, directly or indirectly, must believe that the hedge fund is suitable for any investor. To satisfy this obligation broker-dealers must conduct due diligence regarding any hedge fund that they recommend to potential investors.[93]

- Customer-Specific Suitability. A broker-dealer must believe that its recommendation to invest in a hedge fund product is suitable for that particular investor. To reach this determination, a broker-dealer must, in accordance with NASD Rule 2310, examine the investor's financial status, tax status and investment objectives, as well as any other pertinent information.[94]

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[91] The NASD censured and fined a broker-dealer for failing to disclose the risks associated with hedge funds when marketing them to investors. See infra note 262 (discussing disciplinary action taken against Altegris Investments, Inc.).

[92] The NASD specifically stated, among other things, that broker-dealers "may not claim that hedge funds offer superior professional management with more investment flexibility [and] protection against declining markets . . . unless these statements are fair, accurate, and without exaggeration." In addition, when disclosing the risks of hedge fund investing, the NASD stated that broker-dealers should specifically disclose (where applicable) that hedge funds can be illiquid, engage in leverage and other speculative practices, are not required to provide valuation information to investors, are not regulated like open-end investment companies, may raise complex tax issues and often charge high fees.

[93] This due diligence includes, but is not limited to, investigating the background of the hedge fund adviser, reviewing the offering memorandum and subscription agreements, examining references, and examining the relative performance of the fund.

[94] NASD Rule 2310.

Whether an investor is an accredited investor for purposes of Regulation D under the Securities Act does not, by itself, satisfy the NASD's suitability requirements.

- Internal Controls. A broker-dealer's internal controls, including those relating to compliance and supervision of associated persons, must ensure that the sale of hedge fund products comply with all NASD and Commission rules.

- Training. Broker-dealers must train all associated persons about the features, risks and suitability of hedge funds products before such persons may recommend investment in them.

b. NASD Hot Issues Rule

The NASD's Free-Riding and Withholding Interpretation, IM-2110-1, governs the allocation of so-called "hot issues."[95] IM-2110-1 does not directly restrict a hedge fund's ability to acquire shares of a hot issue. However, it does prohibit an investment adviser to a hedge fund from acquiring shares of a hot issue through a personal account. Hedge fund advisers often have significant interests in the funds that they manage and the investment adviser's interest in the hedge fund does not disqualify the fund itself from acquiring shares of a hot issue, provided that such acquisitions are part of the fund's "normal investment practice," and the notional *pro rata* amount of hot issues acquired by the investment adviser through the fund is "insubstantial and not disproportionate in amount as compared to sales to members of the public."[96]

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95 NASD IM-2110-1 defines "hot issue" as a public offering that trades at a premium in the secondary market whenever such secondary market trading begins.

96 NASD IM-2110-1(b)(5). The NASD has filed a proposed rule change with the Commission that would amend the Interpretation in several respects. Under the proposal, all portfolio managers, including investment advisers to hedge funds, would be "restricted persons." An account in which a restricted person had a beneficial interest generally would be prohibited from purchasing hot issues. Thus, a hedge fund adviser would be prohibited from purchasing a hot issue through a personal account as well as for the account of the hedge fund because the beneficial interest in the hedge fund of even a single restricted person might disqualify the entire fund from purchasing hot issues. The NASD is proposing a *de minimis* exemption whereby a collective investment vehicle (such as a hedge fund) would be permitted to purchase shares of a hot issue, provided that the participation of restricted persons in the fund (the adviser, plus any other restricted persons) does not, among other things, exceed ten percent. *Notice of Filing of Amendment Nos. 3 and 4 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding Restrictions on the Purchase and Sale of Initial Public Offerings of Equity Securities,* Exchange Act Release No. 46942 (Dec. 4, 2002). The Commission has received comments from the hedge

3. Regulation under ERISA

An investment adviser to a hedge fund is an ERISA plan fiduciary if it exercises discretionary authority over the management of "plan assets."[97] The assets of a hedge fund are deemed to be "plan assets" if an ERISA plan's investment in that hedge fund is "significant." An ERISA plan's investment is deemed to be significant if, immediately after the most recent acquisition of any equity interest in the hedge fund, more than 25 percent of the value of any class of equity interests in the hedge fund is held collectively by the employee benefit plan investors.[98] Many hedge fund advisers take measures to ensure that employee benefit plan investments in hedge funds do not exceed this 25 percent threshold in order to avoid being subject to regulation as an ERISA fiduciary.[99]

Some hedge fund advisers, however, accept regulation under ERISA because they view ERISA plans as attractive investors for the hedge funds they advise. As a result, they permit the investment of significant amounts of employee plan assets in the hedge funds. Before investing plan assets in such a hedge fund, however, the non-adviser ERISA plan fiduciary typically will require assurances from the hedge fund adviser that it will not be liable under ERISA for any misconduct on the part of the hedge fund adviser in managing the plan assets. Generally, a hedge fund adviser can shield ERISA plan fiduciaries from liability for its misconduct by registering as an investment adviser under the Advisers Act, and by qualifying as an "investment manager" under ERISA.[100]

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fund industry strongly opposing this approach. It has not yet taken final action on the NASD's proposal.

97 See Section 3(21)(A) of ERISA. Once an investment adviser is deemed to be an ERISA fiduciary, it is subject to ERISA's provisions governing, among other things, prohibited transactions, fiduciary obligations and liability for the acts of co-fiduciaries.

98 See Rule 3-101 under ERISA.

99 The fund adviser will monitor the percentage of equity held by employee benefit plan investors on every purchase, redemption or transfer. Among other things, hedge funds may disclose in the private placement memorandum delivered to investors that they may deny a subscription, forcibly redeem shares owned by benefit plan investors or refuse to recognize transfers that would cause the fund to reach the 25 percent limitation.

100 An ERISA trustee generally will be insulated from co-trustee liability for actions taken by an "investment manager" that meets certain criteria established by the statute. See Section 405(d) of ERISA. In order to qualify as an "investment manager" for the purposes of ERISA, a hedge fund adviser generally must: (1) have the power to manage, acquire or dispose of plan assets; (2) be registered as an investment adviser under the Advisers Act; and (3) acknowledge in writing that it is a plan fiduciary. See Section 3(38) of ERISA. In lieu of being a federally registered

4. *Treasury Department Regulations*

a. *Treasury Securities Position Reports*

Pursuant to authority granted by the Exchange Act, the Treasury Department has adopted rules that govern the reporting of large positions in U.S. Treasury securities by persons who participate in the government securities market, including registered investment advisers and hedge funds.[101] Pursuant to these rules, the Treasury Department periodically provides notices of Treasury security issues for which large position information must be reported ("reportable position") and the applicable large position threshold for that issue.[102] Hedge funds that have a reportable position in a noticed government securities issue that is equal to or greater than the large position threshold must file a report with the Federal Reserve Bank of New York ("FRBNY") containing certain prescribed information relating to that issue of securities.[103] Hedge funds may also be required to make and keep certain records related to their large position reports.[104]

b. *Foreign Currency Position Reports*

The Treasury Department also requires weekly, monthly or quarterly reports from hedge fund advisers and other institutions (e.g., U.S. banks, brokers, dealers and registered investment company advisers) that hold more than a designated dollar equivalent threshold of foreign exchange contracts.[105] Specifically, hedge funds that had more than the equivalent of $50 billion

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investment adviser, a person also generally may qualify as an "investment manager" under ERISA if it is a bank, insurance company or state registered investment adviser that files a copy of its Form ADV with the Secretary of Labor each time it updates that document. Id.

101 See Section 15C(f) of the Exchange Act (grant of rulemaking authority) and 17 C.F.R. pt. 420 (2003) (rules adopted pursuant to grant of authority).

102 See 17 C.F.R. § 420.3(a) (2003). To date, the Treasury has only issued test notices. See, e.g., *Government Securities Act Regulations: Large Position Rules*, 67 Fed. Reg. 77411 (Dec. 18, 2002) (stating "[s]ince the rules became effective in 1997, we have conducted annual calls for reports to test the accuracy and reliability of large position reporting systems."). The large position threshold is a dollar amount set by Treasury that is no less than $2 billion. See 17 C.F.R. § 420.2(d) (2003).

103 See 17 C.F.R. § 420.3 (2003).

104 See 17 C.F.R. § 420.4 (2003).

105 See 31 U.S.C. § 5315 (reports on foreign currency transactions); 31 C.F.R. § 128 (reporting of international capital and foreign currency transactions and positions). The value of the contracts

in foreign exchange contracts on the last business day of any calendar quarter during the previous year must file Form FC-1 on a weekly basis and Form FC-2 on a monthly basis with the FRBNY.[106] The foreign currency reporting provisions provide information on the nature and source of flows of mobile capital with respect to six "specified currencies" (i.e., U.S. dollars, Euros, Swiss francs, U.K. pounds, Japanese yen and Canadian dollars). The reports collect consolidated data of foreign exchange contracts and positions and include, among other things, all foreign exchange contracts involving specified currencies that are used for hedging. The reported data is not publicly disclosed in a manner that will reveal the information reported by any individual entity.[107]

c. Recent Anti-Money Laundering Regulations

Section 352 of the USA Patriot Act requires every "financial institution" to establish an anti-money laundering program that meets certain minimum requirements.[108] In connection with Section 352, the Treasury has proposed a rule that would require hedge funds, among other entities, to adopt anti-money laundering procedures.[109] In addition to adopting an anti-money

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is calculated using the prevailing exchange rates at the end of each quarter. See, e.g., Treasury Foreign Currency Form FC-1, General Instructions Section B (Who Must Report).

[106] Hedge funds that have more than the equivalent of $5 billion in foreign exchange contracts on the last business day of any calendar quarter during the previous year and that do not file Form FC-2 must file Form FC-3 on a quarterly basis with the FRBNY.

[107] See 31 C.F.R. § 128.3 (permitting only the publishing or disclosure of aggregate data).

[108] See Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56 (Oct. 26, 2001) ("USA Patriot Act"). These requirements include: (1) the development of internal policies, procedures and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test the program.

[109] See *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 60617 (Sept. 26, 2002) ("Treasury Anti-Money Laundering Proposal"). The term "financial institution" includes "investment companies." The Treasury rule would define "investment company" to include entities operating in reliance on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, commodity pools and companies investing primarily in real estate or interests in real estate. These entities would be included in the definition of "investment company," provided that they: permit owners to redeem ownership interests within two years of purchase; have total assets, as of the most recently completed calendar quarter, of $1 million or more; and are organized under the laws of a state or the United States, are organized, operated or sponsored by a U.S. person or sell their ownership interests to U.S. persons. The rule excludes from its requirements family companies, employee benefit plans, employees' securities companies (as defined in Section 2(a)(13) of the Investment Company Act) or persons that are otherwise required to have anti-money laundering plans. Id.

laundering program, these entities would be required to provide a written notice to the Treasury within 90 days of becoming subject to the rule.[110]

5. *State Regulation*

a. *State Regulation of Hedge Funds*

Unlike the Investment Company Act, state securities laws do not regulate the operations of pooled investment vehicles such as investment companies or hedge funds. Although states do not regulate hedge funds directly, they may regulate them indirectly through the fund's investment adviser or by regulating the offer and sale of interests in the hedge fund. Because of federal preemption and the availability of exemptions from adviser registration, only some states exercise regulatory authority over some hedge fund advisers, and most do not regulate the offer and sale of interests in hedge funds.

b. *State Regulation of Offers and Sales of Hedge Fund Securities*

The adoption of the National Securities Markets Improvements Act of 1996 ("NSMIA")[111] also greatly reduced state regulation of offers and sales of hedge fund securities. Most hedge funds issue securities in offerings that are exempt from registration under the Securities Act in reliance upon Rule 506 of Regulation D, and are therefore deemed to be "covered securities" under Section 18 of the Securities Act.[112] Under Section 18, covered securities are exempt from state regulations that: (1) require the registration or qualification of securities or securities transactions; (2) impose any requirements related to disclosure documents used in an offering; or (3) impose any merit regulation of such offerings. The states, however,

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[110] The form of the proposed notice would require the filing entity to provide identifying information, a statement of the assets held by the "investment company" at the end of the preceding fiscal year and a disclosure of the number of participants, interest holders or securities holders of the "investment companies." See id. If adopted, the form of notice filed by a hedge fund would be a partial source of information about that hedge fund.

[111] Pub. L. No. 104-290, 110 Stat. 3416 (1996) (codified in scattered sections of the United States Code).

[112] See Section 18(b)(4)(D) of the Securities Act.

retain their antifraud jurisdiction.[113] They may also impose notice filing requirements and notice filing fees.[114]

c. State Regulation of Hedge Fund Advisers

Hedge fund advisers registered with the Commission under the Advisers Act are not required to register with the state securities authorities and are exempt from most substantive provisions of state investment adviser laws. Moreover, hedge fund advisers not registered with the Commission may also be eligible for exemptions from state registration and regulatory requirements.[115] State exemptions can be found in a number of states where hedge fund advisers are concentrated, including California, Connecticut and New York.[116] As a result, it is not uncommon for a hedge fund adviser to be exempt from registration under both state and federal investment adviser laws.

A hedge fund adviser that is subject to state investment adviser laws is likely to face regulations similar to the Commission's, as state regulation of investment advisers is generally similar to the Advisers Act. Broadly speaking, the investment adviser must register with authorities and must provide certain disclosures to clients. The adviser is also subject to rules designed to protect investors and prevent fraud, and may be subject to periodic examination by regulators.[117]

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[113] See Section 18(c)(1) of the Securities Act. See also, e.g., *In the Matter of James Pangione, Timothy Rassias, Hercules Capital Management, LLC, Hercules Hedgehog Fund, LP* No. E-2003-56 (Mass. Sec. Div. filed Aug. 13, 2003).

[114] See Section 18(c)(2) of the Securities Act.

[115] The preemption of state investment adviser laws applies only to those investment advisers that are registered with the Commission. Advisers that rely on an exemption from registration with the Commission may therefore be subject to state investment adviser laws. See Section 203A(b)(1) of the Advisers Act.

[116] See California Code of Regulations Title 10, Section 260.204.9; *Order Governing Certain Federally Exempt Investment Advisers*, Connecticut Department of Banking Order (Oct. 14, 1997) (each, in pertinent part, granting an exemption from state registration to any investment adviser that relies on the exemption from Commission registration in Section 203(b)(3) of the Advisers Act). See also NY Gen. Bus. Law Section 359-eee(a)(5) and Codes, Rules and Regulations of the State of New York Part 11.12(a) (respectively, providing an exclusion from the definition of adviser if an adviser has fewer than six clients, and counting limited partnerships, and other legal organizations, as single clients).

[117] Both the Commission and states retain antifraud jurisdiction to bring enforcement actions against all investment advisers, whether registered or not.

IV. Operations of Hedge Funds

A. Hedge Fund Investment Strategies

1. Overview

Hedge funds generally employ an absolute return approach to investing through which they seek to make money in a variety of market environments. Registered investment companies, in contrast, tend to favor a relative return approach. These funds attempt to duplicate or exceed the performance of a selected asset class or securities index.

Because an absolute return approach places a premium on flexibility (a successful bull market strategy is unlikely to produce positive returns during bear markets), many hedge funds tend to be opportunistic in seeking positive returns while avoiding loss of principal. The organizational documents of most hedge funds establish broad objectives and authorize multiple strategies in order to provide flexibility to take advantage of changing market conditions.[118]

Some hedge funds use traditional tools of fundamental or technical analysis to purchase or sell short individual stocks and bonds. Others take a directional view on a particular stock, bond or currency market. Still others engage in arbitrage in order to exploit perceived inefficiencies in the markets or to make money from particular expected events, such as mergers or bankruptcies. Certain hedge funds take large, concentrated positions in securities. Others invest across diverse asset classes and types of securities. When market conditions turn negative, many hedge funds sell short, utilize derivatives that increase in value as security values fall or take positions that are less dependent on the price movements of broad market averages. Many hedge funds use some or all of these strategies from time to time, based on their view of what strategy is most favored by current market conditions.[119] Finally, a number of hedge funds eschew all of these techniques and adopt traditional, long-only strategies similar to those used by most registered investment companies.

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[118] See Roundtable Transcript, May 14 (statement of Robert Schulman) ("The hedge fund industry has avoided, in large measure, the catastrophic impacts of the market by having enough flexibility in the [private placement] document and using it to react to what you would call changing market conditions.").

The flexibility of some hedge fund advisers appears to be restricted only by the presence of investors who have invested in a hedge fund because of its use of a particular investment strategy and their expectation, communicated to the hedge fund adviser, that the fund will only invest in accordance with that strategy. See Alexander M. Ineichen, *Absolute Returns: The Risk and Opportunities of Hedge Fund Investing* 123 (2003) ("Ineichen").

[119] See *Hedge Funds: A Guide*, The Economist 82 (Oct. 3, 1998).

2. *Hedge Funds Strategies*

Hedge funds use a wide variety of investment styles and strategies.[120] Even among hedge funds that purport to use the same investment strategy or invest within the same asset class, there is a wide range of investment activities, performance and risk levels.[121] Because the investment activities of hedge funds are so diverse, the hedge funds assigned to a particular investment category are likely to exhibit less similarity than more traditional investment vehicles, such as registered investment companies.

Although classification systems vary, hedge funds may generally be classified according to broad style and strategy categories, including:

- **Market Trend (Directional/Tactical) Strategies**

(These strategies exploit broad market trends in equities, interest rates or commodity prices.)

– **Macro**: These funds may take positions in currencies (often unhedged) based on their opinion of various countries' macroeconomic fundamentals. For example, if a country's economic policies look inconsistent and its ability to sustain its exchange rate appears questionable, macro funds may take positions designed to profit from devaluation, usually by selling the currency short.

– **Long/Short**: (includes sector and market neutral/relative value funds): These funds try to exploit perceived anomalies in the prices of securities. For example, a hedge fund may buy bonds that it believes to be underpriced and sell short bonds that it believes to be overpriced. No matter what happens to overall interest rates, as long as the spread between the two narrows, the fund profits. Conversely, if spreads widen,

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[120] One commenter classifies hedge fund investment strategies into more than 25 categories. Comment submitted by Roundtable Panelist John G. Gaine on behalf of the Managed Funds Association, at 2 (“Managed Funds Association Comment Letter”).

[121] See Roundtable Transcript, May 14 (statement of Michael Neus) (“When speaking about hedge funds [whether] the average hedge fund is less risky or more risky, I think that misses the point. It's not a monolithic institution. Hedge funds, by and large, are incredibly entrepreneurial; are constantly innovating and mutating.”).

gains can turn quickly into losses. Long/short equity is the most frequently used strategy among hedge funds.[122]

- **Event-Driven Strategies**

(These strategies attempt to exploit discrete events such as bankruptcies, mergers, and takeovers.)

– **Distressed Securities**: These funds may take long and/or short positions to attempt to profit from pricing anomalies among securities issued by companies going through bankruptcy or reorganization.

– **Risk/Merger Arbitrage**: These funds attempt to profit from pending merger transactions by, for example, taking a long position in the stock of the company to be acquired in a merger, leverage buyout or takeover and simultaneously taking a short position in the stock of the acquiring company.

- **Arbitrage Strategies**[123]

(These strategies, which exploit pricing discrepancies between closely related securities, are designed to be among the less risky hedge fund strategies. Arbitrage also may be a significant strategy component for funds in the event-driven and long/short categories.)

– **Convertible Arbitrage**: This strategy involves taking long positions in a company's convertible bonds, preferred stock, or warrants that are deemed to be undervalued while taking short positions in the company's common stock.

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[122] The actual percentage varies according to different commenters, probably because commenters often define investment strategies differently. One commenter claimed that over 60 percent of hedge fund assets were managed using this strategy. Hennessee Group Comment Letter, supra note 4 at 3. Another commenter stated that, as of the third quarter of 2001, approximately 45 percent of hedge fund assets were managed using this strategy. Ineichen, supra note 118 at 42-43.

[123] Many arbitrage strategies contribute substantial benefits to the U.S. financial markets by exploiting mispricings and inefficiencies. These efforts often result in enhanced liquidity and improved market efficiency. As was recently demonstrated, however, some abusive strategies used by hedge fund advisers such as mutual fund "market timing" activities provide no benefits to the securities markets. See State of New York v. Canary Capital Partners, LLC, (N.Y. Sup. Ct., complaint filed Sept. 3, 2003), available at: http://www.oag.state.ny.us/press/2003/sep/canary_complaint.pdf ("Canary Capital Partners").

– **Fixed Income Arbitrage**: Hedge funds in this category seek to provide stable, positive returns by exploiting the relatively small pricing inefficiencies of fixed income instruments. For example, a newly issued ("on the run") 10-year Treasury bond may trade at a slightly higher price than a similar previously issued ("off-the-run") 10-year Treasury bond. A hedge fund may seek to profit from this disparity by purchasing off-the-run Treasuries and selling on-the-run Treasuries short.

– **Statistical Arbitrage**: Funds in this category attempt to profit from pricing inefficiencies identified through the use of mathematical models. Statistical arbitrage attempts to profit from the likelihood that prices will trend toward a historical norm.

3. Hedge Fund Investment Activities Compared to those of Registered Investment Companies

As discussed above, registered investment companies typically seek positive returns compared to the performance of a particular asset class or index ("benchmark"). Thus, in a declining market, a registered investment company may be considered successful even if it loses money, so long as the company outperforms its benchmark (i.e., its relative return is positive). In a rising market the registered investment company may be considered unsuccessful if the company, though profitable, underperforms the benchmark (i.e., its relative return is negative). In brief, in the relative return paradigm, downside risk means the risk of failing to perform as well as the benchmark. In contrast, a hedge fund that utilizes an absolute return strategy may be considered successful only if it is profitable in both rising and declining markets.[124] In the absolute return paradigm, downside risk means the risk of failing to make money.

Registered investment companies generally have less flexibility to change their investment objectives than do most hedge funds. As a result, these funds provide investors with greater certainty of the risks their advisers will take, but provide their advisers with a diminished ability to take alternative investment approaches when market conditions change. Most of the restrictions on registered investment companies are self imposed, and are designed to assure investors that the fund will be managed in a manner consistent with their expectations.[125]

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[124] As discussed in Part IV.F. infra, compensation arrangements for hedge fund advisers are typically structured to reinforce the incentive to produce positive returns, irrespective of the direction of the market.

[125] The Investment Company Act does not require registered investment companies to restrict the flexibility of fund advisers. Section 13(a)(3) of the Investment Company Act requires registered investment companies to obtain the consent of their shareholders before deviating from their fundamental policies, including concentration in certain industries, but does not require registered investment companies to have policies restricting investments. Similarly, Section 13(a)(2) of the Investment Company Act requires registered investment companies to seek the approval of their

4. Leverage

a. Background

Leverage is an important component of many hedge fund investment strategies. Leverage can be defined in numerous ways. As a general matter, however, leverage, can be viewed as a means of potentially increasing an investment's value or return without increasing the amount invested. Although leverage historically was obtained primarily by purchasing securities with borrowed money, today futures, options and other derivative contracts may be a major source of leverage. The use of leverage may have a significant impact on investment results because, while it may enhance investment gains, it may also magnify investment losses. Leverage also may increase the risk caused by holding assets that are illiquid or whose full value cannot be realized in a quick sale.[126]

b. Use of Leverage by Hedge Funds

The degree to which a hedge fund uses leverage depends largely on its investment strategy. Macro funds and funds that attempt to capitalize on small inefficiencies in relative values (e.g., fixed income arbitrage and statistical arbitrage) are more likely to engage in leverage and to take more highly leveraged positions[127] than are hedge funds that use other investment strategies, such as investing in distressed securities situations.[128]

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shareholders before they deviate from their policies regarding borrowing money, issuing senior securities, underwriting certain securities, purchasing or selling real estate or commodities or making loans, but does not preclude registered investment companies from having policies permitting all such activities to the extent permitted by law.

126 *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management - Report of The President's Working Group on Financial Markets* 5 (Apr. 1999) ("LTCM Report").

127 For example, according to hedge fund data consultants, approximately 89 percent of macro funds use leverage. Of those macro funds, 52 percent have leverage ratios greater than 2 to 1. (Here, a leverage ratio is defined as the ratio of total absolute dollars invested to total dollars of equity. A leverage ratio of greater than 2 to 1 is considered high; while a ratio of less than or equal to 2 to 1 is considered low.) This information is based on a sample of funds and may not be representative of all hedge funds. See Van Hedge Fund Advisors International, Inc., *Global Hedge Funds - Use of Leverage As of December 2002* (2003).

128 Slightly over half (52 percent) of hedge funds that employ a distressed securities strategy use leverage. Of hedge funds using distressed securities strategies that use leverage, only six percent have leverage ratios greater than 2 to 1. Id.

A hedge fund's limitation on its use of leverage is often dictated by any margin or collateral requirements imposed on lenders or on others (e.g., broker-dealers), and the willingness of lenders or other counterparties to provide it with credit. For example, a broker-dealer extending credit to a hedge fund in connection with a short sale would have to comply with Regulation T issued by the Board of Governors of the Federal Reserve System.[129] The hedge fund could also be required to provide additional "maintenance margin" for transactions in short sales under margin requirements imposed by self-regulatory organizations.[130]

c. Use of Leverage by Registered Investment Companies

Although registered investment companies may use leverage and sell short, their ability to use these tools is more limited than is the case with hedge funds. For example, the Investment Company Act generally allows open-end investment companies to leverage themselves only by borrowing from a bank, and provided that the borrowing is subject to 300 percent asset coverage.[131] Closed-end investment companies are subject to less restrictive limits.[132] The Commission and staff have applied the Investment Company Act provisions governing use of leverage to permit registered investment companies to engage in certain transactions involving leverage ("senior security transactions"), generally, however, only if the registered fund "covers" the transaction by setting aside liquid assets in an amount equal to the potential liability or exposure created by the transaction.[133] A registered investment company's board of directors has

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[129] 12 C.F.R.§ 220.12. This could require the hedge fund to provide margin for a short sale of a "nonexempted security," such as a security registered on a national securities exchange, of 150 percent of the current market value of the security. 12 C.F.R.§ 220.12(c)(1).

[130] See NASD Rule 2520(c) and NYSE Rule 431(c). See also NASD Rule 2520(d) and NYSE Rule 431(d), which permit broker-dealers to institute higher short-sale margin requirements than those imposed by self-regulatory organizations rules.

[131] Section 18(f)(1) of the Investment Company Act. The Investment Company Act also allows registered investment companies to engage in certain private and temporary borrowings without 300 percent asset coverage, and from non-bank lenders. See Section 18(g) of the Investment Company Act.

[132] See Sections 18(a) - (e) of the Investment Company Act.

[133] See, e.g., *Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666") (discussing Section 18 regulation of reverse repurchase agreements, firm commitment agreements, standby agreements and other transactions having similar effects on the capital structure of an investment company). See also, e.g., *Dreyfus Strategic Investing & Dreyfus Strategic Income* (pub. avail. June 22, 1987) ("*Dreyfus*") (short selling transactions and certain derivatives transactions such as: purchasing and selling futures contracts; purchasing and selling options on specific securities, stock indexes,

certain responsibilities in connection with the company's use of leverage,[134] and information about the characteristics and risks of permitted leverage transactions must be disclosed to investors in fund prospectuses.[135]

5. Short Selling

a. Background

A short sale is the sale of a security that the seller does not own or a sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[136] In order to deliver the security to the purchaser, the short seller borrows the security, typically from a broker-dealer or an institutional investor. The short seller later closes out the position by returning the security to the lender, typically by purchasing equivalent securities on the open market, or by using an equivalent security that it already owns. In general, short selling is

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or interest rate futures contacts; and purchasing and selling forward contracts on currencies "involve potential leveraging.").

The requirement that registered investment companies set aside liquid assets to cover senior security transactions is also referred to as the "segregated account" obligation. The purpose of this requirement is to limit the amount of leverage in which a registered investment company may engage, and to ensure the availability of adequate funds to meet the obligations arising under the senior security transactions. See, e.g., Release 10666, as modified by *Dreyfus* and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 2, 1996) ("*MLAM*"). This requirement applies in addition to any margin requirements, which apply to investment companies just as they do to hedge funds and other brokerage customers engaging in margin transactions. The assets set aside to cover the senior security transactions are considered frozen and unavailable for sale or any other purpose. See, e.g., Release 10666; *MLAM*.

[134] Specifically, the board must conclude that senior security transactions are consistent with the policies recited in its registration statement pursuant to Section 8(b) of the Investment Company Act, and must also make sure that the level of senior security transactions will not impair the investment company's ability: to meet current obligations; to honor requests for redemption (for open-end investment companies); and to manage properly the investment portfolio in a manner consistent with the investment company's stated investment objectives. See Release 10666, supra note 133.

[135] See Form N-1A , Items 4(b)(1) (requiring a description of the fund's principal investment strategies) and 4(c) (requiring a description of the principal risks of investing in the fund, including circumstances reasonably likely to affect adversely the fund's net asset value, yield or total return). See also Release 10666, supra note 133.

[136] See Rule 3b-3 under the Exchange Act.

utilized to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand or to hedge the risk of a long position in the same or a related security.

Short selling can provide the market with important benefits, including market liquidity and pricing efficiency. Market liquidity is provided through short selling by market professionals, such as market makers (including specialists) and block positioners, who offset temporary imbalances in the supply and demand for securities. Short sales effected in the market by securities professionals add to the trading supply of stock available to purchasers and thus may reduce the risk that the price paid by investors is artificially high.

Short selling also can contribute to the pricing efficiency of the markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on or hedges against a downward movement in a security, the transaction is a mirror image of the person's who purchases the security based upon speculation that the security's price will rise or in order to hedge against such an increase. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security.[137]

Although short selling serves useful market purposes, it also may be used to manipulate stock prices. One example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest.[138] Unrestricted short selling can also exacerbate a declining market in a security by eliminating bids and causing a further reduction in the price of a security by creating an appearance that the price is falling for fundamental reasons.

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[137] Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a related security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.

[138] Many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash. See 7 Louis Loss and Joel Seligman, *Securities Regulation* 3203-04, n. 213 (3d ed. 1989).

b. Regulatory Restrictions on Short Selling

The Commission has traditionally held the belief that protections against abusive short selling are important for issuer and investor confidence, and has enacted prophylactic rules designed to curb manipulative behavior. Rule 10a-1 under the Exchange Act was adopted in 1938 after several years of considering the effects of short selling in a declining market.[139] The core requirement of Rule 10a-1 is commonly referred to as the "tick test." The tick test provides that, subject to certain exceptions, an exchange-listed security may only be sold short: (1) at a price above the immediately preceding reported price ("plus tick"); or (2) at the last sale price if it is higher than the last different reported price ("zero-plus tick"). Subsection (c) and (d) of Rule 10a-1 also require broker-dealers effecting sell orders for exchange-listed securities to mark such orders "long" or "short." The Commission has also approved a price test for certain Nasdaq securities.[140]

There are other requirements that apply to short selling. For example, the self-regulatory organizations ("SROs") have adopted rules generally requiring that, prior to effecting short sales, member firms must "locate" stock available for borrowing, so that the short seller may effect delivery to the purchaser.[141] In addition, short sale transactions are subject to margin requirements,[142] and may impact a broker-dealer's net capital.[143] Other securities market

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[139] By adopting Rule 10a-1, the Commission sought to achieve three objectives: (1) allow relatively unrestricted short selling in an advancing market; (2) prevent short selling at successively lower prices, thus eliminating short selling as a tool for driving the market down; and (3) prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, causing successively lower prices to be established by long sellers. See *Short Sales of Securities*, Exchange Act Release No. 13091 (Dec. 21, 1976).

[140] NASD Rule 3350 uses a "bid test" that prohibits NASD members from effecting short sales in NASDAQ National Market System Securities at or below the best bid when the best bid displayed is below the preceding best bid in a security.

[141] See, e.g., NASD Rule 3370; NYSE Rule 440C.

[142] See, e.g., Section 220.12(c)(1) of Regulation T of the Board of Governors of the Federal Reserve System, which requires margin for a short sale of a nonexempted equity security of 150 percent of the current market value of the security. An investor may be required to deposit additional "maintenance margin" for transactions in short sales under margin requirements imposed by SROs. See, e.g., NASD Rule 2520(c) and NYSE 431(c). Further, broker-dealers may institute higher short sale margin requirements than those imposed by self-regulatory organization rules. See, e.g., NASD Rule 2520(d); NYSE Rule 431(d).

[143] For example, a broker-dealer with a proprietary short position in an equity security may be required to deduct a percentage of the market value of the position when computing net capital under Exchange Act Rule 15c3-1. See Rule 15c3-1(c)(2)(vi)(J) under the Exchange Act. There may also be net capital implications for a broker-dealer executing short sale transactions for

participants, such as registered clearing agencies, may also establish requirements for firms engaging in short sale transactions.[144]

The SROs also have rules requiring members to report monthly aggregate short positions in all customer and proprietary accounts in securities listed on such exchanges or traded on NASDAQ.[145] This information is publicly available from a number of different sources, including Barrons, the Wall Street Journal and some financial websites.

c. Short Selling by Hedge Funds

Many hedge funds regularly engage in short selling as a major component of their investment strategy. For example, hedge funds may engage in long/short strategies that consist of buying higher-expected-return securities and selling short lower-expected-return securities. Hedge funds also may sell short in connection with arbitrage activities. A risk arbitrage position would consist of buying the target company securities coupled with simultaneous shorting of the securities of the acquiring company. Convertible arbitrage involves taking long positions in convertible securities while shorting the underlying securities, thereby taking advantage of a difference between the prices. Statistical arbitrage involves attempting to profit from pricing differentials between statistically related securities identified through the use of mathematical models.

The use of short selling by hedge funds has led to allegations that some hedge funds may be engaging in short selling as part of a manipulative scheme. Issuers have alleged that the hedge funds accumulated bearish positions in their stocks (i.e., sold securities short or purchased put options and credit-default swaps) and subsequently issued critical reports regarding the issuers in an attempt to drive down their security prices.[146]

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customers. For example, a broker-dealer may be required to deduct the amount of cash required in a customer's account to meet maintenance margin requirements arising from the customer's short sale transactions. See Rule 15c3-1(c)(2)(xii) under the Exchange Act.

[144] There are capital and risk management standards established by the National Securities Clearing Corporation, which generally acts as the guarantor of trades between broker-dealers. See National Securities Clearing Corporation Rules of Procedures, Addendum K (effective Aug. 11, 2003).

[145] See, e.g., NASD Rule 3360; NYSE Rule 421.10.

[146] See, e.g., Randall Smith, *Regulators Review Complaints About Hedge Funds*, Wall Street Journal, (Jan. 22, 2003).

d. Short Selling by Registered Investment Companies

Registered investment companies have less flexibility than hedge funds to engage in short selling. While there are registered investment companies that actively sell short, registered investment companies are constrained by requirements of the Investment Company Act. Registered investment companies that sell short need to ensure that their prospectuses and other disclosure documents adequately inform shareholders about the risks associated with short selling.[147] Registered investment advisers and directors of registered investment companies should consider the consistency of such risks with the companies' disclosures and (for open-end investment companies) with the duty to have sufficient liquid assets to meet redemption requests in a timely manner.[148]

B. Nature of Hedge Fund Investors

Historically, hedge funds were sold primarily to high net worth individuals and families. Individual investors and families continue to represent a large portion of the hedge fund investor population today.[149] Much of the recent growth in the hedge fund industry, however, can be attributed to the investments of institutional investors.[150] Institutional investors such as pension

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147 See Form N-1A, Items 4, 12. Registered investment companies are required to disclose their short sale activity in their financial statements that accompany their annual reports and semi-annual reports. For example, open- and closed-end investment companies must provide a Schedule of Securities Sold Short along with their financial statements, which schedule specifically lists the securities sold short during the relevant reporting period. See Regulation S-X, Rules 6-10 and 12-12A. In addition, all registered investment companies must disclose: (1) the amount held by others in connection with short sales in the asset section of the balance sheet; (2) the amount payable for securities sold short in the liability section of the balance sheet; and (3) the gain or loss on closed short positions in securities in the statement of operations. See Regulation S-X, Rules 6-04, 6-07.

148 See, e.g., Release 10666, supra note 133; *MLAM*, supra note 133.

149 According to one commenter, as of January 1, 2003, individuals and families invested $249 billion in hedge funds, representing approximately 42 percent of industry assets. Over the past several years, however, these investments, as a percentage of all hedge fund assets, have been declining. Hennessee Group Comment Letter, supra note 4 at 7-9.

150 See e.g., Roundtable Transcript, May 14 (statement of Robert Schulman) ("[T]he vast majority of . . . [the] growth [in the hedge fund industry] is coming institutionally. So although there's been a lot of talk about the retailization of the business . . . the reality is it is large commitments from big public plans . . . , like CALPERS and Texas Teachers, that is leading the way towards the growth in this asset.").

plans, endowments and foundations are increasingly considering investments in hedge funds, and those who are already investing are devoting a larger portion of their portfolios to these funds.[151] These institutional investors are shifting portions of their portfolios away from more traditional investments to investment vehicles employing absolute return strategies.[152] According to one commenter, the catalyst for this shift was the performance of these vehicles during the recent 3-year bear market.[153] These investors are also increasingly investing in FOHFs.[154]

C. Hedge Fund Marketing

Typically, hedge fund advisers market and distribute hedge funds to investors directly,[155] as compared to registered investment companies, which often are sold through broker-dealers.[156] Hedge funds rely heavily on investors' pre-existing relationships with the hedge fund's advisory personnel (either on a personal basis or through a prior advisory relationship) and existing investors' recommendations. In addition, some hedge fund advisers have staff dedicated to

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According to one commenter, institutional investors in the aggregate invested $175 billion in hedge funds in 2002, compared to $53 billion four years earlier. Hennessee Group Comment Letter, supra note 4, at 14.

151 See, e.g., Chris Clair, *A Growing Role: Institutional Investors Jumping Big into the Hedge Fund Market,* Pensions and Investments 3 (Feb.18, 2002); Gregory Zuckerman, *Hedge Funds May Give Colleges Painful Lesson,* WSJ.com (Oct. 7, 2002); Andy Serwer, *Where the Money's Really Made*, Fortune 106 (Mar. 31, 2003).

152 Hedge funds are only one of the alternative investments that institutional investors are exploring as part of an overall diversification strategy. Other alternative investments include real estate, timberland and oil and gas. See *Foundations, Endowments Try Real Assets*, Fundfire (Aug. 25, 2003).

153 See Roundtable Transcript, May 14 (statement of Charles Gradante).

154 According to one commenter, as of January 1, 2003, FOHFs represented approximately 27 percent of hedge fund assets, compared to 20 percent the year before. Hennessee Group Comment Letter, supra note 4, at 8-9.

155 One commenter stated that, as of January 1, 2003, hedge funds raised approximately 88 percent of their capital as a result of in-house marketing efforts. Id., at 10. Close to half (43 percent) of this capital, however, came from the hedge fund's general partners and employees. Id.

156 Some hedge funds, however, use the services of a broker-dealer as a placement agent for their securities. Broker-dealers often may place hedge fund shares with wealthy clients through divisions of broker-dealers dedicated to providing services to "high net worth" customers. We note, however, that for most broker-dealers that sell hedge funds, these sales account for a minimum amount of total revenue.

marketing the fund, which may include identifying new investors, holding seminars for potential investors and assisting potential investors in understanding the products and completing the subscription documents.

Many hedge fund advisers also operate Internet websites through which they communicate with investors. As sponsors of securities offerings by hedge funds, the advisers are required to limit both the content of their websites and the persons who may access them in order to avoid general solicitation and general advertising concerns in connection with the hedge fund securities offering.[157] Many hedge fund advisers provide information about themselves, but typically do not mention to the general public that they manage hedge funds. Some hedge fund advisers follow the staff and the Commission's guidance on using password protected websites to communicate with existing investors and investors with whom they or persons acting on their behalf have substantive, pre-existing relationships.

Hedge fund advisers using the Internet and other medium of electronic communications are subject to the constraints of the exemptions from the applicable registration requirements that they are relying on in selling the hedge fund securities or engaging in advisory activities. Moreover, if advisers and hedge funds do not follow the Commission's guidance on the use of the Internet in engaging in private offerings, they run a risk of not being able to rely on an exemption from the registration requirements of the Securities and Investment Company Acts. Purchasers of securities sold in violation of these registration requirements have the right to rescind their purchase and obtain the amount of their investment plus interest.

In addition to obtaining marketing information directly from hedge fund advisers, prospective investors and financial professionals also may receive information about potential investment opportunities in hedge funds through third-party intermediaries. Many potential investors are introduced to hedge funds through capital introduction services that are provided by

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[157] See supra Part III.B.2.c. (discussing permissible and prohibited solicitation activities in connection with securities offerings).

broker-dealers.[158] Also, many investors hire consultants to advise them about investing in hedge funds.[159] Hedge funds also hire consultants as "marketers" to introduce investors to the fund.[160]

D. Disclosure by Hedge Funds to Investors and Prospective Investors

Hedge fund advisers typically provide information to investors during an investor's initial due diligence review of the fund, although some, more proprietary, information may not be provided until after the investor has made a capital commitment to the fund, if at all. Most hedge funds provide written information to their investors in the form of a private offering memorandum or private placement memorandum ("PPM").[161] This reflects market practice and the expectations of the sophisticated investors who typically invest in hedge funds. It also reflects the realization of the sponsors and their attorneys that the exemptions from the registration and prospectus delivery provisions of Section 5 of the Securities Act available under Section 4(2) of the Securities Act and Rule 506 thereunder do not extend to the antifraud provisions of the federal securities laws. The disclosures furnished to investors serve as protection to the principals against liability under the antifraud provisions. Some of the information may be disclosed less formally in one-on-one conversations between investors and the hedge fund adviser.

Hedge fund advisers may also provide information to hedge fund investors in the form of letters, conference calls and financial statements. In addition, some hedge fund advisers may provide prospective investors with access to their prime brokers and other service providers, such

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158 See infra Part IV.E.2. (discussing broker-dealers/prime brokers). According to one survey, capital introduction services sponsored by broker-dealers are the second most popular method by which investors are introduced to hedge fund advisers, following networking. Deutsche Bank, *Equity Prime Services Alternative Investment Survey Results Part 2: Inside the Mind of the Hedge Fund Investor* 22 (Mar. 2003) (the "Deutsche Bank Survey").

159 See infra Part IV.E.5. (discussing consultants and other finders). See also *Investors Jump Long-Only Ship for Hedge Funds*, Fundfire (Jan. 30, 2003); *Plans Seek Sound Advice on Hedge Funds,* Fundfire (May 29, 2002).

160 See infra Part IV.E.5. (discussing consultants and other finders).

161 Rule 506 does not require that issuers provide any specific written information to accredited investors. This reflects the Commission's view that accredited investors are sophisticated enough and have enough bargaining power to obtain any information they need from an issuer in making an investment decision. If the offering is extended to anyone who is not an accredited investor, the issuer must provide extensive written information to the investors who are not accredited. See Rule 502(b) under the Securities Act.

as administrators, both during the investor's initial due diligence of the hedge fund and subsequently.

Hedge fund investors must often spend significant resources, frequently hiring a consultant or a private investigation firm, to discover or verify information about the background and reputation of a hedge fund adviser.[162] In practice, even very large and sophisticated investors often have little leverage in setting terms of their investment and accessing information about hedge funds and their advisers.[163]

1. Private Placement Memoranda

As a matter of practice, hedge funds generally provide investors with a PPM before an investment is made. As with any other offering solely to accredited investors, there are no specific disclosure requirements that pertain to the PPM under Section 4(2) or Rule 506.[164] While we are not passing on the adequacy and content of PPM disclosure generally, we note that certain basic information about the hedge fund's adviser and the hedge fund is typically disclosed. The information disclosed in PPMs varies from adviser to adviser, however, and often is general in scope. PPMs generally discuss in broad terms the fund's investment strategies and practices. They also typically disclose that the hedge fund's investment adviser may invest fund assets in illiquid, difficult-to-value securities and that the adviser reserves the discretion to value

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[162] Roundtable Transcript, May 14 (statement of Michael Neus) ("Whether they do it internally or whether they hire a consultant, they do more than kick the tires. They audit. Sometimes they audit results, they do background checks, they do a huge amount of legal work internally, as well as externally -- talking to other investors."); Roundtable Transcript, May 15 (statement of Sandra Manzke) ("[I]t's very difficult to get answers out of managers, and they hold all the keys right now. If you want to get into a good fund, and you ask some difficult questions, you may not get that answer. Sure, there is a lot of access, to get online and do background checks, and hire firms . . . . But that's expensive. And can the retail investor do it? No. Firms like ours, we spend a lot of money, we have a lot more people working for us now to uncover these types of situations.").

[163] Roundtable Transcript, May 15 (statement of Mark Anson) ("[t]he power remains with the hedge fund managers . . . .[T]here are far more attorneys out there representing hedge fund managers than representing investors in hedge funds. So when you get down to negotiating the nitty gritty, generally you're sitting across the table from a hedge fund manager who has better legal representation than you do as an investor. . . .The best hedge fund managers close their hedge funds. Or, if they open them for a small period of time, . . . it's basically a take it or leave it. 'You want into my fund? Here are the terms that you get.' The bargaining and leverage remains with the best hedge fund managers.").

[164] Hedge fund advisers that are registered investment advisers, however, are required to provide investors with a disclosure statement that includes information required under Part II of Form ADV. See supra Part III.D. (discussing hedge fund advisers and the Advisers Act). This may be satisfied by providing a copy of the PPM that includes the appropriate disclosure to an investor.

such securities as it believes appropriate under the circumstances.[165] The PPM also may disclose that the adviser may exercise its discretion to invest fund assets outside the stated strategy or strategies.

PPMs also generally discuss qualifications and procedures for a prospective investor to become a limited partner, as well as provide information about the hedge fund's operations.[166] For example, PPMs generally discuss fund expenses, allocations of gains and losses, tax aspects of investing in the fund and may incorporate the hedge fund's financial statements. PPMs disclose any lock-up period that new investors must observe, as well as laying out the specifics for when investors will be able to redeem some or all of their investments out of the hedge fund. PPMs also may name frequently used service providers to the fund.

PPMs may generally disclose potential conflicts of interest to investors, frequently under the heading of "risk factors." A hedge fund's PPM may note that the fund's valuation practices give rise to an inherent conflict of interest because the level of fees that the investment adviser earns is based on the value of the fund's portfolio holdings as determined by the fund's adviser. PPMs also may discuss potential conflicts arising from the adviser's "side-by-side management" of multiple accounts, including the hedge fund, private accounts, proprietary accounts and registered investment companies.[167] A hedge fund's PPM may also disclose the investment adviser's conflicts in allocating its time and certain investment opportunities among its clients. Some PPMs spell out allocation policies with respect to limited investment opportunities in great detail, while others may list, and only briefly discuss, the factors on which such allocations will be decided.

PPMs also often provide information concerning the use of affiliated services providers, including affiliated broker-dealers. Some PPMs also may note that the hedge fund may direct brokerage business to, and use other services of, firms that introduce investors to the fund. PPMs may disclose that the adviser may use soft dollars to pay for research and other services used by the adviser to benefit other accounts that it manages, and may further disclose that soft

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165 See infra Part IV.B. (discussing concerns relating to valuation practices of hedge funds).

166 Alternatively, the information may be detailed in the fund's limited partnership and/or subscription agreement.

167 A registered investment adviser, including a registered adviser managing a hedge fund, is generally required to provide this disclosure. See infra Part VI.E. (discussing conflicts of interest).

dollar arrangements could give the adviser an incentive to place trades more actively than it might otherwise in order to generate additional credits with executing broker-dealers.[168]

2. *Limited Partnership Agreements*

Investors in a hedge fund structured as a limited partnership enter into a limited partnership agreement. These agreements specify the respective rights and responsibilities of the limited partners and the general partner (usually the investment adviser). For example, these documents frequently list any restrictions on the percentage of an investor's assets invested in the hedge fund that a hedge fund will repurchase at any one time.

3. *Transparency*

Hedge fund advisers may provide investors with a list of hedge fund securities positions and holdings (position transparency) or information about the risks associated with the hedge fund's market positions (risk transparency).[169] The information may be provided in full or in part and on a current or delayed basis.

Position transparency may help investors monitor whether a hedge fund adviser is following the fund's stated strategies. For example, an investor who receives a month-end aggregated position report by industry can see whether the hedge fund adviser is drifting away from earlier statements about the fund's industry concentrations.[170] Many hedge funds, however, decline to share specific position transparency citing, among other reasons, the need to keep such

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[168] The Commission has defined soft dollar practices as arrangements under which an adviser obtains products or services other than execution of securities transactions from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer. See *Disclosure by Investment Advisers Regarding Soft Dollar Practices,* Advisers Act Release No. 1469 (Feb. 14, 1995) (proposing amendments to Form ADV).

[169] There are divergent views as to the utility of position transparency. See, e.g., *Consultants Demand Hedge Fund Transparency*, Fundfire (Mar. 27, 2003). Many experts believe that position transparency is of little value to most investors because hedge fund advisers tend to engage in complex strategies beyond the understanding of those investors. See, e.g., Roundtable Transcript, May 14 (statement of George Hall) ("position level transparency is basically meaningless . . . to most investors.").

[170] In one survey, 75 percent of institutional investors named monitoring strategy drift as one of their primary reasons for requiring additional transparency and 57 percent of those polled said that monitoring sector concentration was important to them. Deutsche Bank Survey, supra note 158, at 15.

proprietary information confidential.[171] For example, many worry that such disclosure might permit other market participants to take advantage of short positions that the hedge fund might hold, to the detriment of the fund and its investors. Moreover, position transparency with respect to a hedge fund implementing a merger arbitrage strategy, for example, will reveal little about the risks involved because it reveals nothing about the likelihood of certain events occurring and it does not disclose what leverage, if any, the investment adviser is using.[172]

The financial press has reported increased investor interest in risk transparency, and has ascribed this trend primarily to institutional investor demand as hedge funds become a component of mainstream investing programs for pension plans, endowments, foundations and other non-private institutional investors.[173] Proponents of increased risk transparency assert that it provides a more meaningful measure of the risks associated with an ongoing hedge fund investment than position transparency.[174]

4. Periodic Reporting

Many hedge fund advisers provide periodic reports to their investors, although they are not specifically required under the federal securities laws.[175] The information in such reports varies widely among hedge fund advisers in terms of the types of information shared and the quality of the disclosure. Some hedge fund advisers report only the hedge fund's overall performance during the most recent period, while other reports disclose each individual

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171 See Roundtable Transcript, May 15 (statement of Mark Anson) ("If there is a public disclosure of the hedge fund manager's trading positions, well, that may reveal that hedge fund manager's competitive advantage. And as an investor, that doesn't help me, that's just going to erode my returns.").

172 Roundtable Transcript, May 14 (statement of George Hall) ("[I]f you look at most of the well-known blowups and problems that have happened, . . .[position] transparency wouldn't have made investors get out of those investments.").

173 See Alison Bisbey Colter, *Hedge-Fund Investors Seek Detailed Data, Survey Finds*, Wall Street Journal (Apr. 1, 2003); *Hedge Funds Seen Upping Risk Transparency*, Fundfire (Mar. 10, 2003).

174 Leslie Rahl, *Hedge Fund Transparency: Unraveling the Complex and Controversial Debate* 31-32 (2003); Comment submitted by Price Meadows Inc. at 3.

175 Hedge fund advisers are not required to provide investors with semiannual or any other reports containing information about their investments under the federal securities laws. In contrast, a registered investment company is required to provide shareholders with semiannual reports containing, among other information, a balance sheet and income statement within 60 days after the close of the reporting period. These reports also typically include a discussion of management's explanation of the investment company's performance. See Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder.

investor's performance. Periodic reports may include detailed information about the fund, its investments, including whether the adviser has diverged from the fund's primary investment strategies, its performance history and relevant market commentary. Hedge fund advisers also may provide investors with account statements reporting their capital account balances with these periodic reports.

5. Additional Sources of Hedge Fund Information

Hedge fund databases and indices are an additional source of information about hedge funds.[176] Hedge fund indices are statistical composites that measure and report value changes in hedge fund groupings based on information contained in various databases. Various commenters, however, have questioned the accuracy and utility of these sources of information.[177] Among the complaints is the concern that, because there is no known universe of hedge funds, it is impossible to determine if all hedge funds that meet the qualifications of a particular index or database are actually represented in that index or database. In addition, there is no requirement for hedge funds to report their performance, and those that do may choose to stop providing the information at any time.[178] Studies also suggest that databases reflect a survivorship bias in that they may include only hedge funds currently in operation, and may exclude funds that close down as a result of poor performance and for other reasons.[179] Finally, the accuracy of hedge fund performance data provided by hedge fund advisers cannot be verified because of the lack of independent oversight of a hedge fund adviser's valuation of a hedge fund's portfolio securities and the fact that hedge fund performance results are not required to be reported using a uniform or standardized performance measure.

Information about hedge funds is also available through third-party websites (i.e., websites sponsored by persons not connected to any hedge fund). Generally these websites provide in one central location descriptive and performance-related information about a number

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176 Bloomberg posts the results of over 100 hedge fund indices. The data for the indices is compiled by several database repositories/consultants, including: Credit Suisse First Boston/Tremont Partners; Evaluation Associates Capital Markets; Lehman Brothers; Hedge Fund Research, Inc.; Hennessee Hedge Fund Group; and Standard & Poor's.

177 See, e.g., Comment submitted by Craig S. Tyle on behalf of the Investment Company Institute; Bing Liang, *Hedge Funds: The Living and the Dead*, 35 Journal of Financial and Quantitative Analysis 309 (Sept. 2000); Harry M. Kat, *10 Things That Investors Should Know About Hedge Funds*, The Journal of Wealth Management 72 (Spring 2003).

178 For example, a successful hedge fund that has reached its capacity limits may close the fund to new investors and stop reporting altogether.

179 See, e.g., Liang, supra note 177 at 309; Kat, supra note 177 at 72, 73.

of hedge funds. Subscribers who are pre-qualified as accredited investors may, for a fee, receive a password permitting them access to this information.[180]

Finally, some information about hedge funds can be obtained from institutional reporting services such as Bloomberg and from financial newsletters. In addition, consistent with the growth of hedge funds, members of the press and other forms of media actively cover the hedge fund industry.[181]

E. Hedge Fund Service Providers

1. Hedge Fund Investment Advisers

A hedge fund typically is sponsored, organized and managed by its investment adviser. Many hedge fund investment advisers were founded by former traders, analysts or portfolio managers who left investment banks, investment management firms and other large financial institutions to establish their own hedge funds. Many of these individuals were attracted by the entrepreneurial aspects of starting their own business and managing assets using investment strategies in which they may have a particular expertise.[182] They also often are lured to establish their firms by the potential compensation that can be earned by managing hedge funds.

A hedge fund's investment adviser usually is responsible for establishing the hedge fund and overseeing the preparation of the hedge fund's PPM and subscription agreement, as well as the applicable limited partnership or limited liability company agreements (for domestic funds).[183] The investment adviser negotiates the hedge fund's arrangements with various service

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[180] See *Lamp*, supra note 36.

[181] As discussed below, some of these practices lead to questions regarding the sources of hedge fund information and more importantly, whether hedge fund advisory personnel that provide information through these sources or that respond to inquiries from the media are engaged in a general solicitation or in a general advertising for purposes of the federal securities laws. See infra Part VI.F. (discussing concerns relating to general solicitation).

[182] See Roundtable Transcript, May 14 (statement of Joel Press) ("It really is a business of people wanting to create their own culture, their own environment, . . . creating their way of earning dollars in a way that's unique to them, in their own strategy, their own people, their own compensation environment, and allowing them to exist in today's technology wherever they choose to set up their organization and just work and trade and do their research. It's a very unique entrepreneur.").

[183] If the fund is a limited partnership, the investment adviser typically serves as the fund's general partner. If the fund is a limited liability company, the investment adviser typically serves as the

providers, including broker-dealers providing prime brokerage services. The investment adviser also generally is responsible, at least in the early stages of the hedge fund's existence, for marketing and distributing the fund's securities to investors. Finally, the investment adviser often is responsible for investor relations, including providing periodic reports to investors about fund performance.

The nature and capabilities of hedge fund investment advisers vary greatly. Some hedge fund advisers are exceedingly sophisticated entities that manage billions of dollars in investment assets. These advisers employ multiple portfolio managers, analysts, brokers and compliance, risk management, legal and other operational personnel. These advisers also have the ability to install sophisticated systems and procedures to assist in complying with the advisers' fiduciary duties. At the opposite end of the spectrum are smaller, typically recently established investment advisers where one individual serves as marketer, portfolio manager, trader, operations officer and risk manager. Many of these types of advisers have few, if any, formal procedures.

2. Broker-Dealers/Prime Brokers

Full service broker-dealers frequently offer prime brokerage services, in addition to typical brokerage services, to hedge fund advisers. Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades and to provide other services for substantial retail and institutional customers, including hedge funds.[184] Hedge fund advisers often select prime brokers by matching the hedge fund's strategies with the specific services and areas of expertise offered by one or more different full-service broker-dealers.[185] Among the key services that may be offered by broker-dealers are:

- Streamlined Trading. Prime brokers clear and settle hedge funds' trades executed by other broker-dealers ("executing brokers") upon instructions from hedge fund advisers.[186] The hedge fund maintains its funds and securities in an account with the

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fund's managing member. Terrance J. O'Malley, *The Regulation of Hedge Fund Managers by the SEC* 2 (2003).

184 See Testimony of William H. Donaldson, Chairman, U.S. Securities and Exchange Commission, Before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (May 22, 2003) ("Chairman Donaldson Testimony").

185 Less established hedge funds tend to have arrangements with a single prime broker, which is often the firm that assisted in the hedge fund's start-up. More established hedge funds and those with more complex investment strategies are more likely to use multiple prime brokers. Hedge fund advisers may also use multiple broker-dealers in order to ensure only limited exposure of their investment strategies and portfolio holdings to any one broker-dealer.

186 See *Prime Broker Committee* (pub. avail. Jan. 25, 1994).

prime broker. Transactions placed with executing brokers are effected through accounts with those brokers in the name of the prime broker for the benefit of the hedge fund. After executing a trade, the executing broker and the hedge fund adviser report the details to the prime broker, who clears the trade and provides custody of the securities.

- Securities Lending. Many hedge funds' investment strategies involve short selling. A broker-dealer's securities loan capability plays a critical role in this process. Prime brokers use their relationships in the banking and brokerage communities to locate and acquire securities to lend to their customers for short selling purposes. Hedge funds often choose prime brokers who have the largest inventories of securities available for loans, or those who are able, through relationships and market clout, to easily acquire the securities.

- Margin Lending. Broker-dealers maintain margin accounts and provide loans and other services in connection with facilitating transactions for their customers. Prime brokers are generally required to maintain collateral to secure margin loans to hedge funds as a result of regulatory requirements and internal limits on risk exposure, which are constantly monitored for changes.

- Capital Introduction. These services are designed to introduce hedge fund advisers to potential hedge fund investors. Prime brokers may sponsor seminars for consultants and institutional investors seeking exposure to hedge funds. Prime brokers may also set up one-on-one meetings and prepare marketing materials to introduce potential investors to hedge fund advisers.

- Hedge Fund Start-up Services. Broker-dealers may offer new hedge fund advisers with the means of operating a hedge fund through introductions or referrals to lawyers, accountants and other service providers. In addition to assisting these hedge fund advisers with back office support, the broker-dealer may provide the hedge fund adviser with office space.

- Customized Reporting. Some broker-dealers offer to provide hedge fund advisers with customized periodic reports, including: (1) reports that reflect end of day pricing of securities; (2) reports that provide risk management to investment advisers, such as value-at-risk, liquidity and stress testing; and (3) reports that allow fund advisers to provide investors with some limited transparency information.

- Research. Most broker-dealers offer to provide proprietary and third-party research and other soft dollar arrangements related to individual securities and particular market sectors of interest to the hedge fund's investment adviser.

- Valuation. Some broker-dealers may function as a source of prices for certain types of (or individual) securities.

- Technology. Some broker-dealers facilitate the start-up of new hedge funds by offering technology services, including reporting systems, software, trading systems, connections to ECNs, fixed connectivity and risk management systems. Other broker-dealer firms offer advice in these areas and may arrange for these services to be provided by a third-party.

- Operations Services. Broker-dealers may offer to provide persons seeking to start a hedge fund with: (1) advice regarding minimum and maximum amounts of investor subscriptions required to be raised and rates of returns expected by investors; (2) services such as the preparation of offering materials and reports to investors; (3) information on strategies to assist in obtaining investments; (4) advice as to appropriate investment alternatives for excess cash; and (5) referrals of requests for information from potential investors.

Compensation for prime brokers varies based on the nature of the services that they provide to their customers. While some broker-dealer firms have guidelines for fees, most will negotiate final fees on a case-by-case basis.[187] To determine fees, prime brokers evaluate each hedge fund adviser on an overall risk/return basis and on the business done at the broker-dealer firm. Prime brokers generate revenue on hedge fund business from commissions, spreads, administrative fees, ticket charges, stock loans and credit interest earned from providing position financing and arranging securities loans.[188] The prime broker will generally assess the package of services required by the hedge fund and suggest a price on that basis.

3. Offshore Administrators

Investment advisers of offshore hedge funds typically rely on offshore administrators to provide various types of operational support.[189] These administrators provide offshore hedge funds with a number of services, many of which were initially offered to assist offshore hedge

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187 Fee arrangements for prime brokerage services generally take the form of undocumented, verbal agreements.

188 For example, prime brokers that finance margin transactions receive income based on the spread between the prime broker's cost of borrowing and the rate charged to the hedge fund for the loan. In short sale arrangements handled by the prime broker, the prime broker generally retains the spread between the interest earned on collateral (i.e., cash) posted by the borrower and the rebate paid to the borrower. In addition, prime brokers may receive income by charging a "ticket charge" for each transaction processed through the prime broker.

189 *Outsourcing the Administration of Alternative Investment and Hedge Funds* – Presentation by Dermot S.L. Butler to the Mastering Investments and Offshore Funds Conference in Dublin, Ireland (Nov. 28, 2001), available at www.customhousegroup.com/outsourcing.htm.

funds in addressing certain U.S. tax provisions.[190] Notwithstanding the repeal of these provisions, many offshore funds continue to maintain their relationships with offshore administrators as a matter of convenience and investor preference.

Hedge fund advisers contract with offshore administrators for specific services that the administrator will provide their offshore hedge funds.[191] Offshore administrators may assist a hedge fund adviser to set up an offshore hedge fund in accordance with applicable foreign laws and also may assist the fund in complying with such laws on an ongoing basis. Offshore administrators also may assist hedge fund advisers by organizing meetings of investors and directors. They also may provide accounting, record keeping and reporting services, as well as assist in calculating fees and accruals. Offshore administrators may provide offshore hedge fund advisers with some oversight of their activities, particularly with respect to hedge fund finances.[192]

One of the more important tasks an offshore administrator may provide to an offshore hedge fund adviser is to assist it in pricing the fund's portfolio securities. The scope of this service frequently depends on the nature of the agreement with the offshore administrator, as well as the investment strategies used by a particular fund and whether prices are easily obtainable for the securities in which the hedge fund invests. In some cases, the administrator will not provide independent prices of specific securities, but may generally defer to the valuations provided to it by the hedge fund adviser and calculate the offshore hedge fund's net asset value based on that information.[193]

Certain offshore jurisdictions regulate offshore hedge fund administrators operating within their borders. Such regulation may subject the administrators to licensing, auditing and record keeping requirements. For example, many offshore hedge funds are domiciled in The

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[190] Prior to 1998, if an offshore hedge fund performed a set of specific services (called the "Ten Commandments") from offices outside of the United States, the IRS would not consider the fund to have its principal office in the United States, and generally would not subject the hedge fund to U.S. taxation. The Taxpayer Relief Act of 1997 eliminated the need for offshore hedge funds to comply with the Ten Commandments. Pub. L. No. 105-34, 111 Stat. 788 (1997).

[191] For a discussion of the range of possible services provided by an offshore third-party hedge fund administrator, see Roundtable Transcript, May 14 (statement of William Keunen).

[192] See *Ready to Take Advantage*, International Fund Services Review Dublin 40 (2001). See also Roundtable Transcript, May 14 (statement of William Keunen).

[193] Hedge fund PPMs typically state that the general partner/managing member has ultimate authority in the valuation of securities.

Bahamas, Bermuda, the British Virgin Islands and the Cayman Islands.[194] These jurisdictions generally apply certain laws regulating the operations and conduct of investment pools and investment pool administrators to hedge funds and hedge fund administrators. These laws generally require fund administrators to be licensed, and three of the four jurisdictions require licensed fund administrators to have their accounts audited by an auditor approved by the regulator.[195] With respect to record keeping, each of these jurisdictions also subjects licensed fund administrators to anti-money laundering provisions. These provisions set forth client identification and record keeping requirements in addition to obligations to report any suspicious activity with respect to the funds they administer to the relevant authority in that jurisdiction.[196]

4. Auditors

Unlike registered investment companies, there is no statutory or regulatory requirement that a hedge fund have its financial statements audited.[197] Whether a hedge fund undergoes an annual audit of its financial statements is a contractual matter between the hedge fund and its investors. The auditors of hedge funds that provide audited financial statements to their investors generally conduct independent audits of hedge funds pursuant to Generally Accepted Auditing Standards in the United States ("GAAS"),[198] and generally render an opinion on

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194 See generally The Bahamas Mutual Funds Act, 1995 (June 2001 Revision); Bermuda Monetary Authority Act 1969; Bermuda Companies Act 1981, Part XIIA (Mutual Fund Companies); Bermuda Monetary Authority (Collective Investment Scheme Classification) Regulations 1998; British Virgin Islands Mutual Funds Act, 1996 (as amended 1997); and Cayman Islands Mutual Funds Law (2003 Revision).

195 We understand that the fourth jurisdiction, Bermuda, has legislation pending that would require such audits.

196 See generally Bermuda Proceeds of Crime (Money Laundering) Regulations Sections 4-6 (1998); British Virgin Islands Anti-Money Laundering Code of Practice (1999); Cayman Islands Proceeds of Criminal Conduct Law (Money Laundering Regulations) (2000); The Bahamas Financial Transactions Reporting Act (2001 Revision).

197 Generally, the federal securities laws effectively prohibit any issuer, including registered investment companies, from offering or selling its securities publicly unless the issuer has filed a registration statement with the Commission which is required to include the issuer's financial statements and an opinion from an independent accountant. This prohibition, however, does not apply to hedge funds because they do not publicly offer or sell their securities. See Sections 5 and 7 of the Securities Act.

198 GAAS is generally comprised of the professional standards established by the American Institute of Certified Public Accountants ("AICPA"), including the industry audit and accounting guides. See *Implementation of Section 10A of the Securities Exchange Act of 1934*, Exchange Act Release No. 38387 (Mar. 12, 1997) (citing AU Section 150.02, AICPA Codification of Statements on Auditing Standards).

whether a hedge fund's financial statements are materially consistent with Generally Accepted Accounting Principles in the United States ("GAAP")[199] Depending on its agreement with its investors, the investment adviser may forward the independent accountant's report and the hedge fund's financial statements to investors upon the completion of the audit.[200]

A domestic hedge fund's engagement of an independent accountant to audit its financial statements is normally the responsibility of the fund's investment adviser. The selection of an independent accountant by domestic hedge funds, because they are typically organized as limited partnerships, is not subject to ratification or approval by a board of directors or other representative body of the investors in the hedge fund.[201]

The qualifications of an independent accountant that may be used by a hedge fund are not as stringent as those used for registered investment companies. A hedge fund's independent accountant must comply with the general independence standards of the AICPA or of the individual State Boards of Accountancy where the independent accountant practices. In contrast, a registered investment company independent accountant must comply with the requirements of the Investment Company Act of 1940 and is required to follow certain regulations established under the Sarbanes-Oxley Act of 2002 and various Commission rules to ensure the independence

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199 A minority of domestic hedge funds and many offshore hedge funds prepare financial statements on a different comprehensive basis of accounting (e.g., tax accounting standards, international accounting standards (IAS) or local country generally accepted accounting principles (foreign GAAP)). If the financial statements are prepared in accordance with another comprehensive basis of accounting instead of GAAP, an audit may still be conducted under GAAS.

200 There are no time constraints on delivering the hedge fund's audited financial statements to investors unless specifically stated in the PPM or partnership agreement. But see Rule 206(4)-2 of the Advisers Act (registered investment adviser with custody of client assets is required to provide all limited partners or beneficial owners of the hedge fund with audited financial statements within 120 days in certain circumstances). In contrast, registered investment companies must transmit to shareholders audited financial statements within 60 days of their fiscal year end. See Rule 30e-1(c) under the Investment Company Act.

201 The selection process used by domestic hedge funds contrasts with the selection of an independent accountant by a registered investment company. The Investment Company Act regulates both the selection process of the fund's accountant and the continuing oversight of a registered investment company's auditing processes by requiring an independent accountant to be approved by either a majority vote of the disinterested board members or the approval by the board's audit committee. See Section 32(a) of the Investment Company Act and Rule 32a-4 thereunder. There may be some oversight of the selection of the independent accountants by offshore hedge funds, because they are typically organized as corporations.

of auditors.[202] In addition, a hedge fund's independent accountant is not required to register with the Public Company Accounting Oversight Board ("PCAOB") unless if it also serves as the independent auditor for a public company.[203] A hedge fund's independent auditor is not otherwise required to register with PCAOB, nor are its audits with respect to private issuers subject to PCAOB examination. As a result, the audits of hedge fund financial statements will not be subject to the examination process of the PCAOB in its oversight of registered accounting firms.[204]

5. Consultants and Other Finders

Hedge fund consultants are generally third parties who perform services for hedge fund investors and the hedge funds. Consultants offer investors educational and due diligence services to assist them in navigating the complexities of hedge fund investing.[205] They also may provide hedge fund advisers with services, such as assisting those advisers to determine the eligibility of new investors. Many consultants manage their own proprietary hedge fund products for sale to investors.

Hedge fund consultants educate investors with respect to the type of information that should be sought in connection with any hedge fund investment.[206] They may assess the

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[202] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) ("Sarbanes-Oxley Act"). See also Article 2 of Regulation S-X (qualifications and reports of accountants).

[203] PCAOB has jurisdiction over entities that are issuers pursuant to Section 3(a)(8) of the Exchange Act. PCAOB oversees the audits of financial statements of such public companies through registration, standard setting, inspection and disciplinary programs. See Sarbanes-Oxley Act, Sections 102-105, 108.

[204] The independent audits of public companies, including registered investment companies, will be subject to PCAOB examination. PCAOB is in the process of establishing auditing, quality control and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. The implementation of these standards may indirectly benefit audits of hedge funds to the extent that PCAOB-registered firms also perform audits of hedge funds and draw on the standards applicable with respect to public companies.

[205] Hedge fund investors also frequently hire private investigator services to assist them in verifying the information provided by the investment adviser and its personnel. For example, these services may be called upon to verify a portfolio manager's educational or employment background as well as to confirm reported investment performance assertions. See Roundtable Transcript, May 15 (statement of Sandra Manzke), supra note 162.

[206] Most hedge fund investors perform extensive due diligence prior to making initial and subsequent investments. According to a survey of institutional investors, 60 percent of institutional investors take between two to six months to complete due diligence on a hedge fund. Deutsche Bank Survey, supra note 158, at 7.

suitability of a hedge fund investment in light of the investor's investment objectives and risk tolerance and may assist with asset allocation decisions.[207]

Consultants often provide investors with due diligence services relating to specific hedge fund investments, such as analyzing the hedge fund's offering and partnership documents, compiling historic return information and checking background information about the hedge fund adviser. Consultants may also make an assessment of the operational capabilities of a particular hedge fund by visiting the adviser. After an investment is made, consultants assist investors' monitoring of hedge fund investments and management through regular communications with the hedge fund adviser and tracking of the fund's performance against other funds that utilize the same investment strategy.

The intermediary role of hedge fund consultants may present certain conflicts of interest. A conflict of interest may exist when a hedge fund consultant provides an advisory service to investors, but also offers or recommends its own proprietary hedge fund products. A conflict of interest may also arise when the consultant essentially acts as a "marketer" for the hedge fund and receives a "rebate" or fee (e.g., a percentage of the hedge fund's management and performance fees) from the hedge fund.[208] This contrasts with other arrangements where the

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207 See, e.g., Hennessee Group Comment Letter, supra note 4, at 18-19. Consultants who, for compensation, recommend specific hedge funds to investors generally are serving as investment advisers under Section 202(a)(11) of the Advisers Act. A consultant that merely engages in solicitation activities for a registered investment adviser is deemed to be an associated person of that investment adviser. See *Requirements Governing Payments of Cash Referral Fees by Investment Advisers*, Advisers Act Release No. 688 (July 12, 1979).

208 Generally, the obligation to disclose conflicts arises from the consultant's status as an investment adviser. Consultants that market hedge fund interests, however, may be acting as a broker and be required to register with the Commission as such under Section 15(b) of the Exchange Act. Section 3(a)(4) of the Exchange Act generally defines a "broker" as a person who is "engaged in the business of effecting transactions in securities for the account of others." "Regularity of participation" in securities transactions is primary indicia of being engaged in the business of effecting securities transactions. *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 12-13 (D.D.C. 1998). A person may be found to be acting as a broker if he participates in securities transactions "at key points in the chain of distribution." *Massachusetts Financial Services, Inc. v. Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.), aff'd, 545 F.2d 754 (1st Cir. 1976), cert. denied, 431 U.S. 904 (1977). Key factors indicating that a person may be acting as a broker -- and, thus would need to register with the Commission -- are solicitation of investors to purchase securities, involvement in negotiations between the issuer and the investor, and receipt of transaction-related compensation. See, e.g., *SEC v. Hansen*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) 91,426 (S.D.N.Y. 1984). It is not necessary to prove scienter to establish a violation of Section 15(a)(1). *SEC v. National Executive Planners, Ltd.*,503 F. Supp. 1066, 1073 (M.D.N.C. 1980).

consultant receives a fee from the investor, in the form of either a retainer, or a flat or asset-based fee.[209]

F. Hedge Fund Advisory Fees

An investment adviser to a hedge fund generally receives compensation composed of an investment management fee and an incentive allocation.[210] The investment management fee is an asset-based fee that is similar to the advisory fee charged by advisers to registered investment companies and is designed to provide the investment adviser with current cash flow to maintain operations. The investment management fee is generally one to two percent of net assets.[211]

The incentive allocation is not a fee paid to the investment adviser, but instead, is an allocation of partnership earnings and profits to the general partner of the partnership. Unlike the management fee, the incentive allocation is usually calculated as a percentage of the hedge fund's net investment income, realized capital gains and unrealized capital appreciation. Incentive allocations for hedge funds tend to be 20 percent of realized and unrealized gains.[212]

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[209] Hedge fund advisers that are registered investment advisers that have referral/solicitation arrangements with various consultants or broker-dealers are specifically required to disclose, among other things, the compensation that they pay to solicitors. See Rule 206(4)-3 under the Investment Advisers Act and Form ADV, Part II, Item 13. Any conflicts of interest surrounding the referral arrangement (e.g., when the solicitor is also an investor in the hedge fund) must also be disclosed.

[210] The nature of a hedge fund's fees and the tax implications are intertwined with the fund's domicile and organizational structure.

[211] According to Van Hedge Fund Advisers ("VHFA"), as of the first quarter of 2003, the median hedge fund had a management fee of one percent. VHFA tracks over 4,000 hedge funds. See Van Hedge Fund Advisors International, Inc., *Global Hedge Funds*, characteristics as of the first quarter of 2003 ("Global Hedge Funds Characteristics"). See also *Clinton Group Hikes Fees on Macro Fund*, Alternative Investment News (July 1, 2003) (noting that the fund increased its management fee to three percent).

[212] Section 205 of the Advisers Act and Rule 205-3 thereunder address the assessment of fees based upon a share of capital gains and capital appreciation. These provisions generally prohibit registered investment advisers from charging performance-based fees to most clients that are not "qualified clients," as defined in Rule 205-3. This prohibition does not apply to advisory relationships with hedge funds that rely on Section 3(c)(7). See Section 205(b)(4) of the Advisers Act.

Rule 205-3 generally defines a qualified client as one of the following: (1) a natural person or company that has $750,000 under the management of the adviser; or (2) a natural person or company whom the adviser believes has (a) a net worth of $1.5 million or (b) is a qualified

In comparison with the asset-based fees typically charged by registered investment companies, the incentive allocations, or performance fees typically charged by hedge fund advisers, are often perceived as creating incentives for investment advisers to take greater risks with client assets.[213]

Hedge fund advisers often agree to certain conditions that are designed to align the adviser's interests with those of the hedge fund investors. For example, investors often require the investment adviser to have a significant financial investment in the hedge fund. Investors rely on this requirement to serve a number of purposes, including curbing any temptation for the adviser to take undue risks.

The partnership agreement may also contain other provisions that protect investors from paying incentive allocations for poor performance, such as high water marks and hurdle rates. High water marks are thresholds that the investment adviser must achieve before an incentive allocation can be assessed.[214] Generally, a high water mark varies for each limited partner based on the maximum value of the limited partner's interest in the partnership since its initial investment in the fund. The investment adviser must generate investment returns beyond the "high water mark" before the investment adviser can assess an incentive allocation. In essence, the hedge fund's performance must surpass its previous high point before additional incentive allocations can be assessed. This prohibits an adviser from collecting an incentive allocation twice for the same performance.[215]

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purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act. Rule 205-3(b) requires a registered investment adviser intending to charge a hedge fund relying on Section 3(c)(1) a performance fee to look through the hedge fund to ensure that each of its equity owners is also a qualified client. See *Exemption to Allow Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account,* Advisers Act Release No. 1731 at text accompanying nn.28-32 (July 15, 1998).

213 See H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees have been characterized as "heads I win, tails you lose" arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940). See also Investment Trusts and Investment Companies, H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939); *Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account.* Advisers Act Release No. 996 (Nov. 26, 1985); *Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account*, Advisers Act Release No. 1682 (Nov. 13, 1997).

214 According to VHFA, of those funds with performance fee arrangements, 89 percent have a high water mark. See Global Hedge Funds Characteristics, supra note 211.

215 For example, assuming an initial investment of $10,000, a 20 percent performance fee, and a first year return of ten percent, the first year's performance fee would be $200: [($10,000 * 1.10 =

Hurdle rates are also used to guarantee that the hedge fund achieves a minimum investment performance before the fund's adviser may receive any incentive allocation.[216] A hurdle rate establishes a performance floor that the investment adviser must exceed in order to obtain the incentive allocation.[217]

Hedge funds that cannot consistently achieve positive performance are likely to exit the business. Because the incentive allocation provides the majority of an investment adviser's income from its hedge fund, failure to produce positive returns will prevent a hedge fund from collecting the performance fee. If an adviser's performance allocation is subject to a high water mark, the hedge fund must surpass its previous high point before a performance allocation is paid. The failure to produce positive returns has other effects beyond denying the fund's adviser of profits. These may include the departure of the fund's key employees, as well as the redemption of investments. Of course, these factors are key determinants into whether the hedge fund will survive.[218]

When hedge funds do close, certain liquidation issues may be present. Hedge fund management contracts typically have provisions designed to protect the adviser and the remaining limited partners in the event of liquidation. "Holdback provisions" permit hedge funds to withhold specified fractions of redeeming limited partner's capital. These provisions

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$11,000) and ($11,000 - $10,000) * 0.20 = $200]. If the second year's return is -20 percent [$11,000 * 0.80 = $8,800], the adviser receives no performance fee since the $8,800 is less than the high water mark of $11,000. If in the third year the fund has a 30 percent return [$8,800 * 1.30 = $11,440], the adviser receives a performance fee of $88 [$11,440 - $11,000 = $440 * 0.20 = $88].

216 According to VHFA, of those funds with performance fee arrangements, 18 percent have a hurdle rate. See Global Hedge Funds Characteristics, supra note 211.

217 If a hedge fund investment adviser performance compensation plan is subject to a 10 percent hurdle rate provision, then the investment adviser must exceed a 10 percent return on the fund before an incentive allocation can be assessed. For example, assuming an initial investment of $10,000, a hurdle rate of ten percent, a 20 percent performance fee and first year actual fund performance of 25 percent, then the adviser would earn $300 in incentive allocation: [{10,000*(1.25-1.10)}*.20=300]. In other variations, a hurdle rate can be applied to all profits, but only after the net return has exceeded the hurdle rate (i.e., the investment return after consideration of the incentive allocation is greater than the hurdle rate).

218 The President's Working Group on Financial Markets report estimated that, based on a sample of 397 hedge funds from 1994 to 1998, the survival rate was less than 60 percent. LTCM Report, supra note 126, at A-4. VFHF reports that the median hedge fund age is only 5.5 years. See Global Hedge Funds Characteristics, supra note 211.

guard against the possibility that investors should have received less money than they received on the redemption dates.

G. Hedge Fund Valuation Practices

Hedge funds that invest in liquid securities normally value their portfolio securities using market values for those securities when available. Hedge fund advisers generally "fair value" portfolio securities when market prices for those securities are not readily available.[219] Some hedge fund advisers fair value their portfolio securities by reference to an accounting industry standard, which standard generally equates fair value to the price that the fund might reasonably expect to receive for a security or other asset upon its current sale.[220]

The key difference between the valuation of a registered investment company's portfolio securities and those of a hedge fund's portfolio securities, is that a hedge fund investment adviser generally has complete discretion with respect to the valuations used to price the fund's securities, whereas the board of directors of a registered investment company provides independent oversight of the adviser's valuation activities.[221] For example, some hedge funds may value the securities of non-publicly traded companies at cost and may not revalue them until a public trading market for the securities develops or the issuer engages in a subsequent round of equity financing.

Third parties also may assist hedge funds in the valuation process. Many hedge funds obtain pricing information from independent pricing services to either ascertain the market values or assist the investment adviser in establishing fair values of the securities. Prime brokers, as well as third-party administrators to offshore hedge funds, often perform fund valuation services as part of the package of services they provide to hedge funds.[222] Whether

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[219] Illiquid securities, certain debt instruments and securities issued in private placements and other difficult-to-price securities are the types of securities a hedge fund would be expected to fair value.

[220] See Statement of Financial Accounting Standards No. 107, Financial Accounting Standards Bd. (1991); Statement of Financial Accounting Standards No. 115, Financial Accounting Standards Bd. (1993); and Statement of Financial Accounting Standards No 133, Financial Accounting Standards Bd. (1998).

[221] See supra note 16.

[222] See supra Part IV.E.2. (discussing role of broker-dealers/prime brokers) and Part IV.E.3. (discussing offshore administrators). Prime brokers and administrators may review the valuation of portfolio securities, provide independent prices and reconciliation of portfolios and calculate and report NAVs.

interposing a third-party into the fund's valuation process increases the accuracy of the reported NAV largely will depend on the relationship of the third party to the hedge fund adviser and on what responsibilities the third-party is required to perform under the service contract.[223] To assist in valuing particularly difficult securities, some hedge funds segregate these securities into "side pockets," and postpone including the value of those securities in the hedge fund's NAV calculation until the investment is liquidated.[224]

H. Audit Reports

When conducting an audit of a hedge fund in accordance with GAAS, auditors are required to follow the AICPA's Investment Company Audit and Accounting Guide. Similar to an audit of a registered investment company, the auditor designs a series of tests, based upon an assessment of the hedge fund's internal control environment, that verify the validity of the assets, liabilities, income, expenses and capital transactions of the hedge fund. In addition, this audit testing typically verifies the accuracy of partner capital balances, management and incentive fee calculations and of NAV calculations at intervals when significant contributions and withdrawals are permitted by the fund.

A hedge fund audit, however, is not required to be identical to an audit of a registered investment company.[225] Unlike an audit of a registered investment company, a hedge fund audit generally utilizes a substantive test approach and does not rely on a strong, established internal control system.[226] The audit testing typically includes a sample confirmation of assets and

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[223] For example, the service contract may require a third party to simply transmit prices or check computations based on valuations provided by the hedge fund or its prime broker, without inquiry into the reasonableness of those prices.

[224] "Side pockets" protect investors against adverse timing of withdrawals. Since investment advisers tend to redeem more liquid assets first, as limited partners withdraw their money, the portion of the fund that is illiquid may increase significantly, leaving the remaining limited partners with an illiquid investment. The use of "side pocket" accounting effectively reduces the risk of illiquidity issues for limited partners that remain in the fund.

[225] The AICPA is in the process of revising its guidance to clarify the differences in accounting and auditing by registered investment companies and non-registered investment partnerships, such as hedge funds. See, e.g., AICPA Accounting Standards Executive Committee, Exposure Draft of a Proposed Statement of Position (SOP), *Reporting Financial Highlights and Schedule of Investments by Nonregistered Investment Partnerships: An Amendment to the Audit and Accounting Guide Audits of Investment Companies and AICPA Statement of Position 95-2*, *Financial Reporting by Nonpublic Investment Partnership* (July 15, 2003).

[226] A hedge fund auditor is not required to render a separate opinion on whether the internal control system contains any material weaknesses. See Form N-SAR, Item 77B.

liabilities with independent third-party service providers to the hedge fund. In addition, a hedge fund audit generally permits the use of sampling techniques (i.e., less than 100 percent) in audit areas where the statutory provisions or regulatory rules applicable to registered investment companies require 100 percent verification, such as with respect to the existence and valuation of portfolio securities.[227]

When conducting an audit of a hedge fund in accordance with GAAS, auditors are required to review a hedge fund's fair valuation procedures for consistency with the fund's PPM or partnership agreement, as applicable, to determine the reasonableness of the procedures.[228] Although the audit procedures with respect to valuation also are similar to those used for registered investment companies, a hedge fund audit provides less assurance about the valuation process for two reasons.[229] First, a hedge fund audit evaluates a valuation determination that is made by the hedge fund's investment adviser, who both makes investment decisions for the hedge fund and typically has ultimate discretion for assigning a value to its portfolio securities. This valuation process contrasts with the delegation of duties in the registered investment company context, where the investment company's board of directors establishes valuation procedures and provides independent review of valuation determinations. Second, hedge fund auditors perform sample valuation tests of the hedge fund's portfolio securities that are less comprehensive than the 100 percent verification standard applicable to registered investment companies.[230]

I. Risk Management

Hedge fund advisers are expected to achieve performance returns for investors by using strategies that are designed to assume or eliminate calculated risks consistent with the hedge fund's investment objective. The observation that some hedge funds are riskier than others

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[227] See Section 30(g) of the Investment Company Act (100 percent custody verification) and Accounting Series Release No. 118, Financial Reporting Codification (CCH) Section 404.03 (Dec. 23, 1970) (100 percent verification of pricing).

[228] Hedge fund auditors typically conduct substantive tests on the application of the procedures in pricing portfolio securities to ensure that the process is being consistently applied.

[229] See infra Part VI.B. (discussing concerns about valuation of hedge fund portfolio securities).

[230] Many hedge funds obtain pricing information from pricing/valuation services such as Bloomberg, Reuters and FT Interactive Data to either ascertain market values or assist the investment adviser in establishing fair values. As with registered investment companies, auditors of hedge funds confirm the accuracy of market-priced security valuations with an independent third party by comparing the portfolio values obtained from a pricing service to the valuations used in a hedge fund's financial statements.

reflects the wide latitude hedge fund advisers have to operate their funds and the potential that exists for some hedge funds to suffer significant losses. An effective risk management system, therefore, is important to a hedge fund's operations.

The risk management systems used by hedge funds vary by firm. Larger and more seasoned hedge funds often establish an internal risk management structure using their own resources and personnel. It is common for less established hedge fund advisers that usually have fewer financial and personnel resources to outsource the risk management function to their prime brokers or to other service providers. Some of the less established hedge fund advisers have little or no risk management controls.

Generally, risk management is a monitoring function that quantifies and tracks the risks involved after investments are acquired. Effective risk management systems require hedge fund advisers to identify, measure, monitor and manage the various dimensions of risk. These processes generally differ by firm because they are based on the resources and investment strategies of the hedge fund adviser. The risks that are associated with hedge funds generally may be divided into three broad areas of concern: portfolio risks; the effect of leverage on portfolio risks; and operational risks. Portfolio risks may be further divided into market risk, liquidity risk and credit risk.

As a general industry standard, hedge fund advisers uniformly review information about positions, transactions, orders and margin to identify and monitor exposures at the individual portfolio level and on an aggregate basis for portfolios with the same adviser and/or using the same strategy. This information is then used to identify any excessive concentration of holdings in any one market and any concentration of holdings with potential converging correlations.

J. Funds of Hedge Funds

1. Background

A FOHF is a hedge fund that utilizes a multi-manager, multi-strategy approach by investing all, or a significant portion, of its assets in hedge funds.[231] Although FOHFs can invest in as many underlying hedge funds as they choose, they typically invest in 15 to 25 funds. Institutional investors often choose to invest in FOHFs, rather than in single-manager hedge funds, in order to diversify against the risks associated with a particular hedge fund adviser. One

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[231] The Investment Company Act generally does not limit the investment in hedge funds by registered investment companies, including registered FOHFs. But see supra note 34 (look-through provision of Section 3(c)(1)) and supra note 41 (companies formed for the specific purpose of investing in a Section 3(c)(7) fund may not be a qualified purchaser).

article reports that during the first three quarters of 2002, the number of FOHFs grew from an estimated 510 to 675, an increase of 32 percent, and FOHF assets increased by 84 percent.[232]

Most FOHFs are not registered as investment companies under the Investment Company Act and privately place their securities generally with accredited investors or qualified purchasers. FOHFs employ a compensation structure similar to that of other hedge funds. FOHFs typically charge asset-based investment management fees that range from about one-half to two percent and a performance allocation that ranges up to 20 percent. These fees are levied in addition to the asset-based fees and performance allocations assessed by the underlying hedge funds.

2. Registered FOHFs

An increasing number of FOHFs are registering as investment companies with the Commission; as of early September 2003, 82 FOHFs had registered as closed-end investment companies under the Investment Company Act.[233] At the same time that a FOHF registers as an investment company under the Investment Company Act, it may also choose to register the offer and sale of its securities under the Securities Act ("Dual Registered FOHF"). Registration under the Securities Act allows a registered FOHF to, among other things publicly offer its securities. Dual Registered FOHFs must comply with the prospectus requirements of the Securities Act.

In contrast to Dual Registered FOHFs, registered FOHFs that do not register their offerings under the Securities Act must privately place their securities in reliance on an exemption from registration ("40 Act only Registered FOHF").[234] More than two-thirds of the 82 registered FOHFs are Dual Registered FOHFs.[235] Registered FOHFs collectively have

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[232] Justin Dini, *The Fund of Hedge Fund,* Institutional Investor 50, 51 (Dec. 2002) (citing information from HFR, an organization that collects hedge fund data).

[233] In 1998, the first FOHF registered as an investment company under the Investment Company Act. See PW After Tax Equity Partners (SEC File No. 811-08803).

[234] See supra Part III.B.2 (discussing Regulation D).

[235] In October 2001, Oppenheimer Tremont Market Neutral Fund (SEC File No. 811-10537) and Oppenheimer Tremont Opportunity Fund (SEC File No. 811-10541) became the first FOHFs to register as investment companies under the Investment Company Act and to register the offering of their securities under the Securities Act.

approximately $3.7 billion of assets under management. Investment advisers to registered FOHFs must register under the Advisers Act.[236]

To date, all operating registered FOHFs have imposed a minimum initial investment requirement on their investors ranging from $25,000 up to $1 million.[237] With respect to eligibility standards, registered FOHFs, including Dual Registered FOHFs, have restricted sales to investors that, at a minimum, satisfy the accredited investor standard.[238] Registered FOHFs, however, may lower or eliminate the investment minimum at any time because this investment qualification is not required by law.[239]

Importantly, other net worth-related, eligibility criteria may apply to investors in a registered FOHF, depending, in large part, on whether the fund intends to charge a performance fee. If the investment adviser wishes to charge a performance fee to the registered FOHF, all of the fund's investors must satisfy the definition of a "qualified client" under the Investment Advisers Act.[240]

Investors in a registered FOHF are directly subject to the fees and expenses charged at the registered FOHF level. They are also indirectly subject to the fees and expenses charged by the underlying hedge funds in which the registered FOHF invests.[241] Typically, a registered FOHF pays its investment adviser an asset-based management fee, generally equal to one to two percent of assets under management and, again provided that the fund's investors are all qualified clients, a performance allocation based on the capital gains and capital appreciation of

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[236] See Rule 203A-1 of the Advisers Act (requiring registration of advisers to registered investment companies).

[237] Notwithstanding the stated investment minimum, the offering documents of a registered FOHF (like those of hedge funds or unregistered FOHFs) may provide that the fund may reduce or waive the required minimum investment in limited circumstances, such as when the investor already is an existing client of the investment adviser with substantial assets under management, or when the investor is an officer or employee of the investment adviser.

[238] See supra Part III.B. (discussing accredited investor standard).

[239] But see infra note 250 (pending registration statement of FOHF that will offer and sell its securities without investor eligibility limitations).

[240] See supra note 212.

[241] The underlying hedge funds could also be FOHFs, which would further compound fees and affect the performance of an investor's investment in a registered FOHF.

the fund's portfolio.[242] The underlying hedge funds, in turn, pay similarly structured investment advisory fees to their investment advisers. In addition, operational expenses, including brokerage commissions, custody fees and transfer agent fees, may be incurred at both levels of a registered FOHF.

Registered FOHFs are structured as closed-end management investment companies. As a general matter, closed-end investment companies offer a fixed number of shares to investors during the initial offering period. Investors purchase registered FOHF shares either in the fund's initial offering or in any subsequent offerings.[243] Many registered FOHFs provide for subsequent offerings on a semi-annual or quarterly basis, but other registered FOHFs allow investors to purchase shares on a more frequent basis. The number and dates of any subsequent offerings are determined by the fund.

A registered FOHF uses the Form N-2 to register as a closed-end investment company under the Investment Company Act.[244] The prospectus portion of the registration statement discloses information about, among other things, the FOHF's investment objectives and strategies, risks, expenses and performance. Additional or more detailed information regarding the FOHF and its operations, such as: fund history and policies; officers, directors, and persons controlling the fund; advisory and other services; brokerage commissions; and tax and other matters are contained in the Statement of Additional Information portion of the registration statement.[245]

A 40 Act only Registered FOHF may commence offering and selling its shares immediately upon filing a registration statement with the Commission because such registration statements are deemed effective upon filing.[246] Because 40 Act only Registered FOHFs do not register their securities offerings under the Securities Act, the prospectus delivery requirements under the Securities Act do not apply. Accordingly, these funds typically provide a PPM to interested investors that may not necessarily provide all the information required to be included in the N-2 registration statement.

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242 See supra note 212. See also supra Part IV.F. (discussing hedge fund advisory fees).

243 Unlike open-end registered investment companies, closed-end funds do not continuously offer to sell and redeem fund shares.

244 The Form N-2 is used by FOHFs that choose also to register their shares under the Securities Act.

245 Registration statements on Form N-2 are available to the public on the Commission's website.

246 See Section 8(a) of the Investment Company Act. The FOHF also would file a notice on Form D with the Commission no later than 15 days after the first sale of securities.

Under the Investment Company Act, shareholders in Dual Registered FOHFs and 40 Act only Registered FOHFs receive semiannual shareholder reports that are required to disclose, among other information, the fund's financial statements and portfolio holdings, during the relevant period.[247] Registered FOHFs may fulfill this disclosure obligation by listing the hedge funds in which the registered FOHF has invested, but they are not required to identify the securities in which the underlying hedge funds have invested.

3. Repurchases

Registered FOHFs generally provide limited liquidity to their shareholders by offering to repurchase their securities pursuant to tender offers structured to comply with Section 23(c)(2) of the Investment Company Act and Rule 13e-4 of the Exchange Act.[248] Many registered FOHFs provide for repurchases twice a year, but other registered FOHFs provide for repurchases on a quarterly or more frequent basis. The registered FOHF's adviser sets the terms of repurchase, which are disclosed to investors in the fund's offering documents.[249] Unlike most closed-end registered investment companies, shares of registered FOHFs have not been, to date, listed for trading in the United States on an exchange or NASDAQ.[250]

4. Content of Registered FOHF Disclosure.

Registered FOHFs provide in their registration statements on Form N-2 information that is required to be disclosed by all closed-end investment companies. In addition, they disclose information about the fund's unique strategies, operations and risks. Registration statements also provide information about the valuation of portfolio securities, certain risks involved in the investment and fees and expenses.

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247 See Section 30(e) of the Investment Company Act and Rule 30e-1 thereunder.

248 Under Section 23(c)(2) of the Investment Company Act, registered closed-end investment companies may repurchase their shares in tender offers. Generally, Rule 13e-4 under the Exchange Act governs issuer tender offers and prohibits fraudulent, deceptive and manipulative acts by an issuer or an affiliate in connection with an issuer tender offer, and prescribes filing, timing, disclosure, anti-discrimination provisions and other requirements.

249 Registered FOHF prospectuses typically state that the fund "expects" to repurchase shares on a semi-annual, quarterly, or other basis. However, these funds do not qualify as "interval funds" for purposes of the Investment Company Act because they do not comply with all of the requirements of Rule 23c-3 under that Act. For example, registered FOHFs have not, to date, designated periodic repurchases as a fundamental policy.

250 One Dual Registered FOHF that seeks to list its shares on the New York Stock Exchange has filed a registration statement with the Commission. That registration statement is currently under review. See CINTRA Select Fund (SEC File Nos. 811-21165 and 333-96821).

- Valuation. Many registered FOHFs disclose that, prior to investing in a hedge fund, the registered FOHF's adviser conducts due diligence reviews of the valuation methodologies used by each potential hedge fund investment. Most registered FOHFs disclose that one of the factors that they rely on to value their interests in hedge funds is valuation information provided to them by the advisers to the underlying hedge funds. They also typically disclose that they generally lack access to the information that would be needed to confirm independently the accuracy of valuation information provided by the underlying hedge funds.

- Risks. Registered FOHFs typically disclose that only those investors who can tolerate a high degree of risk, e.g., the loss of all or a portion of the investment, should invest in such funds. Some registered FOHFs also disclose that a potential investor should consider various factors (such as the investor's net worth, income, age, risk tolerance and liquidity needs) before deciding whether the particular registered FOHF is a suitable investment.

- Fees and Expenses. The fact that investors pay fees and expenses at both the registered FOHF and underlying hedge fund level is disclosed prominently to investors, as are the types of fees charged at the hedge fund level. Registered FOHFs generally do not, however, disclose the actual or estimated amount of fees indirectly incurred by the FOHF through its investment in the underlying hedge funds.[251]

- Investment Strategies. Registered FOHFs typically disclose the various investment strategies that the underlying hedge funds may employ, including, in some cases, the impact of style shifts in underlying hedge funds on the registered FOHF's ability to achieve its stated investment objective.

V. Hedge Fund Enforcement Actions

A. Commission Actions

Although hedge funds are not registered under the Investment Company Act, they and their advisers (regardless of whether the advisers are registered under the Advisers Act) are subject to the antifraud provisions of the federal securities laws. In recent years, the Commission

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[251] Form N-2 requires disclosure of the fees and expenses incurred by the registered FOHF, but does not encompass disclosure of fees and expenses incurred by the underlying hedge funds. See infra note 322.

has instituted a significant number of actions alleging hedge fund fraud.[252] Since 1999, the Commission has brought approximately 38 enforcement actions relating to hedge fund advisers and hedge funds, and, in the last few years, the Commission has seen a steady increase in actions. The Commission staff is currently investigating a number of additional matters involving possible fraud or other violations by hedge fund advisers and hedge funds.

There is no evidence indicating that hedge funds or their advisers engage disproportionately in fraudulent activity. However, the growth in the number of hedge fund fraud cases is likely attributable to a number of factors, including: the popularity of hedge fund investments and the large amounts of money they involve (and thus their attractiveness to perpetrators of fraud); the entrance to the industry of inexperienced, untested and, in some cases, unqualified individuals; and lack of adequate controls on the operations of some hedge fund advisers.

The fraud charged in Commission enforcement actions against hedge fund advisers has been similar to the types of fraud charged against other types of investment advisers. Examples include: misappropriation of assets;[253] misrepresentation of portfolio performance;[254] falsification of experience, credentials and past returns;[255] misleading disclosure regarding

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[252] In most cases involving hedge funds, the Commission institutes enforcement actions against the hedge fund adviser and/or the adviser's principals.

[253] See, e.g., *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 18216 (July 7, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc. Sirens Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.,* Litigation Release No. 18150 (May 20, 2003); *SEC v. Vestron Financial Corp.,* Litigation Release No. 18065 (Apr. 2, 2003); *SEC v. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003).

[254] See, e.g., *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, Litigation Release No. 18247 (July 23, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments, Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.,* Litigation Release No. 18150 (May 20, 2003); *In the Matter of Charles K. Seavey*, Advisers Act Release No. 2119 (Mar. 27, 2003); *SEC v. Hoover and Hoover Capital Management, Inc.,* Litigation Release No. 17981 (Feb. 11, 2003); *SEC v. Beacon Hill Asset Management LLC*, Litigation Release No. 17831 (Nov. 7, 2002); *SEC v. Edward Thomas Jung,* Litigation Release No. 17417 (Mar. 15, 2002); *SEC v. Jerry A. Womack*, Litigation Release No. 17293 (Jan. 2, 2002); *SEC v. Michael W. Berger, Manhattan Investment Fund, Ltd., Manhattan Capital Management Inc.*, Litigation Release No. 17193 (Oct. 16, 2001).

[255] See, e.g., *SEC v. Jean Baptiste Jean Pierre, Gabriel Toks Pearse and Darius L. Lee*, Litigation Release No. 18216 (July 7, 2003); *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. Vestron Financial Corp.*, Litigation Release No. 18065 (Apr. 2, 2003); *SEC v.*

claimed trading strategies;[256] and improper valuation of assets.[257] The overwhelming majority of the cases the Commission has instituted involve charges under each of the Securities Act, the Exchange Act and the Investment Advisers Act.

There are a number of observations that can be made regarding hedge fund enforcement actions brought since 1999. Nearly a third of the hedge fund cases brought in the last four years involved criminal charges. Another characteristic, which appears common to hedge fund cases, is the lengths to which the violators go to conceal their fraud. In almost half of the enforcement actions brought since 1999, the defendants or respondents created false documentation in an effort to hide their fraud. These documents included account statements and other types of reports to customers, confirmations and pricing sheets. The third characteristic that is perhaps more common to hedge fund cases than the typical investment adviser's case is the greater frequency of outright theft, or misappropriation, of investor funds that occurs. Finally, based on the Commission's recent cases, both registered and unregistered investment advisers have engaged in hedge fund fraud. We have also found the same individual operating both registered and unregistered investment advisers while engaging in hedge fund fraud.[258]

B. State and SRO Enforcement Activities

State attorneys general are using state antifraud statutes to pursue enforcement actions against hedge funds. For example, New York Attorney General Eliot Spitzer used a 1921 New York business statute, the Martin Act, in asserting fraudulent trading arrangements between a

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House Asset Management, L.L.C., House Edge, L.P., Paul J. House, and Brandon R. Moore, Litigation Release No. 17583 (June 24, 2002); *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001).

[256] See, e.g., *SEC v. Peter W. Chabot, Chabot Investments, Inc., Sirens Investments Inc., Sirens Synergy and the Synergy Fund, LLC*, Litigation Release No. 18214 (July 3, 2003); *SEC v. David M. Mobley, Sr.*, Litigation Release No. 18150 (May 20, 2003); *SEC v. Edward Thomas Jung,* Litigation Release No. 17417 (Mar. 15, 2002); *SEC v. Jerry A. Womack*, Litigation Release No. 17293 (Jan. 2, 2002); *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001).

[257] See, e.g., *SEC v. Michael Lauer, Lancer Management Group, LLC, and Lancer Management Group II, LLC*, Litigation Release No. 18247 (July 23, 2003); *SEC v. Beacon Hill Asset Management LLC*, Litigation Release No. 17831 (Nov. 7, 2002); *SEC v. Michael L. Smirlock and LASER Advisers, Inc*, Litigation Release No. 17630 (July 24, 2002).

[258] *SEC v. Stevin R. Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003).

hedge fund and four mutual fund companies.[259] Other state securities regulators are also investigating state securities law violations involving hedge funds.[260]

These state enforcement actions underscore the fact that the activities of hedge funds can have a material effect on both the securities markets and investors at large. The opaqueness of hedge funds, however, presents a significant obstacle in regulatory efforts to monitor hedge fund activities. For example, the fact that most hedge fund advisers are not registered with the Commission as investment advisers conceals not only the existence of advisers but also of hedge funds themselves. The states' efforts against hedge fund frauds assist the Commission in promoting fairness in the securities markets.

Self-regulatory organizations have also been active in instituting hedge fund related enforcement actions. The NASD recently censured and fined a firm for failing to disclose the risks associated with hedge funds when marketing them to investors, and for exaggerated and unwarranted statements made in sale literature.[261] The NASD also censured and fined the firm's

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[259] See Canary Capital Partners, supra note 123. See also *Spitzer Alleges Mutual Funds Allowed Fraudulent Trading*, Wall Street Journal (Sept. 4, 2003)

[260] For example, the Illinois Secretary of State's Office has launched an investigation in connection with the New York Attorney General's investigation of hedge fund trading in mutual fund shares. See, e.g., *Illinois Probing Hedge Fund Samaritan*, Reuters English News Service (Sept. 10, 2003). In August, Massachusetts securities regulators filed three complaints against hedge funds and their advisers for a variety of state securities law violations. See *In the Matter of Rahul V. Singh*, No. E-2003-55 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging sales of hedge fund interests to non-accredited investors); *In the Matter of Michael F. Payne, Futronix Trading, LTD*, No. E-2003-55 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging use of misleading performance claims and sales to non-accredited investors); *In the Matter of James Pangione, Timothy Rassias, Hercules Capital Management, LLC, Hercules Hedgehog Fund, LP*, No. E-2003-56 (Mass. Sec. Div. filed Aug. 13, 2003) (alleging use of misleading statements on adviser qualifications and experience, investment strategy and risk levels); *In re Stonehouse*, No. E-2003-52 (Mass. Sec. Div. filed Sept. 22, 2003) (alleging, among other things, fraud in the offering of hedge fund securities).

[261] See NASD Notice to Members 03-07 (June 16, 2003) (announcing disciplinary action taken against Altegris Investments, Inc.); see also *In the Matter of the Application of Brian Prendergast*, Exchange Act Release No. 44632 (Aug. 1, 2001) (Commission sustaining NASD bar and censure of hedge fund co-adviser for, among other things, using materially misleading PPM and sales literature).

Chief Compliance Officer for failing to adequately supervise the firm's advertising practices in this area.[262]

VI. Concerns

We have identified below a number of significant concerns in connection with the growth of hedge funds.

A. Lack of Commission Regulatory Oversight

1. Inability to Detect Fraud and Other Misconduct at Early Stages

As noted above, in the last five years, the Commission has instituted 38 enforcement actions involving hedge fund fraud, involving significant losses to investors. The Commission typically identifies frauds and other misconduct involving hedge funds only after fund investors or service providers suspect fraudulent activity and contact the Commission. Thus, the Commission often finds itself instituting enforcement action against an unregistered hedge fund adviser only after significant losses have occurred.[263] In contrast, the Commission has an advantage in identifying the misconduct of registered investment advisers because they are subject to periodic examinations by Commission staff. When fraudulent or other unlawful activity does occur, examinations can lead to earlier discovery – often before significant losses have resulted. Further, the Commission uses the potential for a surprise examination and

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262 See id. Specifically, the NASD found that between October 2002 and February 2003, Altegris distributed 26 different pieces of hedge fund sales literature to its customers. Each of these marketing pieces failed to include important disclosures regarding specific risks of investing in hedge funds and made unbalanced presentations about the particular hedge funds that failed to provide investors with a sound basis for evaluating whether to invest in these hedge fund products.

263 Roundtable Transcript, May 15 (statement of Stephen M. Cutler) ("[I]n the case of unregistered advisers, [the Commission's Enforcement Division is] not going to be the beneficiar[y] of an examination that is going to have identified a problem, brought it to our attention in the form of an enforcement referral. So a lot of what we end up seeing in the hedge fund area is after the train wreck has already happened. We will get a complaint from an investor that finds that he's been wiped out."); Roundtable Transcript, May 15 (statement of Mark Anson) ("[W]hile the antifraud provisions can deter fraud, they really can't prevent it. [W]here hedge fund managers don't disclose their losses immediately . . . once the fraud is uncovered, and the antifraud provisions kick in, and action can be taken, well, by that time, the losses have already occurred. And it's difficult for investors to get their money back."). See also Robert Lenzner and Michael Maiello, *The Money Vanishes*, Forbes 70 (Aug. 6, 2001) ("[I]f there is mischief [in unregulated hedge funds], the [Commission] will find out about it too late.").

deficiency letters to encourage a culture of compliance at regulated entities. We believe that the prospect of Commission examination serves as a deterrent to fraud and other misconduct.

2. *Lack of Meaningful Information about Hedge Funds and Hedge Fund Advisers*

The Commission has long been concerned about the lack of information available about hedge funds and their investment advisers.[264] Despite the growth of the hedge fund industry in the last decade, we do not have accurate information about how many hedge funds operate in the United States, their assets or who controls them.[265] Instead, we must rely on information provided by private organizations, the accuracy of which information remains unclear.[266]

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[264] See Hugh F. Owens, *A Regulator Looks at Some Unregulated Investment Companies The Exotic Funds,* Address before the North American Securities Administrators Ass'n (Oct. 21, 1969) ("I am limited to relying on conventional wisdom because the Commission does not presently have sufficient information on which to base unqualified statements on the nature of hedge funds' investment techniques. . . . The lack of information on hedge funds is explained in part, of course, by the fact that we have no registration data to refer to because of claimed exemptions or exceptions by the funds from the registration requirements of the various federal securities laws."). See also Breeden Letter, supra note 2 (attaching staff memorandum stating that the Commission is unable to provide the House Subcommittee with statistics on the number of hedge funds, their managed assets, their investors, rates of return, leverage or investments in various classes of financial assets).

[265] For example, the Commission was unable to provide the Treasury Department with accurate information about the number of hedge funds for use in connection with its proposals to require hedge funds to adopt anti-money laundering programs. Treasury Anti-Money Laundering Proposal, see supra note 109. Because there is no government source of information to identify or locate hedge funds, the Treasury Department has proposed a rule under the USA Patriot Act that will require hedge funds, among others, to file a notice with the Department with certain information about their operations. Id. at p. 60622. See also supra Part III.E.4.c. (discussing Treasury Department Regulations). As noted, the proposed notice will only be a partial source of information about hedge funds and their advisers.

Chairman Donaldson Testimony, supra note 184 ("[T]here are no precise figures available regarding the number, size and assets of hedge funds. This is due, in part, to the fact that there is no industry-wide definition of hedge fund; in part, because those that track hedge fund data rely on self-reporting by hedge funds; and in part because hedge funds generally do not register with the SEC, so we cannot independently track the data."). See also *The President's Working Group Study on Hedge Funds: Hearing Before the House Comm. on Banking and Financial Services, 106th Cong.* 5 (1999) (statement of Representative John LaFalce, Member, House Comm. on Banking and Financial Services) ("The message of LTCM is. . . that we can no longer doubt that we have a new powerful kind of financial institution in our midst, the hedge fund, and that we

The nature of hedge fund investors is changing. Although we did not observe an existing retail market for hedge funds, the potential for that market is clearly at hand. Investment advisers already have proposed to offer registered FOHFs to retail investors without sophistication or other wealth requirements.[267] Moreover, the amount of retirement assets directly invested in hedge funds is growing.[268] In our view, the Commission is impeded in its ability to formulate public policy that appropriately protects the interests of the U.S. investing public unless it also has access to accurate and current information about hedge funds and their advisers.

Also, hedge funds are becoming a significant participant in our financial markets. We are concerned about the incomplete nature of information we are able to compile about the trading practices of hedge fund advisers on behalf of hedge funds. Hedge funds are active and important participants in our securities markets. Among other things, hedge fund advisers can invest hedge

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know very little about them."); LTCM Report, supra note 126, at 1 ("[I]t is difficult to estimate precisely the size of the [hedge fund] industry . . . .").

[266] See Liang, supra note 177, at 310 (study of statistical inconsistencies in two major hedge fund databases, noting that "the reliability of hedge fund data is an open question critical to hedge fund research and the investment community"). See also William Fung and David A. Hsieh, *Measuring the Market Impact of Hedge Funds*, 7 Journal of Empirical Finance 1, 3 (2000) ("There are varying estimates of the size of the hedge fund industry."); and *Hedge-matics: How Many Funds Exist?*, Wall Street Journal C5 (May 22, 2003) ("Just how big is the hedge-fund industry? This simple question has been debated because the data on hedge funds are spotty.").

[267] See supra note 250.

[268] See, e.g., *US Pension Plan Looks to Hedge Funds,* Financial Times (London), Global Investing 21 (June 26, 2003) (Virginia retirement system plans to invest $1 billion in hedge funds); Michael P. Norton, *Changes to State Pension Sought; Hedge Funds Top Treasurer's Plan to Reduce Risks*, The Patriot Ledger (Quincy, MA), Business 24 (June 5, 2003) (proposal to invest up to five percent of pension fund assets in hedge funds); and *NYC Fund Eyes Maiden Hedge Fund of Funds Investment*, 4 Alternative Investment News 19 (June 1, 2003) (Manhattan & Bronx Surface Transit Operating Authority Retirement Fund considers investment in hedge funds). See also Chris Clair, *'Unprecedented Pressure': Public Plans Race to Embrace Hedge Funds; This Time They Are Leading, Not Following, Their Corporate Counterparts,* Pensions and Investments 2 (July 8, 2002); Susan L. Barreto, *Hedge Funds Become Saving Grace for Endowments in Tough Times,* HedgeWorld Daily News (Apr. 4, 2002); *Virginia Exposure Soars to 60%,* Financial News (Daily) (Apr. 27, 2003) (University of Virginia has invested 50 percent of its portfolio in hedge funds, and plans to increase its exposure to 60 percent of its total portfolio); *University of Wisconsin Searching for Hedge Funds,* 4 Alternative Investment News 20 (Feb. 1, 2003) ($300 million University of Wisconsin endowment will allocate up to ten percent, or $25-30 million, to a fund of funds adviser); and *Baylor University; Inside The Buyside; Increases Hedge Fund Activity by $20-25 Million*, 4 Alternative Investment News 6 (Feb. 1, 2003).

fund assets in innovative, and sometimes aggressive, ways in order to effectuate their investment strategies.[269] The Commission's inability to examine unregistered investment advisers, however, inhibits its ability to familiarize itself with the types of trading and other investment activities taking place in hedge funds.

Moreover, because of the close relationships between hedge funds and broker-dealers, the failure of a large hedge fund could also impact those firms. Interactions between broker-dealers and hedge funds have long been a Commission concern and one that has been addressed in particular as part of the Commission's supervision of broker-dealers. Our concern is based both on the possible loss of customer assets held by broker-dealers, which the Commission has a mandate to protect in conjunction with the Securities Investors Protection Corporation, and the systemic risk implications for the broader financial system, should a large broker-dealer fail due to exposure to a hedge fund. The Commission may indirectly view certain limited aspects of hedge fund trading activities through its supervision of other market participants, i.e., broker-dealers, SROs, etc. These avenues, however, present a fragmented view of the overall trading activity of hedge funds.

B. Valuation of Hedge Fund Portfolio Securities

The lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio securities is among the most serious concerns we have identified in the course of our investigation of hedge funds. Hedge fund advisers have powerful incentives to achieve superior (and positive) performance. The requirement to achieve positive performance in order to receive a performance allocation (and to remain in business) is just one such incentive. The adviser's own investment in the hedge fund is another. Hedge fund advisers that perform well find it easier to retain investors and raise additional capital.

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[269] Among the most common trading practices used by hedge fund advisers is short selling. The staff makes no recommendations to the Commission regarding short selling at this time, but notes that it is currently considering recommending that the Commission propose rule amendments that would modernize short sale regulation designed to target areas of abuse, including naked short selling. ("Naked" short selling generally refers to a sale of securities when the seller does not own the securities sold and makes no arrangements to borrow the securities in order to make delivery on the sale.) The amendments would also be designed to ease regulatory restrictions where they are unnecessary or inhibit beneficial short selling.

Business Week recently reported that trading of a single hedge fund adviser routinely accounts for "as much as 3% of the New York Stock Exchange's average daily trading, plus up to 1% of the NASDAQ's -- a total of at least 20 million shares a day." See Marcia Vickers, *The Most Powerful Trader on Wall Street You've Never Heard Of*, Business Week 66 (July 21, 2003).

A hedge fund adviser has broad discretion to value these securities; hedge funds need only value its portfolio securities in a manner consistent with the valuation policies and guidelines they disclose to their investors.[270] Moreover, even when hedge fund advisers use an outside service provider such as an administrator or pricing service to assist in valuing securities, advisers may exercise their discretion to override such prices.

The absence of any form of independent oversight over hedge fund pricing raises significant questions about the quality and fairness of the prices at which investors buy or redeem interests in some hedge funds. Because many hedge funds invest in highly illiquid securities, these concerns are heightened. In addition, smaller hedge fund advisers often lack the resources to establish and install adequate pricing systems. Moreover, the Commission lacks the authority to examine many hedge fund advisers' books and records or conduct on-site inspections of hedge fund adviser operations, which could reveal instances of mispricing.

C. Retailization

One of the primary objectives of the staff's investigation was to determine whether, as a result of the growth of hedge funds, or otherwise, significant numbers of less sophisticated investors were investing in hedge funds.

1. Direct Investment in Hedge Funds

Inflation, along with the sustained growth in wealth and income of the 1990s, has boosted a substantial number of investors past the "accredited investor" standard.[271] To date, however, the staff has not uncovered evidence of significant numbers of retail investors investing directly in hedge funds. A number of factors may account for this, including that most hedge funds maintain investment minimums that effectively limit the entry of minimally qualified investors into the funds.[272] Hedge fund sponsors also assert that they do not seek retail investors because such investors may not be suitable for the inherent risks that accompany some hedge funds and

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[270] See supra Part IV.G. (discussing hedge fund valuation practices).

[271] See supra Part III.B.2. (discussing Regulation D).

[272] The investment minimum for hedge funds typically ranges from $50,000 to $10 million. The staff, however, found that hedge funds may waive these minimums for pre-qualified investors and that these minimums have dropped in recent years.

that the effort required to ensure such suitability often outweighs the benefit of any investments that they might make.[273]

Nevertheless, the increased number of retail investors qualifying as accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds. We have observed that the minimum qualifications required to invest in some hedge funds has decreased as newer entrants into the alternative investments market compete for investors. We remain concerned that less sophisticated investors, even those meeting the accredited investor standard, may not possess the understanding or market power to engage a hedge fund adviser to provide the necessary information to make an informed investment decision.

2. *Registered Funds of Hedge Funds*

The staff's concerns about registered FOHFs mirror our concerns expressed in this Report about hedge funds generally. Our concerns are amplified, however, by the possibility that the retail public may be offered access to some of these investment opportunities without restriction in the future.

We are concerned about the reliability of registered FOHFs' calculations of net asset value ("NAV"). There are no readily available market prices for hedge fund securities. In addition, as discussed above, an adviser of a FOHF may find it difficult to independently verify the accuracy of the valuation provided by the underlying hedge funds because it does not have access to portfolio holdings of those hedge funds.[274] Despite disclosure that advisers to registered FOHFs will look to a variety of factors in valuing hedge fund securities, some advisers may still rely almost completely on a hedge fund adviser to provide it with the value of the hedge fund's securities.

The lack of hedge fund transparency presents other problems as well, including with respect to fees and expenses of the underlying hedge funds and evaluating overall investment diversification or risk exposures. Although a registered FOHF generally is required to disclose its fees and expenses in its registration statement, it is not required to disclose, and investors do not have specific information about, the fees and expenses of the hedge funds in which the

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[273] See Roundtable Transcript, May 14 (statement of James R. Hedges) ("[I]t is my sense that the lion's share of the hedge fund industry is actually not interested in the retail investor. More hedge fund managers that I talk to than not have no interest whatsoever in selling their product in a retail channel. They like being privately placed to accredited or qualified purchasers. They like the freedom that that enables them to have. And they are not interested in getting into a different type of construct in order to target the retail investor.").

[274] See supra Part IV.G. (discussing hedge fund valuation practices).

FOHF invests. In addition, the lack of transparency limits the ability of the registered FOHF adviser to ascertain the diversification of the registered FOHF's portfolio. Consequently, a registered FOHF adviser following a particular strategy may invest in a number of hedge funds executing similar strategies. Each of the underlying hedge funds could be taking similar positions in its portfolio. The potential for this to occur is particularly a concern for registered FOHFs executing convertible or merger arbitrage strategies. The registered FOHF adviser may have no way of knowing if it is, in fact, making duplicate investments, and possibly magnifying its risk. Significantly, retail investors seeking diversification by investing in a Dual Registered FOHF are also unable to ascertain this information, and may take on more risk than desired as a part of their overall portfolio.

3. Pension Plan and Other Institutional Investment in Hedge Funds

Perhaps the greatest change in terms of indirect exposure of individual investments in hedge funds has been the frequency with which pension plans, universities, endowments, foundations and other charitable organizations are investing in hedge funds. Pension plans were among the earliest hedge fund investors.[275] The pace of these investments, however, has increased over the past few years.[276]

The staff is concerned that recent infusions of funds from public and private pension plans, universities, endowments, foundations and other charitable organizations into hedge funds may raise public policy considerations that heretofore have not been examined. These concerns do not relate to the ability or propriety of pension plan sponsors or trustees making investment decisions to place plan assets into hedge funds. Indeed, many trustees may believe that hedge fund investments are critical parts of a prudent investment strategy.

Instead, our immediate concern stems from the increasing presence of these investors in hedge funds over which neither the Commission nor any other regulatory authority exercises meaningful oversight. Although these institutions typically qualify as "accredited investors" or "qualified purchasers," these institutions, by investing in hedge funds, expose their participants or other beneficiaries to hedge funds. Thus, for example, a pension plan that experiences substantial losses as a result of hedge fund fraud may be unable to meet its obligations to pensioners. The collective indirect investment of the assets of less sophisticated individuals into vehicles that are managed by entities that are not examined by the Commission leaves open the

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[275] See, e.g., Loomis, supra note 10, at 103.

[276] See generally http://www.iialternatives.com/home.asp; *Hedge Funds Gaining Acceptance Among Pension Funds*, supra note 268; Lewis Knox, *The Hedge Fund: Institutional Money is Swelling the Coffers of the World's Largest Hedge Fund Managers,* 28 Institutional Investor (International Edition) 53 (June 1, 2003); and Dan Neel, *Michigan Preps For Hedge, Real Estate,* Investment Management Weekly (Apr. 28, 2003). See also supra note 268.

possibility that the Commission will be unable to anticipate problems involving hedge funds that may invest on behalf of these institutions.

D. Disclosure

As discussed above, hedge funds are not subject to any minimum disclosure requirements.[277] Although hedge fund advisers generally provide investors with a PPM, and while we acknowledge that there are often a range of other communications between hedge fund advisers and hedge fund investors, we are concerned that investors may not always receive disclosure about certain fundamental information relating to the investment adviser and its management of a hedge fund. We are also concerned that investors may not receive information about material changes to an adviser's management of a hedge fund on an ongoing and regular basis.

E. Conflicts of Interests

An investment adviser must act solely in the best interests of its clients consistent with its fiduciary obligations owed to clients. Hedge fund advisers often have substantial conflicts of interest, both with the hedge fund and with other non-hedge fund investors. In recognition that certain conflicts may be unavoidable, an investment adviser may discharge its fiduciary obligation only by disclosing conflicts of interest to its client.[278] We are concerned, however, that disclosure currently being provided to some hedge fund investors could be improved to address the level of the conflict.

1. Side-by-Side Management of Client Accounts

Conflicts of interest between investment advisers and their clients are not new. As one commenter at the Hedge Fund Roundtable noted, "conflicts exist any time a manager has two clients."[279] Unique facts, however, including the nature of the fees paid, the interests of the

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[277] See supra Part IV.D (discussing disclosure by hedge funds).

[278] See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963) ("Capital Gains") ("The Investment Advisers Act of 1940 thus reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a Congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested" (citations omitted)). Undisclosed, such conflicts may constitute fraud by an investment adviser.

[279] Roundtable Transcript, May 14 (statement of Richard Phillips). See also *Institutional Investor Study Report of the Securities and Exchange Commission*, H.R. Rep. 92-64, Vol. 2, pt. 2, at 348 (1971) (noting that advisers might give preferential treatment to accounts in which they have a

adviser and the nature of hedge fund investment strategies themselves, distinguish hedge funds from other pooled investment vehicles offered by investment advisers, and bring these conflicts into even sharper focus.

The relationship between a hedge fund and its investment adviser incorporates a number of significant incentives that have the potential to motivate an adviser to favor its hedge fund client over other clients. Performance fees, which often are 20 percent or more of the realized capital gains and capital appreciation of the hedge fund, are significantly higher than the asset-based fees paid on traditional accounts, including registered investment companies. In addition, many investment advisers have significant investments in hedge funds that they manage.[280] As a result, the investment adviser has additional incentives to favor the hedge fund client over other clients by allocating investment opportunities to the hedge fund.[281]

The very nature of the investment strategies used by hedge funds may put them at odds with other, more traditional investment products and thus, may raise additional conflicts of interest for the adviser. For example, an investment adviser that manages a mutual fund using a long-only strategy may, at the same time, manage a hedge fund using a different strategy. The investment adviser may determine that an equity security that the mutual fund holds long is appropriate for the hedge fund to sell short.[282] The short sale may have a negative effect on the price of the security and therefore also have a negative effect on the mutual fund's performance. Similarly, a model-driven statistical arbitrage fund may be engaging in short-term buying while

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greater self-interest) and *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, pt. 1, at 373 (1963).

280 Hedge fund investors generally insist on hedge fund advisers and their principals investing a significant percentage of their net worth alongside the limited partners' investments to ensure that a hedge fund adviser's interests are aligned with theirs. See, e.g., Roundtable Transcript, May 14 (statement of David Swensen).

281 See *In the Matter of Nevis Capital Management, LLC, David R. Wilmerding, III and Jon C. Baker*, Advisers Act Release No. 2154 (July 31, 2003) (alleged unfair allocations of "hot issues" to two clients, including a hedge fund). See also *In the Matter of F.W. Thompson Co. and Frederick W. Thompson*, Advisers Act Release No. 1895 (Sept. 7, 2000) (undisclosed preferential allocation of hot issues to certain clients); and *In the Matter of McKenzie Walker Investment Management, Inc. and Richard C. McKenzie Jr.*, Advisers Act Release No. 1571 (July 16, 1996) (undisclosed favoritism of performance-fee paying clients).

282 For example, a registered investment company may have a focus on a particular industry or sector and must choose (and remain fully invested in) those securities that the adviser believes represent the best opportunities within that universe. Nonetheless, that adviser may simultaneously be quite bearish on the same industry and may choose to short sell certain representative securities, including those held long in the registered investment company.

the investment adviser is selling the same securities in another account that follows a different strategy. Both strategies may be used for legitimate business reasons, but the conflicting nature of the strategies may affect certain clients negatively.

2. *Relationships with Prime Brokers*

Services provided by prime brokers can be very important to a hedge fund's operations. The nature of the services provided by a prime broker to a hedge fund adviser varies, depending upon its stage of development, organization and structure and investment strategy. Notwithstanding the importance of these services to the hedge funds, we found that the quality of disclosure typically provided to hedge fund investors about advisers' relationships with their prime broker(s) is minimal. Hedge fund advisers rarely disclose the nature of the services that they receive from a prime broker, nor is there clear disclosure regarding how they compensate the prime broker for these services.

We are concerned that hedge fund advisers may not be disclosing that fees paid to prime brokers may include amounts for services that do not benefit investors. For example, the provision of, and payment for, capital introduction services to a hedge fund's adviser presents a conflict of interest in that the introduction of new investors to the hedge fund may occur because the adviser used (and used fund assets to pay for) certain of the prime broker's services.[283] The provision of office space to the hedge fund adviser as part of the package of services provided to the adviser and paid for by the hedge fund creates a similar conflict of interest.

There are other potential conflicts of interest that may raise disclosure issues. For example, accepting "seed capital" investments by prime brokers without disclosing the potential conflicts inherent in such arrangements may raise concerns. The acceptance of such capital may, for example, negate any flexibility that the hedge fund adviser would have to freely choose its prime broker, or negotiate more attractive fees. As another example, there may be a *quid pro quo* for the inclusion of a hedge fund on a prime broker's "preferred" list of hedge funds, or its inclusion in a proprietary fund of hedge funds, which would essentially wed the hedge fund to the prime broker. These conflicts of interest also raise a concern that a hedge fund may pay more than is usual for core services (such as fees relating to securities borrowing) provided by the prime broker, or may satisfy pre-determined minimum targets for services, such as margin or brokerage, that are established prior to the delivery of services.

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[283] Broker-dealer firms typically do not charge separately for capital introduction services. Moreover, they assert that this service, like others, is provided "gratis" as an accommodation to the hedge fund. We are not persuaded that these services are free. Although they do not receive separate compensation, broker-dealers are compensated for such services, albeit indirectly, through the fees that they negotiate and receive for the entire package of services provided to the hedge fund.

F. Concerns about General Solicitation

We also have concerns about the proliferation of public information about hedge funds that has accompanied the growth of the hedge fund industry. We believe that questions exist whether some participants in the hedge fund industry may not be complying with the prohibition on general solicitation and general advertising in privately offering and selling the hedge fund securities. As discussed above, as a condition to the availability of the safe harbor of Rule 506, hedge funds may not engage in any form of general solicitation or general advertising in finding investors.[284] The hedge fund has the burden of proving the availability of the exemption from registration. If the hedge fund, its adviser or other persons acting on its behalf uses general solicitation or general advertising to sell the hedge fund interests, the hedge fund will not be able to rely on the safe harbor.

Current marketing practices by some hedge fund advisers raise questions as to whether the hedge fund is engaging in a general solicitation or general advertising. For example, information contained in newsletters, press articles and even institutional reporting services about a specific hedge fund raises concerns about whether the hedge fund is engaged in a general solicitation or general advertising if that information is provided by the hedge fund's adviser or at their behest.[285] The extensive use of the Internet by hedge fund advisers has exacerbated this concern. Given the public nature of the Internet, issues arise as to how to sufficiently target information to eligible investors without running afoul of the general solicitation or advertising prohibition.[286] Although the Commission has been clear in its interpretive releases about the ways in which the Internet can be used in private offerings, questions exist as to whether some hedge fund advisers and sponsors have not followed the Commission's and staff's guidance. In fact, the Commission, in its 2000 Interpretive Release on the Use of Electronic Media, recognized that parties are not following staff guidance on when web sites may constitute general

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[284] See supra Part III.B. (discussing hedge funds and the Securities Act). See also Roundtable Transcript, May 14 (statement of Alan Beller) ("You can't put up a billboard on Times Square and say, 'We have a new hedge fund but please understand that unless you are an accredited investor, don't call.' ").

[285] The staff has found numerous media reports quoting hedge fund advisory personnel discussing the "rollout" of new hedge funds.

[286] See supra Part III.B. See also Roundtable Transcript, May 14 (statement of Alan Beller) ("Even targeted means of publicity to offer to persons to whom or with whom the adviser or the other intermediary seller does not have a pre-existing relationship can also raise general solicitation questions, especially as that targeting becomes less targeted, if you will. You send out an e-mail or make a website generally available and say, 'You can buy this but only if you are an accredited investor, and people with whom you don't have a preexisting relationship have access to that page, that itself can be problematic under our current rules.' ").

solicitation for particular offerings and again reminded market participants of the permissible types of activities.

Although the restrictions on general solicitation and general advertising apply only to activities that are used to offer and sell securities, for hedge fund advisers using the Internet, questions arise as to whether information about their services and their activities would be outside the scope of the restriction on general solicitation and general advertising. In addition to the implications of the use of the Internet for the hedge fund offering itself, the Commission has also made clear that if an unregistered adviser uses a publicly available web site to provide information about its services, it would not qualify for the exemption from registration in Section 203(b)(3) of the Advisers Act because it would be considered to be holding itself out generally to the public as an investment adviser.[287]

The use of the Internet by hedge fund advisers in marketing their products has sharpened the question as to whether, at least with respect to a certain category of sophisticated investors, the prohibition on general advertising and general solicitation continues to be necessary. While it may not be appropriate to revisit the limitations on general solicitation, including those resulting from the use of electronic media, in the context of private offerings generally or even hedge funds specifically, it may be worthwhile to consider the need for such limitations for funds whose owners are limited to investors that clearly meet a higher standard or may be presumed to be able to "fend for themselves" such as, for example, the "qualified purchaser" standard of Section 3(c)(7).

G. Concerns about Whether the Federal Securities Laws and Regulations Are Impairing the Investment Activities of Registered Investment Companies

The staff's investigation of hedge funds revealed the broad investment flexibility that most hedge fund advisers find necessary in order to effectuate their absolute return strategies. The staff believes that this flexibility may have contributed to hedge funds avoiding some of the losses sustained by investors in registered investment companies during the 2000-2002 bear market.[288] One investor advocate for individual investors who participated in the Roundtable

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[287] *Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information; Additional Examples Under the Securities Act of 1933, Securities Exchange Act of 1934, and Investment Company Act of 1940*, Exchange Act Release No. 37182 (May 9, 1996).

[288] One Roundtable participant cited data that registered open-end investment companies lost approximately $1.4 trillion from 2000-2002. See Comment submitted by Roundtable Panelist Frederick C. "Rick" Lake.

expressed the view that these types of investment vehicles should be made available to a broader array of investors.[289]

A very small percentage of registered investment companies currently use certain hedge fund investment strategies, including long/short, market neutral and merger arbitrage. The registered investment companies that pursue such investment strategies represent, in our estimation, less than one half of one percent of the investment company industry's assets under management as of June 30, 2003.[290] It is unclear why so few registered investment companies pursue these types of strategies, although the restrictions placed on investment companies and investment advisers to such companies may be at least partially responsible.

VII. Recommendations

We recommend that the Commission consider making several changes to the regulatory framework relating to hedge funds and their investment advisers. We believe that these changes will address the concerns that we have identified above. The adoption of our recommendations would result in a shift in the federal securities laws' approach to the regulation of the hedge fund industry, but would add a greater level of investor protection to investors in hedge funds and FOHFs. It would also provide greater insight into this growing segment of the investment management industry without constraining the legitimate investment activities of hedge funds and their advisers.

Our recommendations are intended to address, on a going forward basis, existing and emerging issues that flow from the growth in the number of hedge funds and the assets under management at those funds. The adoption of our primary recommendation, that the Commission consider mandating federal registration of hedge fund investment advisers under the Advisers Act, would mean that hedge fund investors would receive important information regarding the funds and their advisers. We believe that these measures will also foster stronger compliance programs and provide the Commission with the ability to: identify important participants in the U.S. financial markets; examine the activities of investment advisers to assist in evaluating issues relating to market movements; and deter fraud and wrongdoing.

We have recommended changes to the regulatory framework with a view toward minimizing any impediments that these changes may have on the manner in which advisers

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[289] See Roundtable Transcript, May 15 (statement of John Markese) (expressing the view that with registration and appropriate information, hedge fund-type products may be useful in assisting investors in diversifying their investment portfolios).

[290] According to the staff's estimate, companies with a market neutral or merger arbitrage investment style had approximately $2.1 billion under management at the end of June 2003.

manage hedge funds to achieve their investment goals. Indeed, in making these recommendations we recognize the beneficial role that hedge funds play in our financial markets. We also suggest that the hedge fund industry observe and continue to develop best practices guidelines that will result in better investor protection and healthier financial markets.

Finally, we ask the Commission to consider a number of recommendations that apply to registered investment companies. Some of these recommendations are designed to provide additional protections to investors in registered FOHFs. Other recommendations suggest that the Commission reconsider certain of the restrictions generally applicable to registered investment companies and their investment advisers. For example, we recommend that the Commission take steps to determine if hedge fund-type strategies can be made available to less sophisticated investors in a manner that both achieves investment goals and protects investors.

A. The Commission Should Consider Requiring Hedge Fund Advisers to Register as Investment Advisers under the Advisers Act, Taking into Account Whether the Benefits Outweigh the Burdens of Registration

We recommend that the Commission consider amending Rule 203(b)(3)-1 under the Advisers Act to require hedge fund advisers to "look through" any hedge funds that they manage and count each separate investor as a client.[291] By amending Rule 203(b)(3)-1 to redefine "client," the Commission would shift the regulatory emphasis away from counting the number of hedge funds advised by the investment adviser and refocus it so that it reflects a determination of whether an investment adviser is of a size to merit federal regulation. In our view, the result of the recommendation to amend Rule 203(b)(3)-1 would be consistent with the underlying purpose of Section 203(b)(3), which was designed to exempt advisers whose advisory business is so limited that it does not warrant federal attention.[292] We also recommend that the Commission

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291 See supra Part III.D. (discussing hedge fund advisers and the Advisers Act).

292 There is no legislative history explaining the *de minimis* exception of Section 203(b)(3). That provision appears to reflect Congress's view that investment advisers with only a handful of clients that do not hold themselves out to the public are presumably "private" and therefore do not raise issues of federal interest and need not register. Yet an investment adviser that manages client assets through hedge funds could have thousands of clients. For example, one hedge fund that relies on Section 3(c)(7) of the Investment Company Act could have 499 investors, one short of the threshold number at which an issuer must register its securities and comply with certain reporting requirements of the Exchange Act. An adviser that managed 14 such hedge funds would then manage the assets of 6,986 clients. In addition, if any of those clients were also hedge funds that the adviser managed, the number of clients would increase by the number of investors in those hedge funds.

consider incorporating into any such amendment a threshold for Commission registration based upon the aggregate amount of assets managed by the hedge fund adviser.[293]

In the course of the staff's investigation of hedge funds, we frequently raised, with industry participants and others, the question of whether the Commission should require all hedge fund advisers to register as investment advisers. Some supported required registration as a means of obtaining needed oversight of the hedge fund industry and providing appropriate transparency[294] and background information about the adviser for investors,[295] without impeding the functioning of hedge funds.[296] Some felt that required registration would benefit a maturing hedge fund industry by helping reduce fraudulent activities that diminish all members' reputations. One thought that it would provide a basis for permitting greater retail participation in hedge funds.[297]

Many of those opposing required registration expressed a strong preference for leaving the hedge fund industry "unregulated." They argued that the incidence of fraud among hedge fund advisers is low, and that hedge funds are adequately supervised by prime brokers, auditors and lenders.[298] Some asserted that there would be no purpose in requiring registration, arguing that the types of clients investing in hedge funds are able to take steps to protect themselves without the assistance of the Commission.[299]

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[293] Such a threshold would maintain the registration exemption for advisers to very small hedge funds whose investors are likely to have personal relationships with the hedge fund adviser. It would also be consistent with the approach taken by Congress when it amended the Advisers Act in NSMIA to divide oversight of advisers between the states (for advisers with less than $25 million in assets under management) and the Commission (for advisers with assets under management of $25 million or more). We note, however, that even with such a threshold, our recommendation would require most hedge fund advisers to register under the Advisers Act.

[294] Roundtable Transcript, May 15 (statement of Mark Anson).

[295] Roundtable Transcript, May 15 (statement of Sandra Manzke).

[296] Roundtable Transcript, May 14 (statement of Richard Phillips).

[297] Roundtable Transcript, May 15 (statement of John Markese).

[298] Roundtable Transcript, May 15 (statement of Paul Roth). See also, Managed Funds Association Comment Letter, supra note 120.

[299] Roundtable Transcript, May 15 (statement of Paul Roth). See also Gibson, *Is Hedge Fund Regulation Necessary?*, 73 Temple Law Review 713-14 (Summer 2000) (hedge fund investors' ability to privately assert rights under antifraud provisions of federal securities laws obviates need for SEC regulation). We note, however, that there are limited private rights of action under the

During the course of the staff's investigation of hedge funds, we also questioned whether mandating registration of investment advisers to hedge funds would impede the operations or investment activities of hedge fund advisers. No one identified any provision of the Advisers Act or Commission rules that, if applied to hedge fund advisers, would have this result.[300] Although industry participants had mixed reactions to mandatory registration of hedge fund advisers,[301] many hedge fund advisers register voluntarily. This belies any notion that

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Advisers Act. Hedge fund investors would be unable to bring a private action against a hedge fund adviser for monetary relief based on violations of the Advisers Act antifraud provisions. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[300] Indeed, hedge fund lawyers indicated to us that the U.S. approach to excluding hedge fund advisers (or making registration optional, depending upon the other advisory activities of the adviser) appeared to be unique among countries with developed markets and regulatory systems, most of which regulate the activities of hedge fund advisers (and in some cases hedge funds themselves), or are in the process of changing their laws to add hedge funds and hedge fund advisers to the country's existing system of investment management regulation. See, e.g., Japanese Securities Investment Adviser Association website, *About the Industry in Japan* at http://jsiaa.mediagalaxy.ne.jp/komon_e/index.html; Securities and Futures Commission (Hong Kong), Securities and Futures Ordinance (Cap. 571, Sec. 114 and Sch. 5), at http://www.hksfc.org.hk/eng/bills/html/index/index0.html; Securities and Futures Commission (Hong Kong), Fund Managers Code of Conduct (April 2003), at http://www.hksfc.org.hk/eng/bills/html/index/index0.html. One author has suggested that the European approach to regulating hedge fund advisers has benefited the industry by establishing minimum standards of practice in which investors can have some confidence. Neil Wilson, *Why Regulation Can Be Good,* Absolute Return (Apr. 2003) (U.K. regulation of hedge fund advisers has not impeded growth, and encourages advisers to build professional operations before launching funds; many of the firms deterred by regulation probably should not be managing hedge funds).

[301] A few Roundtable panelists suggested that if the Commission requires mandatory registration for most hedge funds advisers, some of those advisers would move their operations to jurisdictions that did not have such a requirement. We believe that such concerns are unwarranted. A hedge fund adviser could not avoid application of the Advisers Act simply by moving its office to a non-U.S. location. In fact, an adviser moving offshore would be required to register if more than 14 U.S. investors owned interests in the hedge fund. See Rule 203(b)(3)-1(b)(5) under the Advisers Act. At least one hedge fund consultant has suggested that advisers foregoing U.S. investors is unlikely to occur. Ron Orol, *Firmly Rooted*, Daily Deal (July 14, 2003) (citing Arthur Bell of Arthur Bell & Associates as stating that U.S. investors would be "virtually impossible to replace.")

Several Roundtable panelists asserted that registration under the Advisers Act was unnecessary because hedge fund advisers are already registered with the CFTC as CPOs or CTAs and examined by the NFA. Roundtable Transcript, May 14 (statement of Anthony Artabane); Roundtable Transcript, May 15 (statements of Patrick McCarty and Armando Belly). As discussed above, however, the CFTC and the NFA necessarily focus their examinations more

registration of hedge fund advisers is detrimental to a hedge fund's legitimate investment activities.

Registration under the Advisers Act represents the least intrusive form of regulation available to address many of the concerns identified in this Report. Our recommendation that hedge fund advisers register with the Commission under the Advisers Act would not result in any changes with respect to those advisers' ability to effectuate their investment strategies. Registration would not place any restrictions on hedge fund advisers' ability to trade securities, use leverage, sell securities short or enter into derivatives transactions. Nor would registration under the Act require the disclosure of any proprietary trading strategy. In addition, registration would not result in hedge funds and hedge fund advisers being subject to any additional portfolio disclosure requirements.

Our recommendation would not result in hedge funds having to register the offerings of their interests with the Commission, nor would it require that they modify their organizational structures. Advisers would be able to maintain their existing lock-up and repurchase schedules. Adviser registration would not result in public disclosure of the identities of advisers' clients. Finally, registration would not restrict the amount of fees that hedge fund advisers may charge hedge funds, although an adviser to a hedge fund relying on Section 3(c)(1) of the Investment Company Act would be permitted to charge that fund a performance fee only if each of the investors in the fund are qualified clients under Rule 205-3 under the Advisers Act.[302]

1. *Benefits of Mandatory Registration*

a. *Registration of Hedge Fund Advisers Would Serve as a Deterrent to Fraud*

Our examination experience with registered investment advisers demonstrates that examinations can lead to earlier discovery of actual and potential misconduct and frequently reduces the possibility that such misconduct will occur.[303] Periodic examination of hedge fund advisers can be expected to have the same result. We concede, however, that Commission examinations cannot assure that frauds do not occur. Indeed, a number of our enforcement actions involving hedge fund frauds have been against hedge fund advisers that are registered

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closely on futures trading. Moreover, the CFTC recently adopted rules that may permit most hedge fund advisers, including those currently able to avoid investment adviser registration, to avoid registering as CPOs or CTAs.

302 See supra note 212. Hedge fund advisers to funds relying on Section 3(c)(7) under the Investment Company Act would not be subject to any such limitation.

303 See supra Part VI.A. (discussing concerns about lack of Commission oversight).

with us.[304] Nevertheless, the prospect of Commission examination may discourage persons from using hedge funds to engage in fraud. Moreover, we believe that the lack of regulatory oversight of hedge funds may contribute to the belief on the part of hedge fund advisers that fraud will not be exposed.

b. Registration of Hedge Fund Advisers Would Provide the Commission with Examination Authority and Foster Strong Compliance Practices

Advisers, including hedge fund advisers, are fiduciaries that must avoid conflicts of interest with their clients, or fully disclose those conflicts.[305] To protect against the adverse consequences of these conflicts, hedge fund advisers should adopt a "culture of compliance," which involves making compliance considerations a part of an adviser's business plan.

Our investigation revealed that many unregistered hedge fund advisers already have adopted sound compliance practices, which would need little modification to address registration requirements. Those unregistered advisers, however, tended to be larger firms that have substantial reputational risk at stake. Several participants in the hedge fund industry with whom we met during the course of our investigation, however, expressed concern that newer industry participants had not adopted compliance controls adequate for the amount of assets under their control.

While some new entrants to the hedge fund industry brought with them – from their previous employment with a money management or brokerage firm – an understanding of their obligations to fund investors, other new entrants may have little such experience. Our examinations confirmed that in many cases controls at some hedge fund advisers are very informal. We believe that the prospect of a compliance examination by the Commission staff will result in the adoption of procedures and controls designed to fulfill the hedge fund adviser's fiduciary responsibilities to the hedge fund and its investors.[306]

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[304] See, e.g., *Hoover and Hoover Capital Management, Inc.*, Litigation Release No. 17981 (Feb. 11, 2003); *SEC v. Michael L. Smirlock and LASER Advisers, Inc.*, Litigation Release No. 17630 (July 24, 2002); *In the Matter of William F. Branston*, Advisers Act Release No. 2040 (June 26, 2002); *In the Matter of Abraham and Sons Capital, Inc. and Brett G. Brubaker*, Advisers Act Release No. 1956 (July 31, 2001).

[305] Capital Gains, supra note 278, at 191, 194.

[306] See Neil Wilson, *Why Regulation Can Be Good,* Absolute Return (Apr. 2003) (U.K. regulation of hedge fund advisers establishes minimum standards of practice; the process of registration encourages advisers to build professional operations before launching a fund "rather than scrambling to put them together after launch.").

Earlier this year, the Commission proposed a new rule that, if adopted, would require all registered investment advisers to adopt written compliance procedures, review them at least annually and appoint a chief compliance officer.[307] Application of this rule to hedge fund advisers would, in our view, be particularly useful.

As registered investment advisers, hedge fund advisers would be required to make certain prescribed disclosures to the Commission and investors, including disclosure regarding the advisers' business practices and disciplinary history, and to maintain required books and records and safeguard client assets. The Commission could conduct periodic compliance examinations of these advisers and monitor whether they conduct their operations (as well as those of hedge funds that they manage) so as to avoid the concerns identified in this report. We anticipate that the prospect of a staff compliance examination will serve to support business decisions to allocate resources necessary to ensure the implementation of strong compliance controls and the satisfaction of hedge fund advisers' fiduciary responsibilities to their clients.

c. *Registration Would Provide the Commission with Important Information about a Segment of the U.S. Financial System that Is Growing in Significance*

Hedge fund adviser registration under the Advisers Act would permit the Commission to collect basic information about virtually all hedge fund advisers, including the number of hedge funds that they manage, the amount of assets of those hedge funds and the identity of persons controlling the hedge fund advisers.[308] This requirement also would enable the Commission to more comprehensively and effectively observe the trading activities of the funds managed by such advisers. Currently, the Commission generally has access to records of trading on behalf of hedge funds through the books and records maintained by the brokers that the hedge fund advisers use and the markets on which they trade. These records, however, are dispersed and it could be difficult to detect improper trading activities conducted by a particular hedge fund if such activities were effected through orders placed with multiple brokers and traded on multiple markets. The ability to directly examine the trading activities of hedge fund advisers would

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[307] *Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release No. 2107 (Feb. 5, 2003).

[308] Roundtable panelists suggested that it would be valuable for the Commission to gather information about hedge funds. Roundtable Transcript, May 15 (statement of Thomas Fedorek) ("[T]here's a real opportunity here for the SEC to be not just a cop but to be what it is, actually, to a large extent already, an information provider. [N]ot a day that goes by that I don't dial into one of the SEC's databases to get information to help me in the research that I do in my investigations."); Roundtable Transcript, May 15 (statement of Andrew Lo) (suggesting that the Commission is in a unique position to gather hedge fund data that are not generally and publicly available, and noting that an understanding of risks involved in hedge funds begins with data.).

provide a more complete picture of their trading activities and make it easier to detect improper or illegal trading practices.

Much of this information currently can be collected from hedge fund advisers that are registered with the Commission.[309] Using the Commission's existing authority under the Advisers Act to obtain information about hedge fund advisers is particularly appropriate because, as originally enacted, the Advisers Act was designed to be "a continuing census of the Nation's investment advisers."[310]

d. Mandatory Registration Would Effectively Raise the Standards for Direct Investments in Hedge Funds

Our investigation of hedge funds was driven, in part, by the Commission's concern that the growth in hedge funds was being fueled by the direct investments of less sophisticated investors in hedge funds. Although our investigation did not uncover significant direct investment in hedge funds by less sophisticated investors, we continue to believe that the rise in investor wealth and incomes could ultimately result in retail investors investing directly in hedge funds relying on Section 3(c)(1) of the Investment Company Act. A number of commenters expressed their views that this concern could be remedied by raising the wealth standards, primarily the accredited investor standard under Regulation D.[311] Registration of hedge fund advisers, however, would effectively address our concerns.

In general, the Advisers Act prohibits registered investment advisers from charging performance fees to hedge funds relying on Section 3(c)(1) of the Investment Company Act unless all of the fund's clients are "qualified clients."[312] The wealth standards for qualified

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309 A registered adviser that is the general partner of a hedge fund must report that it advises a "pooled vehicle" in response to Item 5.D.4. of Part 1A of Form ADV, list each pooled vehicle on Schedule D (Section 7B) and disclose the amount of assets in the fund and the minimum amount of capital investment per investor.

310 H.R. Rep. No. 1760, 86th Cong., 2d Sess. 2 (1960).

311 See, e.g., Managed Funds Association Comment Letter, supra note 120 (proposing increases to the accredited investor thresholds to $2 million in net worth, $400,000 in annual income and $500,000 in annual income jointly with one's spouse); Comments submitted by the Ad Hoc Hedge Fund Committee of the Securities Industry Association (supporting suggestions to tighten the accredited investor standard built into Regulation D under the Securities Act of 1933); Comments submitted by David G. Tittsworth on behalf of the Investment Counsel Association of America (urging the Commission to consider revising the current definition of "accredited investor").

312 See Section 205(a)(1) of the Advisers Act and Rule 205-3(d)(1) thereunder. See supra note 212.

clients are appreciably higher than those for "accredited investors," requiring that the investor have $750,000 invested with that adviser, or generally have a net worth of $1.5 million.[313] Our recommendation also has the salutary effect of permitting the Commission to reevaluate any future concerns about the nature of hedge fund investors and address any such concerns through regulation under the Advisers Act.

2. *Concerns about Mandatory Registration*

We recognize that adviser registration will impose additional costs on hedge fund advisers that are not already registered with the Commission. Nevertheless, we believe that the benefits of adviser registration outlined in this Report outweigh the additional costs that would be imposed on unregistered hedge fund advisers.[314] There are three types of costs associated with registering: (1) electronic filing, which costs $1100 the first year and $550 each year thereafter; (2) recordkeeping systems meeting the requirements of the Advisers Act, which are typically provided by the hedge fund's prime broker and thus, in many cases, would involve no additional costs; and (3) ongoing costs related to regulatory compliance. Most of these latter costs are attributable to compliance with the Act's antifraud provisions to which unregistered advisers already are subject and thus should be incurred regardless of whether the adviser is registered under the Act. In connection with any rulemaking, the staff would prepare a more complete analysis of the costs and benefits of requiring hedge fund advisers to register under the Advisers Act.

We are also mindful that the Commission's resources available to examine advisers are limited. Thus, we recommend that any rule the Commission adopts requiring advisers to count clients by "looking through" the hedge fund limit the number of new registrants by distinguishing between hedge funds and other investment vehicles that do not register under the Investment Company Act in reliance on Sections 3(c)(1) or 3(c)(7). These other investment vehicles include venture capital funds, private equity funds and structured financing vehicles.[315]

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[313] Our recommendation also is attentive to the Commission's interest in maintaining existing regulations that support its mission to assist small business development. See Chairman Donaldson Testimony, supra note 184. By leaving eligibility requirements for "accredited investors" under Regulation D unchanged, small businesses may continue to seek capital from historical sources.

[314] In addition, some advisers to hedge funds that are already registered with the Commission have indicated that the burdens of adviser registration do not impose significant additional costs on their operations. Further, many advisers of hedge funds that are not registered have indicated that they conform their operations to those of registered advisers.

[315] The President's Working Group cited the difficulty of limiting registration to advisers to hedge funds as one reason for not requiring hedge fund managers to register under the Advisers Act. LTCM Report, supra note 126, at B-16. In developing anti-money laundering rules under the USA Patriot Act, the Treasury Department was, however, able to craft such a limitation by

In addition, we recommend that the Commission consider its available resources when establishing the amount of assets under management threshold for registration with the Commission.

The Commission should carefully evaluate its resources and capabilities to seek to ensure that any rulemaking would not affect the efficacy of the Commission's examination program before taking action on our recommendations. Moreover, the Commission would have to devote the resources necessary to modify its existing investment adviser examination program so that it recognizes the unique nature of hedge fund advisers and identifies deficiencies and possible violations.[316] We also believe that our recommendations would require that additional resources be dedicated to the Division of Investment Management so that it may consider and evaluate regulatory policy regarding hedge fund investment advisers.

B. The Commission Should Consider Revising its Regulations Under the Advisers Act to Require Advisers to Provide a Brochure Specifically Designed for Hedge Funds

We recommend that the Commission consider revising its rules to require that hedge fund advisers file with the Commission, and deliver to investors, a disclosure statement tailored to meet the needs of hedge fund investors.[317] Disclosure could be in the form of a brochure and

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proposing to apply its rule only to funds that offered certain redemption rights. See Treasury Anti-Money Laundering Proposal, supra note 265; see also supra Part III.E.4.c.

316 Requiring hedge fund advisers to register with the Commission would not impose any additional burdens on state securities authorities. Hedge fund advisers registered under state law would, upon registering with the Commission, be eligible to withdraw their state registrations. See Section 203A(b)(1) of the Advisers Act. The rulemaking that we recommend that the Commission consider may thus be expected to relieve some state regulators of their regulatory obligations with respect to some hedge fund advisers that are registered with state securities authorities. See supra Part III.E.5.c. (discussing state regulation of hedge fund advisers).

317 Investment advisers register with the Commission or state securities administrators on Form ADV. See http://www.sec.gov/divisions/investment/iard.shtml. Part I of Form ADV requires general disclosure about the adviser's business and certain disciplinary information. Part I of an adviser's Form ADV is available on the Commission's web site. Part II of Form ADV requires disclosure of certain information, including conflicts of interest, assets under management and whether the adviser manages any pooled assets. Part II of Form ADV (or a brochure incorporating the information required in Part II) must be delivered to clients and prospective clients under Rule 204-3 under the Advisers Act. Advisers to hedge funds must deliver their brochures to the hedge fund investors, rather than the hedge fund itself. *Electronic Filing by Investment Advisers; Proposed Amendments to Form ADV,* Advisers Act Release No. 1862 n.117 (Apr. 5, 2000). The Commission has under consideration a proposal to make Part II of Form ADV available on the Commission's website.

would prescribe minimum requirements for basic disclosure information provided to investors and prospective investors. The Commission could require, for example, disclosure about various conflicts of interest, what risk management measures the adviser performs,[318] how the adviser values securities held by hedge funds (and the extent to which that valuation will be determined independently) and what lock-up periods may apply to an investor's investment in hedge funds managed by the adviser. Although hedge fund investors may already receive some of the information in the fund's PPM, we would propose that the Commission require that this information be disclosed in the "hedge fund brochure" – the brochure having the added benefit of requiring the adviser to update its disclosures periodically and make that information available to investors on an ongoing basis.[319] Moreover, these disclosures could be useful to other clients of the adviser in identifying conflicts of interests on the part of the adviser.

The information contained in Form ADV would not, we recognize, give investors in hedge funds all the information that they may need or want. Because that form is designed to provide information about investment advisers, there would be limitations on information about specific hedge funds. In addition, Form ADV cannot provide investors with sufficient information to evaluate the character of the hedge fund adviser or its employees.[320] But Form

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318 The Commission also could consider exploring the possibility of developing appropriate risk measures that hedge fund advisers could use to provide investors with ongoing risk information. Hedge fund advisers, institutional investors and knowledgeable groups such as the Investor Risk Committee of the International Association of Financial Engineers could be contacted to assist the Commission in developing risk measures that would be meaningful to, and meet the needs of, hedge fund investors.

We note that our recommendation would implement one of the recommendations in the LTCM Report, supra note 126, at 32-33. The Working Group recommended the enactment of legislation granting any necessary authority to require disclosure by hedge funds that were not registered with the CFTC as commodity pools. Legislation was introduced into Congress but was never enacted. Legislation would be unnecessary to effect the Working Group's recommendation once hedge fund advisers registered with the Commission.

319 See Roundtable Transcript of May 14 (statement of George Hall) (the private placement memorandum does not provide for ongoing information – ongoing information is provided more informally, "more outside of the documents").

320 Roundtable Transcript of May 14 (statement of David Swensen) ("[W]hat we really care about when we're making investment decisions is, first and foremost, the quality of the people, and there's no way that you can look at somebody's disclosure document and figure out if the people that you're invested with have the character, the intelligence, the integrity, the creativity, and market savvy that you want to have in a partner in this arena or any other investment arena, for that matter."); Roundtable Transcript of May 15 (statement of Pamela Parizek) ("While there is a great deal of information that's available in the public domain, . . . things like reputation and integrity [are] not generally going to be available and frequently we are called upon to get that type of information for many of our investors.").

ADV disclosure would, we believe, make the due diligence process in which many hedge fund investors engage substantially more efficient and provide investors with more current information about the operations of hedge fund advisers and the strategies, policies, management and operations of the hedge funds that they operate.

C. The Commission Should Consider Requiring Certain Registered Investment Companies to Follow Board Adopted Valuation Procedures

We recommend that the Commission consider rulemaking to address our concerns about how registered investment companies, including registered FOHFs, that invest their assets in hedge funds value their portfolio holdings. As noted above, the Investment Company Act requires boards of directors to fair value in good faith any securities for which there are no readily available market quotations. Best practices would suggest that all registered investment companies adopt procedures under which they may satisfy this requirement. Because of our heightened concerns relating to registered FOHFs, however, we recommend that the Commission consider a rule that would prohibit registered investment companies from investing in the securities of hedge funds unless their boards of directors have adopted procedures designed to ensure that the funds value those assets consistently with the requirements of Section 2(a)(41) of the Investment Company Act. In making this recommendation, however, we note that the requirement under Section 2(a)(41) that a board of directors determine, in good faith, the fair value of securities for which there is no readily available market quotation reflects Congress's recognition that a board of directors must exercise its best business judgment in valuing these types of securities. We do not recommend, therefore, that the Commission consider mandating the specific procedures that a fund must follow in valuing its assets.[321]

D. The Commission Should Consider Requiring Additional Disclosure to be Provided About Layered Fees of "Funds of Funds"

We recommend that the Commission consider adopting its recently proposed rule that would expressly require all registered investment companies, including registered FOHFs, that invest all or substantially all of their assets in hedge funds (collectively "funds of funds") to disclose in the fee table the estimated fees (both asset based and performance based) and expenses of the underlying funds.[322] The staff believes that disclosure of the expenses of both the fund in which an investor invests and the funds in which a fund of funds invests is important to provide meaningful information to investors.

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[321] We believe that this recommendation could ultimately address our concerns about a registered FOHFs diversification and risk exposure. See supra Part VI.C.2. (discussing concerns relating to registered FOHFs).

[322] See *Fund of Funds Investments*, Investment Company Act Release (to be released).

We believe our recommendation is particularly germane to registered FOHFs. Neither the Investment Company Act nor the Advisers Act limits the amount of fees that may be charged by hedge fund advisers. Moreover, to the extent that performance fees may be charged at the hedge fund level, a registered FOHF investor may indirectly pay performance fees to some hedge fund advisers regardless of how poorly the investor's registered FOHF performed overall. Because an investor in a registered FOHF has access only to the fee disclosure in that fund's prospectus, the investor cannot accurately evaluate his or her investment goals and expectations against the costs of the investment, without additional disclosure that would be required under the recommended rule.

E. Regulators Should Continue to Monitor Whether Suitability Obligations Are Being Met

We do not recommend specific measures to be taken with respect to suitability determinations at this time. We believe that the staffs of the NASD and the Commission are carefully focusing their examinations of broker-dealers to, among other things, ensure that they are meeting their obligation to evaluate and disclose to investors the general suitability of hedge funds and FOHFs (both registered and not registered with the Commission), as well as their suitability for specific investors. Although we believe that the examination of broker-dealers has been effective in deterring abusive sales practices relating to these securities, we also urge the examination staffs of the NASD and Commission to continue to be vigilant in identifying any violations of broker-dealer suitability obligations.

F. The Commission Should Consider Permitting General Solicitation in Section 3(c)(7) Hedge Fund Offerings

We question whether the restrictions on general solicitation for private placement offerings of interests in funds relying on Section 3(c)(7) of the Investment Company Act should be retained. Unlike a Section 3(c)(1) fund, a Section 3(c)(7) fund can be sold to an unlimited number of investors, so long as they are "qualified purchasers." There seems to be little compelling policy justification for prohibiting general solicitation or general advertising in private placement offerings of Section 3(c)(7) funds that are sold only to qualified purchasers.[323]

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[323] The Commission has requested comment in various rulemakings as to whether the restrictions on general solicitation should be relaxed as to certain types of offerings or certain types of investors. See, e.g., *The Regulation of Securities Offerings*, Securities Act Release No. 7606A (Nov. 13, 1998); *Securities Act Concepts and their Effects on Capital Formation*, Securities Act Release No. 7314 (July 25, 1996); *Exception for Certain California Limited Issues*, Securities Act Release No. 7285 (May 1, 1996); *Exemption for Certain California Limited Issues*, Securities Act Release No. 7185 (June 27, 1995). To date, the Commission has not adopted proposals to relax general solicitation or general advertising restrictions. The Commission and the staff have, however,

The staff would be reluctant to ease or eliminate the prohibition on general solicitation for hedge funds or other funds that use the accredited investor standard as their minimum investor criteria. We believe that such an arrangement could increase the level of risk of investment interest by less wealthy investors. On the other hand, permitting funds, including hedge funds, that limit their investors to a higher standard (e.g., "qualified purchasers") to engage in a general solicitation could facilitate capital formation without raising significant investor protection concerns.

G. Monitor Capital Introduction Services Provided by Prime Brokers

Prime brokers frequently provide certain investors with information about hedge funds. In particular, prime brokers who provide capital introduction services to hedge fund advisers often invite these investors to attend capital introduction conferences and seminars. Prime brokers have asserted that these "dating service" activities do not rise to the level of acting as a broker or investment adviser. We question whether this conclusion is accurate in all circumstances. Accordingly, we encourage examiners to be vigilant in examining capital introduction services to determine whether prime brokers are complying with all applicable regulatory requirements.

H. Encourage the Hedge Fund Industry to Embrace and Further Develop Best Practices

The Commission should encourage the hedge fund industry and others involved with the industry to embrace existing "best practices" and expand and develop additional best practice guidelines in areas that further investor protections and enhance the ability of hedge funds to manage their operations. Generally, best practice guidelines allow firms to benchmark their activities relative to their peers and can produce a self-regulatory solution to issues arising within an industry. At least three industry groups and associations have issued best practice recommendations for hedge fund advisers.[324]

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recognized that a shorter time frame, 30 days, between the end of activities that may be considered general solicitation or general advertising and the commencement of an offering may be sufficient to eliminate a concern that investors in the subsequently commenced private offering were found by means of general solicitation or general advertising. See e.g., *Integration of Abandoned Offerings*, Securities Act Release No. 7943 (Jan. 26, 2001).

[324] See The Managed Funds Association, *2003 Sound Practices for Hedge Fund Managers* (Aug. 2003) ("MFA 2003 Sound Practices"); The Alternative Investment Management Association Ltd., *Guide to Sound Practices for European Hedge Fund Managers* (Aug. 30, 2002) ("AIMA Guide to Sound Practices"); and The International Association of Financial Engineers, Investor Risk Committee, *Hedge Fund Disclosure for Institutional Investors* (July 27, 2001).

Some best practice recommendations were developed in response to issues arising out of LTCM, and therefore focus largely on risk management techniques, addressing investor protection issues in the context of market, leverage, and operational risks. The Managed Funds Association recently revised its sound practices.[325] These sound practices include recommendations concerning the type of information that should be disclosed to a hedge fund's investors, such as the fund's investment objectives and strategies, performance information, and range of permissible investments as well as valuation policies and business continuity and disaster recovery. These recommendations also acknowledge that hedge fund operations may generally present conflicts of interest and that these conflicts, if material, should be appropriately disclosed. The Alternative Investment Management Association sound practices guide covers topics such as: creating and managing a hedge fund business; hedge fund structures and organizations; the investment process and portfolio risk management; portfolio administration and operation controls; as well as capital raising and investor relations. AIMA guidelines, for example, address among the most critical conflicts of interest confronted by investment advisers: side-by-side management of hedge funds and other clients. The AIMA guidelines emphasize that addressing side-by-side management issues in managing various portfolios should be an "overriding principle of business."[326]

The use of best practices can be an effective means of addressing issues that arise in the hedge fund industry. For example, based on its examination of major brokerage houses, the Commission staff discovered that many firms responded favorably to recommendations made in the President's Working Group on Financial Markets' report to address the risk management and transparency issues raised in LTCM. The Managed Funds Association has also indicated that the best practices it issued was "widely recognized by members of the hedge fund industry as a highly useful resource for hedge fund managers."[327] Best practices may thus be a useful tool to improve how firms address issues, such as conflicts of interest, beyond regulatory and legal mandates.

While we are encouraged by the best practice guidelines that currently exist, we believe that the industry should be encouraged to continue to refine and expand their scope, especially in light of evolving industry developments. For example, we believe that certain of these recommendations are general in nature and may be more meaningful if they provide specific policies and procedures that hedge fund advisers may follow or consider to improve their operations and to prevent conflicts from harming their clients.

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[325] See MFA 2003 Sound Practices, supra note 324.

[326] See AIMA Guide to Sound Practices, supra note 324.

[327] See MFA 2003 Sound Practices, supra note 324 (referring to sound practices recommendations that the MFA previously issued in 2000).

I. Investor Education

As this Report notes, improvements in disclosure practices of hedge fund advisers is desirable to help investors make more informed investment decisions regarding hedge fund securities. Even if the Commission follows our recommendations, there may be practical limits on the extent to which investor education can assist retail investors to make informed decisions about hedge funds and FOHFs. It also may be that some investors overlook the correlation between risk and reward.

The Commission's website provides a partial list of questions that investors should ask, and most importantly, understand the answers to before making any investments in hedge funds or registered FOHFs. These issues run the gamut from understanding the costs associated with investing in hedge fund or registered FOHF securities, to understanding any limitations on an investor's ability to liquidate the investment to understanding how the lack of transparency affects the investor's personal investment needs (e.g., diversification). We recommend that the Commission continue to provide and enhance investor education relating to hedge funds and registered FOHFs.

In February 2003, in response to increasing publicity about hedge funds and registered FOHFs, the Commission developed a website advertising a simulated hedge fund, Guaranteed Returns Diversified, Inc. ("GRDI" for short, pronounced "greedy").[328] This website demonstrates how easy it is to be taken in by false statements and seeks to sensitize investors to their vulnerability. Although the Commission's website provides a link to the fake scam, many investors appear to be finding it by surfing the Internet looking for quick and easy hedge fund returns. Several hedge fund websites, and bulletin boards frequented by hedge fund investors, also steer investors to the site. Since the Commission launched the website on February 13, 2003, there have been over 80,000 hits on it.[329]

VIII. The Commission Should Consider Issuing a Concept Release for Examining Wider Use of Hedge Fund Investment Strategies in Registered Investment Companies

We recommend that the Commission consider issuing a Concept Release exploring the wider use of hedge fund-type/absolute return strategies. Many hedge funds use absolute return strategies that are designed to produce positive returns irrespective of the performance of other securities markets. These investments typically have lower correlations to the broader debt and equity markets and thus, may provide benefits to investors under a wider variety of market

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[328] See http://www.growthventure.com/grdi.

[329] The agency has received telephone calls and a handful of e-mailed comments from investors who have visited the GRDI site. Nearly half of these calls and comments came from investors who, upon reading the website's description of unbelievably high returns, wished to invest.

conditions. The staff believes that these investments may have benefits that could assist other investors, including retail investors, in diversifying their overall portfolios. The staff is not recommending that hedge funds be made more readily available and does not believe that direct investment into hedge funds by retail investors is appropriate.[330] Instead, we believe it may be the case that retail investors interested in absolute return strategies should be able to pursue those investments through the registered investment company structure.

We recommend that the Commission consider issuing a Concept Release assessing the steps that should be taken to encourage the wider use of absolute return strategies in registered investment companies. This release would seek information including, but not limited to, the following: what, if any, statutory or regulatory changes would enable more effective deployment of absolute return strategies in registered investment companies; and what is the ability of retail investors to understand absolute return strategies.

A. Different Registered Investment Company Structures Provide Various Benefits and Challenges in the Deployment of Absolute Return Strategies

Several registered investment companies currently offered to the public utilize absolute return strategies. Although still quite small, this group appears to have grown markedly since 1997 when Congress repealed the "short-short" rule, a tax regulation that limited the amount of profits that an open-end investment company could derive from short-term trading or short selling. Many of the strategies currently being used in registered investment companies attempt to use offsetting long and short positions in an attempt to mitigate market risk and generate positive returns. Among the types of funds currently being offered are market neutral, long/short equity and even merger arbitrage investment strategies.[331] The growth of these funds suggests that the Investment Company Act presents manageable impediments to the retail offering of hedge fund (or hedge fund-like) investment funds.

Some of the registered investment companies using hedge fund strategies are organized as open-end management companies, and thus must make payment on redemption requests no

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330 A few jurisdictions, such as Hong Kong, Singapore and Switzerland, permit individual hedge funds to be marketed and sold directly to retail investors. See *Hedge Funds and the FSA*, Financial Services Authority Discussion Paper No. 16, at 21-22 (Aug. 2002) at http://www.fsa.gov.uk/pubs/discussion/16.

331 Registered investment companies with market neutral, merger arbitrage and other absolute return strategies represent a very small niche of the approximately $6.8 trillion investment company industry. One estimate is that there are approximately 50 such registered investment companies with about $8 billion under management. See *Hedging Trims Some Fund Gains*, Wall Street Journal (Aug. 4, 2003).

more than seven days after receipt of those requests.[332] As a result, these funds are unable to impose "lock-ups" or notice requirements, both of which are common among hedge funds. Moreover, the need to manage cash flows as a result of purchases and redemptions (aggravated by market timers) may make the open-end management company structure less attractive or may negatively affect returns of the fund.[333] However, for those many hedge fund strategies involving investments in highly liquid securities, redemption requirements of the Investment Company Act do not present a significant obstacle.

Those advisers using strategies involving illiquid securities or who wish to avoid cash flow management obligations, may register their funds as closed-end investment companies. The closed-end investment company offers several significant advantages over the mutual fund structure in the utilization of absolute return strategies. Closed-end funds do not issue redeemable securities and are therefore not required to liquidate securities in order to meet redemption requests. This more stable asset base permits advisers to remain fully invested. Closed-end funds are also not required to hold any specified percentage of their assets in liquid securities and may engage in strategies that require large portions of illiquid securities as a percentage of their total assets.[334] Closed-end funds, of course, may offer less liquidity to their shareholders.[335] As discussed below, closed-end funds can engage in leveraging transactions

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332 See Section 22(e) of the Investment Company Act (prohibiting registered investment companies issuing redeemable securities from suspending the right of redemption for more that seven days following tender of security).

333 Open-end funds may hold no more that 15 percent of their assets in illiquid securities. A security is considered "illiquid" if a fund is unable to promptly sell or dispose of the security in the ordinary course of business at its current value within seven days. See *Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies*, Investment Company Act Release No. 14983 (Mar. 21, 1986) (adopting amendments to Rule 2a-7). The Commission has historically recommended the 15 percent ceiling in order to maintain and enhance a registered investment company's liquidity. See *Revisions of Guidelines to Form N-1A*, Investment Company Act Release No. 18612 (Mar. 12, 1992). While the Guidelines were not republished when Form N-1A was amended in 1998, they continue to set forth the staff's views on issues not addressed in the 1998 amendments to Form N-1A. See *Registration Form Used by Open-End Management Investment Companies*, Investment Company Act Release No. 23064 (Mar. 13, 1998).

334 Because of the ability to hold illiquid securities, closed-end investment companies tend to specialize in less liquid bonds, foreign securities, small/microcap securities and securities issued by companies that are not publicly traded.

335 Most closed-end funds provide liquidity to their shareholders by listing their securities for trading on an exchange or on the over-the-counter markets. However, there is no requirement that closed-end fund shares be publicly traded and many funds provide their shareholders with liquidity solely through periodic purchases of their own shares or through tender offers.

beyond those of open-end investment companies. Unlike open-end investment companies, however, closed-end investment companies cannot engage in continuous offerings and often have difficulty raising additional assets.[336]

Closed-end investment companies that elect to operate as "interval" funds under Rule 23c-3 under the Investment Company Act may be well suited for use of absolute return strategies.[337] Interval funds are registered closed-end investment companies that adopt as a fundamental investment policy that they will engage in periodic repurchases of their own shares at net asset value.[338] There are few interval funds currently in operation.[339] One reason for the reluctance to use the interval fund structure may be the requirement that the fund maintain liquid assets equal to at least 100 percent of the amount of the mandatory repurchase offer. Complying with this provision may require selling securities in anticipation of the periodic repurchases. Interval funds also lack the same flexibility of other closed-end funds with respect to the use of leverage.[340]

We recommend that the Commission consider seeking comment through a Concept Release to learn the extent to which hedge fund investment strategies might be effectively deployed in the open-end investment company structure. The release should request comment on what measures could assist these companies in offering absolute return strategies consistent with the issuance of redeemable securities, including whether there should be flexibility with respect to the limitation on illiquid securities. The release should also seek comment on how closed-end investment companies could be made to be more conducive for the use of absolute return strategies. Similarly, the Concept Release should seek comment on what steps could be taken to increase the utility of Rule 23c-3 under the Investment Company Act, including whether raising the maximum permitted redemption amount above 25 percent would be helpful.

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336 Section 23 of the Investment Company Act generally prohibits closed-end funds from issuing shares below NAV, and since closed-end fund shares often trade at discounts to NAV, the presence of a trading discount limits the issuance of additional shares to rights offerings, for practical purposes.

337 See *Repurchase Offers by Closed-End Management Investment Companies*, Investment Company Act Release No. 19399 (Apr. 7, 1993).

338 The periodic repurchase provisions are intended to allow closed-end investment companies to offer their investors a limited ability to resell shares—a benefit traditionally available only to shareholders of registered open-end investment companies. Id.

339 Commission records indicate that 43 investment companies or portfolios operate pursuant to Rule 23c-3 under the Investment Company Act.

340 Rule 23c-3 under the Investment Company Act requires that leveraged positions either mature or be callable in advance of the periodic repurchases.

B. Registered Investment Companies are Subject to Restrictions on Leverage and Short Selling that Hedge Funds Avoid

While hedge funds may no longer engage solely in strategies that involve hedging and leverage, the majority of hedge funds still use these techniques to varying degrees. The ability to borrow money to engage in securities transactions and to sell securities short are of critical importance to most hedge fund advisers.

Congress chose to *limit*, but not to *prohibit*, the ability of investment companies to engage in leverage.[341] Section 18 of the Investment Company Act addresses leverage concerns by limiting the ability of investment companies to borrow and incur indebtedness.[342] Under the Investment Company Act, securities and related transactions in which the registered investment company is a borrower, or that involve indebtedness on the part of the registered investment company, are generally known as "senior securities." Congress limited the ability of investment companies to engage in leverage by limiting their ability to issue "senior securities."[343] In

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341 See, e.g., Mutual Fund Use of Derivatives, Letter from Arthur Levitt, Chairman of the SEC, to Hon. Edward J. Markey and Hon. Jack Fields, U.S. House of Representatives, attaching Division of Investment Management Memorandum, at n. 83 (Sept. 26, 1994) ("The legislative history of the Investment Company Act indicates that the Act was not intended to eliminate all leverage from fund investments.") See also id. at n. 82 ("The framers of the Investment Company Act specifically disavowed any attempt to prohibit speculative mutual fund investments."). The Commission has stated that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return." See Release 10666, supra note 133.

342 See, e.g., Sections 18(a) - (e) of the Investment Company Act (restrictions on closed-end investment companies); Section 18(f) of the Investment Company Act (restrictions on open-end investment companies); Section 18(g) of the Investment Company Act (definition of "senior security"); and Section 18(h) of the Investment Company Act (asset coverage formula).

343 Because securities issued by open-end investment company securities are redeemable, and securities issued by closed-end investment companies are not, Sections 18(a) and (f) of the Act limit the use of leverage by these different types of investment companies in different ways. A closed-end company may issue a senior security representing indebtedness if it maintains asset coverage of at least 300 percent. See Sections 18(a)(1)(A) and (h) of the Investment Company Act. A closed-end company may issue a senior security that is a stock, e.g., preferred stock, if it maintains asset coverage of at least 200 percent. See Section 18(a)(2)(A) of the Investment Company Act. The Investment Company Act generally limits a closed-end company to issuing one class of senior securities representing indebtedness and one class of senior stock, but the class of indebtedness or stock may be issued in one or more series. See Section 18(c) of the Investment Company Act. Under the Investment Company Act, open-end companies generally may not issue senior securities, except that they may borrow from banks provided that the borrowing is subject to 300 percent asset coverage. See Section 18(f) of the Investment Company Act. The Investment Company Act also permits open-end investment companies to engage in

practice, these restrictions limit the amount of leverage in which registered investment companies may engage. Hedge funds are not subject to these limitations.

The Investment Company Act does not prohibit a registered investment company from engaging in short selling.[344] Registered investment companies are permitted to short sell provided that they cover any open short positions by setting aside or "segregating" cash or other liquid securities.[345] Assets set aside to cover a short position are generally frozen and unavailable to the fund for any other purpose, including other short selling or leveraged transactions.[346] By taking these assets "out of circulation," the asset set-aside (segregation) requirement serves as a de facto limit on the amount of short selling in which an investment company may engage.[347] Nonetheless, even with these limits, registered investment companies still have the ability to engage in high levels of short selling.

The Concept Release should seek comment on whether the Investment Company Act's restrictions on the use of leverage and short selling are discouraging the use of absolute return strategies in registered investment companies, as well as impairing the ability of registered investment companies to effectively employ such strategies. The release should also consider whether certain types of derivatives may be useful to registered investment companies seeking to use absolute return strategies. The release should also invite comment on what additional steps,

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certain private and temporary borrowings, from banks and non-banks, without 300 percent asset coverage, because such borrowings are not "senior securities." See Section 18(g) of the Investment Company Act.

344 According to Commission records, for the six-month period ended April 30, 2003, approximately 3,900 mutual funds, out of a universe of approximately 9,000 mutual funds, disclosed that they were authorized to short sell. During this period, 236 mutual funds engaged in short selling.

345 Registered investment companies must set aside or segregate an amount equal to the daily price of the shorted securities less any non-proceeds margin posted under applicable margin rules. See, e.g., Release 10666, supra note 133; *MLAM*, supra note 133; *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995); *Dreyfus*, supra note 133. Instead of setting aside assets, the staff has permitted a fund to cover its short positions by owning the security or holding a call option on the security with a strike price no higher than the price at which the security was sold. See id.

346 See, e.g., Release 10666, supra note 133.

347 All mutual funds, irrespective of whether they are engaging in short selling, must ensure their ability to satisfy their redemption requirements under Section 22(e) of the Investment Company Act. A fund's board of directors must ensure that short selling will not interfere with the fund's ability to: meet current obligations; honor requests for redemptions (in the case of a mutual fund); and manage properly its investment portfolio in a manner consistent with the fund's stated investment objectives, especially as short selling approaches high levels. Id.

including clarifying existing guidance, may be taken to enhance the ability of all registered investment companies to utilize these tools.

C. Alignment of the Investment Adviser's Interests with Investors

Hedge funds advisers argue that two factors are critical to aligning their interests with those of their investors. First, they assert that a properly configured performance fee arrangement providing compensation based on capital gains and capital appreciation provides a greater incentive for the adviser to produce absolute returns. The requirement that an absolute return be achieved before the performance fee is paid, in their view, insures diligence in managing the fund.[348]

Second, investment of the adviser's own assets alongside the investors' helps assure that the adviser acts responsibly.[349] Hedge fund investors rely on having the adviser's assets in the fund to serve as a curb on any adviser who may seek to engage in high-risk investment strategies. If the adviser stands to lose as much as the fund's investors by engaging in unduly risky investment activities, that adviser may be deterred from such activities.[350] Not surprisingly, a number of private placement memoranda include provisions requiring that the general partner disclose significant withdrawals from their capital account.

Performance fees based on capital gains and capital appreciation have an interesting history under the federal securities laws. [351] Congress originally limited the receipt of these types

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[348] "Hedge fund managers seek out and exploit mispricings of securities using a variety of financial instruments. They produce superior performance, and they are not judged by their ability to track a passive benchmark. As a result, the compensation structure within the industry is based largely on performance." See Steven J. Brown et al., *Offshore Hedge Funds: Survival and Performance, 1989-95*, 72 Journal of Finance 91 (1999).

[349] Hedge fund investors also look to the adviser's own investment in the fund as a measure of prudence to ensure that the manger acts responsibly in others areas, e.g., brokerage fees, soft dollars, etc.

[350] The Commission has recognized that where advisers have their own substantial investment in certain accounts, it reduces their incentive to take undue risks. See, e.g., *Foster Management Company*, Advisers Act Release Nos. 646 (Nov. 1, 1978) and 651 (Nov. 28, 1978); *Weiss, Peck & Greer*, Advisers Act Release Nos. 623 (Mar. 28, 1978) and 625 (Apr. 25, 1978).

[351] Section 205(a) of the Advisers Act, in general, prohibits registered investment advisers from entering into a contract to provide investment advisory services that, among other things, "provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client." See Section 205(a)(1) of the Investment Advisers Act. For a discussion of the history of performance fees in

of fees out of a concern that they encouraged managers to take inappropriate risks.[352] Notwithstanding this history, the Investment Advisers Act did not originally prohibit registered investment advisers from charging a performance fee to registered investment companies.[353] In 1970, however, Congress extended the performance fee prohibition to cover advisory contracts with registered investment companies in response to information demonstrating that performance fee arrangements that were included in such contracts were unfair to the registered investment companies' shareholders.[354]

The staff believes that it is appropriate to re-examine whether fee arrangements that are based on a share of the capital gains and capital appreciation may be appropriate for agreements between investment advisers and registered investment companies. The staff also believes that it is worth exploring whether encouraging investment advisers to invest in the funds that they manage may help to ensure responsible management of registered investment companies using absolute return strategies.[355]

D. Absolute Return Strategies May Challenge Traditional Investor Expectations

Perhaps the most formidable obstacle to further use of absolute return strategies may lie in whether investors can understand and feel comfortable with these products. Absolute return investment vehicles operate differently from traditional, long-only/relative return products. Thus, it would be useful for the Concept Release to explore some of these differences, as highlighted below.

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investment advisory contracts, see *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management 237-249 (May 1992) ("*Protecting Investors*").

352 H.R. Rep. No. 2639, 76th Cong., 2d Sess. 29 (1940).

353 The investment company industry persuaded Congress that performance fees closely linked the interests of investors and management and that the basis for management's compensation should not be specified by statute as long as the basis for such compensation was adequately disclosed to shareholders. See *Protecting Investors*, supra note 351, at 242.

354 More than two-thirds of the performance fees in existence at that time either permitted the registered investment company's adviser to earn a bonus for good performance without suffering a penalty for poor performance, or had fee arrangements in which the potential rewards were substantially greater than the potential penalties. See id., at 242.

355 The Investment Company Act requires that the sponsors of registered investment companies make initial investments in those companies. See *Automation Shares*, 37 S.E.C. 771 (1957) (Section 14(a) of the Investment Company Act requires that seed capital be provided by "shareholders with a bona fide investment purpose without any present intention to dispose of the security.").

Registered investment companies generally engage in long-only/relative return strategies whose performance is highly correlated to specific benchmarks or indexes.[356] One benefit of relative-return strategies is the ease with which investors may compare their investment's performance with that of the relevant benchmark, as well as against similar funds using the same benchmark. These characteristics help shape many of the expectations that retail investors have today. For example, an investor in a long-only/relative return product will generally be able to assume that if the major equity markets are rising, the performance of the investment will rise as well. Index funds and exchange-traded funds, which are designed to replicate entire markets or segments of markets, further attune investors to performance results that track the broader markets.

In contrast, absolute return strategies generally seek to achieve a high level of return for their funds in a variety of market environments, rather than attempting to duplicate or exceed the performance of a particular benchmark or index. Absolute return strategies are designed to move independently of the underlying markets and thus, have lower correlations to the broader markets. During falling markets the performance of the fund should stay independent from that of broader market movements, thus providing some protection from those downward movements. In rising markets, however, it is not uncommon for funds employing absolute return strategies to lag behind more traditional, long-only investments.[357] Indeed, some proponents of hedge funds admit that during periods of strong equity performance, hedge fund performance may suffer.[358]

Broader use of absolute return strategies might also require investors to modify their expectations with respect to the investment flexibility accorded to investment advisers. Perhaps the most critical aspect of an adviser's ability to seek absolute returns is the often unfettered discretion to manage the fund in light of changing market conditions. Many hedge funds have broad investment objectives and are authorized to use multiple strategies in order to take advantage of changing market conditions.[359] In adverse markets, a hedge fund adviser will

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[356] See supra Part IV.A. (discussion of hedge fund investment strategies).

[357] This is because the hedging portions of the portfolio will act as a drag on the long portions. One Roundtable participant explains that "[b]y definition, hedge funds are not going to outperform a broad index in a strongly rising market, like the one we saw in the second quarter [April-June 2003]." See Neil Martin, *Bull in the Hedges*, Barron's (July 28, 2003) (quoting Greg Newton).

[358] "Hedge funds under perform the stock market only when the latter is strong, that is, when the stock market yields a positive annual return." See *Absolute Returns*, supra note 118, at 105.

[359] See Roundtable Transcript, May 14 (statement of Robert Schulman) ("The hedge fund industry has avoided, in large measure, the catastrophic impacts of the market by having enough flexibility in the [private placement] document and using it to react to what you would call changing market conditions.").

generally have the flexibility to hedge against market declines, engage in short-selling or take positions that are less dependent on the price movements of broad market averages to make profits or limit losses.[360] Most traditional relative-return products, including registered investment companies, are either limited in their flexibility or forego engaging in these strategies.

More flexible investment mandates permit the adviser to manage the fund according to his or her best judgment. Poor choices, of course, are a continual possibility for absolute return advisers, as they are for all investment advisers. For example, if an absolute return adviser redeploys assets incorrectly, the performance of the fund may suffer. This may contrast with instances where an adviser with less flexibility must adhere to a particular investment mandate, which, in the end, prevents the adviser from exercising more discretion, and possibly, making a mistake.

The flexibility that absolute return advisers require often makes it more difficult for investors to categorize the precise nature of their investments. For example, investors in long-only/relative return strategies often associate their investment with the type of portfolio securities that their mutual fund or closed-end fund typically holds. Retail investors often rely on the structure and nature of the particular fund's investments to provide continuity to their portfolio. In contrast, absolute return investments may lack that continuity or assurance. In one sense, investors in funds utilizing absolute return strategies must rely more heavily, and may associate their investment more closely, with an adviser, rather than with a fund itself.[361]

The Concept Release should explore whether investor education would be helpful in connection with absolute return investments. The Concept Release should also examine whether any particular absolute return strategies raise especially difficult issues with respect to investor expectations. The Concept Release should explore whether more education is necessary to familiarize retail investors with the risks of engaging in short selling and leveraging transactions.[362] Moreover, the Concept Release should seek comment on what, if any, additional

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[360] Because these strategies often necessitate a steady turnover in the nature and character of the underlying investments, investors should recognize that they may have little ongoing insight into how a hedge fund is invested. This may differ from traditional long-only relative return products that permit investors to remain focused on sectors or sub-sectors of the broader markets.

[361] "[T]he most interesting feature of hedge funds is that they are thought of as nearly pure 'bets' on manager skill." See Brown, supra note 348.

[362] The primary market risk from short selling is the fact that losses "can be infinite, depending on how high the stock price moves after the [short] sale." Comment submitted by Roundtable Panelist James Chanos.

disclosure is necessary to ensure that absolute return investments are fully understood by investors.[363]

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[363] In the Concept Release, the Commission may also wish to explore whether there are other alternatives that will expand the accessibility of absolute return strategies to a broader group of suitable investors. It could explore, for example, whether certain hedge funds relying on Section 3(c)(7) of the Investment Company Act may be permitted to accept investors below the qualified purchaser standard, so long as that hedge fund provides fundamental Investment Company Act protections commensurate with the level of investors permitted to invest.

Summary of the Commission's Previous Studies or Investigations of Hedge Funds

In January 1969, the Commission commenced an investigative study of hedge funds in response to the rapid increase in the number of hedge funds and their assets under management. At that time, the Commission estimated that there were almost 200 hedge funds in existence with estimated total assets of $1.5 billion. The Commission's study, however, was not limited to unregistered funds. It also examined the activities of registered investment companies that engaged in hedge fund trading techniques such as leveraging and short selling. The Commission sent questionnaires to registered and unregistered funds in an effort to obtain basic background information, information about trading and brokerage practices, affiliations of hedge fund principals, borrowing practices and sources of credit.

Twenty three years later, the Commission, in collaboration with representatives of the Treasury Department and the Board of Governors of the Federal Reserve System ("Federal Reserve") issued a report focusing on abuses in the market for United States government securities (i.e., Treasury bills, notes and bonds) following admissions by Salomon Brothers Inc. of violations of Treasury auction rules.[1] The report did not make any legislative proposals with respect to hedge funds, but did recommend reforms for administrative and regulatory changes regarding Treasury auction participation, policies and enforcement as well as the means for detecting and combating short squeezes in the U.S. government securities market.[2]

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[1] See *Joint Report on the Government Securities Market* (Jan. 1992) ("Joint Report").

[2] Id., at xiii-xv. The report also made related legislative recommendations. However, in an appendix discussing hedge funds, the report recognized the potential dangers of the use of leverage by hedge funds, stating:

> Events in the government securities market have shown that their capacity for leverage allows hedge funds to take large trading positions disproportionate to their capital base. Thus far, [hedge] fund managers have proved very adept at controlling their market risk, and their lending counterparties appear to consider them creditworthy. However, the sheer size of the positions taken by hedge funds raises concerns about systemic risk that these funds may introduce into the financial markets.

Appendix B to Joint Report.

In 1992, the Commission's Division of Investment Management looked at hedge funds in connection with its study of the Investment Company Act and recommended that the Commission propose a new private investment company exception for qualified purchasers.[3]

Later that year, in response to a Congressional inquiry, the Commission provided detailed information about both the nature and regulatory treatment of hedge funds to Congress.[4] That staff report focused on the systemic risk posed by hedge funds and analyzed how various provisions of the federal securities laws affect hedge funds. The staff made clear at that time that it had no direct source of information regarding hedge fund activities, and that a limited amount of information about hedge funds was publicly available.[5] The report concluded that the relevant regulatory issues did not involve the protection of hedge fund investors, but instead, the potential of hedge funds to affect the equity markets due to their size and active market presence. At that time, the Commission believed that its proposed large trader reporting system would enhance its ability to examine the activities of hedge funds in the event of large movements in the equity markets.[6]

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3 See *Protecting Investors: A Half Century of Investment Company Regulation*, Division of Investment Management, May 1992, p. 103-105. The Division's recommendation was subsequently adopted as Section 3(c)(7) as part of the National Securities Markets Improvement Act of 1996. See *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 (Apr. 3, 1997).

4 See Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (June 12, 1992).

5 Press reports estimate that approximately 400 hedge funds existed at that time. With respect to the asset base of the hedge fund industry, the staff was able to identify publicly available information for only 17 hedge funds with approximately $13 billion in assets under management as of December 31, 1991.

6 The Commission's authority to implement the large trader reporting system is provided in Section 13(h) of the Exchange Act, which was added to the statute by the Market Reform Act of 1990 to remedy difficulties that the Commission encountered during its attempts to reconstruct and analyze trading activity following the stock market breaks of October 1987 and October 1989. The Commission, however, never adopted implementing regulations due, in part, to the availability of other mechanisms for monitoring stock market activity (e.g., the electronic blue sheet system). See also *Electronic Submission of Securities Trading Data by Exchange Members, Brokers and Dealers*, Exchange Act Release No. 42741 (May 2, 2000) (proposing rule 17a-25 under the Exchange Act and stating that public comments raised concerns that, among other things, the comprehensive system envisioned by Section 13(h) could prove difficult to implement and maintain, and most likely would not expedite trading reconstructions to the extent contemplated in 1990).

The President's Working Group on Financial Markets ("Working Group")[7] issued a report in April 1999 in the wake of the near-collapse of Long Term Capital Management ("LTCM").[8] The report examined hedge funds in general as well as LTCM, analyzed the public policy issues presented to the markets by leverage, risk and bankruptcy, and recommended a number of measures designed to constrain excessive leverage in the financial system.

The report focused on the risk management and transparency issues raised by LTCM as well as "highly leveraged institutions" in general. It also focused on the exposure of banks and others to the counterparty risks of highly leveraged entities such as hedge funds. The Working Group looked at such issues as these entities' use of leverage and whether that use was excessive, counterparty adherence to stated policies, margin and collateral requirements and how well risk models functioned. The Working Group also recommended in its report that no changes be made to the exemptions for hedge funds and hedge fund advisers under the Investment Company Act and the Advisers Act.[9] The report took the position that registration of hedge funds and their advisers at that time did not appear to be a useful method of monitoring hedge fund activity.

In addition to the examination of risk management and transparency issues by the Working Group, the Commission staff actively supported the work of the Multidisciplinary Working Group on Enhanced Disclosure ("MWGED"), which was established by the international regulatory and central banking community to assess the feasibility and utility of enhanced public disclosure by financial intermediaries (i.e., banks, securities firms, insurance companies and hedge funds). The MWGED issued a report in April 2001 that recommended that all regulated financial intermediaries move promptly to make routine, periodic disclosures of certain quantitative risk measurements to their shareholders, creditors and counterparties. It also recommended that hedge funds be encouraged to make such disclosures, when material, to their

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7 The President's Working Group, which continues to examine market leverage and counterparty risks, includes representatives from the Commission, the Treasury Department, the Federal Reserve and the Commodity Futures Trading Commission.

8 See *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management - Report of The President's Working Group on Financial Markets* (Apr. 1999) ("LTCM Report"). LTCM was a prominent and successful hedge fund in the 1990s that was distinguished by its size, leverage and trading strategies (e.g., convergence trading and dynamic hedging). These characteristics made LTCM vulnerable to the market conditions that followed Russia's devaluation of the ruble, and caused it to suffer approximately $1.8 billion in losses in August 1998. At that time, LTCM's simple balance sheet leverage ratio had reportedly climbed to in excess of 25 to 1, and the hedge fund had difficulty meeting its margin call requirements. Because, among other things, many Wall Street firms were creditors and counterparties to LTCM, there was a general concern that the fund's collapse would have an impact on the financial markets, and the Federal Reserve intervened by facilitating a private-sector recapitalization of the fund.

9 See Appendix B to LTCM Report.

investors, creditors and counterparties. The MWGED's successor, the Joint Forum Working Group on Enhanced Disclosure ("JFWGED"), which the Commission chairs, also addresses issues of enhanced disclosure for financial intermediaries. The work of the JFWGED is ongoing, and the Commission believes that many in the hedge fund industry are considering the recommendations of these two groups and continuing to explore ways to improve some of their practices.[10]

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[10] The Commission has also been involved in other reviews of market stability and counterparty risk issues posed by hedge funds in the wake of LTCM's near collapse conducted by foreign financial regulators. See, e.g., *Review of issues relating to Highly Leveraged Institutions (HLIs)*, Basel Committee on Banking Supervision and International Organization of Securities Commissions (Mar. 2001).

Appendix H- Glossary

Table of Contents

10b-10 SEC Rule requiring written confirmations for securities transactions. Equivalent to FDIC Part 344.

12b-1 SEC Rule permitting mutual funds to use a portion of the mutual fund's assets for promotional expenses. The fund must be specifically registered as 12b-1 fund and disclose the existence and amount of such charges against the fund.

13d SEC Rule requiring a filing by any person acquiring a direct or indirect 5% interest in a registered stock.

13f-1 SEC Rule requiring quarterly Form 13F reports by institutions holding more than $100 million in discretionary equities.

13g SEC Rule requiring an annual filing by persons holding a direct or indirect 5% interest in a registered stock for passive investment purposes.

17f-1 SEC Rule covering lost, stolen, counterfeit and missing securities certificates, and requiring banks and transfer agents to register with the Securities Information Center.

114 Form 114 was an old designation for the Statement of Principles of Trust Department Management.

156 SEC Rule governing mutual fund advertising and sales literature, and prohibiting false and misleading materials.

401(a) Plan A savings plan in which contributions are made in after tax dollars.

401(h) Account A separate account of a pension plan that, under Section 401(h) of the Internal Revenue Code, may be used to fund medical benefits for retirees and dependents.

401(h) Plan An employee benefit that provides, through a pension or annuity plan, for the payment of benefits for sickness, accident, hospitalization and medical expenses for retirees, their spouses and dependents, subject to certain restrictions.

401(k) Plan A defined contribution plan established by an employer which enables employees to make pretax contributions by salary reductions structured within the format of a cash or deferred plan.

403(b) Annuity An annuity that provides retirement income for employees of certain tax-exempt organizations or public schools. Also known as a tax-sheltered annuity.

403(b) Plan A defined contribution employee benefit plan established by certain tax-exempt organizations (such as charities) and public schools for their employees. Similar to a 401(k) plan.

457 Plan A deferred compensation plan for employees of state and local governments. Named after the governing section of the Internal Revenue Code, a portion of their income may be deferred and is not taxable until a distribution is made.

501(c)(9) Trust (1) Used by employers and jointly administered welfare funds to provide group employee benefits of the following types: medical, disability, term life insurance, severance compensation, vacation benefits, recreational facilities and unemployment compensation. These trusts are governed by

Section 501(c)(9) of the Internal Revenue Code. (2) A type of self-insured or self-funded plan that is a tax exempt trust. Under its terms, both employer and employee contributions are paid into the fund, with claims and expenses paid out of it. Excess funds are invested as reserves by the fund's trustees. In a tax-qualified fund, the employer's deductions are immediately deductible, the trust's investment income is tax exempt, and employee contributions are not currently taxed. See also VEBAs.

Abatement The reduction of a gift under a will because of insufficiency of assets to satisfy the gifts after the legal obligations of the estate (debts, taxes, charges, and claims) have been paid in full. The general rule is that all gifts of the same class shall abate proportionately, unless otherwise provided.

ACCELERATED DEATH BENEFIT (ADB) Provision in a life insurance policy that permits a terminally ill person get a percentage of the life insurance benefit from the life insurance company prior to death. See also Viatical Settlement.

Accounting (1) The record of an account showing the transactions therein. (2) The submission of such a record to the court or to the beneficiaries of a trust or estate by the fiduciary.

Active Trust A trust regarding which the trustee has some active duty to perform; opposed to bare, naked, or passive trust.

Actuary, Enrolled See Enrolled Actuary.

ADA Americans With Disabilities Act of 1990.

ADB See Accelerated Death Benefit.

Adequate Consideration (1) For a security with a generally recognized market value: (a) the price of the security on a national securities exchange, or (b) if not traded on a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by current bid and asked prices quoted by persons independent of the issuer and of any party in interest; (2) for other assets, the fair market value of the asset as determined in good faith by a fiduciary.

Adjusted Gross Estate The value of an estate after all allowable deductions have reduced the gross estate, but before Federal estate taxes.

Ad Litem For the purpose of the suit.

Administrator An individual or a trust institution appointed by a court to settle the estate of a person who has died without leaving a valid will. If the individual appointed is a woman, she is known as an administratrix.

Administrator Ad Litem An administrator appointed by the court to supply a party to an action at law or in equity in which the decedent or his representative was, or is, a necessary party.

Administrator Cum Testamento Annexo (Administrator with the will annexed): An individual or a trust institution appointed by a court to settle the estate of a deceased person in accordance with the terms of his will when no executor has been named in the will or when the one named has failed to qualify.

Administrator Cum Testamento Annexo De Bonis Non (Administrator with the will annexed as to property not yet distributed): An individual or a trust institution appointed by a court to complete the settlement of the estate of a deceased person in accordance with the terms of his will when the executor or the administrator with the will annexed has failed to continue in office.

Administrator De Bonis Non (Administrator as to property not yet distributed): An individual or a trust institution appointed by a court to complete the settlement of the estate of a person who has died without leaving a valid will when the administrator originally appointed has failed to continue in office.

Administrator with the will annexed An individual or a trust institution appointed by a court to settle the estate of a deceased person in accordance with the terms of his will when no executor has been named in the will or when the one named has failed to qualify.

Administratrix See Administrator.

ADR See American Depository Receipt.

Advance See Overdraft.

Agency An account in which the title to the property constituting the agency does not pass to the trust institution but remains in the owner of the property, who is known as the principal, and in which the agent is charged with certain duties with respect to the property.

Agent A person who acts for another person by the latter's authority. The distinguishing characteristics of an agent are (1) that he acts on behalf and subject to the control of his principal, (2) that he does not have title to the property of his principal, and (3) that he owes the duty of obedience to his principal's orders.

Allocation (1) The crediting of a receipt in its entirety or the charging of a disbursement in its entirety to one account, as to the principal account or to the income account; to be distinguished from apportionment. (2) A process that determines the optimum distribution of funds among various types of assets that offer the highest probability of consistently achieving investment objectives within a given risk tolerance. The process often uses a computer model to aid in processing a myriad of data.

Allowance (1) The sum or sums awarded a fiduciary by a court as compensation for its services; to be distinguished from charge, commission, and fee. (2) See Widow's Allowance. (3) Waiver by a beneficiary or other interested party of certain actions performed by the fiduciary which might not conform with instrument terms, local statutes, prudent practices, etc.

Alpha A numerical investment measure sometimes used as a performance indicator or to aid in selection of securities. Alpha is the premium an investment would be expected to earn if the market rate of return were equal to the Treasury bill rate, e.g., a premium of zero for the market rate of return. A positive alpha indicates that you have earned on the average a premium above that expected for the level of market variability. A negative alpha indicates, on the average, a premium lower than that expected for the level of market variability. See also Beta.

AMBAC American Municipal Bond Assurance Corporation.

American Depository Receipts (ADR) American certificates issued by an approved New York bank or trust company against the original (foreign) shares with a European branch of the New York institution. These receipts facilitate the financing of foreign companies in the United States. As foreign shares are deposited abroad, the equivalent ADR's change hands, not the certificates. This eliminates the actual shipment of stock certificates between the U. S. and foreign countries.

American Option An option that can be exercised any time during an exercise period.

AmortizationWith respect to bonds purchased at a premium, the process by which a part of the income is set aside as received to reduce gradually the amount by which the cost of the bond exceeds its face value.

Ancillary Subordinate or auxiliary to something or someone else; used in such terms as ancillary administration, ancillary administrator, and ancillary guardian.

Annuity (1) A contract that provides an income for a specified period of time or for life; (2) the periodic payments provided under an annuity contract, (3) the specified monthly or periodic payment to a pensioner.

Annuity Certain A contract the provides an income for a specified number of years, regardless of life or death. If an annuitant dies, the beneficiary will receive payments for the remaining number of specified years. Also called period certain, term certain or dollar temporary annuity.

Annuity Contract A contract in which an insurance company unconditionally undertakes a legal obligation to provide specified pension benefits to specific individuals in return for a fixed fee or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance company. Also called allocated contracts.

Apportionment The division or distribution of a receipt or a disbursement of property between or among two or more accounts, as between principal and income; to be distinguished from allocation.

Approved List A list, statutory or otherwise, which contains the authorized investments that a fiduciary may acquire.

Arbitrage A technique employed to take advantage of price differences in separate markets. This is accomplished by purchasing in one market for immediate sale at a better price in another market. Such transactions may be executed in the same type or similar types of securities.

Assent Written agreement with or approval of actions of a fiduciary which have already taken place.

Assurance (1) A pledge or guaranty of performance or protection from loss. Generally, prohibited for banks to give such a surety or indemnification. (2) A Canadian and British term for insurance.

At-The-Money Option An option whose exercise price equals the spot price of the underlying instrument.

Attorney In Fact A person who, acting as agent, is given written authorization by another person to transact business for him out of court; to be distinguished from attorney at law. See also Power of Attorney.

Authentication Applied to bonds, the signing, by the trustee, of a certificate on a bond for the purpose of identifying it as being issued under a certain indenture, thus validating the bond.

Back End Load A sales charge due upon the sale, transfer or disposition of securities (usually mutual funds), partnership interests, annuities and life insurance.

Bankers Acceptance An irrevocable obligation of an issuing bank and the borrower whereby both are liable for payment. Used in domestic and international commerce to finance the shipment and storage of goods or to facilitate dollar exchanges with foreign banks. Bankers acceptances are issued in a wide variety of principal amounts. Maturities can be up to 180 days, but usually are for 30-60-90 days.

Bank Investment Certificate See BIC.

Basis In futures and forwards, the difference between a futures contract price for an item and the current spot price of the same item.

Basis Convergence In futures and forwards, the phenomenon where the market value of a futures contract approaches the spot price for the underlying item as the delivery date nears.

Basis Swap A variable-for-variable interest rate swap.

Beneficiary (1) The person for whose benefit a trust is created. (2) The person to whom the amount of an insurance policy or annuity is payable.

Bequeath To give personal property by will; to be distinguished from devise.

Bequest A gift of personal property by will; a legacy.

Best Execution The principal whereby a trust department has a duty to obtain the most favorable possible performance of securities purchases and sales. This is generally done through the selection of a broker for a particular transaction. Given the size and type of the transaction, its complexity and where it is traded, the most favorable mix of at least the following factors must be obtained: (1) most favorable price, (2) lowest commission or equivalent, (3) prompt and accurate execution of orders, (4) prompt and accurate confirmation of orders, (5) prompt and accurate delivery of securities or proceeds. A broker's special abilities, access to, or knowledge of a particular type of investment or transaction could also impact on best execution.

Beta A numerical investment measure sometimes used as a performance indicator or to aid in selection of securities. Beta measures market sensitivity: the extent to which a portfolio fluctuates with the market as represented by the S&P 500. Beta is calculated by measuring the sensitivity of a fund's portfolio to market patterns. It is a statistical estimate of the average change in a fund's rate of return corresponding to a one percent change in the market. An investment with a Beta of 1 matched the market; a beta of 1.1 indicates 10% better performance than the market in up markets, 10% worse in down markets. See also **Alpha**.

BIC A "BIC" is a bank investment certificate. This is a large certificate of deposit sold to institutional investors, such as employee benefit plans. There is a facts-and-circumstances test as to whether FDIC insurance covers the instrument; if so, the first $100,000 of the BIC is insured by FDIC, and pass-through deposit insurance coverage may also apply. A BIC is the deposit industry's equivalent of a "GIC". See

also "GIC", "Bullets", and "Windows".

Bid/Ask Spread – The difference between the quoted bid (broker will buys stock) and the quoted ask or offer (broker will sell a stock).

Bifurcation The separation of gains and losses on investment transactions involving foreign currencies. For instance, the amount of profit attributable to the increase in the price of a German stock on the Frankfurt DAX Stock Exchange, as opposed to the amount of profit attributable to the change in the Deutsche Mark versus the dollar. Important for provisions of IRS Code 988.

Blackout Period Any period of more than 3 consecutive business days during which the ability of not fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell, or otherwise acquire or transfer an interest in any plan is temporarily suspended by the issuer or by a fiduciary of the plan.

Blue Sky Laws State securities laws that attempt to ensure that the terms of securities offerings are fair, just and equitable and meet minimum standards of quality. Generally, certain information must be filed with a state's securities regulator before the security can be offered for sale within the state.

Bond Anticipation Note Short-term notes sold in anticipation of a bond issue and retired with the proceeds from the sale of the bonds.

Bond Power A form of assignment executed by the owner of registered bonds which contains an irrevocable appointment of an attorney in fact to make the actual transfer on the books of the corporation.

Breach of Trust Violation of a duty of a trustee to a beneficiary.

Bullet A term used with BIC's and GIC's when a lump sum of money is invested at a fixed interest rate, and repaid at maturity. Interest may be compounded or paid out periodically.

Cafetaria Plan An approach to offering health benefits to employees where the employee may select which benefits, and how much coverage within a type of benefit, they elect to have. Such plans enable employees to tailor benefits coverage to their own situation. Some plans require a common core of benefits. Sometimes, employee contributions are permitted for additional coverage. Also known as Flexible Benefit Plans and Flexible Compensation.

Callable A bond issue, all of part of which may be redeemed ("called") by the issuer prior to maturity. Specific terms in the bond indenture ensure that the bonds may not be called prior to the call date(s). Call provisions in the indenture also set the price at which the bond may be called; to compensate for this privilege, a price above par is usually paid.

Call Option Option to buy shares of a certain stock within a given period of time at a specific price fixed in the contract.

Cap An option contract that protects the holder from a rise in interest rates or some other underlying index beyond a certain point.

Cash Balance Plansa defined benefit plan which defines benefits in terms of a stated "account balance," as opposed to a specific monthly benefit for life under traditional defined benefit pension plans. In this type of plan, employers credit a participant’s account each year with a "pay credit" (typically based on a percentage of compensation) plus an "interest credit" (either a fixed rate, or a rate which is linked to an index, such as the one year treasury bill rate). When a participant retires under a cash balance plan, he or she is entitled to the balance of his or her vested benefit (similar to a defined contribution plan), which may be taken as an annuity or in a lump sum. This is opposed to retirements under traditional defined benefit pension plans, where retirees are entitled to lifetime monthly annuities based upon years of service and pay.

Cash Equivalents Short-term investments held in lieu of cash and readily converted into cash within a short time-span (i.e. Certificates of Deposit, commercial paper, Treasury bills, etc.).

Cede and Company The name of the nominee partnership for securities held at Depository Trust Company, New York.

Cemetry Trust A trust which has as its purpose the upkeep of a grave, burial plot, or cemetery.

Cesop (Tax) Credit ESOP.

Cestui Que Trust (plural, cestuis que trust) A person for whose benefit a trust is created; a beneficiary.

Charge The price fixed or demanded by a trust institution for service; compensation which a trust institution has a legal right to fix (in the form of either a commission of a fee), in contrast to an allowance which is granted by a court. See also Allowance, Commission, and Fee.

Chesop Charity ESOP.

Chinese Wall A policy barrier between the trust department and the rest of the bank designed to stop the flow of non-public information for the purpose of preventing use by the trust department of any material inside information, which may come into the possession of other bank departments, in making investment decisions.

CIF See Collective Investment Fund.

Clifford Trust See Short-Term Trust.

Cliff Vesting Full (100%) vesting after ***x*** years of service. Benefits must be 100% vested after not more than 5 years of service, except in collectively bargained plans, where the maximum period is 10 years.

Closed End Mutual Fund A mutual fund which is limited in the number of shares outstanding. The shares are traded on a securities exchange or the over-the-counter market. The value is determined by bid and asked prices in the open market.

COBRA The Consolidated Budget Reconciliation Act of 1985.

CODA Cash or Deferred Arrangements. A term associated with certain employee benefit plans where the employee is given a choice of receiving an employer contribution in cash or having it deferred under a plan and/or the choice of making his or her own contribution to the plan from before-tax income. Most CODA's are either cash or deferred profit sharing plans or thrift and savings plans.

Codicil An amendment or supplement to a will executed with all the formalities of the will itself.

Collar An upper and lower limit on the coupon of a floating rate note. The issuer pays a premium for the collar.

Collateral Heir A person not in the direct line of the decedent from whom he inherits real property, as, for example, a nephew of the decedent who receives a share of his uncle's estate.

Collective Investment Fund A pooled fund, operated by a bank or trust company in conformity with Section 9.18 of OCC Regulation 9 or Revenue Ruling 81-100, for investment of the assets of separate trust accounts.

Commercial Paper Negotiable, short-term, unsecured promissory notes issued in bearer form on a discount or coupon basis by a corporation to raise working capital, for up to 270 days term. A direct obligation of the issuer, it is sold in multiples of $25,000 and is rated by Standard & Poor's (A-1, A-2, and A-3) and Moody's (Prime 1, Prime 2, and Prime 3). Interest is paid at maturity. Payment is required in Federal Funds on settlement date (usually at the buyer's option) and payment is required by Federal Funds on the maturity at the issuer's bank. The principal types are Prime Finance Paper issued by sales finance companies and certain large bank holding companies, Prime Industrial Paper issued by leading industrial companies, and Finance Paper of less-than-prime quality. For Prime Finance Paper, investors may specify both the issue and maturity dates. For Prime Industrial Paper, only those maturities listed on the market are available.

Commission A percentage of the principal or of the income or of both which a fiduciary receives as compensation for its services; to be distinguished from allowance, charge, and fee.

Committee for incompetent An individual or a trust institution appointed by a court to care for the property or the person (or both) of an incompetent; similar to a guardian, conservator, or curator.

Common Law The legal system prevailing in the English-speaking countries - that is, the United States of American and the British Commonwealth of Nations. It originated in England and its form of development was different from that of Roman (civil) law. Compare Civil Law.

Common Trust Fund A fund maintained by a bank or a trust company exclusively for the collective investment and reinvestment of money contributed to the fund by the bank or trust company in its capacity as trustee, executor, administrator, or guardian and in conformity with the rules and regulations of the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks, as well as with the statutes and regulations (if any) of the several states.

Community Property Property in which a husband and wife have each an undivided one-half interest by reason of their marital status; recognized in all civil law countries and in certain states of the Southwest and Pacific Coast area of the United States.

Compliance Risk The risk that non compliance with laws and regulations can lead to financial loss and/or damage to the institution's reputation.

Compound Option One type of option contract. It is an option, such as a put on a call, a call on a put, a put on a put, or a call on a call.

Conservator (1) Generally, an individual or a trust institution appointed by a court to care for property. (2) Specifically, an individual or a trust institution appointed by a court to care for and manage the property of an incompetent person, in the same way as a guardian cares for an manages the property of a minor.

Contingent Liability (1) For FDIC Trust Examinations: an estimate by the examiner of the gross possible liability of the institution resulting from the purchase of nonconforming investments for trust accounts, unwarranted retention of nonconforming assets, self-dealing, questionable practices and procedures, or other acts of omission or commission which appear not to comply with the terms of governing trust instruments or provisions of law and on which an accounting may be subject to objection by appropriate parties. Until appropriate consents, waivers or releases of liability are obtained from interested parties or nonliability is determined by a court of competent jurisdiction, the liabilities are regarded as "contingent." (2) A liability which is dependent upon certain events occurring before it becomes an active liability.

Contractual Derivative These investment instruments represent a one-of-a-kind arrangement between two parties and include swaps, floors, collars, and swaptions. They are not standardized contracts nor do they trade on a regulated exchange. While they offer enticing return potential, some carry high degrees of both market risk and income risk. Because they are not standardized or exchange traded, they are subject to valuation risk (the potential for inaccurate pricing) and liquidity risk (the potential that it cannot be sold at a reasonable price). See also Derivatives.

Conversion (1) In law, wrongful appropriation to one's own use of the property of another. (2) In equity, the change of property from one form to that of another (as from real property to personal property, or the reverse) which is considered to have taken place even though no actual exchange has been effected.

Corporate Depositary A trust institution serving as the depositary of funds or other property. See also Depositary, and Depository.

Corporate Fiduciary A trust institution serving in a fiduciary capacity, such as executor, administrator, trustee, or guardian.

Corporate Trust A trust created by a corporation, typical of which is a trust to secure a bond issue.

Corpus (Body) The principal or capital of an estate, as distinguished from the income.

Counterparty A principal party to a transaction, other than an intermediary. When looked at from the buyer's viewpoint, the seller is the counterparty and vice versa.

Court Account Accounts which require court accountings and approval in their normal conduct. Probate, guardianship, conservatorship, and testamentary trust accounts are the most common.

Covered Call A type of stock option in which a trust account sells to a third party the right (the option) to purchase a specific stock (the call) at a specific price until a specific expiration date. Possession of the stock by the trust account (covered) is the final element for a covered call option. It is different from a naked call option, in which the trust account does not own the stock.

Covered Put A type of option on an instrument or commodity in which the writer has a short position.

Credit Risk Credit risk is the possibility of loss due to a counterparty's or an issuer's default or inability to meet contractual payment terms. Default exposes the holder of the instrument to the cost of replacing the instrument under present market conditions. The amount of credit risk equals the replacement cost (also known as current exposure) of an identical instrument. The replacement cost is established by assessing the instrument's current market value rather than its value at its inception.

Crown Loan Refers to an interest-free or below-market-rate term or demand loan, viewed by the IRS as a taxable gift to the borrower. Name stems from the *L. Crown* case at the U.S. Court of Appeals for the Seventh Circuit [84-1 USTC]. Current precedent is Supreme Court case involving E.C. Dickman [84-1 USTC]. Refer to Section 7872 of the Internal Revenue Code and also to Revenue Procedure 86-46 (8-26-85), IR 85-86, and Announcement 85-132.

Crummey Trust A type of unfunded insurance trust. The trust acts as owner of a life insurance policy. The trust receives the donor's cash payments on a periodic basis, from which the beneficiary of the trust has a specified period to make a cash withdrawal. If this is not done, the cash paid by the donor is used to pay the premiums due on the life insurance policy. The IRS has ruled that such an arrangement represents a gift of present value interest has been made by the donor. Since it is a gift of present value, the donor may contribute up to $10,000 ($20,000 if two donors, such has husband and wife contribute) per year in premium payments and enjoy the gift tax exclusion. When the donor dies, the life insurance policy in the trust is effectively removed from the donor's estate.

Curator An individual or a trust institution appointed by a court to care for the property of a minor or an incompetent person. In some states a curator is essentially the same as a temporary administrator or a temporary guardian.

Currency Coupon Swap A variation of a currency swap in which one party's interest payments are variable-rate. Essentially a combination of a currency swap and an interest rate swap.

Currency Swap A swap contract in which two counterparties agree to exchange principal and interest denominated in different currencies based on an agreed-upon currency exchange rate.

Cusip Acronym for Committee on Uniform Security Identification Procedures. Standardized numbering system begun in 1968 for identifying individual issues of equity and debt securities in the United States and Canada to facilitate compatible automated processing by multiple organizations (banks, brokers, etc.). Not all issues meet the criteria for issuance of a CUSIP number. System operated by the CUSIP Service Bureau, a part of the Standard and Poor's Corporation. See also FINS.

Custody Account An agency account concerning which the main duties of the custodian (agent) are to keep safe and preserve the property and to perform ministerial acts with respect to the property as directed by the principal. The agent has no investment or managerial responsibilities. To be distinguished from managing agency account and safekeeping account.

Cy-Pres Doctrine Cy-pres means "as nearly as may be." The doctrine, applied in English and Scots law and in some of the states of the United States, that, where a testator or settlor make a gift to or for a charitable object that cannot be carried out to the letter, the court will direct that the gift will be made as nearly as possible, in its judgment, in conformity with the intention of the donor.

Daily Settlement In futures and forwards, the process where futures participants are charged for their losses or credited for their gains at the end of each trading day.

Debenture A general debt obligation backed only by the integrity and net worth of the issuer. An obligation that is not secured by a specific lien on property, as an unsecured note of a corporation.

Deed - A written instrument, signed, sealed, and delivered according to applicable law, containing some transfer, bargain, or contract with respect to property. The common term for an instrument transferring the ownership of property.

Deed of Trust - A sealed instrument in writing duly executed and delivered, conveying or transferring property to a trustee. This is usually real property.

DefaultWith regard to a bond or promissory note, the failure to make a payment either of principal or interest as or when due.

Defective Trust A trust designed that income taxes are paid outside of the trust by the grantor. The most commonly used provision allows the grantor the power to substitute property he or she owns for equally valued trust property.

Defeasement A type of municipal debt financing which enables the issuing government entity to reduce the amount of interest it pays on existing outstanding bonds. As an example, an entity that has high-rate outstanding bonds issues new debt at a lower rate. The proceeds are used to buy Treasuries, which pay enough interest to pay the interest on the old outstanding bonds. The Treasuries can be sold when the old bonds reach their call date, providing a source of funds to retire the old debt. The net effect is the government entity pays less on a current basis.

Deferred Payment Swap A swap that requires payments to be made at a later date than the date at which the payments are determined.

Defined Benefit Plan A pension plan which guarantees the payment of a specified benefit at retirement age and provides annual contributions equal to an actuarially determined amount sufficient to produce the specified benefit.

Defined Contribution Plan A pension plan which provides for an individual account for each participant and for benefits based upon the amount contributed to the participant's account including any income, expenses, gains, or losses. See also Individual Account Plan, Money Purchase Plans, Profit Sharing Plans, Target Plans, and Employee Stock Ownership Plans (ESOP's).

DEFRA Deficit Reduction Act of 1984. One part of this act was the Tax Reform Act of 1984. Another part was the Spending Reduction Act of 1984.

Depletion The consumption or exhaustion of wasting property - such as, royalties, patent rights, mines, oil and gas wells, quarries, timberlands, and other things that are consumed or worn out in the sing.

Deposit Administration Contract A funding contract with an insurance company in which an unallocated account is kept for active participants. Annuities are purchased for employees when they retire.

Depositary One who receives a deposit of money, securities, instruments, or other property; to be distinguished from depository, which is the place of deposit.

Depository A place where something is deposited, such as a safe deposit vault. See Securities Depository.

Derivative A financial contract whose value is designed to track the return on stocks, bonds, currencies, or some other benchmark. Generally, derivatives fall into two broad categories: forward-type contracts and option-type contracts. They may be traded on exchanges or traded privately. See also Contractual Derivatives, Security-Based Derivatives, and Synthetic Derivatives.

Determination Letter A letter issued by the District office of the Internal Revenue Service which states whether a plan meets the qualification requirements under the Internal Revenue Code. Requesting an IRS Determination Letter is not an IRS requirement and is optional with the plan sponsor.

Devise A gift of real property by will; to be distinguished from bequest.

Devisee A person to whom a devise is given.

Direct Heir A person in the direct line of ascent or descent of the decedent; as, father, mother, son, daughter.

Directed Trust One under which a trustee has less then full managerial authority because another party or parties has the power to control some of the trustee's actions. Normally, this involves the investments of an employee benefit plan. Often, this direction is provided by an outside investment manager, a "named fiduciary", or the individual participant.

Disbursement Money paid out in discharge of a debt or an expense; to be distinguished from distribution.

Disqualified Person Term defined in Section 4975(e)(2) of the Internal Revenue Code that is roughly equivalent to ERISA's *party in interest*, but also includes highly-compensated employees. See Party in

Interest.

Distribution The apportionment of personal property (or its proceeds) among those entitled to receive the property according to the applicable statute of distribution or under the terms of the will or trust agreement; to be distinguished from disbursement.

DOL Department of Labor.

Domicile The place which a person regards as his permanent home and principal establishment; the place to which, whenever he is absent, he has the intention of returning. A person's domicile may or may not be the same as his residence at a given time. See also Residence.

Donor One who makes a gift.

DTC Depository Trust Company, New York City. A noninsured limited-purpose state chartered trust company which is a member of the Federal Reserve System. Securities certificates belonging to a variety of financial institutions (banks, trust companies, broker-dealers, mutual funds, etc.) are kept at DTC, with transfers between "depositors" accomplished by bookkeeping entry. This greatly reduces the volume of physical transfers which must be made within the securities industry.

DRP Dividend Reinvestment Plan.

Duration A numerical measure of the price change of a bond due to a change in its yield to maturity. Duration summarizes the various characteristics that cause bond prices to fluctuate in response to interest rate changes. The lower the duration number, the less change that can be expected in a bond's price.

Education IRA is not a retirement arrangement. It is a trust or custodial account established for the purpose of paying "qualified higher education expenses" of the designated beneficiary at an "eligible educational institution." Up to $500 per year can be contributed to an Education IRA. Contributions to the IRA are taxable. Investments grow tax free until distributed. If withdrawals are less than the beneficiary's "qualified higher education expenses," the withdrawals are tax free. Any portion of a withdrawal that is greater than the beneficiary's educational expenses is taxable to the beneficiary.

Eleemosynary Pertaining or devoted to legal charity; as an eleemosynary institution.

Embedded Derivatives Derivatives that are part of another financial instrument. For example, a callable bond consists of the bond and a call option. The call option is the embedded derivative.

Employee Benefit Security Administration This office was formerly known as the Pension and Welfare Benefits Administration, PWBA, and is a part of the U. S. Department of Labor.

Employee Benefit Plan A plan established or maintained by an employer or employee organization, or both, for the purpose of providing employees a certain benefit, such as pension profit-sharing, stock bonus, thrift medical, sickness, accident, or disability benefits.

Employee Stock Ownership Plan An employee benefit account in which employees may become stockholders of the employer. These plans are qualified under the Internal Revenue Code and are not subject to the 10% ERISA limits on holdings of employer stock. Typically, an employer's contributions to an ESOP are used to purchase existing or new shares of the employer's stock, thus providing a means for the employer to raise new capital while, at the same time, getting a tax deduction for the annual contributions. When such purchases are from insiders, the IRS has special requirements concerning the valuation of the stock's price. Often, ESOP's involve borrowing funds by the ESOP with which to purchase employer stock; such plans are termed "leveraged" ESOP's. When speaking of the trust account, ESOP's are sometimes called ESOT's: Employee Stock Ownership Trusts. See also CESOP, CHESOP, PAYSOP, and TRASOP.

En Ventre Sa Mere "In mother's womb" - a child conceived but not yet born.

Enrolled Actuary A person who performs actuarial services for an employee benefit plan which is subject to ERISA and who is enrolled with the federal Joint Board for Enrolling Actuaries. ERISA plans may use only Enrolled Actuaries to perform services for the plan.

ERISA An acronym for the Employee Retirement Income Security Act of 1974 which set up federal minimum standards for employee benefit plans, including standards regulating the conduct of plan

fiduciaries and trustees. The Act also established an insurance program designed to guarantee workers receipt of pension benefits if their defined benefit pension plan should terminate.

ERTA Economic Recovery Tax Act of 1981. Expanded IRA and Keogh plan availability. Covered specific areas of employee compensation, including incentive stock options, deductible voluntary employee contributions, tax credit ESOP's, and withdrawal provisions in savings/thrift plans.

Escheat The reversion of property to the state (in the United States) in case there are no devisees, legatees, heirs, or next of kin; originally applicable only to real property but now applicable to all kinds of property.

Escrow Money, securities, instruments, or other property or evidences of property deposited by two or more persons with a third person, to be delivered on a certain contingency or on the happening of a certain event. The subject matter of the transaction (the money, securities, instruments, or other property) is the escrow; the terms upon which it is deposited with the third person constitute the escrow agreement; and the third person is termed the escrow agent.

Escrow Agent See Escrow.

ESOP See Employee Stock Ownership Plan.

ESOT See Employee Stock Ownership Plan **(Trust)**.

Estate (1) The right, title, or interest which a person has in any property; to be distinguished from the property itself, which is the subject matter of the interest. (2) The property of a decedent.

Estate Tax A tax imposed on a decedent's estate as such and not on the distributive shares of the estate or on the right to receive the shares; to be distinguished from an inheritance tax.

Estimated Loss For FDIC Trust Examinations: an estimate by the examiner of the amount of loss which appears certain to be sustained by the institution as a result of its fiduciary activities.

ETI Acronym used by the Labor Department in ERISA Interpretive Bulletin (IB) 94-1 for Economically Targeted Investment. See Social Investing.

Eurobond A bond denominated in U.S. dollars (or another currency) and sold to investors outside the country whose currency is used. An example might be a bond denominated in German Deutsche Mark but issued by a Dutch company and sold to Swiss investors.

Eurodollar Certificate of Deposit A certificate of deposit issued by banks outside the U.S., primarily in Europe, with interest and principal paid in dollars. Such CDs usually have minimum denominations of $100,000 and short-term maturities of less than two years. Interest rates are usually pegged to LIBOR.

European Option An option that can only be exercised on the expiration date.

Event of Default The non-occurrence or non-performance of something called for in a bond indenture. Examples of events of default are: (1) nonpayment of interest, (2) nonpayment of principal, (3) failure to make payments into a sinking fund, (4) filing of bankruptcy or reorganization, (5) nonpayment of a prior lien obligation, (6) failure to perform any obligation called for in the indenture (such as provide financial statements, insurance, proof of tax payments, etc.).

Excess Benefit Plan A non-qualified plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of those which, because of Internal Revenue Code limitations on contributions and benefits, can be provided by the employer's qualified plan.

Exculpatory Provision A provision in a will or trust instrument relieving or attempting to relieve an executor or trustee from liability for breach of trust; sometimes called an immunity provision.

Executor An individual or a trust institution nominated in a will and appointed by a court to settle the estate of the testator. If a woman, she is an executrix.

Executor De Bonis Non The individual or corporation named in the will to take over and complete the settlement of an estate in those cases in which the original executor, for one reason or another, has failed or been unable to do so. Unless the testator himself names such a successor executor, the court appoints an administrator de bonis non.

Executrix See Executor.

Exercise Period The period of time during which an option may be exercised.

Expiration Date The last day an option can be exercised.

Express Trust A trust stated orally or in writing, with the terms of the trust definitely prescribed; to be distinguished from a resulting trust and a constructive trust.

Family Incentive Trust– Twist on an irrevocable family trust. Assets enter the trust in the normal fashion. However, there is specific language as to how funds may be taken out of the trust. The purpose of the trust is to provide an incentive for the beneficiary to lead a productive life. The trusts also contain a safety-net so a beneficiary will not become destitute. Examples of what distribution provisions include are (1) Matching earnings dollar for dollar, (2) Paying a parent for staying home with the children, (3) Paying an amount for completing a higher education, and (4) Starting a new business.

FAS Financial Accounting Standard. Authoritative accounting pronouncement on handling different specific accounting situations. Issued by FASB.

FAS 87 Statement issued by FASB covering employer accounting for pensions.

FAS 106 Statement issued by FASB requiring employers to record on their balance sheets the future financial liability they incur by promising health benefits to retirees.

FASB Financial Accounting Standards Board. Non-governmental authority for establishing accounting standards in the United States.

Fee (1) Fixed amount which a trust institution receives as compensation for its services; to be distinguished from allowance, charge, and commission. (2) An estate of inheritance in real property, sometimes referred to as an estate in fee or fee simple estate.

Fee Simple An estate of inheritance without limitation to any particular class of heirs and with no restrictions upon alienation; sometimes known as fee simple absolute; the largest interest or estate in real property a person may own.

Fiduciary An individual or a trust institution charged with the duty of acting for the benefit of another party as to matters coming within the scope of the relationship between them. The relationship between a guardian and his ward, an agent and his principal, an attorney and his client, one partner and another partner, a trustee and a beneficiary, each is an example of fiduciary relationship, See also ERISA Section 3(21)(A).

FINS Acronym for Financial Industry Number Standard. Standardized numbering system for identifying individual institutions (brokers, banks, transfer agents) in the securities industry in the United States and Canada to facilitate compatible automated processing in multiple organizations. FINS Numbers issued by Depository Trust Company, New York City. See also CUSIP.

Fiscal Agent (1) An agent for a corporation to handle specified matters relating to taxes in connection with an issue of bonds. (2) An agent for a national, state, or municipal government or government body to pay its bonds and coupons or to perform certain other duties related to financial matters.

Flexible Benefit Plan/Flexible Compensation See Cafeteria Plan.

Flexible Spending Accounts or Arrangements Employee benefit which gives employees a choice between taxable cash and nontaxable compensation in the form of payment or reimbursement of eligible, tax-favored benefits. FSAs can be funded through salary reduction, employer contributions, or a combination of the two. Employees can purchase additional benefits, pay health insurance deductibles, and copayments, or pay for child care benefits with FSAs.

Floater A floating rate instrument that pays interest at a rate that adjusts periodically, relative to a spread over a specific benchmark or index.

Floor An option contract that protects the holder against a decline in interest rates or some other underlying below a certain point.

Form Adv Form used to apply for registration as an investment advisor or to amend a registration. It

consists of two parts. Part I contains general and personal information about the applicant. Part II contains information relating to the nature of the applicant’s business, including basic operations, services offered, fees charged, types of clients advised, educational and business backgrounds of associates and other business activities of the applicant.

Forward Contract A cash market transaction in which two parties agree to the purchase and sale of a commodity at some future time under such conditions as the two agree. In contrast to futures contracts, the terms of forward contracts are not standardized. A forward contract is not transferable and usually can be cancelled only with the consent of the other party, which often must be obtained for consideration and under penalty. Forward contracts are not traded in federally designated contract markets.

Forward-Start Swaps An agreement that includes a deferred start date before the swaps' interest payments are exchanged.

Fourth Market The trading of securities directly from one institutional investor to another without the services of a brokerage firm.

Fractional Share BequestA bequest of property, often made in connection with the establishment of a marital deduction trust, that is expressed in terms of a proportion of the assets involved rather than in terms of a specific dollar amount.

Freddie Mac Trade name for the Federal Home Loan Mortgage Corporation.

Front-End Receipt Swaps Also known as off-market swaps. A swap in which one party receives an amount equal to the present value of a future fixed rate swap payment now rather than at the respective periodic payment dates.

Front Running A practice where an investment manager purchases securities for his/her own personal interest prior to an anticipated purchase of the same securities by the accounts for which he/she acts as investment manager.

Funded Insurance Trust An insurance trust in which, in addition to life insurance policies, cash and securities have been placed in trust to provide sufficient income for the payment of premiums and other charges on or assessments against the insurance policies.

Futures Contract A transferable agreement to make or take delivery of standardized minimum quality grades, during a specific month, under terms and conditions established by a federally designated contract market upon which trading is conducted.

General Account An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. Funds held by an insurance company that are not maintained in a *separate* account are in its *general* account.

General Obligation (GO) Bond A type of municipal bond that is backed by the full faith, credit and taxing power of the issuer for payment of interest and principal. Its sale finances public improvements. It is repaid by taxes.

General Partner A person who usually is actively engaged in the trade or business of the partnership and has unlimited personal liability in the partnership.

General Partnership A form of business whose partners include only general partners. Profits, losses and deductions are passed through to the individual partners involved in the business.

Generally Accepted Accounting Principles(GAAP) Uniform minimum standards of and guidelines to financial accounting and reporting, which govern the form and content of financial statements. GAAP encompass principles necessary to define accepted accounting practice at a particular time and include detailed procedures as well as broad guidelines.

Generation-Skipping Tax A tax imposed on any testamentary generation-skipping transfer, with the intention that this tax be substantially equal to the transfer tax which would have been payable if the property had actually been transferred outright to each generation.

Generation-Skipping Trust Any trust having beneficiaries who belong to two or more generations younger than the grantor.

GIC A "GIC" is a guaranteed investment contract, normally offered by insurance companies. It is similar to a financial institution's certificate of deposit in that it provides a guaranteed rate of return over a specified period. GIC's are normally used by institutional investors, such as employee benefit plans. GIC's are dependent upon the financial soundness of the issuing insurance company for their repayment. See also "BIC", "SLIC", "Synthetic GIC", "Bullets", and "Windows".

Gift Causa Mortis A gift of personal property made by a person in expectation of death, completed by actual delivery of the property, and effective only if the donor dies; to be distinguished from gift inter vivos.

Gift Tax A tax imposed by the Federal Government since 1932 and by some states on transfers of property by gift during the donor's lifetime. Gifts, under this law, may include irrevocable living trusts.

Ginnie Mae Colloquial for Government National Mortgage Association.

Going Concern Value A valuation approach used by appraisers. It implies that a company is actively and profitably in business and, therefore, should be valued on that basis rather than on the liquidation of its assets.

Government National Mortgage Association (GNMA) A wholly-owned government corporation within the Department of Housing and Urban Development (HUD). Also known colloquially as Ginnie Mae.

Governmental Plan An employee benefit plan established or maintained by the employees of the U.S. government or any state or political subdivision thereof or by any agency or instrumentality of the foregoing.

Grantor A person who transfers property by deed or who grants property rights by means of a trust instrument or some other document. See also Settlor.

Grantor Trust For purposes of the income taxation of trusts and estates, a trust in which the grantor or a third party, because of certain rights to income or principal or certain power over the disposition of income and principal, is treated as the owner of the trust and taxed on the income thereof. Consequently, a grantor trust is not treated as a separate entity for income tax purposes.

GRIT Acronym for a grantor retained income trust, which is an irrevocable trust to which a residence is transferred for a term of years, with the grantor retaining the use of the residence for that term. At the end of the term, the residence becomes the property of the remainder beneficiary. The present value of the retained interest is not taxed for transfer tax purposes. The present value of the retained interest is the sum of: (1) the value of an income interest for the specified term, and (2) the present value of the contingent right to receive the value if the grantor dies during the specified term.

Guaranteed Investment Contract See "GIC"

Guardian An individual or a trust institution appointed by a court to care for the property or the person (or both) of a minor or an incompetent person. When the guardian's duties are limited to the property, he is known as a guardian of the property; when they are limited to the person, he is known as a guardian of the person; when they apply both to property and to the person, he is known merely as a guardian. In some states the term committee, conservator, curator, or tutor is used to designate one who performs substantially the same duties as those of a guardian.

Guardian Ad Litem A person appointed by a court to represent and defend a minor or an incompetent person in connection with court proceedings; sometimes called a special guardian.

Hard Dollars Goods or services purchased with cash are said to be purchased with "hard" dollars. Purchases made with brokerage commissions are said to be made with "soft" dollars.

Health Stock Ownership Plan (HSOP) Combination of an employee stock ownership plan (ESOP) and a 401(h) account. HSOPs allow the sponsor to provide for retiree medical benefits for its current employees without having to accrue such future liabilities currently for financial accounting purposes.

Hedging The temporary purchase and sale of a contract calling for future delivery of a specific quantity of a particular commodity at an agreed-upon price to offset a present (or anticipated) position in the cash market. An operation intended to protect against loss in another operation.

Heir A person who inherits real property; to be distinguished from next of kin and from distributee. An

heir of the body is an heir in the direct line of the decedent. A son, for example, is the heir of the body of his father or mother. See also Collateral Heir; Direct Heir; Next of Kin.

Hereditament Any kind of property that is capable of being inherited. If the property is visible and tangible, it is a corporeal hereditament; of it is not, it is an incorporeal hereditament -- for example, a right to rent or a promise to pay money.

HH Bonds Effective August 31, 2004. Series HH bonds are no longer offered. HH bonds issued prior to that date pay a fixed rate of interest based on market rates at the time of issuance. Interest is paid semi-annually and the bonds have a maturity of 20 years after date of issuance.

Highly Compensated Employee (HCE) Any employee who, during the current or preceding plan year: (1) owned more than 5% of the company; or (2) received more than $80,000 (indexed) in annual compensation, and was in the top 20% of employees ranked on the basis of annual compensation, under Section 414(q) of the IRC; or, (3) was an officer of the company earning more than the defined benefit limit under Section 415 of the IRC. Discrimination in favor of this group is prohibited. For 2005, highly compensated employees are those earning $95,000 or more.

Highly Compensated Individual For purposes of IRC § 105(h), (1) one of the five highest paid officers, (2) a 10% owner or (3) an employee who is among the highest 25% of all employees (other than the 10% owners who are not participants).

Highly Compensation Participant Under IRC § 125(e), an officer, a more-than-5% shareholder, a highly compensated employee, or a spouse or dependent of one of the former.

Holographic Will A will entirely in the handwriting of the testator.

Hours Worked Standard hours worked in a year is 2,080 (52 weeks x 40 hours per week).

HR 10 Plan See Keogh Plan.

HSOP See Health Stock Ownership Plan.

Hurdle Rate A minimum standard rate of return for acceptability as an investment.

Hybrid Pension Plan A qualified retirement plan that has characteristics typical of both defined benefit and defined contribution plans.

Immunization The design of a bond portfolio to achieve a target level of return in the face of changing reinvestment rates and price levels. It is the combining of short- and long-term bonds in the same portfolio to produce a predictable rate of return regardless of movements in interest rates.

Income The return from property, such as rent, interest, dividends, profits, and royalties; opposed to principal or capital.

Income Beneficiary The beneficiary of a trust who is entitled to receive the income from it.

Incorporeal Hereditament See Hereditament.

Indemnity Protection or exemption from loss or damage.

Indenture (1) A mutual agreement in writing between or among two or more parties whereof usually each party has a counterpart or duplicate; originally so called because the parts were indented by a notched cut or line so that the two parts could be fitted together. (2) A legal document prepared in connection with a bond issue describing the terms of the issue, such as a security, maturity date, interest rate, and remedies in case of default.

Index Amortizing Swaps Swaps that operate as basic swaps for an initial period, after which time the notional principal balance is amortized or extended based on a schedule linked to interest rate changes or some other index during the interim period.

Index Fund A collective investment fund or common trust fund which is composed of securities which are intended to duplicate the returns of a designated securities index, such as the Standard & Poor's 500 stock index. Not all of the securities which make up the designated index need to be in an index fund.

Individual Account Plan A defined contribution plan that allows participants to choose, from a broad

range of investment options, how their own accounts will be invested. See also Defined Contributions Plan and Money Purchase Plan.

Individual Retirement Account (IRA) A retirement savings program for individuals to which yearly tax deductible contributions up to a specified limit can be made. The amounts contributed are not taxed until withdrawal. Withdrawal is not permitted, without penalty, until the individual reaches age 59 1/2.

Infant A person not of legal age, which at common law was 21 years but which in some states has been changed by statue; the same as a minor.

Inheritance Tax A tax on the right to receive property by inheritance; to be distinguished from an estate tax.

Initial Margin In futures and forwards, the amount of cash that must be deposited with a broker when a futures position is initiated.

Initial Public Offering (IPO) The original sale of a company's securities to the public.

In-Kind Transfer - A distribution of property (e.g., stock, bond, partnership, etc.) from a trust or estate other than in cash. Noncash contributions to a trust or estate are also "in-kind" transfers.

Insurance Guaranty Fund A fund maintained by a state guaranty association which pay claims of insolvent insurance companies. The fund is financed by contributions from insurance companies.

Insurance Trust A trust composed partly or wholly of life insurance policy contracts.

Insured Pension Plans Retirement and other employee benefit plans the source of the benefits of which is life insurance paid for wholly or partially by the employer.

Inter-Account Transaction Transactions in which a trust department sells assets directly from one account to another, bypassing a non-affiliated third party broker. This form of transaction should be permissible under local law and the governing instrument, and it should be covered by written policy. Fiduciaries engaging in this type of activity place themselves in an onerous conflict of interest position. They must be capable of demonstrating to each party to the transaction that it simultaneously sold an asset at the highest fair market value, and purchased it at the lowest fair market value. Generally, management should be cautioned against engaging in these transactions.

Interest Assumption The expected rate of investment return on a plan's assets. It includes interest on debt securities, dividends on equity securities, rentals on real estate, and gains or losses on fund investments.

Interest Rate Futures A transferable agreement to make or take delivery of a fixed income security at a specific time, under terms and conditions established by the federally designated market upon which futures trading is conducted.

Interest Rate Risk One of the three types of investment risk. When interest rates rise, the market value of fixed income contracts (such as bonds) declines. Similarly, when interest rates decline, the market value of fixed income contracts increases. Interest rate risk is the risk associated with these fluctuations. See also Credit Risk and Market Risk.

Internal Revenue Code (IRC) This is the basic federal tax law.

Inter Vivos Between living persons.

Inter Vivos Trust A trust created during the settlor's lifetime; the same as a living trust; to be distinguished from trust under will or testamentary trust.

Intestacy The condition resulting from a person's dying without leaving a valid will.

Intestate (Adjective): (1) Without having made and left a valid will. (2) Not devised or bequeathed; not disposed of by will. (Noun): A person who dies intestate.

In The Money Option A call option whose exercise price is lower than the spot price of the underlying or a put option whose exercise price is greater than the spot price of the underlying instrument.

Intrinsic Value The value of an option were it to be exercised. Only in-the-money options have intrinsic

value.

Inverse Floater A floating rate instrument that adjusts inversely with changes in the benchmark index.

Investment Adviser A person who advises the public concerning the purchase or sale of securities. Such persons must generally register with the Securities and Exchange Commission under the Investment Advisers Act of 1940. Effective May 12, 2001, there is no longer a unilateral exemption afforded to banks. However, banks will continue to be exempt provided that investment advisory services is only made available to individuals and those other than mutual funds. The category of other includes private equity issues and unregistered mutual funds.

Investment Advisor Agent An agency account in which the trust department provides investment recommendations on various types of assets, without actually having custody or safekeeping of those assets.

Investment Management Agent An agency account in which the trust department contracts to analyze and review the various assets, to make recommendations for changes in existing investments, and to make recommendations for new investments. The department also performs safekeeping and custodial functions for the assets of the account.

Investment Company Legal term for a mutual fund. The Investment Company Act of 1940 provides the framework for SEC regulatory authority over mutual fund operations.

Investment Powers The powers of a fiduciary regarding the investments in the account.

IO (Interest Only) The holder of this derivative instrument receives interest payments from a specific regular interest class or from a piece of the collateral. The holder receives no interest payments.

IPO See Initial Public Offering.

IRA See Individual Retirement Account.

IRC Internal Revenue Code. This is the basic federal tax law.

Irrevocable Trust A trust which by its terms (1) cannot be revoked by the settlor or (2) can be terminated by him only with the consent of someone who has an adverse interest in the trust -- that is, someone to whose interest it would be for the trust not to be terminated, such as a beneficiary; to be distinguished from a revocable trust with consented approval.

ISN A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

Issue All persons who have descended from a common ancestor; a broader term than children.

Item A Registered Transfer Agent term defined in SEC Rule 17Ad-1(a)(1), as follows: (i) A certificate or certificates of the same issue of securities covered by one ticket (or, if there is no ticket, presented by one presentor) presented for transfer, or an instruction to a transfer agent which holds securities registered in the name of the presentor to transfer or to make available all or a portion of those securities; (ii) Each line on a "deposit shipment control list" or a "withdrawal shipment control list"; or (iii) In the case of an outside registrar, each certificate to be countersigned.

Joint and Several Liability Used when compensation for liability may be obtained from one or more parties either individually or jointly, whichever may be most advantageous. Example: Partners are responsible for their own and other partners' actions.

Joint and Survivor Annuity A contract that provides income periodically during the longer lifetime of two persons. The benefit amount may be adjusted to account for the extended life expectancy of the couple, and the benefit amount may decrease when one or the other dies. The contingent annuitant is usually the spouse.

Joint Tenancy The holding of property by two or more persons in such a manner that, upon the death of one joint owner, the survivor or survivors take the entire property; to be distinguished from tenancy in common and tenancy by the entirety.

Junk Bonds Bonds that are issued by organizations which often are encountering financial setbacks. A

junk bond may be issued as a low quality security, or its issuer may encounter setbacks so that a quality bond is reduced to junk level. They offer high interest and high risk. Assurance of interest and principal payments in the future is limited; repayment often depends on asset sales rather than the ongoing profitability of the business. Junk bonds are often issued in conjunction with takeovers, leveraged buyouts and restructurings.

KEOGH Plan A retirement plan for self-employed persons and their employees to which yearly tax deductible contributions up to a specified limit can be made, if the plan meets certain requirements of the Internal Revenue Code.

KSOP 401(k) Employee Stock Ownership Plan.

Laches Neglect to do a thing at the proper time; such as undue delay in asserting a right or asking for a privilege.

Land Trust An unincorporated association for holding real property by putting the title in one or more trustees for the benefit of the members whose interests are evidenced by land-trust certificates. In general terms, it is a trust created to effectuate a real estate ownership relationship in which the trustee holds legal and equitable title to the property subject to the provisions of a trust agreement setting out the rights of the beneficiaries whose interests in the trust are declared to be personal property.

Last Will and Testament A legally enforceable declaration of a person's wishes regarding matters to be attended to after his death and not operative until his death; usually but not always relating to property; revocable (or amendable by means of a codicil) up to the time of his death or loss of mental capacity to make a valid will. Originally, "will" related to real property; "testament", to personal property; but at the present time, "will" is equally applicable to real and personal property.

Legacy A gift of personal property by will; the same as a bequest. A person receiving such a gift is called a legatee.

Legal Common Trust Fund A common trust fund invested wholly in property that is legal for the investment of trust funds in the state in which the common trust is being administered. The term is employed most often in or with respect to common trust funds in states that have a statutory or court-approved list of authorized investments for trustees where the terms of the trust do not provide otherwise.

Legal Investment An investment that conforms to the requirements of the statutes. A term used principally with reference to investments by trustees and other fiduciaries and by savings banks; often abbreviated to "legals"; to be distinguished from an authorized investment.

Legal List A list of securities legal for fiduciary investments, as compiled and promulgated by a state agency (such as the state banking department) for the use and guidance of fiduciaries, lawyers, trustees, savings banks. Used infrequently now, as most states have adopted either the Prudent Man or Prudent Investor Rules.

Legatee See Legacy.

Letter of Attorney- A written instrument which evidences the authority of an agent who is known as an attorney-in-fact.

Letters of Administration A certificate of authority to settle a particular estate issued to an administrator by the appointing court; to be distinguished from letters testamentary.

Letters of Conservatorship A certificate of authority issued by the court to an individual or corporate fiduciary to serve as conservator of the property of a person; corresponds with letters of guardianship.

Letter Ruling A private ruling issued by the IRS in response to a request from a taxpayer about the tax consequences of a proposed or completed transaction. Private letter rulings are not considered to be precedents for use by taxpayers other than the one who requested the ruling, but they do give an indication of the current IRS attitude towards the transaction in question.

Letters Testamentary A certificate of authority to settle a particular estate issued by the appointing court to the executor named in the will; to be distinguished from letters of administration.

Leveraged Buyout The purchase of assets or stock of a privately owned company, a public company, or a subsidiary thereof, in which the acquirer uses a significant amount of debt and very little (or no)

capital. This is accomplished primarily by utilizing the purchased assets for collateral and the acquired earnings stream to amortize the debt.

Leveraged ESOP An employee stock ownership plan (ESOP) in which money is borrowed by the ESOP trust for the purpose of buying stock of the employer. The stock is normally held as security by the lender and is released for allocation to participant accounts as the loan is paid off.

LIBOR London InterBank Offered Rate (of interest).

Life Beneficiary The beneficiary of a trust usually for the term of his own life, but it may be for the life of some other person.

Life Estate Either an estate for the life of the life tenant alone or an estate for the life or lives of some other person or persons. If the estate is for the life of a person other than the life tenant, it is known as an estate pour autre vie.

Life Insurance Trust See Insurance Trust.

Life Interest The estate or interest that a person has in property that will endure only during his own or someone else's lifetime.

Limit Order – An order to buy or sell a stock but only at a specific price or better. It allows the individual initiating the trade to set a ceiling on the purchase price they are willing to pay and a floor on the sales price they are willing to accept.. However, because of the limits the trade is not always executed.

Listed Stock The stock of a company that is traded on a recognized securities exchange. The various stock exchanges have different standards for listings. The New York Stock Exchange, for instance, includes national interest in the company, at least 1 million shares publicly held by at least 2,000 round lot shareholders, $16 million in market value, more than $2.5 million pre-tax income in the most recent year, and $2 million in pre-tax income in each of the preceding two years.

Lives in Being Lives in existence at a given time. See Rule Against Perpetuities.

Living Trust A trust that becomes operative during the lifetime of the settlor; opposed to a trust under will. The same as an inter vivos trust.

Living Will A document that allows a person to state in advance his/her wishes regarding the use or removal of life-sustaining or death-delaying procedures in the event of illness or injury.

Load A sales charge paid when purchasing or selling mutual fund shares. A "front end" load is assessed when money is initially invested. A "back end" load is assessed when shares are sold or funds withdrawn, and may be levied as a percentage of the withdrawn amount or at a flat rate. Back end loads may also be known as a redemption or exit fee. Loads may also be charged when dividends are reinvested.

Lookback Option One type of an option contract which confers the retroactive right to buy a given financial instrument at its minimum price, or sell at its maximum price, during a specific "lookback" period.

Lump Sum Distribution With respect to pension plans, the distribution of an individual's benefits in the form of one payment rather than in equal installments over a specified period of time or the individual's lifetime. The Internal Revenue Code imposes certain requirements in order for the distribution to qualify for special tax treatment.

LUST Acronym for leaking underground storage tank. Covered by Recourse Conservation and Recovery Act (RCRA).

Maintenance Margin In futures and forwards, the level to which a margin account may fall before the holder of the contract is required to bring the balance back up to the initial margin level.

Managing Agency Accounts An agency account concerning which the agent has managerial duties and responsibilities appropriate to the kind of property and in conformity with the terms of the agency; to be distinguished from a safekeeping or custody account.

Marital Deduction The portion of a decedent's estate that may be given to the surviving wife or husband

without its becoming subject to the Federal estate tax levied against the decedent's estate; a term that came into general use under the Internal Revenue Act of 1954.

Market Order – An order to buy or sell shares at the prevailing market price. This type of order will always be complete. The individual initiating the purchase or sale has no control over the price, hence the name market.

MarketabilityThe degree of investment or speculative interest that underlies any security; the ease with which it can be sold. Synonymous with "saleability."

Market Maker A dealer that stands prepared to buy or sell at the bid and offer prices that it quotes. The market is maintained when the dealer continues to quote bids and offerings over a period of time. See also Specialist.

Market Risk One of three types of investment risk. Deals with the day-to-day fluctuations at which a security can be bought or sold. See also Interest Rate Risk and Credit Risk.

Massachusetts Rule A term frequently applied to a rule for the investment of trust funds enunciated by the Supreme Judicial Court of Massachusetts in 1830; now commonly referred to as the prudent man rule. See Prudent Man Rule.

Master-Feeder Mutual Fund A two-tiered mutual fund arrangement in which one or more mutual funds (the feeder funds) invest solely in the securities of another mutual fund (the master fund). Master-feeder funds are authorized, without prior SEC approval, under SEC Rule 18f-3. A multiple-class fund is different from a multiple-class mutual fund.

Master Plan A defined benefit or defined contribution employee benefit plan that has been prepared by a sponsoring organization and provides a single trust account in which all adopting employers must invest their plan contributions; the sponsoring organization must have the plan approved by the Internal Revenue Service. See also Prototype Plan.

Master Trust An arrangement designating the custodianship and accounting for all employee benefit assets of a corporation or a controlled group of corporations to a single trustee, facilitating uniform administration of the assets of multiple plans and multiple investment managers.

Material Information Anything of material fact that could affect an investor's decision to buy a certain security.

Matched Swap An interest rate swap in which an asset or liability of the counterparty has interest payment terms similar to those of the swap.

MBIA Municipal Bond Insurance Association.

MEWA A Multiple Employer Welfare Arrangement. A means whereby small employers can pool contributions to purchase health insurance at a lower cost. Suppliers of MEWA's may offer insurance-like products, but normally are not insurance companies. These suppliers generally are not subject to state insurance regulation or reserve requirements.

Mezzanine FinancingG Use of preferred stock or convertible subordinated debentures to finance a takeover. This type of financing expands the resulting company's equity capital instead of its debt.

MGIC Mortgage Guaranty Insurance Corporation.

Modern Portfolio Theory The theoretical constructs that enable investment managers to classify, estimate and control the sources of risk and return. In popular terms, the term is applied to modern investment and portfolio theory. Refer to Appendix C, Uniform Prudent Investor Act for additional discussion.

Money Market Instruments Fixed income securities that mature in less than one year. Also known as cash equivalents since their marketability and characteristics provide easy liquidity. Included are U.S. government securities, negotiable certificates of deposit, commercial paper, STIF accounts, bankers acceptances and mutual funds.

Money Purchase Plan The basic type of a defined contribution employee benefit plan. The employer or plan sponsor's contribution to the plan is specified for each employee in terms of a flat dollar amount

($100 per month of employment), or in terms of a percentage (10% of compensation), or on the basis of a point system. Unlike a profit sharing plan, forfeitures are not added to participants' accounts; they are used to reduce employer contributions. See also Individual Account Plan.

Mortgage Banker An organization that originates mortgages and then sells them to investors, usually retaining servicing rights. Income is derived from origination and servicing fees. Funding for the mortgages is usually from borrowings, which are paid off when the loan is sold.

Mortgage Pass-Through Securities A security consisting of a pool of residential mortgages, with monthly distribution of 100% of the interest and principal to the investor. There are both government (Freddie Mac and Ginnie Mae) and commercial versions of these instruments.

MPPAA Multiemployer Pension Plan Amendments Act of 1980

Multi-Employer Plan For purposes of ERISA, a pension plan maintained pursuant to one or more collective bargaining agreements to which more than one employer is required to contribute.

Multiple-Class Mutual Fund A mutual fund which has multiple classes of shares. Each class participates in the same portfolio of investments and is identical to other classes of shares except that each class has different sales charges and/or other expenses. In some cases, there may also be a difference in the services rendered to different classes of the fund. Multiple-class funds are authorized, without prior SEC approval, under SEC Rule 18f-3. A multiple-class fund is different from a master-feeder mutual fund.

Multiple Employer Welfare Arrangement (MEWA) See MEWA.

Municipal Bonds Debt issues of state and local governments, and their agencies. In general, interest paid on municipal bonds is exempt from federal income taxes and from state and local income taxes within the state of issue.

Negligence Failure, through omission or commission, to act as an ordinary, reasonable and prudent person would act. Consideration must be given to the particular situation, circumstances involved, and knowledge of the parties.

Next of Kin The person or persons in the nearest degree of blood relationship to the decedent. As the term is usually employed, those entitled by law to the personal property of a person who has died without leaving a valid will (such persons do not include the surviving spouse and wife except where specifically so provided by statute); to be distinguished from the heirs, who take the real property.

Nominee The partnership in whose name registered securities are held. This facilitates the making of "good" delivery of securities to brokers at the time of sale or exchange. Nominee names are usually registered with the American Society of Corporate Secretaries, to preclude the possibility of more than one nominee with the same name.

Non Compos Mentis (Not of sound mind): A term that includes all forms of mental unsoundness.

Nonlegal Investment An investment that does not conform to the requirements of the statutes; a term used principally with references to trust investments; to be distinguished from unauthorized investment.

Notional Principal Amount In an interest rate swap, the contractual amount on which interest payments are calculated.

Nuncupative Will An oral will made by a person on his deathbed or by one who is conscious of the possibility of meeting death in the near future -- as by a person in active military service. It is declared in the presence of at least two witnesses and later reduced to writing by someone other than the testator and offered for probate in the manner prescribed by statute.

OBRA Omnibus Budget Reconciliation Acts of 1986, 1987, 1988 and 1989. OBRA 1989 partially repealed the interest exclusion on ESOP loans, provided Labor Department civil money penalties for fiduciary violations, and created a tax penalty for overstatement of pension liabilities in determining deductibility.

OCC Office of the Comptroller of the Currency.

Off-Market Swaps See Front-end receipt swaps.

Open End Mutual Funds These funds issue shares to investors continuously and stand ready to repurchase them at any time based on Net Asset Value. Both load and no-load funds are included.

Operating (Transactional) Risk The possibility that inadequate internal controls or procedures, human error, system failure or fraud can cause loss.

Optimization The process of selecting a securities portfolio that minimizes risk for a given level of risk. An example would be an aim that a portfolio have no more than 5% of its value in a single stock and/or that the current yield be at least 4%. Optimization includes expected return, variances of expected return, and covariance of return with every other security under consideration.

Option A contract for which the buyer pays a fee in exchange for the right, but not the obligation, to buy or sell, a fixed amount of a given financial instrument at a set price within a specified time. Options are considered a type of "price insurance" because they protect buyers from adverse swings in the price of the underlying asset. The buyer can never lose more than the price paid for the option, but the seller's losses are potentially unlimited. See also Call Option, Compound Option, Lookback Option, and Put Option.

Optionee Buyer of the option. The person who received an option on property.

Optioner Seller of the option. The person who gives an option on his/her property.

Option Overriding A type of options management where an options manager writes options on stocks managed by another manager. The goal is to provide an incremental return to the equity portfolio without interfering with the equity manager.

Option Premiums The dollar amounts paid to the writer for the option. The amount is determine generally by supply and demand, duration of the contract and difference between the fluctuations, among various considerations.

Order Flow Practice whereby securities brokers agree to receive cash payments in exchange for routine customer orders to specific dealers for execution.

Ordinary Care Generally considered to be the prudent man standard, subject to the facts and circumstances of a particular case.

Out of the Money An option whose exercise price is above the stock's current price.

Overdraft- The amount by which a debit or charge against an account exceeds the balance of the trust account.

PAC (Planned Amortization Class) A type of derivative instrument with scheduled payments over a range of prepayment speeds (PAC bands or ranges).

Parol Evidence (Pronounced *payroll*) Legal proof based on oral statements; with regard to a document, any evidence extrinsic to the document itself.

Participant An employee or former employee who is (or may become) eligible to receive a benefit of any type from an employee benefit plan. Also includes eligible beneficiaries.

Party In Interest A person or other entity which has control or close affinity to an employee benefit plan; an "insider". Defined by Section 3(14) of ERISA to include fiduciaries, trustees, and custodians, the plan administrator, the plan sponsor (employer and/or union), those who control 50% or more of these insiders, 10% or more stockholders of these insiders. Also covered are the outside interests of such insiders. Certain relatives of insiders are also included. See also Disqualified Person.

Paying Agent An agent to receive funds from an obligor to pay maturing bonds and coupons, or from a corporation for the payment of dividends.

PAYSOP An ESOP eligible for tax credits based on employee payroll. PAYSOP's replaced TRASOP's in 1983. The tax credits were repealed by the Tax Reform Act of 1986. See also Employee Stock Ownership Plan.

PBGC See Pension Benefit Guaranty Corporation.

Pecuniary Bequest A bequest of property, often made in connection with the establishment of a marital deduction trust, that is expressed in terms of a specific dollar amount rather than in terms of a proportion of the assets involved.

Pennsylvania Rule A rule that requires credit of extraordinary dividends received in trust on the basis of the source of such dividends; to income if declared from earnings of the corporation during the life of the trust, and to principal if from earnings accumulated before commencement of the trust.

Pension Benefit Guaranty Corporation (PBGC) Congressionally-chartered corporation responsible for guaranteeing private defined benefit pension plans. Membership in PBGC is mandatory for all such plans. If a covered plan terminates, retirees and beneficiaries are entitled to the benefit calculated under the plan (subject to certain phase-in rules for new plans to preclude abuse), up to a maximum monthly benefit payment. The maximum monthly payment is based on the year a plan terminated and was set in 1974 at $750 per month, indexed for inflation. Plans terminating in 2004 have a maximum monthly benefit of $3,698 or $44,386 per year for those who have attained age 65. The guarantee is increased for those over 65 and decreased for those under 65.

Pension Trust A trust established by an employer (commonly a corporation) to provide benefits for incapacitated, retired, or superannuated employees, with or without contributions by the employees.

PEPPRA Public Employee Pension Plan Reporting and Accountability Act.

Per Capita (By the head): A term used in the distribution of property; distribution to persons as individuals (per capita) and not as members of a family (per stirpes). For example, "I give my estate in equal shares to my son A and to my grandsons C, D, and E (the sons of my deceased son B) per capita". C, D, and E take as individuals (not as the sons of B), each taking the same share as A, namely, one-fourth of the estate.

Performance-Based Fees Investment management fees that are related to investment results, not to the size of the assets managed. Also known as incentive fees.

Person An individual, partnership, joint venture, corporation, mutual company, joint stock company, trust, estate, unincorporated organization, association or employee organization.

Personal Property All property other than real property.

Personal Representative A general term applicable to both executor and administrator.

Personalty Personal property.

Per Stirpes (*By the branch*): A term used in the distribution of property; distribution to persons as members of a family (per stirpes) and not as individuals (per capita). Two or more children of the same parent take per stirpes when together they take what the parent, if living, would take. For example, "I give my estate to my son A and to my grandsons C, D, and E (the sons of my deceased son B). My grandsons are to take per stirpes." C, D, and E take as the sons of B (not as individuals), each receiving one-sixth of the estate (one-third of the one-half to which B would be entitled if living), while A receives one-half of the estate. Taking per stirpes is also known as taking by right of representation.

Pink Sheets Quotation lists of various over-the-counter securities published daily on pink paper by the National Quotation Bureau, Inc.

Plain Vanilla Interest Rate Swap A single-currency swap agreement in which one counterparty agrees to pay a fixed rate of interest to the other counterparty in exchange for a variable rate of interest on a fixed notional principal amount over a specified period of time.

Plan Administrator See Administrator.

Plan Sponsor See Sponsor.

Plan Year The 12-month period on which employee benefit records are kept. Normally a fiscal year, but may be a calendar year.

PO (Principal Only) The holder of this instrument receives principal payments only and does not receive any interest. POs are offered at substantial discounts to their original principal amounts.

Point (1) *Bonds*: A point means 1%. Since bonds are quoted based on $1,000 face value, it also means $10. A bond that has increased by 3 points has gone up $3% or $30. (2) *Stocks*: A point means $1. If XYZ stock goes up 3 points, it has increased $3 per share. (3) *Mortgages*: A point is 1% of the principal amount of the mortgage. For Truth in Lending/Regulation Z purposes, a point is considered part of the Finance Charge disclosure and is included when calculating the APR.

Potential Loss For FDIC Trust Examinations: the examiner's estimate of the portion of a contingent liability which may develop into a loss to the institution. The amount of the loss indicated is potential rather than definite and fixed, pending settlement of the accounts. Also see Contingent Liability.

Pour-Over A term referring to the transfer of property from an estate or trust to another estate or trust upon the happening of an event as provided in the instrument.

Power of Attorney A document, witnessed and acknowledged, authorizing the person named therein to act as his agent, called attorney-in-fact, for the person signing the document. If the attorney-in-fact is authorized to act for his principal in all matters, he has a general power of attorney; if he has authority to do only certain specified things, he has a **special power of attorney**. If the authority granted in the power of attorney survives the disability of the principal, the attorney in fact has a **durable power of attorney**. If the authority granted in the power of attorney commences in the future only upon the occurrence of a specific event or contingency, the power of attorney is known as a **springing power.** A power of attorney can be limited to property concerns or to health care matters. See also Bond Power; Letter of Attorney; Stock Power.

Power of Retention Power expressed or implied in will or trust agreement permitting the trustee to retain certain or all of the investments comprising the trust property at inception, even though they may not be of a type suitable for new investments made by the trustee.

Precatory Words Expressions in a will praying or requesting (but not directing) that a thing be done or not done.

Preemptive Right A right accorded present shareholders, before any new shareholders, to subscribe to new shares in a company at a stipulated price on or before a fixed date. See also Rights.

Principal (1) One who employs an agent to act for him. (2) One who is primarily liable on an obligation. (3) The property of an estate other than the income from the property; the same as capital.

Private Foundations In general, all charitable foundations except those deriving substantial support from the public. They fall into two categories; private operating foundations, those where substantially all of the assets and income are used to carry on its exempt function, e.g., a museum; or private nonoperating foundations, which include most family foundations.

Private Placement The sale of stocks, bonds, or other investments directly to an institutional investor, such as an insurance company or employee benefit plan. This precludes SEC registration requirements and may provide the purchases with (for debt issues) a higher interest rate and a customized maturity.

Probate (Verb): To present a will to the court for appointment of the executor or administrator c.t.a., which is the first step in the settlement of an estate.

Probate Court The court that has jurisdiction with respect to wills and intestacies and sometimes guardianships and adoptions; also called court of probate, surrogate's court, ordinary court, orphan's court, and prefect's court.

Profit Sharing Plan A defined contribution employee benefit plan established by an employer (usually a corporation) as a means of having the employees share in the profits of the enterprise.

Prototype Plan A standardized plan, approved and qualified as to its concept by the Internal Revenue Service, that is made available by banks, insurance companies and mutual funds for the use of employers. See also Master Plan.

Prudent Investor Rule The latest development in evaluating fiduciary prudence. The current (1992) model uniform act differs from the traditional Prudent Man Rule in that it indicates that: (1) no asset is automatically imprudent, but must be suitable to the needs of the beneficiaries, (2) the entire portfolio is viewed when evaluating the prudence of a fiduciary, and (3) certain actions can be delegated to other agents and fiduciaries. ERISA [§ 404(a)(1)(C)] generally follows the approach of the Prudent Investor

Rule. The Uniform Prudent Investor Rule is found in Appendix C. Caution: review state statutes before applying to discretionary nonERISA trust accounts.

Prudent Man Rule A rule originally stated in 1830 by the Supreme Judicial Court of Massachusetts in Harvard College v. Amory [9 Pick. (Mass.) 446], that, in investing, all that can be required of a trustee is that he conduct himself faithfully and exercise a sound discretion and observe how men of prudence, discretion, and intelligence manage their own affairs not in regard to speculation, but in regard to the permanent disposition of their funds considering the probable income as well as the probable safety of the capital to be invested. The current (1959) model uniform rule categorizes certain types of assets as automatically imprudent, looks at each investment separately in determining prudence, and prohibits the delegation of responsibilities. Most states have adopted the Rule as a part of state fiduciary law, usually with certain different specifics from state to state. The Prudent Man Rule is found in Appendix C

Purchase-Money Mortgage A mortgage given by a purchaser of real property to the seller in part payment of the purchase price.

Put Option Option to sell shares of a particular stock within a given period of time at a specific price fixed in the contract.

PWBA Pension and Welfare Benefits Administration, U.S. Department of Labor. This agency is now known as the Employee Benefit Security Administration, EBSA.

QDRO (*Pronounced "Cue-Dro"*) Qualified Domestic Relations Order. Court order which may be issued upon a divorce, specifying a spouse's share in certain employee benefit plans. IRA's, 401(k) plans, and defined benefit pension plans are often covered by QDRO's.

QERP Acronym for Qualified Employee Real Property. Involves the investment of ERISA plan assets in real property leased to the plan sponsor or an affiliate thereof. See ERISA § 407(d)(4).

QPAM Qualified Professional Asset Manager. Term used in ERISA Prohibited Transaction Class Exemption (PTE) 84-14 for a bank, thrift, insurance company or registered investment adviser which meets certain minimum capital, net worth, or total managed assets thresholds.

QTIP Qualified Terminable Interest Property Trust. A type of personal trust which allows assets to be transferred between spouses. The grantor directs income from the assets to his/her spouse for life, but has the poser to distribute the trust's assets upon the death of the spouse. Such trusts qualify for the unlimited marital deduction if the spouse should die first. A QTIP trust is often used to provide for the welfare of a spouse while keeping the assets out of the estate of another (such as a future marriage partner) if the grantor dies first.

Qualified Domestic Relations Order See QDRO.

Qualified Plan or Trust An employer's trust or plan that qualifies under the Internal Revenue Code of 1954 for the exclusive benefit of his employees or their beneficiaries in such manner and form as to entitle the payments made by the employer to the plan or trust to the deductions and income tax benefits as set forth in the Code.

Rabbi Trust A form of employee benefit in which an employer establishes a trust to provide non-qualified deferred compensation to certain key employees. The trust usually contains restrictions on revocation and is subject to claims of general creditors of the employer. Employer contributions are not taxable as income to the employee at the time of contribution. Any income earned prior to distribution to the employee is taxed to the employer. The term "*rabbi*" arose because the first trust of this type approved by the Internal Revenue Service involved a rabbi.

Rabbicular Trust A form of employee benefit which attempts to combine the rabbi trust with a secular trust. The plan originates as a rabbi trust and remains such as long as the sponsor company remains financially healthy. If certain defined situations arise, the rabbi trust becomes a secular trust. The covered employee then must pay any applicable tax, but is assured of receiving what is held in the trust, instead of being just another unsecured creditor.

REA Retirement Equity Act of 1984. Provided for greater pension equity for female workers and surviving spouses.

Real Estate Investment Trust See REIT.

Reciprocal Trust A trust created by one person in consideration of the creation by the beneficiary of a similar trust for him.

Record Date The date on which a shareholder must be listed in a company's shareholder records in order to receive a declared dividend or vote on company matters.

Registrar (1) In connection with stock, the agent which affixes its signature to each stock certificate issued, the object being the prevention of over-issuance. (2) In connection with bonds, the agent which maintains the records of who owns an issue of registered bonds, similar to a transfer agent.

Regulation 9 A regulation issued by the Comptroller of the Currency under authority of Section 1(j) of the Act of September 28, 1962 [76 Stat. 668, 12 USC 92a] relating to the conduct of fiduciary business by national banks. The full title of the regulation is Regulation 9 - Fiduciary Powers of National Banks and Collective Investment Funds. Section 9.18 of the regulation, dealing with collective investment funds, applies to collective investment funds operated by state-chartered banks through Section 584 of the Internal Revenue Code, which requires compliance with Regulation 9.

REIT Real Estate Investment Trust. A trust which operates somewhat like a mutual fund. REITs invest in real estate loans and/or equity interests in real estate. Ninety-five percent of its income must be paid out to shareholders if the REIT is to qualify for a tax exemption.

Remainder A future estate or interest in property which will become an estate or interest in possession upon the termination of the prior estate or interest created at the same time and by the same instrument. For example, A conveys Blackacre to B for life and upon B's death to C in fee simple. C's interest is a remainder. The term remainder over is sometimes used in such phrases as "To A for life, with remainder over to B," calling attention to the fact that there is a prior estate or interest. To be distinguished from reversion.

Remainderman A person or entity entitled to a future interest in a trust or estate. The rights to the property in the trust or estate are typically transferred after the interests of the prior beneficiary (such as the income beneficiary) have terminated.

REMIC Acronym for a real estate mortgage investment conduit. This is a pass-through type of investment vehicle created by the Tax Reform Act of 1986 to issue multi-class mortgage-backed securities. REMIC's may be organized as corporations, partnerships or trusts. Those meeting certain qualifications are not subject to double taxation. Interests in REMIC's may be senior or junior, regular (debt instruments) or residual (equity interests). REMIC's generally provide the issuer with more flexibility than a collateralized mortgage obligation (CMO), as they permit mortgage pools to be separated not only into maturity classes but also into risk classes. While CMO's usually have AAA ratings, REMIC's represent a range of risk levels.

Reportable Event Serious situations involving a private defined benefit employee benefit plan which require a notice to be filed with the PBGC. Events covered include loss of tax qualification, 80% or more drop in participation from the previous year, full or partial plan termination, inability to pay benefits, merger with another plan, bankruptcy of the plan sponsor, etc.

Representative (1) A general term designating either an executor or an administrator. (2) The person who acts or speaks for another under his authority.

Repurchase Agreement As applicable to trust departments, means a "loan" by a trust account to a financial institution or securities dealer. Normally, these loans are secured by U. S. Government or agency securities, bear a fixed rate, are payable at a fixed maturity, and may be subject to other terms. The regulatory agencies have generally taken the position that repurchase agreements with the fiduciary bank are a conflict of interest and self-dealing unless specifically authorized. Also sometimes called reverse repurchase agreements, repo, asset repo, RP, and buy back.

Reputation Risk The possibility that negative publicity will expose the institution to costly litigation, financial loss, or effect its ability to establish new relationships, or to continue existing relationships.

ResidenceThe place where one resides, whether temporarily or permanently. See also Domicile.

Residuary Trust A trust which is composed of the property of the testator, remaining in the estate after the payment of all taxes, debts, expenses, charges, and the satisfaction of all other gifts under the will.

Resulting Trust A trust which results in law from the acts of the parties, regardless of whether they

intend to create a trust, as when a person disposes of property under circumstances which raise an inference that he does not intend that the person taking or holding the property shall have the beneficial interest in it; to be distinguished from an express trust and a constructive trust.

Revenue Anticipation Note A debt obligation issued by a state or political subdivision to be repaid from the receipt of the anticipated revenue.

Revenue Bond A municipal bond payable, not from general tax collections, but from revenue generated by either the operation of a public facility or from a special source of revenue.

Reverse Repurchase Agreement An agreement in which Party A purchases an asset (financial instrument) from Party B and agrees to sell it back to Party B for a specified price at a specified date. See Repurchase Agreement.

Reverse Swap A swap that has terms opposite those of another swap, therefore effectively canceling the former swap.

Reversion The interest in an estate remaining in the grantor after a particular interest, less than the whole estate, has been granted by the owner to another person; to be distinguished from remainder. The reversion remains in the grantor; the remainder goes to some grantee.

Revocable Trust A trust which may be terminated by the settlor or by another person; opposed to an irrevocable trust.

RHO The rate at which the price of an option changes in response to a given move in interest rates.

Rights A privilege granted to existing shareholders of a corporation to purchase new shares of common stock at a discount from its market price. Rights are offered under terms of a Rights Offering. The right must be exercised within a short (30-60 day) timespan. Sometimes, rights are issued under state law that requires existing shareholders be given an opportunity to maintain their proportionate share of ownership. See Preemptive Rights.

Rollover The procedure of repeated investment of the proceeds of short-term securities upon maturity. See Tax-Free Rollover.

Roth IRA was introduced in 1998. Except for some special rules which apply only to Roth IRAs, these individual retirement accounts are subject to many of the same IRS rules as are traditional IRAs. Unlike traditional IRAs, contributions are taxable, but distributions are not taxed. Also, no distributions from Roth IRAs are ever required, and IRA owners may continue to contribute to the IRA after the age of 70 ½.

Routine A Registered Transfer Agent term defined in SEC Rule 17Ad-1(i), as follows: An item is "routine" if it does not:

(1) require requisitioning certificates of an issue for which the transfer agent, under the terms of its agency, does not maintain a supply of certificates;

(2) include a certificate as to which the transfer agent has received notice of a stop order, adverse claim, or any other restriction on transfer;

(3) require any additional certificates, documentation, instructions, assignments, guarantees, endorsements, explanations, or opinions of counsel before transfer may be effected;

(4) require review of supporting documentation other than assignments, endorsements or stock powers, certified corporate resolutions, signature, or other common and ordinary guarantees, or appropriate tax, or tax waivers;

(5) involve a transfer in connection with a reorganization, tender offer, exchange, redemption, or liquidation,

(6) include a warrant, right, or convertible security presented for transfer of record ownership within five business days before any day upon which exercise or conversion privileges lapse or change;

(7) include a warrant, right, or convertible security presented for exercise or conversion; or

(8) include a security of an issue which within the previous 15 business days was offered to the public, pursuant to a registration statement effective under the Securities Act of 1933, in an offering not of a continuing nature.

RPM Trust - Remainder Purchase Marital Trust, is a special type of trust for the benefit of the grantor's spouse that is designed to qualify for the gift tax marital deduction, but will not be subject to estate tax at the spouse's death. As a result, the trust property passes to the grantor's children completely free of gift and estate tax. This can be a replacement for a GRIT or a GRAT without their inherent drawbacks. Both RPM Income and RPM Annuity Trusts provide benefits.

Rule Against Perpetuties A rule of common law that makes void any estate or interest in property so limited that it will not take effect or vest within a period measured by a life or lives in being at the time of the creation of the estate plus 21 years and the period of gestation. In many states the rule has been modified by statute. Sometimes it is known as the rule against remoteness of vesting.

Safekeeping Account An agency account concerning which the duties of the agent are to receipt for, keep safe, and deliver the property in the account on demand of the principal or his order; to be distinguished from a custody account and a managing agency account.

Samurai Bond A bond issued in the United States but denominated in Japanese Yen.

SAR Summary Annual Report for ERISA employee benefit plans.

SARSEP Acronym for Salary Reduction Simplified Employee Pension, a type of defined contribution employee benefit plan first authorized in 1986. Sometimes referred to as an *elective deferral arrangement*. SARSEPs are available to employers with 25 or less employees, and at least 50% of eligible employees must participate in the plan. Employees contribute a percentage of their salary, thus reducing current income. SARSEPs could be adopted by employers through 12-31-96. Beginning 1-1-97, SARSEPs were replaced by SIMPLE Retirement Plans, and no more new SARSEPs could be started. SARSEPs adopted prior to 1997 can be continued, however, with additional contributions made to them.

Scalping Trading for small gains over a short period of time, usually within a day. In some cases, this may involve taking advantage of very narrow spreads in volatile markets.

Secular Trust A form of employee benefit plan that operates differently from a rabbi trust. In contrast to a rabbi trust, contributions to a secular trust are taxable to the participant, but participants also have a vested interest in plan assets. While the trust is taxable, the employee is ensured of receiving the funds entrusted to the trust should the plan sponsor fail. See also Rabbi Trust and Rabbicular Trust.

Security-Based Derivative These investment instruments are specially tailored from other securities, such as municipal, corporate, or U.S. Government agency bonds. While they offer enticing return potential, some carry high degrees of both market risk and income risk. They range from the highly predictable to the highly unpredictable. Examples of the highly unpredictable include inverse floaters, interest-only or principal-only STRIPS. Also called Synthetic Derivatives. See also Derivatives.

Securities Depository (Clearing Agency): A physical location or organization where securities certificates are deposited and transferred by bookkeeping entry.

Securities Lending A practice where owners of securities, either directly or indirectly, lend their securities to (primarily) brokerage firms for a fee. The borrower pledges either cash, securities or a letter of credit to protect the lender. Securities are borrowed by cover fails of deliveries or short sales, provide proper denominations, and enable brokerage firms to engage in arbitrage trading activities.

Sedol A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

Self-Employed Retirement Plan See Keogh Plan.

Self-Settled Trust A trust which is funded from assets which came from the beneficiary.

SEP Simplified Employee Pension (plan). Basically, an IRA (SEP-IRA) established by an employer for the benefit of each covered employee. Both the employer and employees may contribute to the SEP-IRA. Employer contributions are excluded from an employee's income.

Separate Line of Business See SLOB.

SEPPAA Single Employer Pension Plan Amendments Act of 1986.

SERP Supplemental Executive Retirement Plan. A non-tax-qualified pension plan that permits an employer to offer greater benefits to its highly paid employees.

Settlement (1) The winding up and distribution of an estate by an executor or an administrator; to be distinguished from the administration of an estate by a trustee or a guardian. (2) A property arrangement, as between a husband and wife or a parent and child, frequently involving a trust.

Settlor A person who creates a trust, such as a living trust, to become operative during his lifetime; also called donor, grantor, and trustor. Compare Testator.

Short-Term Trust Also known as a Clifford Trust. An irrevocable trust running for a period of ten years or longer, in which the income is payable to a person other than the settlor, and established under the provisions of the Revenue Act of 1954. The income from a trust of this kind is taxable to the income beneficiary and not to the settlor. The agreement may provide that on the date fixed for the termination of the trust, or on the prior death of the income beneficiary, the assets of the trust shall be returned to the settlor. The Tax Reform Act of 1986 eliminated the 10-year or Clifford trusts exception from grantor-trust taxation rules. Income from 10 year and other grantor trusts is taxed to the grantor, not the beneficiary if the trust property will revert to the grantor or the grantor's spouse. It applies to transfers in trusts after March 1, 1986.

SICOVAM A securities identification numbering system similar to CUSIP but used in some countries outside the United States.

Simple Acronym for Savings Incentive Match Plan for Employees, a type of defined contribution employee benefit plan passed by Congress in 1996 and effective beginning January 1, 1997. SIMPLE plans may be used by employers with 100 or less employees at any time during a year with no other employer-sponsored retirement plan. SIMPLE plans may take the form of an IRA or a 401(k) plan.

Sinking Fund An accumulation of amounts set aside periodically by municipalities or corporations, which will be sufficient to satisfy a debt, such as a bond issue, at maturity. See also Amortization.

SIPC Securities Investor Protection Corporation. Congressionally-chartered corporation that protects investor funds at broker-dealers. In general, when a broker-dealer registers with the SEC, it automatically becomes a member of SIPC. SIPC covers an investor's account for an aggregate of $500,000 in cash and securities, with a maximum of $100,000 cash coverage.

SLIC A guaranteed investment contract issued by a savings and loan association or similar thrift institution. See also GIC.

SLOB IRS term for a "separate line of business," as used in determining compliance with minimum coverage and participation requirements for employee benefit plans. The concept permits businesses that are part of a controlled group to ignore affiliates when testing for nondiscrimination in retirement and dependent care plans.

Social Investing Socially-sensitive investments which, when compared to normal fiduciary-quality investments, are considered to either (1) have a greater social or moral quality, or (2) create employment opportunities for plan participants. Social investing attempts to achieve the same investment quality and rate of return as other investments. Criteria for social investing may be expressed in positive and/or negative terms. Positive qualities might include firms which are seen to be pollution-free, union or employee-friendly, U.S. (or locally) based, providing housing or medical services, food production, or producing safe and high-quality consumer products, etc. Negative qualities might be heavy users of energy or polluters; firms moving jobs overseas; alcohol, tobacco or weapons manufacturers, etc. At one time, a "standard" negative quality was a firm doing business in South Africa. Under some criteria, fossil and/or nuclear energy firms can be viewed either positively or negatively. See also ETIs.

Soft Dollars The purchase of research materials from brokerage firms and paid for by commissions (or part of the commissions) generated by securities transactions of trust accounts. Covered by Section 28(e)(1) of the Securities Exchange Act of 1934. Opposed to this is the purchase of materials by "hard dollars", which is when payment is made by the trust department itself, typically by issuing a check.

SPD Summary Plan Description for ERISA employee benefit plans.

SPTDM Statement of Principles of Trust Department Management.

Specialist A member of the New York Stock Exchange who has two functions: (1) Maintain an orderly market, insofar as possible, in the stocks for which he/she is registered as a specialist. This is done by buying or selling, for the specialist's own account, when there is a disparity between supply and demand. (2) Act as a broker's broker, to place "limit" orders that cannot be immediately executed by the broker. A limit order is one that says buy XYZ at $50, but it is now selling at $60; the specialist holds the broker's order until the price drops to $50. There are about 350 NYSE specialists. See also Market Maker.

Spendthrift Clause The provision in a will or trust instrument which limits the right of the beneficiary to dispose of his interest, as by assignment, and the right of his creditors to reach it, as by attachment.

Spillover Trust Type of trust which by its terms is merged with or added to another trust or estate upon the happening of a certain event. See Pour-Over.

SPIRA Spousal IRA.

Split Stock term. Division of a company's stock into a greater number of shares. In the case of a four-for-one split, four new shares are issued for each old share. The opposite of a split is a *reverse split*, where a company shrinks its stock base by issuing fewer shares for each existing share.

Sponsor The party that establishes and maintains an employee benefit plan. This is normally the employer or an employee organization (union).

Sprinkling Trusts Trusts in which the income or principal is distributed among the members of a designated class in amounts and proportions as may be determined in the discretion of the trustee. Also called spray trusts.

Step-up Swaps A swap that contains periodic increases (or step-ups) in the fixed-rate side of the swap combined with an embedded option that gives the fixed-rate payer the right to extend the swap to a predetermined maximum maturity.

STIF Acronym for a Short Term Investment Fund, a money-market collective investment fund.

Stock Bonus Plan A defined contributions employee benefit plan similar to a profit sharing plan, except that employer contributions are not necessarily dependent upon profits and benefits are in the form of employer stock.

Stock Option Right to purchase stock of employer, generally at a fixed price for a fixed period of time.

Stock Power A form of assignment executed by the owner of stock which contains an irrevocable appointment of an attorney in fact to make the actual transfer on the books of the corporation.

Stock Purchase Trust A trust under which a surviving stockholder of a close corporation may purchase the stock of a deceased stockholder; usually, but not necessarily, an insurance trust.

Stock Transfer Agent The agent of a corporation appointed for the purpose of effecting transfers of stock from one stockholder to another by the actual cancellation of the surrendered certificates and the issuance of new certificates in the name of the new stockholder. See also Transfer Agent.

Stop Order – An order to buy or sell a stock once it reaches a certain target price.

Stop-Limit Order – Instructs a broker to buy or sell once a stock hits the stop price but only at the limit price or better.

Strategic Risk The possibility that insufficient due diligence reviews or infrastructure preparations were made on the introduction of new products and services.

Street Name Shares of stock owned by a broker's customer but held in the name of the broker.

Sub-Chapter S Corporation An election available to a corporation to be treated as a partnership for income tax purposes. To be eligible to make the election, a corporation must meet certain requirements as to kind and number of shareholders, classes of stock, and sources of income.

Subordinated Debenture A debt obligation that has unsecured junior claims to interest and principal, which are subordinated to ordinary debentures or other debt of the issuing corporation.

Subrogation The substitution of one person for another with reference to a lawful claim or right and frequently referred to as the doctrine of substitution. It is a device adopted or invented by equity to compel the ultimate discharge of a debt or obligation by him who in good conscience should pay it.

Successor Trustee A trustee following the original or a prior trustee the appointment of whom is provided for in the trust instrument; to be distinguished from a substituted trustee.

Surcharge (Noun): An amount which the fiduciary is required by court decree to make good because of negligence or other failure of duty. The term is also used as a verb; as the court surcharged the trustee.

Surety An individual or a company that, at the request of another, usually called the principal, agrees to be responsible for the performance of some act in favor of a third person in the event that the principal fails to perform as agreed; as the surety on an administrator's or a guardian's bond.

Swap A forward-type contract in which two parties agree to exchange streams of payments over time according to a predetermined rule. In an **interest rate swap**, one party agrees to pay a fixed interest rate in exchange for receiving a floating interest rate from another party. An **equity index swap** may involve swapping the returns on two different stock market indices, or swapping the return on a stock index for a floating interest rate.

Swaption An option giving the holder the right, but not the obligation, to enter into or cancel a swap agreement at a future date.

Synthetic Derivative A type of security dependent on other securities. Includes inverse floaters and STRIPS. See Security-Based Derivatives.

Synthetic Forward An agreement to either (1) purchase a call and write a put at the same strike price and expiration date, or (2) purchase a put and write a call at the same strike price and expiration date.

Synthetic GIC A Guaranteed Investment Contract issued by other than an insurance company. See "GIC", "BIC", "SLIC".

TAB U.S. Treasury Tax Anticipation Bill. These bills generally mature a week after the corporate income tax dates and are acceptable at par on the tax date. See also Treasury Bills.

TAC (Targeted Amortization Class) A type of derivative that provides investors with a predefined payment schedule applicable to a single prepayment speed. Prepayments in excess of the predefined prepayment speed are allocated to companion, or support, classes and generally do not affect the TAC class. If prepayments fall below the predefined speed, however, the TAC will have slower principal repayment and its average life will extend.

TAMRA Technical and Miscellaneous Revenue Act of 1988.

Target Plan A type of employee benefit plan which combines elements of both defined contribution and defined benefit plans. Levels of contributions are established and a "target benefit" aimed for. An individual account is established for each participant. Actual benefits are based on the amount of the contributions, as affected by the individual's pro-rata share in the profits and losses of the investment portfolio.

Tax Free Rollover Provision whereby an individual receiving a lump sum distribution from a qualified pension or profit sharing plan can preserve the tax deferred status of these funds by a "rollover" into an IRA or another qualified plan if rolled over within sixty days of receipt.

Tax Reduction Act of 1975 Provided special investment tax incentives for establishment of ESOP's (initially known as TRASOP's and changed to tax credit ESOP's by the Technical Corrections Act of 1979). The Tax Reform Act of 1986 repealed these credits.

TEFRA Tax Equity and Fiscal Responsibility Act of 1982. Among other things, this Act provides that (1) municipal bond issues had to be registered, rather than bearer, as to ownership information and (2) changed Section 72 of the Internal Revenue Code as to loans to participants of employee benefit plans.

Tenancy By The Entirety Tenancy by a husband and wife in such a manner that, except in concert with the other, neither husband nor wife has a disposable interest in the property during the lifetime of the other. Upon the death of either, the property goes to the survivor. To be distinguished from joint tenancy and tenancy in common.

Tenancy In Common The holding of property by two or more persons in such a manner that each has an undivided interest which, upon his death, passes as such to his heirs or devisees and not to the survivor or survivors; the same as an estate in common; to be distinguished from joint tenancy and tenancy by the entirety.

Testamentary Trust A trust established by the terms of a will.

Testate (Adjective): Having made and left a valid will; opposed to intestate.

Testator A man who has made and left a valid will at his death. Compare Settlor. See also Trustor.

Testatrix A woman who has made and left a valid will at her death.

Tickler Any record established to serve as a reminder of action to be taken on a fixed future date. It is always arranged in the order dates on which such action is to be taken.

Time Value The difference between the total value of an option and the option's intrinsic value.

Top Hat Plan An unfunded plan maintained to provide deferred compensation for a select group of management or highly compensated employees.

Top Heavy Plan A plan that provides more than 60% of its aggregate accrued benefits or account balances to key employees. Such plans must meet certain additional qualification rules regarding vesting and contributions.

"Totten" Trust Trust created by deposit of one's own money in his own name as trustee for another. Title is vested in the record owner (trustee), who during his life holds it on a revocable trust for the named beneficiary. At the death of the depositor a presumption arises that an absolute trust was created as to the balance on hand at the death of the depositor.

Tracking Error For stock and bond index funds, the difference between index return and the actual return of the fund.

Tranches (1) Risk maturity or other classes into which a multi-class security, such as a collateralized mortgage obligation (CMO) or real estate mortgage investment conduit (REMIC) is split. (2) Subunits of a large ($10 - $30 million) Eurodollar certificate of deposit that are marketed to smaller investors in $10,000 denominations. These are represented by separate certificates, and have the same issue date, interest rate and maturity as the original instrument.

Transfer Agent A corporate agency account whose duties are to transfer stock from one owner to another. A transfer agent maintains records of shareholders, and issues stock certificates. Transfer agents which transfer stock of companies with, generally, 500 stockholders and $1 million in assets must register with either the SEC or its banking agency (as appropriate) under Section 17A of the Securities and Exchange Act of 1934. A transfer agent for bonds usually is known as a registrar. See also Stock-Transfer Agent.

TRASOP An employee benefit account dealing with employee stock ownership plans which meet certain qualifications under the Tax Reduction Acts of 1975 and 1976. These Acts encouraged the use of TRASOP's by allowing a special investment credit as an incentive for establishing such a plan. The Technical Corrections Act of 1979 provided for further such incentives. The tax credits were repealed by the Tax Reform Act of 1986. See also Employee Stock Ownership Plan.

Treasury Bills Short-term direct obligations of the U.S. Government. Often referred to as T-Bills. They are issued with maturities of three months, six months or one year, in denominations of $10,000 and up in multiples of $5,000. See also TABs.

Treasury Bonds Long-term direct obligations of the U.S. Government issued with maturities of five to 30 years, paying interest semiannually.

Treasury Notes Short- to intermediate-term direct obligations of the U.S. Government issued with

maturities of one to seven years, paying interest semiannually.

TRESOP Tax Reduction (Act) ESOP. See TRASOP.

Triple Witching The last trading hour on the third Friday of March, June, September and December when options and futures on stock indexes expire concurrently. Massive trades in index futures, options and underlying stocks by hedge strategists and arbitragers cause abnormal activity and volatility. See also Witching.

Trust A fiduciary relationship in which one person (the trustee) is the holder of the legal title to property (the trust property) subject to an equitable obligation (an obligation enforceable in a court of equity) to keep or use the property for the benefit of another person (the beneficiary).

Trust Agreement A written agreement between settlor and trustee setting forth the terms of a trust. See also Deed of Trust.

Trust Committee A committee of directors or officers or both of a trust institution charged with general or specific duties relating to its trust business.

Trustee An individual or a trust institution which holds the legal title to property for the benefit of someone else.

Trusteed Pension Plan A pension plan in which the corporation's contributions to the plan are placed in a trust for investment and reinvestment, as distinguished from a plan in which the benefits are secured by life insurance.

Trustor A person who creates a trust; a broad term which includes settlor and testator.

Trust Under Agreement A trust evidenced by an agreement between the settlor and the trustee.

Trust Under Deed A trust evidenced by a deed of conveyance, as distinguished from an agreement; originally confined to real property but not frequently applied to personal property as well.

Trust Under Will A trust created by a valid will, to become operative only on the death of the testator; opposed to a living trust and the same as testamentary trust.

Ultra Vires Term applied to acts of a corporation which exceed its corporate powers.

Undistributed Net Income (UNI) The amount by which the distributable net income for the year exceeds the sum of any amount of income for the year required to be distributed currently, any other amounts properly paid, credited, or required to be distributed for such year, and the amount of taxes properly allocable to the undistributed portion of the distributable net income.

Unfunded Insurance Trust An insurance trust in which the premiums on the policies are to be paid by the insured or by some third person and not by the trustee; to be distinguished from a funded insurance trust.

Unfunded Vested Pension Liability In a defined benefit pension plan, the difference between the actuarially-determined value of the vested (nonforfeitable) benefits under the plan, and the market value of the plan's assets.

Unfunded Prior Service Pension Liability In a defined benefit pension plan, the difference between the actuarially-determined value of the projected future benefit costs (both vested and manifested) and administrative expenses, as well as the unamortized portion of prior benefit costs, under the plan, and the market value of the plan's assets.

Unified Credit A dollar amount allocated to each taxpayer which can be applied against the gift tax, the estate tax and, under certain circumstances, the generation-skipping tax.

Uniform Gifts To Minors Act An act adopted by most states providing for a means of transferring property to a minor, wherein the designated custodian of the property has the legal right to act on behalf of the minor without the necessity of a guardianship.

Unit Investment Trust An investment vehicle registered with the SEC under the Investment Company Act of 1940 that purchases a fixed portfolio of securities. Units in the trust are sold to investors, who

receive a proportionate undivided interest in the principal and income of the portfolio. The portfolio of securities remains fixed until the securities mature or, unusually, are sold.

Unmatched Swap An interest rate swap that the counterparty has not paired with an asset or liability with interest payment terms similar to those of the swap.

Unwinding a Swap Terminating a swap agreement.

VAR Value at Risk. An alternative approach (supposedly more sophisticated and accurate) to stress tests for measuring the risk in certain securities activities, such as derivatives. A rudimentary probability analysis, VAR measures the potential for fluctuation in securities prices. VAR is designed to show probable risk, whereas stress tests show what is possible. In the U.S., VAR calculations are usually based on the daily RiskMetrics data issued by Morgan Guaranty Trust Company over Internet. The use of VAR to measure risk is endorsed by the Group of 30; the Basel Committee of international bank supervisors is leaning towards the use of VAR.

Variable Amount Note Note evidencing the amount the trust department lends to a borrower from cash held in various fiduciary accounts; the amount of the loan outstanding fluctuates depending on the amount of cash on hand.

VEBA Acronym for Voluntary Employees' Benefit Association. A tax exempt fund that pays death, health, accident or other benefits to plan participants, their dependents and/or beneficiaries. Generally covered under Section 501(c)(9) of the Internal Revenue Code.

Vest (Verb): To confer an immediate, fixed right of immediate or future possession and enjoyment of property.

Vesting As applied to pension and profit-sharing plans, vesting is a term that indicates the attainment by a participant of a benefit right, attributable to employer contributions, that is not contingent upon his continued employment. Vesting may be total and immediate, graduated over a period of years, or may occur on completion of stated service or participation requirements.

Viatical Settlement (From the Latin *viaticum*, for *provisions for a journey*.) The sale or transfer (settlement) of ownership rights to a life insurance policy prior to death by an insured individual with a terminal illness. The insured person receives a percentage of the life insurance policy's proceeds, with the amount paid is based on a number of factors, such as the life expectancy of the insured person, the amount payable on death, estimated future premiums, and any commissions or other costs. Purchasers may be brokers who sell interests in the life insurance policy's proceeds to investors, with the broker taking its own commission. Once the insurance policy is sold to a broker, the insured is not responsible for paying premiums on the policy. In a 6-8-95 letter to the Texas Department of Banking, the IRS stated that IRA accounts could not "lend" funds to a "viatical trust" for other than the IRA owner, as § 408(a)(3) of the Internal Revenue Code and § 1.408-2(b)(3) of IRS Regulations prohibit investment of IRA funds in insurance contracts. Beginning 1-1-97, funds received from viatical settlements are not taxable for federal income tax purposes if the insured has a life expectancy of less than 24 months or (under special conditions) is chronically ill. See also Accelerated Death Benefit (ADB).

Volatility The degree of price fluctuation for a given asset, rate, or index. Usually expressed as variance or standard deviation.

Voting Authority The power to vote a stock. A trustee may have sole, shared, or no authority to vote stock held in trust.

Vulture Fund A type of limited partnership that invests in depressed properties, usually real estate, aiming to make a profit when prices recover.

Waiver (1) The voluntary relinquishment of a right, privilege, or advantage. (2) The document by which the relinquishment is evidenced.

Warrant A securities certificate which carries the privilege of buying a certain number of shares of stock at a fixed price. They are sometimes attached to securities, at other times they are issued in connection with subscription privileges to holders of stock. See Right.

Wasting Assets Assets which are exhausted through use or lose their value through the passage of time, such as oil wells, mining claims, and patents.

Wearaway a device which may be offered to employees with long company service when traditional defined benefit pension plans are converted to defined benefit cash balance plans. Wearaway provides employees the option of receiving the greater of their frozen benefit under the previous pension plan formula, or their total benefit under the new cash balance formula.

Welfare Plans A term defined by Section 3(1) of ERISA as employee benefit plans which provide the following types of benefits: medical, surgical, hospital care or benefits, sickness, accident, disability, death or unemployment, or vacation benefits. Also includes apprenticeship or other training programs, day care centers, scholarship funds, prepaid legal services, and similar types of benefits other than pensions.

Will A legally enforceable declaration of a person's wishes in writing regarding matters to be attended to after his death and inoperative until his death. A will usually, but not always, relates to the testator's property, is revocable (or amendable by means of a codicil) up to the time of his death, and is applicable to the situation which exists at the time of his death.

Window A term used with BIC's and GIC's for a contract where periodic deposits may be made over an agreed-upon period, usually three months to a year.

Witching The final trading hour, usually on the third Friday of months other than March, June, September and December, when index futures or options expire. This may lead to abnormally high levels of stock trading and volatility. See also Triple Witching.

When Issued (WI) Short form of "when, as, and if issued." Refers to a transaction made conditionally because a security, while authorized, has not yet been issued. New issues of stocks and bonds, stocks that have split are traded on a when issued basis. Newspaper listings often indicate such issues by a "WI."

Whoops Nickname for the Washington Public Power Supply System. In the late 1970's and early 1980's, WHOOPS raised billions of dollars through municipal bonds to finance construction of five nuclear power plants. WHOOPS cancelled two of the plants and defaulted on the related bonds. It was the largest municipal bond default in history.

WPPDA Welfare and Pension Plans Disclosure Act, also known as the Landrum-Griffin Act. Pre-ERISA law now repealed and replaced by ERISA.

WRAP A wrap account is an account offered by a broker or investment dealer where the investor is charged an annual management fee for all services, usually based on the value of invested assets. Wrap fees are paid in lieu of commissions in such an account. Refer to Section 7, Subsection N.2, of the Trust Manual for a discussion of wrap accounts offered by a trust department.

Writer (short) The seller of an option (financial instrument).

Yankee Certificate of Deposit A certificate of deposit issued by the U.S. branch of a foreign bank.

Z Pac A derivatives term. Similar to a Z Tranche, but holders also receive principal if prepayments fall within a specified range.

Z Tranche A derivatives term for a tranche with a stated interest, but where the interest is not paid until certain other classes have been paid.

Appendix E — Employee Benefit Law

Interagency Referral Agreement for ERISA Violations

INTERAGENCY AGREEMENT

Procedures for Cooperation Between the Federal Financial Institution Regulatory Agencies and the Department of Labor in the Enforcement of the Employee Retirement Income Security Act of 1974

The Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency and Office of Thrift Supervision (the federal financial institution regulatory agencies) as part of their supervision of the institutions regulated by them, conduct examinations and perform other functions which occasionally disclose possible violations of the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor (DOL) is charged with the administration, interpretation and enforcement of standards of conduct and responsibility of fiduciaries of employee benefit plans under ERISA.

Section 3004(b) of ERISA provides that the Secretary of Labor may utilize the facilities or services of any department, agency, or establishment of the United States, with the lawful consent of such department, agency, or establishment, and each department, agency or establishment of the United States is authorized and directed to cooperate with the Secretary of Labor and, to the extent permitted by law, to provide such information and facilities as the Secretary may request for his assistance in the performance of his functions under ERISA. This agreement is executed pursuant to that authority.

1. To the maximum extent consistent with law and dependent upon the availability of resources, the federal financial institution regulatory agencies shall provide written notification to the DOL of possible violations of ERISA of a significant nature, which are discovered in the course of their supervision of institutions subject to their respective jurisdiction.

2. A possible violation shall be considered significant when, in the view of the appropriate federal financial institution regulatory agency, it falls within the following circumstances:

a. Where the financial institution does not serve as plan administrator or plan sponsor, as those terms are defined in ERISA Section 3(16), possible violations of:

(1) Title I, Part 4, Section 404, relating to fiduciary duties (including transactions directed by named fiduciaries or qualified investment managers), except where the transaction amounts, individually or in combination with other questionable transactions, constitute less than $100,000;

(2) Title I, Part 4 Section 405, relating to liability for breach of co-fiduciary duties (including transactions directed by named fiduciaries or qualified investment managers), except where the transaction amounts, individually or in combination with other questionable transactions, constitute less than $100,000;

(3) Title I, Part 4, Sections 406 and 407(a), relating to prohibited transactions, except where the threat of loss to the plan participants is de minimis;

(4) Title I, Part 4, Section 411, relating to prohibition against certain persons holding certain positions;

(5) Title I, Part 4, Section 412, relating to the bonding requirements as applicable to the financial institution itself.

b. Where the financial institution, in respect to a plan, also serves as plan administrator or plan sponsor, the agencies shall provide written notification of possible violations of the ERISA sections enumerated in a. above and, in addition, shall provide written notification of possible violations of Title I, Part 1, of ERISA relating to reporting and disclosure.

3. The written notification to the DOL shall include the following:

a. The name of the financial institution.

b. The name of the plan.

c. A brief description of the nature of the possible violation, and any corrective action requested by the federal financial institution regulatory agency and/or initiated by the federal financial institution regulatory agency.

4. The DOL agrees that any information received from the federal financial institution regulatory agencies pursuant to this agreement shall, to the extent permissible by law, be held in strict confidence and may be used for investigative purposes only; and that no other use of such information shall be made without the express written authorization of the agency that supplied such information.

5. The written notification shall be sent to the Director of Enforcement, Employee Benefits Security Administration, U.S. Department of Labor, Washington, D.C. 20210.

Trust Examination Manual

Appendix E — Employee Benefit Law

Employee Retirement Income Security Act OF 1974

(Current through P.L. 103-219, approved 3-9-94)

Definitions (selected)

ERISA Section 3

(29 USC 1002)

For purposes of this subchapter:

1. The terms "employee welfare benefit plan" and "welfare plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 186(c) of this title (other than pensions on retirement or death, and insurance to provide such pensions).
2. (A)Except as provided in subparagraph (B), the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program -

   i. Provides retirement income to employees, or
   ii. Results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

   (B) The Secretary may by regulation prescribe rules consistent with the standards and purposes of this chapter providing one or more exempt categories under which -

   i. Severance pay arrangements, and
   ii. Supplemental retirement income payments, under which the pension benefits of retirees or their beneficiaries are supplemented to take into account some portion or all of the increases in the cost of living (as determined by the Secretary of Labor) since retirement, shall, for purposes of this subchapter, be treated as welfare plans rather than pension plans. In the case of any arrangement or payment a principal effect of which is the evasion of the standards or purposes of this chapter applicable to pension plans, such arrangement or payment shall be treated as a pension plan.

3. The term "employee benefit plan" or "plan" means an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan.
4. The term "employee organization" means any labor union or any organization of any kind, or any

agency or employee representation committee, association, group, or plan, in which employees participate and which exists for the purpose, in whole or in part, of dealing with employers concerning an employee benefit plan, or other matters incidental to employment relationships; or any employees' beneficiary association organized for the purpose in whole or in part, of establishing such a plan.

5. The term "employer" means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan; and includes a group or association of employers acting for an employer in such capacity.
6. The term "employee" means any individual employed by an employer.
7. The term "participant" means any employee or former employee of an employer, or any member or former member of an employee organization, who is or may become eligible to receive a benefit of any type from an employee benefit plan which covers employees of such employer or members of such organization, or whose beneficiaries may be eligible to receive any such benefit.
8. The term "beneficiary" means a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder.
9. The term "person" means an individual, partnership, joint venture, corporation, mutual company, joint-stock company, trust, estate, unincorporated organization, association, or employee organization.
10. The term "State" includes any State of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, American Samoa, Guam, Wake Island, and the Canal Zone. The term "United States" when used in the geographic sense means the States and the Outer Continental Shelf lands defined in the Outer Continental Shelf Lands Act (43 USC 1331-1343).
11. The term "commerce" means trade, traffic, commerce, transportation, or communication between any State and any place outside thereof.
12. The term "industry or activity affecting commerce" means any activity, business, or industry in commerce or in which a labor dispute would hinder or obstruct commerce or the free flow of commerce, and includes any activity or industry "affecting commerce" within the meaning of the Labor Management Relations Act, 1947 [29 USCA 141 et seq.] or the Railway Labor Act [45 USCA 151 et seq.]
13. The term "Secretary" means the Secretary of Labor.
14. The term "party in interest" means, as to an employee benefit plan -

    Editor's Note: Also see " Disqualified Person" definition, Internal Revenue Code § 4975(e)(2) .

    A. Any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;
    B. A person providing services to such plan;
    C. An employer any of whose employees are covered by such plan;
    D. An employee organization any of whose members are covered by such plan;
    E. An owner, direct or indirect, of 50 percent or more of -

        i. The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.
        ii. The capital interest or the profits interest of a partnership, or
        iii. The beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

    F. A relative (as defined in paragraph (15)) of any individual described in subparagraph (A), (B), (C), or (E);
    G. A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of -

        i. The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,
        ii. The capital interest or profits interest of such partnership, or
        iii. The beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

    H. An employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or
    I. A 10 percent or more (directly or indirectly in capital or profits) partner or joint venture of a person described in subparagraph (B), (C), (D), (E), or (G).

    The Secretary, after consultation and coordination with the Secretary of the Treasury, may by regulation prescribe a percentage lower than 50 percent for subparagraph (E) and (G) and lower

than 10 percent for subparagraph (H) or (I). The Secretary may prescribe regulations for determining the ownership (direct or indirect) of profits and beneficial interests, and the manner in which indirect stock holdings are taken into account. Any person who is a party in interest with respect to a plan to which a trust described in section 501(c)(22) of Title 26 is permitted to make payments under section 1403 of this title shall be treated as a party in interest with respect to such trust.

15. The term "relative" means a spouse, ancestor, lineal descendant, or spouse of a lineal descendant.

    Editor's Note: Also see "Family Member" definition, Internal Revenue Code § 4975(e)(6) .

16. (A) The term "administrator" means -

    i. The person specifically so designated by the terms of the instrument under which the plan is operated;
    ii. If an administrator is not so designated, the plan sponsor; or
    iii. In the case of a plan for which an administrator is not designated and a plan sponsor cannot be identified, such other person as the Secretary may by regulation prescribe.

    (B) The term "plan sponsor" means -

    i. The employer in the case of an employee benefit plan established or maintained by a single employer,
    ii. The employee organization in the case of a plan established or maintained by an employee organization, or
    iii. In the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

17. The term "separate account" means an account established or maintained by an insurance company under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.
18. The term "adequate consideration" when used in part 4 of subtitle B of this subchapter means -

    A. In the case of a security for which there is a generally recognized market, either -

        i. The price of the security prevailing on a national securities exchange which is registered under section 78f of Title 15, or
        ii. If the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest; and

    B. In the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary.

19. The term "nonforfeitable" when used with respect to a pension benefit or right means a claim obtained by a participant or his beneficiary to that part of an immediate or deferred benefit under a pension plan which arises from the participant's service, which is unconditional, and which is legally enforceable against the plan. For purposes of this paragraph, a right to an accrued benefit derived from employer contributions shall not be treated as forfeitable merely because the plan contains a provision described in section 1053(a)(3) of this title.
20. The term "security" has the same meaning as such term has under section 77b(1) of Title 15.
21. (A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent -

    Editor's Note: Also see "Fiduciary" definition, Internal Revenue Code § 4975(e)(3) .

    i. He exercises any discretionary authority or discretionary control respecting management

of such plan or exercises any authority or control respecting management or disposition of its assets,

ii. He renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or

iii. He has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 1105(c)(1)(B) of this title.

(B) If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940 [15 USCA 80a-1 et seq.], such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this subchapter, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

22. The term "normal retirement benefit" means the greater of the early retirement benefit under the plan, or the benefit under the plan commencing at normal retirement age. The normal retirement benefit shall be determined without regard to -
    A. Medical benefits, and
    B. Disability benefits not in excess of the qualified disability benefit.

    For purposes of this paragraph, a qualified disability benefit is a disability benefit provided by a plan which does not exceed the benefit which would be provided for the participant if he separated from the service at normal retirement age. For purposes of this paragraph, the early retirement benefit under a plan shall be determined without regard to any benefit under the plan which the Secretary of the Treasury finds to be a benefit described in section 1054(b)(1)(G) of this title.

23. The term "accrued benefit" means -

    A. In the case of a defined benefit plan, the individual's accrued benefit determined under the plan and, except as provided in section 1054(c)(3) of this title, expressed in the form of an annual benefit commencing at normal retirement age, or
    B. In the case of a plan which is an individual account plan, the balance of the individual's account.

    The accrued benefit of an employee shall not be less than the amount determined under section 1054(c)(2)(B) of this title with respect to the employee's accumulated contribution.

24. The term "normal retirement age" means the earlier of -

    A. The time a plan participant attains normal retirement age under the plan, or
    B. The later of -

        i. The time a plan participant attains age 65, or
        ii. The 5th anniversary of the time a plan participant commenced participation in the plan.

25. The term "vested liabilities" means the present value of the immediate or deferred benefits available at normal retirement age for participants and their beneficiaries which are nonforfeitable.
26. The term "current value" means fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary (as defined in section 1102(a)(2) of this title) pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination.
27. The term "present value", with respect to a liability, means the value adjusted to reflect anticipated events. Such adjustments shall conform to such regulations as the Secretary of the Treasury may prescribe.
28. The term "normal service cost" or "normal cost" means the annual cost of future pension benefits and administrative expenses assigned, under an actuarial cost method, to years subsequent to a particular valuation date of a pension plan. The Secretary of the Treasury may prescribe regulations to carry out this paragraph.

29. The term "accrued liability" means the excess of the present value, as of a particular valuation date of a pension plan, of the projected future benefit costs and administrative expenses for all plan participants and beneficiaries over the present value of future contributions for the normal cost of all applicable plan participants and beneficiaries. The Secretary of the Treasury may prescribe regulations to carry out this paragraph.
30. The term "unfunded accrued liability" means the excess of the accrued liability, under an actuarial cost method which so provides, over the present value of the assets of a pension plan. The Secretary of the Treasury may prescribe regulations to carry out this paragraph.
31. The term "advance funding actuarial cost method" or "actuarial cost method" means a recognized actuarial technique utilized for establishing the amount and incidence of the annual actuarial cost of pension plan benefits and expenses. Acceptable actuarial cost methods shall include the accrued benefit cost method (unit credit method), the entry age normal cost method, the individual level premium cost method, the aggregate cost method, the attained age normal cost method, and the frozen initial liability cost method. The terminal funding cost method and the current funding (pay-as-you-go) cost method are not acceptable actuarial cost methods. The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods.
32. The term "governmental plan" means a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 [45 USCA 231 et seq.] applies, and which is financed by contributions required under that Act and any plan of an international organization which is exempt from taxation under the provisions of the International Organizations Immunities Act [22 USCA 288 et seq.].
33. (A) The term "church plan" means a plan established and maintained (to the extent required in clause (ii) of subparagraph (B)) for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501 of Title 26.

    (B) The term "church plan" does not include a plan -

    i. Which is established and maintained primarily for the benefit of employees (or their beneficiaries) of such church or convention or association of churches who are employed in connection with one or more unrelated trades or businesses (within the meaning of section 513 of Title 26), or
    ii. If less than substantially all of the individuals included in the plan are individuals described in subparagraph (A) or in clause (ii) of subparagraph (C) (or their beneficiaries).

    (C) For purposes of this paragraph -

    i. A plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches includes a plan maintained by an organization, whether a civil law corporation or otherwise, the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches, if such organization is controlled by or associated with a church or a convention or association of churches.
    ii. The term employee of a church or a convention or association of churches includes -

        I. A duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, regardless of the source of his compensation;
        II. An employee of an organization, whether a civil law corporation or otherwise, which is exempt from tax under section 501 of Title 26 and which is controlled by or associated with a church or a convention or association of churches; and
        III. An individual described in clause (v).

    iii. A church or a convention or association of churches which is exempt from tax under section 501 of Title 26 shall be deemed the employer of any individual included as an employee under clause (ii).
    iv. An organization, whether a civil law corporation or otherwise, is associated with a church or a convention or association of churches if it shares common religious bonds and convictions with that church or convention or association of churches.
    v. If an employee who is included in a church plan separates from the service of a church or a convention or association of churches or an organization, whether a civil law

corporation or otherwise, which is exempt from tax under section 501 of Title 26 and which is controlled by or associated with a church or a convention or association of churches, the church plan shall not fail to meet the requirements of this paragraph merely because the plan -

I. Retains the employee's accrued benefit or account for the payment of benefits to the employee or his beneficiaries pursuant to the terms of the plan; or
II. Receives contributions on the employee's behalf after the employee's separation from such service, but only for a period of 5 years after such separation, unless the employee is disabled (within the meaning of the disability provisions of the church plan or, if there are no such provisions in the church plan, within the meaning of section 72(m)(7) of Title 26) at the time of such separation from service.

(D) (i) If a plan established and maintained for its employees (or their beneficiaries) by a church or by a convention or association of churches which is exempt from tax under section 501 of Title 26 fails to meet one or more of the requirements of this paragraph and corrects its failure to meet such requirements within the correction period, the plan shall be deemed to meet the requirements of this paragraph for the year in which the correction was made and for all prior years.

ii. If a correction is not made within the correction period, the plan shall be deemed not to meet the requirements of this paragraph beginning with the date on which the earliest failure to meet one or more of such requirements occurred.
iii. For purposes of this subparagraph, the term "correction period" means -

I. The period ending 270 days after the date of mailing by the Secretary of the Treasury of a notice of default with respect to the plan's failure to meet one or more of the requirements of this paragraph; or
II. Any period set by a court of competent jurisdiction after a final determination that the plan fails to meet such requirements, or, if the court does not specify such period, any reasonable period determined by the Secretary of the Treasury on the basis of all the facts and circumstances, but in any event not less than 270 days after the determination has become final; or
III. Any additional period which the Secretary of the Treasury determines is reasonable or necessary for the correction of the default, whichever has the latest ending date.

34. The term "individual account plan" or "defined contribution plan" means a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.
35. The term "defined benefit plan" means a pension plan other than an individual account plan; except that a pension plan which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant -

A. For the purposes of section 1052 of this title, shall be treated as an individual account plan, and
B. For the purposes of paragraph (23) of this section and section 1054 of this title, shall be treated as an individual account plan to the extent benefits are based upon the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan.

36. The term "excess benefit plan" means a plan maintained by an employer solely for the purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits imposed by section 415 of Title 26 on plans to which that section applies, without regard to whether the plan is funded. To the extent that a separable part of a plan (as determined by the Secretary of Labor) maintained by an employer is maintained for such purpose, that part shall be treated as a separate plan which is an excess benefit plan.
37. (A) The term "multiemployer plan" means a plan -

i. To which more than one employer is required to contribute,
ii. Which is maintained pursuant to one or more collective bargaining

agreements between one or more employee organizations and more than one employer, and
   iii. Which satisfies such other requirements as the Secretary may prescribe by regulation.

B. For purposes of this paragraph, all trades or businesses (whether or not incorporated) which are under common control within the meaning of section 1301(b)(1) of this title are considered a single employer.
C. Notwithstanding subparagraph (A), a plan is a multiemployer plan on and after its termination date if the plan was a multiemployer plan under this paragraph for the plan year preceding its termination date.
D. For purposes of this subchapter, notwithstanding the preceding provisions of this paragraph, for any plan year which began before September 26, 1980, the term "multiemployer plan" means a plan described in this paragraph (37) as in effect immediately before such date.
E. Within one year after September 26, 1980, a multiemployer plan may irrevocably elect, pursuant to procedures established by the corporation and subject to the provisions of sections 1453(b) and (c) of this title, that the plan shall not be treated as a multiemployer plan for all purposes under this chapter or Title 26 if for each of the last 3 plan years ending prior to the effective date of the Multiemployer Pension Plan Amendments Act of 1980 -
   i. The plan was not a multiemployer plan because the plan was not a plan described in subparagraph (A)(iii) of this paragraph and section 414(f)(1)(C) of Title 26 (as such provisions were in effect on the day before September 26, 1980); and
   ii. The plan had been identified as a plan that was not a multiemployer plan in substantially all its filings with the corporation, the Secretary of Labor and the Secretary of the Treasury.
F. (i) For purposes of this title a qualified football coaches plan -
      I. Shall be treated as a multiemployer plan to the extent not inconsistent with the purposes of this subparagraph; and
      II. Notwithstanding section 401(k)(4)(B) of Title 26, may include a qualified cash and deferred arrangement.

   ii. For purposes of this subparagraph, the term "qualified football coaches plan" means any defined contribution plan which is established and maintained by an organization -

      I. Which is described in section 501(c) of Title 26;
      II. The membership of which consists entirely of individuals who primarily coach football as full-time employees of 4-year colleges or universities described in section 170(b)(1)(A)(ii) of Title 26; and
      III. Which was in existence on September 18, 1986.

38. The term "investment manager" means any fiduciary (other than a trustee or named fiduciary, as defined in section 1102(a)(2) of this title) -

   A. Who has the power to manage, acquire, or dispose of any asset of a plan;
   B. Who is -

      i. Registered as an investment adviser under the Investment Advisers Act of 1940 [15 USCA 80b-1 et seq.];
      ii. Is a bank, as defined in that Act; or
      iii. Is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and

   C. Has acknowledged in writing that he is a fiduciary with respect to the plan.

39. The terms "plan year" and "fiscal year of the plan" mean, with respect to a plan, the calendar, policy, or fiscal year on which the records of the plan are kept.
40. (A) The term "multiple employer welfare arrangement" means an employee welfare benefit plan, or any other arrangement (other than an employee welfare benefit plan), which is established or maintained for the purpose of offering or providing any benefit described in paragraph (1) to the employees of two or more employers (including one or more self-employed individuals), or to their beneficiaries, except that such term does not include any such plan or other arrangement which is established or maintained -

ii. Under or pursuant to one or more agreements which the Secretary finds to be collective bargaining agreements,
iii. By a rural electric cooperative, or
iv. By a rural telephone cooperative association.

B. For purposes of this paragraph -

i. Two or more trades or businesses, whether or not incorporated, shall be deemed a single employer if such trades or businesses are within the same control group,
ii. The term "control group" means a group of trades or businesses under common control,
iii. The determination of whether a trade or business is under "common control" with another trade or business shall be determined under regulations of the Secretary applying principles similar to the principles applied in determining whether employees of two or more trades or businesses are treated as employed by a single employer under section 1301(b) of this title, except that, for purposes of this paragraph, common control shall not be based on an interest of less than 25 percent,
iv. The term "rural electric cooperative" means -

I. Any organization which is exempt from tax under section 501(a) of Title 26 and which is engaged primarily in providing electric service on a mutual or cooperative basis, and
II. Any organization described in paragraph (4) or (6) of section 501(c) of Title 26 which is exempt from tax under section 501(a) of such Title 26 and at least 80 percent of the members of which are organizations described in subclause (I), and

v. The term "rural telephone cooperative association" means an organization described in paragraph (4) or (6) of section 501(c) of Title 26 which is exempt from tax under section 501(a) of such Title and at least 80 percent of the members of which are organizations engaged primarily in providing telephone service to rural areas of the United States on a mutual, cooperative, or other basis.

41. Single-employer plan. The term "single-employer plan" means an employee benefit plan other than a multiemployer plan.

1 The term "single employer plan" means a plan which is not a multiemployer plan.

Other Provisions Relating to Form and Payment of Benefits

[Excerpt] Pledging by Participant of Vested Interest - Prohibition

ERISA Section 206

(29 USC 1056)

In accordance with section 1056(d)(1)-(2) of this title:

* * *

(d) Assignment or alienation of plan benefits

1. Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated.
2. For the purposes of paragraph (1) of this subsection, there shall not be taken into account any voluntary and revocable assignment of not to exceed 10 percent of any benefit payment, or of any irrevocable assignment or alienation of benefits executed before September 2, 1974. The

preceding sentence shall not apply to any assignment or alienation made for the purposes of defraying plan administration costs. For purposes of this paragraph a loan made to a participant or beneficiary shall not be treated as an assignment or alienation if such loan is secured by the participant's accrued nonforfeitable benefit and is exempt from the tax imposed by section 4975 of Title 26 (relating to tax on prohibited transactions) by reason of section 4975(d)(1) of Title 26.

* * *

Coverage

ERISA Section 401

(29 USC 1101)

a. **This part shall apply to any employee benefit plan described in section 4(a) (and not exempted under section 4(b)), other than:**

   1. A plan which is unfunded and is maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees; or
   2. Any agreement described in section 736 of Title 26, which provides payments to a retired partner or deceased partner or a deceased partner's successor in interest.

b. **For purposes of this part:**

   1. In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940 [15 USCA 80a-1 et seq.], the assets of such plan shall be deemed to include such security but shall not, solely by reason of such investment, be deemed to include any assets of such investment company.
   2. In the case of a plan to which a guaranteed benefit policy is issued by an insurer, the assets of such plan shall be deemed to include such policy, but shall not, solely by reason of the issuance of such policy, be deemed to include any assets of such insurer. For purposes of this paragraph:

      A. The term "insurer" means an insurance company, insurance service, or insurance organization, qualified to do business in a State.
      B. The term "guaranteed benefit policy" means an insurance policy or contract to the extent that such policy or contact provides for benefits the amount of which is guaranteed by the insurer. Such term includes any surplus in a separate account, but excludes any other portion of a separate account.

Establishment of Plan

ERISA Section 402

(29 USC 1102)

a. **Named fiduciaries**

   1. Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan.
   2. For purposes of this subchapter, the term "named fiduciary" means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary -

      A. By a person who is an employer or employee organization with respect to the plan or
      B. By such an employer and such an employee organization acting jointly.

b. **Requisite features of plan. Every employee benefit plan shall -**

1. Provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and the requirements of this subchapter,
2. Describe any procedure under the plan for the allocation of responsibilities for the operation and administration of the plan (including any procedure described in section 1105(c)(1) of this title),
3. Provide a procedure for amending such plan, and for identifying the persons who have authority to amend the plan, and
4. Specify the basis on which payments are made to and from the plan.

c. **Optional features of plan. Any employee benefit plan may provide -**

    1. That any person or group of persons may serve in more than one fiduciary capacity with respect to the plan (including service both as trustee and administrator);
    2. That a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 1105(c)(1) of this title, may employ one or more persons to render advice with regard to any responsibility such fiduciary has under the plan; or
    3. That a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.

Establishment of Trust

ERISA Section 403

(29 USC 1103)

a. **Benefit plan assets to be held in trust; authority of trustees.**

    Except as provided in subsection (b) of this section, all assets of an employee benefit plan shall be held in trust by one or more trustees. Such trustee or trustees shall be either named in the trust instrument or in the plan instrument described in section 1102(a) of this title or appointed by a person who is a named fiduciary, and upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that -

    1. The plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this chapter, or
    2. Authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers pursuant to section 1102(c)(3) of this title.

b. **Exceptions. The requirements of subsection (a) of this section shall not apply -**

    1. To any assets of a plan which consist of insurance contracts or policies issued by an insurance company qualified to do business in a State;
    2. To any assets of such an insurance company or any assets of a plan which are held by such an insurance company;
    3. To a plan -

        A. Some or all of the participants of which are employees described in section 401(c)(1) of Title 26; or
        B. Which consists of one or more individual retirement accounts described in section 408 of Title 26; to the extent that such plan's assets are held in one or more custodial accounts which qualify under section 401(f) or 408(h) of Title 26, whichever is applicable.

    4. To a plan which the Secretary exempts from the requirement of subsection (a) of this section and which is not subject to any of the following provisions of this chapter -

        A. Part 2 of this subtitle,
        B. Part 3 of this subtitle, or

C. Subchapter III of this chapter; or

5. To a contract established and maintained under section 403(b) of Title 26 to the extent that the assets of the contract are held in one or more custodial accounts pursuant to section 403(b)(7) of Title 26.
6. Any plan, fund or program under which an employer, all of whose stock is directly or indirectly owned by employees, former employees or their beneficiaries, proposes through an unfunded arrangement to compensate retired employees for benefits which were forfeited by such employees under a pension plan maintained by a former employer prior to the date such pension plan became subject to this chapter.

c. Assets of plan not to inure to benefit of employer; allowable purposes of holding plan assets

1. Except as provided in paragraph (2), (3), or (4) or subsection (d) of this section, or under sections 1342 and 1344 of this title (relating to termination of insured plans), or under section 420 of Title 26 as in effect on January 1, 1995) the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.
2. (A)In the case of a contribution, or a payment of withdrawal liability under part 1 of subtitle E of subchapter III of this chapter -

    i. If such contribution or payment is made by an employer to a plan (other than a multiemployer plan) by a mistake of fact, paragraph (1) shall not prohibit the return of such contribution to the employer within one year after the payment of the contribution, and
    ii. If such contribution or payment is made by an employer to a multiemployer plan by a mistake of fact or law (other than a mistake relating to whether the plan is described in section 401(a) of Title 26 or the trust which is part of such plan is exempt from taxation under section 501(a) of Title 26), paragraph (1) shall not prohibit the return of such contribution or payment to the employer within 6 months after the plan administrator determines that the contribution was made by such a mistake.

    B. If a contribution is conditioned on initial qualification of the plan under section 401 or 403(a) of Title 26, and if the plan receives an adverse determination with respect to its initial qualification, then paragraph (1) shall not prohibit the return of such contribution to the employer within one year after such determination, but only if the application for the determination is made by the time prescribed by law for filing the employer's return for the taxable year in which such plan was adopted, or such later date as the Secretary of the Treasury may prescribe.
    C. If a contribution is conditioned upon the deductibility of the contribution under section 404 of Title 26, then, to the extent the deduction is disallowed, paragraph (1) shall not prohibit the return to the employer of such contribution (to the extent disallowed) within one year after the disallowance of the deduction.

3. In the case of a withdrawal liability payment which has been determined to be an overpayment, paragraph (1) shall not prohibit the return of such payment to the employer within 6 months after the date of such determination.
4. Redesignated (3).

d. Termination of plan.

1. Upon termination of a pension plan to which section 1321 of this title does not apply at the time of termination and to which this part applies (other than a plan to which no employer contributions have been made) the assets of the plan shall be allocated in accordance with the provisions of section 1344 of this title, except as otherwise provided in regulations of the Secretary.
2. The assets of a welfare plan which terminates shall be distributed in accordance with the terms of

the plan, except as otherwise provided in regulations of the Secretary.

Fiduciary Duties

ERISA Section 404

(29 USC 1104)

a. Prudent man standard of care.

1. Subject to sections 1103(c) and (d), 1342, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and -

    A. For the exclusive purpose of:

        i. Providing benefits to participants and their beneficiaries; and
        ii. Defraying reasonable expenses of administering the plan;

    B. With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
    C. By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
    D. In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter and subchapter III of this chapter.

2. In the case of an eligible individual account plan (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

b. Indicia of ownership of assets outside jurisdiction of district courts.

Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

c. Control over assets by participant or beneficiary.

In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over the assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) -

1. Such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and
2. No person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

d. Plan terminations.

1. If, in connection with the termination of a pension plan which is a single-employer plan, there is an election to establish or maintain a qualified replacement plan, or to increase benefits, as provided under section 4980(d) of Title 26, a fiduciary shall discharge the fiduciary's duties under this subchapter and subchapter III of this chapter in accordance with the following requirements:

    A. In the case of a fiduciary of the terminated plan, any requirement -

        i. Under section 4980(d)(2)(B) of Title 26 with respect to the

transfer of assets from the terminated plan to a qualified replacement plan, and
    ii. Under section 4980(d)(2)(B)(ii) or 4980(d)(3) of Title 26 with respect to any increase in benefits under the terminated plan.

B. In the case of a fiduciary of a qualified replacement plan, any requirement -

    i. Under section 4980(d)(2)(A) of Title 26 with respect to participation in the qualified replacement plan of active participants in the terminated plan,
    ii. Under section 4980(d)(2)(B) of Title 26 with respect to the receipt of assets from the terminated plan, and
    iii. Under section 4980(d)(2)(C) of Title 26 with respect to the allocation of assets to participants of the qualified replacement plan.

2. For purposes of this subsection -

    A. Any term used in this subsection which is also used in section 4980(d) of Title 26 shall have the same meaning as when used in such section, and
    B. Any reference in this subsection to Title 26 shall be a reference to Title 26 as in effect immediately after the enactment of the Omnibus Budget Reconciliation Act of 1990.

Co-Fiduciary Liability

ERISA Section 405

(29 USC 1105)

a. Circumstances giving rise to liability

In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

1. If he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
2. If, by his failure to comply with section 1104(a)(1) of this title in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
3. If he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

b. Assets held by two or more trustees.

1. Except as otherwise provided in subsection (d) of this section and in section 1103(a)(1) and (2) of this title, if the assets of a plan are held by two or more trustees -

    A. Each shall use reasonable care to prevent a co-trustee from committing a breach; and
    B. They shall jointly manage and control the assets of the plan, except that nothing in this subparagraph (B) shall preclude any agreement, authorized by the trust instrument, allocating specific responsibilities, obligations, or duties among trustees, in which event a trustee to whom certain responsibilities, obligations, or duties have not been allocated shall not be liable by reason of this subparagraph (B) either individually or as a trustee for any loss resulting to the plan arising from the acts or omissions on the part of another trustee to whom such responsibilities, obligations, or duties have been allocated.

2. Nothing in this subsection shall limit any liability that a fiduciary may have under subsection (a) of this section or any other provision of this part.
3. (A)In the case of a plan the assets of which are held in more than one trust, a trustee shall not be liable under paragraph (1) except with respect to an act or omission of a trustee of a trust of which he is a trustee.

   (B) No trustee shall be liable under this subsection for following instructions referred to in section 1103(a)(1) of this title.

c. Allocation of fiduciary responsibility; designated persons to carry out fiduciary responsibilities

1. The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.
2. If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that -

   A. The named fiduciary violated section 1104(a)(1) of this title -

      i. With respect to such allocation or designation,
      ii. With respect to the establishment or implementation of the procedure under paragraph (1), or
      iii. In continuing the allocation or designation; or

   B. The named fiduciary would otherwise be liable in accordance with subsection (a) of this section.

3. For purposes of this subsection, the term "trustee responsibility" means any responsibility provided in the plan's trust instrument (if any) to manage or control the assets of the plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with section 1102(c)(3) of this title.

d. Investment managers.

1. If an investment manager or managers have been appointed under section 1102(c)(3) of this title, then, notwithstanding subsections (a)(2) and (3) and subsection (b) of this section, no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.
2. Nothing in this subsection shall relieve any trustee of any liability under this part for any act of such trustee.

Prohibited Transactions

ERISA Section 406

(29 USC 1106)

Editor's Note: Also see Prohibited Transaction provisions of Internal Revenue Code § 4975(c)(1) .

a. Transactions between plan and party in interest. Except as provided in section 1108 of this title:

1. A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect -

   A. Sale or exchange, or leasing, of any property between the plan and a party in interest;
   B. Lending of money or other extension of credit between the plan and a party

in interest;
C. Furnishing of goods, services, or facilities between the plan and a party in interest;
D. Transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
E. Acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 1107(a) of this title.

2. No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 1107(a) of this title.

b. Transactions between plan and fiduciary. A fiduciary with respect to a plan shall not -

1. Deal with the assets of the plan in his own interest or for his own account,
2. In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
3. Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

c. **Transfer of real or personal property to plan by party in interest.**

A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year period ending on the date of the transfer.

10 Percent Limitation on Employer Securities and Employer Real Property

ERISA Section 407

(29 USC 1107)

a. Percentage limitation. Except as otherwise provided in this section and section 1114 of this title:

1. A plan may not acquire or hold -

   A. Any employer security which is not a qualifying employer security, or
   B. Any employer real property which is not qualifying employer real property.

Editor's Note: See DOL ERISA Regulation 2550.408e: Qualifying Employer Securities and Real Estate .

2. A plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan.
3. (A) After December 31, 1984, a plan may not hold any qualifying employer securities or qualifying employer real property (or both) to the extent that the aggregate fair market value of such securities and property determined on December 31, 1984, exceeds 10 percent of the greater of -

   i. The fair market value of the assets of the plan, determined on December 31, 1984, or
   ii. The fair market value of the assets of the plan determined on January 1, 1975.

   (B) Subparagraph (A) of this paragraph shall not apply to any plan which on any date after December 31, 1974; and before January 1, 1985, did not hold employer securities or employer real property (or both) the aggregate fair market value of which determined on such date exceeded 10 percent of the greater of -

   i. The fair market value of the assets of the plan, determined on such date, or

ii. The fair market value of the assets of the plan determined on January 1, 1975.

4. (A) After December 31, 1979, a plan may not hold any employer securities or employer real property in excess of the amount specified in regulations under subparagraph (B). This subparagraph shall not apply to a plan after the earliest date after December 31, 1974, on which it complies with such regulations.

   (B) Not later than December 31, 1976, the Secretary shall prescribe regulations which shall have the effect of requiring that a plan divest itself of 50 percent of the holdings of employer securities and employer real property which the plan would be required to divest before January 1, 1985, under paragraph (2) or subsection (c) of this section (whichever is applicable).

b. Exception

1. Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account plan.
2. Cross References.

   A. For exemption from diversification requirements for holding of qualifying employer securities and qualifying employer real property by eligible individual account plans, see section 1104(a)(2) of this title.
   B. For exemption from prohibited transactions for certain acquisitions of qualifying employer securities and qualifying employer real property which are not in violation of 10 percent limitation, see section 1108(e) of this title.
   C. For transitional rules respecting securities or real property subject to binding contracts in effect on June 30, 1974, see section 1114(c) of this title.

c. Election

1. A plan which makes the election, under paragraph (3) shall be treated as satisfying the requirement of subsection (a)(3) of this section if and only if employer securities held on any date after December 31, 1974 and before January 1, 1985 have a fair market value, determined as of December 31, 1974, not in excess of 10 percent of the lesser of -

   A. The fair market value of the assets of the plan determined on such date (disregarding any portion of the fair market value of employer securities which is attributable to appreciation of such securities after December 31, 1974) but not less than the fair market value of plan assets on January 1, 1975, or
   B. An amount equal to the sum of -

   i. The total amount of the contributions to the plan received after December 31, 1974, and prior to such date, plus
   ii. The fair market value of the assets of the plan, determined on January 1, 1975.

2. For purposes of this subsection, in the case of an employer security held by a plan after January 1, 1975, the ownership of which is derived from ownership of employer securities held by the plan on January 1, 1975, or from the exercise of rights derived from such ownership, the value of such security held after January 1, 1975, shall be based on the value as of January 1, 1975, of the security from which ownership was derived. The Secretary shall prescribe regulations to carry out this paragraph.
3. An election under this paragraph may not be made after December 31, 1975. Such an election shall be made in accordance with regulations prescribed by the Secretary, and shall be irrevocable. A plan may make an election under this paragraph only if on January 1, 1975, the plan holds no employer real property. After such election and before January 1, 1985 the plan may not acquire any employer real property.

d. Definitions.

For purposes of this section -

1. The term "employer security" means a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. A contract to which section 1108(b)(5) of this title applies shall not be treated as a security for purposes of this section.
2. The term "employer real property" means real property (and related personal property) which is leased to an employer of employees covered by the plan, or to an affiliate of such employer. For purposes of determining the time at which a plan acquires employer real property for purposes of this section, such property shall be deemed to be acquired by the plan on the date on which the plan acquires the property or on the date on which the lease to the employer (or affiliate) is entered into, whichever is later.
3. (A) The term "eligible individual account plan" means an individual account plan which is-

   i. A profit-sharing, stock bonus, thrift, or savings plan;
   ii. An employee stock ownership plan; or
   iii. A money purchase plan which was in existence on September 2, 1974, and which on such date invested primarily in qualifying employer securities. Such term excludes an individual retirement account or annuity described in section 408 of Title 26.

   (B) Notwithstanding subparagraph (A), a plan shall be treated as an eligible individual account plan with respect to the acquisition or holding of qualifying employer real property or qualifying employer securities only if such plan explicitly provides for acquisition and holding of qualifying employer securities or qualifying employer real property (as the case may be). In the case of a plan in existence on September 2, 1974, this subparagraph shall not take effect until January 1, 1976.

   (C) The term "eligible individual account plan" does not include any individual account plan the benefits of which are taken into account in determining the benefits payable to a participant under any defined benefit plan.

4. The term "qualifying employer real property" means parcels of employer real property -

   A. If a substantial number of the parcels are dispersed geographically;
   B. If each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use;
   C. Even if all of such real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and
   D. If the acquisition and retention of such property comply with the provisions of this part (other than section 1104(a)(1)(B) of this title to the extent it requires diversification, and sections 1104(a)(1)(C), 1106 of this title, and subsection (a) of this section).

5. The term "qualifying employer security" means an employer security which is -

   A. Stock,
   B. A marketable obligation (as defined in subsection (e)), or
   C. An interest in a publicly traded partnership (as defined in section 7704(b) of Title 26, but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue Act of 1987 (Public Law 100-203).

   After December 17, 1987, in the case of a plan other than an eligible individual account plan, an employer security described in subparagraph (A) or (C) shall be considered a qualifying employer security only if such employer security satisfies the requirements of subsection (f)(1) of this section.

6. The term "employee stock ownership plan" means an individual account plan -

   Editor's Note: Also see "ESOP" definition, Internal Revenue Code § 4975(e)(7) .

   A. Which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of Title 26, and which is designed to invest primarily in qualifying employer securities, and
   B. Which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.

7. A corporation is an affiliate of an employer if it is a member of any controlled group of corporations (as defined in section 1563(a) of Title 26, except that "applicable percentage" shall be substituted for "80 percent" wherever the latter percentage appears in such section) of which the employer who maintains the plan is a member. For purposes of the preceding sentence, the term "applicable percentage" means 50 percent, or such lower percentage as the Secretary may prescribe by regulation. A person other than a corporation shall be treated as an affiliate of an employer to the extent provided in regulations of the Secretary. An employer which is a person other than a corporation shall be treated as affiliated with another person to the extent provided by regulations of the Secretary. Regulations under this paragraph shall be prescribed only after consultation and coordination with the Secretary of the Treasury.
8. The Secretary may prescribe regulations specifying the extent to which conversions, splits, the exercise of rights, and similar transactions are not treated as acquisitions.
9. For purposes of this section, an arrangement which consists of a defined benefit plan and an individual account plan shall be treated as 1 plan if the benefits of such individual account plan are taken into account in determining the benefits payable under such defined benefit plan.

e. Marketable obligations. For purposes of subsection (d)(5) of this section, the term "marketable obligation" means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this subsection referred to as "obligation") if -

1. Such obligation is acquired -

   A. On the market, either -

      i. At the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or
      ii. If the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

   B. From an underwriter, at a price -

      i. Not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and
      ii. At which a substantial portion of the same issue is acquired by persons independent of the issuer; or

   C. Directly from the issuer, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

2. Immediately following acquisition of such obligation -

   A. Not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and
   B. At least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and

3. Immediately following acquisition of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.

f. Maximum percentage of stock held by plan; time of holding or acquisition; necessity of legally binding contract

1. Stock satisfies the requirements of this paragraph if, immediately following the acquisition of such stock -

   A. No more than 25 percent of the aggregate amount of stock of the same class issued and outstanding at the time of acquisition is held by the plan,

and

B. At least 50 percent of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer.

2. Until January 1, 1993, a plan shall not be treated as violating subsection (a) of this section solely by holding stock which fails to satisfy the requirements of paragraph (1) if such stock -

   A. Has been so held since December 17, 1987, or
   B. Was acquired after December 17, 1987, pursuant to a legally binding contract in effect on December 17, 1987, and has been so held at all times after the acquisition.

3. After December 17, 1987, no plan may acquire stock which does not satisfy the requirements of paragraph (1) unless the acquisition is made pursuant to a legally binding contract in effect on such date.

Statutory Exemption from Prohibited Transactions

ERISA Section 408

(29 USC 1108)

a. **Grant of exemptions.**
The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any fiduciary or transaction, or class of fiduciaries or transactions, from all or part of the restrictions imposed by sections 1106 and 1107(a) of this title. Action under this subsection may be taken only after consultation and coordination with the Secretary of the Treasury. An exemption granted under this section shall not relieve a fiduciary from any other applicable provision of this chapter. The Secretary may not grant an exemption under this subsection unless he finds that such exemption is -

   1. Administratively feasible,
   2. In the interest of the plan and of its participants and beneficiaries, and
   3. Protective of the rights of participants and beneficiaries of such plan.

   Editor's Note: See DOL Regulation 2570.30 through .52 , which replaced DOL ERISA Procedure 75-1.

Before granting an exemption under this subsection from section 1106(a) or 1107(a) of this title, the Secretary shall publish notice in the Federal Register of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons opportunity to present views. The Secretary may not grant an exemption under this subsection from section 1106(b) of this title unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2), and (3) of this subsection.

b. **Enumeration of transactions exempted from section 1106 prohibitions. The prohibitions provided in section 1106 of this title shall not apply to any of the following transactions:**

   1. Any loans made by the plan to parties in interest who are participants or beneficiaries of the plan if such loans -

   Editor's Note: Also see participant loan provisions of Internal Revenue Code § 4975(d)(1) and DOL Regulation 2550.408b-1 .

      A. Are available to all such participants and beneficiaries on a reasonably equivalent basis,
      B. Are not made available to highly compensated employees (within the meaning of section 414(q) of Title 26), in an amount greater than the amount made available to other employees,
      C. Are made in accordance with specific provisions regarding such loans set forth in the plan,

  D. Bear a reasonable rate of interest, and
  E. Are adequately secured.

2. Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore.

   Editor's Note: Also see ancillary services provisions of Internal Revenue Code § 4975(d)(2) .

3. A loan to an employee stock ownership plan (as defined in section 1107(d)(6) of this title), if -

   Editor's Note: Also see ESOP loan provisions of Internal Revenue Code § 4975(d)(3) .

   A. Such loan is primarily for the benefit of participants and beneficiaries of the plan, and
   B. Such loan is at an interest rate which is not in excess of a reasonable rate.

   If the plan gives collateral to a party in interest for such loan, such collateral may consist only of qualifying employer securities (as defined in section 1107(d)(5) of this title).

4. The investment of all or part of a plan's assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if -

   Editor's Note: Also see deposit provisions of Internal Revenue Code § 4975(d)(4) .

   A. The plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or
   B. Such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliate thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment.

5. Any contract for life insurance, health insurance, or annuities with one or more insurers which are qualified to do business in a State, if the plan pays no more than adequate consideration, and if each such insurer or insurers is -

   A. The employer maintaining the plan, or
   B. A party in interest which is wholly owned (directly or indirectly) by the employer maintaining the plan, or by any person which is a party in interest with respect to the plan, but only if the total premiums and annuity considerations written by such insurers for life insurance, health insurance, or annuities for all plans (and their employers) with respect to which such insurers are parties in interest (not including premiums or annuity considerations written by the employer maintaining the plan) do not exceed 5 percent of the total premiums and annuity considerations written for all lines of insurance in that year by such insurers (not including premiums or annuity considerations written by the employer maintaining the plan).

6. The providing of an ancillary service by a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan, and if -

   Editor's Note: Also see bank ancillary services provisions of Internal Revenue Code § 4975(d)(6) .

   A. Such bank or similar financial institution has adopted adequate internal safeguards which assure that the providing of such ancillary service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority, and
   B. The extent to which such ancillary service is provided is subject to specific guidelines issued by such bank or similar financial institution (as determined by the Secretary after consultation with Federal and State supervisory authority), and adherence to such guidelines would reasonably

preclude such bank or similar financial institution from providing such ancillary service -

i. In an excessive or unreasonable manner, and
ii. In a manner that would be inconsistent with the best interests of participants and beneficiaries of employee benefit plans.

Such ancillary services shall not be provided at more than reasonable compensation.

7. The exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary, but only if the plan receives no less than adequate consideration pursuant to such conversion.
8. Any transaction between a plan and -

i. A common or collective trust fund or pooled investment fund maintained by a party in interest which is a bank or trust company supervised by a State or Federal agency or
ii. A pooled investment fund of an insurance company qualified to do business in a State, if -

Editor's Note: Also see collective investment fund provisions of Internal Revenue Code § 4975(d)(8) .

A. The transaction is a sale or purchase of an interest in the fund,
B. The bank, trust company, or insurance company receives not more than reasonable compensation, and
C. Such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank, trust company, or insurance company, or an affiliate thereof) who has authority to manage and control the assets of the plan.

9. The making by a fiduciary of a distribution of the assets of the plan in accordance with the terms of the plan if such assets are distributed in the same manner as provided under section 1344 of this title (relating to allocation of assets).
10. Any transaction required or permitted under part 1 of subtitle E of subchapter III of this chapter.
11. A merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 1411 of this title.
12. The sale by a plan to a party in interest on or after December 18, 1987, of any stock, if -

A. The requirements of paragraphs (1) and (2) of subsection (e) of this section are met with respect to such stock,
B. On the later of the date on which the stock was acquired by the plan, or January 1, 1975, such stock constituted a qualifying employer security (as defined in section 1107(d)(5) of this title as then in effect), and
C. Such stock does not constitute a qualifying employer security (as defined in section 1107(d)(5) of this title as in effect at the time of the sale).

13. Any transfer in a taxable year beginning before January 1, 2001, of excess pension assets from a defined benefit plan to a retiree health account in a qualified transfer permitted under section 420 of Title 26 (as in effect on January 1, 1996).

c. Fiduciary benefits and compensation not prohibited by section 1106. Nothing in section 1106 of this title shall be construed to prohibit any fiduciary from -

1. Receiving any benefit to which he may be entitled as a participant or beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries;
2. Receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan; except that no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan, or from an employee organization whose members are participants in such plan shall receive compensation from such plan, except for reimbursement of expenses properly and actually incurred; or

3. Serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

d. Owner-employees; family members; shareholder employees. Section 1107(b) of this title and subsections (b), (c), and (e) of this section shall not apply to any transaction in which a plan, directly or indirectly -

1. Lends any part of the corpus or income of the plan to;
2. Pays any compensation for personal services rendered to the plan to; or
3. Acquires for the plan any property from or sells any property to; any person who is with respect to the plan an owner-employee (as defined in section 401(c)(3) of Title 26), a member of the family (as defined in section 267(c)(4) of Title 26) of any such owner-employee, or a corporation controlled by any such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation. For purposes of this subsection a shareholder employee (as defined in section 1379 of Title 26 as in effect on the day before the date of the enactment of the Subchapter § Revision Act of 1982) and a participant or beneficiary of an individual retirement account or individual retirement annuity described in section 408 of Title 26 or a retirement bond described in section 409 of Title 26 (as effective for obligations issued before January 1, 1984) and an employer or association of employers which establishes such an account or annuity under section 408(c) of Title 26 shall be deemed to be an owner-employee.

e. Acquisition or sale by plan of qualifying employer securities; acquisition, sale, or lease by plan of qualifying employer real property.

Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 1107(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 1107(d)(4) of this title) -

1. If such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under section 1107(e)(1) of this title),
2. If no commission is charged with respect thereto, and
3. If -
   - A. The plan is an eligible individual account plan (as defined in section 1107(d)(3) of this title), or
   - B. In the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 1107(a) of this title.

f. Applicability of statutory prohibitions to mergers or transfers. Section 1106(b)(2) of this title shall not apply to any merger or transfer described in subsection (b)(11) of this section.

Liability for Breach of Fiduciary Duty

ERISA Section 409

(29 USC 1109)

a. Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this subchapter shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 1111 of this title.
b. No fiduciary shall be liable with respect to a breach of fiduciary duty under this subchapter if such breach was committed before he became a fiduciary or after he ceased to be a fiduciary.

Exculpatory Provisions; Insurance

ERISA Section 410

(29 USC 1110)

a. Except as provided in sections 1105(b)(1) and 1105(d) of this title, any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.
b. Nothing in this subpart shall preclude -
    1. A plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;
    2. A fiduciary from purchasing insurance to cover liability under this part from and for his own account; or
    3. An employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

Prohibition Against Certain Persons Holding Certain Positions

ERISA Section 411

(29 USC 1111)

a. Conviction or imprisonment. No person who has been convicted of, or has been imprisoned as a result of his conviction of, robbery, bribery, extortion, embezzlement, fraud, grand larceny, burglary, arson, a felony violation of Federal or State law involving substances defined in section 802(6) of Title 21, murder, rape, kidnapping, perjury, assault with intent to kill, any crime described in section 80a-9(a)(1) of Title 15, a violation of any provision of this chapter, a violation of section 186 of this title, a violation of chapter 63 of Title 18, a violation of section 874, 1027, 1503, 1505, 1506, 1510, 1951, or 1954 of Title 18, a violation of the Labor-Management Reporting and Disclosure Act of 1959 (29 USC 401), any felony involving abuse or misuse of such person's position or employment in a labor organization or employee benefit plan to seek or obtain an illegal gain at the expense of the members of the labor organization or the beneficiaries of the employee benefit plan, or conspiracy to commit any such crimes or attempt to commit any such crimes, or a crime in which any of the foregoing crimes is an element, shall serve or be permitted to serve -
    1. As an administrator, fiduciary, officer, trustee, custodian, counsel, agent, employee, or representative in any capacity of any employee benefit plan,
    2. As a consultant or adviser to an employee benefit plan, including but not limited to any entity whose activities are in whole or substantial part devoted to providing goods or services to any employee benefit plan, or
    3. In any capacity that involves decision making authority or custody or control of the moneys, funds, assets, or property of any employee benefit plan, during or for the period of thirteen years after such conviction or after the end of such imprisonment, whichever is later, unless the sentencing court on the motion of the person convicted sets a lesser period of at least three years after such conviction or after the end of such imprisonment, whichever is later, or unless prior to the end of such period, in the case of a person so convicted or imprisoned -
        A. His citizenship rights, having been revoked as a result of such conviction, have been fully restored, or
        B. If the offense is a Federal offense, the sentencing judge or, if the offense is a State or local offense, the United States district court for the district in which the offense was committed, pursuant to sentencing guidelines and policy statements under section 994(a) of Title 28, determines that such person's service in any capacity referred to in paragraphs (1) through (3) would not be contrary to the purposes of this subchapter. Prior to making

any such determination the court shall hold a hearing and shall give notice to such proceeding by certified mail to the Secretary of Labor and to State, county, and Federal prosecuting officials in the jurisdiction or jurisdictions in which such person was convicted. The court's determination in any such proceeding shall be final. No person shall knowingly hire, retain, employ, or otherwise place any other person to serve in any capacity in violation of this subsection.

Notwithstanding the preceding provisions of this subsection, no corporation or partnership will be precluded from acting as an administrator, fiduciary, officer, trustee, custodian, counsel, agent, or employee of any employee benefit plan or as a consultant to any employee benefit plan without a notice, hearing, and determination by such court that such service would be inconsistent with the intention of this section.

b. Penalty. Any person who intentionally violates this section shall be fined not more than $10,000 or imprisoned for not more than five years, or both.
c. Definitions. For the purpose of this section -

    1. A person shall be deemed to have been "convicted" and under the disability of "conviction" from the date of the judgment of the trial court, regardless of whether that judgment remains under appeal.
    2. The term "consultant" means any person who, for compensation, advises, or represents an employee benefit plan or who provides other assistance to such plan, concerning the establishment or operation of such plan.
    3. A period of parole or supervised release shall not be considered as part of a period of imprisonment.

d. Payment of salary into escrow. Whenever any person -

    1. By operation of this section, has been barred from office or other position in an employee benefit plan as a result of a conviction, and
    2. Has filed an appeal of that conviction,

any salary which would be otherwise due such person by virtue of such office or position, shall be placed in escrow by the individual or organization responsible for payment of such salary. Payment of such salary into escrow shall continue for the duration of the appeal or for the period of time during which such salary would be otherwise due, whichever period is shorter. Upon the final reversal of such person's conviction on appeal, the amounts in escrow shall be paid to such person. Upon the final sustaining of that person's conviction on appeal, the amounts in escrow shall be returned to the individual or organization responsible for payments of those amounts. Upon final reversal of such person's conviction, such person shall no longer be barred by this statute from assuming any position from which such person was previously barred.

Bonding of Fiduciaries

ERISA Section 412

(29 USC 1112)

a. Requisite bonding of plan officials. Every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan (hereafter in this section referred to as "plan official") shall be bonded as provided in this section; except that -

    1. Where such plan is one under which the only assets from which benefits are paid are the general assets of a union or of an employer, the administrator, officers, and employees of such plan shall be exempt from the bonding requirements of this section, and
    2. No bond shall be required of a fiduciary (or of any director, officer, or employee of such fiduciary) if such fiduciary -

        A. Is a corporation organized and doing business under the laws of the United States or of any State;and
        B. Is authorized under such laws to exercise trust powers or to conduct an

insurance business;and

C. Is subject to supervision or examination by Federal or State authority; and
D. Has at all times a combined capital and surplus in excess of such a minimum amount as may be established by regulations issued by the Secretary, which amount shall be at least $1,000,000. Paragraph (2) shall apply to a bank or other financial institution which is authorized to exercise trust powers and the deposits of which are not insured by the Federal Deposit Insurance Corporation, only if such bank or institution meets bonding or similar requirements under State law which the Secretary determines are at least equivalent to those imposed on banks by Federal law; or
E. Is registered as a broker or dealer under Section 15(b) of the Securities Exchange Act of 1934 if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization.

The amount of such bond shall be fixed at the beginning of each fiscal year of the plan. Such amount shall be not less than 10 per centum of the amount of funds handled. In no case shall such bond be less than $1,000 nor more than $500,000, except in the case of a plan that holds employer securities, in which case the maximum amount of such bond shall be $1,000,000. The Secretary, however, after due notice and opportunity for hearing to all interested parties, and after consideration of the record, may prescribe an amount in excess of $500,000, subject to the 10 per centum limitation of the preceding sentence. For purposes of fixing the amount of such bond, the amount of funds handled shall be determined by the funds handled by the person, group, or class to be covered by such bond and by their predecessor or predecessors, if any, during the preceding reporting year, or if the plan has no preceding reporting year, the amount of funds to be handled during the current reporting year by such person, group, or class, estimated as provided in regulations of the Secretary. Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of the plan official, directly or through connivance with others. Any bond shall have as surety thereon a corporate surety company which is an acceptable surety on Federal bonds under authority granted by the Secretary of the Treasury pursuant to sections 9304-9308 of Title 31. Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule of blanket forms of bonds which cover a group or class.

b. Unlawful acts. It shall be unlawful for any plan official to whom subsection (a) of this section applies, to receive, handle, disburse, or otherwise exercise custody or control of any of the funds or other property of any employee benefit plan, without being bonded as required by subsection (a) of this section and it shall be unlawful for any plan official of such plan, or any other person having authority to direct the performance of such functions, to permit such functions, or any of them, to be performed by any plan official, with respect to whom the requirements of subsection (a) of this section have not been met.
c. Conflict of interest prohibited in procuring bonds. It shall be unlawful for any person to procure any bond required by subsection (a) of this section from any surety or other company or through any agent or broker in whose business operations such plan or any party in interest in such plan has any control or significant financial interest, direct or indirect.
d. Exclusiveness of statutory basis for bonding requirement for persons handling funds or other property of employee benefit plans.

Nothing in any other provision of law shall require any person, required to be bonded as provided in subsection (a) of this section because he handles funds or other property of an employee benefit plan, to be bonded insofar as the handling by such person of the funds or other property of such plan is concerned.

e. Regulations. The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section including exempting a plan from the requirements of this section where he finds that -

1. Other bonding arrangements or
2. The overall financial condition of the plan would be adequate to protect the interests of the beneficiaries and participants.

When, in the opinion of the Secretary, the administrator of a plan offers adequate evidence of the financial responsibility of the plan, or that other bonding arrangements would provide adequate protection of the beneficiaries and participants, he may exempt such plan from the requirements

of this section.

Limitation on Actions

ERISA SECTION 413

(29 USC 1113)

No action may be commenced under this subchapter with respect to a fiduciary's breach of any responsibility, duty, or obligation under this part, or with respect to a violation of this part, after the earlier of -

1. Six years after (A) the date of the last action which constituted a part of the breach or violation, or (B) in the case of an omission, the latest date on which the fiduciary could have cured the breach or violation, or
2. Three years after the earliest date on which the plaintiff had actual knowledge of the breach or violation;

except that in the case of fraud or concealment, such action may be commenced not later than six years after the date of discovery of such breach or violation.

Civil Enforcement

ERISA SECTION 502

(29 USC 1132)

* * *

(i) Administrative assessment of civil penalty. In the case of a transaction prohibited by section 406 (29 USC 1106) by a party in interest with respect to a plan to which this part applies, the Secretary may assess a civil penalty against such party in interest. The amount of such penalty may not exceed 10 percent of the amount involved in each such transaction (as defined in section 4975(f)(4) of the Internal Revenue Code, amended as of 1997) for each year or part thereof during which the prohibited transaction continues, except that, if the transaction is not corrected (in such manner as the Secretary shall prescribe in regulations which shall be consistent with section 4975(f)(5) of such Code within 90 days after notice from the Secretary (or such longer period as the Secretary may permit), such penalty may be in an amount not more than 100 percent of the amount involved. This subsection shall not apply to a transaction with respect to a plan described in section 4975(e)(1) of such Code.

* * *

(l) (1) Civil penalties on violations by fiduciaries. In the case of -

A. Any breach of fiduciary responsibility under (or any violation of) part 4 by a fiduciary, or
B. Any knowing participation in such breach or violation by any other person,

the Secretary shall assess a civil penalty against such fiduciary or other person in an amount equal to 20 percent of the applicable recovery amount.

(2) For purposes of paragraph (l), the term "applicable recovery amount" means any amount which is recovered from a fiduciary or other person with respect to a breach or violation described in paragraph (1) -

A. Pursuant to any settlement agreement with the Secretary, or
B. Ordered by a court to be paid by such fiduciary or other person to a plan or its participants and beneficiaries in a judicial proceeding instituted by the Secretary under subsection (a)(2) or (a)(5).

(3) The Secretary may, in the Secretary's sole discretion, waive or reduce the amount of the penalty under paragraph (l) if the Secretary determines in writing that -

A. The fiduciary or other person acted reasonably and in good faith, or
B. It is reasonable to expect that the fiduciary or other person will not be able to restore all losses to the plan without severe financial hardship unless such waiver or reduction is granted.

(4) The penalty imposed on a fiduciary or other person under this subsection with respect to any transaction shall be reduced by the amount of any penalty or tax imposed on such fiduciary or other person with respect to such transaction under subsection (i) of this section and section 4975 of the Internal Revenue Code of 1986.

Cross-References Between ERISA and Equivalent Parts of Internal Revenue Section 4975

Material		**ERISA Section**	**IRC Section 4975**
Definitions:			
Employee Stock Ownership Plan (ESOP)	407(d)(6)	(e)(7)	
Fiduciary	3(21)	(e)(3)	
Party in Interest/Disqualified Person	3(14)	(e)(2)	
Relative/Family Member	3(15)	(e)(6)	
Prohibited Transaction		406	(c)(1)
Statutory Exemptions:			
Ancillary Services	408(b)(2)	(d)(2)	
Bank Ancillary Services	408(b)(6)	(d)(6)	
Collective Investment Funds	408(b)(8)	(d)(8)	
Deposits	408(b)(4)	(d)(4)	
ESOP Loans	408(b)(3)	(d)(3)	

Trust Examination Manual

Appendix E — Employee Benefit Law

E R I S A

Section-by-Section Interpretations

Regulations, Advisory Opinions, Court Cases, Opinion Letters,

and Class Exemptions

Abbreviations Used

AO Advisory Opinion (Department of Labor)

DOL Department of Labor

ERISA Employee Retirement Security Act of 1974

FR Federal Register

PTE Prohibited Transaction Exemption

PLR Private Letter Ruling

WPPDA Welfare and Pension Plans Disclosure Act

WSB Washington Service Bureau

10-27-94

Definitions ERISA Section 3

ERISA Section 3(14) **"Party in Interest"**	
The term "party in interest" means, as to an employee benefit plan -	
(A)	Any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;
(B)	A person providing services to such plan;
(C)	An employer any of whose employees are covered by such plan;
(D)	An employee organization any of whose members are covered by such plan;
(E)	An owner, direct or indirect, of 50% or more of -

	(i)	The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
	(ii)	The capital interest or the profits interest of a partnership, or
	(iii)	The beneficial interest of a trust or unincorporated enterprise, which is the employer or an employee organization described in subparagraph (C) or (D);
(F)	A relative (as defined in paragraph (15)) of any individual described in subparagraph (A), (B), (C), or (E);	
(G)	A corporation, partnership, or trust or estate of which (or in which) 50% or more of -	
	(i)	The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,
	(ii)	The capital interest or the profits interest of a partnership, or
	(iii)	The beneficial interest of a such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C) (D), or (E);
(H)	An employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors, or a 10% or more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or	
(I)	A 10% or more (directly or indirectly in capital or profits) partner or joint venture of a person described in subparagraph (B), (C), (D), (E) or (G). The Secretary, after consultation and coordination with the Secretary of the Treasury, may by regulation prescribe a percentage lower than 50%, for subparagraph (E) and (G) and lower than 10% for subparagraph (H) or (I). The Secretary may prescribe regulations for determining the ownership (direct or indirect) of profits and beneficial interests, and the manner in which indirect stock holdings are taken into account. Any person who is a party in interest with respect to a plan to which a trust described in Section 501(c)(22) of the Internal Revenue Code of 1954 is permitted to make payments under Section 4223 shall be treated as a party in interest with respect to such trust.	

A. Conference Report

See the discussion of the term "*party in interest*" at page 323 of the Congressional Conference Report.

B. Prohibited Transaction Class Exemptions (PTE)

1. [Plans] Two or more multi-employer plans or multiple employer plans are not parties in interest or disqualified persons with respect to each other merely because they are maintained by the same plan sponsors. However, a multi-employer plan or a multiple employer plan may be a party in interest or a disqualified person with respect to another multiemployer plan or multiple employer plan for other reasons (for example, one plan providing services to another). Final PTE 76-1; AO 77-47.

C. Advisory Opinions

1. [Affiliates] A corporation 50% or more of which is owned by a more than 50% shareholder of the employer maintaining the plan is a party in interest. *Proposed* PTE I-492.
2. [Banks] A savings and loan association is not a party in interest merely because plan assets are held on deposit. AO 77-11; AO 79-10.
3. [Broker-Dealers] Broker-dealers who execute securities transactions for plans are parties in interest. AO 76-76.
4. [Custodians] Custodians of plan assets are parties in interest. AO 76-76; PLR 7907091.
5. [Employer] Employers are parties in interest. WSB 77-14; PLR 7847034. Directors of an employer are parties in interest. WSB 77-14. An employer council is a party in interest because it acts on behalf of employers. AO 76-103.
6. [Employer] An employer of employees covered by the plan is a party in interest pursuant to ERISA Section 3(14)(C) even if it is merely an affiliate or subsidiary of the employer plan sponsor. Thus, absent a statutory or administrative exemption, the exchange of common stock for preferred stock and the cancellation of a note in connection therewith as a transaction

between the affiliate corporation and the plan would constitute a prohibited transaction under Section 406(a)(1)(A). AO 81-34A.

7. [Insurance Companies] Insurance companies are not parties in interest merely because they issue group insurance policies to plans. AO 76-36.
8. [Mergers & Acquisitions] A corporation proposes to acquire all of an unrelated third party's assets. In connection therewith, the, acquiring corporation will not assume, adopt or maintain the existing plan of the corporation to be acquired. The acquiring corporation desires to purchase or lease a building owned by the plan. Certain employees of the acquired corporation will become employees of the acquiring corporation. The term party in interest includes in Subsection (c) an employer any of whose employees are covered by the plan. However, the definition of an employer under Section 3(14)(C) must be viewed in light of the overall statutory framework of ERISA, including Section 3(5). That section provides in relevant part that the term "employer" means any person acting directly as an employer or indirectly in the interest of an employer in relation to an employee benefit plan. Since the acquiring corporation had no relationship with the plan in the past and will not assume, maintain or adopt the plan or its accompanying trust after the acquisition, that entity is not a Section 3(14)(C) "party in interest" to the plan upon its acquisition of substantially all of the plan sponsor's assets. Advisory Opinion 81-78A.
9. [Ownership] A person is not a 50% owner of a corporation or partnership under Section 3(14)(G) if such 50% ownership interest will not be acquired until sometime in the future. AO 75-147; AO 77-83.
10. [Partners] Section 3(14)(I) applies only to 10% partners in a party in interest, not 10% partners with a party in interest in a partnership that is not itself a party in interest. AO 75-147; AO 77-83.
11. [Relatives] Relatives are parties in interest. AO 75-137.
12. [Service Providers] Service providers are parties in interest even if they receive no compensation from the plan. WSB 78-17. However, a person who only provides services to the employer before the plan is established is not a party in interest. AO 76-65.
13. [Trustees] Trustees of a plan and employees of a trustee are parties in interest. AO 77-84.
14. [Unions] Unions are parties in interest. AO 76-91; WSB 78-25. Employees of a union are parties in interest. AO 76-91. However, the mere fact that union officers are also directors and employees of a corporation does not make such corporation a party in interest. AO 76-120.

D. Court Decisions

1. Trustees of a pension or welfare plan are parties in interest to the plan under Section 3(14)(A). Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y. 1977), aff'd in part, 572 F.2d 894 (2d Cir. 1978).
2. Trustees and fiduciaries of employee benefit plans are parties in interest within the meaning of ERISA Section 3(14)(A). Donovan v. Bryans, 566 F. Supp. 1258, 4 EBC 1772 (E.D.Pa. 1983). A party in interest as defined by ERISA Section 3(14) includes any fiduciary and any employer of employees covered by an employee benefit plan. Brock v. Gilliken, 677 F. Supp. 398, 9 EBC 1803 (E.D.N.Y. 1987).
3. In an action by terminated employee claiming applicability of retroactive amendment in employee stock ownership plan, under ERISA Section 3(14) a party in interest includes the employer and its officers, directors and major stockholders. Allen v. The Katz Agency, Inc. Employee Stock Ownership Plan, 677 F.2d 193, 3 EBC 1352 (2d Cir. 1982).
4. A construction company is deemed a party in interest under Section 3(14)(G) when its sole stock owner and president is the trustee of an employee benefit plan and the company receives loans from such plan. Brock v. Gilliken, 677 F. Supp. 398, 9 EBC 1803 (E.D.N.Y. 1987).
5. A law firm that receives excessive amounts of money in relationship to services rendered by the firm and benefits received by the members of the represented employee welfare plan is treated as a party in interest in an action alleging the trustees breached their fiduciary duties by overpaying the law firm. Benvenuto v. Schneider 678 F. Supp. 51, 9 EBC 1528 (E.D.N.Y. 1988).

Section 3(15) **"Relative"**
The term "relative" means a spouse, ancestor, lineal descendant, or spouse of a lineal descendant.

A. Conference Report

The Congressional Conference Report does not discuss the term "relative."

B. Advisory Opinions

1. The brother of a fiduciary is not a relative under Section 3(15) and, therefore, is not a party in interest under Section 3(14)(F). AO 77-05.

Section 3(18) **"Adequate Consideration"**
The term "adequate consideration" when used in part 4 of subtitle B means:
In the case of a security for which there is a generally recognized market, either
The price of the security prevailing on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, or
If the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest; and
In the case of an asset other than a security for which there is a generally recognized market, the market value of the asset as determined in good faith by the trustee or named fiduciary, pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary [of Labor].

A. Conference Report

The Congressional Conference Report does not discuss the definition of the term "adequate consideration."

B. Regulations

DOL ERISA Regulation 2510.3-18(b) was proposed in 1988 but has not yet been adopted. It provided guidance on how thinly-traded securities should be valued.

C. Advisory Opinions

1. In the absence of regulations under Section 3(18), securities for which there is no generally recognized market should be valued by the trustees or other appropriate plan fiduciary by making a good faith determination of the fair market value of the securities, utilizing recognized methods of determining value. AO 75-141; AO 76-16.
2. If securities are publicly traded in the over-the-counter market and if there are current bid and asked prices quoted by persons independent of the issuer and of any party in interest, a plan may not purchase a controlling block of stock at a price greater than such current bid and asked prices. AO 76-52.
3. Reliance by a plan trustee on a ruling received from the IRS that a method of determining the fair market value of book value shares constitutes a reasonable method of determining fair market value for purposes of Treasury Regulation 1.421-7(e)(2) would be considered evidence that the trustee's determination of fair market value was made in good faith for purposes of Section 3(18)(B). AO 77-35.

D. Court Decisions

1. [ESOP - Stock Valuation] Where an ESOP purchases securities from a sponsoring company that does not have a generally recognized market, adequate consideration as defined in ERISA requires the trustee to exercise objective good faith by prudently using sound business principles of evaluation for the sole benefit of the employees' plan. Trustees who relied on appraisals that were 13 and 20 months old did not exercise good faith and sound business principles, and the amount paid for the securities purchased by the plan was more than adequate consideration. Donovan v. Cunningham, 716 F.2d 1455, 4 EBC 2329 (5th Cir. 1983).
2. Adequate consideration is the price for the stock quoted on the American Stock Exchange. The

fact that a sale of the stock over a longer period of time might have resulted in a higher return or that a premium might have been obtained for the sale of a large block need not be taken into account. Leonard v. Drug Fair, Inc., No. 78-1335, Fed. Sec. L. Rep. (CCH) 97,144 (D.D.C. 1979).

Section 3(21) "Fiduciary"	
Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent	
(i)	He exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
(ii)	He renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or
(iii)	He has any discretionary authority or discretionary responsibility in the administration of such plan.
Such term includes any person designated under section 405(c)(1)(B).	

A. Conference Report

See the discussion of the term "fiduciary" at page 323 of the Congressional Conference Report.

B. Regulations

1. Refer to DOL Regulation 2510.3-21 and IRS Regulation 54.4975-9.
2. The regulation clarifies the applicability of the definition fiduciary to persons who provide investment advice to plans and to securities brokers and dealers who execute securities transactions for plans. DOL Regulation 2510.3-21(c)-(e).
3. A person is a fiduciary only to the extent of his or her fiduciary responsibilities to a plan. DOL Regulation 2510.3-21(c)(2), (d)(2).
4. As a general matter, a person (e.g., a securities broker) is not a fiduciary to a plan if he or she does not know, and has no reason to know, that he or she is acting for a plan. Preamble to DOL Regulation 2510.3-21(c)-(e).
5. A fee or other compensation, direct or indirect, for the rendering of investment advice to a plan, within the meaning of Section 3(21)(A)(ii), should be deemed to include all fees or other compensation incident to the transaction in which the investment advice to the plan has been rendered or will be rendered. This may include, for example, brokerage commissions, mutual fund sales commissions and insurance sales commissions. Preamble to DOL ERISA Regulation 2510.3-21(c)-(e).
6. Depending on the facts and circumstances, a sales presentation and recommendations made to a plan fiduciary by an insurance agent or broker, pension consultant or mutual fund principal underwriter in connection with insurance or annuity contracts or mutual funds may constitute investment advice under Section 3(21). Preamble to DOL ERISA Regulation 2510.3-21(c)-(e).
7. A person who exercises discretion in the administration of a plan by making final decisions on appeals from claim denials is a fiduciary to the plan under Section 3(21)(A)(iii) even if the plan documents fail to state do the person is a named fiduciary or merely a fiduciary. Preamble to DOL ERISA Regulation 2560.503-1 (Claims Procedure).

C. Interpretive Bulletins

1. [Trustees] A plan trustee and a plan administrator are plan fiduciaries because of the nature of their functions for a plan. IB 75-8, Question D-3.
2. People who perform purely ministerial functions for a plan within a framework of policies, interpretations, rules, practices and procedures made by others are not fiduciaries under Section 3(21). IB 75-8, Question D-2. This question contains examples of purely ministerial

functions.

3. An officer, director, or employee of an employer maintaining a plan will not be a fiduciary for the plan, unless he or she has or exercises any of the authority, responsibility or control described in Section 3(21)(A) or provides investment advice to the plan for a fee or other compensation. IB 75-8, Questions D-4 and D-5.
4. An attorney, accountant, actuary, or consultant for a plan who neither exercises nor has any of the responsibilities, authority or control described in Section 3(21)(A), and who does not provide investment advice to the plan for a fee or other compensation, is not a fiduciary to the plan under Section 3(21). IB 75-5, Question D-1.
5. A person who merely calculates the amount of benefits to which a participant is entitled in accordance with a formula contained in a plan document is not a fiduciary under Section 3(21). However, a person who has the final authority to authorize or disallow claims for benefits based on an interpretation of plan provisions relating to eligibility for benefits would be a fiduciary under Section 3(21). IB 75-8, Question D-3.

D. Prohibited Transaction Class Exemptions (PTE)

1. [Broker-Dealers] Where a broker-dealer acts as an investment adviser in recommending securities transactions and a second fiduciary decides whether each such transaction should be entered into, the broker-dealer may be a fiduciary by reason of providing investment advice within the meaning of ERISA Section 3(21)(A)(ii) and Code Section 4975(e)(3)(B). However, since he or she would not have the power to manage, acquire, or dispose of plan assets without the approval of the second fiduciary, he or she would not be an investment manager as that term is defined in ERISA Section 3(38). Final PTE C 78-10.
2. [Investment Advisor] A person may be a fiduciary by reason of being an investment adviser even if such person does not exercise investment discretion as that term is defined by the Securities and Exchange Commission under Section 3(a)(35) of the Securities Exchange Act of 1934. Final PTE C 78-10.

E. Advisory Opinions

1. The term "*investment discretion*" is defined in Section 3(a)(35) of the Securities Exchange Act of 1934. In general, a person who exercises investment discretion for a plan under that definition would also be a fiduciary with respect to the plan as defined in Section 3(21) of ERISA and Section 4975(e)(3) of the Code. A person also would also be a fiduciary as the result of rendering investment advice for compensation to a plan. *Proposed* Extension of Paragraph I(a) of PTE C 75-1.
2. [Banks] The mere fact that a plan invests in a savings account or certificate of deposit of a savings and loan association does not make the association a plan fiduciary. AO 77-11; AO 79-10.
3. [**Custodians**] A custodian of plan assets who has no discretionary authority or control over the management of the plan or the disposition of the assets, and who does not provide investment advice to the plan, is not a fiduciary under Section 3(21)(A). PLR 7907091.
4. [Insurance Companies] An insurance company maintaining a separate account in which a plan invests is a fiduciary to the plan. *Proposed* PTE C 78-19.
5. [Investments] A partnership in which a plan has invested does not become a plan fiduciary merely by reason of such investment. WSB 78-17.
6. [Plan Committee Members] The individuals serving on one investment committee of a plan with responsibility for managing plan assets and appointing investment managers for the plan are fiduciaries under Section 3(21)(A). AO 76-15.
7. [Trust Department Staff] A person who merely makes a report to plan fiduciaries on a plan's asset management staff and serves on a committee that advises Plan fiduciaries on plan investment policies and objectives will not be a plan fiduciary under Section 3(21)(A) or ERISA Regulations Section 2510.3-21. AO 77-68.
8. The advice and recommendations made to plans and plan fiduciaries by insurance agents and brokers, pension consultants and mutual fund principal underwriters (or their employees) regarding plan purchases of insurance contacts or annuities or mutual fund shares constitutes advice as to the value of securities or other property or recommendations as to the advisability of investing in, purchasing or selling securities or other property and could constitute investment advice so as to classify the persons who furnish such advice as fiduciaries if it is rendered under certain circumstances. *Proposed* PTE C 77-9; WSB 79-99.

F. Court Decisions

1. [General] The definition of fiduciary under ERISA Section 3(21) is to be broadly construed. Thus, fiduciary should be defined not only by reference to particular titles, such as trustee, but also by considering the authority that a particular person has or exercises over an employee benefit plan. Donovan v. Mercer, 747 F.2d 304, 5 EBC 2512 (5th Cir. 1984).
2. [General] ERISA fiduciary status is determined by focusing on the function performed by the individual rather than on the individual's title; an accounting firm was a fiduciary to the extent that it controlled whether or not contributions were returned to plan participants. Blan v. Marshall and Lasserman, 812 F.2d 810, 8 EBC 1495 (2d Cir. 1987).
3. [General] Because the terms of an employee benefit plan conferred authority on defendants to exercise discretion in the management of the plan and its assets, the defendants were fiduciaries as defined by ERISA Section 3(21). Donovan v. Bryans, 566 F. Supp. 1258, 4 EBC 1772 (E.D.Pa. 1983).
4. [General] ERISA permits the named plan fiduciary the option of delegating the responsibility of investing plan assets to a professional investment adviser who then might assume the ERISA fiduciary obligations to the plan, including the duties of care and loyalty. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 8 EBC 2457 (2d Cir. 987).
5. [General] A fiduciary continues in his status as such absent any clear resignation or removal under permissible circumstances. Marshall v. Dekeyser, 485 F.Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
6. [General] ERISA Section 3(21)(A) limits the scope of both fiduciary status and responsibility; a person is a fiduciary with only for those aspects of the plan over which he or she exercises control or authority, and his or her fiduciary duty extends solely to those functions. Jury instructions should delineate the requisite control necessary to consider a person a fiduciary and warn jurors against drawing inferences of control or authority merely from a person's status, including status as a former employer, an officer, a principal shareholder or a director. Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enterprises, Inc., 793 F.2d 1456, 7 EBC 1782 (5th Cir. 1986), cert. denied, 479 U.S. 1089 (1987).
7. [General] Under ERISA Section 3(21), a person is a fiduciary to a plan to the extent that he or she has any discretionary authority or discretionary responsibility in the administration of such plan. A duty to report "difficulties" concerning borrowers interest payments includes authority, responsibility and discretion to determine what constitutes difficulties. One who is conferred such authority is a fiduciary as defined by ERISA Section 3(21). Davidson v. Cook, 567 F.Supp. 225, 4 EBC 1816 (E.D.Va. 1983), aff'd, 734 F.2d 10 (4th Cir. 1984).
8. [Attorneys] Attorneys who counsel a plan sponsor, members of a plan investment committee, and stockbrokers or dealers who recommend certain securities and then participate in the purchase or sale of the securities and receive a commission for their services, may be plan fiduciaries by reason of providing investment advice for a fee or other compensation. Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).
9. [Broker-Dealer] A stockbroker is a fiduciary as defined by ERISA when, without authorization, he invests the assets of an employee benefit plan in unsuitable, highly speculative securities and disregards the trustee's instructions to liquidate. Metzner v. D. H. Blair & Co., Inc., 663 F. Supp. 716, Fed. Sec. L. Rep. (CCH) 993,306, 8 EBC 2159 (S.D.N.Y. 1987).
10. [**Custodians**] A plan custodian can be a fiduciary, but only if the custodian possesses the requisite discretionary authority and discretionary control required by Section 3(21). The parenthetical language after "any fiduciary" in Section 3(14)(A) does not expand upon persons who are fiduciaries. A person is only a fiduciary under Section 3(14)(A) if such person is a fiduciary under Section 3(21). The Hibernia Bank v. International Brotherhood of Teamsters, Chauffeurs, Warehouseman and Helpers of America, 411 F.Supp. 478 (N.D.Cal. 1976).
11. [Insurance Agent] An insurance agent, who was solely responsible for formulating the specifications of an employee plan, represents himself as the administrator of the plan and subsequently gives investment advice regarding such plan, even though he was never formally appointed as plan administrator nor paid a fee for his services, is deemed a fiduciary as defined by Section 3(21)(A). Applying the agency theory of apparent authority, the insurance company, as the principal of the insurance agent, is designated a fiduciary as well. Miller v. Lay Trucking C&, Inc, 606 F. Supp 1326 (N.D.Ind. 1985).
12. [Insurance Companies] Congress did not want to make an insurance company that sells a standard annuity contract - one that provides "benefits the amount of which is guaranteed by the insurer" -- a fiduciary toward the contract's purchaser. However, where pension trustees did not buy an insurance contract with a fixed payment but turned over the assets of the pension plan to an insurance company to manage with full investment discretion, subject only to a modest income guarantee, that company was a fiduciary as defined in Section 3(21) of ERISA. Amato v.

Western Union International, Inc., 596 F. Supp. 963, 5 EBC 2718 (S.D.N.Y. 1984), aff'd in part and rev'd in part, 773 F.2d 1402 (2d Cir. 1985).

13. [Mergers & Acquisitions] An individual acted as a plan fiduciary when he recommended, designed, and implemented an amendment to a profit-sharing plan that changed the plan to an ESOP and required the plan to invest large sums of money in employer stock so as to enable the individual to acquire control of the employer. Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).
14. [Plan Administrator] By the very nature of his position, a plan administrator is a fiduciary to the plan. Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
15. [Plan Sponsor] Officers and directors of a plan sponsor are plan fiduciaries if they exercise control through the selection of the investment committee, administrative committee or plan officers or directors. Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978); Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
16. [Plan Sponsor] An employer, whose only control over the management of the employee welfare plan is its authority to appoint, retain and remove the plan's administrator, is only a fiduciary for these acts and not for any others. Independent Association of Publishers' Employees, Inc. v. Dow Jones & Co., Inc., 671 F Supp. 1365 (S.D.N.Y. 1987).
17. [Plan Sponsor] An employer is a fiduciary to a plan only when and to the extent that it engages in activities governed by ERISA, including acing in the capacity of plan administrator. Amato v. Western Union International, Inc., 773 F.2d 1402, 6 EBC 2226 (2d Cir. 1985), cert. dismissed, 474 U.S. 1113 (1986). Contra Ashenbaugh v. Crucible, Inc., 854 F.2d 1516, 9 EBC 2560 (3d Cir. 1988).
18. [Plan Sponsor] An employer that is also a plan administrator of a plan has assumed two distinct statuses. ERISA's fiduciary duty attaches when the employer/administrator performs the function of a plan administrator but not when it acts in the capacity of an employer. When renegotiating a welfare benefit plan or benefits not vesting under ERISA the employer/administrator is acting in its employer capacity and, thus, can breach no ERISA fiduciary duty, because such fiduciary obligations do not attach to employer functions. United Independent Flight Officers, Inc. v. United Air Lines, Inc., 756 F.2d 1262, 6 EBC 1075, 6 EBC 1291, 118 L.R.R.M. (BNA) 2474,102 Lab. Cas. (CCH) 911,382 (7th Cir. 1985).
19. [Service Provider] Where a defendant provided claims processing services to a health and welfare fund using adjustment standards established jointly by the fund and the defendant and the fund made final determinations on any contested payments according to the adjustment standards, it was not established that the defendant exercised sufficient discretionary authority or control over the fund or its assets to make it a fiduciary within the meaning of Section 3(21)(A) of ERISA. Donovan v. Robbins, 558 F. Supp. 319 (N.D.Ill. 1983), aff'd, 703 F.2d 570 (7th Cir. 1983).
20. [Recordkeeping] A company was delegated by a bank trustee or custodian for self-directed IRA accounts the function of maintaining records and preparing appropriate reports required by Section 103 of ERISA. A company maintaining records necessary for the preparation of such reports is a plan fiduciary and must perform these functions with the degree of care set forth in Section 404(a)(1)(B). Redwood Bank v. QTA, Inc., No. C-79-1586, slip op. (N.D.Cal., Oct. 23, 1979).
21. [Trustees] The trustees of a pension or welfare plan are fiduciaries under Section 3(21)(A). Marshall v. Snyder, 430 F. Supp. 1224 (E.D.N.Y. 1977), aff'd in part, 572 F.2d 894 (2d Cir. 1978); Marshall v. Dekeyser 485 F. Suay (29, I EBC 1898 (W.D.Wis.1979).
22. [Trustees - Directed] Trustees who merely distribute plan assets upon direction from the plan's administrators in accordance with a court order and with no discretionary authority over the plan assets, do not exercise the required authority over a plan's assets that would impose fiduciary responsibilities. Richardson v. U.S. News & World Report, 623 F. Supp. 350 (D.D.C. 1985).
23. [Trustees - Directed] Even though a plan trustee has no authority for investment decisions, it cannot disavow itself a responsibility for such decisions, since it is still a fiduciary. However, under the allocation provisions of Section 405(c)(1), the trustee may, in fact, not be liable for such decisions. Leonard v. Drug Fair, Inc., No. 78-1335, Fed. Sec. L. Rep. (CCH) 997,144 (D.D.C. 1979).

Section 3(21)(B)

Investment Company (Mutual Fund) as Fiduciary

If any money or other property of an employee benefit plan is invested in securities issued by an investment company registered under the Investment Company Act of 1940, such investment shall not by itself cause such investment company or such investment company's investment adviser or principal underwriter to be deemed to be a fiduciary or a party in interest as those terms are defined in this title, except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser or its principal underwriter. Nothing contained in this subparagraph shall limit the duties imposed on such investment company, investment adviser, or principal underwriter by any other law.

A. Conference Report

See coverage of this provision on pages 296-297 of the Congressional Conference Report.

B. Interpretive Bulletins

1. The principles of Section 3(21)(B) are restated in IB 75-3, which also states that if an investment company, its investment adviser or its principal underwriter is a fiduciary or party in interest for a reason other than the investment in the securities of the investment company, such a person remains a fiduciary or party in interest regardless of Section 3(21)(B).

Section 3(38)

"Investment Manager"

The term "investment manager" means any fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2)) -		
(A)	Who has the power to manage, acquire, or dispose of any asset of a plan;	
(B)	Who is -	
	(i)	Registered as an investment advisor under the Investment Advisers Act of 1940;
	(ii)	Is a bank, as defined in that Act; or
	(iii)	Is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and
(C)	Has acknowledged in writing that he is a fiduciary with respect to the plan.	

A. Conference Report

Page 302 of the Congressional Conference Report discusses the term investment manager.

B. Interpretive Bulletins

1. A person who is not registered under the Investment Advisers Act of 1940 because of an exemption from registration under that act (and who is not a bank or an insurance company) may not be an investment manager. IB 75-5, Question FR-6.
2. A person cannot be an investment manager if his or her application for registration under the Investment Advisers Act is still pending. IB 75-5, Question FR-7.

C. Advisory Opinions

1. An entity is an investment manager as defined in Section 3(38) of ERISA if it meets the three tests set forth in the statute.
2. A person can be both a named fiduciary and an investment manager provided that, as named fiduciary, such person does not have the power on behalf of the plan to appoint himself or herself or monitor his or her own performance as investment manager. AO 77-69/70.
3. A person who is registered only as a broker-dealer under the Securities Exchange Act of 1934 cannot serve as an investment manager. AO 76-20.

D. **Court Decisions**

1. Where an investment management firm had broad powers to manage plan assets, was registered as an investment adviser under the Investment Advisers Act of 1940, and had explicitly acknowledged itself as a fiduciary to the plan in its employment contract, it is considered an investment manager as defined in ERISA, regardless of any oral modifications of the agreement. Lowen v. Tower Asset Management, Inc, 829 F.2d 1209, 8 EBC 2457 (2d Cir. 1987).
2. Where an investment management company was not registered as an independent adviser under the Investment Advisers Act of 1940, was not a bank or insurance company, and had not acknowledged itself in writing as a fiduciary to the plan, it is not considered an investment manager as defined in ERISA. The trustee of an ESOP may not claim a defense under ERISA Section 405(d)(1). Whitfield v. Cohen, 682 F.Supp. 188, 9 EBC 1739 (S.D.N.Y 1988).

Plans Covered

ERISA Section 4

Section 4	
Except as provided in subsection (b) and in sections 201, 301 and 401, this title shall apply to any employee benefit plan if it is established or maintained:	
(1)	By any employer engaged in commerce or in any industry or activity affecting commerce; or
(2)	By any employee organization or organizations representing employees engaged in commerce or in any industry or activity affecting commerce; or
(3)	By both.
The provisions of this title shall not apply to any employee benefit plan if -	
(1)	Such plan is a governmental plan (as defined in section 3(32));
(2)	Such plan is a church plan (as defined in section 3(33)) with respect to which no election has been made under section 410(d) of the Internal Revenue Code of 1954;
(3) (4) (5)	Such plan is maintained solely for the purpose of complying with applicable workmen's compensation or unemployment compensation or disability insurance laws; Such plan is maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens; or Such plan is an excess benefit plan (as defined in section 3(30)) and is unfunded.

A. **Conference Report**

These provisions are discussed on pages 255-256 of the Congressional Conference Report.

Fiduciary Duties

ERISA Section 404

Section 404(a)(1)
Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and
For the exclusive purpose of:

Providing benefits to participants and their beneficiaries, and
Defraying reasonable expenses of administering the plan;
With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
By diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

A. Conference Report

All the fiduciary responsibilities imposed by Section 404(a)(1) are discussed at pages 302-305 of the Congressional Conference Report.

B. Regulations

1. Plan assets are defined in DOL ERISA Regulation 2510.3-101.
2. Prudence is covered in DOL ERISA Regulation 2550.404a-1 on "Investment Duties" and the specific coverage of § 404(a)(1)(B), below.
3. See DOL ERISA Regulation 404c-1 , which exempts fiduciaries from certain ERISA liability if plans meet certain conditions and participants direct their own investments.

C. Interpretive Bulletins

1. Social Investments ("Economically Targeted Investments") (ETIs). Establishes DOL's position on permissibility of making investments which achieve a social goal in addition to a financial return. The IB indicates that ETIs are not prohibited by ERISA, and that their choice as an investment must follow DOL ERISA regulation 2550.404a-1 regarding Investment Duties, be prudent, not be a prohibited transaction, and not provide less return to a plan than a normal investment. IB 94-1.
2. Proxy Voting. Among the fiduciary responsibilities of an investment manager are those to vote proxies for stock owned by ERISA plans. IB 94-2.
3. Investment Policies. An investment policy designed to further the purposes of a plan and its funding policy is consistent with, but not required by, ERISA 404(a)(1)(A) and (B). IB 94-2.

D. Advisory Opinions

1. Pursuant to ERISA Procedure 76-1 and particularly Section 5.02(o), the Department of Labor ordinarily will not issue advisory opinions on ERISA Section 404(a). AO 80-13A.
2. Service by a bank as trustee of a plan that has a significant portion of its assets invested in employer securities, while the bank is also a substantial secured creditor of the employer, may constitute a violation of Section 404(a)(1) by the bank. AO 76-32.

E. Court Decisions

1. [Effective Date] Actions by fiduciaries occurring after 1974 are not insulated from ERISA coverage merely because the roots of such action can be traced to an event prior to the effective date of ERISA. Marshall v. Craft, 463 F. Supp. 493 (N.D.Ga. 1978); Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
2. [Exemption Applicability] Exemptions from the prohibited transaction restrictions have no effect on the basic fiduciary responsibility rules of Section 404(a)(1). Marshall v. Dekeyser, 485 F.Supp. 629, 1 EBC 1898 (W.D.Vas. 1979).
3. [Precedent] Section 404(a)(1) codifies the common law rule that a trustee owes individual loyalty to the beneficiaries. Although trustees should carefully consider all recommendations submitted by the parties who appointed them, trustees are bound to exercise their independent judgment when making decisions in the administration of the trust. Sheet Metal Workers' International Association v. Central Florida Sheetmetal Contractors Association, 234 NLRB (CCH) No. 162 (1978).
4. [Precedent] ERISA Section 404 essentially codified the strict fiduciary standards that trustees

under Section 302 of the Labor-Management Relations Act must meet. The legislative history of ERISA demonstrates that any employee benefit fund trustee is a fiduciary whose duty to the trust beneficiaries must overcome any loyalty to the interest of the plan that appointed him. N.L.R.B. v. Amax Coal Co., 453 U.S. 322,107 L.R.R.M. (BNA) 2769, 91 Lab. Cas. (CCH) Para 12,821, 2 EBC 1489 (1981).

5. [Bank Stock - Purchase/Retention/Sale of Fiduciary Bank/BHC Stock] The discretionary purchase, retention, or sale of the stock of the fiduciary bank is imprudent. DOL indicates that "*it burdens our imagination to envision a situation in which a trustee with investment discretion could make an objective decision, solely on the basis of the prudence standard, regarding the purchase or sale of its own stock."* [emphasis added] See 1980 letter from DOL to OCC. Also see AO 88-9 regarding self-directed IRA purchases and AO 88-28 covering self-directed IRA purchases on an initial public offering (IPO) from a mutual-to-stock thrift conversion, and AO 92-23 which permits non-discretionary purchase and retention of holding company stock.
6. [Exclusive Purpose] The statutory phrase, "*solely in the interest*" is, at least in part, a codification of the most fundamental duty traditionally owed by a trustee - the duty of loyalty. Accordingly, a fiduciary bears a heavy burden in justifying his conduct in situations where his interests or the interests of others come into conflict with those of plan beneficiaries. Marshall v. Snyder, 430 F. Supp. 1224 (S.D.N.Y. 1977), aff'd in part, rev'd in part, 572 F.2d 894 (2d Cir. 1978).
7. [Exclusive Purpose] A plan's administrator who is also an officer for the corporate employer, as a fiduciary has a duty to avoid putting himself in a position where he may be forced to compromise his duty of complete loyalty to the plan to act on the employer's behalf. Amato v. Western Union International, Inc., 773 F.2d 1402, 6 EBC 2226 (2d Cir. 1985), cert. dismissed, 474 U.S. 1113 (1986). Contra Ashenbaugh v. Crucible, Inc., 854 F.2d 1516, 9 EBC 2560 (3d Cir. 1988).
8. [Exclusive Purpose] ERISA Section 404(a)(1) and subsection (a) require a fiduciary to act solely in the interest of the participants and beneficiaries of a plan and for the exclusive purpose of paying plan benefits at a reasonable cost. One who, in his capacity as a trustee, attempts to prevent a trust from suing him for substantial damages cannot reasonably be said to do so solely for the interest or for the exclusive purpose of benefiting others. Iron Workers Local No. 272 v. Bowen, 624 F.2d 1255 (5th Cir. 1980).
9. [Exclusive Purpose] Preferential effect of trustees' decision alone does not constitute a violation of Section 404(a) of ERISA. Id.
10. [Exclusive Purpose] Where trustees resolve to extend plan coverage to themselves as trustees and participants in the plan and paid themselves benefits of the plan, such self-dealing conduct was improper and a violation of fiduciary duty under ERISA Section 404(a)(1)(A) and (D). Donovan v. Daugherty, 550 F.Supp. 390, 3 EBC 2079 (S.D.Ala. 1982).
11. [Exclusive Benefit] An employer that creates a retirement program that encourages early retirement, thereby reducing the workforce at overstaffed facilities, does not violate the exclusive purpose duty because of the consequential benefit of enhanced efficiency to the employer. Trenton v. Scott Paper Co., 832 F.2d 806, 45 Fair Empl. Prac. Case (BNA) 327, 45 Empl. Prac. Dec. (CCH) 137,744, 9 EBC 1075 (3d Cir. 1987), cert. denied, 108 S. Ct. 1576, 9 EBC 1968 (1988).
12. [Exclusive Benefit] A fiduciary who pays himself a sales commission from plan assets in the sale of plan property despite the lack of any obligation on the part of the plan to pay the commission violates Section 404(a)(1). Marshall v. Kelly, 465 F. Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
13. [Exclusive Benefit] Where the sale of ownership of the employer is likely to have an impact on the plan's ability to obtain payment on employer notes held by the plan, which, in turn, is likely to affect the plan's ability to pay benefits under the plan, the plan trustees' duties of loyalty and prudence require them to advise the participants of the full facts concerning the sale. Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wisc. 1979).
14. [Exclusive Purpose - Arbitrary & Capricious] Because the potential burden of *per se* personal liability for any violation of ERISA might deter capable persons from serving as trustees of benefit plans, Section 404 of ERISA does not establish a *per se* rule of fiduciary conduct and a trustee's decision to cancel past service credits will not be overturned unless it is arbitrary and capricious. Fentron Industries, Inc v. Shopmen Pension Fund, 674 F.2d 1300, 34 Fed. R. Serv.2d 281, 94 Lab. Cas. (CCH) Para 113,559, 3 EBC 1323 (9th Cir. 1982).
15. [Exclusive Purpose - Arbitrary & Capricious] In reviewing the propriety of trustees' action, the judicial standard is whether the trustees acted in an arbitrary and capricious manner or abused their discretion. Robinson v. Central States Pension Fund, 572 F.2d 1208 (8th Cir. 1978). To the same effect: see Robinson v. United Mine Workers, 449 F. Supp. 941 (D.D.C. 1978); Shaw v. Kruidenier, 620 F.2d 307 (8th Cir. 1980); Mosley v. The National Maritime Union Pension and Welfare Plan, 451 F. Supp. 226 (E.D.N.Y. 1978); Taylor v. Bakery and Confectionery Welfare Fund, 455 F. Supp. 816 (E.D.N.C. 1978); Peters v. Operating Engineers Pension Fund, No. CV

76-3747-FW, slip op. (D.C.Cal., April 14, 1979); Bayles v. Central States Pension Fund, 602 F.2d 97 (5th Cir. 1979); Vaughn v. Metal Lathers Local 46 Pension Fund, No. 78 Civ. 2170 (S.D.N.Y. June 14, 1979). To the contrary, see Winpisinger v. Aurora Corporation Illinois, 456 F. Supp. 559 (N.D. Ohio 1978) (standard for judicial review is whether trustees complied with their ERISA fiduciary responsibilities). See also Pierce v. NECA-IBEW Welfare Trust Fund, 488 F. Supp. 559 (E.D.Tenn. 1978), aff'd, 620 F.2d 589 (6th Cir.), cert. denied, 449 U.S. 1015 (1980).

16. [ESOP] While an ESOP fiduciary may be released from certain per se violations on investments in employer securities under the provisions of ERISA Sections 406 and 407, the structure of ERISA itself requires that in making an investment decision of whether or not a plan's assets should be invested in employer securities, an ESOP fiduciary, just as fiduciaries of other plans, is governed by the solely-in-the-interest and prudence tests of Sections 404(a)(1)(A) and (B). Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).
17. [ESOP] Trustee's failure to conform stock ownership plan to Treasury requirements applicable to ESOPs in effect at the time of plaintiff's termination was not a breach of fiduciary duty under Section 404(a)(1) of ERISA for which a beneficiary may sue when defendant's stock ownership plan never functioned as an ESOP within the meaning of ERISA regulations. Allen v. The Katz Agency, Inc. Employee Stock Ownership Plan, 677 F.2d 193, 3 EBC 1352 (2d Cir. 1982).
18. [Plan Management] Corporate shareholders and directors, who are also pension plan investment managers and custodians violated their fiduciary duties when they refused to attend meetings of the shareholders, board of directors and trustees, thereby preventing any action in favor of the plan while also opposing the sale of shares of preferred hospital stock to the plan. Schoenholtz v. Doniger, 628 F. Supp. 1420, 7 EBC 1501 (S. D. N. Y. 1986).
19. [Plan Management] An insurance company that possesses the ultimate responsibility to grant or deny claims is a fiduciary under ERISA and must comply with the fiduciary duties enumerated in Section 404. Wickman v. Northwestern National Life Insurance, 9 EBC 1482 (D. Mass. 1987).
20. [Plan Management] An operator of a corporation's pension plan, who is also controlling the corporation in receivership, does not violate any fiduciary duties by amending the plan, freezing the accrual of benefits, returning excess funds to the corporation, and terminating the plan in accordance with the state court's appointment order and ERISA. Chait v. Bernstein, 645 F. Supp. 1092, 8 EBC 1126 (D.N.J. 1986), aff'd, 835 F.2d 1017, 9 EBC 1257 (3d Cir. 1987).
21. [Contributions] Corporate president violated his fiduciary duties when he failed to forward employer contributions and employee contributions, although they were deducted from employee paychecks; failed to notify employees that contributions had not been forwarded; allocated the monies to corporate expenses; and assumed conflicting roles of fiduciary and an officer of a struggling corporation. PBGC v. Solmsen, 671 F. Supp. 938, 9 EBC 1391 (E.D.N.Y 1987).
22. [Loans] Where trustees did not hold the local's proposal for a "loan at arm's length and compare it to other available investments, but instead did their best to accommodate" the local's needs, they violated ERISA Section 404(a)(1)(A)(i). Davidson v. Cook, 567 F. Supp. 225, 4 EBC 1816 (E. D. Va. 1983).
23. [Loans] A trustee breaches its fiduciary obligations by (1) making loans of plan assets under terms more favorable to the debtor than the plan and then not collecting the balance due; (2) allowing loans of plan assets to a debtor with an unproven business record and unstable financial condition; (3) lending an unreasonably large portion of loan assets to one entity and then concealing the existence of such loans; and (4) failing to adhere to guidelines in plan requiring that loans be at a reasonable rate of interest with adequate collateral. Brock v. Gilliken, 677 F. Supp. 398, 9 EBC 1803 (E.D.N.C. 1987).
24. [Loans] A fiduciary who makes or renews loans of plan assets based on inadequate security and at a lower interest rate than contemporaneous loans to others, and who fails to pursue timely repayment of principal and interest and to enforce the security agreement violates Section 404(a)(1). Marshall v. Kelly, 465 F. Supp. 341, 1 EBC 1850 (W.D.Okla. 1978); Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
25. [Loans/Leases] Pension fund trustees do not breach their fiduciary duties when they approve the construction of an office building after seeking advice from three legal firms, professional engineers, architects, appraisers, contractors and, in addition, eliminate certain aspects or demand cheaper designs when the project appears over budget. Furthermore, a lease agreement with a union *that contains certain favorable terms for the union, while also benefiting the plan participants and beneficiaries*, does not make the transaction imprudent when the trustees' *decisions are calculated to benefit the fund members*. Donovan v. Walton, 609 F.Supp. 1221, 6 EBC 1677 (S.D.Fla. 1985), aff'd, Brock v. Walton 794 F.2d 586, 7 EBC 1769, reh'g denied, 802 F.2d 1399 (11th Cir. 1986).
26. [Mergers & Acquisitions] A corporation which, through its pension board, acts as a fiduciary for

the employee pension plan, does not breach its fiduciary duties when a purchase agreement selling a division of the company provides for the transfer of all assets, properly allocable under ERISA, to the trustees of the successor corporation's pension plan, provided the sale was not to avoid any unfunded pension obligations. United Steelworkers 2116 v. Cyclops Corp., 653 F. Supp. 574, 8 EBC 1194 (S.D.Ohio 1987), aff'd in part, vacated in part, 860 F.2d 189, 10 EBC 1345 (6th Cir. 1988).

27. [Mergers & Acquisitions] Pension plan fiduciary, who liquidated stock of one corporation to buy shares of another corporation to further his own corporate expansion goal without any effort to seek independent analysis to examine further investment opportunities, does not satisfy the prudent person test. Sandoval v. Simmons, 622 F.2d Supp. 1174, 6 EBC 2161 (C.D.Ill. 1985).
28. [Service in Dual Capacities: Lender and Plan Trustee] Prior to naming a bank as plan trustee, an ERISA plan had invested $796,000 in unsecured notes issued by Supreme Finance (Supreme), a used car finance company. During this time, the bank had extended a $3 million secured line of credit to Supreme. After being named trustee, the bank refused to renew its line of credit because of Supreme's financial difficulties. At the same time, the bank gave notice of resignation as trustee. Supreme subsequently filed for bankruptcy and the only assets remaining were applied to the bank's loan. The federal district court found, and was upheld on appeal, that:

    a. The bank's acceptance of the trusteeship did not violate ERISA because -

        1. nowhere does ERISA explicitly prohibit a trustee from holding positions of dual loyalties, and
        2. the act did not cause the plan's losses.

    b. The bank's decision not to renew Supreme's line of credit did not violate ERISA. The court noted that a fiduciary serving in both corporate and fiduciary capacities may make decisions in its own benefit without violating its fiduciary duty to the plan.

    (Friend v. Sanwa Bank California, CA 9, No. 92-55641, 9-13-94).

29. [Summary Plan Disclosure] ERISA Section 404(a)(1) imposes a duty to provide employees with a comprehensive explanation of the plan. However, it does not impose an affirmative duty to alert an individual participant as to the vesting requirements of the plan once that individual notifies fiduciaries that he was "thinking of retirement." Schlomchik v. Retirement Plan of Amalgamated Insurance Fund, 502 F. Supp. 240 (E.D.Pa. 1980), aff'd, 671 F.2d 496 (3d Cir. 1981).

Section 404(a)(1)(A)	
Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and	
(A)	For the exclusive purpose of-
	Providing benefits to participants and their beneficiaries; and
	Defraying reasonable expenses of administering the plan.

A. Interpretive Bulletins

1. A vacation plan may pay all or any portion of the benefits to which a plan participant or beneficiary is entitled to a third party without violating Section 404(a)(1)(A) if (a) the plan documents expressly provide for such payments to third parties at the direction of a participant or beneficiary, (b) the participant or beneficiary directs in writing that the plan trustees pay a named third party all or a specified portion of the sum of money that would otherwise be paid to the participant or beneficiary, and (c) payment is made to the third party only when or after the money would otherwise be payable to the participant or beneficiary. IB 78-1.
2. Social Investments ("Economically Targeted Investments") (ETIs) Establishes DOL position on permissibility of making investments which achieve a social goal in addition to a financial return. Indicates that ETIs are not prohibited by ERISA, and that their choice as an investment must follow DOL ERISA regulation 2550.404a-1 regarding Investment Duties, be prudent, not be a prohibited transaction, and not provide less return to a plan than a normal investment. IB 94-1.

3. Proxy Voting. Among the fiduciary responsibilities of an investment manager are those to vote proxies for stock owned by ERISA plans. IB 94-2.
4. Investment Policies. An investment policy designed to further the purposes of a plan and its funding policy is consistent with, but not required by, ERISA 404(a)(1)(A) and (B). IB 94-2.

B. Advisory Opinions

1. Payments by a plan for services rendered by a person prohibited from being employed in any capacity by the plan may violate Section 404(a)(1)(A). AO 75-90.
2. If a participant or beneficiary in Plan A refuses to repay an erroneous overpayment of benefits to Plan A, the fiduciaries of Plan B, a related plan, would fail to be acting solely in the interests of the plan's participants and beneficiaries if they attempted to penalize the participant or beneficiary by delaying or reducing benefits under Plan B. AO 77-07.
3. A plan provision authorizing reimbursement of legal fees in the event of any legal action that may arise from the performance of a trustee's fiduciary duties is too broad and would be prohibited under Section 404(a)(1)(A). Where a fiduciary is found in a legal proceeding to have violated his fiduciary duties, reimbursement of legal fees by the plan would not be permitted. AO 78-29.

C. Court Decisions

1. [Provide Benefits] Dividing pension benefits, once they are being paid out, between a participant and his divorced spouse does not violate Section 404(a)(1)(A). Campa v. Campa, 89 Cal. App.3d 113C (1st Dist. 1979), appeal dismissed, Carpenters Pension Trust Fund for Northern California v. Campa, 444 U. S. 1028 (1980).
2. [Provide Benefits] The payment of rent on behalf of the widow of a former plan trustee constitutes a violation of Section 404(a)(1)(A) even though the payment was morally commendable and not made for the personal gain of plan fiduciaries. Marshall v. Cuevas, I EBC 1580 (D.P.R. 1979).
3. [Provide Benefits] Where a plan participant has nonforfeitable vested pension rights under the plan, the plan administrative committee's denial of those rights; based on a retroactive plan amendment adopted by the plan sponsor violated the administrative committee's fiduciary duty to pay benefits when due. Fox v. Abrams, No. CV 77-881-ALS, slip op. (C.D.Cal. 1978).
4. [Exclusive Purpose] Plan monies, even if they constitute surplus assets, must be applied for the exclusive purpose of plan participants and beneficiaries. Marshall v. Snyder, 430 IF. Supp. 1224 (S.D.N.Y. 1977), aff'd in part, rev'd in part, 572 F.2d 894 (2d Cir. 1978).
5. [Exclusive Purpose] Where a plan trustee fails to keep adequate records of the plan's financial obligations, questions of whether the plan owes money to the trustee should be resolved in favor of the plan. Marshall v. Kelly, 465 F. Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
6. [Exclusive Purpose] Lease by a plan of an aircraft unnecessary for plan operation violates Section 404(a)(1). Usery v. Wilson, 3-76-373 (E.D.Tenn. 1977) (consent order).
7. [Exclusive Purpose] Purchase by a multiemployer plan of individual automobile insurance policies for plan trustees and employees violates Section 404(a)(1)(A). Usery v. Wilson, 3-76-373 (E.D.Tenn. 1977) (consent order).
8. [Reasonable Expenses] Payments of in excess of $1 million over a two and one-half year period by a multiemployer plan to an individual for administrative services constitutes excessive compensation in violation of Section 404(a)(1)(A). Marshall v. Snyder, 430 F. Supp. 1224 (S.D.N.Y. 1977), aff'd in part, 572 F.2d 894 (2d Cir. 1978). To the same effect, see Marshall v. Knee, No. C-3-7793 (S.D.Ohio 1977) (complaint).
9. [Reasonable Expenses] A fiduciary who causes a plan to pay excessive amounts for the construction of a building on plan property violates Section 404(a)(1)(A). Marshall v. Kelly, 465 F. Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).

Section 404(a)(1)(B) **"Prudent Man Rule"**
Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries **and** with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.

A. Statute

Investments in collectibles are generally prohibited by Section 408(m) of the Internal Revenue Code and PTE 91-55.

B. Regulations

1. Refer to DOL ERISA Regulation 2550.404a-1.

    a. The regulation sets forth guidelines for plan fiduciaries for compliance with the prudence requirement in connection with their investment duties.
    b. As a general rule, a fiduciary, in connection with his or her investment duties, is required to give appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved. This includes consideration of the role an investment is intended to play in the plan's investment portfolio for which the fiduciary has investment duties.
    c. The regulations also set forth a safe harbor rule. If a fiduciary complies with the safe harbor rule, the Labor Department will presume that the fiduciary has complied with the prudence requirement.

    The safe harbor rule requires a fiduciary in connection with any particular investment or investment course of action -

    a. To determine that the investment is reasonably designed as part of the portfolio (or the portion of the plan's portfolio) for which the fiduciary has investment duties) to further the purposes of the plan, taking into account the investment's risk of loss and opportunity for gain; and
    b. To consider the portfolio's (or portion of the portfolio's) -

        i. Diversification,
        ii. Liquidity and current return relative to plan cash flow, needs, and
        iii. Projected return relative to plan funding requirements.

2. For a definition of plan assets, see DOL ERISA Regulation 2510.3-101.
3. See DOL ERISA Regulation 404c-1, which exempts fiduciaries from certain ERISA liability, including the duty to monitor for prudence, if plans meet certain conditions and participants direct their own investments.

C. Interpretive Bulletins

1. A plan fiduciary responsible for appointing trustees or other plan fiduciaries should periodically review the performance of such trustees or other fiduciaries. The procedure for review may vary according to the circumstances. IB 75-8, Question FR-17.
2. Plan fiduciaries may rely on information and data supplied by non-fiduciaries in discharging their fiduciary duties. IB 75-8, Question FR-11.
3. Social Investments ("Economically Targeted Investments") (ETIs) Establishes DOL position on permissibility of making investments which achieve a social goal in addition to a financial return. Indicates that ETIs are not prohibited by ERISA, and that their choice as an investment must follow DOL ERISA regulation 2550.404a-1 regarding Investment Duties, be prudent, not be a prohibited transaction, and not provide less return to a plan than a normal investment. IB 94-1.
4. Proxy Voting. Among the fiduciary responsibilities of an investment manager are those to vote proxies for stock owned by ERISA plans. IB 94-2.
5. Investment Policies. An investment policy designed to further the purposes of a plan and its funding policy is consistent with, but not required by, ERISA 404(a)(1)(A) and (B). IB 94-2.

D. Advisory Opinions

1. [General] Section 404(a)(1)(B) does not absolutely prohibit any general type of investment. Whether an investment is prudent depends on the nature of the investment and the character and aims of the plan. AO 75-83.
2. [Bank Stock - Purchase/Retention/Sale of Fiduciary Bank/BHC Stock]: The discretionary

purchase, retention, or sale of the stock of the fiduciary bank is imprudent. DOL indicates that "*it burdens our imagination to envision a situation in which a trustee with investment discretion could make an objective decision, solely on the basis of the prudence standard, regarding the purchase or sale of its own stock."* [emphasis added] See 1980 letter from DOL to OCC. Also see AO 88-9 regarding self-directed IRA purchases and AO 88-28 covering self-directed IRA purchases on an initial public offering (IPO) from a mutual-to-stock thrift conversion, and AO 92-23 which permits non-discretionary purchase and retention of holding company stock.

3. [Mortgage Valuations] Plan fiduciaries will be acting prudently under Section 404(a)(1)(B) if they value plan assets consisting of real estate mortgage loans that the plan has no current intention of selling and that are not financially troubled at the remaining principal balance of the loan. Financially troubled loans should be valued on the basis of any guarantees, security or other factors that a prudent person would deem relevant. AO 77-78; AO 77-81.
4. [DOL Investigations] Where the Labor Department is already conducting an investigation of plan investments, the new investment managers for the plan will be acting prudently under Section 404(a)(1)(B) if they report any breaches of fiduciary duties by others of which they become aware to the plan trustees and to the Labor Department and make available to the Labor Department all information requested about past transactions. AO 77-60/61; AO 77-79/80.

E. Court Decisions

1. [General] ERISA's prudence test is not that of a prudent lay person but, rather, that of a prudent fiduciary with experience dealing with a similar enterprise. Marshall v. Snyder 430 F. Supp. 1224 (S.D.N.Y. 1977), aff'd in part, rev'd in part, 572 F.2d 894 (2d Cir. 1978).
2. [General] Plan trustees violate their fiduciary obligations if they act arbitrarily or capriciously in light of all of the surrounding circumstances. Reviewing courts are hesitant to second guess the trustees' decisions and will do so only if there is no reasonable justification for the decision. Stewart v. National Shopmen Pension Fund, 795 F.2d 1079, 7 EBC 1917 (D.C.Cir. 1986).
3. [General] Fiduciaries are not relieved of their fiduciary responsibilities by their lack of involvement in a particular transaction. By failing to monitor the conduct of other trustees, a trustee may violate Section 404(a)(1)(B) and be held liable under Section 405(a)(2). Marshall v. Dekeyser 485 F, Supp. 629, 1 EBC 1898 (W.D.Wisc. 1979).
4. [General] The prudent person standard found in Section 404 is violated if a trustee who lacks the requisite education, experience and skill to make investment decisions fails to consult independent counsel prior to the making of such decisions. Donovan v. Walton, 609 F. Supp. EM, 6 EBC 1677 (S.D.Fla. 1985), aff'd, Brock c Walton 794 F.2d 586, 7 EBC 1769, reh'g denied, 802 F.2d 1399 (11th Cir. 1986).
5. [Plan Management] Failure by trustees of a multiemployer plan to maintain full and complete minutes of trustees meetings constitutes a violation of Section 404(a)(1)(B). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
6. [Plan Management] Implicit in ERISA's standard for fiduciary responsibility set forth under Section 404 is fiduciaries' duty to take an initiative to cause reasonably available evidence to be developed and considered in the decision making process. An employer and underwriter breached the duly to develop such evidence by relying upon erroneous, incomplete and sometimes irrelevant information in denying claims and thereby rendered their decisions in an arbitrary and capricious manner. Rosen v. Hotel and Restaurant Employees Union, 637 F.2d 592, 106 L.R.R.M. (BNA) 2745, 90 Lab. Cas. (CCH) Para 912,612, 2 EBC 1054 (3d Cir.), cert. denied, 454 U.S. 898 (1981).
7. [Arbitrary/Capricious Actions] Pension fiduciaries breach fiduciary duty when they act arbitrarily and capriciously or act with improper discriminatory or bad faith motives. Chambless v. Masters, Mates and Pilots Pension Plan, 571 F. Supp. 1430 (S.D.N.Y. 1983).
8. [Arbitrary/Capricious Actions] Trustees violated the prudent man standard when they failed to adequately investigate the basis and justification for the payment of over $10 million to a claims processing company as fees for services over a two year period, notwithstanding the court's subsequent finding that the fees were reasonable. Brock v. Robbins 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987).
9. [ESOP] While an ESOP fiduciary may be released from certain per se violations on investments in employer securities under the provisions of Sections 406 and 407 of ERISA, the structure of ERISA itself requires that in making an investment decision of whether or not a plan's assets should be invested in employer securities, an ESOP fiduciary, just as fiduciaries of other plans, is governed by the solely-in-the-interest and prudence tests of Sections 404(a)(1)(A) and (B). Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978).
10. [ESOP] United Missouri Bank won a case where it continued to purchase a distressed company's

stock for an ESOP, relying on an independent appraiser's valuation. The 10th Circuit Court of Appeals ruled that the bank (1) followed "proper" directions from the ESOP administrator, (2) paid no more than "appropriate consideration" by relying on the appraisals, (3) retained the stock appropriately because it was restricted by the ESOP agreement and to do so "would have run counter to the intended purpose of [the] ESOP," and (4) maintained an effective Chinese Wall within the bank to prevent transmittal of material inside information from the commercial lending to the trust investment areas. Ershick v. United Missouri Bank of Kansas City, N.A., 948 F.2d 660 (10th Cir. 1991).

11. [ESOP] A Washington bank was found liable for following a similar procedure in Fink v. National Savings & Trust Co., 772 F.2d 951 (D.C. Cir. 1985). The court found the ERISA fiduciary duty of prudence overrides the provisions of plan, such as in ESOPs, which are designed to invest in employer stock.
12. [ESOP] Banc One Arizona settled for $19 million (plus a $1.15 million DOL penalty) involving the Kroy, Inc., ESOP covering 400 employees. Kroy eventually declared bankruptcy. Banc One continued purchasing stock until Kroy declared bankruptcy. Banc One was criticized for apparently paying too much for the stock. The primary issue of the case dealt with ERISA Section 3(18)(B) regarding "adequate consideration."
13. [ESOP] The Statewide Bancorp ESOP directed the Plan Committee (who were also directors) to invest "primarily" in Statewide stock. The Committee continued to purchase Statewide stock even as its stock price fell to less than 25 cents a share. Eventually, all remaining assets were placed in money market accounts. Statewide declared bankruptcy. The 3rd Circuit Court of Appeals found that the purchase of Statewide stock was *permissive*, not mandatory. The court held that two standards apply:

    - If the plan *requires* investment in employer securities, the trustee must comply unless "compliance would be impossible or illegal" or a court approves a deviation.

    - If investment language is *permissive*, "the fiduciary must still exercise care, skill, and caution in making decisions to acquire or retain the investment." In such permissive situations, the fiduciary is presumed to have complied with ERISA in purchasing employer securities unless the facts and circumstances would defeat or substantially impair the purposes of the trust. If trustees are also directors or officers of the employer, they must show that they acted impartially in investigating available investment alternatives - particularly if the employer is experiencing financial difficulty.

      The court evaluated the reasonableness of the trustees' actions under the standard set by the U.S. Supreme Court, in the Firestone Tire and Rubber Co. v. Bruch, 489 U.S. 101 (1989) case. Reasonableness is judged by whether:

        - the interpretation is consistent with the goals of the plan;
        - it renders any plan language meaningless or internally inconsistent;
        - it conflicts with the substantive or procedural requirements of ERISA law;
        - the provision has been interpreted consistently; and
        - the interpretation is contrary to the clear language of the plan.

        Moench v. Robertson, 62 F.3d 553 (3d Cir. 1995).

14. [Investments] Purchase of stock in a financially unstable corporation constitutes a violation of Section 404(a)(1)(B). Usery v. Wilson, et al, No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
15. [Loans] Evidence that mortgage loans were made at interest rates below the prevailing market rate is insufficient to establish a violation of the prudent investor rule established in ERISA Section 404(a)(1)(A) and (B) where pension fund trustees, in developing a plan participant mortgage loan program, consulted with experts, including accountants and mortgage brokers; examined and considered rates charged on traditional and nontraditional mortgage loans; examined the prospective borrower's employment background; required that the loan be adequately secured; and thereafter set highest rates that not only generated a higher rate of return than any other portfolio asset but exceeded the fund's actuarial and funding requirements. Brock v. Walton, 794 F.2d 586, 7 EBC 1769 (11th Cir.), reh'g denied, 802 F.2d 1399 (11th Cir. 1986) (en banc).

16. [Loans] Trustees making loans violated the prudence test under ERISA Section 404(a)(1)(B) by failing to properly appraise the proposed building, investigate the borrower's financial resources, evaluate the likely rental income to be derived from the building, take an assignment of rents, require sureties on the loan and require a principal repayment schedule. Davidson v. Cook, 567 F. Supp. 225, 4 EBC 1816 (E.D.Va. 1983), aff'd, 734 F.2d 10 (4th Cir.), cert. denied, 469 U.S. 899 (1984).
17. [Loans] Where independent investigation based on financial statements would have disclosed imprudence of making loans and where trustees failed to seek outside counsel when "under the circumstances then prevailing ... a prudent man acting in a like capacity and familiar with such matters" would have sought outside counsel, ERISA, Section 404(a)(1)(B) is violated. A trustee's duty to make an independent investigation includes the obligation of not relying on representations, predictions, and hopes of a borrower. Katsaros v. Cody, 503 F. Supp. 360, 4 EBC 1910 (E.D.N.Y 1983).
18. [Loans] Even assuming the real estate attorney for the pension fund was a fiduciary, the opening bid of $5 million where the property was allegedly worth less, was not a breach of fiduciary duty of care under Section 404 of ERISA when the bid was made in the context of a foreclosure sale, the final judgment against the debtor was $9,615,422.26, and an unrealistically low bid might have precluded a deficiency judgment. Furthermore, although attorney was not instructed to establish $100,000 bid increments, such action was not imprudent where he was instructed to continue bidding the price upwards to $7 million. Donovan v. Nellis, 528 F. Supp. 538, 33 Fed. Rul. Serv. 2d (Cahaghan) 1742, 2 EBC 2209 (N.D.Fla. 1980.
19. [Loans - Employer] Where plan trustees make loans to employers that lack any security and are at interest rates below those that an arm's length lender would accept under the circumstances the trustees have violated Section 404(a)(1)(B). Marshall v. Dekeyser; 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
20. [Mergers & Acquisitions] In a contest for corporate control where potential conflicts of interest between plan administrators and beneficiaries existed, administrators who did not conduct independent, "intensive and scrupulous" investigation of plan's investment options violated ERISA Section 404. Leigh v. Engle, 727 F.2d 113, 4 EBC 2702 (7th Cir. 1984).
21. [Mergers & Acquisitions] Trustees breached ERISA's exclusive purpose and prudent man rules Section 404(a)(1)(A) and (B), by agreeing to the sale of employer securities to the employer's pension plan as part of alleged attempt to maintain corporate control without conducting any investigation as to the proposed transaction. Dimond v. Retirement Plan, 582 F. Supp. 892, 4 EBC 1457 (W.D.Pa. 1983).
22. [Mergers & Acquisitions] Where sale of ownership of the employer is likely to have an impact on the plan's ability to obtain payment on employer notes held by the plan, which, in turn, is likely to affect the plan's ability to pay benefits under the plan, the plan trustees' duties of loyalty and prudence require them to advise the participants of the full facts concerning the sale. Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
23. [Payments, Excessive] Payment of an excessive amount of rent by a plan for the lease of an aircraft violates Section 404(a)(1)(B). Usery v. Wilson, et al., No. 3-76-373 (E. D.Tenn., June 6, 1977) (consent order).
24. [Payments, Excessive] Trustees of an employee welfare plan breached fiduciary duties when they improperly overpaid a law firm $292,800 for legal services rendered to members of the plan. Law firm that knowingly receives excessive payments from trustees of a plan is held accountable for the breaches committed by the trustees and jointly liable for be overpayment. Benvenuto v. Schneider, 678 F. Supp. 51, 9 EBC 1528 (E.D.N.Y. 1988).
25. [Recordkeeping] A company was delegated by a bank trustee or custodian for self-directed IRA accounts the function of maintaining records and preparing appropriate reports required by Section 103 of ERISA. A company maintaining records necessary for the preparation of such reports is a plan fiduciary and must perform these functions with the degree of care set forth in Section 404(a)(1)(B). Redwood Bank v. QTA, Inc., No. C-79-1586, slip op. (N.D.Cal., Oct. 23, 1979).
26. [Self-Dealing] Purchase of automobile insurance covering plan trustees and employees, but which does not protect the plan, constitutes a violation of Section 404(a)(1)(B). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).

Section 404(a)(1)(C)
Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries **and** by diversifying

the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

A. **Advisory Opinions**

1. [Deposits - Insured/Uninsured] The diversification requirement of Section 404(a)(1)(C) generally will not be violated if all plan assets in an individual account plan are invested in a federally insured savings account, so long as the account is fully insured. Where the account balance exceeds the amount covered by federal insurance, compliance with Section 404(a)(1)(C) is determined by whether the bank invests its assets in a diversified manner. AO 77-46.
2. [Collective Investment Funds] An investment by an ERISA plan in a single collective investment pool may be deemed to be a properly diversified investment if the pool is itself diversified. In this case, each of the investments of the collective trust is deemed to be an investment of the plan. AO 80-13A.
3. [Mutual funds/Annuities] A plan may invest all of its assets in insurance or annuity contracts (AO 75-79) or a mutual fund (AO 75-93) without violating Section 404(a)(1)(C) dealing with diversification.
4. [Real Estate] Where the assets of a plan consist largely of real estate mortgage loans, the new investment managers of the plan will not violate the diversification requirements of Section 404(a)(1)(C) if they follow a policy whereby decisions to retain or dispose of individual loans and properties will be made on the basis of economic and prudent management generally and not on a basis that requires diversification of plan assets in situations in which the principles of economic and prudent management would indicate that such loans and properties should be retained. AO 77-62/63.
5. [REIT] Proper diversification for plan assets invested in a real estate investment trust (REIT) is determined by considering the assets held by the REIT. AO 78-30.

B. **Court Decisions**

1. [General] Section 404 of ERISA requires that fiduciaries conduct their activities as would a prudent man under similar circumstances. While there is flexibility in the prudence standard, it is not a refuge for fiduciaries who are not equipped to evaluate a complex investment. Glass/Metal Association and Glaziers and Glass Workers Pension Plan, 507 F. Supp. 378, 2 EBC 1006 (D.Hawaii 1980).
2. [General] Where plan trustees, lacking prior lending experience, fail to follow the procedure that a prudent lender would utilize by failing to consider other real estate investment vehicles that offered greater opportunity for diversification, and by committing plan assets without adequate procedures for evaluation of a risk, the plan trustees violated their duty to act with care, skill, prudence and diligence as required under Section 404(a)(1)(B) of ERISA. Glass/Metal Association and Glaziers and Glass Workers Pension Plan, 507 F. Supp. 378, 2 EBC 1006 (D.Hawaii 1980).
3. [General] In contrast to traditional trust law, both Congress and the courts have recognized that the diversification requirement of ERISA Section 404(a)(1)(C) imposes a separate duty on plan fiduciaries to spread the risk of loss of the plan. Therefore, if consummated, a commitment of 23% of the pension plan's total assets to a single loan would subject a disproportionate amount of the pension trust's assets to the risk of a large loss and violate the diversification requirement. Glass/Metal Association and Glaziers and Glass Workers Pension Plan, 507 F. Supp. 378, 2 EBC 1006 (D.Hawaii 1980).
4. [Loans] A loan of 36% of plan assets to finance the expansion of a hotel and gambling casino violates Section 404(a)(1)(C). Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F. Supp. 986 (E.D.N.Y. 1978).
5. [Loans - Employers] The investment of virtually all of a plan's assets in loans to employers, on its face, represents a complete failure to diversify the investments of the plan so as to minimize the risk of large losses required by Section 404(a)(1)(C). Once a plaintiff proves failure to diversify, the burden shifts to the defendant to demonstrate that nondiversification was prudent under the circumstances. Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
6. [Loans] Where trustees failed to collect what defendants owed the pension trust, renewed unfavorable loans and failed to diversity holdings, they violated Section 404(a)(1)(B) and (C). Donovan v. Schmoutey, 592 F. Supp. 1361 (D.Nev. 1984).
7. [Market Valuation] Pension plan service company that fails to revalue the market value of properties to determine a fair rental value to the lessee, the plan's sponsor, and also fails to advise trustees that the plan assets should be diversified and not concentrated in the buildings

leased to the plan's sponsor, breaches its fiduciary duties under ERISA. Brock v. Self, 632 F. Supp. 1509, 7 EBC 1512 (W. D. La. 1986).

Section 404(a)(1)(D)
Subject to sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and In accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter or subchapter III of this chapter.

A. Interpretive Bulletins

1. A vacation plan may pay all or any portion of the benefits to which a plan participant or beneficiary is entitled to a different party without violating Section 404(a)(1)(D) if (a) the plan documents expressly provide for such payments to third parties at the direction of a participant or beneficiary, (b) the participant or beneficiary directs in writing that the plan trustees pay a named third party all or a specified portion of the sum of money that would otherwise be paid to the participant or beneficiary and (c) payment is made to the third party only when or after the money would otherwise be payable to the participant or beneficiary. IB 78-1.
2. Investment Policies. An investment policy designed to further the purposes of a plan and its funding policy is consistent with, but not required by, ERISA 404(a)(1)(A) and (B). If one exists, it is considered one of the "documents and instruments governing the plan", and must be followed. IB 94-2.

B. Advisory Opinions

1. Within the mandate of Section 404(a)(1)(D) is the rule that plan trustees and fiduciaries must administer the plan in accordance with clear and unambiguous provisions of the plan document and the law. The fact that policy reasons mandate a change in the plan provisions is relevant to a judicial review of the validity of the plan change, but such conditions are not relevant in the interpretation and implementation of such rule. Where, in this case, the plan's rules were clear and unambiguous and were upheld by the courts as valid, the trustees must enforce them as so written. AO 82-IA.
2. Whether the trustees can accept contributions from employers for certain specific individuals or classes thereof and/or make benefit payments to such individuals is a matter to be determined by the plan document. Section 404(a)(1)(D) requires that the plan be administered in accordance with the plan document to the extent that the plan document is in accordance with the law. AO 81-30A.

C. Court Decisions

1. A limitation in the plan instruments on the authority of the trustees to invest plan assets, which is not inconsistent with any provisions of ERISA, is binding on the trustees under Section 404(a)(1)(D). Marshall v. Teamsters Local 282 Pension Trust Fund, 458 F. Supp. 986 (E.D.N.Y. 1978).
2. Where plan document provided that administrative committee member having interest in transaction shall not participate in transaction and fiduciary acted contrary to plan terms, there was a violation of ERISA Section 404(a)(1)(D). Donovan v. Cunningham, 716 F.2d 1455, 4 EBC 2329 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984).
3. Payment of compensation to plan trustees without express authorization in plan instruments violates Section 404(a)(1)(D). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
4. Payment of benefits to ineligible persons violates Section 404(a)(1)(D). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
5. A trustee's failure to declare his own forfeiture of benefits under a plan by reason of his violation of a 'bad boy' clause does not constitute a breach of fiduciary duty. Fremont v. McGraw-Edison Company, 460 F. Supp. 599 (N.D.Ill. 1978), aff'd in part, rev'd in part, 606 F.2d 752 (7th Cir. 1979), cert. denied, 445 U.S. 951 (1980).
6. Dividing pension benefits, once they are being paid out, between a participant and his divorced spouse does not violate Section 404(a)(1)(D). Campa v. Campa, 89 Cal. App.3d 113C (1st Dist. 1979), appeal dismissed, Carpenters Pension Trust Fund for Northern California v. Campa, 444

U. S. 1028 (1980).

Section 404(a)(2)
In the case of an eligible individual account plan (as defined in Section 407(d)(3)), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the extent that it requires diversification) of paragraph (1)(B) is not violated by acquisition or holding of qualifying employer real property or qualifying employer securities (as defined in Section 407(d)(4) and (5)).

A. Conference Report

This provision is discussed on page 317 of the Congressional Conference Report.

B. Advisory Opinions

1. The purchase of employer securities by a profit-sharing plan is covered by Section 404(a)(2). AO 75-89; WSB 79-86 (thrift plan).

Section 404(b)
Except as authorized by the Secretary by regulation, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

A. Conference Report

Page 306 of the Congressional Conference Report explains this provision.

B. Regulations

Refer to DOL ERISA Regulation 2550.404b-1.

1. Plan assets may be held by persons located outside the United States if the assets are foreign securities and (a) the plan fiduciary, empowered to authorize such holding is a United States regulated bank, insurance company or investment adviser, has its principal place of business in the United States and meets certain minimum financial conditions; or (b) the securities are in the possession of a United States bank, a registered broker or dealer; or an SEC-designated "satisfactory control location" and certain other conditions are met. DOL ERISA Regulation 2550.404b-1.
2. An ADR (American depository receipt) that enables a person to demand delivery of a foreign security constitutes the "indicia of ownership" of the foreign security for purposes of Section 404(b). Preamble to DOL ERISA Regulation 2550.404b-1.
3. The indicia of ownership of any plan assets (e.g., foreign securities, United States securities, etc.) attributable to contributions made on behalf of plan participants who are Canadian citizens or residents may be maintained in Canada if required by Canadian tax or other laws. DOL ERISA Regulation 2550.404b-1.

C. Advisory Opinions

1. Section 404(b) does not prohibit the investment of plan assets in enterprises located outside the United States provided that the indicia of ownership (e.g., stock certificates) of such assets is maintained in the U.S. (or in accordance with DOL ERISA Regulation 2550.404b-1). AO 75-80.

Section 404(c)
In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant

or beneficiary exercises control over the assets in the account (as determined under regulations of the Secretary) -	
(1)	Such participant or beneficiary shall not be deemed to be a fiduciary by reasons of such exercise, and
(2)	No person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's, or beneficiary's exercise of control.

A. Conference Report

This provision is explained on pages 305-306 of the Congressional Conference Report.

B. Regulations

See DOL ERISA Regulation 404c-1, which exempts fiduciaries from certain ERISA liability if plans meet certain conditions and participants direct their own investments.

C. Advisory Opinions

1. Section 404(c) does not exempt transactions covered by Section 404(c) from all provisions of ERISA; it only exempts fiduciaries from liability regarding such transactions and the participant or beneficiary from being a fiduciary by reason of exercising control under Section 404(c). AO 75-81.
2. The fact that transactions might be exempted from the provisions of Section 406 by reason of Section 404(c) does not affect the application of Section 4975 of the Code. PLR 7821122.
3. [Individual Account] A person who is a plan fiduciary and who also exercises control over assets in his or her own individual account will not be treated as a fiduciary with respect to such exercise of control. AO 75-24.

D. Court Decisions

1. [Fiduciary Liability for Self-Directed Plan Investments] A 401(k) plan offered GICs as one of several investment vehicles for plan participants, who directed their own investments. GICs were issued, in part, by Executive Life Insurance. The trustees relied on ratings of rating services. When Executive Life encountered financial difficulties and was eventually downgraded by the rating services, the plan notified participants that GIC investments were not guaranteed from loss. Unisys negotiated more liberal waiting periods for transfers from the GIC fund to other investment vehicles, but was restricted on what it could tell participants. As a result, it did not tell participants of Executive Life's problems. Unisys did; however, pay for the replacement of an annuity issued to its Chairman by Executive Life with an annuity from another insurer. Executive Life was declared insolvent by state insurance regulators in 1991. Plan participants sued the fiduciaries for breach of fiduciary responsibilities under ERISA Section 404(a). The Unisys trustees' defense was that they were protected from fiduciary responsibility by ERISA Section 404(c).

   The courts ruled that (1) the duty of prudent inquiry may have been breached by total reliance on insurance rating services, (2) plan fiduciaries did not release material information to plan participants, (3) the participants' control over their investments may release the fiduciaries from investment liability, and (4) the case was remanded back to the District Court so plan participants may pursue their claims [3rd Circuit Court of Appeals, *In Re Unisys Savings Plan Litigation (Meinhardt v. Unisys Corp.)*, 74 F.3d 420 (3d. Cir. 1996)].

Co-Fiduciary Liability

ERISA Section 405

Section 405(a)

In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:	
(1)	If he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;
(2)	If, by his failure to comply with section 404(a)(1) in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or
(3)	If he had knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

A. Conference Report

Pages 299-300 of the Congressional Conference Report discuss co-fiduciary liability provisions.

B. Interpretive Bulletins

1. A plan fiduciary who knows of a breach committed by another fiduciary must take steps to remedy the breach, such as instituting a lawsuit, notifying the Department of Labor or publicizing the breach. Mere resignation by the fiduciary as a protest against the breach is not sufficient. IB 75-5, Question FR-10.
2. Even though a fiduciary has only limited functions to perform (e.g., because the fiduciaries have properly allocated functions among themselves or delegated them to others), the fiduciary can become liable for breaches in other areas by other plan fiduciaries under Section 405(a). IB 75-8, Questions FR-13, FR-14 and FR-16.
3. Where the Labor Department is already conducting an investigation of plan investments, the new investment managers for the plan will not be acting in violation of Section 405(a) if they report any breaches of fiduciary duties by others of which they become aware to the plan trustees and to the Labor Department and make available to the Labor Department all information requested about past transactions. AO 77-60/61; AO 77-79/80.

C. Court Decisions

1. [General] A fiduciary is liable under ERISA Section 405(a)(1) if he participates knowingly in, or knowingly undertakes to conceal, a co-fiduciary's breach of duty. Davidson v. Cook, 567 F. Supp. 225, 4 EBC 1816 (E.D.Va. 1983), aff'd, 734 F.2d 10 (4th Cir.), cert. denied, 469 U.S. 899 (1984).
2. [General] ERISA Section 405 does not impose vicarious liability; actual knowledge is required. The fiduciary must know the other person is a fiduciary to the plan, must know that he participated in the act that constituted a breach, and must know that it was a breach. Donovan v. Cunningham, 716 F.2d 1455, 4 EBC 2329 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984).
3. [General] Under Section 405 of ERISA a fiduciary is liable for a co-fiduciary's breach of fiduciary duties if he knowingly participates and/or conceals such breach; furthermore, a fiduciary is required to make reasonable efforts to remedy a known breach by another fiduciary. Davidson v. Cook, 567 F. Supp. 225, 4 EBC 1816 (E.D. Va. 1983), aff'd, 734 F.2d 10 (4th Cir.), cert. denied, 469 U.S. 899 (1984).
4. [General] Co-fiduciaries each have responsibility for the actions of the others and will be found liable for the others' breach of fiduciary duty if such co-fiduciary participates knowingly in a breach or if, by his failure to comply with Section 404 of ERISA, he enables another fiduciary to commit a breach. LeFebre v. Westinghouse Electrical Corp., 549 F. Supp. 1021, 3 EBC 2353, as amended by 3 EBC 2359 (D.Md. 1982), rev'd, 747 F.2d 197 (4th Cir. 1984).
5. [General] Relying on the advice or information of a co-trustee alone may subject a trustee to liability. Katsaros v. Cody, 568 F. Supp. 360, 4 EBC 1910 (E.D.N.Y. 1983).
6. [Omission vs. Commission] Fiduciaries are not relieved of their fiduciary responsibilities by their lack of involvement in a particular transaction. By failing to monitor the conduct of other trustees, a trustee may violate Section 404(a)(1)(B) and be held liable under Section 405(a)(2). Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
7. [Successor Trustees] New trustees of a plan are not required to investigate how prudently prior trustees had negotiated a contract. If the contract terms are found reasonable and no other facts indicate the contrary, new trustees are not liable if prior trustees committed a breach of their fiduciary duties by acting imprudently. Brock v. Robbins, 830 F.2d 640, 8 EBC 2489 (7th Cir.

1987).

8. [Successor Trustees] A successor trustee has a duty to liquidate prior improper investment upon assuming his responsibilities. Marshall v. Craft 463 F. Supp. 493 (N.D.Ga. 1978). See also Morrissey v. Curran, 567 F.2d 546 (2d Cir. 1977).
9. [Resignation Not a Cure] Resignation by a fiduciary is not sufficient to discharge the fiduciary's duty under Section 405(a)(3) to make reasonable efforts to remedy the breach of another fiduciary. Marshall v. Dekeyser, 485 F. Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).

Section 405(b)		
(1)	Except as otherwise provided in subsection (d) and in section 403(a)(1) and (2), if the assets of a plan are held by two or more trustees -	
	(A)	Each shall use reasonable care to prevent a co-trustee from committing a breach; and
	(B)	They shall jointly manage and control the assets of the plan, except that nothing in this subparagraph (B) shall preclude any agreement authorized by the trust instrument, allocating specific responsibilities, obligations, or duties among trustees, in which event a trustee to whom certain responsibilities, obligations, or duties have not been allocated shall not be liable by reason of this subparagraph (B) either individually or as a trustee for any loss resulting to the plan arising from the acts or omissions on the part of another trustee to whom such responsibilities, obligations, or duties have been allocated.
(2)	Nothing in this subsection shall limit any liability that a fiduciary may have under subsection (a) or any other provision of this part.	
(3)	(A)	In the case of a plan the assets of which are held in more than one trust, a trustee shall not be liable under paragraph (1) except with respect to an act or omission of a trustee of a trust of which he is a trustee.
	(B)	No trustee shall be liable under this subsection for following instructions referred to in Section 403(a)(1).

A. Conference Report

The allocation of trustee duties are discussed on pages 300-301 of the Congressional Conference Report.

B. Interpretive Bulletins

1. A plan fiduciary who knows of a breach committed by another fiduciary must take reasonable steps to remedy the breach, such as instituting a lawsuit, notifying the Department of Labor, or publicizing the breach. Mere resignation by the fiduciary as a protest against the breach is not sufficient. IB 75-5, Question FR-10.

Section 405(c)		
(1)	The instrument under which a plan is maintained may expressly provide for procedures -	
	(A)	For allocating fiduciary responsibilities (other than trustee responsibilities) among manned fiduciaries, and
	(B)	For named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.
(2)	If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that -	
	(A)	The named fiduciary violated section 404(a)(1) -

		(i)	With respect to such allocation or designation,
		(ii)	With respect to the establishment or implementation of the procedure under paragraph (1), or
		(iii)	In continuing the allocation or designation; or
	(B)	The named fiduciary would otherwise be liable in accordance with subsection (a).	
(3)	For purposes of this subsection, the term "trustee responsibility" means any responsibility provided in the plan's trust instrument (if any) to manage or control the assets of the plan, other than a power under the trust instrument of a named fiduciary to appoint an investment manager in accordance with Section 402(c)(3).		

A. Conference Report

General fiduciary duty allocation provisions are covered on page 302 of the Congressional Conference Report.

B. Interpretive Bulletins

1. [Allocation] Fiduciary responsibilities not involving management or control of plan assets may be allocated among named fiduciaries and may be delegated by named fiduciaries to others if the plan instruments so provide. IB 75-8, Question FR-12.
2. [Allocation] If directors of an employer are the named fiduciaries of the plan, their liability can be limited by the procedures established in the plan instruments for allocating fiduciary responsibilities among named fiduciaries or for designating others to carry out fiduciary responsibilities. IB 75-8, Question D-4.
3. [Allocation] Even if named fiduciaries allocate responsibilities or designate others to perform these functions, they are still liable for breaches in the establishment and implementation of the allocation or designation procedure. IB 75-8, Questions FR-13 and FR-14.
4. [Delegation] Named fiduciaries cannot delegate authority or discretion to manage or control plan assets to anyone other than an investment manager as defined in Section 3(38). IB 75-8, Question FR-15.

C. Advisory Opinions

1. A named fiduciary with the duty to appoint, remove and monitor a plan's investment managers is not responsible for the day-to-day management of plan assets by the investment managers but must be prudent in appointing the investment managers and in continuing to retain them. AO 77-69/70.

D. Court Decisions

1. [Allocation] Fiduciaries are only liable for imprudent investment decisions made by an investment manager, who has been designated as such by the fiduciaries, if the fiduciaries fail to monitor adequately the performance of the investment manager. Brock v. Berman, 673 F. Supp. 634, 8 EBC 1689 (D.Mass. 1987).
2. [Allocation] Even though a plan trustee has no authority for investment decisions, it cannot disavow itself of responsibility for such decisions, since it is still a fiduciary. However, under the allocation provisions of Section 405(c)(1), the trustee may, in fact, not be liable for such decisions. Leonard v. Drug Fair, Inc., No. 78-1335, Fed. Sec. L. Rep. (CCH) Para 97,144 (D.D.C. 1979).
3. [Recordkeeping] A company was delegated by a bank trustee or custodian for self-directed IRA accounts the function of maintaining records and preparing appropriate reports required by Section 103 of ERISA. A company maintaining records necessary for the preparation of such reports is a plan fiduciary and must perform these functions with the degree of care set forth in Section 404(a)(1)(B). Redwood Bank v. QTA, Inc., No. C-79-1586, slip op. (N.D.Cal., Oct. 23, 1979).

Section 405(d)

(1)	If an investment manager or managers have been appointed under section 402(c)(3), then, notwithstanding subsections (a)(2) and (3) and subsection (b), no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any assets of the plan which is subject to the management of such investment manager.
(2)	Nothing in this subsection shall relieve any trustee of any liability under this part for any act of such trustee.

A. Conference Report

Investment manager appointment provisions are covered on pages -301-302 of the Congressional Conference Report.

B. Regulations

See the DOL plan assets ERISA Regulation 2510.3-101.

Prohibited Transactions **ERISA Sections 406, 407, 408, 414**
Section 406(a)(1)
Except as provided in Section 408 [which contains the exemptions from the prohibited transactions restrictions]:
A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect -
Sale or exchange, or leasing, of any property, between the plan and a party in interest;
Lending of money or other extension of credit between the plan and a party in interest;
Furnishing of goods, services or facilities between the plan and a party in interest;
Transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
Acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a) which contains the 10% limitation on the acquisition and holding of qualified employer securities and real property.

A. Statute

Investments in collectibles are generally prohibited by Section 408(m) of the Internal Revenue Code and PTE 91-55 .

B. Conference Report

These prohibited transaction provisions are discussed on pages 306-309 and 316-320 of the Congressional Conference Report.

C. Regulations

DOL ERISA Regulation 2510.3-101 defines plan assets.

D. Prohibited Transaction Class Exemptions (PTE)

1. [Broker] The provision of brokerage services to IRAs and to Keogh plans to which Title I of ERISA is inapplicable is not subject to the prohibited transaction provisions of Title I of ERISA. However, such IRAs and Keogh plans remain subject to the prohibited transaction provisions of Title I of ERISA. Final PTE C 79-1.
2. [Coins and Collectibles] PTE 91-55 permits IRA accounts to invest in *American Eagle* gold coins.
3. [Broker] Securities broker-dealers regularly provide research, information and advice concerning

securities and also effect agency transactions for the purchase or sale of securities in the ordinary course of their business as broker-dealers, and the provision of a combination of such services by a fiduciary with regard to employee benefit plans would constitute prohibited transactions under ERISA and the Code. *Proposed* Extension of Paragraph 1(a) of PTE C 75-1; Final PTE C 78-10.

4. [Foreign Exchange] A bank fiduciary may use its own services (or those of an affiliate) to invest, on a non-discretionary basis, in foreign currencies and foreign currency options, subject to a number of conditions. See PTE 94-20 .
5. [Loan by Union Plan to Provide Projects for Union Employers] A loan by a multiemployer plan or a multiple employer plan to an owner of real property who is not a party in interest or a disqualified person to such plan where the loan is for the purpose of enabling such property owner to make construction improvements on such property, and the property owner contracts with an employer participating in the plan to make such construction improvements, is not a prohibited transaction under Section 406(a) of ERISA and Section 4975(c)(1)(A) - (D) of the Code. However, such a loan may give rise to a prohibited transaction if, for example, the loan is made in the context of an arrangement where a specific participating employer is to furnish a portion of the construction, and such employer has a controlling influence over the plan's decision to make the loan. Final PTE C 76-1.
6. [Office Space] In some instances, a multiemployer plan or a multiple employer plan will secure office space and administrative services jointly with a participating employee organization, employer or employer association, or with another multiemployer plan or multiple employer plan that is a party in interest or disqualified person to the plan and will share the costs of securing such office space or administrative services on a pro-rata basis based on each party's use of such space or services. Such joint use of office space or administrative services does not constitute a prohibited transaction. However, if a multiemployer plan or a multiple employer plan independently secures for its own use office space or administrative services and furnishes part of such office space or administrative services to a party in interest or disqualified person, such transactions are prohibited transactions. Final PTE C 76-1.
7. [Securities Lending] A securities lending service, pursuant to which a bank-trustee will lend securities of plans for which it serves as trustee to broker-dealers for an additional fee from the plan, may contravene Section 406(b). AO 79-11. But also see PTE 82-63 .
8. [Securities Lending] Payment to a party in interest of any commission, finder's fee or other compensation for services in connection with the effecting of a loan of securities by the plan to a broker-dealer, bank or other person would be a prohibited transaction. *Proposed* PTE I D-762. But also see PTE 82-63 .

E. Interpretive Bulletins

1. [Plan Assets] In general, the investment by a plan in securities of a corporation will not be considered to be an investment in the underlying assets of the corporation. The assets of the corporation are not plan assets so subsequent transactions between a party in interest and the corporation will not be prohibited. This general proposition is consistent with Section 401(b)(1). However, this does not mean that such an investment may not sometimes constitute an indirect prohibited transaction. For example, if a plan invests in a corporation pursuant to an arrangement whereunder it is expected that the corporation will engage in a transaction with a party in interest, such arrangement will be a prohibited transaction. IB 75-2 (This IB contains several examples).
2. [Contributions, In-Kind] Contributions of non-cash ("in-kind") assets to a defined benefit plan is a prohibited transaction. In-kind contributions to a defined contributions or welfare benefit plan may be a prohibited transaction, depending on the facts and circumstances and provisions of the plan. The basic determinant is whether the in-kind contributions represents an attempt to lessen a present or future obligation to make cash contributions to a plan. IB 94-3 .
3. [Bonding of Fiduciaries] The purchase of a bond required under Section 412 is not a prohibited transaction. IB 75-5, FR-9.
4. [Payment of Benefits] The mere payment of money to which a participant or beneficiary is entitled, at the direction of the participant or beneficiary, to a party in interest does not contravene Section 406(a)(1)(D). IB 78-1.

F. Advisory Opinions

1. [Alienation of Benefits] Because Section 406 prohibits both direct and indirect transactions, a trustee to whom the limitation on compensation in Section 408(c)(2) applies could not assign his rights to compensation for services rendered to a plan to a party in interest, such as an

employer. Therefore, the trustee could not submit a request for compensation to the fund designating his employer as payee on checks issued. WSB 79-92.

2. [Alienation of Vested Benefits] Withholding of benefits from a plan participant and transfer of those benefits to a party in interest in satisfaction of a debt owed by the participant to that party in interest is a prohibited transaction. AO 76-99.
3. [Appointment] The appointment of a bank that is a creditor of the entity maintaining the plan as trustee of the plan assets is not a prohibited transaction. WSB 77-14.
4. [Appointment] The appointment of a party in interest as trustee, and the transfer of plan assets to the trustee pursuant to such appointment, does not constitute a prohibited transaction under Section 406(a)(1)(D) and does not contravene Sections 406(b)(1) or 406(b)(3). WSB 77-14.
5. [Bank Servicer] The owner of a trust company that acts as a fiduciary to employee benefit plans that renders certain services for the trust company, but not for the plans, is not subject to the prohibitions of Section 406(a), since the services would not be a transaction between the plan and a party in interest. AO 82-55A.
6. [Bank Stock - Purchase/Retention/Sale of Fiduciary Bank/BHC Stock]

    - *General Discretionary Rule* - An ERISA plan may not invest in the stock of a fiduciary bank if the bank has discretion over the transaction. The discretionary retention of such stock would also be prohibited. Non-discretionary purchases, sales, retentions are permitted. See 1980 letter from DOL to OCC .

    - *General Non-Discretionary Rule* - An ERISA plan may invest in the stock of a fiduciary bank or its bank holding company if the bank has no discretion over the investment. AO 92-23A .

    - *Self-Directed Purchases* - Permits self-directed accounts to purchase stock (including treasury stock) of the fiduciary bank or its holding company. AO 88-9 .

    - *Mutual Conversions - Initial Public Offerings* - Permits self-directed accounts to purchase stock of the fiduciary bank (or its holding company) in an initial public offering (IPO) or on conversion of a mutual institution to a stock institution. AO 88-28 .

7. [Bonds - Rights] The sale or assignment of rights to debentures by a trust to a party in interest is a prohibited transaction. AO 76-72.
8. [Collective Funds] The investment of plan assets in a commingled fund (for example, a qualified group trust) maintained by a bank trustee causes the assets of such commingled fund to be treated as assets of the plan. Consequently, a purchase or bolding of a master note (i.e, a nonnegotiable obligation issued by a finance company, the principal amount of which fluctuates on a daily basis depending on how much money the fund desires to loan the issuer) by the commingled fund in which the plan has an interest from a subsidiary of the corporation maintaining the plan constitutes a loan from the plan to the subsidiary in violation of Section 406(a)(1)(B) of ERISA and Section 4975(c)(1)(B) of the Code. PLR 7913114; PLR 7913116; *Proposed* PTE C 784.
9. [Collective Funds] The mere transfer of assets between a qualified group trust (CIF) and plans invested therein, and the corresponding increase or decrease in qualified group trust units credited to the plans, are intra plan transactions so long as the group trust is a qualified trust under Section 401(a) of the Code and the transfers are within the terms of the plan. Accordingly, such transactions do not fall within the restrictions of Section 406 of ERISA or Section 4975(c)(1) of the Code. PLR 7913116.
10. [Collective Funds - Conversion to Mutual Funds] The conversion of an ERISA collective investment fund would be a prohibited transaction in violation of Section 406. PTE 77-4 would *not* provide relief for such a conversion. See the 1994 letter from DOL to OCC .
11. [Compensation] The receipt of compensation by a fiduciary from a plan is a prohibited transaction if the fiduciary is already receiving full-time compensation from the employer maintaining the plan. AO 78-08.
12. [Contributions - In-Kind] The contribution to the plan by the employer of a condominium owned by the owner, in lieu of making its contribution to the defined benefit plan, in accordance with the requirements for properly funding the plan, constitutes a prohibited sale or exchange of property between the plan and a party in interest pursuant to Section 406(a)(1)(A).

    Section 406 provides that a transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or a lien that the plan assumes or it is subject to a mortgage or similar lien that a party in interest placed on the

property within the ten year period ending on the date of the transfer. The transfer of an option to purchase a condominium by a party in interest to the plan followed by the exercise of the option by the plan may also constitute a violation of Section 406(a)(1)(A) . AO 81-69A.

13. [Deposits] The investment of plan assets in credit union share accounts, at the direction of the plan participants and beneficiaries, is not a prohibited transaction. AO 76-38.
14. [Deposits] The investment of the assets of a noncollectively bargained multiple employer plan covering employees of banks, in savings accounts and certificates of deposit of banks that are contributing employers, constitutes a prohibited transaction under Section 406(a) and may also be prohibited under Section 406(b)(1) and (2), because members of the administrative board of the plan, which directs plan investments, are officers and employees of contributing employer/banks.

    However, Section 408(b)(4) provides an exemption from Sections 406(a), 406(b)(1), and 406(b)(2) for the investment of plan assets in the deposits of certificates of deposit of a bank that is a plan fiduciary or party in interest, if the requirements of DOL ERISA Regulations Section 2550.408b-4 are met. **One requirement of the regulation is that, for investments made after November 1, 1977, the plan specify the name(s) of the banks in which deposits may be made. The specifications may be made in the plan by amendment retroactive to November 1, 1977.** AO 79-25.

15. [Estates] The purchase of real property from the estate of the sole shareholder of a corporation contributing to a plan is not a prohibited transaction even though one of the executors of the estate formerly was a plan trustee. AO 76-420.
16. [Fees - Own-Bank Plan] A bank is not prohibited from serving as trustee for a plan maintained for the bank's employees *where it receives no compensation from the plan for its trustee services* [Emphasis added]. AO 79-49 .
17. [Fees] The reimbursement of, or payment to, fiduciaries of expenses properly and actually incurred in settlement of pending or threatened litigation by a plan, pursuant to indemnification provisions that do not contravene ERISA, is not a prohibited transaction. AO 77-66/67.
18. [Investment Advisor] The provision of investment advisory, services by a corporation to a plan is not a prohibited transaction even though the corporation also provides such services to other clients who may be parties in interest to the plan. AO 77-44.
19. [Investment Advisor] To the extent that a party renders investment performance measurement services to a plan, providing no more than quantitative measurement and ranking of a plan's investment portfolio and/or management performance based upon objective, reasonable and relevant criteria that are uniformly applied, such service would not constitute the rendering of investment advice. However, where the service provider adopts, applies or modifies performance or portfolio indices in such a way that a plan is furnished with a format for decision making that is designed to influence the plan's continued participation in a particular investment program, the service would constitute investment advice. AO 94-03.
20. [Leases - Sponsor] The leasing by a plan of improved real property to the employer maintaining the plan is a prohibited transaction pursuant to Sections 406(a)(1)(A), (C), (D) and (E) of ERISA and Sections 4975(c)(a)(1),(C) and (D) of the Code. In addition, since any property leased to an employer is "employer real property," as defined in Section 407(d)(2) of ERISA, if such property is not "qualifying employer real property" within the meaning of Section 407(d)(4) of ERISA, the holding of such property by the plan is a prohibited transaction pursuant to Sections 406(a)(2) and 407(a)(1) of ERISA. Also, to the extent that the employer may be a fiduciary to the plan, as defined in Section 3(21)(A) of ERISA and Section 4975(e)(3) of the Code, the lease arrangement may be a prohibited transaction pursuant to Section 406(b)(1) and (2) of ERISA and Section 4975(c)(1)(E) of the Code. *Proposed* PTE F 192.
21. [Loans - Common Borrower] If a loan is made by a plan to a person in order to encourage that person to do business with the employer, the transaction would be prohibited under Sections 406(a)(1)(D) and 406(b). WSB 79-63.
22. [Loan by Construction Union Plan to Provide Employment for Union Members] Because it will not opine on factual circumstances, the Department will not opine on construction industry trustees' direction to their investment manager to invest a specified amount of plan assets in construction mortgages within the jurisdiction of the union whose members are plan participants. The Department states, however, that it would not be inconsistent with the requirements of Sections 403(c) and 404 for plan fiduciaries to select an investment course of action that reflects non-economic factors so long as application of such factors follows the primary consideration of a broad range of investment opportunities that are economically equally advantageous.

Arrangements whereby funds of plans are invested by the fiduciary in transactions that indirectly create employment opportunities and compensation for employee services necessarily require an examination to determine if an indirect use of plan assets for the benefit of a party in interest is involved. AO 85-36A .

23. [Loan by Union Plan to Provide Projects for Union Employers] If a multiemployer plan acquires unimproved real property and arranges for the construction of building structures on such property for the purpose of providing office space for the plan with building contractors and subcontractors some or all of whose employees are participants or beneficiaries of the plan, the arrangement between the plan and such building contractors and subcontractors would constitute prohibited transactions. *Proposed* PTE I 76-2.
24. [Loans - Sponsor] Where a plan has a loan outstanding to X Corp. and the employer with respect to the plan acquires a majority or controlling interest in X Corp., the loan would become a prohibited, indirect extension of credit to the employer, in addition to being a direct prohibited extension of credit to X Corp. However, if the loan transaction is contemplated before the acquisition, the loan would not be a prohibited transaction. AO 79-37.
25. [Loan Guarantee] A guarantee by a party in interest of a loan by a plan to a third party constitutes an extension of credit between the plan and the party in interest. If such loan was made pursuant to a binding contract in effect on July 1, 1974, it may be exempt under Section 414(c)(1), even if the loan constitutes a nonqualifying security under Section 407. See DOL ERISA Regulation Section 2550.407a-1(b) .
26. [Mutual Fund Conversion from Collective Investment Fund] The conversion of an ERISA collective investment fund would be a prohibited transaction in violation of Section 406. PTE 77-4 would *not* provide relief for such a conversion. See 1994 letter from DOL to OCC .
27. [Pooled Fund - Seed Money] The transfer by an insurance company of seed money invested by it in separate investment accounts back to the general account of the insurance company would not be treated as assets of a plan that have invested in the separate accounts and, therefore, the insurance company's redemption of its participation units in the separate accounts does not constitute a violation of the provisions of Sections 404(a)(1)(A) and (D). AO 83-38A.
28. [Sale of Assets to Insider] The sale of certain parcels of real property by a profit-sharing plan to the majority shareholder of the employer maintaining the plan and to a corporation 50% or more of which is owned by such majority shareholder would constitute prohibited transactions pursuant to Section 406(a)(1)(A) and (D) of ERISA and Section 4975(c)(1)(A) and (D) of the Code. In addition, if the majority shareholder has the power to appoint and remove the plan trustee, such sales may be prohibited transactions under Section 406(b)(1) and (2) of ERISA and Section 4975(c)(1)(E) of the Code. *Proposed* PTE I 492.
29. [Stock - Sponsor] The purchase of common stock of the employer maintaining the plan by the employer from the plan is a prohibited transaction (AO 79-23), even if the purchase is made pursuant to a public tender offer (AO 77-48.)
30. [Sweep] Scan and sweep services by a bank for plans for which it provides fiduciary services and for which it is paid a separate fee would be exempt from any of the prohibitions of Section 406(a) if the conditions of Section 408(b)(2) are met. The question of what constitutes a reasonable service, a reasonable contract or arrangement, and reasonable compensation is inherently factual in nature, and not subject to opinion.

    A Section 408(b) violation would be involved if the bank, as fiduciary, exercised its authority, control or responsibility that makes it a fiduciary to cause the plan to enter into a transaction involving the provision of services when such fiduciary has an interest in the transaction that may affect the exercise of its judgment as a fiduciary. Therefore, to the extent the bank would direct the utilization of the scan and sweep services and receive any fee therefore, there would be a *per se* violation of Section 408(b). However, if the bank does not exercise such authority, but the decision is made by the plan sponsor, no violation would exist. AO 88-02A.

G. Court Decisions

1. [General] ERISA Section 406, which prohibits fiduciaries from causing a plan to engage in certain specified transactions, evinced the Congressional desire to prevent transactions that offer a high potential for loss of plan assets and for insider abuse; and to prevent a trustee from being put in a position where he has dual loyalties. McDougall v. Donovan 552 F.Supp. 1206, 3 EBC 2385 (N.D.Ill. 1982).
2. [General] The question of whether ERISA has been violated does not depend on whether any harm results from the transaction. Congress was concerned in ERISA to prevent transactions that offered a high potential for loss of plan assets or for insider abuse. The fact that a prohibited loan is or may be ultimately repaid does not render the loan lawful. Marshall v. Kelly, F.Supp.

341, 1 EBC 1850 (W.D.Okla. 1978); Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979); Marshall v. Dekeyser, 485 F.Supp. 629, 1, EBC 1898 (W.D.Wis. 1979).

3. [General] ERISA Section 406(a) prohibits a fiduciary from causing a plan to enter into transactions with parties whom "he knows or should have known" are parties in interest to the plan. A fiduciary must act with prudence in investigating whether a party-in-interest relationship exists. In the case of a significant transaction, generally for the fiduciary to be prudent he must make a thorough investigation of the other party's relationship to the plan to determine if he is a party in interest. In the case of a normal and insubstantial day-to-day transaction, it may be sufficient to check the identity of the other party against a roster of parties in interest that is periodically updated. Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
4. [General] Congress did not intend to exclude from prohibitions under Section 406 transactions that have independent business purposes, just as it did not exclude transactions that are fair under some independent measure. Congressional intent to eliminate all transactions, with even the potential to bias the independent judgment of plan fiduciaries, must be followed. McDougall v. Donovan 552 F.Supp. 1206, 3 EBC 2385 (N.D.Ill. 1982).
5. [General] Section 406 of ERISA does not create a per se prohibition against plan fiduciaries with dual loyalties acting on behalf of the plan. Donovan v. Bierwirth, 538 F.Supp. 463, 2 EBC 2145 (E.D.N.Y. 1981).
6. [Effective Date] Actions by fiduciaries occurring after 1974 are not insulated from ERISA coverage merely because their roots can be traced to an event prior to the effective date of ERISA. Marshall v. Craft, 463 F.Supp. 493 (N.D.Ga. 1978).
7. [Compensation] The critical analysis under Section 406, regarding a transaction with a party in interest that is exempted under Section 408, is whether the party in interest receives more than reasonable compensation. Brock v. Robbins 830 F.2d 640, 8 EBC 2489 (7th Cir. 1987).
8. [Compensation] The payment by a multiemployer plan of rent for an aircraft leased from a party in interest in an amount in excess of the value received by the multiemployer plan in utilizing the aircraft allegedly constitutes a prohibited transaction under Section 406(a)(1)(D). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
9. [ESOP] Under Section 406(a)(1)(B), one transaction normally prohibited is the lending of money or other extension of credit between the plan and a party in interest; however, loans to employee stock ownership plans are exempt from such prohibitions. Allen v. Katz Agency, Inc. Employee Stock Ownership Plan, 677 F.2d 193, 3 EBC 1352 (2d Cir. 1982).
10. [Ignorance] Where trustees did not inspect complete agreement as drafted by counsel, and thus were not aware that part of the plan would result in the use of plan assets to benefit a party in interest, they violated ERISA Section 406(a)(1). Dimond v. Retirement Plan, 582 F. Supp. 892, 4 EBC 1457 (W.D. Pa. 1983).
11. [Leases] The lease of an airplane by a multiemployer plan from a party in interest allegedly constitutes a prohibited transaction under Section 406(a)(1)(A). Usery v. Wilson, et al, No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
12. [Loans] Fiduciaries cannot act as both borrowers and lenders as these are parties whose interests are adverse; fiduciaries acting on both sides of a loan transaction cannot negotiate the best terms for either party. Davidson v. Cook, 567 F.Supp. 225, 4 EBC 1816 (E.D.Va. 1983), aff'd, 734 F.2d 10 (4th Cir.), cert. denied, 469 U.S. 899 (1984).
13. [Loans to Plan Sponsor] An employer's borrowing of money from the fund violates the prohibition under ERISA Section 406 regarding the lending of money between a plan and a party in interest. Dependahl v. Falstaff Brewing Corp., 491 F.Supp. 1188, 30 Fed. Rul. Serv.2d(Callahan) 564 (E.D.Miss. 1980), aff'd in part, rev'd in part, 653 F.2d 1208 (8th Cir.), cert.
14. [Loans] The phrase "reasonable rate of interest" within the meaning of ERISA Section 406(a)(1)(B) does not equate to the term "prevailing or market rate of interest." Thus, if the other requirements of Section 406(a)(1) are met, a pension fund may charge interest rates lower than the prevailing rate on mortgage loans made to plan participants. Evidence that a pension fund had charged a lower interest rate was insufficient to establish that the loans did not "bear a reasonable rate of interest" and were accordingly not exempted from the prohibition of ERISA Section 406(a) against making loans to plan participants. Brock v. Walton, 794 F.2d 586,7 EBC 1769 (11th Cir.), reh'g denied, 802 F.2d 1399 (11th Cir. 1986) (en banc).
15. [Loans] A loan of money by a multiemployer plan to a party in interest allegedly constitutes a prohibited transaction under Section 406(a)(1)(B). Usery v. Wilson, et al, No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
16. [Loans] Dissolving the improper party-in-interest relationship prior to the execution of a loan did not preclude the transaction from being violative of ERISA Section 406 when the loan agreement already existed at the time of divestiture. M&R Investment Co., Inc. v. Fitzsimmons, 685 F.2d 283, 3 EBC 1835 (9th Cir. 1982).

17. [Loans] A loan by a multiemployer plan to a party in interest for the purpose of enabling the party in interest to remove preexisting liens on an aircraft that the party in interest wished to acquire free of encumbrances allegedly constitutes a prohibited transaction under Section 406(a)(1)(D). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).
18. [Loans] Profit-sharing plan trustees violated ERISA's prohibited transactions provisions by maintaining pre-ERISA loans to employer-sponsor and to one of the trustees after law's effective date, where one loan was made without security with an oral promise to repay, since loans' terms were not at least as favorable to the plan as arm's length transaction would have been. Donovan v. Bryans, 566 F. Supp. 1258, 4 EBC 1816 (E.D.Pa. 1983).
19. [Mergers & Acquisitions] Fiduciaries of a trust, containing assets of corporate employee pension benefits plan, violated ERISA's prohibited transactions in Section 406 when they used the assets to finance another corporation's obligation under an acquisition agreement requiring the purchase of shares of stock held by the trust in another corporation. Sandoval v. Simmons 622 F.Supp. 1174, 6 EBC 2161 (D.C. Ill. 1985).
20. [Mergers & Acquisitions] ERISA Section 406(a)(1)(D) and (b)(1) should be read broadly as a gloss on the duty of loyalty required by Section 404 in light of the Congressional concern with protection of plan beneficiaries and should be read to cover action of trustee who buys shares in target corporation in order to assist either target's management or raider in its quest for corporate control or a control premium. Leigh v. Engle, 727 F.2d 113, 4 EBC 2702 (7th Cir. 1984).
21. [Provide Benefits] The payment of rent on behalf of the widow of a former plan trustee is a prohibited transaction under Section 406(a)(1)(D) even though the payment was morally commendable and was not made for the personal gain of plan fiduciaries. Marshall v. Cuevas, 1 EBC 1580 (D.P.R. 1979).
22. [Successor Trustee] ERISA limits a fiduciary's liability for breach of duty to those breaches committed during his tenure; however, under Section 406 of ERISA a successor trustee has a duty to dispose of prior investments violative of ERISA upon assuming his responsibilities. McDougall v. Donovan 552 F.Supp. 1206, 3 EBC 2385 (N.D.Ill. 1982).
23. [Unions] As Section 406 of ERISA seeks to protect against influences exerted by all parties in interest, Congress intended to prohibit dealings between a plan and any union whose members are among the beneficiaries of the plan. McDougall v. Donovan 552 F.Supp. 1206, 3 EBC 2385 (N.D.Ill. 1982).

Section 406(a)(2)
Except as provided in Section 408 [which contains the exemptions from the prohibited transaction restrictions]:
No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or real property if he knows or should know that holding such security or real property violates section 407(a) which contains the 10% limitation on the acquisition and holding of qualifying employer securities and real property.

A. Conference Report

The prohibited transaction provisions are discussed on pages 306-309 and 316-320 of the Congressional Conference Report.

Section 406(b)(1)	
A fiduciary with respect to a plan shall not -	
(1)	Deal with the assets of the plan in his own interest or for his own account,

A. Conference Report

This prohibition is covered on page 309 of the Congressional Conference Report.

B. Regulations

No regulations have been issued yet. However, the regulations under Section 408(b)(2) amplify

this prohibition .

1. This prohibition is imposed to deter fiduciaries from exercising the authority, control or responsibility that makes such persons fiduciaries when they have interests that may conflict with the interests of the plans for which they act. ERISA Regulation 2550.408b-2(e)(1).
2. A fiduciary does not engage in an act described in Section 406(b)(1) if the fiduciary does not use any of the authority, control or responsibility that makes such person a fiduciary to cause the plan to pay additional fees for a service furnished by such fiduciary or by a person in which such fiduciary has an interest that may affect the exercise of such fiduciary's best judgment as a fiduciary. DOL ERISA Regulation 2550.408b-2(e)(2).
3. The regulation cited above contains several important examples. DOL ERISA Regulation 2550.408b-2(f). Some of the examples, however, only deal with Section 406(b)(1) and not with Sections 406(b)(2) and 406(b)(3). Therefore, even if an example indicates that there is no Section 406(b)(1) prohibition, there may be a Section 406(b)(2) or (3) prohibition.
4. For a definition of plan assets, see DOL ERISA Regulation 2510.3-101.

C. **Advisory Opinions**

1. [General] A fiduciary does not engage in a violation of Section 406(b)(1) unless he uses his fiduciary authority to benefit himself or a related party. WSB 79-20; PLR 7826047; PLR 7826048; PLR 7826049; *Proposed* PTE I 492; *Proposed* Extension of Paragraph 1(a) of PTE C 75-1.
2. [General - Discretion Required] A fiduciary to a plan, by reason of rendering investment advice for a fee or other compensation, shall not be deemed to be a fiduciary regarding any plan assets to which such person does not have discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control and does not render investment advice for a fee or other compensation. Thus, a sale of assets by the corporate trustee and investment manager, but of assets not under the control of that fiduciary, does not involve a possible prohibited transaction under Section 406(b). Also, where a factual analysis confirms that at the time of a transaction, the plan, as seller, and the purchaser had no party-in-interest relationship to one another, the sale cannot constitute a violation of Section 406(a)(1)(A) through (D). AO 81-20A.
3. [General] If a fiduciary uses the authority, control and responsibility that makes him a fiduciary to cause the plan to enter a transaction involving the provision of services when such fiduciary has an interest in the transaction that may affect the exercise of his best judgment as a fiduciary, a transaction described in Section 406(b) would occur. That transaction would be deemed to be a separate transaction from the transaction involving the provision of services and would not be exempted under Section 408(b)(2). Also, questions of what constitutes a necessary service, a reasonable contract or arrangement, and reasonable compensation are inherently factual in nature and will not be the subject of advisory opinions.

   Where a firm is an investment manager to individual employee benefit plans, the initial appointment of that firm as investment manager of a master trust and/or trustees of the master trust by independent plan fiduciaries would not cause the investment manager or trustees to violate Section 406(b)(1) or (2) as long as those persons exercise none of the authority, control or responsibility that makes them fiduciaries to cause the plan to make such appointments.

   - [Collective Investment Funds] Also, Section 406(a)(1) does not apply to any transaction between a plan and a common or collective trust fund maintained by a bank or trust company supervised by a state or a federal agency if (a) the transaction is a sale or purchase of an interest in the fund, (b) the bank or trust company receives no more than reasonable compensation, and (c) the transaction is expressly permitted by the instrument under which the plan is maintained or by a fiduciary who has authority to manage and control the assets of the plan.

   - [Deposits] Section 408(b)(4) provides that the prohibitions of Section 406 shall not apply to the investment of all or a part of plan assets and deposits that bear a reasonable rate of interest in a bank or similar financial institution supervised by the United States of America or by a state if such bank or other institution is a fiduciary of the plan and if (a) the plan covers only employees of such bank or other institution or affiliates of such bank or institution or (b) such investment is expressly authorized by a provision of the plan or by a fiduciary who is expressly empowered by the plan to so instruct the trustee

regarding such an investment.

- [Loan to Provide Employment for Union Members] Finally, the Department of Labor, on its own, notes that one of the collective funds that was the subject of the request for opinion is designated as the union construction fund. The Department indicates that a decision to make an investment may not be influenced, for example, by a desire to stimulate the construction industry and generate employment unless the investment, when judged solely on the basis of the economic value to the plan, would be equal to or superior to alternate investments available to the fund. AO 82-51A.

4. [General] The inquiry concerning whether a fiduciary has violated ERISA Section 406(b)(1) is not limited to the initial decision by the plan regarding retention of the fiduciary to provide additional services. At all times, such fiduciary may make no decision on behalf of the plan (or in any way use his authority or control) to cause the plan to make a decision which would have the effect of personally benefiting himself or any other person in which such fiduciary has an interest.

   However, the potential for a prohibited act of self-dealing in violation of ERISA Section 406(b)(1) may be prospectively avoided through the careful application, in effect as well as in form, of Example (7) of ERISA Regulations Section 2550.408(b)-2(f) (for example, the trustee must physically absent himself from all consideration of the matter and cannot any of his authority or control to influence the plan's decision.) WSB 79-20.

5. [Bank Board Membership] Where an individual is a fiduciary to a plan and where the individual serves as a member of the board of directors of a bank that also serves as a fiduciary to the plan, decisions made by the bank's board of directors regarding plan investments do not necessarily constitute Section 406(b) violations by the individual/director if he absents himself from any arrangements, agreements or understanding; removes himself from all board consideration of these decisions; and does not otherwise exercise any authority, control or responsibility with regard thereto. Provided, however, that if the board itself has an interest in the transaction that could alter or affect its judgment, this would constitute a per se violation under Section 406(b). AO 86-11A.
6. [Bank Custodian - Board Membership] The investment of plan assets in securities of the bank that is custodian, at the direction of a trustee who is also a director of the bank, may be a prohibited transaction under Section 406(b)(1). AO 76-76.
7. [Bank Holding Company Affiliate Use] The appointment of a second tier subsidiary and/or a division of a corporation to perform a fiduciary or nonfiduciary service for a plan, for which the second tier subsidiary or division acts as a fiduciary, would not constitute an act of self-dealing by the fiduciary provided that the appointment is made by a fiduciary who is independent of and unrelated to the parent-subsidiary group. PLR 7826047.
8. [Bank Holding Company Affiliate Use] A second tier subsidiary, acting in its capacity as plan trustee, retained a division of the parent of the first tier subsidiary to provide it with investment advice and related advisory services to the trust for which it was acting as trustee. The services performed by the division were clearly within the existing responsibilities of the second tier subsidiary. The second tier subsidiary did not delegate any of its responsibilities as trustee because it remained fully responsible for managing the plan's investments. The fees charged by the second tier subsidiary included payment for investment advice as well as for custodial services. The second tier subsidiary's fee was not affected by reason of its retaining the division. Rather, at its own expense, the second tier subsidiary compensated the division for the services rendered to it. The second tier subsidiary did not engage in an act of self-dealing under Code Section 4975(c)(1)(E) when it appointed the division to provide investment advice. PLR 7826048.
9. [Brokerage Services] If a plan fiduciary effects securities transactions on behalf of the plan and performs functions incidental to the effecting of such transactions, such transactions would be prohibited by ERISA and the Code unless, under the particular facts and circumstances surrounding the transactions, they do not constitute acts of self-dealing under ERISA Section 406(b)(1) and Code Section 4975(c)(1)(E). *Proposed* Extension of Paragraph 1(a) of PTE C 75-1.
10. [Collective Investment Funds] Also refer to General Advisory Opinions above for AO 82-51A.
11. [Collective Investment Funds] It is a violation of Section 406(b) when a company maintaining a pension advisory and consulting service, dealing in establishing investment objectives, evaluation, recommending managers, and monitoring performance, makes recommendations with regard to investments in collective trust funds to which said party has a fiduciary role, if the recommendations are a primary basis for plan investments. AO 84-04A.

12. [Commissions] This advisory opinion involved transactions by a licensed stock brokerage firm, which was the plan sponsor and involved mutual fund investments made by the plan. The documentation between the plan sponsor and the plan provided that the sponsor would agree to receive and hold all commissions as agent for the trustee on behalf of the plan and to pay the commissions to the plan within 30 days after receipt thereof.

    The Department of Labor ruled that the receipt of brokerage commissions by a plan fiduciary from a transaction involving assets held by the fiduciary as agent for the plan would not constitute a violation of ERISA if the fiduciary had no right, title or interest in the proceeds passed to the fiduciary, the commissions were returned to the plan in the ordinary course of business, and the fiduciary does not benefit in any manner from the holding of the money. AO 81-90A.

13. [Compensation] The receipt of compensation by a fiduciary from a plan is a prohibited transaction if the fiduciary is already receiving full-time compensation from the employer maintaining the plan. AO 78-08.
14. [Compensation] The appointment by a plan trustee of his secretary as plan administrator may violate Section 406(b)(1). Plan fiduciaries are prohibited from dealing with plan assets in their own interest or for their own account. If the compensation paid by the plan for administrative services, in fact, serves to compensate the trustee's secretary for the time spent in the performance of her secretarial duties, a violation of Section 406(b)(1) might occur. AO 77-84.
15. [Deposits] Also refer to General Advisory Opinions above for AO 82-51A.
16. [Deposits] The investment of the assets of a plan covering employees of banks, in savings accounts and certificates of deposit of banks that are contributing employers, constitutes a prohibited transaction under Section 406(a) and may also be prohibited under Section 406(b)(1) and (2) because members of the administrative board of the plan, which directs plan investments, are officers and employees of contributing employer/banks.

    However, Section 408(b)(4) provides an exemption from Sections 406(a), 406(b)(1) and 406(b)(2) for the investment of plan assets in the deposits or certificates of deposit of a bank that is a plan fiduciary or party in interest, if the requirements of ERISA Regulations Section 2550.408b-4 are met. **One requirement of the regulation is that, for investments made after November 1, 1977, the plan specify the name(s) of the banks in which deposits may be made. The specifications may be made to the plan by amendment retroactive to November 1, 1977**. AO 79-25.

17. [Fees, Incentive] Payment of an incentive fee pursuant to appropriate contractual relationship between an investment manager (fiduciary) and the plan would not, in and of itself, violate Section 406(b)(1). The amount of compensation that the manager earns depends solely on the changes in value of the securities in the individual accounts and, therefore, the manager would not be exercising any of its fiduciary authority or control to cause the plan to pay an additional fee.

    Moreover, it does not appear that the manager would be acting on behalf of or representing a person whose interests are adverse to the plan merely because it enters into an incentive fee arrangement. However, the Department notes that incentive fee arrangements could, under certain facts and circumstances, violate both Sections 406(a) and 406(b), as well as Section 404(a). Thus, the plan fiduciary must act prudently in deciding to enter into an incentive compensation arrangement with an investment manager, as well as the negotiation of the specific formula under which the compensation will be paid. The Department's position is that the fiduciary, prior to a decision to enter into an incentive compensation arrangement, must fully understand the compensation formula and the risks associated with this manner of compensation and have all relevant information pertaining thereto available to it. Further, the plan fiduciary must be capable of periodically monitoring the actions taken by the manager in the performance of its investment duties. AO 86-20A; accord AO 86-21A.

18. [Float] The ancillary services exemptions (§ 408(b)(2) and 408(b)(6)) do not include the float earned by the fiduciary bank from a demand deposit account to the extent that it is reasonably possible to earn a return on such funds. Retention of float would be permissible if it was a part of the bank's overall compensation from the plan and if the bank had made appropriate disclosures regarding the use of float. Failure to comply would result in a violation of ERISA Section 406(b)(1). AO 93-24A.
19. [Leases to Sponsor] The leasing by a plan of improved real property to the employer maintaining

the plan is a prohibited transaction pursuant to ERISA Section 406(a)(1)(A), (C), (D) and (E) and Code Section 4975(c)(1)(A), (C) and (D). In addition, since any property leased to an employer is employer real property as defined in ERISA Section 407(d)(2), if such property is not qualifying employer real property within the meaning of ERISA Section 407(d)(4), the holding of such property by the plan is a prohibited transaction pursuant to ERISA Sections 406(a)(2) and 407(a)(1). Also, to the extent that the employer may be a fiduciary to the plan as defined in ERISA Section 3(21)(A) and Code Section 4975(e)(3), the lease arrangement may be a prohibited transaction pursuant to ERISA Section 406(b)(1) and (2) and Code Section 4975(c)(1)(E). *Proposed* PTE I 192.

20. [Loan by Construction Union Plan to Provide Employment for Union Members] Also refer to General Advisory Opinions above for AO 82-51A.
21. [Loans] If a loan is made by a plan to a person in order to encourage that person to do business with the employer, the transaction would be prohibited under Section 406(a)(1)(D) and 406(b). WSB 79-63.
22. [Sale to Insider] The sale of certain parcels of real property by a profit-sharing plan to the majority shareholder of the employer maintaining the plan and to a corporation 50% or more of which is owned by such majority shareholder would constitute prohibited transactions pursuant to Section 406(a)(1)(A) and (D) of ERISA and Section 4975(c)(1)(A) and (D) of the Code. In addition, if the majority shareholder has the power to appoint and remove the plan trustee, such sales may be prohibited transactions under Section 406(b)(1) and (2) of ERISA and Section 4975(c)(1)(E) of the Code. *Proposed* PTE I 492.
23. [Stock - Exchanges] An exchange of securities held by a stock bonus plan in connection with a reorganization is not a prohibited transaction. WSB 78-29.

D. Court Decisions

1. [General] ERISA Section 406(b) codifies the principle that ERISA fiduciaries owe the plan, its participants and its beneficiaries a duty of loyalty and cautions fiduciaries that they must either avoid certain types of transactions or not serve as fiduciaries. Section 406 is violated if fiduciaries invest plan assets in companies in which any fiduciary owns an equity interest or from which any fiduciary receives compensation for the investment. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 8 EBC 2457 (2d Cir. 1987).
2. [General] Based on Congressional concern about protection of plan beneficiaries, ERISA Sections 406(a)(1)(D) and (b)(1) should be read broadly as a gloss on the duty of loyalty required by Section 404 and should be read to cover action of trustee who buys shares in target corporation in order to assist either target's management or raider in its quest for corporate control or a control premium. Leigh v. Engle, 727 F.2d 113, 4 EBC 2702 (7th Cir. 1984).
3. [Compensation] The prohibition against fiduciaries acting in conflict of interest situations is violated where trustees authorize, for each other, monthly payment from plan's assets as compensation for their services as trustees while they are receiving full-time pay from participating employers or union and further authorize plans to make contributions on their behalf so as to make each other eligible for receipts of benefits from the plans. Donovan v. Daugherty, 550 F.Supp. 390, 3 EBC 2079 (S. D. Ala. 1982).
4. [Loans] Two trustees of a multiemployer plan who owned a large interest in a corporation and who caused the plan to make a loan commitment to the corporation so that the corporation could remove liens on an aircraft the corporation wished to acquire free of encumbrances allegedly violated Section 406(b)(1). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order). See also Marshall v. Dekeyser, 485 F.Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).

Section 406(b)(2)	
A fiduciary with respect to a plan shall not -	
(2)	In his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, . . .

A. Conference Report

Page 309 of the Congressional Conference Report covers the above provision.

B. Regulations

No regulations have been issued yet. However, the regulations under Section 408(b)(2) and two prohibited transaction class exemptions amplify this prohibition.

1. This prohibition is imposed to deter fiduciaries from exercising the authority, control or responsibility that makes such persons fiduciaries when they have interests that may conflict with the interests of the plans for which they act. ERISA Regulation § 2550.408b-2(e)(1).
2. A fiduciary may not use the authority, control or responsibility that makes such a person a fiduciary to cause the plan to pay an additional fee to such fiduciary (or to a person in which such person has an interest that may affect the exercise of such fiduciary's best judgment as a fiduciary). DOL ERISA Regulation 2550.408b-2(e)(1).
3. The regulation cited above contains several important examples. DOL ERISA Regulation 2550.408b-2(f); however, not all of the examples deal with Section 406(b)(2).
4. The preambles to PTE C 76-1 and PTE 77-10 amplify the interrelationships between this prohibition and the other prohibitions.

C. Interpretive Bulletins

1. If a fiduciary, in addition to his duties for the plan, serves in a decision making capacity with another party, the mere fact that such fiduciary effects payments to such party of money to which a participant is entitled at the direction of the participant and in accordance with specific plan provisions does not contravene Section 406(b)(2). IB 78-1.

D. Advisory Opinions

1. [Bank Stock] The investment of plan assets in a bank of which a fiduciary is a director may be a prohibited transaction under Section 406(b)(2). AO 76-62.
2. [Bank Stock - Purchase/Retention/Sale of Fiduciary Bank/BHC Stock]

   General Discretionary Rule - An ERISA plan may not invest in the stock of a fiduciary bank if the bank has discretion over the transaction. The discretionary retention of such stock would also be prohibited. Non-discretionary purchases, sales, and retentions are permitted.

   DOL notes the duty of undivided loyalty owed under § 406(b) , but the conflict of interest which may occur if a sale of bank stock would be in the best interests of a plan, but such a sale (or the news of such a sale) might lower the price of the bank's stock.

   See 1980 letter from DOL to OCC .

3. [Custodians] The interests of the bank that performs the services of custodial agent for the plan and is a plan fiduciary are or could be deemed to be adverse to the interests of the plan. AO 76-76.
4. [Deposits] Investment of the assets of a noncollectively bargained multiple employer plan covering employees of banks, in savings accounts and certificates of deposit of banks that are contributing employers, constitutes a prohibited transaction under Section 406(a) and may also be prohibited under Section 406(b)(1) and (2) because members of the administrative board of the plan, which directs plan investments, are officers and employees of contributing employer banks.

   However, Section 408(b)(4) provides an exemption from Sections 406(a), 406(b)(1) and 406(b)(2) for the investment of plan assets in the deposits or certificates of deposit of a bank that is a plan fiduciary or party in interest if the requirements of ERISA Regulations Section 2550.408b-4 are met. **One requirement of the regulation is that, for investments made after November 1, 1977, the plan specify the name(s) of the banks in which deposits may be made. The specifications may be made to the plan by amendment retroactive to November 1, 1977.** AO 79-25.

5. [Investment Manager Appointment] The involvement of a plan fiduciary in the appointment of a corporation of which such fiduciary is a director as an investment manager of the plan's assets may be a prohibited transaction under Section 406(b)(2). AO 76-15.
6. [Investment Management] The provision of investment management services by the plan manager to a fund would be exempt from Section 406(a) if the conditions of Section 408(b)(2) are met. The question of what constitutes a necessary service, a reasonable contract or arrangement, or reasonable compensation is factual in nature and not subject to advisory

opinions.

Further, the mere selection of the manager to provide investment management services to a plan where the payment of compensation for such services is to be made by the plan sponsor receiving such services would not constitute a per se violation of Section 406(b)(1), but such violation could occur in the course of the committee's deliberations to invest in the fund and the concomitant retention of the plan manager. Accordingly, a ruling that the arrangement is exempt from Section 406(b)(1) cannot be made.

Generally, a fiduciary's decision to retain an affiliate service provider whose fees will be paid by the plan sponsor will not involve an adversity of interest as contemplated by Section 406(b)(2) of the act. If, for example, a fiduciary of the plan, in negotiating a service contract on behalf of the plan, also acts on behalf of a person and causes that person to benefit from such a decision at the expense of any kind to the plan, the decision to retain the service provider would result in a violation of Section 406(b)(2). Accordingly, the decision to retain the manager to service the plan investments in the fund would not, in itself, constitute a violation of Section 406(b)(2); but because it is inherently factual in nature, no opinions can be rendered thereon. AO 83-44A.

7. [Leases to Sponsor] The leasing by a plan of improved real estate to the employer maintaining the plan is a prohibited transaction pursuant to ERISA Section 406(a)(1)(A), (C), (D) and (E) and Code Section 4975(c)(1)(A), (C) and (D). In addition, since any property leased to an employer is employer real property as defined in ERISA Section 407(d)(2), if such property is not qualifying employer real property within the meaning of ERISA Section 407(d)(4), the holding of such property by the plan is a prohibited transaction pursuant to ERISA Sections 406(a)(2) and 407(a)(1). Also, to the extent that the employer may be a fiduciary to the plan as defined in ERISA Section 3(21)(A) and Code Section 4975(e)(3), the lease arrangement may be a prohibited transaction pursuant to ERISA Section 406(b)(1) and (2) and Code Section 4975(c)(1)(E). *Proposed* PTE I 192.
8. [Sale to Insider of Sponsor] The sale of certain parcels of real property by a profit-sharing plan to the majority shareholder of the employer maintaining the plan and to a corporation 50% or more of which is owned by such majority shareholder would constitute prohibited transactions pursuant to ERISA Section 406(a)(1)(A) and (D) and Code Section 4975(c)(1)(A) and (D). In addition, if the majority shareholder has the power to appoint and remove the plan trustee, such sales may be prohibited transactions under ERISA Section 406(b)(1) and (2) and Code Section 4975(c)(1)(E). *Proposed* PTE I 492.

E. Court Decisions

1. [General] ERISA Section 406(b)(2) is to be read as requiring a transaction between the plan and a party having an adverse interest for the prohibition to apply. Donovan v. Bierwirth, 680 F.2d 263, 3 EBC 1417 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).
2. [General] ERISA Section 406(b)(2) prohibits representation of parties who are adverse in the technical sense. A transaction does not have to exhibit fiduciary misconduct, reflecting harm to the beneficiaries, before ERISA Section 406(b)(2) is violated. When identical trustees of two plans whose participants and beneficiaries are not identical effect a loan between the plans without a statutory or administrative exemption, a per se violation of ERISA exists. ERISA Section 406(b) contains a blanket prohibition of certain transactions, no matter how fair. Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979).
3. [Loans] A party who is a borrower from a plan or who is claiming payment from a plan will, by definition, have interests adverse to the interests of the plan. Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978); Marshall v. Dekeyser, 485 F.Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).
4. [Loans] An employer trustee of a Taft-Hartley plan, who was also the director of the employer association, did not violate Section 406(b)(2) by either:

    a. advising employers not to make contributions to the plan and to resist audits by the plan, or
    b. bringing suit to block the plan's collection procedures that the trustee believed to be unauthorized.

    The court noted that under Section 408(c)(3), a plan trustee can also serve as the director of an employer association and perform all of the duties required of a person holding each of these positions. The

court also indicated that, where a trustee acts pursuant to Section 405(a)(3) to remedy a breach of fiduciary duty that such trustee believes to have been committed by another plan fiduciary, the trustee is not acting in violation of Section 406(b)(2) regardless of the trustee's motivation. Curren v. Freitag, 432 F.Supp. 668 (S.D.Ill. 1977). See also N.L.R.B. v. Construction and General Laborers Union Local 110, 577 F.2d 16 (8th Cir. 1978), cert. denied, 439 U.S. 1070 (1979) (union trustee and secretary-treasurer of union).

5. [Loans] The trustees of a multiemployer plan who agreed to cause the plan to: (a) pay rent to a corporation for the joint lease of an airplane (with a union) at a time when the plan held two notes from such corporation that were in default, or (b) make a loan commitment to the corporation so that the corporation could remove liens on an airplane it wished to acquire free of encumbrances, allegedly violated Section 406(b)(2). Usery v. Wilson, et al., No. 3-76-373 (E.D.Tenn., June 6, 1977) (consent order).

Section 406(b)(3)
A fiduciary with respect to a plan shall not -
Receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

A. Conference Report

The above section is explained on page 309 of the Congressional Conference Report.

B. Regulations

No regulations have been issued yet. However, the regulations under Section 408(b)(2) amplify this prohibition.

1. This prohibition is imposed to deter fiduciaries from exercising the authority, control or responsibility that makes such persons fiduciaries when they have interests that may conflict with the interests of the plans for which they act. DOL ERISA Regulation 2550.408b-2(e)(1).
2. A fiduciary may not use the authority, control or responsibility that makes such a person a fiduciary to cause the plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest that may affect the exercise of such fiduciary best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction. DOL ERISA Regulation 2550.408b-2(f).
3. The regulation cited above contains several important examples. DOL ERISA Regulation 2550.408b-2(f); however, not all of the examples deal with Section 406(b)(3).
4. For a definition of plan assets, see DOL ERISA Regulation 2510.3-101 .

C. Advisory Opinions

1. [Compensation] The receipt of compensation by a fiduciary from a plan is a prohibited transaction if the fiduciary is already receiving full-time compensation from the employer maintaining the plan. AO 78-08.
2. [Estate Legacy] A violation of Section 406(b)(3) would not generally occur from the mere receipt of a distribution from an estate by a plan fiduciary as beneficiary of the estate in a transaction separate and apart from the plan's acquisition of qualifying employer securities from that estate. Under such circumstances, the distribution would not appear to be in connection with the transaction involving plan assets. AO 87-04A.
3. [Mutual Funds] No Section 406(b)(2) or (3) violations arise, per se, because fiduciaries to certain employee benefit plans are also sponsors of and advisers to certain mutual funds and the employee benefit plans purchase shares therein so long as these fiduciaries exercise none of the authority, control, or responsibility of the plans with regard to causing the plans to purchase units in the mutual funds. AO 82-31A.

D. Court Decisions

1. Fiduciary charged with violation of Section 406(b)(3) prohibiting receipt of consideration for fiduciary's own personal account from any party dealing with plan either must prove by a preponderance of evidence that the transaction in question fell within an exception, or must prove by clear and convincing evidence that compensation received was for services other than transactions involving plan assets. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 8 EBC 2457 (2d Cir. 1987).
2. If charged with a violation of Section 406(b)(3) the fiduciary bears the burden of proving that the questionable transaction fell within a Section 408 or regulatory exemption to Section 406(b)(3) or that compensation was for services other than the questionable transaction. For purposes of deciding a motion for summary judgment, if the transaction at issue is not exempted from the prohibitions of Section 406, the evidence before the court must be sufficient to permit a jury to conclude, by clear and convincing evidence, that the compensation received by a fiduciary was not "in connection with" the questionable investment of plan assets. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 8 EBC 2457 (2d Cir. 1987).

Section 406(c)
A transfer of real or personal property by a party in interest to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a party-in-interest placed on the property within the 10-year ending on the date of the transfer.

A. **Conference Report**

This provision is explained on page 308 of the Congressional Conference Report.

10 Percent Limitation on employer securities and employer real property **ERISA Section 407**	
Section 407(a)(1)	
Except as otherwise provided in this section and section 414, a plan may not acquire, or hold:	
(A)	Any employer security which is not a qualifying employer security, or
(B)	Any employer real property which is not qualifying employer real property.

A. Conference Report

Pages 316-320 of the Congressional Conference Report explains the employer security and real property provisions.

B. **Regulations**

1. Refer to DOL ERISA Regulation 2550.407a-1. A plan may hold or acquire only employer securities that are qualifying employer securities and employer real property that is qualifying employer real property. A plan may not hold employer securities and employer real property that are not qualifying employer securities and qualifying employer real property except in certain circumstances.
2. See DOL ERISA Regulation 404c-1 , covering participant-directed plans (such as 401(k) and 403(b)), which contains authorization for investments in employer securities (404c-1(b)(2)(B)(1)(vii)), and special conditions when offering them as an "investment alternative" (see 404c-1(d)(2)(ii)(E)(4)(vii), (viii) and (ix), as well as general 404c-1 requirements). In general, fiduciaries are exempted from certain ERISA fiduciary responsibility liability if plans meet certain conditions and participants direct their own investments.
3. Also refer to IRS Regulation 54.4975-12, which defines the term "Qualifying Employer Security".

C. **Advisory Opinions**

1. [Concentrations] The only language of ERISA that specifically limits the percentage amount of a particular asset that a plan may hold is found in Section 407, and this limitation refers to the holding or acquisition of qualifying employer securities or real property. Other than Section 407, the amount or percentage of plan assets that may be placed in a particular investment vehicle is governed by the general standards of fiduciary responsibility. AO 76-74.
2. [Limited Partnerships] Units in a limited partnership are not qualifying employer securities within the definition of ERISA Section 407(d)(5). The continued holding of such units may be a prohibited transaction under ERISA Sections 406(a)(2) and 407(a)(1). *Proposed* PTE I 038.
3. [Property - Leased] The leasing by a plan of improved real property to the employer maintaining the plan is a prohibited transaction pursuant to ERISA Section 406(a)(1)(A), (C), (D) and (E) and Code Section 4975(c)(1)(A), (C) and (D). In addition, since any property leased to an employer is "employer real property" as defined in ERISA Section 407(d)(2), if such property is not "qualifying employer real property" within the meaning of ERISA Section 407(d)(4), the holding of such property by the plan is a prohibited transaction pursuant to ERISA Sections 406(a)(2) and 407(a)(1). Also, to the extent that the employer may be a fiduciary to the plan as defined in ERISA Section 3(21)(A) and Code Section 4975(e)(3), the lease arrangement may be a prohibited transaction pursuant to ERISA Section 406(b)(1) and (2) and Code Section 4975(c)(1)(E). *Proposed* PTE I 192.
4. [Stock] Stock of the parent in a controlled group corporation held by an employee benefit plan sponsored and maintained by a wholly owned subsidiary constitutes employer qualified securities under Section 407. AO 84-36A.

Section 407(a)(2)
Except as otherwise provided in this section and section 414, a plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of employer securities and employer real property held by the plan exceeds 10% of the fair market value of the assets of the plan.

A. Conference Report

Pages 316-320 of the Congressional Conference Report explains this employer security and real property provision.

B. Advisory Opinions

1. [Stock Exchanges] The exchange of stock between the employer maintaining the plan and the plan pursuant to a re-incorporation of the employer in another state is not an acquisition of employer stock by the plan. AO 75-100.
2. [Warrants] The acquisition of an employer's common stock by a plan through the exercise of warrants constitutes an acquisition by a plan of qualifying employer securities within the meaning of ERISA Section 407(a)(2). PLR 791005.

Section 407(a)(3)
Except as otherwise provided in this section and section 414:
After December 31, 1984, a plan may not hold any qualifying employer securities or qualifying employer real property (or both) to the extent that the aggregate fair market value of such securities and property determined on December 31, 1984 exceeds 10% or the greater of:
The fair market value of the assets of the plan, determined on December 31, 1984, or
The fair market value of the assets of the plan determined on January 1, 1975.
Subparagraph (A) of this paragraph shall not apply to any plan that on any date after December 31, 1974, and before January 1, 1985, did not hold employer securities or employer real property (or both) the aggregate fair market value of which determined on such date exceeded 10% of the greater of -
The fair market value of the assets of the plan, determined on such date, or

The fair market value of the assets of the plan determined on January 1, 1975.

A. Conference Report

Pages 316-320 of the Congressional Conference Report explains the employer security and real property provisions.

B. Advisory Opinions

1. A plan will meet the requirements of Section 407(a)(3)(B) if it falls below the 10% limitation on any day prior to December 31, 1984. AO 79-27.

C. Court Decisions

1. Where a trustee invests less than 10% of a pension plan's assets complying with ERISA Section 407(a)(3), a trustee is not relieved of other fiduciary duties contained in ERISA. Donovan v. Bierwirth, 680 F.2d 263, 3 EBC 1417 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

Section 407(a)(4)	
Except as otherwise provided in this section and section 414:	
(A)	After December 31, 1979, a plan may not hold any employer securities or employer real property in excess of the amount specified in regulations under subparagraph (B). This subparagraph shall not apply to a plan after the earliest date after December 31, 1974, on which it complies with such regulations.
(B)	Not later than December 31, 1976, the Secretary shall prescribe regulations which shall have the effect of requiring that a plan divest itself of 50% of the holdings of employer securities and employer real property which the plan would be required to divest before January 1, 1985, under paragraph (2) or subsection (c) (whichever is applicable).

A. Conference Report

Pages 316-320 of the Congressional Conference Report explain the employer security and real property provisions.

B. Advisory Opinions

1. [Bonds] A plan's holding of debentures issued by an employer may constitute a loan or extension of credit to the employer, which, if the conditions of Section 414(c)(1) are met, would be exempt until June 30, 1984 from the restrictions of Section 407(a). WSB 79-69.

Section 407(b)		
(1)	Subsection (a) of this section shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property by an eligible individual account.	
(2)	Cross References. -	
	(A)	For exemption from diversification requirements for holding of qualifying employer securities and qualifying employer real property by eligible individual account plans, see section 404(a)(2).
	(B)	For exemption from prohibited transactions for certain acquisitions of qualifying employer securities and qualifying employer real property which are not in violation of the 10% limitation, see section 408(e).
	(C)	For transitional rules respecting securities or real property subject to binding contracts in effect on June 30, 1974, see section 414(c).

A. Conference Report

Pages 316-320 of the Congressional Conference Report explains the above employer security and real property provision.

Section 407(c)		
(1)	A plan which makes the election under paragraph (3) shall be treated as satisfying the requirements of section 407(a)(3) if -- and only if -- employer securities held on any date after December 31, 1974 and before January 1, 1985 have a fair market value, determined as of December 31, 1974, not in excess of 10% of the lesser of	
	(A)	The fair market value of the assets of the plan determined on such date (disregarding any portion of the fair market value of employer securities which is attributable to appreciation of such securities after December 31, 1974 but not less than the fair market value of plan assets on January 1, 1975), or
	(B)	An amount equal to the sum of (i) the total amount of the contributions to the plan received after December 31, 1974, and prior to such date, plus (ii) the fair market value of the assets of the plan, determined on January 1, 1975.
(2)	For purposes of this subsection, in the case of an employer security held by a plan after January 1, 1975, the ownership of which is derived from ownership of employer securities held by the plan on January 1, 1975, or from the exercise of rights derived from such ownership, the value of such security held after January 1, 1975, shall be based on the value as of January 1, 1975, of the security from which ownership was derived. The Secretary shall prescribe regulations to carry out this paragraph.	
(3)	An election under this paragraph may not be made after December 31, 1975. Such an election shall be made in accordance with regulations prescribed by the Secretary, and shall be irrevocable. A plan may make an election under this paragraph only if on January 1, 1975, the plan holds no employer real property. After such election and before January 1, 1985, the plan may not acquire any employer real property.	

A. **Conference Report**

Pages 316-320 of the Congressional Conference Report explain the employer security and real property provisions.

Section 407(d)(1)
For purposes of this section -
The term "employer security" means a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. A contract to which section 408(b)(5) applies shall not be treated as a security for purposes of this section.

A. Conference Report

Pages 316-320 of the Congressional Conference Report explain the definition of the term employer security.

B. **Advisory Opinions**

1. [Bonds] Rights to certain debentures may be employer securities. AO 76-72.
2. [Loan Guarantees] The guarantee by an employer of loans made by the plan to a third party constitutes an employer, under Section 407(d)(1) but not a qualifying employer security under Sections 407(d)(5) and 407(e). WSB 79-51.

Section 407(d)(2)
For purposes of this section -

The term "employer real property" means real property (and related personal property) which is leased to an employer of employees covered by the plan, or to an affiliate of such employer. For purposes of determining the time at which a plan acquires employer real property, for purposes of this section, such property shall be deemed to be acquired by the plan on the date on which the plan acquires the property or the date on which the lease to the employer (or affiliate) is entered into, whichever is later.

A. Conference Report

Pages 316-320 of the Congressional Conference Report explain the definition of the term employer real property.

Section 407(d)(3)	
For purposes of this section -	
(A)	The term "eligible individual account plan" means an individual account plan which is (i) a profit-sharing, stock bonus, thrift or savings plan; (ii) an employee stock ownership plan; or (iii) a money purchase plan which was in existence on the date of enactment of this Act and which on such date invested primarily in qualifying employer securities. Such term excludes an individual retirement account or annuity described in section 408 of the Internal Revenue Code of 1954.
(B)	Notwithstanding subparagraph (A) a plan shall be treated as an eligible individual account plan with respect to the acquisition or holding of qualifying employer real property or qualifying employer securities only if such plan explicitly provides for acquisition and holding of qualifying employer securities or qualifying employer real property (as the case may be). In the case of a plan in existence on the date of enactment of this Act, this subparagraph shall not take effect until January 1, 1976.

A. Conference Report

The term eligible individual account plan is covered at pages 316-320 of the Congressional Conference Report.

B. Advisory Opinions

1. [ESOPs] Section 407(b)(1) provides that the limitations on the acquisition and retention of qualifying employer securities and qualifying employer real property as contained in Section 407(a) do not apply to eligible individual account plans. Section 407(d)(3) defines the term eligible individual account plan to include an individual account plan that is an ESOP and that expressly provides for the acquisition and holding of employer securities. AO 81-67A.
2. An individual account plan is not an *eligible* individual account plan unless it explicitly provides for the acquisition and holding of qualifying employer securities or qualifying employer real property. AO 78-25; WSB 79-86.
3. [Profit Sharing Plans] Where a plan is a profit-sharing plan and, therefore, meets the requirements of Section 407(d)(3)(A), it would constitute an eligible individual account plan for purposes of Section 407(d)(3) in connection with the sale of employer stock held by the plan, even though the plan does not expressly provide for the acquisition and holding of employer securities as required by Section 407(d)(3)(B). WSB 79-88.

C. Court Decisions

1. [Governing Documents] For purposes of determining whether a plan provides for the purchase of employer securities, both the plan and the trust agreement can be looked to as plan documents. Leonard v. Drug Fair, Inc., Fed. Sec. L. Rep. (CCH) 997,144 (D.D.C. 1979).
2. [Defined Contribution Plan] Where the board of directors amended a pension plan to allow up to 50% of the plan's assets to be used to purchase the employer's securities, the plan will not violate ERISA Section 407 if the plan is within the definition of an eligible individual account plan. District 65, U.A. W. v. Harper & Row Publishers, Inc., 576 F.Supp. 1468, 4 EBC 2586, F&L S&L L. Rep. (CCH) 999,608 (S.D.N.Y. 1983).
3. [ESOPs] If a pension plan that allows up to 50% of the plan's assets to be used to purchase the

employer's securities is an ESOP, the plan must conform to Code Section 401 in order to be an eligible individual account plan under ERISA Section 407(a). District 65, U.A. W. v. Harper & Row Publishers, Inc., 576 F.Supp. 1468, 4 EBC 2586, F&L S&L L. Rep. (CCH) 999,608 (S.D.N.Y. 1983).
4. [Bonds] In order for the purchase of debt securities by an eligible individual account plan to be exempt from the Section 407 limitations, the plan must specifically provide for the holding of marketable obligations of the type involved. Marshall v. Dekeyser, 485 F.Supp. 629, 1 EBC 1898 (W.D.Wis. 1979).

Section 407(d)(3)(C)
The term "eligible individual account plan" does not include any individual account plan the benefits of which are taken into account in determining the benefits pursuant to a participant under any defined benefit plan.

Section 407(d)(4)	
For purposes of this section -	
The term "qualifying employer real property" means parcels of employer real property-	
(A)	if a substantial number of the parcels are dispersed geographically;
(B)	if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use;
(C)	even if all such real property, is leased to one lessee (which may be an employer, or an affiliate of an employer); and
(D)	if the acquisition and retention of such property comply with the provisions of this part (other than section 404(a)(1)(B) to the extent it requires diversification, and sections 404(c)(1)(C), 406 and 407(a) of this section).

A. Conference Report

Pages 316-320 of the Congressional Conference Report explain the definition of the term qualifying employer real property.

B. Advisory Opinions

1. To meet the substantial number requirement of Section 407(d)(4)(A), there must be more than one parcel. AO 84-20A.
2. A single parcel of real property cannot be qualifying employer real property. Qualifying employer real property means parcels (plural) of employer real property. AO 76-14; AO 76-132; AO 77-16; *Proposed* PTE I 192, PLR 7847043.
3. Whether a substantial number of parcels of employer real property are geographically dispersed so as to provide protection for a plan in the event of adverse economic conditions in any one area, and whether such parcels are suitable or adaptable without excessive cost for more than one use are both questions that are inherently factual in nature and will not be the subject of advisory opinions. AO 84-20A.
4. Employer real property, is qualifying employer real property where there are six parcels of real property located in four different states; no two parcels are closer than 80 miles apart; five of the six parcels contain simple one-story structures and the machinery located therein could be removed at minimal costs without affecting the structure; and the sixth parcel contains a building with offices and open space for laboratories and machinery. AO 75-11.
5. The definition of the term qualifying employer real property requires a determination regarding whether a particular acquisition or retention of employer real property complies with ERISA Section 404. The Department of Labor will not issue an advisory opinion under Section 407(d)(4)(D) as to whether particular employer real property is qualifying employer real property. The Department will; however, issue advisory opinions regarding the other substantive conditions of Section 407(d)(4). AO 77-01.
6. The geographical dispersion requirement is satisfied where three parcels of property contain

three restaurants that serve and draw from different fast food markets. AO 77-01.

Section 407(d)(5)
For purposes of this section -
The term "qualifying employer security" means an employer security which is (1) stock; (2) a marketable obligation (as defined in section (e)), or (3) an interest in a publicly traded partnership (as defined in section 7704(b) of the IRC of 1986), but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue Act of 1987 (Public Law 100-203). After December 17, 1987, in the case of a plan other than an eligible individual account plan, stock shall be considered a qualifying employer security only if such stock satisfies the requirements of subsection (f)(1).

A. Conference Report

Pages 316-320 of the Congressional Conference Report explain the definition of the term qualifying employer security.

B. Regulations

DOL ERISA Regulation 2550.407d-5 merely restates the statutory provisions.

C. Advisory Opinions

1. [Affiliate] A plan owns 100% of the stock of a corporation, but employees of that corporation do not participate in the plan. The stock of the corporation is not qualifying employer securities under Section 407(d)(5), since it has not been issued by an employer or an affiliate of an employer. AO 79-27.
2. [Affiliate] In general, where the employees of two or more employers [whether or not affiliated within the meaning of Section 407(d)(7)] are covered by a single plan, the securities issued by each employer or by an affiliate thereof, as defined in Section 407(d)(7), would ordinarily constitute qualifying employer securities within the meaning of Section 407(d)(5) if the applicable requirements under that section are satisfied. Accordingly, if the plan is, in fact, a single plan and continues to be maintained as one plan by both employers for their respective employees, the common stocks of each and both employers would constitute qualifying employer securities for purposes of applying the provisions of Sections 404(a)(2) and 407. AO 81-5A.
3. [Affiliate Stock] The common stock of a wholly owned subsidiary would be a qualifying employer security because it is a stock issued by an affiliate of an employer of employees covered by the plan. If the subsidiary has such employees, it would be stock issued by an employer of employees covered by the plan. If the subsidiary has employees covered by the plan, the subsidiary's stock will continue to be a qualifying employer security after the plan owns all of such stock. WSB 78-31. See also AO 77-30; WSB 78-26; WSB 79-86.
4. [Convertible Bonds] Debentures issued by an employer that are convertible into stock do not constitute stock for Purposes of Section 407(d)(5). AO 79-45.
5. [Loan Guarantees] The guarantee by an employer of loans made by the plan to a third party constitutes an employer security under Section 407(d)(1) but not a qualifying employer security under Sections 407(d)(5) and 407(e). WSB 79-51.
6. [Rights] Rights to certain debentures are not qualifying employer securities because they are neither stock nor marketable obligations. AO 76-72.
7. [Stock] Book value shares are qualifying employer securities. AO 77-35.
8. [Stock - Preferred] Preferred stock issued by an affiliate of an employer whose employees are covered by a plan is a qualifying employer security. AO 75-89.

Section 407(d)(6)	
For purposes of this section -	
The term "employee stock ownership plan" means an individual account plan -	
(A)	Which is a stock bonus plan which is qualified, or a stock bonus plan and money

	purchase plan both of which are qualified, under section 401 of the Internal Revenue Code of 1954, and which is designed to invest primarily in qualifying employer securities, and
(B)	Which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.

A. Conference Report

The term ESOP is covered at pages 316-320 of the Congressional Conference Report.

B. Regulations

Refer to DOL ERISA Regulation 2550.407d-6. These regulations contain several requirements relating to ESOPs.

An ESOP must also meet such other requirements as the Secretary of the Treasury may prescribe by regulation under Section 4975(e)(7) of the Internal Revenue Code.

C. Advisory Opinions

1. [ESOPs] Where a plan is organized and established as an employee stock ownership plan for the purpose of investing primarily in qualifying employer securities but where under the circumstances it would not be prudent or otherwise beneficial to plan participants for the ESOP to invest a large percentage of its assets in qualifying employer securities, even though plan documents generally provide for such investments. In that situation the potential liability for breach of fiduciary duty makes a fiduciary's decision to disregard a plan provision difficult. A plan provision that requires a plan to invest more than 50% of is assets in qualifying employer securities would normally be deemed to satisfy the requirement of Section 407(d)(6) that a plan must satisfy the primary requirement with regard to its primary investment objectives and vehicle. AO 83-6A.

D. Court Decisions

1. [ESOPs] Where a pension plan purchased common stock without voting rights, the plan can still qualify as an ESOP under ERISA Section 407(d)(6), since Code Section 401 does not require stock to have voting rights for tax qualified plans. However, the ESOP must obtain voting power equal to or in excess of the amount of voting power held in said stock by the employer. Schoenholtz v. Doniger 657 F.Supp. 899, 8 EBC 2031 (S.D.N.Y. 1987).

Section 407(d)(7)
For purposes of this section -
A corporation is an affiliate of an employer if it is a member of any controlled group of corporations (as defined in section 1563(a) of the Internal Revenue Code of 1954, except that "applicable percentage" shall be substituted for "80%" whenever the latter percentage appears in such section) of which the employer who maintains the plan is a member. For purposes of the preceding sentence, the term "applicable percentage" means 50%, or such lower percentage as the Secretary may prescribe by regulation. A person other than a corporation shall be treated as an affiliate of an employer to the extent provided in regulations of the Secretary. An employer which is a person other than a corporation shall be treated as affiliated with another person to the extent provided by regulations of the Secretary. Regulations under this paragraph shall be prescribed only after consultation and coordination with the Secretary of the Treasury.

A. Conference Report

"Affiliate" is discussed on pages 316-320 of the Congressional Conference Report.

B. Advisory Opinions

1. A corporation must be an affiliate prior to the sale of its securities for its securities to be either

employer securities or qualifying employer securities. AO 77-18.

2. [Affiliate] Where an employer owns 62% of the outstanding stock of a corporation, such corporation is an "affiliate" of the employer under Section 407(d)(7). AO 79-23.
3. [Affiliate] A plan owns 100% of the stock of a corporation, but employees of that corporation do not participate in the plan. The stock of the corporation is not qualifying employer securities under Section 407(d)(5), since it has not been issued by an employer or an affiliate of an employer. AO 79-27.
4. For the exemption provided by Section 408(e) to apply to any sale, the property being sold must be either qualifying employer securities or qualifying employer real property at the time such securities or property, are sold by the plan. If a corporation is not a member of a controlled group prior to the consummation of a sale, the corporation's securities will not be securities of an affiliate prior to the sale. AO 77-18.

Section 407(d)(8)
For purposes of this section -
The Secretary may prescribe regulations specifying the extent to which conversions, splits, the exercise of rights, and similar transactions are not treated as acquisitions.

A. Conference Report

The above provision is covered at pages 316-320 of the Congressional Conference Report.

Section 407(d)(9)
For purposes of this section, an arrangement which consists of a defined benefit plan and an individual account plan shall be treated as one plan if the benefits of such individual account plan are taken into account in determining the benefits payable under such defined benefit plan.

Section 407(e)		
For purposes of subsection (d)(5), the term "marketable obligation" means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this subsection referred to as "obligation") if -		
(1)	Such obligation is acquired -	
	(A)	On the market, either
		At the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or
		If the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;
	(B)	From an underwriter, at a price
		Not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and
		At which a substantial portion of the same issue is acquired by persons independent of the issuer; or
	(C)	Directly from the issuer, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;
(2)	Immediately following acquisition of such obligation -	

	(A)	Not more than 25% of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and
	(B)	At least 50% of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer; and
(3)	Immediately following acquisition of the obligation, not more than 25% of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.	

A. Conference Report

These employer security provisions are discussed at pages 316-320 the Congressional Conference Report.

B. Regulations

No regulations have been issued under Section 407(e), but regulations have been issued under Section 407(d)(5). ERISA Regulation 2550.407d-5.

C. Advisory Opinions

1. ["Independence"] A relative of an officer of the issuer is not "independent of the issuer." WSB 77-13; AO 78-25.
2. ["Independence"] A private foundation that was created by and may receive contributions from the issuer is not "independent of the issuer." AO 78-25.
3. [Loan Guarantees] The guarantee by an employer of loans made by the plan to a third party constitutes an employer security under Section 407(d)(1), but not a qualifying employer security under Sections 407(d)(5) and 407(e). WSB 79-51.
4. ["Marketable"] Debentures issued by a subsidiary of an employer constitute marketable obligations where they are purchased at the closing price on the New York Stock Exchange on the date of purchase, where they represent only 1.14% of the aggregate amount of debentures outstanding, where 50% of such aggregate amount is held by persons independent of the employer, and where the value of the debentures represents 22% of plan assets. AO 79-39.
5. [Mergers & Acquisitions] A trust will not be considered to have acquired certain debentures if, prior to the corporate merger pursuant to which the trust would have received the debentures, the trust sells or irrevocably assigns the rights to the debentures that it would have received in the merger. AO 76-72.
6. [Notes] A promissory note issued by an employer to a plan in lieu of a cash contribution to the plan will not constitute a marketable obligation if a substantial portion of the same issue of rates is not acquired by persons independent of the issuer for purposes of Section 407(e)(1) contemporaneously with the acquisition by the plan. PLR 7939009.

Section 407(f)		
Stock satisfies the requirements of this subsection if immediately following the acquisition of such stock -		
(1)	(A)	No more than 25% of the aggregate amount of stock of the same class issued and outstanding at the time of acquisition is held by the plan, and
	(B)	At least 50% of the aggregate amount referred to in subparagraph (A) is held by persons independent of the issuer.
(2)	Until January 1, 1993, a plan shall not be treated as violating subsection (A) solely by holding stock which fails to satisfy the requirements of paragraph (1) if such stock -	
	(A)	Has been held since December 17, 1987, or
	(B)	Was acquired after December 17, 1987 pursuant to a legally binding contract in effect on December 17, 1987, and has been so held at all times after the acquisition.
(3)	After December 17, 1987, no plan may acquire stock which does not satisfy the requirements of paragraph (1) unless the acquisition is made pursuant to a legally binding contract in effect on such date.	

Exemptions from prohibited transactions

ERISA Section 408

Section 408(a)

Exemption Procedures

The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any fiduciary or transaction, or class of fiduciaries or transactions, from all or part of the restrictions imposed by Sections 406 and 407(a). Action under this subsection shall be taken only after consultation and coordination with the Secretary of the Treasury. An exemption granted under this section shall not relieve a fiduciary from any other applicable provision of this Act. The Secretary may not grant an exemption under this subsection unless he finds that such exemption is -

Administratively feasible,

In the interests of the plan and of its participants and beneficiaries, and

Protective of the rights of participants and beneficiaries of such plan. Before granting an exemption under this subsection from section 406(a) or section 407(a), the Secretary shall publish notice in the Federal Register of the pendency of the exemption, shall require that adequate notice be given to interested persons, and shall afford interested persons an opportunity to present views. The Secretary may not grant an exemption under this subsection from section 406(b) unless he affords an opportunity for a hearing and makes a determination on the record with respect to the findings required by paragraphs (1), (2) and (3) of this subsection.

A. **Conference Report.**

The above exemption procedure is discussed on pages 309-311 of the Congressional Conference Report.

B. **Regulations.**

See DOL ERISA Regulation 2570.30 through .52 . The regulation covers who may file for an exemption, where applications must be filed, the information to be included with an application, rights and procedures to a conference, publication and notification of interested persons, and the effect of an exemption. See also Revenue Procedure 75-26.

C. **Prohibited Transaction Class Exemptions (PTE)**

1. [Annuities] PTE C 77-8 covers the transfer of individual life insurance and annuity contracts *from* plans to a plan participant, the relative of a participant, the participant's employer or another plan. PTE C 77-7 covers transfers of the same assets *to* plans from plan participants or employers.
2. [Brokerage Services] PTE 79-1 granted an exemption for securities transactions for employee benefit plans by broker-dealers who serve as fiduciaries to the plans.
3. [Brokerage Services] In PTE 78-10, an exemption was granted for provision of securities by broker-dealers to plans for which they are fiduciaries.
4. [Brokerage Services] Exemption is granted for the execution of certain securities transactions in PTE 86-128 .
5. [Collective Investment Funds] An exemption was granted for transactions between bank collective investment funds and parties in interest. PTE 80-51 (restated to PTE 91-38).
6. [Court-Authorized Transactions] PTE C 79-15 covers certain transactions authorized or required by judicial order or judicially approved settlement decree.
7. [Court-Directed Transactions] An exemption was granted for transactions authorized or permitted

by a court. PTE 79-15.

8. [Customer Notes] A class exemption is granted for the purchase of customer notes of a party-in-interest employer by an employee benefit plan in PTE 85-68.
9. [Debt Retirement] PTE 80-83 provided an exemption for employee plans' purchase of securities used to retire indebtedness owed to parties in interest .
10. [Interest-Free Loans] PTE 80-26 granted an exemption for certain interest free loans, such as overdrafts, between employee benefit plans and parties in interest .
11. [Mortgages] An exemption was granted for employee benefit plans to provide mortgage financing to purchasers of certain residential construction in PTE 82-87 .
12. [Mortgage Pools] PTE 81-7 exempted certain transactions between employee benefit plans and parties in interest involving mortgage pool investment trusts.
13. [Mutual Funds] PTE 77-4 covers the purchase and sale by a plan of mutual fund shares when a fiduciary to the plan is also the investment adviser for the mutual fund. Also see 1994 DOL letter to OCC.
14. [Mutual Funds - Closed-End] In PTE 79-13, an exemption was granted for acquisitions of shares in closed-end investment companies by employee benefit plans.
15. [Mutual Funds - Own] PTE 77-3 covers the purchase and sale of in-house mutual fund shares by an employee benefit plan covering employees of the mutual fund, its investment adviser or principal underwriter, or an affiliate thereof.
16. [Mutual Funds - Own Closed-End] PTE 79-13 covers the acquisition and sale of shares of certain registered closed end investment companies by plans that cover employees of the company, its investment adviser or an affiliate thereof.
17. [Office Space] PTE 77-10 grants an exemption for sharing and leasing of office space and administrative goods by multiple employer plans.
18. [Overdrafts] PTE 80-26 granted an exemption for certain interest free loans, such as overdrafts, between employee benefit plans and parties in interest.
19. [QPAM] PTE 84-14 covers certain prohibited transactions involving plans whose assets are managed by a qualified professional asset manager (QPAM).
20. [Repurchase Agreements] PTE 81-8 deals with the exemption granted for certain short-term investments (including repurchase agreements) by employee benefit plans.
21. [Securities Lending] PTE 81-6 granted an exemption for the lending of securities by employee benefit plans to broker-dealers and banks that are parties in interest to the plan.
22. [Securities Lending - Fees] An exemption was granted for the provision of securities lending services by a fiduciary to an employee benefit plan in PTE 82-63.
23. [Short-Term Investments] PTE 81-8 deals with the exemption granted for certain short-term investments (including repurchase agreements) by employee benefit plans.
24. PTE 77-9 covers six classes of transactions involving insurance agents and brokers, pension consultants, insurance companies, investment companies, investment company principal underwriters, and employee benefit plans:

    - The fourth class covers the purchase with plan assets of an insurance or annuity contract from an insurance company.

    - The fifth and sixth classes of transactions cover the purchase with plan assets of insurance or annuity contracts or securities issued by an investment company in situations where the insurance company, investment company, or investment company principal underwriter is a fiduciary or service provider to the plan solely by reason of sponsorship of a master or prototype plan.

25. Exemptions from prohibitions respecting certain transactions in which multiemployer and multiple employer plans are involved. PTE 76-1 and PTE 77-10. These exemptions cover three classes of transactions: (1) delinquent employer contributions; (2) construction loans; and (3) office space, administrative services and goods.
26. Exemptions from prohibitions respecting certain classes of transactions involving employee benefit plans and certain broker-dealers, reporting dealers and banks. PTE 75-1, PTE 78-10, and PTE 79-1. These exemptions cover five classes of transactions: (1) agency transactions and services, (2) principal transactions, (3) under writings, (4) market making, and (5) extensions of credit.

D. Advisory Opinions

1. [Bonding of Fiduciaries] The bonding provisions of ERISA are contained in Section 412. It is unlawful under Section 412(c) for any Person to procure a required bond through an agent in

whose business operation a party in interest has any control or significant financial interest. ERISA's exemption provisions regarding bonding are contained in Section 412(e). Accordingly, it is concluded that Sections 408 and 414(c)(4) are not applicable to transactions that are unlawful under Section 412(c). AO 76-92.

2. [Relatives] An agent or broker who is a cousin of a plan fiduciary may receive commissions as agent or broker on the sale of insurance to the plan. WSB 79-104.

E. Court Decisions

1. Even though the terms of a transaction may be fair to the plan, if it constitutes a prohibited transaction under Section 406, the transaction constitutes a per se violation of ERISA without a Section 408 exemption. Approval of the transaction by a Taft-Hartley umpire is not sufficient. Cutaiar v. Marshall, 590 F.2d 523 (3d Cir. 1979).

Section 408(b)(1) **Loans to Plan Participants**
The prohibitions provided in Section 406 shall not apply to any of the following transactions:
Any loans made by the plan to parties in interest who are participants or beneficiaries of the plan if such loans:
Are available to all such participants and beneficiaries on a reasonably equivalent basis,
Are not made available to highly compensated employees (within the meaning of Section 414(q) of Title 26) in an amount greater than the amount made available to other employees,
Are made in accordance with specific provisions regarding such loans set forth in the plan,
Bear a reasonable rate of interest, and
Are adequately secured.

A. Conference Report

Participant loans are discussed on pages 311-316 of the Congressional Conference Report.

B. Statutes

Also refer to Section 72(p) of the Internal Revenue Code, which imposes additional restrictions on loans to plan participants .

C. Regulations

1. Refer to DOL ERISA Regulation 2550.408b-1 .
2. If plan makes more than 25 participant loans in a calendar year, it will be need to make the APR and Finance Charge (and other) disclosures required by the Truth in Lending Act and Federal Reserve Regulation Z. Refer to:

    a. Footnote 3 of Regulation Z, concerning who meets the test of being a *Creditor* under Section 226.2(a)(17) of the Regulation; and
    b. The Federal Reserve Board Official Staff Commentary on Regulation Z explanation of how *Creditor* applies to -

        - Individual trust accounts instead of the Trust Department as a whole [Item 7], and

        - "Employee savings plans" (401(k) and 403(b)-type plans) [Item 8].

D. Advisory Opinions

1. A transaction exempted by Section 408(b) from the prohibitions of Section 406(a) is not

exempted for that portion of the transaction which may constitute a violation of Section 406(b). AO 83-45A.

2. The analysis of a program of investment by an employee benefit plan in residential mortgage loans that may be available to the plan's participants involves consideration of three distinct questions:

   a. Whether the program is prudent within the meaning of Section 404(a)(1)(B),
   b. Whether the loans within such a program are prudent within the meaning of that section, and
   c. Where a loan is to be made to a plan participant, whether the rate of interest charged on the loan is available within the meaning of Section 408(b)(1).

   [Note that the Department of Labor in December 1987 issued regulations under Section 408(b)(1) defining "reasonable rate of interest" consistent with prior decisions under Section 404(a)(2)(B), for example, endorsing the market or prevailing rate of interest.] AO 81-12A.

3. [ESOPs] Section 408(d) makes Section 408(b)(1) unavailable for transactions that involve a loan of any part of the income or corpus of a plan to a shareholder-employee as defined in Code Section 1379(d) of the employer maintaining the plan. The applicability of Section 408(b)(1) depends, among other things, on whether the proposed recipient is such a shareholder-employee. The trustees of the plan are responsible for determining whether the provisions of Section 408(b)(1), or any other section of ERISA, are applicable to the plan. AO 75-105.
4. A transaction that constituted a prohibited transaction but that was subject to a statutory exemption under Section 408(b) when the transaction was entered into may, in the future, become prohibited while the transaction continues because of changes in the relationship, causing the loss of the statutory exemption protection for the transaction. Thus, a loan between a plan and a party in interest may be entitled to relief under Section 408(b)(1) when the loan was made. However, if the party in interest later becomes an owner-employee for purposes of Section 408(d), then the loan is a prohibited transaction for which no relief is available under Section 408(b)(1). AO 84-44A.

E. Court Decisions

1. If other participants are required to provide greater security for their loans from a plan than the participant was required to provide, the loans to the participant are not made on a reasonably equivalent basis to loans to other participants as required by ERISA Section 408(b)(1)(A). Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
2. If a loan from a plan to a participant exceeds the total of all loans to all other participants, the loan does not meet the criteria of ERISA Section 408(b)(1)(B). Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
3. A loan in an amount that exceeds the limits set forth in the plan document does not satisfy ERISA Section 408(b)(1)(C). Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
4. A participant's vested interest in a plan may not constitute adequate security for a loan from the plan under Section 408(b)(1)(E). Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).

Section 408(b)(2) **Ancillary Services**
The prohibitions provided in Section 406 shall not apply to any of the following transactions:
Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore.

A. Conference Report

General ancillary services are covered on pages 311-316 of the Congressional Conference Report.

B. Regulations

Refer to DOL ERISA Regulation 2550.408b-2 .

1. Section 408(b)(2) does not contain an exemption from acts described in Section 406(b)(1) through (3). Such acts are separate transactions not described in Section 408(b)(2). DOL ERISA Regulation 2550.408b-2(a).
2. A service is necessary for the establishment or operation of a plan if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established and maintained. DOL ERISA Regulation 2550.408b-2(b).
3. No contract or arrangement is reasonable if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. DOL ERISA Regulation 2550.408b-2(c).
4. The prohibitions of Section 406(b) supplement the other provisions of Section 406(a) by imposing on parties in interest who are fiduciaries a duty of undivided loyalty to the plans for which they act. The prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control or responsibility that makes such persons fiduciaries when they have interests that may conflict with the interest of the plans for which they act. A fiduciary may not use the authority, control or responsibility that makes such person a fiduciary to cause a plan to pay an additional fee to a person in which such fiduciary has an interest that may affect the exercise of such fiduciary's best judgment as a fiduciary to provide a service. DOL ERISA Regulation 2550.408b-2(e).
5. The regulations cited above contain several important examples. DOL ERISA Regulation 2550.408b-2(f). Some of the examples, however, only deal with Section 406(b)(1) and not with Sections 406(b)(2) and 406(b)(3).
6. The provision of services by a multiemployer plan to a party in interest is the subject of PTE C 76-1 and PTE C 77-10.

C. Prohibited Transaction Class Exemptions (PTE)

1. [Bank - Securities Lending] A securities lending service offered by a bank fiduciary to plans would not be exempt under Section 408(b)(2) because the compensation arrangement, which was based on a percentage of the value of the securities loan, might involve self-dealing. AO 79-11. However, see PTE 81-6 and PTE 82-63 .
2. [Brokerage Services] A broker-dealer who provides investment advice to a plan and is therefore a fiduciary may, under certain circumstances, be able to effect brokerage transactions to a plan provided that he obtains prior authorization from another plan fiduciary before effecting any such transaction. Final PTE C 78-10.
3. [Brokerage Services at Cost or Free] Broker-dealers may perform brokerage services for plans that they sponsor when such services are undertaken to recapture commissions, when such services are provided in accordance with the provisions of Section 408(b)(2), or when such services are performed at no charge to a plan. Final PTE C 79-1.
4. [Indirect Expenses] Under ERISA Section 408(b)(2) and Code Section 4975(d)(2), a fiduciary may perform services for a plan and be reimbursed for certain direct expenses incurred in connection with those services. However, the allocation of overhead costs to the plan may not be covered by this exemption. Final PTE C 79-1.
5. [Office Space] The furnishing of office space or administrative services to a plan by a participating employee organization, employer or employee association, or by another multiemployer plan or multiple employer plan that is a party in interest or disqualified person to the plan, will generally be exempt from the prohibited transaction provisions if the conditions of ERISA Section 408(b)(2) and Code Section 4975(d)(2) are met. Final PTE C 76-1.

D. Advisory Opinions

1. [General] The Department will not rule on what constitutes a "necessary" service, a "reasonable" contract or arrangement, or what constitutes "reasonable" compensation since each issue is inherently factual in nature. Further, although Section 408(b)(2) generally permits the performance of multiple services for the same plan, it does not exempt an act of self-dealing by a fiduciary under the provisions of Section 406(b)(1). AO 82-26A.
2. [Administrative Services] A law firm may provide both legal and administrative services to a plan if the arrangement for all such services meets all of the requirements of Section 408(b)(2) and (c)(2) and Regulations Sections 2550.408b-2 and 2550.408c-2 and does not contravene the

requirements of Section 406(b). WSB 78-18.

3. [Administrative Services] A welfare plan may retain a participating union to provide administrative services to the plan for a fee if those plan trustees who are officers of the union physically absent themselves from all consideration of the matter and do not use any of their authority or control to influence the plan's decision to hire the union). See Example 7 of DOL ERISA Regulation 2550.408b-2(f). WSB 79-41.
4. [Bank - Own-Bank Trustee] A bank is not prohibited from serving as trustee for a plan maintained for the bank's employees *where it receives no compensation from the plan for its trustee services* (Emphasis added). AO 79-49 .
5. [Bank - Brokerage Service] The provision of brokerage services by a bank to employee benefit plans maintained by it for which the bank also serves as custodian and/or investment manager would be exempt from the prohibitions of Section 406(a) if the conditions of Section 408(b)(2) are met. Whether the conditions are met in each case involves questions that are inherently factual in nature and on which the Department of Labor will issue no rulings. AO 85-15; accord AO 85-16.
6. [Bank - CIF Investment Manager] The provision of investment management services by a wholly owned bank subsidiary would be exempt from the prohibitions of Section 406(a)(1) of ERISA in connection with the maintenance of a common or collective trust fund if the conditions of Section 408(b)(2) are specifically met. AO 82-22A.
7. [Bank - CIF Investment Manager] The supplying of investment management and advisory services by a registered advisor/investment manager to a common trust fund of a bank, both of which are part of a single controlled group, would be exempt from the prohibitions of Section 406(a) if the conditions of Section 408(b)(2) are met. The exemption granted by Section 408(b)(2) is limited to Section 406(a) prohibited transactions and does not cover the situations described in Section 406(b). Thus, a decision with regard to the manager's retention by the common trust fiduciaries could constitute a violation of Section 406(b). Further, compensation paid by a service provider to its employees may be a properly reimbursable expense under Regulations Section 2550.408c-2(b)(3) if the expense would not, in fact, have been sustained had the services not been provided and if it can be properly allocated to the particular services provided. What constitutes a direct expense in a particular case; however, is a factual matter to be resolved, taking into account the relevant facts and circumstances, and will not be the subject of an advisory opinion. AO 83-20A.
8. [Bank - CIF/STIF] The provision of trustee services by a bank to employee benefit plans and the investment of plan funds in the bank's commingled short term investment fund would be exempt from the prohibitions of Section 406(a) if the conditions of Sections 408(b)(2) and 408(b)(8) are met. Also, the mere selection of the bank to provide trustee services to the plans would not in itself constitute a violation of Section 406(b)(1). However, self-dealing in violation of Section 406(b)(1) could occur in the case of a committee's deliberations regarding the retention of the bank as trustee, and no opinion can be rendered on that potential circumstance. AO 82-62A.
9. [Bank - Loan Participations] Under Section 408(b)(2), a bank trustee for a plan may also provide services to a plan under a loan participation agreement, even if the plan can terminate such services only by selling its participation. WSB 79-48.
10. [Brokerage/Investment Management at No Cost] A brokerage firm which proposes to provide investment management and brokerage services to employee benefit plans, *to be paid for directly by the plan sponsor*, would be exempt from the prohibitions of Section 406(a)(1) if the conditions contained in Section 408(b)(2) are met (Emphasis added). AO 82-26A.
11. [Custodian] Under the facts of the request, where a brokerage firm acts as custodian of custodial accounts established under a prototype plan for self-employed persons (a Keogh plan) or a simplified employee pension plan (SEP) but possesses no discretionary authority over the investments over the accounts nor any other aspect of the business administration of the custodial accounts, the firm would not be treated as a trustee for purposes of PTE 79-4. AO 82-12A.
12. [Direct Expenses] Where the employer plan sponsor provides administrative services to the plan for charges based upon its actual cost for labor and material in connection therewith, the provision of administrative services would be exempt from the prohibitions of Section 406(a), assuming that, in fact and in operation, the plan service provider has met the conditions of Section 408(b)(2). In addition, it is the Department's view that compensation paid to a service provider to its employees may be a properly reimbursable expense under DOL ERISA Regulation 2550.408c-2(b)(3) if the expense would not have been sustained had the services not been provided, if it can be properly allocated to the particular services provided and the expense does not represent an allocable portion of overhead cost. AO 82-01A.

13. [Float] The ancillary services exemptions (including 408(b)(6)) do not include the float earned by the fiduciary bank from a demand deposit account to the extent that it is reasonably possible to earn a return on such funds. Retention of float would be permissible if it was a part of the bank's overall compensation from the plan and if the bank had made appropriate disclosures regarding the use of float. Failure to comply would result in a violation of ERISA Section 406(b)(1). AO 93-24A .
14. [Related Expenses] A plan may reimburse its attorney for expenses incurred in attending an educational seminar if, under the facts and circumstances, attendance at such seminar was deemed to be relevant to the needs of the plan. WSB 79-85.
15. The provision of services, including construction or repair services, to an apprenticeship plan by a contributing employer or the leasing of office space by an apprenticeship plan from a contributing employer are covered by the statutory exemption under ERISA Section 408(b)(2). *Proposed* PTE C 78-5. AO 79-72.

E. Court Decisions

1. [Written Contract Required] The Section 408(b)(2) exemption is only available where there is a contract or arrangement for services. Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
2. [Partial Exemption Only] ERISA Section 408(b)(2) provides no exemption from the provisions of ERISA Section 406(b). Although the language of ERISA Section 408(b)(2) appears to provide an exemption from all of the prohibitions of Section 406, the court concluded, based on the legislative history of Section 408(b)(2), that it should not be construed to provide an exemption from the prohibitions of ERISA Section 406(b). The decision explicitly supports ERISA Regulations Section 2550.408b-2(a) and (e) . Marshall v. Kelly, 465 F.Supp. 341, 1 EBC 1850 (W.D.Okla. 1978).
3. [Reasonable Compensation] Transactions between trustees of a pension, health and welfare fund and a claims processing company for the rendering of services necessary for the operation of the plan are exempted under Section 408 unless the company receives more than reasonable compensation. Brock v. Robbins 830 F.2d 64, 8 EBC 2489 (7th Cir. 1987).

Section 408(b)(3) **Loans to ESOPs**
The prohibitions provided in Section 406 shall not apply to any of the following transactions:
A loan to an employee stock ownership plan (as defined in section 407(d)(6)), if -
Such loan is primarily for the benefit of participants and beneficiaries of the plan, and
Such loan is at an interest rate which is not in excess of a reasonable rate.
If the plan gives collateral to a party in interest for such loan, such collateral may consist only of qualifying employer securities (as defined in Section 407(d)(5)).

A. Conference Report

ESOP loans are covered in pages 311-316 of the Congressional Conference Report.

B. Regulations

Regulations have been issued under Section 408(b)(3). See DOL ERISA Regulation 2550.408b-3.

1. Section 408(b)(3) provides an exemption from the prohibited transaction provisions of Sections 406(a), 406(b)(1), and 406(b)(2). Section 408(b)(3) does not provide an exemption from the prohibitions of Section 406(b)(3). DOL ERISA Regulation 2550.408b-3(b)(1).
2. The exemption under Section 408(b)(3) includes within its scope certain transactions in which the potential for self-dealing by fiduciaries exists and in which the interests of fiduciaries may conflict with the interests of beneficiaries. To guard against these potential abuses, the Department of

Labor will subject these transactions to special scrutiny to ensure that they are primarily for the benefit of participants and beneficiaries. DOL ERISA Regulation 2550.408b-3(b)(2).

3. These regulations contain several requirements relating to these loans. See also Treasury Department Regulation 54.4975-7(b).

Section 408(b)(4) **Deposits With Fiduciary Banks and Thrifts**
The prohibitions provided in Section 406 shall not apply to any of the following transactions:
The investment of all or part of a plan's assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if -
The plan covers only employees of such bank or other institution, and employees of affiliates of such bank or other institution, or
Such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or such institution or affiliate thereof) who is expressly empowered by the plan to so instruct the trustees with respect to such investment.

A. Conference Report

Deposits with fiduciaries are discussed on pages 311-316 of the Congressional Conference Report.

B. Regulations

Refer to DOL ERISA Regulation 2550.408b-4.

1. Section 408(b)(4) provides an exemption from Section 406(b)(1) and 406(b)(2), as well as Section 406(a)(1) because Section 408(b)(4) contemplates a bank or similar financial institution causing a plan for which it acts as a fiduciary to invest plan assets in its own deposits or certificates of deposit, if the requirements of Section 408(b)(4) are met. However, it does not provide an exemption from Section 406(b)(3). The receipt of such consideration is a separate transaction not described in the statutory exemption. DOL ERISA Regulation 2550.408b-4(a).
2. Such investment may be made if the investment is expressly authorized by a provision of the plan or trust agreement or if the investment is expressly authorized (or made) by a fiduciary of the plan who has authority to make such investments and who has no interest in the transaction that may affect the exercise of such authorizing fiduciary's best judgment as a fiduciary so as to cause such authorization to constitute an act described in Section 406(b). DOL ERISA Regulation 2550.408b-4.
3. If the requirements of Section 408(b)(4) are met, a defined benefit plan maintained by a bank employer may invest in certificates of deposit issued by the bank in excess of the 10% limitation of Section 407(a) of ERISA. AO 79-76.

C. Advisory Opinions

1. [Banks] The investment of plan assets of a noncollectively bargained multiple employer plan covering employees of banks, in savings accounts and certificates of deposit of banks that are contributing employers, constitutes a prohibited transaction under Section 406(a) and may also be prohibited under Section 406(b)(1) and (2) because members of the administrative board of the plan, which directs plan investments, are officers and employees of contributing employer/banks.

   However, Section 408(b)(4) provides an exemption from Sections 406(a), 406(b)(1) and 406(b)(2) for the investment of plan assets in the deposits or certificates of deposit of a bank that is a plan fiduciary or party in interest, if the requirements of DOL ERISA Regulation 2550.408b-4 are met. **One requirement of the regulation is that, for investments made after November 1, 1977, the plan specify the name(s) of the bank(s) in which deposits may be made. The**

specifications may be made in the plan by amendment retroactive to November 1, 1977. AO 79-25.

2. [Naming of Depository] A prototype plan used by a bank contained authorization "to invest in any type of deposit of the Trustee." The prototype plan defined the Trustee as the person who executed an adoption agreement. The bank adopted the prototype by executing an adoption agreement. A question arose as to whether such an indirect designation of the fiduciary bank was satisfactory.

   In response to an FDIC telephone inquiry, the DOL Office of (ERISA) Regulations and Interpretations staff indicated informally that the arrangement was deemed to comply with Section 408(b)(4) of the Act, DOL ERISA Regulation 2550.408b-4, and AO 79-25. The DOL staff indicated DOL would take a rather liberal view of the various documentation that would constitute the plan document(s). [10-27-94.]

3. [Substantial Penalty] The payment by an employee benefit plan to an issuer bank of a penalty upon the early redemption of certificates of deposit is subject to the exemption set forth in Section 408(b)(4) to the extent the exemption was available to the certificates of deposit. AO 81-42A.
4. [Non-bank Bank] A company engaged in the business of issuing face amount certificates for sale to employee benefit plans, among others, is a bank or similar financial institution within the meaning of Section 408(b)(4) based upon the facts set forth in the ruling request. AO 83-18A.
5. [Non-bank Bank] An industrial loan company may qualify as a bank or similar financial institution for purposes of meeting the conditions of Section 408(b)(4), exempting transactions from the prohibitions of Section 406. Thus, investment of assets of employee benefit plans in the industrial loan entity's saving instruments would be permitted under Section 408(b)(4). AO 82-64A.
6. [Deposits - Insured/Uninsured] The diversification requirement of Section 404(a)(1)(C) generally will not be violated if all plan assets in an individual account plan are invested in a federally insured savings account, so long as the account is fully insured. Where the account balance exceeds the amount covered by federal insurance, compliance with Section 404(a)(1)(C) is determined by whether the bank invests its assets in a diversified manner. AO 77-46.

Section 408(b)(5) **Insurance Company Fiduciaries**
The prohibitions provided in Section 406 shall not apply to any of the following transactions:
Any contract for life insurance, health insurance, or annuities with one or more insurers which are qualified to do business in a State, if the plan pays no more than adequate consideration, and if each such insurer or insurers is -
The employer maintaining the plan, or
A party in interest which is wholly owned (directly or indirectly) by the employer maintaining the plan, or by any person which is a party in interest with respect to the plan, but only if the total premiums and annuity considerations written by such insurers for life insurance, health insurance or annuities for all plans (and their employers) with respect to which such insurers are parties in interest (not including premiums or annuity considerations written by the employer maintaining the plan) do not exceed 5% of the total premiums and annuity considerations written for all lines of insurance in that year by such insurers (not including premiums or annuity considerations written by the employer maintaining the plan).

A. Conference Report

The Congressional Conference Report explains this statutory exemption at pages 311-316.

B. Advisory Opinions

1. [Pooled Fund Use] Where the assets of an insurance company's own plan are maintained in a single customer separate account pursuant to a group annuity contract, the transfer of such assets in kind to a pooled separate account maintained by the company in return for the acquisition of units in such pooled account by the plan, together with a change in the contract to permit plan investment in the pooled account, is exempt under Section 408(b)(5). AO 79-79.
2. Stop-loss policies of insurance are deemed to be included in the term "life insurance, health insurance and annuity contracts" as that term is used in PTE C 79-41 in connection with sale of stop-loss insurance by an affiliate of a bank holding company to plan sponsor by the holding company for its employees or employees of its affiliates. AO 83-19A.

<table>
<tr><th colspan="2">Section 408(b)(6)

Ancillary Services by Depository Fiduciaries</th></tr>
<tr><td colspan="2">The prohibitions provided in section 406 shall not apply to any of the following transactions:</td></tr>
<tr><td colspan="2">the providing of any ancillary service by a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan, and if:</td></tr>
<tr><td>(A)</td><td>Such bank or similar financial institution has adopted adequate internal safeguards which assure that the providing of such ancillary service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority, and</td></tr>
<tr><td>(B)</td><td>The extent to which such ancillary service is provided is subject to specific guidelines issued by such bank or similar financial institution (as determined by the Secretary after consultation with Federal and State supervisory authority), and adherence to such guidelines would reasonably preclude such bank or similar financial institution from providing such ancillary service -</td></tr>
<tr><td></td><td>In an excessive or unreasonable manner, and</td></tr>
<tr><td></td><td>In a manner that would be inconsistent with the best interests of participants and beneficiaries of employee benefit plans.</td></tr>
<tr><td colspan="2">Such ancillary services shall not be provided at more than reasonable compensation.</td></tr>
</table>

A. Conference Report

Bank ancillary services are discussed on pages 311-316 of the Congressional Conference Report.

B. Regulations

Regulations have been issued under Section 408(b)(6). DOL ERISA Regulation 2550.408b-6.

1. The Section 408(b)(6) exemption exempts ancillary services that do not meet the requirements of Section 408(b)(2) because the provision of such services involves self-dealing described in Section 406(b)(1) by the fiduciary bank or similar financial institution or a conflict of interest described in Section 406(b)(2). Section 408(b)(6) provides an exemption from Sections 406(b)(1) and (2) because Section 408(b)(6) contemplates the provision of such ancillary services without the approval of a second fiduciary. DOL ERISA Regulation 2550.408b-6(a).
2. Plan assets held by a fiduciary bank that are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest bearing checking account in the bank if the conditions of this regulation are met notwithstanding the provisions of Section 408(b)(4), which required the payment of a reasonable rate of interest on bank deposits. DOL ERISA Regulation 2550-408b-4(a) .
3. Section 408(b)(6) does not provide an exemption for the receipt of compensation described in Section 406(b)(3). The receipt of such consideration is a separate transaction not described in Section 408(b)(6). DOL ERISA Regulation 2550.408b-4(a) .

C. Prohibited Transaction Class Exemptions (PTE)

1. [Securities Lending] Securities lending is an authorized ancillary service which may be offered by

a bank to an ERISA plan. PTE 81-6 permits securities lending and PTE 82-63 permits the bank to receive a fee for providing such services .

D. Advisory Opinions

1. [Bank Loan to Plan] Section 408(b)(6) does not provide an exemption for a loan to a plan by a bank trustee, even if authorized by the plan instruments, in order to aid the plan in paying the purchase price for an asset being purchased by the plan at the direction of the plan's administrative committee. AO 79-73.

Section 408(b)(7) **Conversion of Securities**
The prohibitions provided in section 406 shall not apply to any of the following transactions:
The exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary, but only if the plan receives no less than adequate consideration pursuant to such conversion.

A. Conference Report

The Congressional Conference Report explains this statutory exemption at pages 311-316.

Section 408(b)(8) **Collective Investment Funds**	
The prohibitions provided in Section 406 shall not apply to any of the following transactions:	
Any transaction between a plan and -	
A common or collective trust fund or pooled investment fund maintained by a party in interest which is a bank or trust company supervised by a State or Federal agency or	
A pooled investment fund of an insurance company qualified to do business in a State, if:	
(A)	The transaction is a sale or purchase of an interest in the fund;
(B)	The bank, trust company, or insurance company receives not more than reasonable compensation; and
(C)	Such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank, trust company, or insurance company, or an affiliate thereof) who has authority to manage and control the assets of the plan.

A. Conference Report

The use of a fiduciary's collective investment funds is covered in pages 311-316 of the Congressional Conference Report.

B. Advisory Opinions

1. [Annual Reports to Plan Administrators] CIFs are required to provide an annual report, covering certain material, to plan administrators of participating ERISA plans. See DOL ERISA Regulation 2520.103-5.
2. [CIF Investments in Another CIF] Fund-to-fund investments by affiliates of a multibank holding company, by bank pooled funds in corresponding pooled funds of other affiliates of the holding company, and fund-to-fund investments by a pooled fund of the controlled group in another pooled fund of the controlled group are transactions involving the sale or purchase of all interest

in a fund by an employee benefit plan and would be exempt from the prohibitions of Section 406(a)(1) if the conditions of Section 408(b)(8) are met. AO 82-41A.
3. [Trust Company CIFs] A wholly owned subsidiary corporation of an investment manager established as a trust company and subject to the supervision and examination by the superintendent of banks in the state of its domicile shall be deemed to constitute a bank for purposes of PTE C 80-51, and its common or collective trust fund may be utilized for investment by employee benefit plans managed by the parent-investment manager so long as the conditions of Section 408(b)(8) are satisfied. AO 83-12.

Section 408(b)(9) **Distributions of Plan Assets**
The prohibitions provided in section 406 shall not apply to any of the following transactions:
The making by a fiduciary of a distribution of the assets of the plan in accordance with the terms of the plan if such assets are distributed in the same manner as provided under section 4044 of this Act (relating to allocation of assets).

A. Conference Report

The Congressional Conference Report explains this statutory exemption at pages 311-316.

Section 408(b)(10) and (11)
The prohibitions provided in section 406 shall not apply to any of the following transactions:
Any transaction required or permitted under part 1 of subtitle E of title IV.
A merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231.

Section 408(c)(1)
Nothing in section 406 shall be construed to prohibit any fiduciary from receiving any benefit to which he may be entitled as a participant or a beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries.

A. Conference Report

The Congressional Conference Report does not explain Section 408(c)(1).

B. Court Decisions

1. Profit-sharing plan trustees improperly refused to pay benefits to a former executive on the ground that it would breach his fiduciary duties to receive plan benefits, as he was still a plan trustee when the request was made, since Section 408(c) permits a fiduciary to receive benefits to which he may be entitled as a plan participant so long as benefits are computed and paid in the same manner as they are for other participants. Kann v. Keystone Resources, Inc. Profit Sharing Plan, 575 F.Supp. 1084, 5 EBC 1233 (W.D. Pa. 1983).
2. Where, as a result of termination of employment, an employee is vested in only a portion of his account balance under a profit-sharing plan, the remaining portion being reallocated under the terms of the plan to other accounts of other participants, the fact that participants who are also plan fiduciaries benefited from such reallocation does not constitute self-dealing by virtue of ERISA Section 408(c)(1). Shaw v. Kruidenier, 470 F.Supp. 1375 (S.D.Iowa 1979), aff'd, 620 F.2d 207 (8th Cir. 1980).

Section 408(c)(2)

Fiduciary Fees and Expenses

Nothing in section 406 shall be construed to prohibit any fiduciary from receiving any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan; except that no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan, or from an employee organization whose members are participants in such plan shall receive compensation from such plan, except for reimbursement of expenses properly and actually incurred.

A. Conference Report

The Congressional Conference Report does not explain this interpretation.

B. Regulations

Regulations have been issued under Section 408(c)(2). DOL ERISA Regulation 2550.408c-2.

1. Section 408(b)(2) refers to the payment of reasonable compensation by a plan to a party in interest for services rendered to the plan. Section 408(c)(2) clarifies what constitutes reasonable compensation for such services. DOL ERISA Regulation 2550.408c-2(a).
2. Generally, whether compensation is reasonable under Sections 408(b)(2) and 408(c)(2) depends on the particular facts and circumstances of each case. DOL ERISA Regulation 2550.408c-2(b)(1).
3. The term "reasonable compensation" does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers or from an employer organization, except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. These restrictions do not apply to a party in interest who is not a fiduciary. DOL ERISA Regulation 2550.408c-2(b)(2).
4. An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an applicable portion of overhead costs. DOL ERISA Regulation 2550.408c-2(b)(3).
5. The term "reasonable compensation", as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if certain conditions are satisfied. DOL ERISA Regulation 2550.408c-2(b)(4).

C. Interpretive Bulletins

IB 75-6, relating to Section 408(c)(2), has been superseded by the regulation cited above.

D. Advisory Opinions

1. [General] Section 408(c)(2) was inserted in ERISA as an exemption from the Section 406 prohibited transaction rules to enable certain services to be provided to a plan. The clause in Section 408(c)(2) relating to full-time employee receiving solely reimbursement for expenses is a limitation within an exemption from Section 406. AO 75-21.
2. [General] A fiduciary who receives full-time pay from an employer association acting on behalf of a group of employers as a sponsor of an employee benefit plan where employees of the contributing employers are participants in this plan would be precluded under Section 408(b)(2) from receiving compensation from the plan for his services as a trustee. This is consistent with the legislative history of Section 408(c)(2) wherein Congress expressed an intent to prevent double payment when the sponsoring association, which is supported solely by the contributing employers, already pays the trustee full-time pay. AO 85-19A.
3. [Form of Compensation] Section 408(c)(2) and the regulations thereunder do not proscribe the payment of compensation to fiduciaries in a form other than cash (e.g, purchase of life insurance), provided the amount of total compensation paid in all forms is reasonable. WSB 78-

34.
4. [Compensation] The manner in which a union, an employer, and an employer association characterize the payments that they make to trustees is not dispositive of the issue of whether those payments constitute full-time pay. WSB 78-36.
5. [Compensation] When two union trustees are full-time paid union officers, no compensation is permissible under Section 408(c)(2). AO 76-57.
6. [Compensation] The receipt of compensation by a fiduciary from a plan is a prohibited transaction if the fiduciary is already receiving full-time compensation from the employer maintaining the plan. AO 78-08.
7. [Compensation] A trustee or fiduciary who is paid by his employer on an hourly basis and who loses wages for time spent in connection with his plan duties will not be deemed to be receiving full-time pay from his employer during those periods of time that he is performing his duties as plan trustee or fiduciary; and he may, therefore, receive compensation from the plan for services rendered in the performance of his duties with the plan. AO 76-03; WSB 79-92; WSB 79-97
8. [Compensation - Owner] A management representative/trustee who is the owner of a business that is an employer whose employees are participants in the plan may not receive compensation from the plan for services rendered in the performance of his duties with the plan. The trustee's regular full-time pay or compensation will not be diminished for his time spent on plan duties. AO 76-03; WSB 79-92; WSB 79-97.
9. [Indemnification of Trustee] Reimbursement or payment by the fund, pursuant to certain indemnification provisions, of expenses properly and actually incurred (including reimbursement or payment of expenses properly and actually incurred in settlement of pending or threatened litigation) is not a prohibited transaction under Section 406(a)(1)(B) or (D) to the extent the reimbursement or payment does not exceed amounts allowed under Section 408(c)(2). AO 77-66/67.
10. [Expenses] Section 408(c)(2) expressly does not preclude reimbursement for expenses properly and actually incurred by any plan fiduciary. AO 75-145.
11. [Legal Expenses] Reimbursement of a legal defense expenses of Taft-Hartley plan trustees is permitted under certain circumstances. However, a plan provision authorizing reimbursement of legal fees in the event of *any* legal action that may arise from the performance of a trustee's fiduciary duties is too broad and would be prohibited under Section 408(c)(2). Where a fiduciary is found in legal proceedings to have violated his fiduciary duties, reimbursement of legal fees by the plan would not be permitted (Emphasis added). AO 78-29.

E. Court Decisions

1. [Legal Expenses] Absent any finding of breach of fiduciary duty, the reimbursement of litigation expenses incurred by a fiduciary defending against allegations of breach of fiduciary duty is not prohibited by Section 410(a) and, by virtue of Section 408(c)(2), is not a prohibited transaction. Central States Pension Fund v. American National Bank & Trust Co. of Chicago, No. 77 C 4335, slip op. (N.D.Ill., Oct. 26, 1979).
2. [Commissions] The investment of plan assets in companies in exchange for commissions, equity, or other compensation does not qualify as a Section 408 exempted transaction and, as such, is prohibited by Section 406. Lowen v. Tower Asset Management, Inc., 829 F.2d 1209, 8 EBC 2457 (2d Cir. 1987).
3. [Commissions] The payment of a sales commission to a fiduciary on the sale of plan real property is not exempt under Section 408(c)(2) as the fiduciary received full-time pay from the employer. If the commission is characterized as compensation for "extraordinary services", it is not exempt under Section 408(c)(2), since that section exempts only compensation for the performance of fiduciary duties. Marshall v. Kelly, 465 F.Supp. 341, 1EBC 1850 (W.D.Okla. 1978).

Section 408(c)(3)
Nothing in Section 406 shall be construed to prohibit any fiduciary from serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest.

A. Conference Report

The Congressional Conference Report does not explain this interpretation.

B. Advisory Opinions

1. [General] Section 408(c)(3) has no bearing on the applicability of the fiduciary duties set forth in Section 404(a)(1). The Section also does not deal with possible prohibited transactions that might occur under Section 406(b), depending on the factual situation, when a fiduciary is a director of an investment manager of the plan's assets. AO 76-15.
2. [Own-Bank Plans] A bank is not prohibited from serving as trustee for a plan maintained for the bank's employees *where it receives no compensation from the plan for its trustee services* [Emphasis added]. AO 79-49 .
3. [Bank Director] An individual who is a fiduciary of an employee benefit plan because he has authority to appointment the investment manager is not subject to liability under Section 406 merely because he continues to serve as the director of a trust company that has been appointed as an investment manager to manage assets of such plan. AO 76-15.
4. [Director] A person serving as a director of a fiduciary or a service provider is a representative of a party in interest. As such, he will not be subject to liability under Section 406 merely because he serves as a trustee of a plan while at the same time serving as a director of a bank service provider. AO 77-45.

C. Court Decisions

1. The appointment of an officer or employee of the plan sponsor as plan trustee is not improper merely because of the trustee's relationship to the sponsor. Blackmar v. Lichtenstein, 468 F.Supp. 370 (E.D.Mo.), aff'd, 603 F.2d 1306, 1 EBC 1679 (8th Cir. 1979).

Section 408(d)
Section 407(b) and subsections (b), (c) and (e) of this section shall not apply to any transaction in which a plan directly or indirectly -
Lends any part of the corpus or income of the plan to;
Pays any compensation for personal services rendered to the plan to; or
Acquires for the plan any property from or sells any property to;
any person who is with respect to the plan an owner-employee (as defined in section 401(c)(3) of the Internal Revenue Code of 1954), a member of the family (as defined in section 267(c)(4) of such Code) of my such owner-employee, or a corporation controlled by any such owner-employee through the ownership, directly or indirectly, of 50% or more of the combined voting power of all classes of stock entitled to vote or 50% or more of the total value of shares of all classes of stock of the corporation. For purposes of this subsection a shareholder employee (as defined in section 1379 of the Internal Revenue Code of 1954 as in effect on the day before the date of the enactment of the Subchapter S Revision Act of 1982) and a participant or beneficiary of an individual retirement annuity, or an individual retirement bond (as defined in section 408 or section 409 of the Internal Revenue Code of 1954) and an employer or association of employers which establishes such an account or annuity under section 408(c) of such Code shall be deemed to be an owner-employee.

A. Conference Report

The Congressional Conference Report does not explain this exception to the scope of the exemptions.

B. Advisory Opinions

1. Section 408(d) makes Section 408(b) unavailable for transactions between a plan and a shareholder-employee (as defined in Section 1379(d) of the Internal Revenue Code of 1954) of the plan. The trustees of the plan are, of course, responsible for determining whether the provisions of Section 408(b), or any other section of ERISA, are applicable to the plan. AO 75-105.

Section 408(e)

<table>
<tr><th colspan="2">Sections 406 and 407 shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5)) or acquisition, sale, or lease by a plan of qualifying employer real property (as defined in section 407(d)(4)) -</th></tr>
<tr><td colspan="2">If such acquisition, sale, or lease is for adequate consideration (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under section 407(e)(1)),</td></tr>
<tr><td colspan="2">If no commission is charged with respect thereto, and</td></tr>
<tr><td colspan="2">If -</td></tr>
<tr><td>(A)</td><td>The plan is an eligible individual account plan (as defined in section 407(d)(3)), or</td></tr>
<tr><td>(B)</td><td>In the case of an acquisition or lease of qualifying employer real property by a plan which is not an eligible individual account plan, or of an acquisition of qualifying employer securities by such a plan, the lease or acquisition is not prohibited by section 407(a).</td></tr>
</table>

A. Conference Report

The Congressional Conference Report explains this employer security and real property exemption at pages 316-320.

B. Regulations

See DOL ERISA Regulation 2550.408e .

C. Advisory Opinions

1. [General] For the exemption provided by Section 408(e) to apply to any sale, the property being sold must be either qualifying employer securities or qualifying employer real property *at the time such securities or property are sold by the plan*. If a corporation is not a member of a controlled group prior to the consummation of a sale, the corporation's securities will not be securities of an affiliate prior to the sale (Emphasis added). AO 77-18.
2. [Employer Real Estate] Section 408(e) is not applicable where the property is not "*qualifying* employer real property" (Emphasis added). AO 76-14.
3. [Individual Account Plan] An exchange of employer common stock by an eligible individual account plan for stock of a new parent company is covered by Section 408(e). AO 78-22.
4. [Individual Account Plan] The exemption provided in Section 408(e) is available to an eligible individual account plan only if the conditions set forth in that section are met. AO 79-13 and AO 79-23. The exemption is not affected by the exercise of control by a participant or beneficiary over the assets in his individual account. AO 75-89.
5. [Employer Securities] The prohibited transaction restrictions of Section 406 of ERISA do not apply to a company's repurchase of its stock from its employee benefit plan, provided that the three conditions of Section 408(e) are met. However, the Department will not opine as to whether a particular transaction is for adequate compensation. AO 81-46A.
6. [Employer Securities] The acquisition by the plan of preferred stock of the plan sponsor in payment of a debt owned by the plan sponsor corporation to the plan, and the further acquisition by the plan of the plan sponsor's preferred stock in exchange for the plan sponsor's common stock held by the plan, constitute acquisitions within the meaning of Section 408(e). AO 81-33A.
7. [Valuation - Employer Securities] ERISA Section 3(18) defines the term "*adequate consideration*", in the case of a security for which there is no generally recognized market, as the fair value of the security determined in good faith by the trustee or named fiduciary to a plan pursuant to the terms of the plan and in accordance with regulations promulgated by the Department of Labor. The Department of Labor has not yet issued such regulations and does not, at the present time, contemplate making advance determinations as to adequate consideration in the case of individual purchases and sales of stock. Guidelines to be issued will be general guidelines in the form of regulations under Section 3(18). In view of the fact that no regulations have been issued under Section 3(18), the plan advisory committee should make a good faith determination of the fair market value of the common stock of the employer maintaining the plan, utilizing recognized methods of determining the value of stock of closely held corporations. AO 75-141.
8. [Valuation - Employer Securities] In view of the fact that no regulations have been issued under Section 3(18), the trustee should make a good faith determination of the fair market value of the

book value shares, utilizing recognized methods of determining the value of such shares. The ruling received by the trustee from the Internal Revenue Service as to where the method of determining fair market value of the book value shares was a reasonable one for purposes of Section 1.421-7(e)(2) of the Income Tax Regulations would be considered as evidence that the trustee determining of fair market value was made in good faith. AO 77-35.

Section 408(f)
Section 406(b)(2) shall not apply to any merger or transfer described in subsection (b)(11).

Exculpatory Provisions; Insurance **ERISA Section 410**

Section 410(a) **Exculpatory Provisions**
Except as provided in sections 405(b)(1) and 405(d), any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.

A. Conference Report

The Congressional Conference Report discusses the exculpatory provision prohibition .

B. Interpretive Bulletins

1. Indemnification agreements are not prohibited if the fiduciary who may be indemnified under the agreement remains responsible and liable for his acts or omissions with the indemnifying party merely satisfying the fiduciary liability. For example, an employer or union may agree to indemnity a plan fiduciary under Section 410(a). Also, a fiduciary can agree to indemnity his employees who perform fiduciary functions for a plan. However, a plan cannot agree to indemnify a fiduciary for a breach of fiduciary duty. IB 75-4.

C. Advisory Opinions

1. [Exculpatory Clauses] An exculpatory clause that appears in a plan instrument is void even if the plan is not amended to remove the clause. AO 75-122.
2. [Exculpatory Clauses] Any provision in a plan instrument purporting to relieve the trustees of the duty to collect contributions is void under Section 410(a). AO 78-28.
3. [Indemnification] Indemnification by a multiemployer plan of an investment manager's defense costs and settlement payment is permitted in a lawsuit alleging a breach of fiduciary duty by the investment manager, provided that (1) no court decision was rendered that the investment manager had breached his fiduciary duties; (2) the defense costs indemnified did not exceed a reasonable amount and (3) an opinion is obtained from independent legal counsel that the acts in question did not involve a breach of fiduciary duty by the investment manager. AO 77-66/67.
4. [Indemnification] An advance or reimbursement by a plan of expenses incurred by a plan fiduciary in defending a lawsuit alleging a breach of fiduciary duty is not a prohibited transaction, provided (1) no reimbursement is made or any advances repaid if a court rules that a breach has occurred; and (2) the advance or reimbursement is for expenses properly and actually incurred (see DOL ERISA Regulation 2550.408c-2). AO 77-66/67.
5. [Indemnification] Reimbursement of the legal defense expenses of Taft-Hartley plan trustees is permitted under certain circumstances. However, a plan provision authorizing reimbursement of legal fees in the event of *any* legal action that may arise from the performance of a trustee's fiduciary duties is too broad and would be prohibited under Section 410(a). Where a fiduciary is found in a legal proceeding to have violated his fiduciary duties, reimbursement of legal fees by the plan would not be permitted. AO 78-29.

D. Court Decisions

1. Absent any finding of breach of fiduciary duty, the reimbursement of litigation expenses incurred by a fiduciary in defending against allegations of breach of fiduciary duty is not prohibited by Section 410(a) and, by virtue of Section 408(c)(2), is not a prohibited transaction. Central States Pension Fund v. American National Bank & Trust Co. of Chicago, No. 77 C 4335, slip op. (N.D.Ill., Oct. 26, 1979).
2. Where a pension plan contains a provision to indemnify members of the board of directors, plan administrative committee, trustee and any other person to whom fiduciary responsibility was allocated from liability for a breach of fiduciary duty, except for liabilities and claims arising from willful misconduct, the indemnity agreement is void under ERISA Section 410(a). Donovan v. Cunningham, 541 F.Supp. 276, 3 EBC 1641 (S.D.Tex. 1982), aff'd in part, rev'd in part, 716 F.2d 1455, 4 EBC 2329 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984).
3. A successor trustee cannot be exonerated by the provisions of a trust agreement from his duty to liquidate prior improper investments upon assuming his responsibilities. Marshall v. Craft, 463 F.Supp. 493 (N.D.Ga. 1978).
4. Even though a plan trustee has no authority for investment decisions, it cannot disavow itself of a responsibility for such decision since it is still a fiduciary. However, under the allocation provisions of Section 405(c)(1) the trustee may not, in fact, be liable for such decisions. Leonard v. Drug Fair, Inc., Fed. Sec. L. Rep. (CCH) Para 97,144 (D.D.C. 1979).
5. Where a pension plan was challenged under ERISA Section 410(a) because the summary plan descriptions contained disclaimers, the widow of a deceased employee could not maintain a private action since she was not a beneficiary as defined in ERISA. Trembly v. Marshall, 502 F.Supp. 29, 2 EBC 2500 (D.D.C. 1980).

Section 410(b) **Insurance**
Nothing in this subpart shall preclude -
A plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;
A fiduciary from purchasing insurance to cover liability under this part from and for his own account; or
An employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

A. Conference Report

The Congressional Conference Report discusses the fiduciary insurance provisions of Section 410(b) at pages 320-321.

B. Regulations

No regulations have been issued interpreting Section 410(b). However, in a news release issued on March 4, 1975, the Department of Labor stated that fiduciary insurance purchased by a plan that provides for recourse by the insurer against the fiduciary but that also permits the fiduciary to pay an additional premium to obtain coverage against the insurer's recourse is not prohibited under Section 410(b).

C. Advisory Opinions

1. Section 410(b) does not require plans to maintain fiduciary insurance. AO 76-03.

Bonding of Fiduciaries **ERISA Section 412**

Section 412

(a)	Every fiduciary of an employee benefit plan and every person who handles funds or other property of such plan (hereinafter in this section referred to as "plan official") shall be bonded as provided in this section; except that-			
	(1)	Where such plan is one under which the only assets from which benefits are paid are the general assets of a union or of an employer, the administrator, officers, and employees of such plan shall be exempt from the bonding requirements of this section, and		
	(2)	No bond shall be required of a fiduciary (or of any director, officer, or employee of such fiduciary) if such fiduciary -		
		(A)	Is a corporation organized and doing business under the laws of the United States or any State;	
		(B)	Is authorized under such laws to exercise trust powers or to conduct an insurance business;	
		(C)	Is subject to supervision or examination by Federal or State authority; and	
		(D)	Has at all times a combined capital and surplus in excess of such a minimum amount as may be established by regulations issued by the Secretary, which amount shall be at least $1,000,000. Paragraph (2) shall apply to a bank or other financial institution which is authorized to exercise trust powers and the deposits of which are not insured by the Federal Deposit Insurance Corporation, only if such bank or institution meets bonding or similar requirements under State law which the Secretary determines are at least equivalent to those imposed on banks by Federal law. The amount of such bond shall be fixed at the beginning of each fiscal year of the plan. Such amount shall not be less than 10 per centum of the amount of funds handled. In no case shall such bond be less than $1,000 nor more than $500,000, except that the Secretary, after due notice and opportunity for hearing to all interested parties, and after consideration of the record, may prescribe an amount in excess of $500,000, subject to the 10 per centum limitation of the preceding sentence.	
			For purposes of fixing the amount of such bond, the amount of funds handled shall be determined by the funds handled by the person, group, or class to be covered by such bond and by their predecessor or predecessors, if any, during the preceding reporting year, or if the plan has no preceding reporting year, the amount of funds to be handled during the current reporting year by such person, group, or class, estimated as provided in regulations of the Secretary. Such bond shall provide protection to the plan against loss by reason of acts of fraud or dishonesty on the part of be plan official, directly or through connivance with others. Any bond shall have as surety thereon a corporate surety company which is an acceptable surety on Federal bonds under authority granted by the Secretary of the Treasury pursuant to sections 9304-9308 of title 31. Any bond shall be in a form or of a type approved by the Secretary, including individual bonds or schedule of blanket forms of bonds which cover a group or class.	
(b)	It shall be unlawful for any plan official to whom subsection (a) applies, to receive, handle, disburse, or otherwise exercise custody of any of the funds or other property of any employees benefit plan, without being bonded as required by subsection (a) and it shall be unlawful for any plan official of such plan, or any other person having authority to direct the performance of such functions, to permit such functions, or any, of them, to be performed by any plan official, with respect to whom the requirements of subsection (a) have not been met.			
(c)	It shall be unlawful for any person to procure any bond required by subsection (a) from any surety or other company or through any agent or broker in whose business			

	operations such plan or any party in interest in such plan has any control or significant financial interest, direct or indirect.
(d)	Nothing in any other provision of law, shall make any person, required to be bonded as provided in subsection (a) because he handles funds or other property of an employee benefit plan, to be bonded insofar as the handling by such person of the funds or other property of such plan is concerned.
(e)	The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this section including exempting a plan from the requirements of this section where he finds that (1) other bonding arrangements or (2) the overall financial condition of the plan would be adequate to protect the interests of the beneficiaries and participants. When, in the opinion of the Secretary, the administrator of a plan offers adequate evidence of the financial responsibility of the plan, or that other bonding arrangements would provide adequate protection of the beneficiaries and participants, he may exempt such plan from the requirements of this section.

A. Conference Report

The Congressional Conference Report discusses the bonding requirements of ERISA.

B. Regulations

1. The temporary regulations generally incorporated by reference the bonding regulations issued under Section 13 of the Welfare and Pension Plans Disclosure Act (WPPDA). ERISA Regs. 2550.412-1. WPPDA Regulation Section 464 (29 C.F.R. 464).
2. Section 464.5 of the WPPDA regulations provides that the term "funds or other property" [see ERISA 412(a)] includes all property that is to be used by a plan as a source for paying benefits; however, it does not include, among other things, fixed assets used in the operation of a plan (e.g., a building used as office space by a plan).
3. Section 464.6 of the WPPDA regulations provides that in the case of multiemployer plans, employer contributions become plan funds when they are actually received by the plan.
4. Section 464.7 of the WPPDA regulations indicates the following regarding persons who handle funds or other property:

   a. Generally, a person handles plan funds or other property, when he has a relationship to funds or property that can rise to risk of loss through fraud or dishonesty. DOL WPPDA Regulation 464.7(a)(1).
   b. However, a person is not deemed to be handling where the risk of loss is negligible (e.g., where the person is handling checks, securities or title papers that he cannot negotiate). DOL WPPDA Regulation 464.7(a)(2).
   c. The power to withdraw funds from a bank account generally constitutes handling, regardless of whether the power is authorized. DOL WPPDA Regulation 464.7(b)(2).
   d. Having the authority to transfer ownership of plan assets to others constitutes handling. DOL WPPDA Regulation 464.7(b)(3).
   e. Persons who disburse plan funds or sign plan checks are handling plan funds. DOL WPPDA Regulation 464.7(b)(4).
   f. In the case of fully insured plans, there is generally no handling of plan funds or other assets, unless benefit payments, dividends, etc., are paid to the plan by the insurance company. DOL WPPDA Regulation 464.7(b)(7).

C. Interpretive Bulletins

1. A person who provides investment advice to a plan but does not handle plan funds or other property is not required to be bonded under Section 412. IB 75-5, Question FR-8.
2. A plan can purchase a bond covering plan officials, but the bond must be solely for the protection of the plan. IB 75-5, Question FR-9.
3. Even though a person is not a plan fiduciary, he may be subject to the bonding requirements of Section 412 if he handles plan funds or other property. IB 75-8, Question D-2.

D. Advisory Opinions

1. The Labor Department cannot postpone the applicability of the bonding requirements to any plan. AO 75-120.

2. There is no provision in Section 412 exempting plans with a minimum number of participants from the bonding requirements. AO 75-117.
3. Section 412(a) requires coverage only against fraud or dishonesty; it does not require errors and omissions coverage. AO 75-124.
4. A plan official is not required to be bonded unless he handles funds or other property. Handling occurs whenever the duties or activities of a plan official are such that there is a risk that such funds or other property could be lost in the event of fraud or dishonesty on the part of such person, acting either alone or in collusion with others. The authorization of disbursements may constitute handling, depending on the facts in a particular case. The factors that are considered include the closeness and continuity of supervision; who is, in fact, charged with or actually exercises final responsibility for determining whether specific disbursements or benefit claims are bona fide, regular and made in accordance with the applicable trust instrument or other documents; and who has the final responsibility for determining the propriety of any specific expenditure. AO 77-84.
5. An impartial chairman of a joint board of trustees who is only given full trustee voting authority to resolve disputes between trustees is handling plan funds or other property. AO 75-119.
6. Plan assets deposited in a savings account are not required to be bonded under Section 412. AO 77-11 and AO 79-10.
7. A person who (a) receives insurance policies from the plan trustees or participants for transmissions to the insurance company and (b) handles premium checks made out to the insurance carrier or receives checks made out to the plan trustees from the insurance company (but has no authority to negotiate these checks) is not handling plan funds or other property. AO 76-47.
8. The sale of a group insurance policy to an employer to fund a plan does not alone make the insurance company a party in interest to the plan. Therefore, the insurance company is not prohibited under Section 12(c) from selling a bond to the plan. AO 76-36.
9. The administrator of a plan cannot sell a bond to the plan under Section 412(c). The exemptions provided in Sections 408 and 414(c) apply only to prohibited transactions, not to the bonding restrictions. AO 76-92.

E. Court Decisions

1. A fiduciary who is not bonded is legally disqualified from serving as a fiduciary. Lane v. Marshall, Civ. A. No. 79-0868 (N.D.Cal., April 28,1979).
2. Posting of government obligations in lieu of corporate surety bond does not fulfill ERISA Section 412 bonding requirement. Musso v. Baker, 834 F.2d 78, 9 EBC 1145 (3d Cir. 1987), cert. denied, 101 L.Ed.2d 884, 1988 U.S. LEXIS 2840, 108 S.Ct. 2846, 56 U.S.L.W. 3864, 9 EBC 2304 (U.S. 1988) (where fund trustees deposited fund-owned federal government obligations).

Trust Examination Manual

Appendix E — Employee Benefit Law

Internal Revenue Code

Section 72(p)

26 USC 72(p)

Participant Loans Treated as Distributions

As Amended through 1988 (P.L. 100-647)

1. Treatment as Distributions. -- For purposes of this section -

   A. Loans. -- If during any taxable year a participant or beneficiary receives (directly or indirectly) any amount as a loan from a qualified employer plan, such amount shall be treated as having been received by such individual as a distribution under such plan.

   B. Assignments or pledges. -- If during any taxable year a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan.

2. Exception of certain loans. --

   A. General rule. -- Paragraph (1) shall not apply to any loan to the extent that such loan (when added to the outstanding balance of all other loans from such plan whether made on, before, or after August 13, 1982), does not exceed the lesser of --

      i. $50,000, reduced by the excess (if any) of

         I. The highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over

         II. The outstanding balance of loans from the plan on the date which such loan was more, or

      ii. The greater of --

         I. One-half of the present value of the nonforfeitable accrued benefit of the employee under the plan, or

         II. $10,000.

      For purposes of clause (ii) the present value of the nonforfeitable accrued benefit shall be determined without regard to any accumulated deductible employee contributions (as defined in subsection (O)(5)(b)).

   B. Requirement that loan be repayable within 5 years. --

      i. In general. -- Subparagraph (A) shall not apply to any loan unless such loan, by its terms, is required to be repaid within 5 years.

      ii. Exception for home loans. -- Clause (i) shall not apply to any loan used to acquire any dwelling unit which within a reasonable time is to be used (determined at the time the loan is made) as a principal residence of the participant.

C. Requirement of level amortization. -- Except as provided in regulations, this paragraph shall not apply to any loan unless substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan.
D. Related employers and related plans. -- For purposes of this paragraph

   i. The rules of subsections (b), (c), and (m) of section 414 shall apply, and
   ii. All plans of an employer (determined after the application of such subsections) shall be treated as 1 plan.

3. Denial of interest deductions in certain cases. --

   A. In general. No deduction otherwise allowable under this chapter shall be allowed under this chapter for any interest paid or accrued on any loan to which paragraph (1) does not apply by reason of paragraph (2) during the period described in subparagraph (B).
   B. Period to which subparagraph (A) applies. --For purposes of subparagraph (A), the period described in this subparagraph is the period--

      i. On or after the 1st day on which the individual to whom the loan is made is a key employee (as defined in section 416(i)), or
      ii. Such loan is secured by amounts attributable to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3). made to a key employee (as defined in section 416(i), or

4. Qualified employer plan, etc. For purposes of this subsection

   A. Qualified employer plan -

      i. In general. - The term "qualified employer plan" means -

         I. A plan described in section 401(a) which includes a trust exempt from tax under section 501(a).
         II. A annuity plan described in section 403(a), and
         III. A plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b).

      ii. Special rules. - The term "qualified employer plan" -

         I. Shall include any plan which was (or was determined to be) a qualified employer plan or a government plan, but
         II. Shall not include a plan described in subsection (e)(7).

   B. Government plan. The term "government plan" means any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

5. Special rules for loans, etc., from certain contracts. For purposes of this subsection, any amount received as a loan under a contract purchased under a qualified employer plan (and any assignment or pledge with respect to such a contract) shall be treated as a loan under such employer plan.

Internal Revenue Code

Section 72(p)-1

26 USC 72(p)-1

Participant Loans Treated as Distributions – IRS Guidelines

Section 72(p) was added by section 236 of the Tax Equity and Fiscal Responsibility Act of 1982 (96 Stat. 324), and amended by the Technical Corrections Act of 1982 (96 Stat. 2365), the Deficit Reduction Act of 1984 (98 Stat. 494), the Tax Reform Act of 1986 (100 Stat. 2085), and the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342).

Section 72(p)-1 was added on July 31, 2000 [Federal Register Volume 65, Number 147].

Statutory effective date: Section 72(p) applies to assignments, pledges, and loans made after

August 13, 1982.

Regulatory effective date: Section 72(p)-1 applies to assignments, pledges, and loans made on or after January 1, 2002.

Refer to response to question # 22 (a) through (c)(2) below for applicability dates.

Sec. 1.72(p)-1 Loans treated as distributions.

The questions and answers in this section provide guidance under section 72(p) pertaining to loans from qualified employer plans (including government plans and tax-sheltered annuities and employer plans that were formerly qualified). The examples included in the questions and answers in this section are based on the assumption that a bona fide loan is made to a participant from a qualified defined contribution plan pursuant to an enforceable agreement (in accordance with paragraph (b) of Q&A-3 of this section), with adequate security and with an interest rate and repayment terms that are commercially reasonable. (The particular interest rate used, which is solely for illustration, is 8.75 percent compounded annually.) In addition, unless the contrary is specified, it is assumed in the examples that the amount of the loan does not exceed 50 percent of the participant's nonforfeitable account balance, the participant has no other outstanding loan (and had no prior loan) from the plan or any other plan maintained by the participant's employer or any other person required to be aggregated with the employer under section 414(b), (c) or (m), and the loan is not excluded from section 72(p) as a loan made in the ordinary course of an investment program as described in Q&A-18 of this section. The regulations and examples in this section do not provide guidance on whether a loan from a plan would result in a prohibited transaction under section 4975 of the Internal Revenue Code or on whether a loan from a plan covered by Title I of the Employee Retirement Income Security Act of 1974 (88 Stat. 829) (ERISA) would be consistent with the fiduciary standards of ERISA or would result in a prohibited transaction under section 406 of ERISA. The questions and answers are as follows:

Q-1: In general, what does section 72(p) provide with respect to loans from a qualified employer plan?

A-1: (a) Loans. Under section 72(p), an amount received by a participant or beneficiary as a loan from a qualified employer plan is treated as having been received as a distribution from the plan (a deemed distribution), unless the loan satisfies the requirements of Q&A-3 of this section. For purposes of section 72(p) and this section, a loan made from a contract that has been purchased under a qualified employer plan (including a contract that has been distributed to the participant or beneficiary) is considered a loan made under a qualified employer plan.

(b) Pledges and assignments. Under section 72(p), if a participant or beneficiary assigns or pledges (or agrees to assign or pledge) any portion of his or her interest in a qualified employer plan as security for a loan, the portion of the individual's interest assigned or pledged (or subject to an agreement to assign or pledge) is treated as a loan from the plan to the individual, with the result that such portion is subject to the deemed distribution rule described in paragraph (a) of this Q&A-1. For purposes of section 72(p) and this section, any assignment or pledge of (or agreement to assign or to pledge) any portion of a participant's or beneficiary's interest in a contract that has been purchased under a qualified employer plan (including a contract that has been distributed to the participant or beneficiary) is considered an assignment or pledge of (or agreement to assign or pledge) an interest in a qualified employer plan. However, if all or a portion of a participant's or beneficiary's interest in a qualified employer plan is pledged or assigned as security for a loan from the plan to the participant or the beneficiary, only the amount of the loan received by the participant or the beneficiary, not the amount pledged or assigned, is treated as a loan.

Q-2: What is a qualified employer plan for purposes of section 72(p)?

A-2: For purposes of section 72(p) and this section, a qualified employer plan means--

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b);

(d) Any plan, whether or not qualified, established and maintained for its employees by the

United States, by a State or political subdivision thereof, or by an agency or instrumentality of the United States, a State or a political subdivision of a State; or

(e) Any plan which was (or was determined to be) described in paragraph (a), (b), (c), or (d) of this Q&A-2.

Q-3: What requirements must be satisfied in order for a loan to a participant or beneficiary from a qualified employer plan not to be a deemed distribution?

A-3: (a) In general. A loan to a participant or beneficiary from a qualified employer plan will not be a deemed distribution to the participant or beneficiary if the loan satisfies the repayment term requirement of section 72(p)(2)(B), the level amortization requirement of section 72(p)(2)(C), and the enforceable agreement requirement of paragraph (b) of this Q&A-3, but only to the extent the loan satisfies the amount limitations of section 72(p)(2)(A).

(b) Enforceable agreement requirement. A loan does not satisfy the requirements of this paragraph unless the loan is evidenced by a legally enforceable agreement (which may include more than one document) and the terms of the agreement demonstrate compliance with the requirements of section 72(p)(2) and this section. Thus, the agreement must specify the amount and date of the loan and the repayment schedule. The agreement does not have to be signed if the agreement is enforceable under applicable law without being signed. The agreement must be set forth either--

(1) In a written paper document;

(2) In an electronic medium that is reasonably accessible to the participant or the beneficiary and that is provided under a system that satisfies the following requirements:

(i) The system must be reasonably designed to preclude any individual other than the participant or the beneficiary from requesting a loan.

(ii) The system must provide the participant or the beneficiary with a reasonable opportunity to review and to confirm, modify, or rescind the terms of the loan before the loan is made.

(iii) The system must provide the participant or the beneficiary, within a reasonable time after the loan is made, a confirmation of the loan terms either through a written paper document or through an electronic medium that is reasonably accessible to the participant or the beneficiary and that is provided under a system that is reasonably designed to provide the confirmation in a manner no less understandable to the participant or beneficiary than a written document and, under which, at the time the confirmation is provided, the participant or the beneficiary is advised that he or she may request and receive a written paper document at no charge, and, upon request, that document is provided to the participant or beneficiary at no charge; or

(3) In such other form as may be approved by the Commissioner.

Q-4: If a loan from a qualified employer plan to a participant or beneficiary fails to satisfy the requirements of Q&A-3 of this section, when does a deemed distribution occur?

A-4: (a) Deemed distribution. For purposes of section 72, a deemed distribution occurs at the first time that the requirements of Q&A-3 of this section are not satisfied, in form or in operation. This may occur at the time the loan is made or at a later date. If the terms of the loan do not require repayments that satisfy the repayment term requirement of section 72(p)(2)(B) or the level amortization requirement of section 72(p)(2)(C), or the loan is not evidenced by an enforceable agreement satisfying the requirements of paragraph (b) of Q&A-3 of this section, the entire amount of the loan is a deemed distribution under section 72(p) at the time the loan is made. If the loan satisfies the requirements of Q&A-3 of this section except that the amount loaned exceeds the limitations of section 72(p)(2)(A), the amount of the loan in excess of the applicable limitation is a deemed distribution under section 72(p) at the time the loan is made. If the loan initially satisfies the requirements of

section 72(p)(2)(A), (B) and (C) and the enforceable agreement requirement of paragraph (b) of Q&A-3 of this section, but payments are not made in accordance with the terms applicable to the loan, a deemed distribution occurs as a result of the failure to make such payments. See Q&A-10 of this section regarding when such a deemed distribution occurs and the amount thereof and Q&A-11 of this section regarding the tax treatment of a deemed distribution.

(b) Examples. The following examples illustrate the rules in paragraph (a) of this Q&A-4 and are based upon the assumptions described in the introductory text of this section:

Example 1. (i) A participant has a nonforfeitable account balance of $200,000 and receives $70,000 as a loan repayable in level quarterly installments over five years.

(ii) Under section 72(p), the participant has a deemed distribution of $20,000 (the excess of $70,000 over $50,000) at the time of the loan, because the loan exceeds the $50,000 limit in section 72(p)(2)(A)(i). The remaining $50,000 is not a deemed distribution.

Example 2. (i) A participant with a nonforfeitable account balance of $30,000 borrows $20,000 as a loan repayable in level monthly installments over five years.

(ii) Because the amount of the loan is $5,000 more than 50% of the participant's nonforfeitable account balance, the participant has a deemed distribution of $5,000 at the time of the loan. The remaining $15,000 is not a deemed distribution. (Note also that, if the loan is secured solely by the participant's account balance, the loan may be a prohibited transaction under section 4975 because the loan may not satisfy 29 CFR 2550.408b-1(f)(2).)

Example 3. (i) The nonforfeitable account balance of a participant is $100,000 and a $50,000 loan is made to the participant repayable in level quarterly installments over seven years. The loan is not eligible for the section 72(p)(2)(B)(ii) exception for loans used to acquire certain dwelling units.

(ii) Because the repayment period exceeds the maximum five-year period in section 72(p)(2)(B)(i), the participant has a deemed distribution of $50,000 at the time the loan is made.

Example 4. (i) On August 1, 2002, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making monthly payments through July 2003, the participant fails to make any of the payments due thereafter.

(ii) As a result of the failure to satisfy the requirement that the loan be repaid in level monthly installments, the participant has a deemed distribution. See paragraph (c) of Q&A-10 of this section regarding when such a deemed distribution occurs and the amount thereof.

Q-5: What is a principal residence for purposes of the exception in section 72(p)(2)(B)(ii) from the requirement that a loan be repaid in five years?

A-5: Section 72(p)(2)(B)(ii) provides that the requirement in section 72(p)(2)(B)(i) that a plan loan be repaid within five years does not apply to a loan used to acquire a dwelling unit which will within a reasonable time be used as the principal residence of the participant (a principal residence plan loan). For this purpose, a principal residence has the same meaning as a principal residence under section 121.

Q-6: In order to satisfy the requirements for a principal residence plan loan, is a loan required to be secured by the dwelling unit that will within a reasonable time be used as the principal residence of the participant?

A-6: A loan is not required to be secured by the dwelling unit that will within a reasonable time be used as the participant's principal residence in order to satisfy the requirements for a principal residence plan loan.

Q-7: What tracing rules apply in determining whether a loan qualifies as a principal residence plan loan?

A-7: The tracing rules established under section 163(h)(3)(B) apply in determining whether a loan is treated as for the acquisition of a principal residence in order to qualify as a principal residence plan loan.

Q-8: Can a refinancing qualify as a principal residence plan loan?

A-8: (a) Refinancings. In general, no, a refinancing cannot qualify as a principal residence plan loan. However,

a loan from a qualified employer plan used to repay a loan from a third party will qualify as a principal residence plan loan if the plan loan qualifies as a principal residence plan loan without regard to the loan from the third party.

(b) Example. The following example illustrates the rules in paragraph (a) of this Q&A-8 and is based upon the assumptions described in the introductory text of this section:

Example. (i) On July 1, 2003, a participant requests a $50,000 plan loan to be repaid in level monthly installments over 15 years. On August 1, 2003, the participant acquires a principal residence and pays a portion of the purchase price with a $50,000 bank loan. On September 1, 2003, the plan loans $50,000 to the participant, which the participant uses to pay the bank loan.

(ii) Because the plan loan satisfies the requirements to qualify as a principal residence plan loan (taking into account the tracing rules of section 163(h)(3)(B)), the plan loan qualifies for the exception in section 72(p)(2)(B)(ii).

Q-9: Does the level amortization requirement of section 72(p)(2)(C) apply when a participant is on a leave of absence without pay?

A-9: (a) Leave of absence. The level amortization requirement of section 72(p)(2)(C)does not apply for a period, not longer than one year (or such longer period as may apply under section 414(u)), that a participant is on a bona fide leave of absence, either without pay from the employer or at a rate of pay (after income and employment tax withholding) that is less than the amount of the installment payments required under the terms of the loan. However, the loan (including interest that accrues during the leave of absence) must be repaid by the latest date permitted under section 72(p)(2)(B) (e.g., the suspension of payments cannot extend the term of the loan beyond 5 years, in the case of a loan that is not a principal residence plan loan) and the amount of the installments due after the leave ends (or, if earlier, after the first year of the leave or such longer period as may apply under section 414(u)) must not be less than the amount required under the terms of the original loan.

(b) Military service. See section 414(u)(4) for special rules relating to military service.

(c) Example. The following example illustrates the rules of paragraph (a) of this Q&A-9 and is based upon the assumptions described in the introductory text of this section:

Example. (i) On July 1, 2002, a participant with a nonforfeitable account balance of $80,000 borrows $40,000 to be repaid in level monthly installments of $825 each over 5 years. The loan is not a principal residence plan loan. The participant makes 9 monthly payments and commences an unpaid leave of absence that lasts for 12 months. Thereafter, the participant resumes active employment and resumes making repayments on the loan until the loan is repaid in full (including interest that accrued during the leave of absence). The amount of each monthly installment is increased to $1,130 in order to repay the loan by June 30, 2007.

(ii) Because the loan satisfies the requirements of section 72(p)(2), the participant does not have a deemed distribution. Alternatively, section 72(p)(2) would be satisfied if the participant continued the monthly installments of $825 after resuming active employment and on June 30, 2007 repaid the full balance remaining due.

Q-10: If a participant fails to make the installment payments required under the terms of a loan that satisfied the requirements of Q&A-3 of this section when made, when does a deemed distribution occur and what is the amount of the deemed distribution?

A-10: (a) Timing of deemed distribution. Failure to make any installment payment when due in accordance with the terms of the loan violates section 72(p)(2)(C) and, accordingly, results in a deemed distribution at the time of such failure. However, the plan administrator may allow a cure period and section 72(p)(2)(C) will not be considered to have been violated if the installment payment is made not later than the end of the cure period, which period cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due.

(b) Amount of deemed distribution. If a loan satisfies Q&A-3 of this section when made, but there is a failure to pay the installment payments required under the terms of the loan (taking into account any cure period allowed under paragraph (a) of this Q&A-10), then the amount of the deemed distribution equals the entire outstanding balance of the loan (including accrued interest) at the time of such failure.

(c) Example. The following example illustrates the rules in paragraphs (a) and (b) of this Q&A-10 and is based upon the assumptions described in the introductory text of this section:

Example. (i) On August 1, 2002, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over 5 years in level monthly installments due at the end of each month. After making all monthly payments due through July 31, 2003, the participant fails to make the payment due on August 31, 2003 or any other monthly payments due thereafter. The plan administrator allows a three-month cure period.

(ii) As a result of the failure to satisfy the requirement that the loan be repaid in level installments pursuant to section 72(p)(2)(C), the participant has a deemed distribution on November 30, 2003, which is the last day of the three-month cure period for the August 31, 2003 installment. The amount of the deemed distribution is $17,157, which is the outstanding balance on the loan at November 30, 2003. Alternatively, if the plan administrator had allowed a cure period through the end of the next calendar quarter, there would be a deemed distribution on December 31, 2003 equal to $17,282, which is the outstanding balance of the loan at December 31, 2003.

Q-11: Does section 72 apply to a deemed distribution as if it were an actual distribution?

A-11: (a) Tax basis. If the employee's account includes after-tax contributions or other investment in the contract under section 72(e), section 72 applies to a deemed distribution as if it were an actual distribution, with the result that all or a portion of the deemed distribution may not be taxable.

(b) Section 72(t) and (m). Section 72(t) (which imposes a 10 percent tax on certain early distributions) and section 72(m)(5) (which imposes a separate 10 percent tax on certain amounts received by a 5-percent owner) apply to a deemed distribution under section 72(p) in the same manner as if the deemed distribution were an actual distribution.

Q-12: Is a deemed distribution under section 72(p) treated as an actual distribution for purposes of the qualification requirements of section 401, the distribution provisions of section 402, the distribution restrictions of section 401(k)(2)(B) or 403(b)(11), or the vesting requirements of Sec. 1.411(a)-7(d)(5) (which affects the application of a graded vesting schedule in cases involving a prior distribution)?

A-12: No; thus, for example, if a participant in a money purchase plan who is an active employee has a deemed distribution under section 72(p), the plan will not be considered to have made an in-service distribution to the participant in violation of the qualification requirements applicable to money purchase plans. Similarly, the deemed distribution is not eligible to be rolled over to an eligible retirement plan and is not considered an impermissible distribution of an amount attributable to elective contributions in a section 401(k) plan. See also Sec. 1.402(c)-2, Q&A-4(d) and Sec. 1.401(k)-1(d)(6)(ii).

Q-13: How does a reduction (offset) of an account balance in order to repay a plan loan differ from a deemed distribution?

A-13: (a) Difference between deemed distribution and plan loan offset amount.

(1) Loans to a participant from a qualified employer plan can give rise to two types of taxable distributions-

(i) A deemed distribution pursuant to section 72(p); and

(ii) A distribution of an offset amount.

(2) As described in Q&A-4 of this section, a deemed distribution occurs when the requirements of Q&A-3 of this section are not satisfied, either when the loan is made or at a later time. A deemed distribution is treated as a distribution to the participant or beneficiary only for certain tax purposes and is not a distribution of the accrued benefit. A distribution of a plan loan offset amount (as defined in Sec. 1.402(c)-2, Q&A-9(b)) occurs when, under the terms governing a plan loan, the accrued benefit of the participant or beneficiary is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in the accrued benefit). A distribution of a plan loan offset amount could occur in a variety of circumstances, such as where the terms governing the plan loan require that, in the event of the participant's request for a distribution, a loan be repaid

immediately or treated as in default.

(b) Plan loan offset. In the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p). Accordingly, a plan may be prohibited from making such an offset under the provisions of section 401(a), 401(k)(2)(B) or 403(b)(11) prohibiting or limiting distributions to an active employee. See Sec. 1.402(c)-2, Q&A-9(c), Example 6. See also Q&A-19 of this section for rules regarding the treatment of a loan after a deemed distribution.

Q-14: How is the amount includible in income as a result of a deemed distribution under section 72(p) required to be reported?

A-14: The amount includible in income as a result of a deemed distribution under section 72(p) is required to be reported on Form 1099-R (or any other form prescribed by the Commissioner).

Q-15: What withholding rules apply to plan loans?

A-15: To the extent that a loan, when made, is a deemed distribution or an account balance is reduced (offset) to repay a loan, the amount includible in income is subject to withholding. If a deemed distribution of a loan or a loan repayment by benefit offset results in income at a date after the date the loan is made, withholding is required only if a transfer of cash or property (excluding employer securities) is made to the participant or beneficiary from the plan at the same time. See Secs. 35.3405-1, f-4, and 31.3405(c)-1, Q&A-9 and Q&A-11, of this chapter for further guidance on withholding rules.

Q-16: If a loan fails to satisfy the requirements of Q&A-3 of this section and is a prohibited transaction under section 4975, is the deemed distribution of the loan under section 72(p) a correction of the prohibited transaction?

A-16: No, a deemed distribution is not a correction of a prohibited transaction under section 4975. See Secs. 141.4975-13 and 53.4941(e)-1(c)(1) of this chapter for guidance concerning correction of a prohibited transaction.

Q-17: What are the income tax consequences if an amount is transferred from a qualified employer plan to a participant or beneficiary as a loan, but there is an express or tacit understanding that the loan will not be repaid?

A-17: If there is an express or tacit understanding that the loan will not be repaid or, for any reason, the transaction does not create a debtor-creditor relationship or is otherwise not a bona fide loan, then the amount transferred is treated as an actual distribution from the plan for purposes of the Internal Revenue Code, and is not treated as a loan or as a deemed distribution under section 72(p).

Q-18: If a qualified employer plan maintains a program to invest in residential mortgages, are loans made pursuant to the investment program subject to section 72(p)?

A-18: (a) Residential mortgage loans made by a plan in the ordinary course of an investment program are not subject to section 72(p) if the property acquired with the loans is the primary security for such loans and the amount loaned does not exceed the fair market value of the property. An investment program exists only if the plan has established, in advance of a specific investment under the program, that a certain percentage or amount of plan assets will be invested in residential mortgages available to persons purchasing the property who satisfy commercially customary financial criteria. A loan will not be considered as made under an investment program if--

(1) Any of the loans made under the program matures upon a participant's termination from employment;

(2) Any of the loans made under the program is an earmarked asset of a participant's or beneficiary's individual account in the plan; or

(3) The loans made under the program are made available only to participants or beneficiaries in the plan.

(b) Paragraph (a)(3) of this Q&A-18 shall not apply to a plan which, on December 20, 1995, and at all times thereafter, has had in effect a loan program under which, but for paragraph (a)(3) of this Q&A-18, the loans comply with the conditions of paragraph (a) of this Q&A-18 to constitute residential mortgage loans in the ordinary course of an investment program.

(c) No loan that benefits an officer, director, or owner of the employer maintaining the plan, or their beneficiaries, will be treated as made under an investment program.

(d) This section does not provide guidance on whether a residential mortgage loan made under a plan's investment program would result in a prohibited transaction under section 4975, or on whether such a loan made by a plan covered by Title I of ERISA would be consistent with the fiduciary standards of ERISA or would result in a prohibited transaction under section 406 of ERISA. See 29 CFR 2550.408b-1.

Q-19: If there is a deemed distribution under section 72(p), is the interest that accrues thereafter on the amount of the deemed distribution an indirect loan for income tax purposes?

A-19: (a) General rule. Except as provided in paragraph (b) of this Q&A-19, a deemed distribution of a loan is treated as a distribution for purposes of section 72. Therefore, a loan that is deemed to be distributed under section 72(p)ceases to be an outstanding loan for purposes of section 72, and the interest that accrues thereafter under the plan on the amount deemed distributed is disregarded in applying section 72 to the participant or beneficiary. Even though interest continues to accrue on the outstanding loan (and is taken into account for purposes of determining the tax treatment of any subsequent loan in accordance with paragraph (b) of this Q&A-19), this additional interest is not treated as an additional loan (and, thus, does not result in an additional deemed distribution) for purposes of section 72(p). However, a loan that is deemed distributed under section 72(p) is not considered distributed for all purposes of the Internal Revenue Code. See Q&A-11 through Q&A-16 of this section.

(b) Exception for purposes of applying section 72(p)(2)(A) to a subsequent loan. In the case of a loan that is deemed distributed under section 72(p) and that has not been repaid (such as by a plan loan offset), the unpaid amount of such loan, including accrued interest, is considered outstanding for purposes of applying section 72(p)(2)(A) to determine the maximum amount of any subsequent loan to the participant or beneficiary.

Q-20: May a participant refinance an outstanding loan or have more than one loan outstanding from a plan?

A-20: [Reserved]

Q-21: Is a participant's tax basis under the plan increased if the participant repays the loan after a deemed distribution?

A-21: (a) Repayments after deemed distribution. Yes, if the participant or beneficiary repays the loan after a deemed distribution of the loan under section 72(p), then, for purposes of section 72(e), the participant's or beneficiary's investment in the contract (tax basis) under the plan increases by the amount of the cash repayments that the participant or beneficiary makes on the loan after the deemed distribution. However, loan repayments are not treated as after-tax contributions for other purposes, including sections 401(m) and 415(c)(2)(B).

(b) Example. The following example illustrates the rules in paragraph (a) of this Q&A-21 and is based on the assumptions described in the introductory text of this section:

Example. (i) A participant receives a $20,000 loan on January 1, 2003, to be repaid in 20 quarterly installments of $1,245 each. On December 31, 2003, the outstanding loan balance ($19,179) is deemed distributed as a result of a failure to make quarterly installment payments that were due on September 30, 2003 and December 31, 2003. On June 30, 2004, the participant repays $5,147 (which is the sum of the three installment payments that were due on September 30, 2003, December 31, 2003, and March 31, 2004, with interest thereon to June 30, 2004, plus the installment payment due on June 30, 2004). Thereafter, the participant resumes making the installment payments of $1,245 from September 30, 2004 through December 31, 2007. The loan repayments made after December 31, 2003 through December 31, 2007 total $22,577.

(ii) Because the participant repaid $22,577 after the deemed distribution that occurred on December 31, 2003, the participant has investment in the contract (tax basis) equal to $22,577 (14 payments of $1,245 each plus a single payment of $5,147) as of December 31, 2007.

Q-22: When is the effective date of section 72(p) and the regulations in this section?

A-22: (a) Statutory effective date. Section 72(p) generally applies to assignments, pledges, and loans made after August 13, 1982.

(b) Regulatory effective date. This section applies to assignments, pledges, and loans made on or after January 1, 2002.

(c) Loans made before the regulatory effective date--(1) General rule. A plan is permitted to apply Q&A-19 and Q&A-21 of this section to a loan made before the regulatory effective date in paragraph (b) of this Q&A-22 (and after the statutory effective date in paragraph (a) of this Q&A-22) if there has not been any deemed distribution of the loan before the transition date or if the conditions of paragraph (c)(2) of this Q&A-22 are satisfied with respect to the loan.

(2) Consistency transition rule for certain loans deemed distributed before the regulatory effective date.

(i) The rules in this paragraph (c)(2) of this Q&A-22 apply to a loan made before the regulatory effective date in paragraph (b) of this Q&A-22 (and after the statutory effective date in paragraph (a) of this Q&A-22) if there has been any deemed distribution of the loan before the transition date.

(ii) The plan is permitted to apply Q&A-19 and Q&A-21 of this section to the loan beginning on any January 1, but only if the plan reported, in Box 1 of Form 1099-R, for a taxable year no later than the latest taxable year that would be permitted under this section (if this section had been in effect for all loans made after the statutory effective date in paragraph (a) of this Q&A-22), a gross distribution of an amount at least equal to the initial default amount. For purposes of this section, the initial default amount is the amount that would be reported as a gross distribution under Q&A-4 and Q&A-10 of this section and the transition date is the January 1 on which a plan begins applying Q&A-19 and Q&A-21 of this section to a loan.

(iii) If a plan applies Q&A-19 and Q&A-21 of this section to such a loan, then the plan, in its reporting and withholding on or after the transition date, must not attribute investment in the contract (tax basis) to the participant or beneficiary based upon the initial default amount.

(iv) This paragraph (c)(2)(iv) of this Q&A-22 applies if—

(A) The plan attributed investment in the contract (tax basis) to the participant or beneficiary based on the deemed distribution of the loan;

(B) The plan subsequently made an actual distribution to the participant or beneficiary before the transition date; and

(C) Immediately before the transition date, the initial default amount (or, if less, the amount of the investment in the contract so attributed) exceeds the participant's or beneficiary's investment in the contract (tax basis). If this paragraph (c)(2)(iv) of this Q&A-22 applies, the plan must treat the excess (the loan transition amount) as a loan amount that remains outstanding and must include the excess in the participant's or beneficiary's income at the time of the first actual distribution made on or after the transition date.

(3) Examples. The rules in paragraph (c)(2) of this Q&A-22 are illustrated by the following examples, which are based on the assumptions described in the introductory text of this section (and, except as specifically provided in the examples, also assume that no distributions are made to the participant and that the participant has no investment in the contract with respect to the plan). Example 1, Example 2, and Example 4 of this paragraph (c)(3) of this Q&A-22 illustrate the

application of the rules in paragraph (c)(2) of this Q&A-22 to a plan that, before the transition date, did not treat interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p). Example 3 of this paragraph (c)(3) of this Q&A-22 illustrates the application of the rules in paragraph (c)(2) of this Q&A-22 to a plan that, before the transition date, treated interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p). The examples are as follows:

Example 1. (i) In 1998, when a participant's account balance under a plan is $50,000, the participant receives a loan from the plan. The participant makes the required repayments until 1999 when there is a deemed distribution of $20,000 as a result of a failure to repay the loan. For 1999, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and, in Box 2 of Form 1099-R, a taxable amount of $20,000. The plan then records an increase in the participant's tax basis for the same amount ($20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution is $20,000 and the plan's records show that the participant's tax basis is the same amount ($20,000). As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant's remaining tax basis in the plan is zero. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59\1/2\ in the year 2003 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $60,000 in cash.

(ii) For the year 2003, the plan must report a gross distribution of $60,000 in Box 1 of Form 1099-R and a taxable amount of $60,000 in Box 2 of Form 1099-R.

Example 2. (i) The facts are the same as in Example 1, except that in 1999, immediately prior to the deemed distribution, the participant's account balance under the plan totals $50,000 and the participant's tax basis is $10,000. For 1999, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and reports, in Box 2 of Form 1099-R, a taxable amount of $16,000 (the $20,000 deemed distribution minus $4,000 of tax basis ($10,000 times ($20,000/$50,000)) allocated to the deemed distribution). The plan then records an increase in tax basis equal to the $20,000 deemed distribution, so that the participant's remaining tax basis as of December 31, 1999, totals $26,000 ($10,000 minus $4,000 plus $20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution is $16,000 and the plan's records show that the participant's tax basis is $26,000. As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant's remaining tax basis in the plan is $6,000. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59\1/2\ in the year 2003 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $60,000 in cash.

(ii) For the year 2003, the plan must report a gross distribution of $60,000 in Box 1 of Form 1099-R and a taxable amount of $54,000 in Box 2 of Form 1099-R.

Example 3. (i) In 1993, when a participant's account balance in a plan is $100,000, the participant receives a loan of $50,000 from the plan. The participant makes the required loan repayments until 1995 when there is a deemed distribution of $28,919 as a result of a failure to repay the loan. For 1995, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $28,919 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and, in Box 2 of Form 1099-R, a taxable amount of $28,919. For 1995, the plan also records an increase in the participant's tax basis for the same amount ($28,919). Each year thereafter through 2001, the plan reports a gross distribution equal to the interest accruing that year on the loan balance, reports a taxable amount equal to the interest accruing that year on the loan balance reduced by the participant's tax basis allocated to the gross distribution, and records a net increase in the participant's tax basis equal to that taxable amount. As of December 31, 2001, the taxable amount reported by the plan as a

result of the loan totals $44,329 and the plan's records for purposes of section 72 show that the participant's tax basis totals the same amount ($44,329). As of January 1, 2002, the plan decides to apply Q&A-19 of this section. Accordingly, it reduces the participant's tax basis by the initial default amount of $28,919, so that the participant's remaining tax basis in the plan is $15,410 ($44,329 minus $28,919). Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59\1/2\ in the year 2003 and receives a distribution of the full account balance under the plan consisting of $180,000 in cash and the loan receivable equal to the $28,919 outstanding loan amount in 1995 plus interest accrued thereafter to the payment date in 2003. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $180,000 in cash.

(ii) For the year 2003, the plan must report a gross distribution of $180,000 in Box 1 of Form 1099-R and a taxable amount of $164,590 in Box 2 of Form 1099-R ($180,000 minus the remaining tax basis of $15,410).

Example 4. (i) The facts are the same as in Example 1, except that in 2000, after the deemed distribution, the participant receives a $10,000 hardship distribution. At the time of the hardship distribution, the participant's account balance under the plan totals $50,000. For 2000, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $10,000 and, in Box 2 of Form 1099-R, a taxable amount of $6,000 (the $10,000 actual distribution minus $4,000 of tax basis ($10,000 times ($20,000/$50,000)) allocated to this actual distribution). The plan then records a decrease in tax basis equal to $4,000, so that the participant's remaining tax basis as of December 31, 2000, totals $16,000 ($20,000 minus $4,000). After 1999, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution plus the 2000 actual distribution is $26,000 and the plan's records show that the participant's tax basis is $16,000. As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant's remaining tax basis in the plan is reduced from $16,000 to zero. However, because the $20,000 initial default amount exceeds $16,000, the plan records a loan transition amount of $4,000 ($20,000 minus $16,000). Thereafter, the amount of the outstanding loan, other than the $4,000 loan transition amount, is not treated as part of the account balance for purposes of section 72. The participant attains age 59\1/2\ in the year 2003 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $60,000 in cash.

(ii) In accordance with paragraph (c)(2)(iv) of this Q&A-22, the plan must report in Box 1 of Form 1099-R a gross distribution of $64,000 and in Box 2 of Form 1099-R a taxable amount for the participant for the year 2003 equal to $64,000 (the sum of the $60,000 paid in the year 2003 plus $4,000 as the loan transition amount).

Internal Revenue Code

Section 408(h)

26 USC 408(h)

Custodial Accounts

For purposes of this section, a custodial account shall be treated as a trust if the assets of such account are held by a bank (as defined in subsection (n)) or another person who demonstrates, to the satisfaction of the Secretary, that the manner in which he will administer the account will be consistent with the requirements of this section, and if the custodial account would, except for the fact that it is not a trust, constitute an individual retirement account described in subsection (a). For purposes of this title, in the case of a custodial account treated as a trust by reason of the preceding sentence, the custodian of such account shall be treated as the trustee thereof.

Internal Revenue Code

Section 408(m)

26 USC 408(m)

Investments in Collectibles Treated as Distributions

As Amended through 1988 (P.L. 100-647)

> Editor's Note: Also see PTE 91-55, which permits IRA accounts to hold US *American Eagle* gold coins.

- In general. The acquisition by an individual retirement account or by an individually-directed account under a plan described in section 401(a) of any collectible shall be treated (for purposes of this section and section 402) as a distribution from such account in an amount equal to the cost to such account of such collectible.
- Collectible defined. For purposes of this subsection, the term "collectible" means --

  A. Any work of art,
  B. Any rug or antique,
  C. Any metal or gem,
  D. Any stamp or coin,
  E. Any alcoholic beverage, or
  F. Any other tangible personal property specified by the Secretary for purposes of this subsection.

- Exception for Certain Coins. In the case of an individual retirement account, paragraph (2) shall not apply to any gold coin described in paragraph (7), (8), (9), or (10) of Section 5112(A) of Title 31 or any silver coin described in Section 5112(e) of Title 31.

Internal Revenue Code

Section 408(q)

26 USC 408(q)

Deemed Individual Retirement Accounts

(q) Deemed IRAs under qualified employer plans

(1) General rule
If -

> (A) a qualified employer plan elects to allow employees to make voluntary employee contributions to a separate account or annuity established under the plan, and
>
> (B) under the terms of the qualified employer plan, such account or annuity meets the applicable requirements of this section or section 408A for an individual retirement account or annuity, then such account or annuity shall be treated for purposes of this title in the same manner as an individual retirement plan and not as a qualified employer plan (and contributions to such account or annuity as contributions to an individual retirement plan and not to the qualified employer plan). For purposes of subparagraph (B), the requirements of subsection (a)(5) shall not apply.

(2) Special rules for qualified employer plans
For purposes of this title, a qualified employer plan shall not fail to meet any requirement of this title solely by reason of establishing and maintaining a program described in paragraph (1).

(3) Definitions
For purposes of this subsection -
(A) Qualified employer plan
The term "qualified employer plan" has the meaning given such term by section 72(p)(4); except such term shall not include a government plan which is not a qualified plan unless the plan is an eligible deferred compensation plan (as defined in section 457(b)).
(B) Voluntary employee contribution
The term "voluntary employee contribution" means any contribution (other than a mandatory contribution within the meaning of section 411(c)(2)(C)) -
(i) which is made by an individual as an employee under a qualified employer plan which allows employees to elect to make contributions described in paragraph (1), and
(ii) with respect to which the individual has designated the contribution as a contribution to which this subsection applies.

Internal Revenue Code

Section 409(e)

26 USC 409(e)

Qualifications for Tax Credit ESOPs – Voting Rights

As Amended through 1997 (P.L. 105-34)

(e) Voting rights

1. In general

   A plan meets the requirements of this subsection if it meets the requirements of paragraph (2) or (3), whichever is applicable.

2. Requirements where employer has a registration-type class of securities

   If the employer has a registration-type class of securities, the plan meets the requirements of this paragraph only if each participant or beneficiary in the plan is entitled to direct the plan as to the manner in which securities of the employer which are entitled to vote and are allocated to the account of such participant or beneficiary are to be voted.

3. Requirement for other employers

   If the employer does not have a registration-type class of securities, the plan meets the requirements of this paragraph only if each participant or beneficiary in the plan is entitled to direct the plan as to the manner in which voting rights under securities of the employer which are allocated to the account of such participant or beneficiary are to be exercised with respect to any corporate matter which involves the voting of such shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations.

4. Registration-type class of securities defined

   For purposes of this subsection, the term, "registration-type class of securities" means -

   A. a class of securities required to be registered under section 12 of the Securities Exchange Act of 1934, and
   B. a class of securities which would be required to be so registered except for the exemption from registration provided in subsection (g)(2)(H) of such section 12.

5. 1 vote per participant
   A plan meets the requirements of paragraph (3) with respect to an issue if -
   A. the plan permits each participant 1 vote with respect to such issue, and
   B. the trustee votes the shares held by the plan in the proportion determined after application of subparagraph (A).

Internal Revenue Code

Section 417

26 USC 417

Special Rules for Survivor Annuity Requirements

Section. 417. Definitions and special rules for purposes of minimum survivor annuity requirements

(a) Election to waive qualified joint and survivor annuity or qualified preretirement survivor annuity

(1) In general

A plan meets the requirements of section 401(a)(11) only if –

(A) under the plan, each participant -

(i) may elect at any time during the applicable election period to waive the qualified joint and survivor annuity form of benefit or the qualified preretirement survivor annuity form of benefit (or both), and
(ii) may revoke any such election at any time during the applicable election period, and

(B) the plan meets the requirements of paragraphs (2), (3), and (4) of this subsection.

(2) Spouse must consent to election

Each plan shall provide that an election under paragraph (1)(A)(i) shall not take effect unless -

(A) (i) the spouse of the participant consents in writing to such election, (ii) such election designates a beneficiary (or a form of benefits) which may not be changed without spousal consent (or the consent of the spouse expressly permits designations by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public, or

(B) it is established to the satisfaction of a plan representative that the consent required under subparagraph (A) may not be obtained because there is no spouse, because the spouse cannot be located, or because of such other circumstances as the Secretary may by regulations prescribe.

Any consent by a spouse (or establishment that the consent of a spouse may not be obtained) under the preceding sentence shall be effective only with respect to such spouse.

(3) Plan to provide written explanations

(A) Explanation of joint and survivor annuity
Each plan shall provide to each participant, within a reasonable period of time before the annuity starting date (and consistent with such regulations as the Secretary may prescribe), a written explanation of -

(i) the terms and conditions of the qualified joint and survivor annuity,
(ii) the participant's right to make, and the effect of, an election under paragraph (1) to waive the joint and survivor annuity form of benefit,
(iii) the rights of the participant's spouse under paragraph (2), and
(iv) the right to make, and the effect of, a revocation of an election under paragraph (1).

(B) Explanation of qualified preretirement survivor annuity

(i) In general
Each plan shall provide to each participant, within the applicable period with respect to such participant (and consistent with such regulations as the Secretary may prescribe), a written explanation with respect to the qualified preretirement survivor annuity comparable to

that required under subparagraph (A).
(ii) Applicable period
For purposes of clause (i), the term "applicable period" means, with respect to a participant, whichever of the following periods ends last:

(I) The period beginning with the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year preceding the plan year in which the participant attains age 35.
(II) A reasonable period after the individual becomes a participant.
(III) A reasonable period ending after paragraph (5) ceases to apply to the participant.
(IV) A reasonable period ending after section 401(a)(11) applies to the participant.

In the case of a participant who separates from service before attaining age 35, the applicable period shall be a reasonable period after separation.

(4) Requirement of spousal consent for using plan assets as security for loans

Each plan shall provide that, if section 401(a)(11) applies to a participant when part or all of the participant's accrued benefit is to be used as security for a loan, no portion of the participant's accrued benefit may be used as security for such loan unless -

(A) the spouse of the participant (if any) consents in writing to such use during the 90-day period ending on the date on which the loan is to be so secured, and
(B) requirements comparable to the requirements of paragraph (2) are met with respect to such consent.

(5) Special rules where plan fully subsidizes costs

(A) In general
The requirements of this subsection shall not apply with respect to the qualified joint and survivor annuity form of benefit or the qualified preretirement survivor annuity form of benefit, as the case may be, if such benefit may not be waived (or another beneficiary selected) and if the plan fully subsidizes the costs of such benefit.
(B) Definition
For purposes of subparagraph (A), a plan fully subsidizes the costs of a benefit if under the plan the failure to waive such benefit by a participant would not result in a decrease in any plan benefits with respect to such participant and would not result in increased contributions from such participant.

(6) Applicable election period defined

For purposes of this subsection, the term "applicable election period" means -

(A) in the case of an election to waive the qualified joint and survivor annuity form of benefit, the 90-day period ending on the annuity starting date, or
(B) in the case of an election to waive the qualified preretirement survivor annuity, the period which begins on the first day of the plan year in which the participant attains age 35 and ends on the date of the participant's death.

In the case of a participant who is separated from service, the applicable election period under subparagraph (B) with respect to benefits accrued before the date of such separation from service shall not begin later than such date.

(7) Special rules relating to time for written explanation

Notwithstanding any other provision of this subsection -

(A) Explanation may be provided after annuity starting date

(i) In general
A plan may provide the written explanation described in paragraph (3)(A) after the annuity starting date. In any case to which this subparagraph applies, the applicable election period under paragraph (6) shall not end before the 30th day after the date on which such explanation is provided.
(ii) Regulatory authority
The Secretary may by regulations limit the application of clause (i), except that such regulations may not limit the period of time by which the annuity starting date precedes the provision of the written explanation other than by providing that the annuity starting date may not be earlier than termination of employment.

(B) Waiver of 30-day period
A plan may permit a participant to elect (with any applicable spousal consent) to waive any requirement that the written explanation be provided at least 30 days before the annuity starting date (or to waive the 30-day requirement under subparagraph (A)) if the distribution commences more than 7 days after such explanation is provided.

(b) Definition of qualified joint and survivor annuity

For purposes of this section and section 401(a)(11), the term "qualified joint and survivor annuity" means an annuity -

(1) for the life of the participant with a survivor annuity for the life of the spouse which is not less than 50 percent of (and is not greater than 100 percent of) the amount of the annuity which is payable during the joint lives of the participant and the spouse, and
(2) which is the actuarial equivalent of a single annuity for the life of the participant.

Such term also includes any annuity in a form having the effect of an annuity described in the preceding sentence.

(c) Definition of qualified preretirement survivor annuity

For purposes of this section and section 401(a)(11) -

(1) In general
Except as provided in paragraph (2), the term "qualified preretirement survivor annuity" means a survivor annuity for the life of the surviving spouse of the participant if -

(A) the payments to the surviving spouse under such annuity are not less than the amounts which would be payable as a survivor annuity under the qualified joint and survivor annuity under the plan (or the actuarial equivalent thereof) if -

(i) in the case of a participant who dies after the date on which the participant attained the earliest retirement

age, such participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's date of death, or
(ii) in the case of a participant who dies on or before the date on which the participant would have attained the earliest retirement age, such participant had -

(I) separated from service on the date of death,
(II) survived to the earliest retirement age,
(III) retired with an immediate qualified joint and survivor annuity at the earliest retirement age, and
(IV) died on the day after the day on which such participant would have attained the earliest retirement age, and

(B) under the plan, the earliest period for which the surviving spouse may receive a payment under such annuity is not later than the month in which the participant would have attained the earliest retirement age under the plan.

In the case of an individual who separated from service before the date of such individual's death, subparagraph (A)(ii)(I) shall not apply.

(2) Special rule for defined contribution plans
In the case of any defined contribution plan or participant described in clause (ii) or (iii) of section 401(a)(11)(B), the term ''qualified preretirement survivor annuity'' means an annuity for the life of the surviving spouse the actuarial equivalent of which is not less than 50 percent of the portion of the account balance of the participant (as of the date of death) to which the participant had a nonforfeitable right (within the meaning of section 411(a)).

(3) Security interests taken into account
For purposes of paragraphs (1) and (2), any security interest held by the plan by reason of a loan outstanding to the participant shall be taken into account in determining the amount of the qualified preretirement survivor annuity.

(d) Survivor annuities need not be provided if participant and spouse married less than 1 year

(1) In general
Except as provided in paragraph (2), a plan shall not be treated as failing to meet the requirements of section 401(a)(11) merely because the plan provides that a qualified joint and survivor annuity (or a qualified preretirement survivor annuity) will not be provided unless the participant and spouse had been married throughout the 1-year period ending on the earlier of -

(A) the participant's annuity starting date, or
(B) the date of the participant's death.

(2) Treatment of certain marriages within 1 year of annuity starting date for purposes of qualified joint and survivor annuities
For purposes of paragraph (1), if -

(A) a participant marries within 1 year before the annuity starting date, and
(B) the participant and the participant's spouse in such marriage have been married for at least a 1-year period ending on or before the date of the participant's death, such participant and such spouse shall be treated as having been married throughout the 1-year period ending on the participant's annuity starting date.

(e) Restrictions on cash-outs

(1) Plan may require distribution if present value not in excess of dollar limit
A plan may provide that the present value of a qualified joint and survivor annuity or a qualified preretirement survivor annuity will be immediately distributed if such value does not exceed the dollar limit under section 411(a)(11)(A). No distribution may be made under the preceding sentence after the annuity starting date unless the participant and the spouse of the participant (or where the participant has died, the surviving spouse) consents in writing to such distribution.

(2) Plan may distribute benefit in excess of dollar limit only with consent If -

(A) the present value of the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds the dollar limit under section 411(a)(11)(A), and
(B) the participant and the spouse of the participant (or where the participant has died, the surviving spouse) consent in writing to the distribution, the plan may immediately distribute the present value of such annuity.

(3) Determination of present value

(A) In general

(i) Present value
Except as provided in subparagraph (B), for purposes of paragraphs (1) and (2), the present value shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate.
(ii) Definitions
For purposes of clause (i) -

(I) Applicable mortality table
The term "applicable mortality table" means the table prescribed by the Secretary. Such table shall be based on the prevailing commissioners' standard table (described in section 807(d)(5)(A)) used to determine reserves for group annuity contracts issued on the date as of which present value is being determined (without regard to any other subparagraph of section 807(d)(5)).
(II) Applicable interest rate
The term "applicable interest rate" means the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe.

(B) Exception
In the case of a distribution from a plan that was adopted and in effect before the date of the enactment of the Retirement Protection Act of 1994, the present value of any distribution made before the earlier of -

(i) the later of the date a plan amendment applying subparagraph (A) is adopted or made effective, or
(ii) the first day of the first plan year beginning after December 31, 1999, shall be calculated, for purposes of paragraphs (1) and (2), using the interest rate

determined under the regulations of the Pension Benefit Guaranty Corporation for determining the present value of a lump sum distribution on plan termination that were in effect on September 1, 1993, and using the provisions of the plan as in effect on the day before such date of enactment; but only if such provisions of the plan met the requirements of section 417(e)(3) as in effect on the day before such date of enactment.

(f) Other definitions and special rules

For purposes of this section and section 401(a)(11) -

(1) Vested participant
The term "vested participant" means any participant who has a nonforfeitable right (within the meaning of section 411(a)) to any portion of such participant's accrued benefit.
(2) Annuity starting date

(A) In general
The term "annuity starting date" means -

(i) the first day of the first period for which an amount is payable as an annuity, or
(ii) in the case of a benefit not payable in the form of an annuity, the first day on which all events have occurred which entitle the participant to such benefit.

(B) Special rule for disability benefits
For purposes of subparagraph (A), the first day of the first period for which a benefit is to be received by reason of disability shall be treated as the annuity starting date only if such benefit is not an auxiliary benefit.

(3) Earliest retirement age
The term "earliest retirement age" means the earliest date on which, under the plan, the participant could elect to receive retirement benefits.

(4) Plan may take into account increased costs
A plan may take into account in any equitable manner (as determined by the Secretary) any increased costs resulting from providing a qualified joint or survivor annuity or a qualified preretirement survivor annuity.

(5) Distributions by reason of security interests
If the use of any participant's accrued benefit (or any portion thereof) as security for a loan meets the requirements of subsection (a)(4), nothing in this section or section 411(a)(11) shall prevent any distribution required by reason of a failure to comply with the terms of such loan.

(6) Requirements for certain spousal consents
No consent of a spouse shall be effective for purposes of subsection (e)(1) or (e)(2) (as the case may be) unless requirements comparable to the requirements for spousal consent to an election under subsection (a)(1)(A) are met.

(7) Consultation with the Secretary of Labor
In prescribing regulations under this section and section 401(a)(11), the Secretary shall consult with the Secretary of Labor.

-Source- (Added Pub. L. 98-397, title II, Sec. 203(b), Aug. 23, 1984, 98 Stat. 1441; amended Pub. L. 99-514, title XI, Sec. 1139(b), title XVIII, Sec. 1898(b)(1)(A), (4)(A), (5)(A), (6)(A), (8)(A), (9)(A), (10)(A), (11)(A), (12)(A), (15)(A), (B), Oct. 22,

1986, 100 Stat. 2487, 2944, 2945, 2947-2951; Pub. L. 100-647, title I, Sec. 1018(u)(9), Nov. 10, 1988, 102 Stat. 3590; Pub. L. 101-239, title VII, Sec. 7862(d)(1)(A), Dec. 19, 1989, 103 Stat. 2433; Pub. L. 103-465, title VII, Sec. 767(a)(2), Dec. 8, 1994, 108 Stat. 5038; Pub. L. 104-188, title I, Sec. 1451(a), Aug. 20, 1996, 110 Stat. 1815; Pub. L. 105-34, title X, Sec. 1071(a)(2), Aug. 5, 1997, 111 Stat. 948.)

Internal Revenue Code

Section 4975

26 USC 4975

Tax on Prohibited Transactions

As Amended through July 22, 1998 (P.L. 105-206)

(a) Initial taxes on disqualified person

There is hereby imposed a tax on each prohibited transaction.
The rate of tax shall be equal to 15 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

(b) Additional taxes on disqualified person

In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

(c) Prohibited transaction

(1) General rule

For purposes of this section, the term "prohibited transaction" means any direct or indirect -

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(B) lending of money or other extension of credit between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interests or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

(2) Special exemption

The Secretary shall establish an exemption procedure for purposes of this subsection. Pursuant to such procedure, he may grant a conditional or unconditional exemption of any disqualified person or transaction, orders of disqualified persons or transactions, from all or part of the restrictions imposed by paragraph (1) of this subsection. Action under this subparagraph may be taken only after consultation and coordination with the Secretary of Labor. The Secretary may not grant an exemption under this paragraph unless he finds that such exemption is –

(A) administratively feasible,

(B) in the interests of the plan and of its participants and beneficiaries, and

(C) protective of the rights of participants and beneficiaries of the plan.
Before granting an exemption under this paragraph, the Secretary shall require adequate notice to be given to interested persons and shall publish notice in the Federal Register of the pendency of such exemption and shall afford interested persons an opportunity to present views. No exemption may be granted under this paragraph with respect to a transaction described in subparagraph (E) or (F) of paragraph (1) unless the Secretary affords an opportunity for a hearing and makes a determination on the record with respect to the findings required under subparagraphs (A), (B), and (C) of this paragraph, except that in lieu of such hearing the Secretary may accept any record made by the Secretary of Labor with respect to an application for exemption under section 408(a) of title I of the Employee Retirement Income Security Act of 1974.

(3) Special rule for individual retirement accounts

An individual for whose benefit an individual retirement account is established and his beneficiaries shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be an individual retirement account by reason of the application of section 408(e)(2)(A) or if section 408(e)(4) applies to such account.

(4) Special rule for medical savings accounts

An individual for whose benefit a medical savings account (within the meaning of section 220(d)) is established shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if section 220(e)(2) applies to such transaction.

(5) Special rule for education individual retirement accounts

An individual for whose benefit an education individual retirement account is established and any contributor to such account shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if section 530(d) applies with respect to such transaction.

(d) Exemptions
Except as provided in subsection (f)(6), the prohibitions provided in subsection (c) shall not apply to -

(1) any loan made by the plan to a disqualified person who is a participant or beneficiary of the plan if such loan -

(A) is available to all such participants or beneficiaries on a reasonably equivalent basis,

(B) is not made available to highly compensated employees (within the meaning of section 414(q)) in an amount greater than the amount made available to other employees,

(C) is made in accordance with specific provisions regarding such loans set forth in the plan,

(D) bears a reasonable rate of interest, and

(E) is adequately secured;

(2) any contract, or reasonable arrangement, made with a disqualified person for office space, or

legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore;

(3) any loan to an leveraged employee stock ownership plan (as defined in subsection (e)(7)), if-

(A) such loan is primarily for the benefit of participants and beneficiaries of the plan, and

(B) such loan is at a reasonable rate of interest, and any collateral which is given to a disqualified person by the plan consists only of qualifying employer securities (as defined in subsection (e)(8));

(4) the investment of all or part of a plan's assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of such plan and if -

(A) the plan covers only employees of such bank or other institution and employees of affiliates of such bank or other institution, or

(B) such investment is expressly authorized by a provision of the plan or by a fiduciary (other than such bank or institution or affiliates thereof) who is expressly empowered by the plan to so instruct the trustee with respect to such investment;

(5) any contract for life insurance, health insurance, or annuities with one or more insurers which are qualified to do business in a State if the plan pays no more than adequate consideration, and if each such insurer or insurers is -

(A) he employer maintaining the plan, or

(B) a disqualified person which is wholly owned (directly or indirectly) by the employer establishing the plan, or by any person which is a disqualified person with respect to the plan, but only if the total premiums and annuity considerations written by such insurers for life insurance, health insurance, or annuities for all plans (and their employers) with respect to which such insurers are disqualified persons (not including premiums or annuity considerations written by the employer maintaining the plan) do not exceed 5 percent of the total premiums and annuity considerations written for all lines of insurance in that year by such insurers (not including premiums or annuity considerations written by the employer maintaining the plan);

(6) the provision of any ancillary service by a bank or similar financial institution supervised by the United States or a State, if such service is provided at not more than reasonable compensation, if such bank or other institution is a fiduciary of such plan, and if -

(A) such bank or similar financial institution has adopted adequate internal safeguards which assure that the provision of such ancillary service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority, and

(B) the extent to which such ancillary service is provided is subject to specific guidelines issued by such bank or similar financial institution (as determined by the Secretary after consultation with Federal and State supervisory authority), and under such guidelines the bank or similar financial institution does not provide such ancillary service -

(i) in an excessive or unreasonable manner, and

(ii) in a manner that would be inconsistent with the best interests of participants and beneficiaries of employee benefit plans;

(7) the exercise of a privilege to convert securities, to the extent provided in regulations of the Secretary but only if the plan receives no less than adequate consideration pursuant to such conversion;

(8) any transaction between a plan and a common or collective trust fund or pooled investment fund maintained by a disqualified person which is a bank or trust company supervised by a State or Federal agency or between a plan and a pooled investment fund of an insurance company qualified to do business in a State if –

(A) the transaction is a sale or purchase of an interest in the fund,

(B) the bank, trust company, or insurance company receives not more than a reasonable compensation, and

(C) such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank, trust company, or insurance company, or an affiliate thereof) who has authority to manage and control the assets of the plan;

(9) receipt by a disqualified person of any benefit to which he may be entitled as a participant or beneficiary in the plan, so long as the benefit is computed and paid on a basis which is consistent with the terms of the plan as applied to all other participants and beneficiaries; (10) receipt by a disqualified person of any reasonable compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his duties with the plan, but no person so serving who already receives full-time pay from an employer or an association of employers, whose employees are participants in the plan or from an employee organization whose members are participants in such plan shall receive compensation from such fund, except for reimbursement of expenses properly and actually incurred;

(10) service by a disqualified person as a fiduciary in addition to being an officer, employee, agent, or other representative of a disqualified person;

(11) the making by a fiduciary of a distribution of the assets of the trust in accordance with the terms of the plan if such assets are distributed in the same manner as provided under section 4044 of title IV of the Employee Retirement Income Security Act of 1974 (relating to allocation of assets);

(12) any transaction which is exempt from section 406 of such Act by reason of section 408(e) of such Act (or which would be so exempt if such section 406 applied to such transaction) or which is exempt from section 406 of such Act by reason of section 408(b)(12) of such Act;

(13) any transaction required or permitted under part 1 of subtitle E of title IV or section 4223 of the Employee Retirement Income Security Act of 1974, but this paragraph shall not apply with respect to the application of subsection (c)(1) (E) or (F); or

(14) a merger of multiemployer plans, or the transfer of assets or liabilities between multiemployer plans, determined by the Pension Benefit Guaranty Corporation to meet the requirements of section 4231 of such Act, but this paragraph shall not apply with respect to the application of subsection (c)(1) (E) or (F).

(e) Definitions

(1) Plan

For purposes of this section, the term "plan" means -

(A) a trust described in section 401(a) which forms a part of a plan, or a plan described in section 403(a), which trust or plan is exempt from tax under section 501(a),

(B) an individual retirement account described in section 408(a),

(C) an individual retirement annuity described in section 408(b),

(D) a medical savings account described in section 220(d),

(E) an education individual retirement account described in section 530, or

(F) a trust, plan, account, or annuity which, at any time, has been determined by the Secretary to be described in any preceding subparagraph of this paragraph.

(2) Disqualified person

For purposes of this section, the term "disqualified person" means a person who is -

(A) a fiduciary;

(B) a person providing services to the plan;

(C) an employer any of whose employees are covered by the plan;

(D) an employee organization any of whose members are covered by the plan;

(E) an owner, direct or indirect, of 50 percent or more of -

(i) he combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,

(ii) the capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of -

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or

(I) a 10 percent or more (in capital or profits) partner or joint venture of a person described in subparagraph (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).

(3) Fiduciary

For purposes of this section, the term "fiduciary" means any person who -

(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

(B) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or

(C) has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B) of the Employee Retirement Income Security Act of 1974.

(4) Stockholdings
For purposes of paragraphs (2)(E)(i) and (G)(i) there shall be taken into account indirect stockholdings which would be taken into account under section 267(c), except that, for purposes of this paragraph, section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of paragraph (6).

(5) Partnerships; trusts
For purposes of paragraphs (2)(E)(ii) and (iii), (G)(ii) and (iii), and (I) the ownership of profits or beneficial interests shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) (other than paragraph (3) thereof), except that section 267(c)(4) shall be treated as providing that the members of the family of an individual are the members within the meaning of paragraph (6).

(6) Member of family
For purposes of paragraph (2)(F), the family of any individual shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant.

(7) Employee stock ownership plan
The term "employee stock ownership plan" means a defined contribution plan -

(A) which is a stock bonus plan which is qualified, or a stock bonus and a money purchase plan both of which are qualified under section 401(a), and which are designed to invest primarily in qualifying employer securities; and

(B) which is otherwise defined in regulations prescribed by the Secretary.

A plan shall not be treated as an employee stock ownership plan unless it meets the requirements of section 409(h), section 409(o), and, if applicable, section 409(n) and section 664(g) and, if the employer has a registration-type class of securities (as defined in section 409(e)(4)), it meets the requirements of section 409(e).

(8) Qualifying employer security
The term "qualifying employer security" means any employer security within the meaning of section 409(l). If any moneys or other property of a plan are invested in shares of an investment company registered under the Investment Company Act of 1940, the investment shall not cause that investment company or that investment company's investment adviser or principal underwriter to be treated as a fiduciary or a disqualified person for purposes of this section, except when an investment company or its investment adviser or principal underwriter acts in connection with a plan covering employees of the investment company, its investment adviser, or its principal underwriter.

(9) Section made applicable to withdrawal liability payment funds
For purposes of this section -

(A) In general

The term "plan" includes a trust described in section 501(c)(22).

(B) Disqualified person In the case of any trust to which this section applies by reason of subparagraph (A), the term "disqualified person" includes any person who is a disqualified person with respect to any plan to which such trust is permitted to make payments under section 4223 of the Employee Retirement Income Security Act of 1974.

(f) Other definitions and special rules
For purposes of this section -

(1) Joint and several liability

If more than one person is liable under subsection (a) or (b) with respect to any one prohibited transaction, all such persons shall be jointly and severally liable under such subsection with respect to such transaction.

(2) Taxable period

The term "taxable period" means, with respect to any prohibited transaction, the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of -

(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212,

(B) the date on which the tax imposed by subsection (a) is assessed, or

(C) the date on which correction of the prohibited transaction is completed.

(3) Sale or exchange; encumbered property

A transfer or real or personal property by a disqualified person to a plan shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the plan assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer.

(4) Amount involved

The term "amount involved" means, with respect to a prohibited transaction, the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received; except that, in the case of services described in paragraphs (2) and (10) of subsection (d) the amount involved shall be only the excess compensation. For purposes of the preceding sentence, the fair market value -

(A) in the case of the tax imposed by subsection (a), shall be determined as of the date on which the prohibited transaction occurs; and

(B) in the case of the tax imposed by subsection (b), shall be the highest fair market value during the taxable period.

(5) Correction

The terms "correction" and "correct" mean, with respect to a prohibited transaction, undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than that in which it would be if the disqualified person were acting under the highest fiduciary standards.

(6) Exemptions not to apply to certain transactions

(A) In general

In the case of a trust described in section 401(a) which is part of a plan providing contributions or benefits for employees some or all of whom are owner-employees (as defined in section 401(c)(3)), the exemptions provided by subsection (d) (other than paragraphs (9) and (12)) shall not apply to a transaction in which the plan directly or indirectly -

(i) lends any part of the corpus or income of the plan to,

(ii) pays any compensation for personal services rendered to the plan to, or

(iii) acquires for the plan any property from, or sells any property to, any such owner-employee, a member of the family (as defined in section 267(c)(4)) of any such owner-employee, or any corporation in which any such owner-employee owns, directly or indirectly, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

(B) Special rules for shareholder-employees, etc.

(i) In general

For purposes of subparagraph (A), the following shall be treated as owner-

employees:

(I) A shareholder-employee.

(II) A participant or beneficiary of an individual retirement plan (as defined in section 7701(a)(37)).

(III) An employer or association of employees which establishes such an individual retirement plan under section 408(c).

(ii) Exception for certain transactions involving shareholder-employees

Subparagraph (A)(iii) shall not apply to a transaction which consists of a sale of employer securities to an employee stock ownership plan (as defined in subsection (e)(7)) by a shareholder-employee, a member of the family (as defined in section 267(c)(4)) of such shareholder-employee, or a corporation in which such a shareholder-employee owns stock representing a 50 percent or greater interest described in subparagraph (A).

(C) Shareholder-employee

For purposes of subparagraph (B), the term "shareholder-employee" means an employee or officer of an S corporation who owns (or is considered as owning within the meaning of section 318(a)(1)) more than 5 percent of the outstanding stock of the corporation on any day during the taxable year of such corporation.

(g) Application of section
This section shall not apply -

(1) in the case of a plan to which a guaranteed benefit policy (as defined in section 401(b)(2)(B) of the Employee Retirement Income Security Act of 1974) is issued, to any assets of the insurance company, insurance service, or insurance organization merely because of its issuance of such policy;

(2) to a governmental plan (within the meaning of section 414(d)); or

(3) to a church plan (within the meaning of section 414(e)) with respect to which the election provided by section 410(d) has not been made.

In the case of a plan which invests in any security issued by an investment company registered under the Investment Company Act of 1940, the assets of such plan shall be deemed to include such security but shall not, by reason of such investment, be deemed to include any assets of such company.

(h) Notification of Secretary of Labor
Before sending a notice of deficiency with respect to the tax imposed by subsection (a) or (b), the Secretary shall notify the Secretary of Labor and provide him a reasonable opportunity to obtain a correction of the prohibited transaction or to comment on the imposition of such tax.

(i) Cross reference

For provisions concerning coordination procedures between Secretary of Labor and Secretary of the Treasury with respect to application of tax imposed by this section and for authority to waive imposition of the tax imposed by subsection (b), see section 3003 of the Employee Retirement Income Security Act of 1974.

Source- (Added Pub. L. 93-406, title II, Sec. 2003(a), Sept. 2, 1974, 88 Stat. 971; amended Pub. L. 94-455, title XIX, Sec. 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834; Pub. L. 95-600, title I, Sec. 141(f)(5), (6), Nov. 6, 1978, 92 Stat. 2795; Pub. L. 96-222, title I, Sec. 101(a)(7)(C), (K), (L)(iv)(III), (v)(XI), Apr. 1, 1980, 94 Stat. 198-201; Pub. L. 96-364, title II, Sec. 208(b), 209(b), Sept. 26, 1980, 94 Stat. 1289, 1290; Pub. L. 96-596, Sec. 2(a)(1)(K),(L), (2)(I), (3)(F), Dec. 24, 1980, 94 Stat. 3469, 3471; Pub. L. 97-448, title III, Sec. 305(d)(5), Jan. 12, 1983, 96 Stat. 2400; Pub. L. 98-369, div. A, title IV, Sec. 491(d)(45), (46), (e)(7), (8), July 18, 1984, 98 Stat. 851-853; Pub. L. 99-514, title XI, Sec. 1114(b)(15)(A), title XVIII, Sec. 1854(f)(3)(A), 1899A(51), Oct. 22, 1986, 100 Stat. 2452, 2882, 2961; Pub. L. 101-508, title XI, Sec. 11701(m), Nov. 5, 1990, 104 Stat. 1388-513; Pub. L. 104-188, title I, Sec. 1453(a), 1702(g)(3), Aug. 20, 1996, 110 Stat. 1817, 1873; Pub. L. 104-191, title III, Sec. 301(f), Aug. 21, 1996, 110 Stat. 2051; Pub. L. 105-34, title II, Sec. 213(b), title X, Sec. 1074(a), title

XV, Sec. 1506(b)(1), 1530(c)(10), title XVI, Sec. 1602(a)(5), Aug. 5, 1997, 111 Stat. 816, 949, 1065, 1079, 1094; Pub. L. 105-206, title VI, Sec. 6023(19), July 22, 1998, 112 Stat. 825.)

Internal Revenue Service

Regulation 54.4975-11

26 C.F.R. 54.4975-11

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Appendix E — Employee Benefit Law

ESOP Requirements

Originally issued September 2, 1977 (42 FR 44393)

As revised through January 9, 1979 (44 FR 1978)

a. In general -

1. Type of plan. To be an "ESOP" (employee stock ownership plan), a plan described in section 4975(e)(7)(A) must meet the requirements of this section. See section 4975(e)(7)(B).
2. Designation as ESOP. To be an ESOP, a plan must be formally designated as such in the plan document.
3. Continuing loan provisions under plan -

    i. Creation of protections and rights. The terms of an ESOP must formally provide participants with certain protections and rights with respect to plan assets acquired with the proceeds of an exempt loan. These protections and rights are those referred to in the third sentence of 54.4975-7(b)(4), relating to put, call, or other options and to buy-sell or similar arrangements, and in 54.4975-7(b)(10), (11), and (12), relating to put options.

    ii. "Nonterminable" protections and rights. The terms of an ESOP must also formally provide that these protections and rights are nonterminable. Thus, if a plan holds or has distributed securities acquired with the proceeds of an exempt loan and either the loan is repaid or the plan ceases to be an ESOP, these protections and rights must continue to exist under the terms of the plan. However, the protections and rights will not fail to be nonterminable merely because they are not exercisable under 54.4975-7(b)(11) and (12)(ii). For example, if, after a plan ceases to be an ESOP, securities acquired with the proceeds of an exempt loan cease to be publicly traded, the 15-month period prescribed by 54.4975-7(b)(11) includes the time when the securities are publicly traded.

    iii. No incorporation by reference of protections and rights. The formal requirements of paragraph (a)(3)(i) and (ii) of this section must be set forth in the plan. Mere reference to the third sentence of 54.4975-7(b)(4) and to the provisions of 54.4975-7(b)(10), (11), and (12) is not sufficient.

    iv. Certain remedial amendments. Notwithstanding the limits under paragraph (a)(4) and (10) of this section on the retroactive effect of plan amendments, a remedial plan amendment adopted before December 31, 1979, to meet the requirements of paragraph (a)(3)(i) and (ii) of this section is retroactively effective as of the later of the date on which the plan was designated as an ESOP or November 1, 1977.

4. Retroactive amendment. A plan meets the requirements of this section as of the date that it is designated as an ESOP if it is amended retroactively to meet, and in fact does meet, such requirements at any of the following times:

    i. 12 months after the date on which the plan is designated as an ESOP;

    ii. 90 days after a determination letter is issued with respect to the qualification of the plan as an ESOP under this section, but only if the determination is requested by the time in paragraph (a)(4)(i) of this section; or

    iii. A later date approved by the district director.

5. Addition to other plan. An ESOP may form a portion of a plan the balance of which includes a

qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. A reference to an ESOP includes an ESOP that forms a portion of another plan.

6. Conversion of existing plan to an ESOP. If an existing pension, profit-sharing, or stock bonus plan is converted into an ESOP, the requirements of section 404 of the Employee Retirement Income Security Act of 1974 (ERISA) (88 Stat. 877), relating to fiduciary duties, and section 401(a) of the Code, relating to requirements for plans established for the exclusive benefit of employees, apply to such conversion. A conversion may constitute a termination of an existing plan. For definition of a termination, see the regulations under section 411(d)(3) of the Code and section 4041(f) of ERISA.
7. Certain arrangements barred -
    i. Buy-sell agreements. An arrangement involving an ESOP that creates a put option must not provide for the issuance of put options other than as provided under 54.4975-7 (b)(10), (11), and (12). Also, an ESOP must not otherwise obligate itself to acquire securities from a particular security holder at an indefinite time determined upon the happening of an event such as the death of the holder.
    ii. Integrated plans. A plan designated as an ESOP after November 1, 1977, must not be integrated directly or indirectly with contributions or benefits under Title II of the Social Security Act or any other State or Federal law. ESOPs established and integrated before such date may remain integrated. However, such plans must not be amended to increase the integration level or the integration percentage. Such plans may in operation continue to increase the level of integration if under the plan such increase is limited by reference to a criterion existing apart from the plan.
8. Effect of certain ESOP Provisions on section 401(a) status -
    i. Exempt loan requirements. An ESOP will not fail to meet the requirements of section 401(a)(2) merely because it gives plan assets as collateral for an exempt loan under 54.4975-7(b)(5) or uses plan assets under 54.4975-7(b)(6) to repay an exempt loan in the event of default.
    ii. Individual annual contribution limitation. An ESOP will not fail to meet the requirements of section 401(a)(16) merely because annual additions under section 415(c) are calculated with respect to employer contributions used to repay an exempt loan rather than with respect to securities allocated to participants.
    iii. Income pass-through. An ESOP will not fail to meet the requirements of section 401(a) merely because it provides for the current payment of income under paragraph (f)(3) of this section.
9. Transitional rules for ESOPs established before November 1, 1977. A plan established before November 1, 1977, that otherwise satisfies the provisions of this section constitutes an ESOP if it is amended by December 31, 1977, to comply from November 1, 1977, with this section even though before November 1, 1977, the plan did not satisfy paragraphs (c) and (d)(2), (4), and (5) of this section.
10. Additional transitional rules. Notwithstanding paragraph (a)(9) of this section, a plan established before November 1, 1977, that otherwise satisfies the provisions of this section constitutes an ESOP if by December 31, 1977, it is amended to comply from November 1, 1977, with this section even though before such date the plan did not satisfy the following provisions of this section:
    i. Paragraph (a)(3) and (8)(iii);
    ii. The last sentence of paragraph (d)(3), and
    iii. Paragraph (f)(3). [Amended by T. D. 7571 on November 16, 1978, 43 FR 53718.]

b. Plan designed to invest primarily in qualifying employer securities. A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities. Thus, a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities. Such plan will be treated the same as other stock bonus plans or money purchase pension plans qualified under section 401(a) with respect to those investments.
c. Suspense Account. All assets acquired by an ESOP with the proceeds of an exempt loan under section 4975(d)(3) must be added to and maintained in a suspense account. They are to be withdrawn from the suspense account by applying 54.4975-7(b)(8) and (15) as if all securities in the suspense

account were encumbered. Such assets acquired before November 1, 1977, must be withdrawn by applying 54.4975-7(b)(8) or the provision of the loan that controls release from encumbrance. Assets in such suspense accounts are assets of the ESOP. Thus, for example, such assets are subject to section 401(a)(2).

d. Allocations to accounts of participants -

1. In general. Except as provided in this section, amounts contributed to an ESOP must be allocated as provided under 1.401-1(b)(ii) and (iii) of this chapter, and securities acquired by an ESOP must be accounted for as provided under 1.402(a)-1(b)(2)(ii) of this chapter.
2. Assets withdrawn from suspense account. As of the end of each plan year, the ESOP must consistently allocate to the participants' accounts non-monetary units representing participants' interests in assets withdrawn from the suspense account.
3. Income. Income with respect to securities acquired with the proceeds of an exempt loan must be allocated as income of the plan except to the extent that the ESOP provides for the use of income from such securities to repay the loan. Certain income may be distributed currently under paragraph (f)(3) of this section.
4. Forfeitures. If a portion of a participant's account is forfeited, qualifying employer securities allocated under paragraph (d)(2) of this section must be forfeited only after other assets. If interests in more than one class of qualifying employer securities have been allocated to the participant's account, the participant must be treated as forfeiting the same proportion of each such class.
5. Valuation. For purposes of 54.4975-7(b)(9) and (12) and this section, valuations must be made in good faith and based on all relevant factors for determining the fair market value of securities. In the case of a transaction between a plan and a disqualified person, value must be determined as of the date of the transaction. For all other purposes under this subparagraph (5), value must be determined as of the most recent valuation date under the plan. An independent appraisal will not in itself be a good faith determination of value in the case of a transaction between a plan and a disqualified person. However, in other cases, a determination of fair market value based on at least an annual appraisal independently arrived at by a person who customarily makes such appraisals and who is independent of any party to a transaction under 54.4975-7(b)(9) and (12) will be deemed to be a good faith determination of value. [Amended by T.D. 7571 on November 16, 1978, 43 FR 53718.]

e. Multiple plans -

1. General rule. An ESOP may not be considered together with another plan for purposes of applying section 401(a)(4) and (5) or section 410(b) unless-

    i. The ESOP and such other plan exist on November 1, 1977; or
    ii. Paragraph (e)(2) of this section is satisfied.

2. Special rule for combined ESOPs. Two or more ESOPs, one or more of which does not exist on November 1, 1977, may be considered together for purposes of applying section 401(a)(4) and (5) or section 410(b) only if the proportion of qualifying employer securities to total plan assets is substantially the same for each ESOP and-

    i. The qualifying employer securities held by all ESOPs are all of the same class; or
    ii. The ratios of each class held to all such securities held is substantially the same for each plan.

3. Amended coverage, contribution, or benefit structure. For purposes of paragraph (e)(1)(i) of this section, if the coverage, contribution, or benefit structure of a plan that exists on November 1, 1977, is amended after that date, as of the effective date of the amendment, the plan is no longer considered to be a plan that exists on November 1, 1977. [Amended by T.D. 7571 on November 16, 1978, 43 FR 53718.]

f. Distribution -

1. In general. Except as provided in paragraph (f)(2) and (3) of this section, with respect to distributions, a portion of an ESOP consisting of a stock bonus plan or a money purchase pension plan is not to be distinguished from other such plans under section 401(a). Thus, for example, benefits distributable from the portion of an ESOP consisting of a stock bonus plan are distributable only in stock of the employer. Also, benefits distributable from the money-purchase portion of the ESOP may be, but are not required to be, distributable in qualifying employer

securities.

2. Exempt loan proceeds. If securities acquired with the proceeds of an exempt loan available for distribution consist of more than one class, a distributee must receive substantially the same proportion of each such class. However, as indicated in paragraph (f)(1) of this section, benefits distributable from the portion of an ESOP consisting of a stock bonus plan are distributable only in stock of the employer.
3. Income. Income paid with respect to qualifying employer securities acquired by an ESOP in taxable years beginning after December 31, 1974, may be distributed at any time after receipt by the plan to participants on whose behalf such securities have been allocated. However, under an ESOP that is a stock bonus plan, income held by the plan for a 2-year period or longer must be distributed under the general rules described in paragraph (f)(1) of this section. (See the last sentence of section 803(h), Tax Reform Act of 1976.) [Reg 54.4975-11 added by T. D. 7506 on August 30, 1977; amended by T. D. 7571 on November 16, 1978, 43 FR 53718.]

Internal Revenue Service

Regulation 54.4975-12

26 C.F.R. 54.4975-12

Qualifying Employer Security Defined

Originally Issued September 2, 1977 (42 FR 44394)

a. In general. For purposes of section 4975(e)(8) and this section, the term "qualifying employer security" means an employer security which is -

    1. Stock or otherwise an equity security, or
    2. A bond, debenture, note, or certificate or other evidence of indebtedness which is described in paragraphs (1), (2), and (3) of section 503(e).

b. Special rule. In determining whether a bond, debenture, note, or certificate or other evidence of indebtedness is described in paragraphs (1), (2), and (3) of section 503(e), any organization described in section 401(a) shall be treated as an organization subject to the provisions of section 503. [Reg. 54.4975-12 added August 30, 1977, by T. D. 7506.]

Department of Labor

Pension and Welfare Benefits Administration Regulation

Regulation 2510.3-101

29 C.F.R. 2510.3-101.

"Plan Assets" Defined

Originally issued November 13, 1986 (51 FR 41280)

Subsection (e) amended for a technical correction December 31, 1986 (51 FR 47226)

a. In General.

    1. This section describes what constitute assets of a plan with respect to a plan's investment in another entity for purposes of Subtitle A, and Parts 1 and 4 of Subtitle 3, of Title I of the Act and section 4975 of the Internal Revenue Code. Paragraph (a)(2) contains a general rule relating to plan investments. Paragraphs (b) through (f) define certain terms that are used in the application of the general rule. Paragraph (g) describes how the rules in this section are to be applied when a plan owns property jointly with others or where it acquires an equity interest whose value relates solely to identified assets of an issuer. Paragraph (h) contains special rules relating to particular kinds of plan investments. Paragraph (i) describes the assets that a plan acquires when it purchases certain guaranteed mortgage certificates. Paragraph (j) contains examples illustrating the operation of this section. The effective date of this section is set forth in paragraph (k).
    2. Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity.

However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity, unless it is established that -

i. the entity is an operating company, or
ii. equity participation in the entity by benefit plan investors is not significant.

Therefore, any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan.

b. "Equity Interests" and "Publicly-Offered Securities".

1. The term "equity interest" means any interest in an entity other than an instrument that is treated as indebtedness under applicable local law and which has no substantial equity features. A profits interest in a partnership, an undivided ownership interest in property and a beneficial interest in a trust are equity interests.
2. A "publicly-offered security" is a security that is freely transferable, part of a class of securities that is widely held and either

   i. Part of a class of securities registered under section 12(b) or 12(g) of the Securities Exchange Act of 1934, or
   ii. Sold to the plan as part of an offering of securities to the public pursuant to an effective registration statement under the Securities Act of 1933 and the class of securities of which such security is a part is registered under the Securities Exchange Act of 1934 within 120 days (or such later time as may be allowed by the Securities and Exchange Commission) after the end of the fiscal year of the issuer during which the offering of such securities to the public occurred.

3. For purposes of paragraph (b)(2), a class of securities is "widely-held" only if it is a class of securities that is owned by 100 or more investors independent of the issuer and of one another. A class of securities will not fail to be widely-held solely because subsequent to the initial offering the number of independent investors falls below 100 as a result of events beyond the control of the issuer.
4. For purposes of paragraph (b)(2), whether a security is "freely transferable" is a factual question to be determined on the basis of all relevant facts and circumstances. If a security is part of an offering in which the minimum investment is $10,000 or less, however, the following factors ordinarily will not, alone or in combination, affect a finding that such securities are freely transferable -

   i. Any requirement that not less than a minimum number of shares or units of such security be transferred or assigned by any investor, provided that such requirement does not prevent transfer of all of the then remaining shares or units held by an investor;
   ii. Any prohibition against transfer or assignment of such security or rights in respect thereof to an ineligible or unsuitable investor;
   iii. Any restriction on, or prohibition against, any transfer or assignment which would either result in a termination or reclassification of the entity for federal or state tax purposes or which would violate any state or federal statute, regulation, court order, judicial degree, or rule of law;
   iv. Any requirement that reasonable transfer or administrative fees be paid in connection with a transfer or assignment;
   v. Any requirement that advance notice of a transfer or assignment be given to the entity and any requirement regarding execution of documentation evidencing such transfer or assignment (including documentation setting forth representations from either or both of the transferor or transferee as to compliance with any restriction or requirement described in this paragraph (b)(4) or requiring compliance with the entity's governing instruments);
   vi. Any restriction on substitution of an assignee as a limited partner of a partnership, including a general partner consent requirement, provided that the economic benefits of ownership of the assignor may be transferred or assigned without regard to such restriction or consent (other than compliance with any other

restriction described in this paragraph (b)(4));

vii. Any administrative procedure which establishes an effective date, or an event, such as the completion of the offering, prior to which a transfer or assignment will not be effective; and

viii. Any limitation or restriction on transfer or assignment which is not created or imposed by the issuer or any person acting for or on behalf of such issuer.

c. "Operating Company".

1. An "operating company" is not an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. The term "operating company" includes an entity which is not described in the preceding sentence, but which is a "venture capital operating company" described in paragraph (d) or a "real estate operating company" described in paragraph (e).

[Editorial Note: There is no subsection (c)(2).]

d. "Venture Capital Operating Company".

1. An entity is a "venture capital operating company" for the period beginning on an initial valuation date described in paragraph (d)(5)(i) and ending on the last day of the first "annual valuation period" described in paragraph (d)(5)(ii) (in the case of an entity that is not a venture capital operating company immediately before the determination) or for the 12-month period following the expiration of an "annual valuation period" described in paragraph (d)(5)(ii) (in the case of an entity that is a venture capital operating company immediately before the determination) if -

    i. On such initial valuation date, or at any time within such annual valuation period, at least 50 percent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are invested in venture capital investments described in paragraph (d)(3)(i) or derivative investments described in paragraph (d)(4); and

    ii. During such 12-month period (or during the period beginning on the initial valuation date and ending on the last day of the first annual valuation period), the entity, in the ordinary course of its business, actually exercises management rights of the kind described in paragraph (d)(3)(ii) with respect to one or more of the operating companies in which it invests.

2. (i)A venture capital operating company described in paragraph (d)(1) shall continue to be treated as a venture capital operating company during the "distribution period" described in paragraph (d)(2)(ii). An entity shall not be treated as a venture capital operating company at any time after the end of the distribution period.

    ii. The "distribution period" referred to in paragraph (d)(2)(i) begins on a date established by a venture capital operating company that occurs after the first date on which the venture capital operating company has distributed to investors the proceeds of at least 50 percent of the highest amount of its investments (other than short-term investments made pending long-term commitment or distribution to investors) outstanding at any time from the date it commenced business (determined on the basis of the cost of such investments) and ends on the earlier of -

        A. The date on which the company makes a "new portfolio investment", or

        B. The expiration of 10 years from the beginning of the distribution period.

    iii. For purposes of paragraph (d)(2)(ii)(A), a "new portfolio investment" is an investment other than -

        A. An investment in an entity in which the venture capital operating company had an outstanding venture capital investment at the beginning of the distribution period which has continued to be outstanding at all times during the distribution period, or

        B. A short-term investment pending long-term commitment or

distribution to investors.

3. (i) For purposes of this paragraph (d) a "venture capital investment" is an investment in a operating company (other than a venture capital operating company) as to which the investor has or obtains management rights.

    ii. The term "management rights" means contractual rights directly between the investor and an operating company to substantially participate in, or substantially influence the conduct of, the management of the operating company.

4. (I) An investment is a "derivative investment" for purposes of this paragraph (d) if it is -

        A. A venture capital investment as to which the investor's management rights have ceased in connection with a public offering of securities of the operating company to which the investment relates, or
        B. An investment that is acquired by a venture capital operating company in the ordinary course of its business in exchange for an existing venture capital investment in connection with:

            1. A public offering of securities of the operating company to which the existing venture capital investment relates, or
            2. A merger or reorganization of the operating company to which the existing venture capital investment relates, provided that such merger or reorganization is made for independent business reasons unrelated to extinguishing management rights.

    ii. An investment ceases to be a derivative investment on the later of:

        A. 10 years from the date of the acquisition of the original venture capital investment to which the derivative investment relates, or
        B. 30 months from the date on which the investment becomes a derivative investment.

5. For purposes of this paragraph (d) and paragraph (e) -

    i. An "initial valuation date" is the later of -

        A. Any date designated by the company within the 12-month period ending with the effective date of this section, or
        B. The first date on which an entity makes an investment that is not a short-term investment of funds pending long-term commitment.

    ii. An "annual valuation period" is a pre-established annual period, not exceeding 90 days in duration, which begins no later than the anniversary of an entity's initial valuation date. An annual valuation period, once established may not be changed except for good cause unrelated to a determination under this paragraph (d) or paragraph (e).

e. "Real Estate Operating Company". An entity is a "real estate operating company" for the period beginning on an initial valuation date described in paragraph (d)(5)(i) and ending on the last day of the first "annual valuation period" described in paragraph (d)(5)(ii) (in the case of an entity that is not a real estate operating company immediately before the determination) or for the 12-month period following the expiration of an annual valuation period described in paragraph (d)(5)(ii) (in the case of an entity that is a real estate operating company immediately before the determination) if:

    1. On such initial valuation date, or on any date within such annual valuation period, at least 50 percent of its assets, valued at cost (other than short-term investments pending long-term commitment or distribution to investors), are invested in real estate which is managed or developed and with respect to which such entity has the right to substantially participate directly in the management or development activities; and
    2. During such 12-month period (or during the period beginning on the initial valuation date and ending on the last day of the first annual valuation period) such entity in the ordinary course of its

business is engaged directly in real estate management or development activities.

f. Participation by Benefit Plan Investors.

1. Equity participation in an entity by benefit plan investors is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value of any class of equity interests in the entity is held by benefit plan investors (as defined in paragraph (f)(2)). For purposes of determinations pursuant to this paragraph (f), the value of any equity interests held by a person (other than a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person, shall be disregarded.
2. A "benefit plan investor" is any of the following -

   i. Any employee benefit plan (as defined in section 3(3) of the Act), whether or not it is subject to the provisions of Title I of the Act,
   ii. Any plan described in section 4975(e)(1) of the Internal Rev. Code,
   iii. Any entity whose underlying assets include plan assets by reason of a plan's investment in the entity.

3. An "affiliate" of a person includes any person, directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the person. For purposes of this paragraph (f)(3), "control", with respect to a person other than an individual, means the power to exercise a controlling influence over the management or policies of such person.

g. Joint Ownership. For purposes of this section, where a plan jointly owns property with others, or where the value of a plan's equity interest in an entity relates solely to identified property of the entity, such property shall be treated as the sole property of a separate entity.
h. Specific Rules Relating to Plan Investment. Notwithstanding any other provision of this section-

1. Except where the entity is an investment company registered under the Investment Company Act of 1940, when a plan acquires or holds an interest in any of the following entities its assets include its investment and an undivided interest in each of the underlying assets of the entity:

   i. A group trust which is exempt from taxation under section 501(a) of the Internal Revenue Code pursuant to the principles of Rev. Rul. 81-100, 1981-1 C.B. 326,
   ii. A common or collective trust fund of a bank,
   iii. A separate account of an insurance company, other than a separate account that is maintained solely in connection with fixed contractual obligations of the insurance company under which the amounts payable, or credited, to the plan and to any participant or beneficiary of the plan (including an annuitant) are not affected in any manner by the investment performance of the separate account.

2. When a plan acquires or holds an interest in any entity (other than an insurance company licensed to do business in a State) which is established or maintained for the purpose of offering or providing any benefit described in section 3(1) or section 3(2) of the Act to participants or beneficiaries of the investing plan, its assets will include its investment and an undivided interest in the underlying assets of that entity.
3. When a plan or a related group of plans owns all of the outstanding equity interests (other than director's qualifying shares) in an entity, its assets include those equity interests and all of the underlying assets of the entity. This paragraph (h)(3) does not apply, however, where all of the outstanding equity interests in an entity are qualifying employer securities described in section 407(d)(5) of the Act, owned by one or more eligible individual account plan(s) (as defined in section 407(d)(3) of the Act) maintained by the same employer, provided that substantially all of the participants in the plan(s) are, or have been, employed by the issuer of such securities or by members of a group of affiliated corporations (as determined under section 407(d)(7) of the Act) of which the issuer is a member.
4. For purposes of paragraph (h)(3), a "related group" of employee benefit plans consists of every group of two or more employee benefit plans

   i. Each of which receives 10 percent or more of its aggregate contributions from the same employer or from members of the same controlled group of corporations (as determined under section 1563(a) of the Internal Revenue Code, without regard to section 1563(a)(4) thereof); or

ii. Each of which is either maintained by, or maintained pursuant to a collective bargaining agreement negotiated by, the same employee organization or affiliated employee organizations. For purposes of this paragraph, an "affiliate" of an employee organization means any person controlling, controlled by, or under common control with such organization, and includes any organization chartered by the same parent body, or governed by the same constitution and bylaws, or having the relation of parent and subordinate.

i. Governmental Mortgage Pools.

1. Where a plan acquires a guaranteed governmental mortgage pool certificate, as defined in paragraph (i)(2), the plan's assets include the certificate and all of its rights with respect to such certificate under applicable law, but do not, solely by reason of the plan's holding of such certificate, include any of the mortgages underlying such certificate.
2. A "guaranteed governmental mortgage pool certificate" is a certificate backed by, or evidencing an interest in, specified mortgages or participation interests therein and with respect to which interest and principal payable pursuant to the certificate is guaranteed by the United States or an agency or instrumentality thereof. The term "guaranteed governmental mortgage pool certificate" includes a mortgage pool certificate with respect to which interest and principal payable pursuant to the certificate is guaranteed by:

i. The Government National Mortgage Association;
ii. The Federal Home Loan Mortgage Corporation; or
iii. The Federal National Mortgage Association.

j. Examples. [NOTE: Subsection (j) of the regulation is omitted.]
k. Effective Date and Transitional Rules.

1. In general, this section is effective for purposes of identifying the assets of a plan or after March 13, 1987. Except as a defense, this section shall not apply to investments in an entity in existence on March 13, 1987, if no plan subject to Title I of the Act or plan described in section 4975(e)(1) of the Code (other than a plan described in section 4975(g)(2) or 4975(g)(3)) acquires an interest in the entity from an issuer or underwriter at any time on or after March 13, 1987 except pursuant to a contract binding on the plan in effect on March 13, 1987 with an issuer or underwriter to acquire an interest in the entity.
2. Notwithstanding paragraph (k)(1), this section shall not, except as a defense, apply to a real estate entity described in section 11018(a) of Pub. L. 99-272.

Department of Labor

Regulation 2520.103-5

29 C.F.R. 2520.103-5

Transmittal and certification of information to plan administrator

for annual reporting purposes

(Collective Investment Fund Reporting to Plan Administrators)

Originally issued September 10, 1978 (43 FR 10140)

a. General. In accordance with section 103(a)(2) of the Act, an insurance carrier or other organization which provides benefits under the plan or holds plan assets, a bank or similar institution which holds plan assets, or a plan sponsor, shall transmit and certify such information as needed by the administrator to file the annual report under section 104(a)(1)(A) of the Act and 2520.104a-5 or 2520.104a-6:

1. Within 9 months after the close of the plan year which begins in 1975 or September 30, 1976, whichever is later, and
2. Within 120 days after the close of any plan year which begins after December 31, 1975.

b. Application. This requirement applies with respect to -

1. An insurance carrier or other organization which:

i. Provides from its general asset accounting funds for the payment of benefits under a plan, or
ii. Holds assets of a plan in a separate account;

2. A bank, trust company, or similar institution which holds assets of a plan in a common or collective trust, separate trust, or custodial account; and
3. A plan sponsor as defined in section 3(16)(B) of the Act.

c. Contents. The information required to be provided to the administrator shall include -

1. In the case of an insurance carrier or other organization which -

i. Provides funds from its general asset account for the payment of benefits under a plan, upon request of the plan administrator, such information as is contained within the ordinary business records of the insurance carrier or other organization and is needed by the plan administrator to comply with the requirements of section 104(a)(1)(A) of the Act and 2520.104a-5 or 2520.104a-6;
ii. Holds assets of a plan in a pooled separate account which is exempted from certain reporting requirements under 2520.103-4, a copy of the annual statement of assets and liabilities of the separate account for the fiscal year of such account that ends with or within the plan year for which the annual report is made, and a statement of the value of the plan's units of participation in the separate account;
iii. Holds assets of a plan in a separate account which is not exempted from certain reporting requirements under 2520.103-4, a listing of all transactions of the separate account and, upon request of the plan administrator, such information as is contained within the ordinary business records of the insurance carrier and is needed by the plan administrator to comply with the requirements of section 104(a)(1)(A) of the Act and 2520.104a-5 or 2520.104a-6.

2. In the case of a bank, trust company, or similar institution holding assets of a plan -

i. In a common or collective trust which is exempted from certain reporting requirements under 2520.103-3, a copy of the annual statement of assets and liabilities of the common or collective trust for the fiscal year of such trust that ends with or within the plan year for which the annual report is made, and a statement of the value of the plan's units of participation in the common or collective trust.
ii. In a trust which is not exempted from certain reporting requirements under 2520.103-3, a listing of all transactions of the separate trust and, upon request of the plan administrator, such information as is contained within the ordinary business records of the bank, trust company, or similar institution and is needed by the plan administrator to comply with the requirements of section 104(a)(1)(A) of the Act and 2520.104a-5.
iii. In a custodial account, upon request of the plan administrator, such information as is contained within the ordinary business records of the bank, trust company, or similar institution and is needed by the plan administrator to comply with the requirements of section 104(a)(1)(A) of the Act and 2520.104a-5 or 2520.104a-6.

3. In the case of a plan sponsor, a listing of all transactions directly or indirectly involving plan assets engaged in by the plan sponsor and such information as is needed by the plan administrator to comply with the requirements of section 104(a)(1)(A) of the Act and 2520.104a-5 or 2520.104a-6.

d. Certification.

1. An insurance carrier or other organization a bank, trust company, or similar institution, or plan sponsor, as described in paragraph (b) of this section, shall certify to the accuracy and completeness of the information described in paragraph (c) of this section by a written declaration which is signed by a person authorized to represent the insurance carrier, bank, or plan sponsor. Such certification will serve as a written assurance of the truth of the facts stated therein.
2. Example of Certification. The XYZ Bank (Insurance Carrier) hereby certifies that the foregoing statement furnished pursuant to 20 C.F.R. 2520.103-5(c) is complete and accurate.

Department of Labor

Regulation 2550.404a-1

C.F.R. 2550.404a-1

Investment Duties (Prudence Regulation)

Originally issued June 26, 1979 (44 FR 37225)

The technical corrections of 4-4-78 and the amendment of 3-1-89

contained no changes to this regulation.

Recap
Defines and explains the application of the Prudent Man Rule in ERISA Section 404(a)(1)(B).
The Preamble to the Final Regulation is included to assist examiners in interpreting and applying this Rule.

Editor's Note: Also refer to Interpretive Bulletin 94-1, dealing with the prudence of social ("economically targeted" or ETI) investments. Also see DOL ERISA Regulation 404c-1, which exempts fiduciaries from certain ERISA liability if plans meet certain conditions and participants direct their own investments.

Agency: Department of Labor.

Action: Final regulation.

Summary: This document contains a final regulation relating to the investment duties of a fiduciary of an employee benefit plan under the Employee Retirement Income Security Act of 1974 (the Act). The regulation is relevant to the investment of assets of employee benefit plans for which fiduciaries have investment duties, and, therefore, it affects participants, beneficiaries and fiduciaries of all such plans.

Effective Date: July 23, 1979.

Final Regulation

a. In General. Section 404(a)(1)(B) of the Employee Retirement Income Security Act of 1974 (the Act) provides, in part, that a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
b. Investment Duties.

    1. With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirements of Section 404(a)(1)(B) of the Act set forth in subsection (a) of this section are satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (B) has acted accordingly.
    2. For purpose of paragraph (1) of this subsection, "appropriate consideration" shall include, but is not necessarily limited to:

        A. A determination by the fiduciary that the particular investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties), to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment

course of action, and
B. Consideration of the following factors as they relate to such portion of the portfolio:

i. The composition of the portfolio with regard to diversification;
ii. The liquidity and current rates of return of the portfolio relative to the anticipated cash flow requirements of the plan, and
iii. The projected return of the portfolio relative to the funding objectives of the plan.

3. An investment manager appointed, pursuant to the provisions of Section 402(c)(3) of the Act, to manage all or part of the assets of a plan, may, for purposes of compliance with the provisions of paragraphs (1) and (2) of this subsection, rely on, and act upon the basis of, information pertaining to the plan provided by or at the direction of the appointing fiduciary, if -

A. Such information is provided for the stated purpose of assisting the manager in the performance of his investment duties, and
B. The manager does not know and has no reason to know that the information is incorrect.

c. Definitions.

For purposes of this section:

1. The term "*investment duties*" means any duties imposed upon, or assumed or undertaken by, a person in connection with the investment of plan assets which make or will make such person a fiduciary of an employee benefit plan or which are performed by such person as a fiduciary of an employee benefit plan as defined in Section 3(21)(A)(i) or (ii) of the Act.
2. The term "*investment course of action*" means any series or program of investments or actions related to a fiduciary's performance of his investment duties.
3. The term "*plan*" means an employee benefit plan to which Title I of the Act applies.

Explanatory Preamble

For further information contact: Paul R. Antsen, Office of Fiduciary Standards, Pension and Welfare Benefit Programs, U.S. Department of Labor, Washington, D.C. 20216, (202) 522-8971, or Gregor B. McCurdy, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Washington, D.C. 20216. (202) 523-9141.

Supplemantary information: On April 25, 1978, notice was published in the Federal Register (43 FR 17480)[1] that the Department had under consideration a proposal to adopt a regulation, 29 C.F.R. 2550.404a-1, under section 404(a)(1)(B) of the Act, relating to the investment duties of a fiduciary of an employee benefit plan. Section 404(a)(1)(B) of the Act provides, in part, that a fiduciary shall discharge his duties with respect to an employee benefit plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (the "Prudence" rule).[2]

Public comments were received, in response to the proposal, that generally supported the tentative views of the Department reflected therein, although many suggestions for specific revisions were offered. A few comments opposed the adoption of the proposed or of any, regulation concerning these matters. Among the reasons given in opposition to the adoption of the proposed regulation were: (1) that the courts, rather than the Department, should determine how the "prudence" rule is to be interpreted, (2) that the Department's views regarding the requirements of the "Prudence" rule, as reflected in the proposed regulation, are incorrect, (3) that it is impractical to attempt to define "prudence" by regulation; and (4) that the proposal did not accomplish its stated objectives. The Department has considered the comments opposing adoption of the regulation, but has not been persuaded that the interpretation of the requirements of the "prudence" rule set forth below is incorrect. It believes, moreover, that adoption of a regulation concerning the investment duties of fiduciaries under the "prudence" rule is appropriate because such a regulation would provide guidance for many plan fiduciaries in an important area of their responsibilities under the Act.

Counsel for one group of interested persons, while supporting the proposed regulation in principle, asked that they be given an opportunity to express their views at a public hearing on the proposed regulation. They also

suggested that the regulation should, in any event, be republished to give interested persons additional opportunity for comment. The Department has considered these requests, but has determined that neither a public hearing nor republication of a proposed regulation is necessary or appropriate.

Accordingly, after consideration of all the written comments received, the Department has determined to adopt the proposed regulation as modified and set forth below.

Discussion of the regulation

The legislative history of the Act indicates that the common law of trusts, which forms the basis for and is federalized and codified in part 4 of Title I of the Act, should, nevertheless, not be mechanically applied to employee benefit plans.[3] The "prudence" rule in the Act sets forth a standard built upon, but that should and does depart from, traditional trust law in certain respects.

The Department is of the opinion that (1) generally, the relative riskiness of a specific investment or investment course of action does not render such investment or investment course of action either *per se* prudent or *per se* imprudent, and (2) the prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays with the overall plan portfolio. Thus, although securities Issued by a small or new company may be a riskier investment than securities issued by a "blue chip" company, the investment in the former company may be entirely proper under the Act's prudence" rule.

Accordingly, paragraph (b)(1) of the regulation, as adopted, provides generally that, with respect to an investment or investment course of action taken pursuant to a fiduciary's investment duties, the requirements of the "prudence" rule have been satisfied if the fiduciary has acted in a manner consistent with appropriate consideration of the facts and circumstances that the fiduciary knows or should know are relevant, including the role that the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties. Paragraph (b), as adopted, has been modified in response to certain comments received on the regulation as originally proposed.

As a general observation, the comments received by the Department indicated that many commentators were uncertain of the scope of the proposed regulation. In particular, some commentators appear to have viewed the various factors and conditions set forth in the proposal as a statement of requirements that must necessarily be met in order to satisfy the requirements of the "Prudence" rule. In this regard, it should be noted that the regulation reflects the views of the Department as to a manner of satisfying the requirements of the "prudence" rule, and does not purport to impose any additional requirements or constraints upon plan fiduciaries. It should also be noted that the Department does not view compliance with the provisions of the regulation as necessarily constituting the exclusive method for satisfying the requirements of the "prudence" rule. Rather, the regulation is in the nature of a "safe harbor" provision; it is the opinion of the Department that fiduciaries who comply with the provisions of the regulation will have satisfied the requirements of the "prudence" rule, but no opinion is expressed in the regulation as to the status of activities undertaken or performed that do not so comply.

With regard to more particular matters, a number of comments suggested that one condition of the proposal - that a fiduciary give appropriate consideration to "all" relevant facts and circumstance - could be read as establishing an impossible standard, especially for fiduciaries of small plans, because (1) no fiduciary has unlimited resources to develop all the information that one might deem to be relevant to a particular investment decision, and (2) no fiduciary can be expected to consider all the relevant facts and circumstances, whether or not of material significance.

Because section 404(a)(1)(B) of the Act provides that it is the fiduciary's duties with respect to the plan which must be discharged in accordance with the "prudence" rule, it appears to the Department that the scope of those duties will determine, in part, the factors which should be considered by a plan fiduciary in a given case. The nature of those duties will, of course, depend on the facts and circumstances of the case, including the nature of the arrangement between the fiduciary and the plan. For that reason, the regulation, as adopted, does not distinguish among classes of fiduciaries with respect to what particular duties may be involved. The Department recognizes, however, that a fiduciary should be required neither to expend unreasonable effort in discharging his duties. nor to consider matters outside the scope of those duties. Accordingly, the regulation has been modified to provide that consideration be given to those facts and circumstances which take into account the scope of his investment duties, the fiduciary knows or should know are relevant to the particular investment decision involved. The scope of the fiduciary's inquiry in this respect, therefore, is limited to those facts and circumstances that a prudent person having similar duties and familiar with such matters would consider relevant.

Several commentators asserted that the regulation, in recognition of the Act's provisions permitting delegation of investment duties to, and allocation among, several fiduciaries, should permit a fiduciary who is responsible for the management of plan assets to rely on information supplied by appropriate other plan fiduciaries, and to act in accordance with policies and instructions supplied by those persons in making decisions on the investment of plan assets. Those comments, generally, addressed the situation where several investment managers are involved in managing the assets of a plan, each being responsible for a portion of the plan's investment portfolio.[4] Under those circumstances, it would not, in the view of the commentators, be appropriate to require a fiduciary who is responsible for only a portion of the plan's portfolio to take into consideration facts and circumstances relating to the balance of the portfolio in making an investment decision. The Department agrees, in part, with those comments. Accordingly, paragraph (b)(1) of the regulation as adopted also provides that such a fiduciary need give appropriate consideration to the role the proposed investment or investment course of action plays in that portion only, of the plan's investment portfolio, with respect to which the fiduciary has investment duties.

However, the Department cannot state that, under the foregoing circumstances, a fiduciary is entitled blindly to rely upon instructions or policies established by other plan fiduciaries. Similarly, the regulation does not provide, as requested by one commentator, that the assets of a pooled investment fund may be invested in accordance with its published investment objectives and policies without requiring that consideration be given to the particular needs of any individual plan that has an interest in the fund. It would appear that where authority to manage part (or all) of the assets of a plan has been delegated to one or more investment managers pursuant to section 402(c)(3) of the Act, the primary responsibility for determining that the delegation is appropriate rests with the named fiduciary or fiduciaries effecting the delegation. Nevertheless, the Department considers that each such manager's investment duties, under section 404(a)(1)(B) of the Act, includes (among other things) a duty not to act in accordance with a delegation of plan investment duties to the extent that the manager either knows or should know that the delegation involves a breach of fiduciary responsibility.[5] Once the manager has considered factors otherwise necessary to assure himself that the delegation of investment authority and related specific instructions are appropriate, he may, in exercising such authority and carrying out such instructions, rely upon information provided to him in accordance with the provisions of new paragraph (b)(3) of the regulation. That paragraph provides that an investment manager responsible for the management of all or part of a plan's assets pursuant to an appointment described in section 402(c)(3) of the Act may, for purposes o f complying with the provisions of the regulation, rely upon certain information supplied to him by or at the direction of the appointing fiduciary, provided that the manager neither knows or should know that the information is incorrect.

Paragraph (b)(1) of the proposed regulation also been revised in order to make clear that the fiduciary's acts do not satisfy the "prudence" rule solely because the fiduciary had previously given consideration to relevant facts and circumstances. Some comments questioned whether, under the regulation as originally proposed, a fiduciary might be deemed to be "immunized" once he had given such consideration, not withstanding the nature of his subsequent acts. The regulation, as adopted, provides that it is the "investment" or "investment course of action" in question that will satisfy the requirements of the prudence rule if the criteria set forth in the regulation are met.

Paragraph (b)(2) of the regulation sets forth factors that are to be included, to the extent applicable, in an evaluation of an investment or investment course of action if a fiduciary wishes to rely on the provisions of the regulation. They are: (1) the composition of the portfolio with regard to diversification; (2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (3) the projected return of the portfolio relative to the objectives of the plan. These factors are adopted substantially as proposed, except that the first factor has been revised, in response to questions raised by some of the comments, to make clear that the word "diversification" is to be given its customary meaning as a mechanism for reducing the risk of large losses; that factor, as originally proposed, referred to "diversification of risk." The second factor has also been modified in order to make clear that its principal subject matter is all anticipated cash requirements of the plan, and not solely those arising by reason of payment of benefits. A fourth factor set forth in the proposal which related to the "volatility" of the portfolio, has been eliminated as a factor specifically to be considered because, although paragraph (b)(2) as adopted sets forth factors which must be considered in all cases in order to comply with the provisions of the regulation[6], the reference to volatility may be read, according to some comments, as suggesting that only certain portfolio management techniques are appropriate. Moreover, as discussed more fully below, the subject of risk and opportunity for gain - which subsumes consideration of "volatility" in some respects - is now addressed in subparagraph (A) of paragraph (b)(2). A former fifth factor, which read "the prevailing and projected economic conditions of the entities in which the plan has invested and proposes to invest," is also deal t with in that subparagraph.

Several commentators suggested that inclusion of that fifth factor in the regulation would be contrary to the

intent of the proposal because it focuses attention on the individual investment, rather than on the aggregate plan portfolio. Others objected to its inclusion on the ground that it is antithetical to the theory of operation of certain "passive" investment media (such as "index" funds) that acquire portfolios designed to match the performance of various investment indices and that, accordingly, have little or no discretion in altering the composition of their portfolios.[7]

The regulation, however, is not intended to suggest either that any relevant or material attributes of a contemplated investment may properly be ignored or disregarded, or that a particular plan investment should be deemed to be prudent solely by reason of the propriety of the aggregate risk/return characteristics of the plan's portfolio. Rather, it is the Department's view that an investment reasonably designed - as a part of the portfolio - to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone, would have, for example, a relatively high degree of risk. The Department also believes that appropriate consideration of an investment to further the purposes of the plan must include consideration of the characteristics of the investment itself. Accordingly, paragraph (b)(2) of the regulation provides that, for purposes of paragraph (b)(1), "appropriate consideration" shall include a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio for which the fiduciary is responsible, to further the purposes of the plan, taking into account the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action.[8]

In the case of "passive" investment funds, referred to above, it would seem that, to the extent the fund manager is managing plan assets,[9] the investments made by the fund, as well as the plan's investment in the fund, must meet the requirements of the "prudence" rule. However, to the extent that an index fund, including the screen or filter process described above at note 7, is reasonably designed to fulfill the fund manager's fiduciary obligations with respect to a plan whose assets are managed therein, such manager, acting in accordance with the fund's objective and its filter or screen process, generally would be in compliance with the provisions of the "prudence" rule, as described in the regulation, with respect to that plan.

The terms "investment duties" and "investment course of action" are defined in paragraphs (c)(1) and (2) of the regulation. No comments were received regarding these definitions, and they have been adopted substantially in the form proposed. New paragraph (c)(3) has been added, defining the term "plan" to mean an employee benefit plan to which Title I of the Act applies.

Discussion of certain other comments

Counsel for one group of commentators characterized the factors set forth in paragraph (b)(2) as relating solely to the "investment merit" of a particular investment or investment course of action. Because, in the view of those commentators, the prudence of the acquisition or retention of a contract Issued by an insurance company may involve factors besides "investment merit", they suggested that the regulation should contain a separate provision that would set forth two factors to be considered by a fiduciary, in evaluating the prudence of the acquisition or retention of such a contract: the risks assumed, and the services provided, by the insurance company. The Department is unable to concur with the commentators' view that the regulation as proposed dealt only with matters of "investment merit" as narrowly perceived in the comment. The Department agrees that such factors as the risk to be assumed and the services to be provided under a contract are pertinent to any investment decision involving such contract. The regulation as adopted specifically provides that, in order to come within the scope of the regulation, a fiduciary shall consider the facts and circumstances the fiduciary knows or should know are relevant to the investment decision, and that the factors set forth in paragraph (b)(2) are not intended to be exclusive. Accordingly, the Department believes that it is unnecessary to set forth additional factors with respect to insurance contracts or other specific types of investment.

Two commentators suggested that the Department clarify that the adoption of the regulation would not result in fiduciaries being required to invest in expensive systems or analyses to make investment decisions. Under the "prudence" rule, the standard to which a fiduciary is held in the proper discharge of his investment duties is defined, in part, by what a prudent person acting in a like capacity and familiar with such matters would do. Thus, for example, it would not seem necessary for a fiduciary of a plan with assets of $50,000 to employ, in all respects, the same investment management techniques as would a fiduciary of a plan with assets of $50,000,000.

Numerous comments were received with respect to the factors set forth in paragraph (b)(2). Several persons requested that the Department clarify or define terms such as "diversification of risk". "risk," "volatility" and "liquidity." For example, some persons asked what specific measurements of volatility, risk and liquidity should be utilized by fiduciaries in making investment decisions for a plan. The Department believes that, in view of

the modifications (discussed above) made in the regulation as adopted, it is neither necessary nor appropriate for the regulation to contain such definitions. Several commentators asserted that certain specific types of investments such as, for example, investment in small or recently formed companies, or nonincome producing investments that are not securities (such as, for example, certain precious metals and objects of art) have not been viewed with favor, traditionally, as trust investments. Those comments urged that the regulation specify the extent to which such investments are permissible under the "prudence" rule. Other commentators made reference to the traditional principle that trust investments should be income producing, and suggested that the appropriate measure of investment "return" should be defined to mean 'total return" - that is, an aggregate return computed without regard to whether a contributing factor thereto consists of income or capital items. Although the Department considers that defining "return" would be beyond the appropriate scope of this regulation, it believes that the "prudence" rule does not require that every plan investment produce current income under all circumstances. As indicated above and in the preamble to the proposed regulation, the Department believes that the universe of investments permissible under the "prudence" rule is not necessarily limited to those permitted at common law.

However, the Department does not consider it appropriate to include in the regulation any list of investments, classes of investment, or investment techniques that might be permissible under the "prudence" rule. No such list could be complete; moreover, the Department does not intend to create or suggest a "legal list" of investments for plan fiduciaries.

The preamble to the proposed regulation stated (as does this preamble) that the risk level of an investment does not alone make the investment *per se* prudent or *per se* imprudent. Comments were received which asserted that such proposition is inappropriate and would promote irresponsibility on the part of plan fiduciaries. Other commentators not only agreed with the proposition, but also suggested that it should be incorporated in the regulation. The Department believes that both of these concerns are addressed by the modifications, discussed above, made to paragraph (b)(2) of the regulation as adopted.

The Department has determined that this regulation is not a "significant regulation" as defined in the Department's guidelines (44 FR 5570, January 26, 1979) implementing Executive Order 12044.

Statutory Authority

The regulation set forth below is adopted pursuant to the authority contained in section 505 of the Act (Pub. L. 93-406, 88 Stat. 894 (29 USC 1135)). Although the regulation is an "interpretative rule" within the meaning of 5 USC 553(d), the effective date of the regulation is July 23, 1979, consistent with the statement of the Department, in connection with the regulation as proposed. that such regulation would be effective 30 days after its adoption.

Final Regulation

Accordingly, Part 2550 of Chapter XXV of Title 29 of the Code of Federal) Regulations is amended by inserting in the appropriate place to read 2550.404a-1.

Signed at Washington, D.C, this 20th day of June 1979.

Ian D. Lanoff, Administrator

Pension and Welfare Benefit Programs

Labor-Management Services Administration

United States Department of Labor

- Footnotes -

1. See also 43 FR 27208 (June 23, 1978), in which notice was given of an extension of the original comment period.
2. The regulation pertains only to the investment duties of a fiduciary of an employee benefit plan. Section 404(a)(1)(B) of the Act, however, requires that a fiduciary discharge all of his duties in accordance with the "prudence" rule.
3. It should also be noted that although the proposed regulation made reference to an additional requirement of section 404(a)(1) - that the fiduciary discharge his duties solely in the interest of plan participants and beneficiaries - that reference has been deleted from the regulation as adopted. This was done to avoid suggesting that satisfaction of the "prudence" rule with respect

to an investment or investment course of action necessarily implies satisfaction of that additional requirement.
4. See, e.g., H.R. Rep. No. 1280, 93d Cong., 2d Sess. 302 (1974).
5. See sections 403(a)(2) and 402(c)(3) of the Act.
6. Further, section 405(a) of the Act provides, in part, that a plan fiduciary shall be liable for a breach of fiduciary liability of another fiduciary with respect to the same plan if, among other things, he has knowledge of such a breach and does not make reasonable efforts to remedy it, or he has enabled such other fiduciary to commit a breach by his failure to comply with the requirements of section 404(a)(1) of the Act in the administration of his specific responsibilities which give rise to his status as a fiduciary.
7. Paragraph (b)(2) of the regulation, as proposed, stated that the factors which should be considered may include those listed. In order to reduce uncertainty, reflected in the comments, regarding the application of the regulation, and in view of the fact that the regulation is in the nature of a "safe harbor" provision, paragraph (b)(2) has been restructured so as to indicate the factors which should under all circumstances be considered by any fiduciary who wishes to rely on the provisions of the rule.
8. It should be noted that index funds typically include a screen or filter process by which portfolio investments for any such fund may be changed to reflect significant adverse financial developments affecting any potential or existing portfolio company, notwithstanding the continued inclusion of the company in the index against which the fund is measured.
9. The term "risk" is used here in its ordinary sense, and refers to any and all types of risk applicable to a particular investment or investment course of action.
10. See, e.g., section 401(b) of the Act.

Department of Labor

Regulation 2550.404b-1

29 C.F.R. 2550.404b-1

Indicia of Ownership

Originally issued October 4, 1977 (42 FR 54124)

Amended January 6, 1981 (46 FR 1267)

ERISA 404(b) requires that plan assets be maintained within the jurisdiction of US District Courts. With the advent of international investments, this is often impractical. This regulation provides a means to keep investments at certain types of non-US custodians. A special provision deals with Canada.

a. No fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States, unless:

    1. Such assets are:

        i. Securities issued by a person, as defined in section 3(9) of the Employee Retirement Income Security Act of 1974 (Act) (other than an individual), which is not organized under the laws of the United States or a State and does not have its principal place of business within the United States,
        ii. Securities issued by a government other than the government of the United States or of a State, or any political subdivision, agency or instrumentality of such a government,
        iii. Securities issued by a person, as defined in section 3(9) of the Act (other than an individual), the principal trading market for which securities is outside the jurisdiction of the district courts of the United States, or
        iv. Currency issued by a government other than the government of the United States if such currency is maintained outside the jurisdiction of the district courts of the United States solely as an incident to the purchase, sale or maintenance of securities described in paragraph (a)(1) of this section; and

    2. (i) Such assets are under the management and control of a fiduciary which is a corporation or partnership organized under the laws of the United States or a State, which

fiduciary has its principal place of business within the United States and which is -

A. A bank as defined in section 202(a)(2) of the Investment Advisors Act of 1940 that has, as of the last day of its most recent fiscal year, equity capital in excess of $1,000,000;
B. An insurance company which is qualified under the laws of more than one State to manage, acquire, or dispose of any asset of a plan, which company has, as of the last day of its most recent fiscal year, net worth in excess of $1,000,000 and which is subject to supervision and examination by the State authority having supervision over insurance companies; or
C. An investment adviser registered under the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, total client assets under its management and control in excess $50,000,000 and either

    1. Shareholders' or partners' equity in excess of $750,000 or
    2. All of its obligations and liabilities assumed or guaranteed by a person described in paragraph (a)(2)(i)(A), (B), or (C)(1) or (a)(2)(ii)(A)(2) of this section; or

ii. Such indicia or ownership are either:

A. In the physical possession of, or, as a result of normal business operations, are in transit to the physical possession of, a person which is organized under the laws of the United States or a State, which person has its principal place of business in the United States and which is -

    1. A bank as defined in section 202(a)(2) of the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, equity capital in excess of $1,000,000;
    2. A broker of dealer registered under the Securities Exchange Act of 1934 that has, as of the last day of its most recent fiscal year, net worth in excess of $750,000; or
    3. A broker or dealer registered under the Securities Exchange Act of 1934 that has all of its obligations and liabilities assumed or guaranteed by a person described in paragraph (a)(2)(i)(A), (B), or (C)(1) or (a)(2)(ii)(A)(2) of this section; or

B. Maintained by a broker or dealer, described in paragraph (a)(2)(ii)(A)(2) or (3) of this section, in the custody of an entity designated by the Securities and Exchange Commission as a "satisfactory control location" with respect to such broker or dealer pursuant to Rule 15c3-3 under the Securities Exchange Act of 1934 provided that:

    1. Such entity holds the indicia of ownership as agent for the broker or dealer, and
    2. Such broker or dealer is liable to the plan to the same extent it would be if it retained the physical possession of the indicia of ownership pursuant to paragraph (a)(2)(ii)(A) of this section.

C. Maintained by a bank described in paragraph (a)(2)(ii)(A)(1), in the custody of an entity that is a foreign securities depository, foreign clearing agency which acts as a securities depository, or foreign bank which entity is supervised or regulated by a government agency or regulatory authority in the foreign jurisdiction having

authority over such depositories, clearing agencies or banks, provided that:

1. The foreign entity holds the indicia of ownership as agent for the bank;
2. The bank is liable to the plan to the same extent it would be if it retained the physical possession of the indicia of ownership within the U.S.
3. The indicia of ownership are not subject to any right, charge, security interest, lien or claim of any kind in favor of the foreign entity except for their safe custody or administration;
4. Beneficial ownership of the assets represented by the indicia of ownership is freely transferable without the payment of money or value other than for safe custody or administration; and
5. Upon request by the plan fiduciary who is responsible for the selection and retention of the bank, the bank identifies to such fiduciary the name, address and principal place of business of the foreign entity which acts as custodian for the plan pursuant to this paragraph (a)(2)(ii)(C), and the name and address of the governmental agency or other regulatory authority that supervises or regulates that foreign entity.

b. Notwithstanding any requirement of paragraph (a) of this section, a fiduciary, with respect to a plan may maintain in Canada the indicia of ownership of plan assets which are attributable to a contribution made on behalf of a plan participant who is a citizen or resident of Canada, if such indicia of ownership must remain in Canada in order for the plan to qualify for and maintain tax exempt status under the laws of Canada or to comply with other applicable laws of Canada or any Province of Canada.
c. For purposes of this regulation:

1. The term "management and control" means the power to direct the acquisition or disposition through purchase, sale, pledging, or other means; and
2. The term "depository" means any company, or agency or instrumentality of government, that acts as a custodian of securities in connection with a system for the central handling of securities whereby all securities of a particular class or series or any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates.

Department of Labor

Regulation 2550.404c-1

29 C.F.R. 2550.404c-1.

ERISA Section 404(c) Plans

Originally issued October 4, 1977 (42 FR 54124)

Amended January 26, 1981 (46 FR 1267)

a. In General.

1. Section 404(c) of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) provides that if a pension plan that provides for individual accounts permits a participant or beneficiary to exercise control over assets in his account and that participant or beneficiary in fact exercises control over assets in his account, then the participant or beneficiary shall not be deemed to be a fiduciary by reason of his exercise of control and no person who is otherwise a fiduciary shall be liable for any loss, or by reason of any breach, which results from such exercise of control. This section describes the kinds of plans that are "ERISA section 404(c) plans," the circumstances in which a participant or beneficiary is considered to have exercised independent control over the assets in his account as contemplated by section 404(c), and the consequences of a participant's or beneficiary's exercise of control.

2. The standards set forth in this section are applicable solely for the purpose of determining whether a plan is an ERISA section 404(c) plan and whether a particular transaction engaged in by a participant or beneficiary of such plan is afforded relief by section 404(c). Such standards, therefore, are not intended to be applied in determining whether, or to what extent, a plan which does not meet the requirements for an ERISA section 404(c) plan or a fiduciary with respect to such a plan satisfies the fiduciary responsibility or other provisions of title I of the Act.

b. ERISA section 404(c) plans -

1. In general. An "ERISA section 404(c) plan" is an individual account plan described in section 3(34) of the Act that:

    i. Provides an opportunity for a participant or beneficiary to exercise control over assets in his individual account (see paragraph (b)(2) of this section); and
    ii. Provides a participant or beneficiary an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested (see paragraph (b)(3) of this section).

2. Opportunity to exercise control.

    i. A plan provides a participant or beneficiary an opportunity to exercise control over assets in his account only if -

        A. Under the terms of the plan, the participant or beneficiary has a reasonable opportunity to give investment instructions (in writing or otherwise, with opportunity to obtain written confirmation of such instructions) to an identified plan fiduciary who is obligated to comply with such instructions except as otherwise provided in paragraph (b)(2)(ii)(B) and (d)(2)(ii) of this section; and
        B. The participant or beneficiary is provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments. For purposes of this subparagraph, a participant or beneficiary will not be considered to have sufficient investment information unless -

            1. The participant or beneficiary is provided by an identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on his behalf):

                i. An explanation that the plan is intended to constitute a plan described in section 404(c) of the Employee Retirement Income Security Act, and title 29 of the Code of Federal Regulations Section 2550.440c-1, and that the fiduciaries of the plan may be relieved of liability for any losses which are the direct and necessary result of investment instructions given by such participant or beneficiary;
                ii. A description of the investment alternatives available under the plan and, with respect to each designated investment alternative, a general description of the investment objectives and risk and return characteristics of each such alternative, including information relating to the type and diversification of assets comprising the portfolio of the designated investment alternative;
                iii. Identification of any designated

investment managers;

iv. An explanation of the circumstances under which participants and beneficiaries may give investment instructions and explanation of any specified limitations on such instructions under the terms of the plan, including any restrictions on transfer to or from a designated investment alternative and any restrictions on the exercise of voting, tender and similar rights appurtenant to a participant's or beneficiary's investment in an investment alternative;

v. A description of any transaction fees and expenses which affect the participant's or beneficiary's account balance in connection with purchases or sales of interests in investment alternatives (e.g., commissions, sales load, deferred sales charges, redemption or exchange fees);

vi. The name, address, and phone number of the plan fiduciary (and, if applicable, the person or persons designated by the plan fiduciary to act on his behalf) responsible for providing the information described in paragraph (b)(2)(i)(B)(2) upon request of a participant or beneficiary and a description of the information described in paragraph (b)(2)(i)(B)(2) which may be obtained on request;

vii. In the case of plans which offer an investment alternative which is designed to permit a participant or beneficiary to directly or indirectly acquire or sell any employer security (employer security alternative), a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale of employer securities, and the exercise of voting, tender and similar rights, by participants and beneficiaries, and the name, address and phone number of the plan fiduciary, responsible for monitoring compliance with the procedures (see paragraphs (d)(2)(ii)(E)(4)(vii), (viii) and (ix) of this section); and

viii. In the case of an investment alternative which is subject to the Securities Act of 1933, and in which the participant or beneficiary has no assets invested, immediately following the participant's or beneficiary's initial investment, a copy of the most recent prospectus provided to the plan. This condition will be deemed satisfied if the participant or beneficiary has been provided with a copy of such most recent prospectus immediately prior to the participant's or beneficiary's initial investment in such alternative;

ix. Subsequent to an investment in a

investment alternative, any materials provided to the plan relating to the exercise of voting, tender or similar rights which are incidental to the holding in the account of the participant or beneficiary of an ownership interest in such alternative to the extent that such rights are passed through to participants and beneficiaries under the terms of the plan, as well as a description of or reference to plan provisions relating to the exercise of voting, tender or similar rights.

2. The participants or beneficiary is provided by the identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on his behalf), either directly or upon request, the following information, which shall be based on the latest information available to the plan:

   i. A description of the annual operating expenses of each designated investment alternative (e.g., investment management fees, administrative fees, transaction costs) which reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative;
   ii. Copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternatives available under the plan, to the extent such information is provided to the plan;
   iii. A list of the assets comprising the portfolio of each designated investment alternative which constitute plan assets within the meaning of 29 C.F.R. 2510.3-101, the value of each such asset (or the proportion of the investment alternative which it comprises), and, with respect to each such asset which is a fixed rate investment contract issued by a bank, savings and loan association or insurance company, the name of the issuer of the contract, the term of the contract and the rate of return on the contract;
   iv. Information concerning the value of shares or units in designated investment alternatives available to participants and beneficiaries under the plan, as well as the past and current investment performance of such alternatives, determined net of expenses, on a reasonable and consistent basis; and
   v. Information concerning the value of shares or units in designated investment alternatives held in the accounts of the

participant or beneficiary.

ii. A plan does not fail to provide an opportunity for a participant or beneficiary to exercise control over his individual account merely because it -

A. Imposes charges for reasonable expenses. A plan may charge participants' and beneficiaries' accounts for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform such participants and beneficiaries of actual expenses incurred with respect to their respective individual accounts;
B. Permits a fiduciary to decline to implement investment instructions by participants and beneficiaries. A fiduciary may decline to implement participant and beneficiary instructions which are described at paragraph (d)(2)(ii) of this section, as well as instructions specified in the plan, including instructions -

1. Which would result in a prohibited transaction described in ERISA section 406 or section 4975 of the Internal Revenue Code, and
2. Which would generate income that would be taxable to the plan;

C. Imposes reasonable restrictions on frequency of investment instructions. A plan may impose reasonable restrictions on the frequency with which participants and beneficiaries may give investment instructions. In no event however, is such a restriction reasonable unless, with respect to each investment alternative made available by the plan, it permits participants and beneficiaries to give investment instructions with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject, provided that -

1. At least three of the investment alternatives made available pursuant to the requirements of paragraph (b)(3)(i)(B) of this section, which constitute a broad range of investment alternatives, permit participants and beneficiaries to give investment instructions no less frequently than once within any three month period; and
2. (i) At least one of the investment alternatives meeting the requirements of paragraph (b)(2)(ii)(C)(1) of this section permits participants and beneficiaries to give investment instructions with regard to transfers into the investment alternative as frequently as participants and beneficiaries are permitted to give investment instructions with respect to any investment alternative made available by the plan which permits participants and beneficiaries to give investment instructions more frequently than once within any three month period; or

i. With respect to each investment alternative which permits participants and beneficiaries to give investment instructions more frequently than once within any three month period, participants and beneficiaries are permitted to direct their investments from such alternative into an income producing, low risk, liquid fund, subfund, or account as frequently as their are permitted to give investment instructions with respect to each such alternative

and, with respect to such fund, subfund or account, participants and beneficiaries are permitted to direct investments from the fund, subfund or account to an investment alternative meeting the requirements of paragraph (b)(2)(ii)(C)(1) as frequently as they are permitted to give investment instructions with respect to that investment alternative; and

3. With respect to transfers from an investment alternative which is designed to permit a participant or beneficiary to directly or indirectly acquire or sell any employer security (employer security alternative) either:

    i. All of the investment alternatives meeting the requirements of paragraph (b)(2)(ii)(C)(1) of this section must permit participants and beneficiaries to give investment instructions with regard to transfers into each of the investment alternatives as frequently as participants and beneficiaries are permitted to give investment instructions with respect to the employer security alternative; or
    ii. Participants and beneficiaries are permitted to direct their investments from each employer security alternative into an income producing, low risk, liquid, fund, subfund, or account as frequently as they are permitted to give investment instructions with respect to such employer security alternative and, with respect to such fund, subfund, or account, participants and beneficiaries are permitted to direct investments from the fund, subfund or account to each investment alternative meeting the requirements of paragraph (b)(2)(ii)(C)(1) as frequently as they are permitted to give investment instructions with respect to each such investment alternative.
    iii. Paragraph (c) of this section describes the circumstances under which a participant or beneficiary will be considered to have exercised independent control with respect to a particular transaction.

3. Broad range of investment alternatives.

    i. A plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to:

        A. Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject;
        B. Choose from at least three investment alternatives:

            1. Each of which is diversified;
            2. Each of which has materially different risk and return characteristics;

3. Which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and
4. Each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio;

C. Diversify the investment of that portion of his individual account with respect to which he in permitted to exercise control so as to minimize the risk of large losses, taking into account the nature of the plan and the size of participants' or beneficiaries' accounts. In determining whether a plan provides the participant or beneficiary with a reasonable opportunity to diversify his investments, the nature of the investment alternatives offered by the plan and the size of the portion of the individual's account over which he is permitted to exercise control must be considered. Where such portion of the account of any participant or beneficiary is so limited in size that the opportunity to invest in look-through investment vehicles is the only prudent means to assure an opportunity to achieve appropriate diversification, a plan may satisfy the requirements of this paragraph only by offering look-through investment vehicles.

ii. Diversification and look-through investment vehicles. Where look-through investment vehicles are available as investment alternatives to participants and beneficiaries, the underlying investments of the look-through investment shall be considered in determining whether the plan satisfies the requirements of subparagraphs (b)(3)(i)(B) and (b)(3()i)(C).

c. Exercise of control.

1. In general. -

i. Sections 404(c)(1) and 404(c)(2) of the Act and paragraphs (a) and (d) of this section apply only with respect to a transaction where a participant or beneficiary has exercised independent control in fact with respect to the investment of assets in his individual account under an ERISA section 404(c) plan.
ii. For purposes of sections 404(c)(1) and 4040(c)(2) [sic] of the Act and paragraphs (a) and (d) of this section, a participant or beneficiary will be deemed to have exercised control with respect to the exercise of voting, tender and similar rights appurtenant to the participant's or beneficiary's ownership interest in an investment alternative, provided that the participant's or beneficiary's investment in the investment alternative was itself the result of an exercise of control, the participant or beneficiary was provided a reasonable opportunity to give instruction with respect to such incidents of ownership, including the provision of the information described in paragraph (b)(2)(i)(B)(1)(ix) of this section, and the participant or beneficiary has not failed to exercise control by reason of the circumstances described in Paragraph (c)(2) with respect to such incidents of ownership.

2. Independent control. Whether a participant or beneficiary has exercised independent control in fact with respect to a transaction depends on the facts and circumstances of the particular case. However, a participant's or beneficiary's exercise of control is not independent in fact if:

i. The participant or beneficiary is subjected to improper influence by a plan fiduciary or the plan sponsor with respect to the transaction;
ii. A plan fiduciary has concealed material non-public facts regarding the investment from the participant or beneficiary, unless the disclosure of such information by the plan fiduciary to the participant or beneficiary would violate any provision of federal law or any provision of state law which in not preempted by the Act; or
iii. The participant or beneficiary is legally incompetent and the responsible plan

fiduciary accepts the instructions of the participant or beneficiary knowing him to be legally incompetent.

3. Transactions involving a fiduciary. In the case of a sale, exchange or leasing of property (other than a transaction described in paragraph (d)(2)(ii)(E) of this section) between an ERISA section 404(c) plan and a plan fiduciary or an affiliate of such a fiduciary, or a loan to a plan fiduciary or an affiliate of such a fiduciary, the participant or beneficiary will not be deemed to have exercised independent control unless the transaction is fair and reasonable to him. For purposes of this paragraph (c)(3), a transaction will be deemed to be fair and reasonable to a participant or beneficiary if he pays no more than, or receives no less than, adequate consideration (as defined in section 3(18) of the Act) in connection with the transaction.
4. No obligation to advise. A fiduciary has no obligation under part 4 of Title I of this Act to provide investment advice to a participant or beneficiary under an ERISA section 404(c) plan.

d. Effect of independent exercise of control.

1. Participant or beneficiary not a fiduciary. If a participant or beneficiary of an ERISA section 404(c) plan exercises independent control over assets in his individual account in the manner described in paragraph (c), then such participant or beneficiary is not a fiduciary of the plan by reason of such exercise of control.
2. Limitation on liability of plan fiduciaries -

    i. If a participant or beneficiary of an ERISA section 404(c) plan exercises independent control over assets in his individual account in the manner described in paragraph (c), then no other person who is a fiduciary with respect to such plan shall be liable for any loss, or with respect to any breach of part 4 of Title I of the Act that is the direct and necessary result of that participant's or beneficiary's exercise of control.
    ii. Paragraph (d)(2)(i) does not apply with respect to any instruction, which if implemented -

        A. Would not be in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Title I of ERISA;
        B. Would cause a fiduciary to maintain the indicia of ownership of any assets of the plan outside the jurisdiction of the district courts of the United States other than as permitted by section 404(b) of the Act and 29 C.F.R. 2550.404b-1;
        C. Would jeopardize the plan's tax qualified status under the Internal Revenue Code;
        D. Could result in a loss in excess of a participant's or beneficiary's account balance; or
        E. Would result in a direct or indirect:

            1. Sale, exchange or lease of property between a plan sponsor or any affiliate of the sponsor and the plan except for the acquisition or disposition of any interest in a fund, subfund or portfolio managed by a plan sponsor or an affiliate of the sponsor, or the purchase or sale of any qualifying employer security (as defined in section 407(d)(5) of the Act) which meets the conditions of section 408(e) of ERISA and section (d)(2))(ii)(E)(4) below;
            2. Loan to a plan sponsor or any affiliate of the sponsor;
            3. Acquisition or sale of any employer real property (as defined in section 407(d)(2) of the Act); or
            4. Acquisition or sale of any employer security except to the extent that:

                i. Such securities are qualifying employer securities (as defined in section 407(d)(5) of the Act);
                ii. Such securities are stock or an equity

interest in a publicly traded partnership (as defined in section 7704(b) of the Internal Revenue Code of 1986), but only if such partnership is an existing partnership as defined in section 10211(c)(2)(A) of the Revenue Act of 1987 (Public Law 100-203);

iii. Such securities are publicly traded on a national exchange or other generally recognized market;
iv. Such securities are traded with sufficient frequency and in sufficient volume to assure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently;
v. Information provided to shareholders of such securities is provided to participants and beneficiaries with accounts holding such securities;
vi. Voting, tender and similar rights with respect to such securities are passed through to participants and beneficiaries with accounts holding such securities;
vii. Information relating to the purchase, holding, and sale of securities, and the, exercise of voting, tender, and similar rights with respect to such securities by participants and beneficiaries, is maintained in accordance with procedures which are designed to safeguard the confidentiality of such information, except to the extent necessary to comply with Federal laws or state laws not preempted by the Act;
viii. The plan designates a fiduciary who is responsible for ensuring that: The procedures required under subparagraph (d)(2)(ii)(E)(4)(vii) are sufficient to safeguard the confidentiality of the information described in that subparagraph, such procedures are being followed, and the independent fiduciary required by subparagraph (d)(2)(ii)(E)(4)(ix) is appointed; and
ix. An independent fiduciary is appointed to carry out activities relating to any situations which the fiduciary designated by the plan for purposes of subparagraph (d)(2)(ii)(E)(4)(viii) determines involve a potential for undue employer influence upon participants and beneficiaries, with regard to the direct or indirect exercise of shareholder rights. For purposes of this subparagraph, a fiduciary is not independent if the fiduciary is affiliated with any sponsor of the plan.

iii. The individual investment decisions of an investment manager who is designated directly by a participant or beneficiary or who manages a look-through investment vehicle in which a participant or beneficiary has invested are not direct and necessary results of the designation of the investment manager or of investment in

the look-through investment vehicle. However, this paragraph (d)(2)(iii) shall not be construed to result in liability under section 405 of ERISA with respect to a fiduciary (other than the investment manager) who would otherwise be relieved of liability by reason of section 404(c)(2) of the Act and paragraph (d) of this section.

3. Prohibited Transactions. The relief provided by section 404(c) of the Act and this section applies only to the provisions of part 4 of title I of the Act. Therefore, nothing in this section relieves a disqualified person from the taxes imposed by sections 4975(a) and (b) of the Internal Revenue Code with respect to the transactions prohibited by section 4975(c)(1) of the Code.

e. Definitions. For purposes of this section:

1. *Look-through investment vehicle* means:

   i. An investment company described in section 3(a) of the Investment Company Act of 1940, or a series investment company described in section 18(f) of the 1940 Act or any of the segregated portfolios of such company;
   ii. A common or collective trust fund or a pooled investment fund maintained by a bank or similar institution, a deposit in a bank or similar institution, or a fixed rate investment contract of a bank or similar institution;
   iii. A pooled separate account or a fixed rate investment contract of an insurance company qualified to do business in a State; or
   iv. Any entity whose assets include plan assets by reason of a plan's investment in the entity;

2. *Adequate consideration* has the meaning given it in section 3(18) of the Act and in any regulations under this title;
3. An *affiliate* of a person includes the following:

   i. Any person directly or indirectly controlling, controlled by, or under common control with the person;
   ii. Any officer, director, partner, or employee, an employee of an affiliated employer, relative (as defined in section 3(15) of ERISA), brother, sister, or spouse of a brother or sister, of the person; and
   iii. Any corporation or partnership of which the person is an officer director or partner.

   For purposes of this paragraph (e)(3), the term "*control*" means, with respect to a person other than an individual, the power to exercise a controlling influence over the management or policies of such person.

4. A *designated investment alternative* is a specific investment identified by a plan fiduciary as an available investment alternative under the plan.

f. Examples. The provisions of this section are illustrated by the following examples. Examples (5) through (11) assume that the participant has exercised independent control with respect to his individual account under an ERISA section 404(c) plan described in paragraph (b) and has not directed a transaction described in paragraph (d)(2)(ii).

1. Plan A is an individual account plan described in section 3(34) of the Act. The plan states that a plan participant or beneficiary may direct the plan administrator to invest any portion of his individual account in a particular diversified equity fund managed by an entity which is not affiliated with the plan sponsor, or any other asset administratively feasible for the plan to hold. However, the plan provides that the plan administrator will not implement certain listed instructions for which plan fiduciaries would not be relieved of liability under section 404(c) (see paragraph (d)(2)(ii)).

   Plan participants and beneficiaries are permitted to give investment instructions during the first week of each month with respect to the equity fund and at any time with respect to other investments. The plan provides for the pass-through of voting, tender and similar rights incidental to the holding in the account of a participant or beneficiary of an ownership interest in the equity fund or any other investment alternative available under the plan.

   - The plan administrator of plan A provides each participant and

beneficiary with the information described in subparagraphs (i), (ii), (iii), (iv), (v), (vi) and (vii) of paragraph (b)(2)(i)(B)(1) upon their entry into the plan, and provides updated information in the event of any material change in the information provided.

- Immediately following an investment by a participant or beneficiary in the equity fund, the plan administrator provides a copy of the most recent prospectus received from the fund to the investing participant or beneficiary.
- Immediately following any investment by a participant or beneficiary in any other investment alternative which is subject to the Securities Act of 1933, the plan administrator provides the participant or beneficiary with the most recent prospectus received from that investment alternative (see paragraph (b)(2)(1)(B)(i)(viii)).
- Finally, subsequent to any investment by a participant or beneficiary, the plan administrator forwards to the investing participant or beneficiary any materials provided to the plan relating to the exercise of voting, tender or similar rights attendant to ownership of an interest in such investment (see paragraph (b)(2)(1)(B)(i)(ix)).
- Upon request, the plan administrator provides each participant or beneficiary with copies of any prospectuses, financial statements and reports, and any other materials relating to the investment alternatives available under the plan which are received by the plan (see paragraph (b)(2)(i)(B)(2)(ii)).
- Also upon request, the plan administrator provides each participant and beneficiary with the other information required by paragraph (b)(2)(i)(B)(2) with respect to the equity fund, which is a designated investment alternative, including information concerning the latest available value of the participant's or beneficiary's interest in the equity fund (see paragraph (b)(2)(i)(B)(2)(v)).

Plan A meets the requirements of paragraphs (b)(2)(i)(B)(1) and (2) of this section regarding the provision of investment information.

Note: The regulation imposes no additional obligation on the administrator to furnish or make available materials relating to the companies in which the equity fund invests (e.g., prospectuses, proxies, etc.).

2. Plan C is an individual account plan described in section 3(34) of the Act under which participants and beneficiaries may choose among three investment alternatives which otherwise meet the requirements of paragraph (b) of this section. The plan permits investment instruction with respect to each investment alternative only on the first 10 days of each calendar quarter, i.e., January 1-10, April 1-10, July 1-10 and October 1-10. Plan C satisfies the condition of paragraph (b)(2)(ii)(C)(1) that instruction be permitted not less frequently than once within any three month period, since there is not any three month period during which control could not be exercised.
3. Assume the same facts as in paragraph (f)(2), except that investment instruction may only be given on January 1, April 1, July 1 and October 1. Plan C is not an ERISA section 404(c) plan because it does not satisfy the condition of paragraph (b)(2)(ii)(C)(1) that instruction be permitted not less frequently than once within any three month period. Under these facts, there is a three month period, e.g., January 2 through April 1, during which control could not be exercised by participants and beneficiaries.
4. Plan D is an individual account plan described in section 3(34) of the Act under which participants and beneficiaries may choose among three diversified investment alternatives which constitute a broad range of investment alternatives. The plan also permits investment instruction with respect to an employer securities alternative but provides that a participant or beneficiary can invest no more than 25% of his account balance in this alternative. This restriction does not affect the availability of relief under section 404(c) inasmuch as it does not relate to the three diversified investment alternatives and, therefore, does not cause the plan to fail to provide an

opportunity to choose from a broad range of investment alternatives.

5. A participant, P, independently exercises control over assets in his individual account plan by directing a plan fiduciary, F, to invest 100% of his account balance in a single stock. P is not a fiduciary with respect to the plan by reason of his exercise of control and F will not be liable for any losses that necessarily result from P's investment instruction.
6. Assume the same facts as in paragraph (f)(5), except that P directs F to purchase the stock from B, who is a party in interest with respect to the plan. Neither P nor F has engaged in a transaction prohibited under section 406 of the Act: P because he is not a fiduciary with respect to the plan by reason of his exercise of control and F because he is not liable for any breach of part 4 of Title I that is the direct and necessary consequence of P's exercise of control. However, a prohibited transaction under section 4975(c) of the Internal Revenue Code may have occurred, and, in the absence of an exemption, tax liability may be imposed pursuant to sections 495(a) and (b) of the Code.
7. Assume the same facts as in paragraph (f)(5), except that P does not specify that the stock be purchased from B, and F chooses to purchase the stock from B. In the absence of an exemption, F has engaged in a prohibited transaction described in 406(a) of ERISA because the decision to purchase the stock from B is not a direct or necessary result of P's exercise or control.
8. Pursuant to the terms of the plan, plan fiduciary F designates three reputable investment managers whom participants may appoint to manage assets in their individual accounts. Participant P selects M, one of the designated managers, to manage the assets in his account. M prudently manages P's account for 6 months after which he incurs losses in managing the account through his imprudence. M has engaged in a breach of fiduciary duty because M's imprudent management of P's account is not a direct or necessary result of P's exercise of control (the choice of M as manager). F has no fiduciary liability for M's imprudence because he has no affirmative duty to advise P (see paragraph (c)(4)) and because F is relieved of co-fiduciary liability by reason of section 404(c)(2) (see paragraph (d)(2)(iii)). F does have a duty to monitor M's performance to determine the suitability of continuing M as an investment manager, however, and M's imprudence would be a factor which F must consider in periodically reevaluating its decision to designate M.
9. Participant P instructs plan fiduciary F to appoint G as his investment manager pursuant to the terms of the plan which provide P total discretion in choosing an investment manager. Through G's imprudence, G incurs losses in managing P's account. G has engaged in a breach of fiduciary duty because G's imprudent management of P's account is not a direct or necessary result of P's exercise of control (the choice of G as manager). Plan fiduciary F has no fiduciary liability for G's imprudence because F has no obligation to advise P (see paragraph (c)(4)) and because F is relieved of co-fiduciary liability for G's actions by reason of section 402(c)(2) (see paragraph (d)(2)(iii)). In addition, F also has no duty to determine the suitability of G as an investment manager because the plan does not designate G as an investment manager.
10. Participant P directs a plan fiduciary, F, a bank, to invest all of the assets in his individual account in a collective trust fund managed by F that is designed to be invested solely in a diversified portfolio of common stocks. Due to economic conditions, the value of the common stocks in the bank collective trust fund declines while the value of publicly-offered fixed income obligations remains relatively stable. F is not liable for any losses incurred by P solely because his individual account was not diversified to include fixed income obligations. Such losses are the direct result of P's exercise of control; moreover, under paragraph (c)(4) of this section F has no obligation to advise P regarding his investment decisions.
11. the same facts as in paragraph (f)(10) except that F, in managing the co ve trust fund, inves ts the assets of the fund solely in a few highly speculative stocks. F is liable for losses resulting from its imprudent investment in the speculative stocks and for its failure to diversify the assets of the account. This conduct involves a separate breach of F's fiduciary duty that is not a direct or necessary result of P's exercise of control (see paragraph (d)(2)(iii)).

g. Effective date.

1. In general. Except as provided in paragraph (g)(2), this section is effective with respect to transactions occurring on or after the first day of the second plan year beginning on or after October 13, 1992.
2. This section is effective with respect to transactions occurring under a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before October 13, 1992 after the later of the date determined under paragraph (g)(1) or the date on which the last collective bargaining agreement terminates. For

purposes of this paragraph (g)(2), any extension or renegotiation of a collective bargaining agreement which is ratified on or after October 13, 1992 is to be disregarded in determining the date on which the agreement terminates.

3. Transactions occurring before the date determined under subparagraph (g)(1) or (2) of this section, as applicable, are governed by section 404(c) of, the Act without regard to the regulation.

Department of Labor

Delinquent Filer Voluntary Compliance Program

April 27, 1995 (60 FR 20874)

Recap
Permits delinquent plan administrators to comply with annual reporting obligations under Title I of the ERISA with reduced civil penalties.

Agency: Department of Labor, Employee Benefits Security Administration

Action: Grant of Class Exemption

Effective Date: March 28, 2002

Program

Section 1--Delinquent Filer Voluntary Compliance (DFVC) Program

The DFVC Program is intended to afford eligible plan administrators (described in Section 2 of this Notice) the opportunity to avoid the assessment of civil penalties otherwise applicable to administrators who fail to file timely annual reports for plan years beginning on or after January 1, 1988. Eligible administrators may avail themselves of the DFVC Program by complying with the filing requirements and paying the civil penalties specified in Section 3 or Section 4, as appropriate, of this Notice.

Section 2--Scope, Eligibility and Effective Date

.01 Scope. The DFVC Program described in this Notice provides relief from assessment of civil penalties otherwise applicable to plan administrators who fail or refuse to file timely annual reports. Relief under this Program does not extend to penalties that may be assessed for annual reports that are determined by the Department to be incomplete or otherwise deficient.

.02 Eligibility. The DFVC Program is available only to a plan administrator that complies with the requirements of Section 3 or Section 4, as appropriate, of this Notice prior to the date on which the administrator is notified in writing by the Department of a failure to file a timely annual report under Title I of ERISA.

.03 Effective date. The DFVC Program described herein shall be effective March 28, 2002. The Department intends that this DFVC Program to be of indefinite duration; however, the Program may be modified from time to time or terminated in the sole discretion of the Department upon publication of notice in the Federal Register.

Section 3--Plan Administrators Filing Annual Reports

.01 General. A plan administrator electing to file a late annual report (Form 5500 Series Annual Return/Report) under this DFVC Program must comply with the requirements of this Section 3.

.02 Filing a Complete Annual Report.

(a) The plan administrator must file a complete Form 5500 Series Annual Return/Report, including all required schedules and attachments, for each plan year for which the plan

administrator is seeking relief under the Program. This filing shall be sent to PWBA at the appropriate EFAST address listed in the instructions for the most current Form 5500 Annual Return/Report, or electronically in accordance with the EFAST electronic filing requirements. See the EFAST Internet site at www.efast.dol.gov to view forms and instructions.

Note: Do not forward the applicable penalty amount described in Section 3.03 to the EFAST addresses listed above.

(b) For purposes of subparagraph (a), the plan administrator shall file either: (1) The Form 5500 Series Annual Return/Report form (but not a Form 5500-R) issued for each plan year for which the relief is sought, or (2) the most current Form 5500 Annual Return/Report form issued (and, if necessary, indicate in the appropriate space on the first page of the Form 5500 the plan year for which the annual return/report is being filed). Forms may be obtained from the IRS by calling 1-800-TAX-FORM (1-800-829-3676). Forms for certain pre-1999 plan years also are available through the Internet sites for PWBA and the Internal Revenue Service (IRS) (www.dol.gov/dol/pwba, www.irs.gov). For further information on EFAST filing requirements, see the EFAST Internet site (www.efast.dol.gov) and the instructions for the most current Form 5500.

.03 Payment of Applicable Penalty Amount.

(a) The plan administrator shall pay the applicable penalty amount by submitting to the DFVC Program the information described in subparagraph (b) along with a check made payable to the ``U.S. Department of Labor'' for the applicable penalty amount determined in accordance with subparagraph (c). This separate submission shall be made by mail to: DFVC Program, PWBA, P.O. Box 530292, Atlanta, GA 30353-0292. The annual returns/reports for multiple plans may not be included in a single DFVC Program submission. A separate submission to the DFVC Program (including a separate check for the applicable penalty amount) must be made for each plan.

Note: Personal or private delivery service cannot be made to this address.

(b)

(1) The administrator shall submit to the DFVC Program, with the applicable penalty amount, a paper copy of the Form 5500 Annual Return/Report filed as described in paragraph .02(a), without schedules and attachments. In the event that the plan administrator files as described in paragraph .02(a) using a 1998 or prior plan year form, a paper copy of only the first page of the Form 5500 or Form 5500-C, as applicable, should be submitted to the DFVC Program.

(2) In the case of a plan sponsored by a Code section 501(c)(3) organization described in paragraph .03(c)(4), the administrator shall clearly note ``501(c)(3) Plan'' in the upper-right hand corner of the first page of the Form 5500 Annual Return/Report submitted to the DFVC Program (in Atlanta, Georgia). This notation should not be included on the annual report filed with PWBA pursuant to paragraph .02 (in Lawrence, Kansas) because it may interfere with the proper processing of the required report.

(c) The applicable penalty amount shall be determined as follows:

(1) In the case of a plan with fewer than 100 participants at the beginning of the plan year (or a plan that would be treated as such a plan under the ``80-120'' participant rule described in 29 CFR 2520.103-1(d) for the subject plan year) (hereinafter ``small plan''), the applicable penalty amount is $10 per day for each day the annual report is filed after the date on which the annual report was due (without regard to any extensions), not to exceed the greater of: $750 per annual report or, in the case of a DFVC submission relating to more than one delinquent annual report filing for the plan, $1,500 per plan.

(2) In the case of a plan with 100 or more participants at the beginning of the plan year (other than a plan that is eligible to use and uses the ``80-120'' participant rule) (hereinafter ``large plan''), the applicable penalty amount is $10 per day for each day the annual report is filed after the date on which the annual report was due (without regard to any extensions), not to exceed the greater of: $2,000 per annual report or, in the case of a DFVC submission relating to more than one delinquent annual report filing for the plan, $4,000 per plan.

(3) In the case of a DFVC submission relating to more than one delinquent annual report filing for a plan, the applicable penalty amount shall be determined by reference to paragraph (c)(2) if for any plan year for which the submission is made the plan was a ``large plan.''

(4) In the case of a plan administrator filing an annual report for a ``small plan'' that is sponsored by a Code section 501(c)(3) organization (including a Code section 403(b) plan), the applicable penalty amount is $10 per day for each day the annual report is filed after the date on which the annual report was due (without regard to any extensions), not to exceed $750 per DFVC submission, including DFVC submissions that relate to more than one delinquent annual report filing for the plan. This paragraph (c)(4) shall not apply if, as of the date the plan files pursuant to this DFVC Program, there is a delinquent or late annual report due for a plan year for which the plan was a ``large plan.'' See paragraph .03(b)(2) for special instructions pertaining to small plans sponsored by Code section 501(c)(3) organizations.

.04 Liability for Applicability Amount.

The plan administrator is personally liable for the payment of civil penalties assessed under section 502(c)(2) of ERISA, therefore, civil penalties, including amounts paid under this DFVC Program, shall not be paid from the assets of an employee benefit plan.

Section 4--Plan Administrators Filing Notices for Apprenticeship and Training Plans and Statements for ``Top Hat'' Plans

.01 General. Administrators of apprenticeship and training plans, described in 29 CFR 2520.104-22, and administrators of pension plans for a select group of management or highly compensated employees, described in 29 CFR 2520.104-23(a) (``top hat plans''), who elect to file the applicable notice and statement described in sections 2520.104-22 and 2520.104-23, respectively, as a condition of relief from the annual reporting requirements may, in lieu of filing any past due annual report and paying otherwise applicable civil penalties, comply with the requirements of this Section 4. Administrators who have complied with the requirements of this Section 4 shall be considered as having elected compliance with the exemption(s) and/or alternative method of compliance prescribed in Secs. 2520.104-22, or 2520.104-23, as appropriate, for all subsequent plan years.

.02 Filing Applicable Notice or Statement with the U.S. Department of Labor.

The plan administrator must prepare and file a notice or statement meeting the requirements of Secs. 2520.104-22, or 2520.104-23, as appropriate.

The apprenticeship and training plan notice described in Sec. 2520.104-22 shall be sent by mail or by private delivery service to: Apprenticeship and Training Plan Exemption, Pension and Welfare Benefits Administration, Room N-1513, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210.

The ``top hat'' plan statement described in Sec. 2520.104-23 shall be sent by mail or by private delivery service to: Top Hat Plan Exemption, Pension and Welfare Benefits Administration, Room N-1513, U.S. Department of Labor, 200 Constitution Avenue NW., Washington, DC 20210.

Note: A plan sponsor maintaining more than one ``top hat'' plan is not required to file a separate statement for each such plan. See Sec. 2520.104-23(b).

.03 Payment of Applicable Penalty Amount.

(a) The plan administrator shall pay the applicable penalty amount by submitting to the DFVC Program the information described in subparagraph (b) along with a check made payable to the ``U.S. Department of Labor'' for the applicable penalty amount determined in accordance with subparagraph (c). This submission shall be made by mail to: DFVC Program, PWBA, P.O. Box 530292, Atlanta, GA 30353-0292.

Note: Personal or private delivery service cannot be made to this address.

(b) The administrator shall submit to the DFVC Program with the applicable penalty amount the most current Form 5500 Annual Return/Report (without schedules and attachments). For

purposes of this requirement, the plan administrators must complete Form 5500 line items 1a-1b, 2a-2c, 3a-3c, and use plan number 888 for all ``top hat'' plans and plan number 999 for all apprenticeship and training plans. In the case of plan sponsors maintaining more than one ``top hat'' plan and plan sponsors maintaining more than one apprenticeship and training plan described in Sec. 2520.104-22, the plan administrator shall clearly identify each such plan on the Form 5500 filed with the Department of Labor or on an attachment thereto. The plan administrator also must sign and date the Form 5500.

(c) The applicable penalty amount is $750 for each DFVC submission, without regard to the number of plans maintained by the same plan sponsor for which notices and statements are filed pursuant to Section 4 and without regard to the number of plan participants covered under such plan or plans.

.04 Liability for Applicability Amount.

The plan administrator is personally liable for the payment of civil penalties assessed under section 502(c)(2) of ERISA, therefore, civil penalties, including amounts paid under this DFVC Program, shall not be paid from the assets of an employee benefit plan.

Section 5--Waiver of Right to Notice, Abatement of Assessment and Plan Status

.01 Payment of a penalty under the terms of this DFVC Program constitutes, with regard to the filings submitted under the Program, a waiver of an administrator's right both to receive notices of intent to assess a penalty under Sec. 2560.502c-2 from the Department and to contest the Department's assessment of the penalty amount.

.02 Although this Notice does not provide relief from late filing penalties under the Code, the Internal Revenue Service (IRS) has provided the Department with the following information. The Code and the regulations thereunder require information to be filed on the Form 5500 Series Annual Return/Report and provide the IRS with authority to

impose or assess penalties for failing to timely file. The IRS has agreed to provide certain penalty relief under the Code for delinquent Form 5500 Annual Returns/Reports filed for Title I plans where the conditions of this DFVC Program have been satisfied. See IRS Notice 2002-23.

.03 Although this Notice does not provide relief from late filing penalties under Title IV of ERISA, the Pension Benefit Guaranty Corporation (PBGC) has provided the Department with the following information. Title IV of ERISA and the regulations thereunder require information to be filed on the Form 5500 Series Annual Return/Report and provide the PBGC with authority to assess penalties against a plan administrator under ERISA Sec. 4071 for late filing of the Form 5500 Series Annual Return/Report. The PBGC has agreed that it will not assess a penalty against a plan administrator under ERISA Sec. 4071 for late filing of a Form 5500 Series Annual Return/Report filed for a Title I plan where the conditions of this DFVC Program have been satisfied.

.04 Acceptance by the Department of a filing and penalty payment made pursuant to this DFVC Program does not represent a determinationby the Department of Labor as to the status of the arrangement as a plan, the particular type of plan under Title I or ERISA, the status of the plan sponsor under the Code, or a determination by the Department of Labor that the provisions of Secs. 2520.104-22 or 2520.104-23 have been satisfied.

Signed at Washington, DC, this 25th day of March, 2002.

Ann L. Combs,

Assistant Secretary, Pension and Welfare Benefits Administration, U.S. Department of Labor.

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Department of Labor

Regulation 2550.407a-1

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Part III

Department of Labor

Employee Benefits Security Administration

29 CFR Part 2550

Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule

DEPARTMENT OF LABOR

Employee Benefits Security Administration

29 CFR Part 2550

RIN 1210–AB10

Default Investment Alternatives Under Participant Directed Individual Account Plans

AGENCY: Employee Benefits Security Administration.

ACTION: Final rule.

SUMMARY: This document contains a final regulation that implements recent amendments to title I of the Employee Retirement Income Security Act of 1974 (ERISA) enacted as part of the Pension Protection Act of 2006, Public Law 109–280, under which a participant in a participant directed individual account pension plan will be deemed to have exercised control over assets in his or her account if, in the absence of investment directions from the participant, the plan invests in a qualified default investment alternative. A fiduciary of a plan that complies with this final regulation will not be liable for any loss, or by reason of any breach, that occurs as a result of such investments. This regulation describes the types of investments that qualify as default investment alternatives under section 404(c)(5) of ERISA. Plan fiduciaries remain responsible for the prudent selection and monitoring of the qualified default investment alternative. The regulation conditions relief upon advance notice to participants and beneficiaries describing the circumstances under which contributions or other assets will be invested on their behalf in a qualified default investment alternative, the investment objectives of the qualified default investment alternative, and the right of participants and beneficiaries to direct investments out of the qualified default investment alternative. This regulation will affect plan sponsors and fiduciaries of participant directed individual account plans, the participants and beneficiaries in such plans, and the service providers to such plans.

DATES: This final rule is effective on December 24, 2007.

FOR FURTHER INFORMATION CONTACT: Lisa M. Alexander, Kristen L. Zarenko, or Katherine D. Lewis, Office of Regulations and Interpretations, Employee Benefits Security Administration, (202) 693–8500. This is not a toll-free number.

SUPPLEMENTARY INFORMATION:

A. Background

With the enactment of the Pension Protection Act of 2006 (Pension Protection Act), section 404(c) of ERISA was amended to provide relief afforded by section 404(c)(1) to fiduciaries that invest participant assets in certain types of default investment alternatives in the absence of participant investment direction. Specifically, section 624(a) of the Pension Protection Act added a new section 404(c)(5) to ERISA. Section 404(c)(5)(A) of ERISA provides that, for purposes of section 404(c)(1) of ERISA, a participant in an individual account plan shall be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary of Labor. Section 624(a) of the Pension Protection Act directed that such regulations provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both. In the Department's view, this statutory language provides the stated relief to fiduciaries of any participant directed individual account plan that complies with its terms and with those of the Department's regulation under section 404(c)(5) of ERISA. The relief afforded by section 404(c)(5), therefore, is not contingent on a plan being an ''ERISA 404(c) plan'' or otherwise meeting the requirements of the Department's regulations at § 2550.404c–1. The amendments made by section 624 of the Pension Protection Act apply to plan years beginning after December 31, 2006.

On September 27, 2006, the Department, exercising its authority under section 505 of ERISA and consistent with section 624 of the Pension Protection Act, published a notice of proposed rulemaking in the **Federal Register** (71 FR 56806) that, upon adoption, would implement the provisions of ERISA section 404(c)(5). The notice included an invitation to interested persons to comment on the proposal. In response to this invitation, the Department received over 120 written comments from a variety of parties, including plan sponsors and fiduciaries, plan service providers, financial institutions, and employee benefit plan industry representatives. Submissions are available for review under Public Comments on the Laws & Regulations page of the Department's Employee Benefits Security Administration Web site at *http://www.dol.gov/ebsa*.

Set forth below is an overview of the final regulation, along with a discussion of the public comments received on the proposal.

B. Overview of Final Rule

Scope of the Fiduciary Relief

Paragraph (a)(1) of § 2550.404c–5, like the proposal, generally describes the scope of the regulation and the fiduciary relief afforded by ERISA section 404(c)(5), under which a participant who does not give investment directions will be treated as exercising control over his or her account with respect to assets that the plan invests in a qualified default investment alternative. Paragraph (a)(2) of § 2550.404c–5, also like the proposal, makes clear that the standards set forth in the regulation apply solely for purposes of determining whether a fiduciary meets the requirements of the regulation. These standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under ERISA with respect to the investment of assets on behalf of a participant or beneficiary in an individual account plan who fails to give investment directions. As recognized by the Department in the preamble to the proposal, investments in money market funds, stable value products and other capital preservation investment vehicles may be prudent for some participants or beneficiaries even though such investments themselves may not generally constitute qualified default investment alternatives for purposes of the regulation. The Department further notes that such investments, while not themselves qualified default investment alternatives for purposes of investments made following the effective date of this regulation, may nonetheless constitute part of the investment portfolio of a qualified default investment alternative.

Paragraph (b) of § 2550.404c–5 defines the scope of the fiduciary relief provided. Paragraph (b)(1) of the proposal provided that, subject to certain exceptions, a fiduciary of an individual account plan that permits participants and beneficiaries to direct the investment of assets in their accounts and that meets the conditions of the regulation, as set forth in paragraph (c) of § 2550.404c–5, shall not be liable for any loss, or by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of investing all or part of a

participant's or beneficiary's account in a qualified default investment alternative, or of investment decisions made by the entity described in paragraph (e)(3) in connection with the management of a qualified default investment alternative. The Department has revised paragraph (b)(1) of the final regulation to clarify that a fiduciary of an individual account plan that permits participants and beneficiaries to direct the investment of assets in their accounts and that meets the conditions of the regulation, as set forth in paragraph (c) of § 2550.404c–5, shall not be liable for any loss under part 4 of title I, or by reason of any breach, that is the direct and necessary result of investing all or part of a participant's or beneficiary's account in any qualified default investment alternative within the meaning of paragraph (e), or of investment decisions made by the entity described in paragraph (e)(3) in connection with the management of a qualified default investment alternative. The phrase ''any qualified default investment alternative'' in the final regulation is intended to make clear that a fiduciary will be afforded relief without regard to which type of qualified default investment alternative the fiduciary selects, provided that the fiduciary prudently selects the particular product, portfolio or service, and meets the other conditions of the regulation.

Some commenters asked whether the relief provided by the final regulation covers a plan fiduciary's decision regarding which of the qualified default investment alternatives will be available to a plan's participants and beneficiaries who fail to direct their investments. As long as a plan fiduciary selects any of the qualified default investment alternatives, and otherwise complies with the conditions of the rule, the plan fiduciary will obtain the fiduciary relief described in the rule. The Department believes that each of these qualified default investment alternatives is appropriate for participants and beneficiaries who fail to provide investment direction; accordingly, the rule does not require a plan fiduciary to undertake an evaluation as to which of the qualified default investment alternatives provided for in the regulation is the most prudent for a participant or the plan. However, the plan fiduciary must prudently select and monitor an investment fund, model portfolio, or investment management service within any category of qualified default investment alternatives in accordance with ERISA's general fiduciary rules. For example, a plan fiduciary that chooses an investment management service that is intended to comply with paragraph (e)(4)(iii) of the final regulation must undertake a careful evaluation to prudently select among different investment management services.

Application of General Fiduciary Standards

The scope of fiduciary relief provided by this regulation is the same as that extended to plan fiduciaries under ERISA section 404(c)(1)(B) in connection with carrying out investment directions of plan participants and beneficiaries in an ''ERISA section 404(c) plan'' as described in 29 CFR 2550.404c–1(a), although it is not necessary for a plan to be an ERISA section 404(c) plan in order for the fiduciary to obtain the relief accorded by this regulation. As with section 404(c)(1) of the Act and the regulation issued thereunder (29 CFR 2550.404c–1), the final regulation does not provide relief from the general fiduciary rules applicable to the selection and monitoring of a particular qualified default investment alternative or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. See paragraph (b)(2) of § 2550.404c–5.

Several commenters asked the Department to provide additional guidance concerning the general fiduciary obligations of these plan fiduciaries in selecting a qualified default investment alternative. The selection of a particular qualified default investment alternative (i.e. a specific product, portfolio or service) is a fiduciary act and, therefore, ERISA obligates fiduciaries to act prudently and solely in the interest of the plan's participants and beneficiaries. A fiduciary must engage in an objective, thorough, and analytical process that involves consideration of the quality of competing providers and investment products, as appropriate. As with other investment alternatives made available under the plan, fiduciaries must carefully consider investment fees and expenses when choosing a qualified default investment alternative. See paragraph (b)(2) of § 2550.404c–5.

Paragraph (b)(3) of the final regulation has been modified to reflect changes to paragraph (e)(3)(i) regarding persons responsible for the management of a qualified default investment alternative's assets. Paragraph (b)(3) of § 2550.404c–5 makes clear that nothing in the regulation relieves any such fiduciaries from their general fiduciary duties or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses. As proposed, paragraph (b)(3) was limited to investment managers. The final regulation, at paragraph (e)(3)(i) of § 2550.404c–5, broadens the category of persons who can manage the assets of a qualified default investment alternative, thereby requiring a conforming change to paragraph (b)(3). The changes to paragraph (e)(3)(i) are discussed in detail below.

Finally, the regulation also provides no relief from the prohibited transaction provisions of section 406 of ERISA or from any liability that results from a violation of those provisions, including liability for any resulting losses. Therefore, plan fiduciaries must avoid self-dealing, conflicts of interest, and other improper influences when selecting a qualified default investment alternative. See paragraph (b)(4) of § 2550.404c–5.

Application of Final Rule to Circumstances Other Than Automatic Enrollment

Several commenters requested clarification on the extent to which the fiduciary relief provided by the final regulation will be available to plan fiduciaries for assets that are invested in a qualified default investment alternative on behalf of participants and beneficiaries in circumstances other than automatic enrollment. Consistent with the views expressed concerning the scope of the relief provided by the proposed regulation, it is the view of the Department that nothing in the final regulation limits the application of the fiduciary relief to investments made only on behalf of participants who are automatically enrolled in their plan. Like the proposal, the final regulation applies to situations beyond automatic enrollment. Examples of such situations include: The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant to provide investment instruction. Whenever a participant or beneficiary has the opportunity to direct the investment of assets in his or her account, but does not direct the investment of such assets, plan fiduciaries may avail themselves of the relief provided by this final regulation, so long as all of its conditions have been satisfied.

Conditions for the Fiduciary Relief

Like the proposal, the final regulation contains six conditions for relief. These

conditions are set forth in paragraph (c) of the regulation.

The first condition of the final regulation, consistent with the Department's proposal, requires that assets invested on behalf of participants or beneficiaries under the final regulation be invested in a ''qualified default investment alternative.'' See § 2550.404c–5(c)(1). This condition is unchanged from the proposal.

The second condition also is unchanged from the proposal. The participant or beneficiary on whose behalf assets are being invested in a qualified default investment alternative must have had the opportunity to direct the investment of assets in his or her account but did not direct the investment of the assets. See § 2550.404c–5(c)(2). In other words, no relief is available when a participant or beneficiary has provided affirmative investment direction concerning the assets invested on the participant's or beneficiary's behalf.

The third condition continues to require that participants or beneficiaries receive information concerning the investments that may be made on their behalf. As in the proposal, the final regulation requires both an initial notice and an annual notice. The proposed regulation required an initial notice within a reasonable period of time of at least 30 days in advance of the first investment. A number of commenters explained that requiring 30 days' advance notice would preclude plans with immediate eligibility and automatic enrollment from withholding of contributions as of the first pay period. Commenters argued that plan sponsors should not be discouraged from enrolling employees in their plan on the earliest possible date.

The Department agrees that plan sponsors should not be discouraged from enrolling employees on the earliest possible date. To address this issue, the Department has modified the advance notice requirements that appeared in the proposed regulation. For purposes of the initial notification requirement, the final regulation, at paragraph (c)(3)(i), provides that the notice must be provided (A) at least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of any first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2), or (B) on or before the date of plan eligibility, provided the participant has the opportunity to make a permissible withdrawal (as determined under section 414(w) of the Internal Revenue Code of 1986 (Code)).

With regard to the foregoing, the Department notes that, unlike the proposal, the final regulation measures the time period for the 30-day advance notice requirement from the date of plan eligibility to better coordinate the notice requirements with the Code provisions governing permissible withdrawals. The Department also notes that if a fiduciary fails to comply with the final regulation for a participant's first elective contribution because a notice is not provided at least 30 days in advance of plan eligibility, the fiduciary may obtain relief for later contributions with respect to which the 30-day advance notice requirement is satisfied.

In addition, while retaining the general 30-day advance notice requirement, the final regulation also permits notice ''on or before'' the date of plan eligibility if the participant is permitted to make a permissible withdrawal in accordance with 414(w) of the Code. In this regard, the Department believes that if participants are not going to be afforded the option of withdrawing their contributions without additional tax, such participants should be given notice sufficiently in advance of the contribution to enable them to opt out of plan participation.

The Department notes that the phrase in paragraph (c)(3)(i)—''or at least 30 days in advance of any first investment in a qualified default investment alternative''—is intended to accommodate circumstances other than elective contributions. For example, although fiduciary relief would not be available with respect to a fiduciary's investment of a participant or beneficiary's rollover amount from another plan into a qualified default investment alternative if the 30-day advance notice requirement is not satisfied, relief may be available when a fiduciary invests the rollover amount into a qualified default investment alternative after satisfying the notice requirement in paragraph (c)(3)(i)(A) as well as the regulation's other conditions.

Finally, the phrase—''in advance of the date of plan eligibility * * * or any first investment in a qualified default investment alternative''—is not intended to foreclose availability of relief to fiduciaries that, prior to the adoption of the final regulation, invested assets on behalf of participants and beneficiaries in a default investment alternative that would constitute a ''qualified default investment alternative'' under the regulation. In such cases, the phrase—''in advance of the date of plan eligibility * * * or any first investment''—should be read to mean the first investment with respect to which relief under the final regulation is intended to apply after the effective date of the regulation.

The timing of the annual notice requirement contained in the final regulation has not changed from the proposal. Notice must be provided within a reasonable period of time of at least 30 days in advance of each subsequent plan year. See § 2550.404c–5(c)(3)(ii). One commenter requested that the Department eliminate the annual notice requirement. The Department retained the annual notice requirement because the Pension Protection Act specifically amended ERISA to require an annual notice. Further, the Department believes that it is important to provide regular and ongoing notice to participants and beneficiaries whose assets are invested in a qualified default investment alternative to ensure that they are in a position to make informed decisions concerning their participation in their employer's plan. Several commenters supported the furnishing of an annual reminder to participants and beneficiaries that their assets have been invested in a qualified default investment alternative and that participants and beneficiaries may direct their contributions into other investment alternatives available under the plan.

Paragraph (c)(3), as proposed, provided that the required disclosures could be included in a summary plan description, summary of material modification or other notice meeting the requirements of paragraph (d), which described the content required in the notice. Some commenters expressed concern that permitting the notice requirement to be satisfied though a plan's summary plan description or summary of material modification may result in participants overlooking or ignoring information relating to their participation and the investment of contributions on their behalf. The Department is persuaded that, given the potential length and complexity of summary plan descriptions and summaries of material modifications, the furnishing of the required disclosures through a separate notice will reduce the likelihood of a participant or beneficiary missing or ignoring information about his or her plan participation and the investment of the assets in his or her account in a qualified default investment alternative. Accordingly, the final regulation, at paragraph (c)(3), has been modified to eliminate references to providing notice through a summary plan description or

summary of material modifications. The Department notes that the notice requirements of ERISA section 404(c)(5)(B) and this regulation, and the notice requirements of sections 401(k)(13)(E) and 414(w)(4) of the Code, as amended by the Pension Protection Act, are similar. Accordingly, while the final regulation provides for disclosure through a separate notice, the Department anticipates that the notice requirements of this final regulation and the notice requirements of sections 401(k)(13)(E) and 414(w)(4) of the Code could be satisfied in a single disclosure document. Further, the Department notes that nothing in the regulation should be construed to preclude the distribution of the initial or annual notices with other materials being furnished to participants and beneficiaries. In this regard, the Department recognizes that there may be cost savings that result from distributing multiple disclosures simultaneously and, to the extent that distribution costs may be charged to the accounts of individual participants and beneficiaries, efforts to minimize such costs should be encouraged.

The fourth condition of the proposed regulation required that, under the terms of the plan, any material provided to the plan relating to a participant's or beneficiary's investment in a qualified default investment alternative (e.g., account statements, prospectuses, proxy voting material) would be provided to the participant or beneficiary. See proposed regulation § 2550.404c–5(c)(4). Several commenters asked the Department to clarify whether the phrase ''under the terms of the plan'' would require plan amendments to explicitly incorporate the proposed rule's disclosure provision. Commenters suggested that paragraph (c)(4) of the proposal could be read to require that the disclosure provisions be described in the formal plan document, and the commenters suggested that it is unclear what documents would suffice to meet this condition. The phrase ''under the terms of the plan'' was merely intended to ensure that plans provide for the required pass-through of information. Taking into account both the fact that a pass-through of information is a specific condition of the regulation and the comments on this provision, the Department has concluded that the phrase is confusing and not necessary. Accordingly, the phrase ''under the terms of the plan'' has been removed from paragraph (c)(4) of the final regulation. See § 2550.404c–5(c)(4).

Commenters also requested clarification as to the material intended to be included in the reference to ''material provided to the plan'' in paragraph (c)(4). Specifically, commenters inquired whether material provided to the plan includes information within the custody of a plan service provider or the fiduciary responsible for selecting a qualified default investment alternative, and whether ''material provided to the plan'' includes aggregate, plan-level information received by the plan. Commenters also asked for clarification regarding the manner in which information shall be ''provided to the participant or beneficiary'' in paragraph (c)(4) of the proposed regulation. A number of commenters suggested that the final regulation permit disclosure of information upon request; others recommended that the disclosure requirement should be satisfied by including a statement in the notice required by paragraph (c)(3) of the proposed regulation that provides direction to a participant or beneficiary regarding where he or she can find information about the qualified default investment alternatives. Other commenters asked whether plans could make materials available to a participant or beneficiary instead of affirmatively providing materials to them.

Other commenters suggested that a participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative should not be required to be furnished more material than is required to be furnished to those individuals who direct their investments. In this regard, commenters recommended that the Department apply the same standard set forth in the section 404(c) regulation for the pass-through of information to both participants who fail to direct their investments and participants who elect to direct their investments.

The Department believes that participants who fail to direct their investments should be furnished no less information than is required to be passed through to participants who elect to direct their investments under the plan. The Department also believes there is little, if any, basis for requiring defaulted participants to be furnished more information than is required to be passed through to other participants. For this reason, the Department has adopted the recommendation of those commenters that the pass-through disclosure requirements applicable to section 404(c) plans be applied to the pass-through of information under the final regulation. The Department, therefore, has modified paragraph (c)(4) to provide that a fiduciary shall qualify for the relief described in paragraph (b)(1) of the final regulation if a fiduciary provides material to participants and beneficiaries as set forth in paragraphs (b)(2)(i)(B)(1)(viii) and (ix), and paragraph (b)(2)(i)(B)(2) of the 404(c) regulation, relating to a participant's or beneficiary's investment in a qualified default investment alternative. The Department notes that, as part of a separate regulatory initiative, it is reviewing the disclosure requirements applicable to participants and beneficiaries in participant-directed individual account plans and that, to the extent that the pass-through disclosure requirements contained in § 2550.404c–1 are amended, the language of paragraph (c)(4), as modified, will ensure such amendments automatically extend to § 2550.404c–5. The Department notes, in responding to one commenter's request for clarification, that the plan's obligation to pass through information to participants or beneficiaries would be considered satisfied if the required information is furnished directly to the participant or beneficiary by the provider of the investment alternative or other third-party.

The fifth condition of the proposal required that any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative be afforded the opportunity, consistent with the terms of the plan (but in no event less frequently than once within any three month period), to transfer, in whole or in part, such assets to any other investment alternative available under the plan without financial penalty. See proposed regulation § 2550.404c–5(c)(5). This provision was intended to ensure that participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative have the same opportunity as other plan participants and beneficiaries to direct the investment of their assets, and that neither the plan nor the qualified default investment alternative impose financial penalties that would restrict the rights of participants and beneficiaries to direct their assets to other investment alternatives available under the plan. This provision was not intended to confer greater rights on participants or beneficiaries whose accounts the plan invests in qualified default investment alternatives than are otherwise available under the plan. Thus, if a plan provides participants and beneficiaries the right to direct investments on a quarterly basis, those participants and beneficiaries with investments in a qualified default investment alternative need only be afforded the opportunity to direct their

investments on a quarterly basis. Similarly, if a plan permits daily investment direction, participants and beneficiaries with investments in a qualified default investment alternative must be permitted to direct their investments on a daily basis.

The Department received many comments requesting clarification on this requirement, most often concerning what the Department considers to be a financial penalty. Commenters asked whether investment-level fees and restrictions, as opposed to fees or other restrictions that are imposed by the plan or the plan sponsor, would be considered impermissible restrictions or ''financial penalties.'' Commenters explained that fees and limitations that are part of the investment product are beyond the control of the plan sponsor and should not be considered financial penalties for purposes of the final regulation. The comment letters provided many examples of investment-level fees or restrictions that commenters believed should not be considered punitive, including redemption fees, back-end sales loads, reinvestment timing restrictions, market value adjustments, equity ''wash'' restrictions, and surrender charges.

In response to these and other comments, the Department has modified and restructured paragraph (c)(5) of the final regulation to provide more clarity with respect to limitations that may or may not be imposed on participants and beneficiaries who are defaulted into a qualified default investment alternative. As modified and restructured, paragraph (c)(5) of the final regulation includes three conditions applicable to a defaulted participant's or beneficiary's ability to move assets out of a qualified default investment alternative.

The first condition, as in the proposal, is intended to ensure that defaulted participants and beneficiaries have the same rights as other participants and beneficiaries under the plan regarding the frequency with which they may direct an investment out of a qualified default investment alternative. In this regard, paragraph (c)(5)(i) provides that any participant or beneficiary on whose behalf assets are invested in a qualified default investment alternative must be able to transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded participants and beneficiaries who elect to invest in the qualified default investment alternative, but not less frequently than once within any three month period. The Department received no substantive comments on this provision and it is being adopted unchanged from the proposal.

The second and third conditions, at paragraphs (c)(5)(ii) and (iii), relate to limitations (i.e., restrictions, fees, etc.) other than those relating to the frequency with which participants may direct their investment out of a qualified default investment alternative, which are addressed in paragraph (c)(5)(i). Unlike the proposal, which limited the imposition of financial penalties for the period of a defaulted participant's or beneficiary's investment, the regulation, as modified, precludes the imposition of any restrictions, fees or expenses (other than investment management and similar types of fees and expenses) during the first 90 days of a defaulted participant's or beneficiary's investment in the qualified default investment alternative. At the end of the 90-day period, defaulted participants and beneficiaries may be subject to the restrictions, fees or expenses that are otherwise applicable to participants and beneficiaries under the plan who elected to invest in that qualified default investment alternative. While the condition on restrictions, fees and expenses is limited to 90 days, the condition, as explained below, is broad in its application, thereby providing defaulted participants and beneficiaries an opportunity to redirect or withdraw their contributions. Also, the Department believes that restrictions or fees on qualified default investment alternatives are more likely to be waived if this period is shortened to 90 days. The 90-day period is defined by reference to the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, thereby enabling participants, if their plan permits, to make a permissible withdrawal without being subject to the 10 percent additional tax under section 72(t) of the Code.

Specifically, paragraph (c)(5)(ii) of the regulation provides that any transfer or permissible withdrawal described in paragraph (c)(5) resulting from a participant's or beneficiary's election to make such a transfer or withdrawal during the 90-day period beginning on the date of the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, or other first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2), shall not be subject to any restrictions, fees or expenses (except those fees and expenses that are charged on an ongoing basis for the investment itself, such as investment management and similar fees, and are not imposed, or do not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the investment alternative). Accordingly, no restriction, fee, or expense may be imposed on any transfer or permissible withdrawal of assets, whether assessed by the plan, the plan sponsor, or as part of an underlying investment product or portfolio, and regardless of whether or not the restriction, fee, or expense is considered to be a ''penalty.'' This provision, therefore, would prevent the imposition of any surrender charge, liquidation or exchange fee, or redemption fee. It also would prohibit any market value adjustment or ''round-trip'' restriction on the ability of the participant or beneficiary to reinvest within a defined period of time. As long as the participant's or beneficiary's election is made within the applicable 90-day period, no such charges may be imposed even if, due to administrative or other delays, the actual transfer or withdrawal does not take place until after the 90-day period.

Paragraph (c)(5)(ii)(B) makes clear that the limitations of paragraph (c)(5)(ii)(A) do not apply to fees and expenses that are charged on an ongoing basis for the operation of the investment itself, such as investment management fees, distribution and/or service fees (''12b–1'' fees), and administrative-type fees (legal, accounting, transfer agent expenses, etc.), and are not imposed, or do not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the investment alternative. In response to a request for a clarification, the Department further notes that to the extent that a participant or beneficiary loses the right to elect an annuity as a result of a transfer out of a qualified default investment alternative with an annuity feature, such loss would not constitute an impermissible restriction for purposes of paragraph (c)(5)(ii) inasmuch as the annuity feature is a component of the investment alternative itself.

Paragraph (c)(5)(iii) of the final regulation provides that, following the end of the 90-day period described in paragraph (c)(5)(ii)(A), any transfer or permissible withdrawal described in paragraph (c)(5) shall not be subject to any restrictions, fees or expenses not otherwise applicable to a participant or beneficiary who elected to invest in that qualified default investment alternative. This provision is intended to ensure that defaulted participants and beneficiaries are not subject to restrictions, fees or penalties that would serve to create a greater disincentive for defaulted participants and beneficiaries, than for other participants and

beneficiaries under the plan, to withdraw or transfer assets from a qualified default investment alternative.

The Department notes that the final rule does not otherwise address or provide relief with respect to the direction of investments out of a qualified default investment alternative into another investment alternative available under the plan. See generally section 404(c)(1) of ERISA and 29 CFR 2550.404c–1.

The last condition of paragraph (c) of the regulation adopts, without modification from the proposal, the requirement that plans offer participants and beneficiaries the opportunity to invest in a ''broad range of investment alternatives'' within the meaning of 29 CFR 2550.404c–1(b)(3).[1] See § 2550.404c–5(c)(6). The Department believes that participants and beneficiaries should be afforded a sufficient range of investment alternatives to achieve a diversified portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the pension plan participant or beneficiary. The Department believes that the application of the ''broad range of investment alternatives'' standard of the section 404(c) regulation accomplishes this objective. The Department received no substantive objections to this provision and, as indicated, is adopting the provision without change.

Notices

As discussed above, relief under the final regulation is conditioned on furnishing participants and beneficiaries advance notification concerning the default investment provisions of their plan. See § 2550.404c–5(c)(3). The specific information required to be contained in the notice is set forth in paragraph (d) of the regulation.

As proposed, paragraph (d) of § 2550.404c–5 required that the notice to participants and beneficiaries be written in a manner calculated to be understood by the average plan participant and contain the following information: (1) A description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant and beneficiary in a qualified default investment alternative; (2) a description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative; (3) a description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees, or expenses in connection with such transfer; and (4) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

A few commenters suggested expanding the content of the notice to include procedures for electing other investment options, a description of the right to request additional information, a description of any right to obtain investment advice (if available), a description of fees associated with the qualified default investment alternatives, information about other investment options under the plan, etc. While the Department did not adopt all of the changes suggested by the commenters, the Department has modified the notice content requirements to broaden the required disclosures. As modified, the Department intends that the furnishing of a notice in accordance with the timing and content requirements of this regulation will not only satisfy the notice requirements of section 404(c)(5)(B) of ERISA but also the notice requirements under the preemption provisions of ERISA section 514 applicable to an ''automatic contribution arrangement,'' within the meaning of ERISA section 514(e)(2).

ERISA section 404(c)(5)(B)(i)(I) provides for the furnishing of a notice explaining ''the employee's right under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election by the participant, such contributions and earnings will be invested.'' ERISA section 514(e)(1) provides for the preemption of State laws that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. Section 514(e)(3) provides that a plan administrator of an automatic contribution arrangement shall provide a notice describing the rights and obligations of participants under the arrangement and such notice shall include ''an explanation of the participant's right under the arrangement not to have elective contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage)'' and an explanation of ''how contributions made under the arrangement will be invested in the absence of any investment election by the participant.''

In addition to broadening the required disclosures, the Department revised the disclosures relating to restrictions, fees and expenses to conform the notice requirements to the changes in paragraph (c)(5) relating to restrictions, fees or expenses. As modified, paragraph (d) of the final regulation provides that the notices required by paragraph (c)(3) shall include: (1) A description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contribution, and the right of the participant to elect not to have such contributions made on his or her behalf (or to elect to have such contributions made at a different percentage); (2) an explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts; (3) a description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative; (4) a description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and (5) an explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

Other commenters suggested that the Department provide a model notice.

[1] 29 CFR 2550.404c–1(b)(3) provides that ''[a] plan offers a broad range of investment alternatives only if the available investment alternatives are sufficient to provide the participant or beneficiary with a reasonable opportunity to: (A) Materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject; (B) Choose from at least three investment alternatives: (1) each of which is diversified; (2) each of which has materially different risk and return characteristics; (3) which in the aggregate enable the participant or beneficiary by choosing among them to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary; and (4) each of which when combined with investments in the other alternatives tends to minimize through diversification the overall risk of a participant's or beneficiary's portfolio; * * *''

Because applicable plan provisions and qualified default investment alternatives may vary considerably from plan to plan, the Department believes it would be difficult to provide model language that is general enough to accommodate different plans and different investment products and portfolios and that would allow sufficient flexibility to plan sponsors. Accordingly, the final regulation does not include model language for plan sponsors. However, the Department will explore this concept in the future in coordination with the Department of Treasury concerning the similar notice requirements contained in sections 401(k)(13)(E) and 414(w) of the Code.

Commenters also requested guidance concerning the extent to which the final regulation's notice requirements could be satisfied by electronic distribution. The Department currently is reviewing its rules relating to the use of electronic media for disclosures under title I of ERISA. In the absence of guidance to the contrary, it is the view of the Department that plans that wish to use electronic means by which to satisfy their notice requirements may rely on either guidance issued by the Department of Labor at 29 CFR 2520.104b–1(c) or the guidance issued by the Department of the Treasury and Internal Revenue Service at 26 CFR 1.401(a)–21 relating to the use of electronic media.

Qualified Default Investment Alternatives

Under the final regulation, as in the proposal, relief from fiduciary liability is provided with respect to only those assets invested on behalf of a participant or beneficiary in a ''qualified default investment alternative.'' See § 2550.404c–5(c)(1). Paragraph (e) of § 2550.404c–5 sets forth four requirements for a ''qualified default investment alternative.''

The first requirement, at paragraph (e)(1), addresses investments in employer securities. As indicated in the preamble to the proposal, while the Department does not believe it is appropriate for a qualified default investment alternative to encourage investments in employer securities, the Department also recognizes that an absolute prohibition against holding or investing in employer securities may be unnecessarily limiting and complicated. Accordingly, the proposal, in addition to establishing a general prohibition against qualified default investment alternatives holding or permitting acquisition of employer securities, provided two exceptions to the rule. While, as discussed below, the Department did receive comments generally requesting different or expanded exceptions to the general prohibition, the Department has determined it appropriate to adopt paragraph (e)(1) without modification from the proposal.

The two exceptions to the general prohibition are set forth in paragraph (e)(1)(ii). The first exception applies to employer securities held or acquired by an investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a–1, *et seq.*, or a similar pooled investment vehicle (e.g., a common or collective trust fund or pooled investment fund) regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof.

Several commenters suggested that the exception to investments in employer securities should extend to circumstances when the plan sponsor delegates investment responsibilities to an ERISA section 3(38) investment manager and with respect to which the plan sponsor has no discretion regarding the acquisition or holding of employer securities. The Department did not adopt this suggestion because in such instances the investment manager may be following the investment policies established by the plan sponsor, and, while the plan sponsor may not be directly exercising discretion with respect to the acquisition or holding of employer securities, the plan sponsor might indirectly be influencing such decision through an investment policy that requires the investment manager to acquire or hold various amounts of employer securities. In the Department's view, limiting the exception to regulated financial institutions avoids this type of problem.

Another commenter suggested that the Department limit qualified default investment alternatives to a 10% investment in employer securities. The Department did not adopt this suggestion because it believes that a percentage limit test would effectively require that a plan sponsor or other fiduciary monitor on a daily, if not more frequent, basis the specific holdings of the qualified default investment alternative and fluctuations in the value of the assets in the qualified default investment alternative to determine compliance with a percentage limit. Such a test would, in the Department's view, result in considerable uncertainty as to whether at any given time the intended designated qualified default investment alternative actually met the requirements of the regulation. The Department believes that the approach it has taken to limiting employer securities provides both flexibility and certainty.

The second exception is for employer securities acquired as a matching contribution from the employer/plan sponsor or at the direction of the participant or beneficiary. This exception is intended to make clear that an investment management service will not be precluded from serving as a qualified default investment alternative under § 2550.404c–5(e)(4)(iii) merely because the account of a participant or beneficiary holds employer securities acquired as matching contributions from the employer/plan sponsor, or acquired as a result of prior direction by the participant or beneficiary; however, an investment management service will be considered to be serving as a qualified default investment alternative only with respect to assets of a participant's or beneficiary's account over which the investment management service has authority to exercise discretion.

In the case of employer securities acquired as matching contributions that are subject to a restriction on transferability, relief would not be available with respect to such securities until the investment management service has an unrestricted right to transfer the securities. Although an investment management service would be responsible for determining whether and to what extent the account should continue to hold investments in employer securities, the investment management service could not, except as part of an investment company or similar pooled investment vehicle, exercise its discretion to acquire additional employer securities on behalf of an individual account without violating § 2550.404c–5(e)(1).

In the case of prior direction by a participant or beneficiary, if the participant or beneficiary provided investment direction with respect to employer securities, but failed to provide investment direction following an event, such as a change in investment alternatives, and the terms of the plan provide that in such circumstances the account's assets are invested in a qualified default investment alternative, the final regulation continues to permit an investment management service to hold and manage those employer securities in the absence of participant or beneficiary direction. Although the investment management service may not acquire additional employer securities using participant

contributions, the investment management service may reduce the amount of employer securities held by the account of the participant or beneficiary.

One commenter suggested that the exception be extended to qualified default investment alternatives other than the investment management service described in paragraph (e)(4)(iii). An employer securities match can only constitute part of a qualified default investment alternative if the fiduciary selects an investment management service as the qualified default investment alternative, because only in the investment management service context is the responsible fiduciary undertaking the duty to evaluate the appropriate exposure to employer securities for a particular participant or beneficiary and undertaking the obligation to sell employer securities until the participant's or beneficiary's account reflects that appropriate exposure. Accordingly, the Department declines to adopt the commenter's suggestion to expand the second employer securities exception to other qualified default investment alternatives. The Department further notes that this regulation does not provide relief for the acquisition of employer securities by an investment service.

The second requirement, at paragraph (e)(2), is intended to ensure that the qualified default investment alternative itself does not impose any restrictions, fees or expenses inconsistent with the requirements of paragraph (c)(5) of § 2550.404c–5. While the provision has been redrafted for clarity, it is substantively the same as in the proposal and, therefore, is being adopted without substantive change.

The third requirement, at paragraph (e)(3), addresses the management of a qualified default investment option. As proposed, the regulation required that a qualified default investment alternative be either managed by an investment manager, as defined in section 3(38) of the Act, or an investment company registered under the Investment Company Act of 1940. Several commenters suggested that requiring a qualified default investment alternative to be managed by an investment manager, or to be an investment company, is too restrictive.

A number of commenters noted that section 3(38) of ERISA excludes from the definition of the term ''investment manager'' named fiduciaries, as defined in section 402(a)(2) of ERISA [2] and trustees.[3] With regard to named fiduciaries, commenters pointed out that a number of employers serve as named fiduciaries and manage their plan investments in-house, resulting in reduced administrative and investment management costs. Commenters also noted that implementation of the requirement as proposed would eliminate the ability of plan sponsors who are named fiduciaries to directly manage a qualified default investment alternative, use asset allocation models, develop asset allocations themselves, or engage investment consultants (who may or may not be fiduciaries) to assist in the development of asset allocations. Other commenters, however, suggested that the final regulation retain the requirement that only investment managers within the meaning of section 3(38) of ERISA or registered investment companies be permitted to manage qualified default investment alternatives. Commenters suggested that investment management decisions should be made by investment professionals who are investment managers within the meaning of section 3(38) of ERISA; they asserted that requiring a 3(38) manager is safer and more prudent than other alternatives, and such requirement is administratively feasible.

With regard to permitting plan sponsors to manage a qualified default investment alternative, the Department is persuaded that a plan sponsor's willingness to serve as a named fiduciary responsible for the management of the plan's investment options in conjunction with the potential cost savings to plan participants that can result from such management, is a sufficient basis to expand the regulation to permit plan sponsors that are named fiduciaries to manage a qualified default investment alternative. This modification is reflected in paragraph (e)(3)(i)(C).

A number of commenters also indicated that, under the proposal, investment consultants engaged by plan sponsors would have to assume fiduciary responsibility for asset allocations in order to obtain relief under the proposal. These commenters suggested that requiring an investment consultant to assume fiduciary responsibility for asset allocation would increase costs for the provision of such consulting services, and that these costs inevitably would be passed along to participants. Commenters also asserted that the use of asset allocation models is well-established and is often an effective way to lower costs and to provide a clean structure and process for the formation, selection and monitoring of all elements of a prudent default investment alternative. The commenters also noted that many plan sponsors develop generic asset allocations and select particular funds, tailored to a particular plan, with the input of an investment consultant who may be an investment adviser under the Investment Advisers Act of 1940. With regard to these comments, the Department continues to believe that when plan fiduciaries are relieved of liability for underlying investment management/asset allocation decisions, those responsible for the investment management/asset allocation decisions must be fiduciaries and those fiduciaries must acknowledge their fiduciary responsibility and liability under the ERISA. The Department notes, however, that plan sponsors who serve as named fiduciaries of a qualified default investment alternative may, to the extent they consider it prudent, engage investment consultants, utilize asset allocation models (computer-based or otherwise), etc. to carry out their investment management/asset allocation responsibilities. Accordingly, the Department does not believe the regulation in this regard should to any significant degree alter the availability or cost of such services.

With regard to the exclusion of trustees from the ''investment manager'' definition, commenters suggested that the final regulation make clear that bank trustees of collective investment funds are permitted to manage a qualified default investment alternative. In this regard, commenters noted that the definition of ''investment managers'' recognizes that banks and other

[2] Section 402(a)(2) of ERISA provides that the term ''named fiduciary'' means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary by a person who is an employer or employee organization with respect to the plan, or by such an employer and such an employee organization acting jointly.

[3] Section 3(38) defines the term ''investment manager'' to mean any fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2))—(A) who has the power to manage, acquire, or dispose of any asset of a plan; (B) who (i) is registered as an investment adviser under the Investment Advisers Act of 1940 [15 U.S.C. 80b–1 *et seq.*]; (ii) is not registered as an investment adviser under such Act by reason of paragraph (1) of section 203A(a) of such Act [15 U.S.C. 80b–3a(a)], is registered as an investment adviser under the laws of the State (referred to in such paragraph (1)) in which it maintains its principal office and place of business, and, at the time the fiduciary last filed the registration form most recently filed by the fiduciary with such State in order to maintain the fiduciary's registration under the laws of such State, also filed a copy of such form with the Secretary; (iii) is a bank, as defined in that Act; or (iv) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and (C) has acknowledged in writing that he is a fiduciary with respect to the plan.

institutions can be investment managers, citing ERISA section 3(38)(B)(ii) and (iii), and should not be foreclosed from managing a qualified default investment alternative solely on the basis that the institution might otherwise serve as a trustee. These commenters noted that, similar to investment managers, banks as trustees of collective funds have fiduciary responsibility and liability under ERISA with respect to the funds they maintain. The Department is persuaded that an entity that meets the requirements of section 3(38)(A), (B) and (C) should not be precluded from assuming fiduciary responsibility and liability for the underlying investment management/asset allocation decisions of a qualified default investment alternative solely because that entity serves in a trustee capacity for the plan.[4] The Department has modified the final regulation accordingly. This modification is reflected in paragraph (e)(3)(i)(B).

In response to a request from one commenter, the Department confirms that the provisions of the regulation do not preclude a qualified default investment alternative from having more than one fiduciary (e.g., investment manager) responsible for the investment management/asset allocation decisions of the investment alternative, as would be the case in an arrangement utilizing a ''fund of funds'' approach to designing a qualified default investment alternative.

As with the proposal, the regulation permits a qualified default investment alternative to be an investment company registered under the Investment Company Act of 1940. See paragraph (e)(3)(ii) of § 2550.404c–5.

In addition to the foregoing, paragraph (e)(3) has been expanded to include certain capital preservation products and funds described in paragraph (e)(4)(iv) and (v) of § 2550.404c–5. These products and funds are discussed below.

The last requirement for a qualified default investment alternative conditions relief on the use of specified types of investment fund products, model portfolios or services. See § 2550.404c–5(e)(4). In the proposal, the Department identified three categories of investment alternatives that it determined appropriate for achieving meaningful retirement savings over the long-term for those participants and beneficiaries who, for one reason or another, do not elect to direct the investment of their pension plan assets. After careful consideration of all the comments concerning the nature and type of the investment alternatives that should be included as qualified default investment alternatives under the regulation, the Department, as discussed below, has decided to retain the three proposed categories of investment alternatives, essentially unchanged from the proposal, as the type of alternatives appropriate for default investments under the regulation. However, in recognition of the fact that some plan sponsors may find it desirable to reduce investment risks for all or part of their workforce following employees' initial enrollment in the plan, the Department has added a limited capital preservation option that would constitute a qualified default investment alternative under the regulation for purposes of contributions made on behalf of a participant for a 120-day period following the date of the participant's first elective contribution. See paragraph (e)(4)(iv). In addition, the Department has modified the regulation to include a ''grandfather''-like provision pursuant to which stable value products and funds will constitute a qualified default investment alternative under the regulation for purposes of investments made prior to the effective date of the regulation. See paragraph (e)(4)(v).

As noted above, the three categories of investment alternatives set forth in the proposal are being adopted essentially unchanged from the proposal. One organizational change appearing in the final regulation involves the inclusion of diversification language in each of three categories, rather than as a separate requirement of general applicability as in the proposal (see paragraph (e)(4) of proposed regulation § 2550.404c–5). This change accommodates the addition of the capital preservation investment alternatives mentioned above that may not, given the nature of the investment, satisfy a diversification standard.

Some commenters expressed concern that the Department's approach to defining qualified default investment alternatives takes into account only products currently available in the marketplace and that the defining of qualified default investment alternatives should be based on more general criteria. These commenters emphasized that the regulation should not stifle creativity in the development of the next generation of retirement products. While the Department does provide examples of products, portfolios and services that would fall within the framework of the various definitions of products, portfolios and services set forth in the regulation, these examples are provided solely for the purpose of providing the benefits community with guidance as to what might be included within the defined categories and are not intended in any way to limit the application of the definitions to such vehicles. The Department believes that, on the basis of the information it has at this time and the comments on the proposal generally, the approach it is taking to defining qualified default investment alternatives for purposes of the regulation is sufficiently flexible to accommodate future innovations and developments in retirement products.

A number of commenters requested clarification concerning application of the regulation to possible qualified default investment alternatives that are offered through variable annuity contracts. Commenters explained that variable annuity contracts typically permit participants to invest in a variety of investments through one or more separate accounts (or sub-accounts within the separate account) that would qualify as qualified default investment alternatives under the regulation. Commenters also requested confirmation that the availability of annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts would not themselves affect the status of a variable annuity contract that otherwise met the requirements for a qualified default investment alternative. Consistent with providing flexibility and encouraging innovation in the development and offering of retirement products, model portfolios or services, the Department intends that the definition of ''qualified default investment alternative'' be construed to include products and portfolios offered through variable annuity and similar contracts, as well as through common and collective trust funds or other pooled investment funds, where the qualified default investment alternative satisfies all of the conditions of the regulation. For purposes of identifying the entity responsible for the management of the qualified default investment alternative in such arrangements pursuant to paragraph (e)(3) of § 2550.404c–5, it is the view of the Department that such a determination is made by reference to the entity (e.g., separate account, sub-account, or similar entity) that is responsible for carrying out the day-to-day investment management/asset allocation responsibilities. Finally, with regard to such products and portfolios,

[4] This position is consistent with the Department's long-held view that the parenthetical language of section 3(38) was merely intended to indicate that in order for a person to be an investment manager for a plan, that person must be more than a mere trustee or named fiduciary. See Advisory Opinion No. 77–69/70A

it is the view of the Department that the availability of annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts will not themselves affect the status of a fund, product or portfolio as a qualified default investment alternative when the conditions of the regulation are satisfied. A new paragraph (e)(4)(vi) was added to the regulation to clarify these principles.

A number of commenters submitted questions or comments concerning the specific investment alternatives described in the regulation.

The first investment alternative set forth in the regulation, at paragraph (e)(4)(i), is an investment fund, product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Consistent with the proposal, the description provides that such products and portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. Also like the proposal, the description makes clear that asset allocation decisions for eligible products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a ''life-cycle'' or ''targeted-retirement-date'' fund or account.

The reference to ''an investment fund product or model portfolio'' is intended to make clear that this alternative might be a ''stand alone'' product or a ''fund of funds'' comprised of various investment options otherwise available under the plan for participant investments. As noted in the proposal, the Department believes that, in the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures.

Several commenters asked the Department to clarify whether a plan fiduciary must, or may, consider demographic or other factors in addition to a participant's age or target retirement date when selecting an investment product intended to satisfy the first category of qualified default investment alternatives. For example, commenters suggested that a plan fiduciary may wish to take into account an employer-provided defined benefit plan or an employer stock contribution when selecting the plan's default investment product. Although the final regulation does not preclude consideration of factors other than a participant's age or target retirement date in these circumstances, the regulation is clear that such considerations are neither required nor necessary as a condition to a fiduciary obtaining relief under the regulation. The Department intended to provide plan fiduciaries with certainty that they have complied with the requirements of the regulation; accordingly, as long as a plan fiduciary satisfies its general obligations under ERISA when selecting any qualified default investment alternative, the fiduciary will not lose the relief provided by the regulation if he or she selects a product, portfolio or service described in the regulation.

One commenter requested clarification concerning the status of ''lifestyle'' funds. ''Lifestyle'' funds were defined as being similar to ''lifecycle'' funds, except that the allocation in a given lifestyle fund does not change over time to become more conservative. That is, the investment manager of a lifestyle fund invests the fund's assets to achieve a predetermined level of risk, such as ''conservative,'' ''moderate,'' or ''aggressive.'' While it does not appear that a lifestyle fund, as defined by the commenter, would by itself satisfy the requirements for a product or portfolio within the meaning of paragraph (e)(4)(i), such a fund could, in the Department's view, constitute part of a qualified default investment alternative within the meaning of paragraph (e)(4)(i). Similarly, nothing in the final regulation precludes an investment manager from allocating a portion of a participant's assets to such a fund as part of a qualified default investment alternative within the meaning of paragraph (e)(4)(iii). It is also possible that a lifestyle fund, as defined by the commenter, might be able to constitute an investment within the meaning of paragraph (e)(4)(ii), an example of which is a ''balanced'' fund.

With respect to the language requiring that the investment fund, product or model portfolio provide varying degrees of long-term appreciation and capital preservation through ''a mix of equity and fixed income exposures,'' one commenter inquired whether the Department intended to exclude funds that had no fixed income exposure, which, according to the commenter, might be appropriate for young individuals many years away from retirement. While the Department believes that such an investment option may be appropriate for individuals actively electing to direct their own investments, the Department believes that when an investment is a default investment, the investment should provide for some level of capital preservation through fixed income investments. Accordingly, the final regulation, like the proposal, continues to require that the qualified default investment alternatives, defined in paragraph (e)(4)(i), (ii) and (iii), be designed to provide degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

The second investment alternative set forth in the regulation, at paragraph (e)(4)(ii), is an investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses, and is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this alternative, asset allocation decisions for such products and portfolios are not required to take into account the age of an individual participant, but rather focus on the participant population as a whole. An example of such a fund or portfolio may be a ''balanced'' fund. As with the preceding alternative, the reference to ''an investment fund product or model portfolio'' is intended to make clear that this alternative might be a ''stand alone'' product or a ''fund of funds'' comprised of various investment options otherwise available under the plan for participant investments. In the context of a fund of funds portfolio, it is likely that money market, stable value and similarly performing capital preservation vehicles will play a role in comprising the mix of equity and fixed-income exposures for this alternative.

Although commenters generally supported inclusion of a balanced investment option as a qualified default investment alternative, a number of commenters had questions or expressed concern regarding the requirement that the investment alternative define its investment objectives by reference to ''a target level of risk appropriate for participants of the plan as a whole.'' Commenters indicated that having to take into account the ''participants of the plan as a whole'' would result in uncertainty as to whether the plan sponsor properly matched the chosen fund to its participant population. In

addition, commenters asserted that the on-going monitoring necessary for the plan fiduciary to ensure the continued appropriateness of the match would likely result in unnecessary burdens and costs. One commenter explained that balanced funds as a group hold approximately 60–65% percent of their portfolios in equity investments,[5] and that the typical balanced fund would be somewhat more conservatively invested than most targeted-retirement-date funds; hence, the commenter argued that balanced funds are an appropriate default for all workers. The commenter further noted that periodic monitoring, while adding unnecessary costs, will likely never produce an impetus for changing to a different balanced fund option. After careful consideration of the comments, the Department has decided to retain the requirement that, for purposes of paragraph (e)(4)(ii), the selected qualified default investment alternative reflect ''a target level of risk appropriate for participants of the plan as a whole.'' The Department recognizes that, to the extent that a particular investment fund product or model portfolio does not itself consider or adjust its balance of fixed income and equity exposures to take into account a target level of risk appropriate for the participants of the plan as a whole, plan fiduciaries will retain that responsibility. The Department believes that, as a practical matter, this responsibility would be discharged by the fiduciary in connection with the prudent selection and monitoring of the investment fund product.[6] Specifically, fiduciaries would take into account the diversification of the portfolio, the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, the projected return of the portfolio relative to funding objectives of the plan, and the fees and expenses attendant to the investment.[7]

Unlike the first alternative, which focuses on the age, target retirement date (such as normal retirement age under the plan) or life expectancy of an individual participant, the second alternative requires a fiduciary to take into account the demographics of the plan's participants, and would be similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction. A number of commenters asked the Department to clarify the demographic factors that should be considered by the fiduciary. The Department understands that the only information a plan fiduciary may know about its participant population is age. Thus, when determining a target level of risk appropriate for participants of a plan as a whole, a plan fiduciary is required to consider the age of the participant population. However, a plan fiduciary is not foreclosed from considering other factors relevant to the participant population, if the fiduciary so chooses.

The third alternative set forth in the regulation, at paragraph (e)(4)(iii), is an investment management service with respect to which an investment manager allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy.[8] Such portfolios change their asset allocation and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. Similar to the first two alternatives, these portfolios must be structured in accordance with generally accepted investment theories and diversified so as to minimize the risk of large losses. The final regulation also clarifies that, as with the other alternatives described in the regulation, asset allocation decisions are not required to take into account risk tolerances, other investments or other preferences of an individual participant. An example of such a service may be a ''managed account.''

One commenter requested clarification that, with regard to a participant's account holding employer securities with restrictions on transferability, the investment management service could serve as qualified default investment alternative for purposes of all other assets in the participant's account with respect to which the managed account has investment discretion. As discussed earlier, the mere fact that the account of a participant or beneficiary holds employer securities acquired as matching contributions from the employer/plan sponsor, or acquired as a result of prior direction by the participant or beneficiary, will not preclude an investment management service from serving as a qualified default investment alternative. However, an investment management service will be considered to be serving as a qualified default investment alternative only with respect to the assets of a participant's or beneficiary's account over which the investment management service has authority to exercise discretion. If the investment management service does not have the authority to exercise discretion over investments in employer securities, the investment management service will not be a qualified default investment alternative with respect to those securities. See discussion of paragraph (e)(1)(ii) of § 2550.404c–5, above.

Another commenter expressed concern that requiring the manager of a managed account qualified default investment alternative to be an investment manager may prevent plan sponsors from using existing managed account programs, such as that addressed in Advisory Opinion 2001–09A (the ''SunAmerica Opinion''). The Department believes these concerns are addressed by the modifications to paragraph (e)(3)(i)(C), pursuant to which plan sponsors who are named fiduciaries may manage qualified default investment alternatives.

Many commenters expressed concern that the Department did not include capital preservation, in particular stable value, products as qualified default investment alternatives on a stand alone basis. These commenters pointed out that stable value funds are utilized by a large number of plans as default investment funds. These funds are often chosen by plan sponsors because they provide: Safety of principal; bond-like returns without the volatility associated with bonds; stability and steady growth of principal and earned income; and benefit-responsive liquidity, so that plan participants may transact at ''book value.'' Commenters supporting stable value funds argued that stable value funds are superior to money market

[5] Investment Company Institute, Quarterly Supplementary Data for Quarter Ending June 30, 2006.

[6] See paragraph (b)(2) of 29 CFR 2550.404c–5.

[7] See 29 CFR 2550.404a–(b).

[8] Although investment management services are included within the scope of relief, the Department notes that relief similar to that provided by this regulation is available to plan fiduciaries under the statute. Specifically, section 402(c)(3) of ERISA provides that ''a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.'' Section 405(d)(1) of ERISA provides that ''[i]f an investment manager or managers have been appointed under section 402(c)(3), then * * * no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.'' The Department included investment management services within the scope of fiduciary relief in order to avoid any ambiguity concerning the scope of relief available to plan fiduciaries in the context of participant directed individual account plans.

funds and other cash-equivalent products because stable value investments earn higher rates of return than money market funds and other cash-equivalent products. A number of these commenters also suggested that stable value funds are appropriate for plans with different demographics, including, for example, plans that cover younger, higher turnover employees who are likely to elect lump sum payments, or plans that cover older, near-retirement employees.

Commenters in support of the inclusion of stable value products also indicated that stable value funds have relatively low costs compared to life-cycle, targeted-retirement-date and balanced funds, particularly those that use a ''fund of funds'' structure. These commenters expressed the view that, because stable value returns are comparable to intermediate corporate bond returns, the premium, if any, of equity investments over stable value investments has been overstated. Many of the commenters argued that the exclusion of stable value funds would unduly discourage plan sponsors from using stable value funds as a default option, to the detriment of plan participants. These commenters argued that limiting default investment alternative choices discourages plans from implementing automatic enrollment. In addition, some commenters suggest that if participants whose account balances are invested in qualified default investment alternatives react negatively to volatile equity performance by opting out of plan participation when losses occur, the regulation may ultimately decrease retirement savings, and the potential gains expected from funds with higher historical long-term performance records will not materialize. Some of the comments supporting the inclusion of capital preservation products also argued that the Congress, in referencing ''a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both'' in section 624 of the Pension Protection Act, intended the Department to include capital preservation products as a separate stand alone qualified default investment alternative.

The Department also received comments in support of its determination that capital preservation products, such as money market funds, stable value funds and similarly performing investment vehicles, should not themselves constitute qualified default investment alternatives under the regulation.

After careful consideration of the comments addressing this issue and assessment of related economic impacts, the Department has determined, except as otherwise discussed below, not to include capital preservation products, such as money market or stable value funds, as a separate long-term investment option under the regulation. As a short-term investment, money market or stable value funds may not, in the Department's view, significantly affect retirement savings. The Department recognizes, however, that such investments can, and in many instances will, play an important role as a component of a diversified portfolio that constitutes a qualified default investment alternative. It is the view of the Department that investments made on behalf of defaulted participants ought to and often will be long-term investments and that investment of defaulted participants' contributions and earnings in money market and stable value funds will not over the long-term produce rates of return as favorable as those generated by products, portfolios and services included as qualified default investment alternatives, thereby decreasing the likelihood that participants invested in capital preservation products will have adequate retirement savings.

The Department also is concerned that including capital preservation and stable value products as a qualified default investment alternative for future contributions on behalf of defaulted participants may impede, or even reverse, the current trend away from the use of such products as default investments. The Department understands that, because account balances invested in capital preservation products are unlikely to show a nominal loss, a number of employers, if given a choice between capital preservation products and more diversified investment options, may be more likely to opt for capital preservation products because they are perceived as presenting less litigation risk for employers. If so, inclusion of a capital preservation option without limitation may increase utilization of capital preservation products as default investments and, thereby, increase the number of participants likely to have inadequate retirement savings, as compared with savings that would be generated through investments in the established qualified default investment alternatives.

Lastly, the Department is concerned that inclusion of a capital preservation product as a qualified default investment alternative, without limitation, may be perceived by participants and beneficiaries as an endorsement by the government, by virtue of its inclusion in the regulation, or as an endorsement by the employer, by virtue of its selection as the qualified default investment alternative, as an appropriate investment for long-term retirement savings. Although the Department recognizes that such perceptions on the part of some participants and beneficiaries might be addressed with investment education and investment advice, the Department nonetheless is concerned that, overall, the potentially adverse effect on long-term retirement savings may be significant.

In light of these concerns, the Department, as indicated above, has not included a capital preservation investment alternative as a long-term stand alone investment option for future contributions under the final regulation. The Department, however, has added two exceptions to the regulation that accommodate limited investments in capital preservation products as qualified default investment alternatives. The first exception is at paragraph (e)(4)(iv). In general, this exception treats investments in capital preservation products or funds as an investment in a qualified default investment alternative for a 120-day period following a participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code).

Specifically, paragraph (e)(4)(iv)(A) recognizes, subject to the limitations of paragraph (e)(4)(iv)(B), as a qualified default investment alternative an investment product that is designed to preserve principal and provide a reasonable rate of return, whether or not guaranteed, consistent with liquidity. The product description and applicable standards are similar to the standards adopted for purposes of automatic rollovers of mandatory distributions at 29 CFR 2550.404a–2. The Department believes it is appropriate to include capital preservation products as a limited-duration qualified default investment alternative to afford plan sponsors the flexibility of utilizing a near risk-free investment alternative for the investment of contributions during the period of time when employees are most likely to opt out of plan participation. The use of capital preservation products in these circumstances will enable plan sponsors to return contributed amounts to participants who opt out without concern about loss of principal. In this regard, the limitation set forth in paragraph (e)(4)(iv)(B) provides that capital preservation products described in paragraph (e)(4)(iv)(A) shall, with respect to any given participant, be treated as a qualified default investment

alternative for a 120-day period following the participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code). At the end of the 120-day period, capital preservation products would cease to be a qualified default investment alternative with respect to any assets of the participant that continue to be invested in such products. In order to avail itself of the relief afforded by the regulation, the plan fiduciary must redirect the participant's investment in the capital preservation product to another qualified default investment alternative prior to the end of the 120-day period. As previously stated, such alternative may include an appropriate capital preservation component in the context of a diversified portfolio.

The 120-day time frame is intended to provide plans that allow an employee to elect to make a permissible withdrawal, consistent with section 414(w) of the Code, a reasonable amount of time following the end of the 90-day period provided in section 414(w)(2)(B) (i.e., the period during which employees may elect to make a permissible withdrawal) to effectuate a transfer of a participant's assets to another qualified default investment alternative.

The second exception relating to capital preservation products and funds is at paragraph (e)(4)(v). This exception, unlike the first, is intended to be limited to stable value products and funds with respect to which plan sponsors are typically limited by the terms of the investment contracts from unilaterally reinvesting assets on behalf of participants who fail to give investment direction without triggering a surrender charge or other fees that could directly and adversely affect participant account balances. Under the exception, stable value products and funds will be treated as a qualified default investment alternative solely for purposes of investments in such products or funds made prior to the effective date of this regulation. The Department believes that this ''grandfather''-type provision accommodates the concerns of commenters regarding the utilization of stable value products and funds by plan sponsors as their default investment option in the absence of guidance concerning fiduciary responsibilities attendant to default investments generally, guidance like that provided by this regulation. At the same time, by limiting the exception to pre-effective date contributions, plan sponsors are encouraged to assess whether and under what circumstances they wish to avail themselves of the relief provided under the regulation by utilizing a qualified default investment alternative that extends to participant contributions made after the effective date of this regulation. It is important to note, however, that, as indicated in the regulation itself, the standards applicable to qualified default investment alternatives set forth in the regulation are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under the Act with respect to the investment of assets in the individual account of a participant or beneficiary. Accordingly, fiduciaries may, without regard to this regulation, conclude that a stable value product or fund is an appropriate default investment for their employees and use such product or fund for contributions on behalf of defaulted employees after the effective date of this regulation.

It also is important to note with regard to both of the exceptions discussed above that the relief afforded by the regulation for investments in the covered products or funds on behalf of defaulted participants is contingent on compliance with all the requirements of the regulation.

Finally, the Department disagrees with commenters' assertion that the Department's decision not to include capital preservation products as a qualified default investment alternative is inconsistent with Congressional intent. The Department believes that Congress, in enacting section 624 of the Pension Protection Act, provided the Department broad discretion in framing a regulation that would permit the Department to include or exclude capital preservation products as a separate qualified default investment alternative. The Department also notes that, pursuant to section 505 of ERISA, the Secretary may prescribe such regulations as are necessary or appropriate to carry out the provisions title I of ERISA.

C. Miscellaneous Issues

Transition Issues

A number of commenters raised issues concerning the status of existing default investments and transfers to default investments that would meet the requirements of the regulation. Specifically, commenters requested guidance on what steps should be taken to ensure that a plan's current default investments, which also meet the requirements of the regulation, will be treated as qualified default investment alternatives after the effective date of the regulation. Other commenters requested guidance on what steps should be taken when a plan is moving from default investments that do not meet the requirements of the regulation to qualified default investment alternatives. In both scenarios, commenters noted that plans often will not have the records necessary to distinguish participants who were defaulted into a default investment from those who affirmatively elected to invest in that investment. Some commenters requested retroactive relief for investments that would not otherwise constitute qualified default investment alternatives because a plan's determination to transfer assets out of such investments could trigger a market value adjustment or similar withdrawal penalty.

To ensure that an existing or a new default investment constitutes a qualified default investment alternative with respect to both existing assets and new contributions of participants or beneficiaries, plan fiduciaries must comply with the notice requirements of the regulation. It is the view of the Department that any participant or beneficiary, following receipt of a notice in accordance with the requirements of this regulation, may be treated as failing to give investment direction for purposes of paragraph (c)(2) of § 2550.404c–5, without regard to whether the participant or beneficiary was defaulted into or elected to invest in the original default investment vehicle of the plan. Under such circumstances, and assuming all other conditions of the regulation are satisfied, fiduciaries would obtain relief with respect to investments on behalf of those participants and beneficiaries in existing or new default investments that constitute qualified default investment alternatives.

Several commenters requested guidance on the effective date of the regulation. While section 404(c)(5) of ERISA is effective for plan years beginning after December 31, 2006, relief under section 404(c)(5) is conditioned on, among other things, the investment of a participant's contributions and earnings ''in accordance with regulations issued by the Secretary.'' See section 404(c)(5)(A). Accordingly, relief under section 404(c)(5) is conditioned on compliance with the provisions of this final regulation, which provide relief only for investments on behalf of participants and beneficiaries who were furnished a notice in accordance with paragraphs (c)(3) and (d) of § 2550.404c–5 and who did not give investment directions to the plan after the effective date of the regulation. Although the regulation only provides relief for investments in qualified default investment alternatives when participants and beneficiaries do

not give investment directions after the effective date of the regulation, compliance with the notice requirements may be achieved by providing notice in accordance with the regulation before its effective date.

With regard to the possible assessment of market value adjustments or similar withdrawal penalties that may result from a fiduciary's decision to move assets to a qualified default investment alternative, the Department reminds fiduciaries that such decisions must be made in compliance with ERISA's prudence and exclusive purpose requirements. These decisions cannot be based solely on a fiduciary's desire to take advantage of the limited liability afforded by this regulation, without regard to the financial consequences to the plan's participants and beneficiaries. In this regard, the Department notes that the final regulation does not change the status of an otherwise prudent default investment into an imprudent default investment. The Department has attempted to make clear in both the preamble and the operative language of the final regulation that the standards set forth therein are not intended to be the exclusive means by which fiduciaries might satisfy their responsibilities under the Act with respect to the investment of assets on behalf of participants and beneficiaries who do not give investment directions.

Further, as discussed above under Qualified Default Investment Alternatives, the Department modified the regulation to provide relief for investments made in stable value products or funds prior to the effective date of the regulation. This modification is intended to assist plan fiduciaries who may be limited by the terms of investment contracts for such products or funds from unilaterally reinvesting assets on behalf of participants who fail to direct their investments.

One commenter requested that the Department make clear that once a participant or beneficiary directs any portion of his or her account balance, the participant or beneficiary is considered to have directed the investment of the entire account. The Department agrees that investment direction by a participant or beneficiary with respect to a portion of his or her account balance may be treated as a decision to retain the remainder of the account balance as currently invested, thus permitting the responsible fiduciary to consider the entire account balance as directed by the participant or beneficiary.

A number of commenters requested that the Department clarify the interrelationship between ERISA section 404(c)(4)(A)—the ''mapping'' provisions—and section 404(c)(5) and this regulation. The most obvious difference between the two sections is the circumstances under which relief is available. The relief provided by section 404(c)(4) is limited to circumstances when a plan undertakes a ''qualified change in investment options'' within the meaning of section 404(c)(4)(B). In contrast, section 404(c)(5) and this regulation can apply to changes in investment options and to the selection of initial plan investments when participants or beneficiaries do not give investment directions. Section 404(c)(4) applies only when the investment option from which assets are being transferred was chosen by the participant or beneficiary (see section 404(c)(4)(C)(iii)). Section 404(c)(5), unlike 404(c)(4), can apply to the selection of an investment alternative by the plan fiduciary in the absence of any affirmative direction by the participant or beneficiary. While the fiduciary relief afforded by section 404(c)(4) and section 404(c)(5) is similar, relief under section 404(c)(4) requires that new investments be reasonably similar to the investments of the participant or beneficiary immediately before the change, whereas relief under section 404(c)(5) requires investment to be made in qualified default investment alternatives. In the context of changing investment options under the plan, ERISA sections 404(c)(4) and 404(c)(5) provide fiduciaries flexibility in implementing such changes.

Preemption

Section 902 of the Pension Protection Act added a new section 514(e)(1) to ERISA providing that, notwithstanding any other provision of section 514, title I of ERISA shall supersede any State law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. Section 902 further added section 514(e)(2) to ERISA defining the term ''automatic contribution arrangement'' as an arrangement under which a participant: May elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash; is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage); and under which such contributions are invested in accordance with regulations prescribed by the Secretary of Labor under section 404(c)(5) of ERISA. In the preamble to the proposed regulation, the Department specifically invited comment on whether, and to what extent, regulations would be helpful in addressing the preemption provision of section 514(e).

In response to the Department's invitation, commenters indicated that, while the application of the preemption provisions should be clarified, they did not believe it was necessary at this time for the Department to prescribe regulations establishing minimum standards for automatic contribution arrangements. Commenters also argued that ERISA preemption should extend to all prudent investments under an automatic contribution arrangement, not just those determined to be qualified default investment alternatives under the Department's regulation. In addition, commenters argued that preemption should not depend on compliance with all the requirements of the regulation under section 404(c)(5), noting that section 514(e) has an independent notice requirement. See section 514(e)(3).

In an effort to clarify the application of the preemption provisions of section 514(e), the final regulation includes a new paragraph (f). As set forth in the regulation, section 514(e) broadly preempts any State law that would restrict the use of an automatic contribution arrangement. After reviewing the text and purpose of section 514(e), the Department concluded that Congress intended to supersede the application of such laws to any pension plan that provides for an automatic contribution arrangement, regardless of whether such plan includes an automatic contribution arrangement as defined in the regulation. This conclusion is reflected in paragraph (f)(2) of the final regulation.

With the enactment of section 514(e), Congress intended to occupy the field with respect to automatic contribution arrangements.[9] Thus, section 514(e) of ERISA does not merely supersede State laws ''insofar'' as any particular plan complies with this final regulation, but rather generally supersedes any law ''which would directly or indirectly

[9] This interpretation of section 514(e) is consistent with the Technical Explanation of H.R. 4, the ''Pension Protection Act of 2006,'' as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, a document prepared by the staff of the Joint Committee on Taxation. That document states, on page 230: ''The State preemption rules under the bill are not limited to arrangements that meet the requirements of a qualified enrollment feature.''

prohibit or restrict the inclusion in any plan of an automatic contribution arrangement.'' This language stands in marked contrast to the familiar language of section 514(a) of ERISA, which supersedes State laws only ''insofar'' as they satisfy the ''relates to'' standard set forth in that section.[10]

Additionally, Congress gave the Department discretion in section 514(e)(1) to determine whether and to what extent preemption should be conditioned on plan compliance with minimum standards, stating that ''[t]he Secretary may prescribe regulations which would establish minimum standards that such an arrangement would be required to satisfy in order for this subsection [on preemption] to apply in the case of such arrangement.'' Pursuant to this grant of discretionary authority, the Department has concluded, at this time, that it should not tie preemption to minimum standards for default investments. The Department, therefore, specifically provides in paragraph (f)(4) that nothing in the final regulation precludes a pension plan from including an automatic contribution arrangement that does not meet the conditions of paragraph (a) through (e) of the regulation. While relief under ERISA section 404(c)(5) is available only to plans that comply with the regulation, the Department has determined that it would be inappropriate to discourage plan fiduciaries from selecting default investments that are not identified in the regulation. State laws that hinder the use of any other default investments would be inconsistent with this determination, and with the discretionary authority Congress vested in the Department over the scope of ERISA preemption.

Finally, in an effort to eliminate the need for multiple notices by plan administrators of automatic contribution arrangements, paragraph (f)(3) of the final regulation specifically provides that the administrator of an automatic contribution arrangement within the meaning of paragraph (f)(1) shall be considered to have satisfied the notice requirements of section 514(e)(3) if notices are furnished in accordance with paragraphs (c)(3) and (d) of the regulation. Accordingly, satisfaction of the notice requirements under section 404(c)(5) and this regulation also will serve to satisfy the separate notice requirements set forth in section 514(e)(3) for automatic contribution arrangements.

Enforcement

Section 902 of the Pension Protection Act amended section 502(c)(4) of ERISA to provide that the Secretary of Labor may assess a civil penalty against any person for each violation of section 514(e)(3) of ERISA. Implementing regulations will be developed in a separate rulemaking.

D. Effective Date

This final regulation will be effective 60 days after the date of its publication in the **Federal Register**.

E. Regulatory Impact Analysis

Summary

This regulation is expected to have two major economic consequences. Default investments will be directed more toward higher-return portfolios, boosting average investment returns, and automatic enrollment provisions will become more common, boosting participation. Both of these effects will increase average retirement savings, especially among workers who are younger, have lower earnings and/or more frequent job changes. A substantial number of individuals will enjoy significant increases in retirement income, while a few may experience decreases if the introduction of automatic enrollment slows their saving or if their default investment returns are particularly poor. The magnitude of these effects will be large in absolute terms and proportionately large for many directly affected individuals.

The regulation's effects will be cumulative and gradual, and their magnitude will depend on plan sponsor and participant choices. The Department has developed low- and high-impact estimates to illustrate a range of potential long-term effects.

By 2034 the regulation (together with the automatic enrollment provisions of the Pension Protection Act) is predicted to increase aggregate annual 401(k) plan contributions by between 2.6 percent and 5.1 percent, or by $5.7 billion to $11.3 billion (expressed in 2006 dollars). It is predicted to increase aggregate account balances by between 2.8 percent and 5.4 percent, or by $70 billion to $134 billion. Between 83 percent and 77 percent of net new 401(k) accumulations will be preserved for retirement rather than cashed out early.

Low-impact estimates indicate that the regulation will increase pension income by $1.3 billion per year on aggregate for 1.6 million individuals age 65 and older in 2034, but decrease it by $0.3 billion per year for 0.6 million. High-impact estimates suggest that pension income will increase by $2.5 billion for 2.5 million and fall by $0.6 billion for 0.9 million. Impacts on retirement income will be larger farther in the future, reflecting the fact that automatic enrollment and default investing disproportionately affect young workers.

A substantial portion of the increase in retirement savings will be attributable directly to the movement of default investments away from stand-alone, fixed income capital preservation vehicles and toward qualified default investment alternatives that provide for capital appreciation as well as capital preservation. The majority of the increase, however, will be attributable to the proliferation of automatic enrollment.

The Department believes that the net increase in retirement savings will translate into a net improvement in welfare. There is substantial risk that savings will fall short relative to many workers' retirement income expectations, especially in light of increasing health costs and stresses on defined benefit pension plans and the Social Security program. The regulation will help reduce that risk. An increase in retirement savings additionally is likely to promote investment and long-term economic productivity and growth. The Department therefore concludes that the benefits of this regulation will justify its costs.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Section 3(f) of the Executive Order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal

[10] Section 514(a) of ERISA provides, in pertinent part, that ''the provisions of this title and title IV shall supersede any and all State laws *insofar* as they may now or hereafter relate to any employee benefit plan * * *.'' Emphasis added.

mandates, the President's priorities, or the principles set forth in the Executive Order. This action is significant under section 3(f)(1) because it is likely to have an annual effect on the economy of $100 million or more. Accordingly, the Department has undertaken, as described below, an analysis of the costs and benefits of the regulation. The Department believes that the regulation's benefits justify its costs.

Regulatory Flexibility Act

The Department certified that the proposed regulation, if adopted, would not have a significant economic impact on a substantial number of small entities. 71 FR 56806, 56815 (Sept. 27, 2006). In explaining the basis for this certification, the Department noted that 10 to 20 percent of small participant directed defined contribution plans (28,000 to 56,000 plans) might adopt automatic enrollment programs as a result of the regulation. Consequently, some of the employers sponsoring such plans may have to make additional matching contributions (up to $100 million to $300 million annually). The Department expects that the amount of such additional contributions to small plans would be proportionately similar to those to large plans. The Department did not expect the proposed regulation to have any adverse consequences for small plans or their sponsors because all the factors at issue, including the payment of matching contributions, the adoption of automatic enrollment programs, and compliance with the regulation are voluntary on the part of the plan sponsor.

The Department received one comment regarding the proposed regulation's potential effect on small entities. The commenter believes that certain types of mutual funds that would be qualified default investment alternatives under paragraph (e)(4)(i) (e.g., life-cycle or target-retirement date funds) sometimes invest in other types of mutual funds. According to the commenter, the investment advisers for the life-cycle or target-retirement-date funds may have an incentive to skew the fund's allocation toward sub funds that generate higher fees than to funds that would be most appropriate for the age or expected retirement date of the affected participants. The commenter stated that fiduciaries of small plans wishing to use the safe harbor would need to expend disproportionately more resources than large plan fiduciaries in making sure that the asset allocations (and thus, the corresponding fee structures) are not tainted by conflicts of interest. Specifically, the commenter was concerned that unlike larger plans which could conduct analyses of the neutrality of asset allocations in-house, small plans would have to expend resources on using outside consultants to conduct such analyses or face potential liability for a failure to do so. The commenter mentioned that some funds are willing to indemnify fiduciaries of large plans from any liability associated with choosing such funds. The commenter suggested that the Department add measures to mitigate the likelihood of conflicts, such as requiring that such funds allocate assets pursuant to independent algorithms and require equal treatment for small plan fiduciaries with regard to indemnification.

Plan fiduciaries must take into account potential conflicts of interest and the reasonableness of fees in choosing and monitoring any investment option for a plan, whether covered under the safe harbor or not. This obligation flows from the fiduciary duties of prudence and loyalty to the participants set out in ERISA section 404(a)(1). The regulation imposes no new requirements for selecting qualified default investment alternatives. For large or small plans, the duty to evaluate a plan investment option exists regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary is seeking to comply with this regulation. Thus, the Department continues to believe that this regulation would not have a significant effect on a substantial number of small entities.

The Department considered the commenter's suggestions. Adopting them, however, could limit plans' choices or increase the cost of qualified default investment alternatives. The regulation does not prevent plan fiduciaries from taking features such as independent algorithms into account in choosing qualified default investment alternatives. If it determines that a widespread need for such assistance exists, the Department may consider providing guidance for small plans regarding prudent selection of qualified default investment alternatives.

The Department has also considered the changes made in this document from the proposed regulation. These changes, including the modified notice requirement, allowing trustees and certain plan sponsors to manage qualified default investment alternatives, and the addition of a temporary qualified default investment alternative are discussed more fully earlier in this document. They do not affect the Department's determination regarding the regulation's impact on small entities. Therefore, the Department recertifies its earlier conclusion that this regulation will not have a significant economic impact on a substantial number of small entities.

Paperwork Reduction Act

In accordance with the requirements of the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)), the proposed regulation solicited comments on the information collections included in the proposed regulation. The Department also submitted an information collection request (ICR) to OMB in accordance with 44 U.S.C. 3507(d), contemporaneously with the publication of the proposed regulation, for OMB's review.[11] Although no public comments were received that specifically addressed the paperwork burden analysis of the information collections, the comments that were submitted, and which are described earlier in this preamble, contained information relevant to the costs and administrative burdens attendant to the proposals. The Department took into account such public comments in connection with making changes to the proposal, analyzing the economic impact of the proposals, and developing the revised paperwork burden analysis summarized below.

In connection with publication of this final rule, the Department has submitted an ICR to OMB for its request of a new collection. The public is advised that an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The Department intends to publish a notice announcing OMB's decision upon review of the Department's ICR.

A copy of the ICR may be obtained by contacting the PRA addressee shown below or at *http://www.RegInfo.gov.* PRA ADDRESSEE: Gerald B. Lindrew, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Room N–5718, Washington, DC 20210. Telephone: (202) 693–8410; Fax: (202) 219–4745. These are not toll-free numbers.

The regulation provides certain specified relief from fiduciary liability for fiduciaries who make investment decisions on behalf of participants and beneficiaries in individual account

[11] On Nov. 20, 2006, OMB issued a notice (ICR Reference No. 200608–1210–003) that it would not approve the Department's request for approval of the information collection provisions until after consideration of public comment on the proposed regulation and promulgation of a final rule, describing any changes.

pension plans that provide for participant direction of investments when such participants and beneficiaries fail to direct the investment of their account assets. The regulation describes conditions under which a participant or beneficiary who fails to provide investment direction will be treated as having exercised control over assets in his or her account under an individual account plan as provided in section 404(c)(5)(A) of ERISA. The regulation requires that the assets of non-directing participants or beneficiaries be invested in one of the qualified default investment alternatives described in the regulation and that certain other specified conditions be met.

The regulation imposes two separate disclosure requirements to participants and beneficiaries that are conditions to the relief created by the final regulation, as follows: (1) The plan must provide an initial notice containing specified information to any individual whose assets may be invested in a qualified default investment alternative generally at least 30 days prior to the date of plan eligibility (or on or before the date of plan eligibility if the participant is permitted to make a withdrawal under Code section 414(w)) and thereafter annually at least 30 days before the beginning of each plan year; and (2) the plan must provide certain materials that it receives relating to participants' and beneficiaries' investments in a qualified default investment alternative. The ''pass-through'' materials that must be provided are those specified in the Department's regulation under ERISA section 404(c) at 29 CFR 2550.404c–1(b)(2)(i)(B)(1)(viii) and (ix) and 29 CFR 404c–1(b)(2)(i)(B)(2). The information collection provisions of this regulation are intended to ensure that participants and beneficiaries who are provided the opportunity to direct the investment of their account balances, but who do not do so, are adequately informed about the plan's provisions for default investment and about investments made on their behalf under the plan's default provisions.

The estimates of respondents and responses on which the Department's burden analysis is based are derived primarily from the Form 5500 Series filings for the 2004 plan year, which are the most recent reliable data available to the Department.[12] The burden for the preparation and distribution of the disclosures is treated as an hour burden. Additional cost burden derives solely from materials and postage. It is assumed that electronic means of communication will be used in 38 percent of the responses pertaining to the initial and annual notices and that such communications will make use of existing systems. Accordingly, no cost has been attributed to the electronic distribution of information.

Annual Notice—29 CFR 2550.404c–5(c)(3). The regulation requires that notice be provided initially, before any portion of a participant's or beneficiary's account balance is invested in a qualified default investment alternative, and annually thereafter. The notice generally must describe: (1) The circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage); (2) the right of participants and beneficiaries to direct the investment of assets in their accounts; (3) the qualified default investment alternative, including its investment objectives, risk and return characteristics (if applicable), and fees and expenses; (4) the participants' and beneficiaries' right to direct the investment of the assets to any other investment alternative offered under the plan, including a description of any applicable restrictions, fees or expenses in connection with such a transfer; and (5) where participants and beneficiaries can obtain information about the other investment alternatives available under the plan.

The Department estimates that 424,000[13] participant directed individual account pension plans will prepare and distribute notices to 62,544,000 eligible workers, participants and beneficiaries in the first year in which this regulation becomes applicable. Preparation of the notice in the first year is estimated to require one-half hour of legal professional time for each plan, for a total aggregate estimate of 212,000 burden hours. For the 62 percent of participants and beneficiaries who will receive the notice by mail (38,777,000 individuals), distribution of the notice is estimated to require an additional 310,000 hours of clerical time, based on an estimate of one-half minute of clerical time per notice. No additional burden hours are attributed to the distribution of the notice to the remaining 38 percent of participants and beneficiaries who will receive this notice electronically (23,767,000 individuals). The total annual burden hours estimated for the notice in the first year, therefore, are 522,000. The equivalent cost for this burden hour estimate is $30,232,000 (legal professional time is valued at $106 per hour, and clerical time is valued at $25 per hour).[14]

In addition to burden hours, the Department has estimated annual costs attributable to the notice for the first year, based on materials and postage, at $19,776,000. This comprises the material cost for a two-page notice ($.10 per notice) to 38,777,000 participants and beneficiaries (62 percent of 62,544000 participants and beneficiaries), which equals $3,878,000, plus postage at $0.41 per mailing, which equals $15,899,000. Total annual costs for the notice in the first year are therefore estimated at $19,776,000.

In years subsequent to the first year of applicability, the Department estimates that notices will be prepared only by newly established participant directed individual account pension plans and plans that change their choice of qualified default investment alternative. For purposes of burden analysis, the Department has assumed that one-third (1/3) of all participant directed individual account plans (141,000 plans) will prepare and distribute new or updated notices to all participants and beneficiaries, requiring 24 minutes of legal professional time per notice. The preparation of these notices in each subsequent year is estimated to require 57,000 hours. However, the number of participants receiving notices stays the same. As in the calculation for the initial year, distribution to the 62 percent of participants and beneficiaries who will receive the notice by mail (38,777,000 individuals) will require 310,000 hours and $19,776,000 additional materials and postage cost. (As for the first year, the Department has assumed that electronic distribution of the notice in subsequent years will not add any significant additional paperwork burden.)

Based on those assumptions, the Department estimates that the total

[12] The Department does not anticipate an increase in the number of Form 5500 filings merely due to the changes to the Form 5500 for 2007 to 2009.

[13] All numbers used in this paperwork burden estimate have been rounded to the nearest thousand.

[14] EBSA estimates based on the Bureau of Labor Statistics, National Occupational Employment Survey (May 2005) and the Bureau of Labor Statistics, Employment Cost Index (Sept. 2006).

burden hours for notices under this regulation in each year after the first year of applicability will fall to 367,000 hours. The equivalent cost of such an hour burden (using the same assumptions as for the first year) is $13,749,000. The total cost burden estimated for subsequent years for the notice will remain at $19,776,000.

Pass-through Material—29 CFR 2550.404c–5(c)(4). Under the regulation, the fiduciary shall qualify for the relief described in paragraph (b)(1) of the final regulation if a fiduciary provides material to participants and beneficiaries as set forth in paragraphs (b)(2)(i)(B)(1)(viii) and (ix), and paragraph (b)(2)(i)(B)(2) of the 404(c) regulation. In addition, plans must be prepared to provide certain information on request and must therefore maintain such information in updated form in order to comply. The paperwork burden for the pass-through disclosure requirements calculated here does not include pass-through disclosure burden for section 404(c) plans, as these disclosures for section 404(c) plans were considered in the renewal to OMB Control No. 1210–0090.[15]

The regulation imposes this requirement only with respect to participants and beneficiaries who have an investment in a qualified default investment alternative that was made by default. In conformity with the assumptions underlying the other economic analyses in this preamble, the Department has assumed that, at any given time, 5.3 percent of participants and beneficiaries in participant directed individual account pension plans (3,794,000 individuals) will have default investments. Of these, 1,072,000 individuals are invested in participant directed individual account pension plans that are not section 404(c) plans. For purposes of this burden analysis, the Department has also assumed that plans will receive materials that must be passed through the participants and beneficiaries on a quarterly basis. This assumption takes into account that many, although not all, plans will receive quarterly financial statements and prospectuses, and that plans will also receive other pass-through materials on occasion. These two factors result in an estimate of 4,286,000 responses (distributions of pass-through materials) per year. Duplication and packaging of the pass-through material is estimated to require 1.5 minutes of clerical time per distribution, for an annual hour burden estimate of 107,000 hours of clerical time. The equivalent cost of this hour burden is estimated at $2,679,000. Additional cost burden for the pass-through of material is estimated to include paper cost (40 pages of material yearly per participant or beneficiary) and postage ($.58 per mailing) at $4,629,000 annually for 4 distributions per participant or beneficiary with a default investment.

Plans also need to maintain information in order to provide certain information on request. This preparation is estimated to require one hour of clerical time for each of the 162,000 newly affected plans, for a total of 162,000 burden hours. The Department assumes that, on average, plans will make one disclosure upon request every year and that it takes one-half minute of clerical time per disclosure to send out the materials, requiring about 4,000 hours of clerical time. In total, the preparation and sending of information upon request requires 166,000 burden hours with equivalent costs of $4,145,000. Additional cost burden for the material is estimated to include paper cost (20 pages of material yearly per information request) and postage ($0.89 per mailing) at $306,000.[16]

In total, the Department estimates that providing pass-through disclosures to non-directing participants and beneficiaries under this regulation will require annual burden hours of approximately 273,000 hours (with equivalent costs of $6,824,000) and total costs of $4,935,000.

These paperwork burden estimates are summarized as follows:

Type of Review: New collection.

Agency: Employee Benefits Security Administration, Department of Labor.

Title: Default Investment Alternatives under Participant Directed Individual Account Plans.

OMB Number: 1210–AB10.

Affected Public: Business or other for-profit; not-for-profit institutions.

Respondents: 424,000.

Responses: 66,991,000.

Frequency of Response: Annually; occasionally.

Estimated Total Annual Burden Hours: 795,000 (first year).

Estimated Total Annual Burden Cost: $24,711,000 (first year).

Congressional Review Act

This notice of final rulemaking is subject to the Congressional Review Act provisions of the Small Business Regulatory Enforcement Fairness Act of 1996 (5 U.S.C. 801 *et seq.*) and therefore has been transmitted to the Congress and the Comptroller General for review.

Unfunded Mandates Reform Act

Pursuant to the provisions of the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4), this rule does not include any Federal mandate that may result in expenditures by State, local, or tribal governments, or the private sector, that may impose an annual burden of $100 million or more, adjusted for inflation.

Economic Impacts

By 2034 the regulation (together with the automatic enrollment provisions of the Pension Protection Act) is predicted to increase aggregate account balances by between 2.8 percent and 5.4 percent, or by $70 billion to $134 billion.

Investment Mix

A large but declining proportion[17] of 401(k) plans currently direct default investments exclusively to fixed income capital preservation vehicles such as money market or stable value funds. By reducing risks attendant to fiduciary responsibility and liability, this regulation is expected to encourage more plans to direct default investments to vehicles that include a mix of equity and fixed income instruments and thereby provide the potential for capital appreciation as well as capital preservation.

As a result of this regulation, it is estimated that in 2034, 401(k) plan investments in qualified default investment alternative-type vehicles (expressed in 2006 dollars) will increase by between $65 billion and $116 billion. The portion of this estimated increase that is attributable directly to the redirection of default investments is between $18 billion and $24 billion. The rest is attributable to increased contributions, which are discussed below.[18]

[15] See 71 FR 64564 (Nov. 2, 2006). The paperwork burden as calculated for section 404(c) plans assumes that plans send pass-through disclosures to all participants and beneficiaries in section 404(c) plans, not only to the ones that are actively directing their investments.

[16] The burden arising from these disclosure requirements will be the same in subsequent years.

[17] Various surveys estimate the proportion at 40 percent (Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 39), 41 percent (Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 7), and 21 percent (Vanguard, How America Saves 2006 (Sept. 2006) at 26). Surveys also reveal a trend away from capital preservation defaults toward investment vehicles like those included as qualified default investment alternatives for future contributions under this regulation.

[18] These estimates pertain only to default investments made on behalf of defaulted participants under automatic enrollment programs. The default investment regulation is not so limited. Therefore, these estimates are likely to omit some of the redirection of default investments that will occur under the regulation.

Investment Performance

Historically, over long time horizons, diversified portfolios that include equities have tended to deliver higher returns than those consisting only of lower risk debt instruments.[19] It therefore is widely believed to be advantageous to invest retirement savings in diversified portfolios that include equity.[20]

As noted above, this regulation is expected to encourage the redirection of default investments from stand-alone, low-risk capital preservation instruments to diversified portfolios that include equities. This in turn is expected to improve investment results for a large majority of affected individuals, increasing aggregate account balances by an estimated $5 billion to $7 billion in 2034.

In deriving these estimates, in response to public and peer reviewer comments, the Department refined its assumptions regarding investment performance relative to those relied on in its estimates of the proposed regulation's effects. This is explained further below under headings ''Basis of Estimates'' and ''Peer Review.''

Automatic Enrollment

Automatic enrollment programs are growing in popularity. These programs covered only about 5 percent of workers eligible for 401(k) plans in 2002,[21] but the number may now be as high as 24 percent[22] and could reach 35 percent in the near future, absent this final rule.[23]

The Department expects and intends that this regulation, together with the automatic enrollment provisions of the Pension Protection Act, will promote wider implementation of automatic enrollment programs. The regulation will help alleviate fiduciary concerns that might otherwise discourage implementation of automatic enrollment programs. It will also make it possible for plan sponsors to take advantage of Pension Protection Act provisions that waive certain Internal Revenue Code bars against discrimination in favor of highly compensated employees and that preempt state laws unfriendly to automatic enrollment programs. As a result of the regulation, in the near future automatic enrollment programs may cover 50 percent to 65 percent of 401(k)-eligible workers rather than 35 percent.[24]

Participation

Analyses of automatic enrollment programs demonstrate that such programs increase participation. The increase is most pronounced among employees whose participation rates otherwise tend to be lowest, namely lower-paid, younger and shorter-tenure employees.[25] Automatic enrollment programs increase many such employees' contribution rates from zero to the default rate, often supplemented by some employer matching contributions. These additional contributions tend to come early in the employees' careers and therefore can add disproportionately to retirement income as investment returns accumulate over a long period. However, there is also evidence that automatic enrollment programs can have the effect of lowering contribution rates for some employees below the level that they would have elected absent automatic enrollment. Current surveys indicate that the default contribution rates are typically set at 3 percent of salary.[26] Some employees who might otherwise have actively enrolled in a plan (either at first eligibility or later) and elected a higher contribution rate may instead permit themselves to be enrolled at the default rate. [27]

Plans implementing automatic enrollment programs may increase their participation rates on average from approximately 70 percent to perhaps 90 percent. Consequently, the Department estimates that this regulation will increase overall 401(k) participation rates from 73 percent to between 77 percent and 80 percent.[28] Aggregate annual contributions in 2034 are expected to grow on net by between $5.7 billion and $11.3 billion (expressed in 2006 dollars). These and related estimates are summarized in Table 1 below.

[19] See, e.g., Ibbotson Associates, Stocks, Bonds, Bills and Inflation, 2006 Yearbook (2006).

[20] See, e.g., U.S. Securities and Exchange Commission, Beginners' Guide to Asset Allocation, Diversification, and Rebalancing (May 2007), at *http://www.sec.gov/investor/pubs/assetallocation.htm*; and Stephen P. Utkus, Selecting a Default Fund for a Defined Contribution Plan, Vanguard Center for Retirement Research, Volume 14 (June 2005) at 6.

[21] U.S. Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 2002–2003, Bulletin 2573 (Jan. 2005).

[22] EBSA estimate. The proportion of plans in various size classes that provide automatic enrollment was taken from Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 38. EBSA took a weighted average of these proportions, reflecting the distribution of 401(k) participants across the plan size classes, as estimated by EBSA based on annual reports filed by plans with EBSA.

[23] The incidence of automatic enrollment appears to be growing. According to one series of surveys automatic enrollment spread from 8.4 percent of plans in 2003 to 16.9 percent in 2005 (Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 38). Another found that automatic enrollment spread from 15 percent of plans in 2003 to 23 percent in 2005 with an additional 29 percent considering it for the future (Deloitte Consulting, 2003 Annual 401(k) Benchmarking Survey (2004) at 25 and Deloitte Consulting, Annual 401(k) Benchmarking Survey 2005/2006 Edition (2006) at 7). According to yet another, it grew from 14 percent in 2003 to 24 percent in 2006, with 23 percent of the remainder ''very likely'' and 25 percent ''somewhat likely'' to begin automatic enrollment within the year (Hewitt Associates LLC, Survey Findings: Trends and Experiences in 401(k) Plans, 2005 (2005) at 13, and Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement, 2006 (2006) at 3).

[24] The Department believes these figures reasonably illustrate a range of possible outcomes. The Department is confident that the regulation will increase the incidence of automatic enrollment. According to one survey, among plans that currently are somewhat or very unlikely to offer automatic enrollment in the future, 36 percent cite the need for the Department to identify appropriate default investments, 33 percent cite the need for preemption of unfriendly state laws, and 30 percent cite the need for relief from nondiscrimination requirements (Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement, 2006 (2006) at 5).

[25] According to the Department's low- and high-impact estimates (respectively), under the regulation, active (non-defaulted) participants will number between 32 million and 33 million in 2034. Their ages will average between 44.2 and 44.1 years, and their pay will average between 160 percent and 158 percent of average earnings calculated by the Social Security Administration. Defaulted participants will number between 4.2 million and 5.4 million. In contrast to active participants, their ages will average between 34.0 and 34.1 years, and their pay will average between 109 percent and 108 percent of average pay in Social Security covered employment.

[26] It is possible that in the future more plans will provide for higher or escalating default contribution rates. The Pension Protection Act waives certain bars against discrimination in favor of highly compensated employees for 401(k) plans with automatic enrollment that satisfy certain conditions. One such condition generally provides that a participant's default contribution rate must escalate to at least 6 percent not later than his fourth year of participation.

[27] See, e.g., James J. Choi, David Laibson, Brigette C. Madrian and Andrew Metrick, Saving for Retirement on the Path of Least Resistance (updated draft analysis, July 19, 2004) at 56–57, Figures 2A–2D; and James J. Choi, David Laibson and Brigitte C. Madrian, Plan Design and 401(k) Savings Outcomes (written for the National Tax Journal Forum on Pensions, June 2004) at 11.

[28] These numbers are rounded to the nearest percentage point.

Table 1: Estimated Effect of Regulation on 401(k) Participation and Contributions in 2034
(Dollar amounts expressed in billions of 2006 dollars)

	Low Impact	High Impact
Percentage point increase in participation rate of 401(k)-eligible employees	4%	8%
Added annual contributions	$8.9	$17.4
Discouraged annual contributions	$3.2	$6.0
Net additional contributions	$5.7	$11.3
Increase in aggregate account balances	$70	$134

Preservation

New employee contributions attributable to automatic enrollment will be attributable disproportionately to younger, lower-paid, shorter-tenure workers.

Some such workers, who absent automatic enrollment would have delayed participation, will begin contributing earlier and thereby accumulate larger balances. The investment of these contributions in qualified default investment alternatives, rather than in capital preservation vehicles, will further enlarge account balances on average. Larger balances are more likely to be preserved for retirement. Therefore it is possible that the regulation will increase the proportion of 401(k) accounts that are preserved.[29]

On the other hand, other such workers may accumulate only small accounts before leaving their jobs. Historically, younger, lower-paid workers with small accounts have tended disproportionately to cash out their accounts upon job change rather than preserve them in tax-deferred retirement accounts. It is therefore also possible that, by encouraging automatic enrollment, the proportion (but not the total amount) of 401(k) accounts preserved for retirement could decrease.

The Department estimates that these effects will nearly offset one another. Workers will leave an estimated 4.3 million 401(k)-eligible jobs in 2033. As a result of this regulation (together with the automatic enrollment provisions of the Pension Protection Act), the number leaving with positive account balances will grow from 2.30 million to between 2.45 million and 2.61 million. The proportion of those leaving with positive accounts that preserve their accounts for retirement will fall slightly from 61.0 percent to between 60.4 percent and 59.7 percent, and the proportion of the account balances preserved will fall from 85.9 percent to between 85.8 percent and 85.4 percent. The regulation's marginal effect on the preservation of account balances can be illustrated by comparing estimated net increases in account-holding job leavers and their account balances with estimated net increases in preserved accounts. The proportion of net new job leavers with account balances that preserve their accounts is estimated to be approximately 50 percent, while the proportion of net new job-leaver accounts that is preserved is estimated to be 83 percent to 77 percent.

Retirement Income

Low-impact estimates suggest that the regulation will increase pension income by $1.3 billion per year on aggregate for 1.6 million individuals age 65 and older in 2034 (expressed in 2006 dollars), but decrease it by $0.3 billion per year for 0.6 million. High-impact estimates suggest that average annual pension income will increase by $2.5 billion for 2.5 million and fall by $0.6 million for 0.9 million. These estimates are summarized in Table 2 below. Impacts on retirement income will be larger farther in the future, reflecting the fact that automatic enrollment and default investing disproportionately affect young workers.

[29] There will be other, smaller effects. Because larger accounts are more likely to be preserved, any effect of the regulation on account balances may also affect the preservation rate. As noted below, while automatic enrollment increases contributions for many workers, it may decrease them for a few. Likewise, while movement from capital preservation investments to qualified default investment alternatives will boost investment returns for many, it may reduce returns for a few. All of these effects in turn affect account balances and preservation rates. The Department's estimates account for all of these effects.

Table 2: Effect of Regulation on Annual Pension Income of Individuals Age 65+ in 2034 (Expressed in 2006 Dollars)

Career Pay Quartile	Number with Gains (000s)	Aggregate Gain ($Millions)	Number with Losses (000s)	Aggregate Loss ($Millions)
Low Impact				
All	1,594	$1,330	589	$328
Q1	285	$111	100	$18
Q2	390	$226	142	$52
Q3	434	$343	164	$84
Q4	485	$650	183	$174
High Impact				
All	2,541	$2,465	856	$637
Q1	457	$206	145	$41
Q2	635	$451	206	$97
Q3	686	$611	240	$163
Q4	763	$1,198	265	$336

The regulation is estimated to have distributional consequences, narrowing somewhat the distribution of pension income across earnings groups. Among all individuals age 65 or older in 2034, for example, those in the lowest lifetime earnings quartile would receive just 5 percent of pension income absent the regulation, but they will receive 9 percent of net gains from the regulation. The amount they gain will exceed the amount lost by a factor of five or six (see Table 3 below).

Table 3: Distributional Effect of Regulation on Annual Pension Income of Individuals Age 65+ in 2034 (Expressed in 2006 Dollars)

Career Pay Quartile	Low Impact				High Impact			
	Pension Income Shares		Gain/Loss Ratios		Pension Income Shares		Gain/Loss Ratios	
	Base-line	Net Gain	#	$	Base-line	Net Gain	#	$
Q1	5%	9%	2.8	6.1	5%	9%	3.2	5.1
Q2	12%	17%	2.8	4.3	12%	19%	3.1	4.6
Q3	23%	26%	2.6	4.1	23%	24%	2.9	3.7
Q4	60%	48%	2.7	3.7	60%	47%	2.9	3.6

Administrative Cost

Plan sponsors may incur some administrative costs in order to meet the conditions of the regulation. The Department generally expects such costs to be low. Any changes to plan provisions or procedures necessary to satisfy the regulation's conditions are likely to be no more extensive than those associated with changes that plans implement from time to time in the normal course of business. The boundaries of the regulation are sufficiently broad to encompass a wide range of readily available and competitively priced investment products and services. It is likely that a large majority of participant directed plans already offer one or more investment options that would fall within the safe harbor. Costs attendant to the regulation's notice provisions can be mitigated by furnishing the notices together with other plan disclosures and/or through the use of electronic media. The requirement to pass through certain investment materials to participants and beneficiaries is the same as that already applicable to participant directed individual account plans operating in accordance with ERISA section 404(c). The Department's estimates of these costs are presented above under the heading Paperwork Reduction Act.

The regulation may indirectly prompt some plan sponsors to shoulder additional benefit costs. For example, it is expected that the regulation, by promoting the adoption of automatic enrollment programs, will have the indirect effect of increasing aggregate employer matching contributions in 2034 by between $1.7 billion and $3.4

billion (expressed in 2006 dollars). Adverse consequences are not expected because the adoption of automatic enrollment programs and the provision of matching contributions generally are at the discretion of the plan sponsor. Reliance on the regulation and, therefore, compliance with its provisions are also voluntary on the part of the plan sponsor.

Cost-Benefit Assessment

The Department believes that, by increasing average retirement income, the regulation will improve overall social welfare. There is mounting concern that many Americans have been preparing inadequately for retirement. Most workers are on track to have more retirement wealth than most current retirees, and recent declines in reported savings rates may not be cause for alarm in light of offsetting capital gains. Nonetheless, savings may fall short relative to workers' retirement income expectations, especially in light of increasing health costs and stresses on defined benefit pension plans and the Social Security program.[30] Because of these real risks, the Department believes that policies that increase retirement savings can increase welfare by helping workers secure retirement living standards that meet their expectations.

The regulation may also have macroeconomic consequences, which are likely to be small but positive. An increase in retirement savings is likely to promote investment and long-term economic productivity and growth. The increase in retirement savings will be very small relative to overall market capitalization. Therefore macroeconomic benefits are likely to be small. Based on the foregoing analysis and estimates, the Department believes that the benefits of this regulation will justify its costs.

Basis of Estimates

The Department estimated the effect of the regulation on 401(k) plan participation, contributions, account balances, investment mix, and early cash outs, and its effect on pension incomes in retirement, using a microsimulation model of lifetime pension accumulations known as PENSIM.[31] To produce the low and high impact estimates presented here, PENSIM was parameterized and applied as follows.

First, automatic enrollment was assigned randomly to 401(k) plan eligible employees to achieve incidences of 35 percent (baseline), 50 percent (low impact) and 65 percent. Next, participation and default participation rates were adjusted to reflect available research findings on these rates at various tenures in the presence and absence of automatic enrollment programs.[32] The default contribution rate was assumed to be 3 percent, which surveys indicate is the most common rate currently in use.[33]

Defaulted participants were assumed to invest their contributions as follows:[34] in the baseline estimates, either in a money market fund [35] (50 percent) or a qualified default investment alternative (50 percent); in the low- and high-impact estimates of the regulation's effects, all entirely to a qualified default investment alternative.[36] Active contributors were assumed to invest their contributions either in a qualified default investment alternative (75 percent), a U.S. Treasury bond fund (15 percent), or an even mix of the two (10 percent). Some employer contributions were assumed to be invested in company stock. Price inflation and real returns were estimated stochastically. Mean price inflation was assumed to be 2.8 percent, and mean real returns to money market funds, Treasury bond funds, and equity funds, respectively, were assumed to be 1.3 percent, 2.9 percent, and 4.9 percent. Deducted respectively from

[30] See generally U.S. Council of Economic Advisors, Economic Report of the President, February 2006 (2006).

[31] PENSIM was developed for the Department by the Policy Simulation Group as a tool for examining the macroeconomic and distributional implications of private pension trends and policies. Detailed information on PENSIM is available at *http://www.polsim.com/PENSIM.html.* Examples of PENSIM applications include comparisons of retirement income prospects for different generations contained in U.S. Government Accountability Office, Retirement Income: Intergenerational Comparisons of Wealth and Future Income, GAO–03–429 (Apr. 2003), and comparisons of pension income produced by traditional defined benefit pension plans and cash balance pension plans contained in U.S. Government Accountability Office, Pension Plans: Information on Cash Balance Pension Plans, GAO–06–42 (Oct. 2006).

[32] These findings were drawn from James J. Choi, David Laibson and Brigitte C. Madrian, Plan Design and 401(k) Savings Outcomes (written for the National Tax Journal Forum on Pensions, June 2004). The overall participation rate under automatic enrollment was adjusted upward to 90 percent.

[33] See e.g., Vanguard, How America Saves 2006 (Sept. 2006) at 26, Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 7; Hewitt Associates LLC, Survey Findings: Trends and Experiences in 401(k) Plans, 2005 (2005) at 16; and Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 38.

[34] These estimates assume complete correspondence between automatic enrollment in 401(k) plans and default investing. Participants contributing by automatic enrollment are assumed to invest in the plan's default investment, while those who actively elect to contribute or who are in plans without elective contributions are assumed to actively invest. In practice neither of these assumptions will hold all of the time. Some participants who are automatically enrolled may nonetheless actively direct their investments. Some active contributors or participants in plans without elective contributions may choose to invest in the plan's default investment '' and this regulation may affect the incidence of such default investing. The Department did not attempt to estimate the extent or effect of default investing not associated with automatic enrollment.

[35] Some comments on the proposed regulation suggested that money market funds may not accurately represent the range of capital preservation instruments that might serve as default investments. In particular, according to some comments, stable value funds, relative to money market funds, offer higher returns with similarly low risk. The Department's estimates of the effects of the proposed regulation did not reflect this possibility. The Department agrees that stable value funds, if they perform as projected by their proponents, would outperform money market funds and thereby narrow (but not eliminate) the gains in average account balances and retirement income estimated to result from the shift toward qualified default investment alternatives. However, the Department believes that this possibility should be assessed with caution. Economic theory suggests that if financial markets are efficient, financial instruments with similar risk characteristics will provide similar returns. It therefore seems likely that there are important differences between money market and stable value funds beyond any difference in average returns. The Department understands that stable value products may come with a variety of features that may sometimes erode actual returns in response, for example, to certain plan sponsor actions that have the effect of shifting participant account allocations away from such products. Such stable value product features may sometimes dissuade plans or participants from making investment changes that they otherwise would, thereby imposing opportunity costs. The Department also understands that stable value products may expose investors to the credit risk of the fund vendor in ways that money market funds do not. This credit risk may be sensitive to changes in interest rates. In light of these considerations the Department continues to believe that, for purposes of assessing the impact of this regulation, money market funds reasonably represent available near risk-free investment instruments.

Nonetheless, in an effort to fully consider the potential implications of representations made in the comments, the Department tested the sensitivity of its low-impact estimates to representations regarding the investment performance of stable value products and assuming stable value products would be a substantial part of qualified default investments in the future. The sensitivity test puts aside the above considerations, and replaces money market fund performance with stylized stable value performance that is 200 basis points higher and equally variable. Under this test scenario, the regulation would increase aggregate account balances in 2034 by $68 billion (for comparison the Department's primary estimate is $70 billion), of which $3 billion (compared with $5 billon) is attributable to the shift of default investments from near risk-free instruments to qualified default investment alternatives. Among individuals age 65 and older in 2034, the number gaining retirement income would exceed the number losing by a ratio of 2.2 to 1 (compared with 2.7 to 1) and the aggregate amount gained would exceed that lost by a ratio of 3.8 to 1 (compared with 4.1 to 1).

[36] The qualified default investment alternative is represented by a portfolio resembling a life cycle fund, with 100 percent minus the participant's age in equity and the remainder in U.S. Treasury bonds.

these returns were assumed fees of 45, 45 and 75 basis points.

To estimate the effects of the regulation, the Department compared the baseline estimates to the low- and high-impact estimates.

For a more detailed explanation of the basis of these estimates, see Martin R. Holmer, ''PENSIM Analysis of Impact of Final Regulation on Defined— Contribution Default Investments'' (Policy Simulation Group, February 12, 2007). For additional estimation results, see Holmer, ''EBSA Automatic Enrollment RIA: Final Estimates'' (Policy Simulation Group, February 7, 2007). Both are available as part of the public docket associated with this regulation. Additional information on the Department's use of PENSIM in connection with this regulation is provided below, under the heading ''Peer Review.''

Sensitivity Tests

As noted above, the Department anticipates that this regulation (together with the automatic enrollment provisions of the Pension Protection Act) will have two major, beneficial economic consequences. Default investments will be directed toward higher-return instruments boosting average account performance, and automatic enrollment provisions will become more common boosting participation. In reaching its conclusion that the regulation will increase retirement income and improve social welfare, the Department took into account the potential sensitivity of its estimates to important economic and behavioral variables.

One variable involves the future incidence of automatic enrollment programs. As noted above the Department assessed this variable by comparing both low- and high-impact estimates with a common baseline. This variable affects the magnitude but not the net positive direction of the regulation's estimated effects.

The specific characteristics of future automatic enrollment programs constitute additional variables. For example, will new automatic enrollment programs cover only new employees, or existing non-participating employees as well? [37] The Department's estimates reflect automatic enrollment of new employees only. If plan sponsors automatically enroll existing employees the regulation's effects will be larger than estimated, especially in the near term. What default contribution rates will prevail? [38] The Department's primary estimates assume a uniform 3 percent default contribution rate. Higher contribution rates would increase the size of default participants' contributions, but might also discourage some from participating. To illustrate these potential effects the Department produced two alternative low-impact estimates substituting a 4.5-percent default contribution rate. One estimate assumed that the impact of automatic enrollment on participation was undiminished by the higher default contribution rate, the other that it was diminished by half. These were compared with the primary baseline estimate. Where the Department's primary low-impact estimate placed the increase in aggregate account balances in 2034 at $70 billion, the first alternative placed it at $123 billion, the second at $40 billion.

Additional variables concern what other changes plan sponsors might make to their plans. Plan sponsors implementing qualified default investment alternatives may make other changes to investment options or undertake new efforts to inform or influence participants' investment decisions. Plan sponsors that maintain or begin automatic enrollment programs may change other provisions of their plans, such as matching contribution formulas, eligibility or vesting provisions, loan programs, or distribution policies. Changes such as these could either augment or offset the effects of this regulation.

The investment advice and automatic enrollment provisions of the Pension Protection Act will promote activities and plan designs that are likely to augment the regulation's positive effects on retirement savings. Those provisions will help make investment advice available to more participants and will promote automatic enrollment programs with escalating default contribution rates, generous employer matching contributions and short vesting periods.

Default participants may make other changes in their savings behavior. Default participation might foster financial literacy or a taste for saving, which could augment the regulation's effect. Alternatively, default participants might offset their default savings by reducing other savings or taking on debt. In particular, they may be less likely than active participants to preserve their accounts for retirement when leaving a job.[39] To assess the implications of this possibility the Department produced alternative baseline and low-impact estimates, which assume that participants who leave their jobs while in default status never preserve their accounts. (Default participants who become active participants before leaving their jobs are assumed to preserve their accounts at the same rate as other active participants.) The alternative estimates represent a worst case outer bound. As noted above, comparing its primary baseline and low-impact estimates, the Department found that in 2033, 50 percent of net new job leavers with account balances preserve 83 percent of all net new job-leaver account balances. Comparing the respective alternative estimates, the Department found that the corresponding figures are 25 percent and 72 percent. Based on the Department's primary baseline and low-impact estimates, the regulation is expected to reduce the proportion of account holding job leavers that preserve their accounts from 61.0 percent to 60.4 percent and the proportion of their accounts that is preserved from 85.9 percent to 85.8 percent. Based on the alternative estimates, the corresponding reductions are from 56.9 percent to 54.7 percent and from 85.3 percent to 84.9 percent. Both the primary and alternative estimates strongly suggest that most new retirement saving resulting from this regulation (together with the automatic enrollment provisions of the Pension

[37] According to one survey, 24 percent of employers with automatic enrollment programs extended initial automatic enrollment beyond new hires to include the entire eligible population (Deloitte Consulting, Annual 401(k) Benchmarking Survey, 2005/2006 Edition (2006) at 8).

[38] According to one survey, 14 percent of plans with automatic enrollment provided for escalating default contributions in 2005, up from 7 percent in 2004 (Profit Sharing/401(k) Council of America, 49th Annual Survey of Profit Sharing and 401(k) Plans (2006) at 39). According to another, among the 24 percent of surveyed employers offering automatic enrollment in 2006, 17 percent planned to introduce escalating default contributions and 6 percent intended to increase the default contribution rate; none planned to lower it (Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement, 2006 (2006) at 4).

[39] A number of factors may diminish this possibility. First, participants who contribute and invest by default may also tend to handle account distribution opportunities by default. Laws governing plans' default distribution provisions provide for the preservation of all but the smallest accounts. Absent participant direction to the contrary, accounts of $5,000 or more must remain in the plan, and smaller accounts of $1,000 or more must either remain in the plan or be rolled directly into an IRA. Second, some 401(k) plan sponsors reserve eligibility and automatic enrollment for employees who complete a specified period of service, such as one year. It is possible that sponsors with higher-turnover work forces and/or those offering automatic enrollment are or will be more likely to provide for such waiting periods for eligibility, perhaps in order to avoid the expense of churning very small accounts. Third, it is possible that the small fraction of employees who decline automatic enrollment (perhaps 10 percent) may be largely the same ones who would decline to preserve their accounts. In that case, participants added by automatic enrollment might be more likely to preserve them.

Protection Act) will be preserved for retirement. While one effect of the regulation will be to create many very small and short-lived accounts that participants never actively manage and may be unlikely to preserve, the Department expects that the larger effect will be to spur new, early default contributions by participants who later actively manage their accounts and are likely to preserve them.

The regulation may encourage active (in addition to default) investments in qualified default investment alternatives—a phenomenon sometimes referred to as an endorsement effect. If so, the impact of the regulation on asset allocation, and the attendant net positive effect on account balances and retirement income, will be amplified.[40]

Because the regulation's effects will be cumulative and gradual, they will be fully realized only in the very long run, generally when workers beginning careers today have long since retired. This long time horizon introduces additional, longer-term variables, but most of these implicate less the regulation's effects than the baseline. For example, future investment results may vary.[41] Other variables, which the Department did not attempt to quantify, include future career patterns and compensation levels and mixes.

Peer Review

OMB's ''Final Information Quality Bulletin for Peer Review'' (the Bulletin) establishes that important scientific information shall be peer reviewed by qualified specialists before it is disseminated by the Federal government. Collectively, the PENSIM model, the data and methods underlying it, the surveys and literature used to parameterize it, and the Department's interpretation of these and application of them to estimate the effects of this regulation and the proposed regulation constitute a ''highly influential scientific assessment'' under the Bulletin. Pursuant to the Bulletin, the Department therefore subjected this assessment to peer review. All materials associated with that review, including the Department's full response to the peer review, are available to the public as part of the docket associated with this regulation.[42]

The analysis presented here has been refined in several ways in response to the peer review.

The review questioned whether default participants would cash out their accounts rather than preserve them for retirement. The Department's primary estimates assume that default accounts will be cashed out or preserved at the same rates as other similarly-sized accounts.[43] The results, as reported above, suggest that balances attributable to new default contributions will be nearly as likely as other balances to be preserved. It is possible, however, that default participants will be less likely to preserve their accounts than active participants with similar-sized accounts. The Department therefore prepared alternative estimates that account for this possibility. The results appear under the heading ''Sensitivity Testing'' above.

The review questioned whether lower-paid workers might be more risk averse and might therefore be susceptible to welfare losses if their default investments are redirected from capital preservation vehicles to qualified default investment alternatives. In response the Department more closely examined the regulation's impact on lower-paid workers, finding disproportionate gains in pension income, as described above. These gains may help offset any welfare losses due to sub-optimal risk exposure. In addition, the Department believes the required notice to participants regarding default investments will facilitate the ability of workers to easily choose to actively change their risk exposure if the qualified default investment alternatives do not meet their risk preferences.

The reviews questioned the Department's assumptions regarding investment returns, saying they exaggerated the equity premium, neglected fees, and neglected variation in inflation and returns to debt instruments. In response the Department has moderated its assumption regarding the equity premium,[44] accounted for fees, and incorporated stochastic variation in inflation and debt returns.

Alternatives Considered

Capital Preservation Products

In defining the types of investment products, portfolios or services that may be used as a long-term qualified default investment alternative, the Department, after careful consideration of the many comments supporting capital preservation products, and assessment of related economic impacts, determined not to include capital

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[40] There is some evidence to suggest that qualified default investment alternatives, once established as plan defaults, may claim a disproportionate share of active investments as well. There is some evidence that participants may gravitate toward investment options that appear to be endorsed by their employers, such as by responding to employers' directing of matching contributions into company stock by investing more participant-directed funds in company stock as well (see, *e.g.*, Jeffrey R. Brown, Nellie Liang and Scott Weisbenner, Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans, (Sept. 2006) at 18). This paper summarizes some prior evidence and provides some new evidence of this effect, but also raises the possibility that this effect may be attributable instead to other factors. Participants have been found to exhibit inertia in their investment choices, being slow to rebalance or to respond to changes in the investment options offered to them (see, *e.g.*, Olivia S. Mitchell, Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi, The Inattentive Participant: Portfolio Trading Behavior in 401(k) Plans, Pension Research Council Working Paper 2006–5 (2006) at 16, which finds a lack of rebalancing; see also Jeffrey R. Brown and Scott Weisbenner, Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans (Dec. 2004) at 23, 37, Tables 8a, 8b, which finds inertia in participant response to the addition of new funds). Most on point, some early experience with automatic enrollment programs suggests that a previously available investment alternative, once established as a default in an automatic enrollment program, may attract an increased proportion of actively directed participant accounts (see, e.g, John Beshears, James J. Choi, David Laibson and Brigitte C. Madrian, The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States, National Bureau of Economic Research Working Paper 12009 (Jan. 2006), which provides some evidence of such an endorsement effect; see also Fidelity Investments, Building Futures Volume VII: How Workplace Savings are Shaping the Future of Retirement, (2006) at 124–138, for data on the concentration of participant accounts in default investment alternatives). To assess the potential implications of an endorsement effect for the impact of this regulation, the Department carried out a sensitivity test of its low-impact estimates of the regulation's effects. Where the Department's primary estimates take into account the default investment of defaulted participants' accounts only (no endorsement effect), the sensitivity test additionally assumes that 20 percent of actively directed accounts in plans with automatic enrollment will be directed to default investment alternatives (20 percent endorsement effect). Compared with the primary estimates, the sensitivity test indicates that regulation will increase aggregate account balances in 2034, expressed in 2006 dollars, by $87 billion (rather than $70 billion), of which $26 billion (rather than $5 billion) will be directly attributable to the allocation of more assets to qualified default investment alternatives (the rest will be attributable to growth in automatic enrollment).

[41] The Department's estimates illustrate some of this as variation in results across individuals.

[42] Please see *http://www.dol.gov/ebsa/regs/peerreview.html.*

[43] The Department's estimate of the effect of the proposed regulation assigned uniform cash out probabilities (derived from an industry survey) to accounts within certain arbitrary size categories. For example, all accounts smaller than approximately $11,000 (expressed at 2005 levels) were assigned the same cash out probability. This may have understated the propensity to cash out very small accounts. The Department has since refined its estimation of cash out probabilities. These probabilities are now estimated as a continuous function of account size, based on household survey data.

[44] In its estimates of the effects of the proposed regulation the Department had assumed a real average equity return of 6.5 percent, which was consistent with long-term historical performance. The estimates presented here assume a real average return of 4.9 percent, which is more in line with recent performance and commenters' expectations of the future.

preservation products, such as money market or stable value funds, as a stand-alone long-term investment option for contributions made after the effective date of this regulation. However, the Department believes that such investments can play an important role as a component of a qualified default investment alternative. Further, it is important to note that the exclusion of such funds as a qualified default investment alternative does not preclude their use as a default investment option—fiduciaries are free to adopt default investments they deem to be prudent without availing themselves of the fiduciary relief afforded by this regulation.

Including such instruments for future contributions might have yielded some benefits if, for example, their inclusion would encourage more plan sponsors to implement automatic enrollment programs or fewer workers to opt out of them. The Department believes such cases would be rare, however. First, a decreasing proportion of plans already are designating such instruments as default investments.[45] Second, workers concerned that a default investment provides more risk than they prefer need not refuse or terminate[46] participation in response, but instead need only direct their contributions into a different investment option otherwise available in the plan.

Including such instruments might benefit some affected short-tenure participants who cash out and spend their accounts during downturns in equity prices. Historically, though, equity returns are positive more often then they are negative, so this potential benefit is likely to be outweighed by the opportunity cost to affected short-tenure participants who cash out during upturns.[47] Moreover, the Department believes that this regulation should be calibrated to foster preservation of retirement accounts rather than to accommodate cashouts, consistent with other provisions of law, such as the mandatory withholding and additional tax provisions applicable to premature distributions.

Some comments on the proposed regulation expressed concern that qualified default investment alternatives would expose risk averse participants to excessive investment risk, and on that basis urged the Department to include stand-alone capital preservation instruments as qualified default investment alternatives. The Department is not persuaded by this argument, however, for three reasons. First, the regulation's primary goal is to promote default investments that enhance retirement saving, not to align default investments with individuals' levels of risk tolerance.[48] Second, the Department nonetheless believes that the qualified default investment alternatives included in the regulation can satisfy most affected individuals' risk preferences.[49] Finally, participants who find default investments too risky can opt out of them without opting out of plan participation entirely.

Some comments cautioned that the exclusion of stand-alone capital preservation products from the definition of qualified default investment alternatives would prompt a large, rapid movement of money across asset classes, with negative consequences for financial markets. In particular according to these comments, movement out of stable value products might repress those products' future interest crediting rates and thereby harm investors who continue to hold them. The Department believes, however, that movement away from stable value products and therefore any negative impact on forward crediting rates will be modest, as only a relatively small portion of current assets in stable value products appears to be attributable to defaulted participants.[50] Additionally,

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[45] According to one survey, in 2006, 17 percent of sponsors with automatic enrollment programs were likely to change their default from such instruments to qualified default investment alternative-type instruments, while just 4 percent were likely to do the opposite (Hewitt Associates LLC, Survey Findings: Hot Topics in Retirement 2006 (2006) at 4). According to another, between 1999 and 2005 the proportion designating such instruments as defaults decreased from 69 percent to 56 percent, while the proportion designating qualified default investment alternative-type instruments as defaults increased from 28 percent to 39 percent (Hewitt Associates LLC, Survey Findings: Trends and Experiences in 401(k) Plans 2005, (2005) at 15).

[46] Might a risk-averse participant, enrolled and invested by default, terminate participation in response to news that their account had suffered principal losses? Perhaps not. The same inertia that leads some participants to enroll and invest by default might also prevent them from terminating participation. The Department also observes that an early principal loss usually will not translate into a decline in the account balance reported in a quarterly statement, since quarterly contributions are likely to more than offset such losses during at least the first few years of participation.

[47] Such potential benefits would additionally be offset by reduced average returns to default investors who do not cash out early. As noted above, the Department estimates that most default contributions will be preserved for retirement. As discussed above, even the subset of short term workers who cash out their accounts will experience an overall aggregate increase in wealth from this regulation. Thus, the concern for fostering preservation of retirement accounts is not being weighed against aggregate losses to this subset of workers, but is instead being weighed against the added volatility their accounts might experience. In weighing these interests, the Department kept in mind that short term employees concerned about this volatility are always free to choose a different investment option.

[48] In theory individuals can optimize their investment mix over time to match their personal taste for risk and return. The regulation's provisions that establish participants' right to direct their investments out of qualified default alternatives give participants the opportunity to so do. But in practice investors sometimes do not optimize their investment alternatives. Some may lack clear, fixed and rational preferences for risk and return. Some investors' tastes for risky assets may be distorted by imperfect information, or by irrational and ineffectual behavioral phenomena such as naive diversification (a tendency to divide assets equally across available options), sub-optimal excessive concentration in company stock, market timing, mental accounting and framing, and reliance on peer examples (see, *e.g.*, Richard H. Thaler and Shlomo Benartzi, The Behavioral Economics of Retirement Savings Behavior, AARP Public Policy Institute white paper #2007–02 (Jan. 2007) at 6–16), or inertia. This regulation promotes default investments that can enhance such investors' retirement savings prospects.

[49] One commenter on the proposed regulation called the Department's attention to a study of optimal investment mixes for investors with different levels of risk aversion. The study employed techniques known as stochastic dominance analysis of asset class performance and multi-period investor utility optimization, explaining that these techniques are in some ways superior to alternatives such as mean-variance analysis of asset class performance and single-period utility optimization. The commenter criticized the Department's use of the latter, potentially inferior techniques to assess the question of what mix of asset classes best matches investors' tastes. But in fact the Department did not assess this question, focusing instead on how different asset class mixes affect retirement savings accumulations. Interestingly the study, which utilized stable value product performance data supplied by the industry, concluded that for most investors most of the time, the optimal portfolio will include a mix of equity and stable value products rather than stable value products alone. This suggests to the Department that the qualified default investment alternatives included in this regulation encompass most investors' levels of risk tolerance. The Department also notes that most 401(k) plan participants who actively direct their investments include equity in their portfolios (see, *e.g.*, Sarah Holden and Jack VanDerhei, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2005, EBRI Issue Brief No. 296 (Aug. 2006) at 9, Figure 8; see also Fidelity Investments, Building Futures Volume VII: How Workplace Savings are Shaping the Future of Retirement (2006) at 128, Figure 130).

[50] There are several reasons to believe that asset allocation will not shift very abruptly, and that stable value products will continue to claim a large share of 401(k) plan assets. First, while this regulation generally does not extend fiduciary relief to default investments that consist solely of stable value products, it does not foreclose qualified default investment alternatives from including such products, and leaves intact general fiduciary provisions that may otherwise permit default investments that consist solely of such products. A significant number of plans currently utilize stable value products as their default investment option, reflecting determinations by a significant number of plan fiduciaries that stand-alone stable value products are a prudent investment for defaulted participants. Nothing in this regulation is intended to suggest or require that a plan fiduciary change an otherwise prudent selection of a stable value product for a plan's default investment option. The Department therefore anticipates that some plans will continue to direct all or a portion of default investments to stable value products. Second, the

according to these comments, movement out of stable value products might alter short-term conditions in the markets for debt securities that underlie such products. Decreased demand for stable value products might then repress the price of underlying debt instruments and increased demand for qualified default investment alternatives might drive up equity prices. The Department believes any such effects would be gradual and negligible.[51]

If included as a qualified default investment alternative and thereby promoted as a default investment, stand-alone capital preservation products' generally inferior long-term investment returns would almost certainly erode the regulation's beneficial effect on retirement income. The Department estimates that including capital preservation instruments as a stand-alone qualified default investment alternative would reduce aggregate account balances in 2034 by between $5 billion and $7 billion (expressed in 2006 dollars).[52] This negative effect will be larger if there is an endorsement effect ($26 billion under the low-impact estimate)—that is, if the instruments status as a qualified default investment alternative encourages active (in addition to default) investments in them.[53]

Finally, the Department believes it is desirable for a default investment vehicle to be diversified across asset classes, rather than to include only a single asset class. Such diversification can improve a portfolio's risk and return efficiency.

In summary, in weighing the merits of potential qualified default investment alternatives, the Department sought primarily to promote default investments that enhance retirement savings. The Department considered market trends, generally accepted investment theories, mainstream financial planning practices, and actual investor behavior, as well as the estimated effect of qualified default investment alternatives on retirement savings. All of these criteria suggest that it is desirable to invest retirement savings in vehicles that provide for the possibility of capital appreciation in addition to capital preservation.

Accordingly, the Department did not include stand-alone capital preservation instruments among the qualified default investment alternatives under the regulation. However, the Department has modified the regulation to include a ''grandfather''-like provision pursuant to which stable value products and funds will constitute a qualified default investment alternative under the regulation for purposes of investments made prior to the effective date of the regulation.

Balanced Defaults

The Department also considered whether to include as a qualified default investment alternative an investment fund product or model portfolio that establishes a uniform mix of equity and fixed income exposures for all affected participants. Such a product or model portfolio must be appropriate for participants of the plan as a whole but cannot be separately calibrated for each participant or for particular classes of participants. Therefore, while its risk level may be appropriate for all affected participants it is unlikely to be optimal for all. However, such a product or model portfolio may also have relative advantages. Compared with the other potential qualified default investment alternatives such a product or portfolio may be simpler, less expensive and easier to explain and understand. These advantages sometimes may outweigh the potential advantage of more customized risk levels. And the inclusion of such products or model portfolios might help heighten competition in the market and thereby enhance product quality and affordability across all qualified default investment alternatives. Accordingly, the Department has included such instruments as qualified default investment alternatives under this regulation.

Federalism Statement

Executive Order 13132 (August 4, 1998) outlines fundamental principles of federalism and requires Federal agencies to adhere to specific criteria in the formulation and implementation of policies that have a substantial direct effect on the States, the relationship between the national government and the States, or on the distributive power and responsibilities among the various levels of government. As noted above, section 902(f) of the Pension Protection Act adds a new provision to ERISA (section 514(e)) providing that notwithstanding any other provision of section 514, Title I of ERISA supersedes State laws that would directly or indirectly prohibit or restrict the inclusion of an automatic contribution arrangement in any plan. In the preamble to the notice of proposed rulemaking published on September 27, 2006, the Department specifically discussed the preemption provision enacted in the Pension Protection Act and requested comments on whether, and to what extent, addressing this provision in the regulations would be helpful. Although no States provided comments on the proposed regulation, other commenters requested that the Department use the regulation to clarify the application of the statutory preemption provision. As noted elsewhere in this preamble, paragraph (f) of the final regulation addresses those comments. In accordance with section 4 of the E.O. 13132, the Department of Labor has construed the preemptive effect of ERISA section 514(e) at the minimum level necessary to achieve the objectives of the statute.

Department expects that stable value products will continue to be offered as an investment option by many participant-directed plans and selected by many participants. It is expected that participants will invest only a small fraction of assets by default, and will actively direct a large majority of assets. The Department's low- and high-impact estimates respectively suggest that between 1.2 percent and 1.5 percent of 401(k) plan assets will be invested by default in 2034. Viewed another way, absent this regulation, the Department estimates that just $10 billion would be invested by default in capital preservation vehicles in 2034 (expressed in 2006 dollars). This compares with approximately $400 billion of 401(k) assets invested in stable value products today. Third, there will be some offsetting effect, deriving from the increase in actively invested account balances expected to result from this regulation. The Department estimates that the regulation, by promoting automatic enrollment and higher average investment performance, will increase aggregate actively invested account balances in 2034 by between $59 billion and $114 billion (expressed in 2006 dollars), or between 2.4 percent and 4.6 percent, while aggregate default invested account balances will grow by just $11 billion to $20 billion. Stable value products will capture some share of the increase in actively invested account balances. Fourth, the extent to which some plans do move money out of stable value products may be additionally moderated by stable value product features that have the effect of discouraging large movements and by associated fiduciary considerations. Plan fiduciaries, in determining whether, how and under what circumstances a change should be made in the plan's default investment option, must assess, among other things, the potential economic consequences of such a change to participants' investments in such options. Finally, because this regulation includes a ''grandfather''-like provision applicable to certain stable value products, it provides no direct incentive for plan fiduciaries to reallocate account balances heretofore invested by default in such products.

[51] As noted above, the Department expects that asset allocation will not shift very abruptly, and that stable value products will continue to claim a large share of 401(k) assets. In addition, while stable value products comprise a substantial fraction of all 401(k) assets (perhaps as much as 20 percent), their underlying portfolios hold only a small fraction (generally between 0.5 percent and 2 percent) of all debt and of major debt categories such as mortgages, corporate bonds and treasury and agency issues. These estimates are based on stable value product data provided by the Stable Value Industry Association and the U.S. Federal Reserve Board of Governors' Flow of Funds Accounts.

[52] This assumes that, as under the baseline, 50 percent of default contributions will be directed to capital preservation products and 50 percent to (other) qualified default investment alternatives.

[53] For this calculation, the Department assumes a 20 percent endorsement effect.

In any event, the Department does not view the final rule, as distinct from the statute, as having a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power among the various levels of government. The statute preempts State laws and the regulation merely clarifies application of the statutory provision in a way that is consistent with the plain language and the legislative history. State wage withholding restrictions will not be affected except as they apply to automatic contribution arrangements of ERISA-covered plans. Moreover, the regulation imposes no compliance costs on State or local governments. As a result, the Department concludes that the final regulation does not have federalism implications.

List of Subjects in 29 CFR Part 2550

Employee benefit plans, Exemptions, Fiduciaries, Investments, Pensions, Prohibited transactions, Real estate, Securities, Surety bonds, Trusts and trustees.

■ For the reasons set forth in the preamble, the Department amends Subchapter F, Part 2550 of Title 29 of the Code of Federal Regulations as follows:

SUBCHAPTER F—FIDUCIARY RESPONSIBILITY UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

■ 1. The authority citation for part 2550 is revised to read as follows:

Authority: 29 U.S.C. 1135; sec. 657, Pub. L. 107–16, 115 Stat. 38; and Secretary of Labor's Order No. 1–2003, 68 FR 5374 (Feb. 3, 2003). Sec. 2550.401b–1 also issued under sec. 102, Reorganization Plan No. 4 of 1978, 43 FR 47713 (Oct. 17, 1978), 3 CFR, 1978 Comp. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), 3 CFR, 1978 Comp. 332. Sec. 2550.401c–1 also issued under 29 U.S.C. 1101. Sections 2550.404c–1 and 2550.404c–5 also issued under 29 U.S.C. 1104. Sec. 2550.407c–3 also issued under 29 U.S.C. 1107. Sec. 2550.408b–1 also issued under 29 U.S.C. 1108(b)(1) and sec. 102, Reorganization Plan No. 4 of 1978, 3 CFR, 1978 Comp. p. 332, effective Dec. 31, 1978, 44 FR 1065 (Jan. 3, 1978), and 3 CFR, 1978 Comp. 332. Sec. 2550.412–1 also issued under 29 U.S.C. 1112.

■ 2. Add § 2550.404c–5 to read as follows:

§ 2550.404c–5 Fiduciary relief for investments in qualified default investment alternatives.

(a) *In general.* (1) This section implements the fiduciary relief provided under section 404(c)(5) of the Employee Retirement Income Security Act of 1974, as amended (ERISA or the Act), 29 U.S.C. 1001 et seq., under which a participant or beneficiary in an individual account plan will be treated as exercising control over the assets in his or her account for purposes of ERISA section 404(c)(1) with respect to the amount of contributions and earnings that, in the absence of an investment election by the participant, are invested by the plan in accordance with this regulation. If a participant or beneficiary is treated as exercising control over the assets in his or her account in accordance with ERISA section 404(c)(1) no person who is otherwise a fiduciary shall be liable under part 4 of title I of ERISA for any loss or by reason of any breach which results from such participant's or beneficiary's exercise of control. Except as specifically provided in paragraph (c)(6) of this section, a plan need not meet the requirements for an ERISA section 404(c) plan under 29 CFR 2550.404c–1 in order for a plan fiduciary to obtain the relief under this section.

(2) The standards set forth in this section apply solely for purposes of determining whether a fiduciary meets the requirements of this regulation. Such standards are not intended to be the exclusive means by which a fiduciary might satisfy his or her responsibilities under the Act with respect to the investment of assets in the individual account of a participant or beneficiary.

(b) *Fiduciary relief.* (1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a fiduciary of an individual account plan that permits participants or beneficiaries to direct the investment of assets in their accounts and that meets the conditions of paragraph (c) of this section shall not be liable for any loss, or by reason of any breach under part 4 of title I of ERISA, that is the direct and necessary result of (i) investing all or part of a participant's or beneficiary's account in any qualified default investment alternative within the meaning of paragraph (e) of this section, or (ii) investment decisions made by the entity described in paragraph (e)(3) of this section in connection with the management of a qualified default investment alternative.

(2) Nothing in this section shall relieve a fiduciary from his or her duties under part 4 of title I of ERISA to prudently select and monitor any qualified default investment alternative under the plan or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses.

(3) Nothing in this section shall relieve any fiduciary described in paragraph (e)(3)(i) of this section from its fiduciary duties under part 4 of title I of ERISA or from any liability that results from a failure to satisfy these duties, including liability for any resulting losses.

(4) Nothing in this section shall provide relief from the prohibited transaction provisions of section 406 of ERISA, or from any liability that results from a violation of those provisions, including liability for any resulting losses.

(c) *Conditions.* With respect to the investment of assets in the individual account of a participant or beneficiary, a fiduciary shall qualify for the relief described in paragraph (b)(1) of this section if:

(1) Assets are invested in a qualified default investment alternative within the meaning of paragraph (e) of this section;

(2) The participant or beneficiary on whose behalf the investment is made had the opportunity to direct the investment of the assets in his or her account but did not direct the investment of the assets;

(3) The participant or beneficiary on whose behalf an investment in a qualified default investment alternative may be made is furnished a notice that meets the requirements of paragraph (d) of this section:

(i) (A) At least 30 days in advance of the date of plan eligibility, or at least 30 days in advance of the date of any first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2) of this section; or

(B) On or before the date of plan eligibility provided the participant has the opportunity to make a permissible withdrawal (as determined under section 414(w) of the Internal Revenue Code of 1986, as amended (Code)); and

(ii) Within a reasonable period of time of at least 30 days in advance of each subsequent plan year;

(4) A fiduciary provides to a participant or beneficiary the material set forth in 29 CFR 2550.404c-1(b)(2)(i)(B)(1)(viii) and (ix) and 29 CFR 404c-1(b)(2)(i)(B)(2) relating to a participant's or beneficiary's investment in a qualified default investment alternative;

(5)(i) Any participant or beneficiary on whose behalf assets are invested in

a qualified default investment alternative may transfer, in whole or in part, such assets to any other investment alternative available under the plan with a frequency consistent with that afforded to a participant or beneficiary who elected to invest in the qualified default investment alternative, but not less frequently than once within any three month period;

(ii)(A) Except as provided in paragraph (c)(5)(ii)(B) of this section, any transfer described in paragraph (c)(5)(i), or any permissible withdrawal as determined under section 414(w)(2) of the Code, by a participant or beneficiary of assets invested in a qualified default investment alternative, in whole or in part, resulting from the participant's or beneficiary's election to make such a transfer or withdrawal during the 90-day period beginning on the date of the participant's first elective contribution as determined under section 414(w)(2)(B) of the Code, or other first investment in a qualified default investment alternative on behalf of a participant or beneficiary described in paragraph (c)(2) of this section, shall not be subject to any restrictions, fees or expenses (including surrender charges, liquidation or exchange fees, redemption fees and similar expenses charged in connection with the liquidation of, or transfer from, the investment);

(B) Paragraph (c)(5)(ii)(A) of this section shall not apply to fees and expenses that are charged on an ongoing basis for the operation of the investment itself (such as investment management fees, distribution and/or service fees, ''12b–1'' fees, or legal, accounting, transfer agent and similar administrative expenses), and are not imposed, or do not vary, based on a participant's or beneficiary's decision to withdraw, sell or transfer assets out of the qualified default investment alternative; and

(iii) Following the end of the 90-day period described in paragraph (c)(5)(ii)(A) of this section, any transfer or permissible withdrawal described in this paragraph (c)(5) of this section shall not be subject to any restrictions, fees or expenses not otherwise applicable to a participant or beneficiary who elected to invest in that qualified default investment alternative; and

(6) The plan offers a ''broad range of investment alternatives'' within the meaning of 29 CFR 2550.404c–1(b)(3).

(d) *Notice.* The notice required by paragraph (c)(3) of this section shall be written in a manner calculated to be understood by the average plan participant and shall contain the following:

(1) A description of the circumstances under which assets in the individual account of a participant or beneficiary may be invested on behalf of the participant or beneficiary in a qualified default investment alternative; and, if applicable, an explanation of the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right of the participant to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage);

(2) An explanation of the right of participants and beneficiaries to direct the investment of assets in their individual accounts;

(3) A description of the qualified default investment alternative, including a description of the investment objectives, risk and return characteristics (if applicable), and fees and expenses attendant to the investment alternative;

(4) A description of the right of the participants and beneficiaries on whose behalf assets are invested in a qualified default investment alternative to direct the investment of those assets to any other investment alternative under the plan, including a description of any applicable restrictions, fees or expenses in connection with such transfer; and

(5) An explanation of where the participants and beneficiaries can obtain investment information concerning the other investment alternatives available under the plan.

(e) *Qualified default investment alternative.* For purposes of this section, a qualified default investment alternative means an investment alternative available to participants and beneficiaries that:

(1)(i) Does not hold or permit the acquisition of employer securities, except as provided in paragraph (ii).

(ii) Paragraph (e)(1)(i) of this section shall not apply to: (A) Employer securities held or acquired by an investment company registered under the Investment Company Act of 1940 or a similar pooled investment vehicle regulated and subject to periodic examination by a State or Federal agency and with respect to which investment in such securities is made in accordance with the stated investment objectives of the investment vehicle and independent of the plan sponsor or an affiliate thereof; or (B) with respect to a qualified default investment alternative described in paragraph (e)(4)(iii) of this section, employer securities acquired as a matching contribution from the employer/plan sponsor, or employer securities acquired prior to management by the investment management service to the extent the investment management service has discretionary authority over the disposition of such employer securities;

(2) Satisfies the requirements of paragraph (c)(5) of this section regarding the ability of a participant or beneficiary to transfer, in whole or in part, his or her investment from the qualified default investment alternative to any other investment alternative available under the plan;

(3) Is:

(i) Managed by: (A) an investment manager, within the meaning of section 3(38) of the Act; (B) a trustee of the plan that meets the requirements of section 3(38)(A), (B) and (C) of the Act; or (C) the plan sponsor who is a named fiduciary, within the meaning of section 402(a)(2) of the Act;

(ii) An investment company registered under the Investment Company Act of 1940; or

(iii) An investment product or fund described in paragraph (e)(4)(iv) or (v) of this section; and

(4) Constitutes one of the following:

(i) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(i), asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a ''life-cycle'' or ''targeted-retirement-date'' fund or account.

(ii) An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. For purposes of this paragraph (e)(4)(ii), asset allocation

decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant. An example of such a fund or portfolio may be a ''balanced'' fund.

(iii) An investment management service with respect to which a fiduciary, within the meaning of paragraph (e)(3)(i) of this section, applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. For purposes of this paragraph (e)(4)(iii), asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant. An example of such a service may be a ''managed account.''

(iv)(A) Subject to paragraph (e)(4)(iv)(B) of this section, an investment product or fund designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. Such investment product shall for purposes of this paragraph (e)(4)(iv):

(*1*) Seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product; and

(*2*) Be offered by a State or federally regulated financial institution.

(B) An investment product described in this paragraph (e)(4)(iv) shall constitute a qualified default investment alternative for purposes of paragraph (e) of this section for not more than 120 days after the date of the participant's first elective contribution (as determined under section 414(w)(2)(B) of the Code).

(v)(A) Subject to paragraph (e)(4)(v)(B) of this section, an investment product or fund designed to guarantee principal and a rate of return generally consistent with that earned on intermediate investment grade bonds, while providing liquidity for withdrawals by participants and beneficiaries, including transfers to other investment alternatives. Such investment product or fund shall, for purposes of this paragraph (e)(4)(v), meet the following requirements:

(*1*) There are no fees or surrender charges imposed in connection with withdrawals initiated by a participant or beneficiary; and

(*2*) Principal and rates of return are guaranteed by a State or federally regulated financial institution.

(B) An investment product or fund described in this paragraph (e)(4)(v) shall constitute a qualified default investment alternative for purposes of paragraph (e) of this section solely for purposes of assets invested in such product or fund before December 24, 2007.

(vi) An investment fund product or model portfolio that otherwise meets the requirements of this section shall not fail to constitute a product or portfolio for purposes of paragraph (e)(4)(i) or (ii) of this section solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment fund product or model portfolio.

(f) *Preemption of State laws.* (1) Section 514(e)(1) of the Act provides that title I of the Act supersedes any State law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. For purposes of section 514(e) of the Act and this paragraph (f), an automatic contribution arrangement is an arrangement (or the provisions of a plan) under which:

(i) A participant may elect to have the plan sponsor make payments as contributions under the plan on his or her behalf or receive such payments directly in cash;

(ii) A participant is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage); and

(iii) Contributions are invested in accordance with paragraphs (a) through (e) of this section.

(2) A State law that would directly or indirectly prohibit or restrict the inclusion in any pension plan of an automatic contribution arrangement is superseded as to any pension plan, regardless of whether such plan includes an automatic contribution arrangement as defined in paragraph (f)(1) of this section.

(3) The administrator of an automatic contribution arrangement within the meaning of paragraph (f)(1) of this section shall be considered to have satisfied the notice requirements of section 514(e)(3) of the Act if notices are furnished in accordance with paragraphs (c)(3) and (d) of this section. (4) Nothing in this paragraph (f) precludes a pension plan from including an automatic contribution arrangement that does not meet the conditions of paragraphs (a) through (e) of this section.

Signed at Washington, DC, this 15th day of October, 2007.

Bradford P. Campbell,

Assistant Secretary, Employee Benefits Security Administration, Department of Labor.

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Appendix E — Employee Benefit Law

Employer Securities and Real Property - General

Originally issued September 20, 1977 (42 FR 47201)

a. In General. Section 407(a)(1) of the Employee Retirement Income Security Act of 1974 (the Act) states that except as otherwise provided in section 407 and section 414 of the Act, a plan may not acquire or hold any employer security which is not a qualifying employer security or any employer real property which is not qualifying employer real property. Section 406(a)(1)(E) prohibits a fiduciary from knowingly causing a plan to engage in a transaction which constitutes a direct or indirect acquisition, on behalf of a plan, of any employer security or employer real property in violation of section 407(a), and section 406(a)(2) prohibits a fiduciary who has authority or discretion to control or manage assets of a plan to permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a).
b. Requirements applicable to all plans. A plan may hold or acquire only employer securities which are qualifying employer securities and employer real property which is qualifying employer real property. A plan may not hold employer securities and employer real property which are not qualifying employer securities and qualifying employer real property, except to the extent that:

    1. The employer security is held by a plan which has made an election under section 407(c)(3) of the Act; or
    2. The employer security is a loan or other extension of credit which satisfies the requirements of section 414(c)(1) of the Act or the employer real property is leased to the employer pursuant to a lease which satisfies the requirements of section 414(c)(2) of the Act.

Regulation published in Federal Register September 20, 1977 (42 FR 47201) and amended November 22, 1977 (42 FR 59842).

Codified to 29 C.F.R. 2550.407a-1.

Department of Labor

Regulation 2550.407a-2

29 C.F.R. 2550.407a-2.

Employer Securities and Real Property - Acquisition

Originally issued September 20, 1977 (42 FR 47201)

a. In General. Section 407(a)(2) of the Employee Retirement Income Security Act of 1974 (the Act) provides that a plan may not acquire any qualifying employer security or qualifying employer real property, if immediately after such acquisition the aggregate fair market value of qualifying employer securities and qualifying employer real property held by the plan exceeds 10 percent of the fair market value of the assets of the plan.
b. Acquisitions. For purposes of section 407(a) of the Act, an acquisition by a plan of qualifying employer securities or qualifying employer real property shall include, but not be limited to, an acquisition by purchase, by the exchange of plan assets, by the exercise of warrants or rights, by the conversion of a security (except any acquisition pursuant to a conversion exempt under section 408(b)(7) of the Act), by default of a loan where the qualifying employer security or qualifying employer real property was security for the loan, or by the contribution of such securities or real property to the plan. However, an acquisition of a security shall not be deemed to have occurred if a plan acquires the security as a result

of a stock dividend or stock split.

c. Fair Market Value - Indebtedness incurred in connection with the acquisition of a plan asset. In determining whether a plan is in compliance with the limitation on the acquisition of qualifying employer securities and qualifying employer real property in section 407(a)(2), the limitation on the holding of qualifying employer securities and qualifying employer real property in section 407(a)(3) and the requirement regarding the disposition of employer securities and employer real property in section 407(a)(4) thereunder, the fair market value of total plan assets shall be the fair market value of such assets less the unpaid amount of:

    1. Any indebtedness incurred by the plan in acquiring such assets;
    2. Any indebtedness incurred before the acquisition of such assets if such indebtedness would not have been incurred but for such acquisition; and
    3. Any indebtedness incurred after the acquisition of such assets if such indebtedness would not have been incurred but for such acquisition and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition. However, the fair market value of qualifying employer securities and qualifying employer real property shall be the fair market value of such assets without any reduction for the unpaid amount of any indebtedness incurred by the plan in connection with the acquisition of such employer securities and employer real property.

d. Examples.

    1. Plan assets have a fair market value of $100,000. The plan has no liabilities other than liabilities for vested benefits of participants and does not own any employer securities or employer real property. The plan proposes to acquire qualifying employer securities with a fair market value of $10,000 by paying $1,000 in cash and borrowing $9,000. The fair market value of plan assets would be $100,000 ($100,000 of plan assets less $1,000 cash payment plus $10,000 of employer securities less $9,000 indebtedness), the fair market value of the qualifying employer securities would be $10,000, which is 10 percent of the fair market value of plan assets. Accordingly, the acquisition would not contravene section 407(a).
    2. Plan assets have a fair market value of $100,000. The plan has liabilities of $20,000 which were incurred in connection with the acquisition of those assets, and does not own any employer securities or employer real property. The plan proposes to pay cash for qualifying employer securities with a fair market value of $10,000. The fair market value of plan assets would be $80,000 ($100,000 of plan assets less $10,000 cash payment plus $10,000 of employer securities less $20,000 indebtedness), the fair market value of the qualifying employer securities would be $10,000, which is 12.5 percent of the fair market value of plan assets. Accordingly, the acquisition would contravene section 407(a).

Department of Labor

Regulation 2550.407d-5

29 C.F.R. 2550.407d-5

"Qualifying" Employer Security - Defined

Originally issued September 2, 1977 (42 FR 44388)

a. In General. For purposes of this section and section 407(d)(5) of the Employee Retirement Income Security Act of 1974 (the Act), the term "qualifying employer security" means an employer security which is:

    1. Stock; or
    2. A marketable obligation, as defined in paragraph (b) of this section and section 407(e) of the Act.

b. For purposes of paragraph (a)(2) of this section and section 407(d)(5) of the Act, the term "marketable obligation" means a bond, debenture, note, or certificate, or other evidence of indebtedness (hereinafter in this paragraph referred to as "obligation") if:

    1. Such obligation is acquired -

        i. On the market, either

A. At the price of the obligation prevailing on a national securities exchange which is registered with the Securities and Exchange Commission, or
B. If the obligation is not traded on such a national securities exchange, at a price not less favorable to the plan than the offering price for the obligation as established by current bid and asked prices quoted by persons independent of the issuer;

ii. From an underwriter, at a price -

A. Not in excess of the public offering price for the obligation as set forth in a prospectus or offering circular filed with the Securities and Exchange Commission, and
B. At which a substantial portion of the same issue is acquired by persons independent of the issuer; or

iii. Directly from the issuer at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer;

2. Immediately following acquisition of such obligation,

i. Not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and
ii. At least 50 percent of the aggregate amount referred to in paragraph (A) is held by persons independent of the issuer; and

3. Immediately following acquisition, of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.

Department of Labor

Regulation 2550.407d-6

29 C.F.R. 2550.407d-6

"Employee Stock Ownership Plan" - Defined

Originally issued September 2, 1977 (42 FR 44388)

a. In General. -

1. Type of plan. To be an "ESOP" (employee stock ownership plan), a plan described in section 407(d)(6)(A) of the Employee Retirement Income Security Act of 1974 (the Act) must meet the requirements of this section. See section 407(d)(6)(B).
2. Designation as ESOP. To be an ESOP, plan must be formally designated as such in the plan document.
3. Retroactive amendment. A plan meets the requirements of this section as of the date that it is designated as an ESOP if it is amended retroactively to meet, and in fact does meet, such requirements at any of the following times:

i. 12 months after the date on which the plan is designated as an ESOP;
ii. 90 days after a determination letter is issued with respect to the qualification of the plan as an ESOP under this section, but only if the determination is requested by the date in paragraph (a)(3)(i) of this section; or
iii. A later date approved by the Internal Revenue Service district director.

4. Addition to other plan. An ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP. A reference to an ESOP includes an ESOP that forms a portion of another plan.
5. Conversion of existing plan to an ESOP. If an existing pension, profit-sharing, or stock bonus plan is converted into an ESOP, the requirements of section 404 of the Act, relating to fiduciary duties, and section 401(a) of the Internal Revenue Code (the Code), relating to requirements for plans established for the exclusive benefit of employees, apply to such conversion. A conversion may constitute a termination of an existing plan. For definition of a termination, see the

regulations under section 411(d)(3) of the Code and section 4041(f) of the Act.
6. Certain arrangements barred. (i) buy-sell agreements. An arrangement involving an ESOP that creates a put option must not provide for the issuance of put options other than as provided under Section 2550.408b-3(j), (k) and (l). Also, an ESOP must not otherwise obligate itself to acquire securities from a particular security holder at an indefinite time determined upon the happening of an event such as the death of the holder.

b. Plan designed to invest primarily in qualifying employer securities. A plan constitutes an ESOP only if the plan specifically states that it is designed to invest primarily in qualifying employer securities. Thus, a stock bonus plan or a money purchase pension plan constituting an ESOP may invest part of its assets in other than qualifying employer securities. Such plan will be treated the same as other stock bonus plans or money purchase pension plans qualified under section 401(a) of the Code with respect to those investments.
c. Regulations of the secretary of the treasury. A plan constitutes an ESOP for a plan year only if it meets such other requirements as the Secretary of the Treasury may prescribe by regulation under section 4975(e)(7) of the Code. See 26 C.F.R. 54.4975-11.

Department of Labor

Regulation 2550.408b-1

29 C.F.R. 2550.408b-1

Loans to Plan Participants and Beneficiaries

Originally issued July 20, 1989 (54 FR 30520)

a. (1) In General. Section 408(b)(1) of the Employee Retirement Income Security Act of 1974 (the Act of ERISA) exempts from the prohibitions of section 406(a), 406(b)(1), and 406(b)(2) loans by a plan to parties in interest who are participants or beneficiaries of the plan, provided that such loans:

    i. Are available to all such participants and beneficiaries on a reasonably equivalent basis;
    ii. Are not made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees;
    iii. Are made in accordance with specific provisions regarding such loans set forth in the plan;
    iv. Bear a reasonable rate of interest; and
    v. Are adequately secured.

    The Internal Revenue Code (the Code) contains parallel provisions to section 408(b)(1) of the Act. Effective, December 31, 1978, section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to promulgate regulations of the type published herein to the Secretary of Labor. Therefore, all references herein to section 408(b)(1) of the Act should be read to include reference to the parallel provisions of section 4975(d)(1) of the Code.

    Section 1114(b)(15)(B) of the Tax Reform Act of 1986 amended section 408(b)(1)(B) of ERISA by deleting the phrase "highly compensated employees, officers or shareholders" and substituting the phrase "highly compensated employees (within the meaning of section 414(q) of the Internal Revenue Code of 1986)." Thus, for plans with participant loan programs which are subject to the amended section 408(b)(1)(B), the requirements of this regulation should be read to conform with the amendment.

2. Scope. Section 408(b)(1) of the Act does not contain an exemption from acts described in section 406(b)(3) of the Act (prohibiting fiduciaries from receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving plan assets). If a loan from a plan to a participant who is a party in interest with respect to that plan involves an act described in section 406(b)(3), such an act constitutes a separate transaction which is not exempt under section 408(b)(1) of the Act. The provisions of section 408(b)(1) are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related persons).

3. Loans.

    i. Section 408(b)(1) of the Act provides relief from the prohibitions of section 406(a), 406(b)(1) and 406(b)(2) for the making of a participant loan. The term "participant loan" refers to a loan which is arranged and approved by the fiduciary administering the loan program primarily in the interest of the participant and which otherwise satisfies the criteria set forth in section 408(b)(1) of the Act. The existence of a participant loan or participant loan program will be determined upon consideration of all relevant facts and circumstances. Thus, for example, the mere presence of a loan document appearing to satisfy the requirements of section 408(b)(1) will not be dispositive of whether a participant loan exists where the subsequent administration of the loan indicates that the parties to the loan agreement did not intent the loan to be repaid. Moreover, a loan program containing a precondition designed to benefit a party in interest (other than the participant) is not afforded relief by section 408(b)(1) or this regulation. In this regard, section 408(b)(1) recognizes that a program of participant loans, like other plans investments, must be prudently established and administered for the exclusive purpose of providing benefits to participants and beneficiaries of the plan.
    ii. For the purpose of this regulation, the term "loan" will include any renewal or modification of an existing loan agreement, provided that, at the time of each such renewal or modification, the requirements of section 408(b)(1) and this regulation are met.

4. Examples. The following examples illustrate the provisions of section 2550.408b-1(a).

Example (1): T, a trustee of plan P, has exclusive discretion over the management and disposition of plan assets. As a result, T is a fiduciary with respect to P under section 3(21)(A) of the Act and a party in interest with respect to P pursuant to section 3(14)(A) of the Act. T is also a participant in P. Among T's duties as fiduciary is the administration of a participant loan program which meets the requirements of section 408(b)(1) of the Act. Pursuant to strict objective criteria stated under the program, T, who participates in all loan decisions, receives a loan on the same terms as other participants. Although the exercise of T's discretion on behalf of himself may constitute an act of self-dealing described in section 406(b)(1), section 408(b)(1) provides an exemption from section 406(b)(1). As a result, the loan from P to T would be exempt under section 408(b)(1), provided the conditions of that section are otherwise satisfied.

Example (2): P is a plan covering all the employees of E, the employer who established and maintained P. F is a fiduciary with respect to P and an officer of E. The plan documents governing P give F the authority to establish a participant loan program in accordance with section 408(b)(1) of the Act. Pursuant to an arrangement with E, F establishes such a program but limits the use of loan funds to investments in a limited partnership which is established and maintained by E as general partner. Under these facts, the loan program and any loans made pursuant to this program are outside the scope of relief provided by section 408(b)(1) because the loan program is designed to operate for the benefit of E. Under the circumstance described, the diversion of plan assets for E's benefit would also violate sections 403(c)(1) and 404(a) of the Act.

Example (3): Assume the same facts as in Example 2, above, except that F does not limit the use of loan funds. However, E pressures his employees to borrow funds under P's participant loan program and then reloan the loan proceeds to E. F, unaware of E's activities, arranges and approves the loans. If the loans meet all the conditions of section 408(b)(1), such loans will be exempt under that section. However, E's activities would cause the entire transaction to be viewed as an indirect transfer of plan assets between P and E, who is a party in interest with respect to P, but not the participant borrowing from P. By coercing the employees to engage in loan transactions for its benefit, E has engaged in separate transactions that are not exempt under section 408(b)(1). Accordingly, E would be liable for the payment of excise taxes under section 4975 of the Code.

Example (4): Assume the same facts as in Example 2, above, except that, in return for structuring and administering the loan program as indicated, E agrees to pay F an amount equal to 10 percent of the funds loaned under the program. Such a payment would result in a separate transaction not covered by section 408(b)(1). This transaction would be prohibited under

section 406(b)(3) since F would be receiving consideration from a party in connection with a transaction involving plan assets.

Example (5): F is a fiduciary with respect to plan P. D is a party in interest with respect to plan D. Section 406(a)(1)(B) of the Act would prohibit F from causing P to lend money to D. However, F enters into an agreement with Z, a plan participant, whereby F will cause P to make a participant loan to Z with the express understanding that Z will subsequently lend the loan proceeds to D. An examination of Z's credit standing indicates that he is not creditworthy and would not, under normal circumstances, receive a loan under the conditions established by the participant loan program. F's decision to approve the participant loan to Z on the basis of Z's prior agreement to lend the money to D violates the exclusive purposes requirements of sections 403(c) and 404(a). In effect, the entire transaction is viewed as an indirect transfer of plan assets between P and D, and not a loan to a participant exempt under section 408(b)(1). Z's lack of credit standing would also cause the transaction to fail under section 408(b)(1)(A) of the Act.

Example (6): F is a fiduciary with respect to Plan P. Z is a plan participant. Z and D are both parties in interest with respect to P. F approves a participant loan to Z in accordance with the conditions established under the participant loan program. Upon receipt of the loan, Z intends to lend the money to D. If F has approved this loan solely upon consideration of those factors which would be considered in a normal commercial setting by an entity in the business of making comparable loans, Z's subsequent use of the loan proceeds will not affect the determination of whether loans under P's program satisfy the conditions of section 408(b)(1).

Example (7): A is the trustee of a small individual account plan. D, the president of the plan sponsor, is also a participant in the plan. Pursuant to a participant loan program meeting the requirements of section 408(b)(1), D applies for a loan to be secured by a parcel of real property. D does not intent to repay the loan; rather, upon eventual default, he will permit the property to be foreclosed upon and transferred to the plan in discharge of his legal obligation to repay the loan. A, aware of D's intention, approves the loan. D fails to make two consecutive quarterly payments of principal and interest under the note evidencing the loan thereby placing the loan in default. The plan then acquires the real property upon foreclosure. Such facts and circumstances indicate that the payment of money from the plan to D was not a participant loan eligible for the relief afforded by section 408(b)(1). In effect, this transaction is a prohibited sale or exchange of property between a plan and a party in interest from the time D receives the money.

Example (8): Plan P establishes a participant loan program. All loans are subject to the condition that the borrowed funds must be used to finance home purchases. Interest rates on the loans are the same as those charged by a local savings and loan association under similar circumstances. A loan by P to a participant to finance a home purchase would be subject to the relief provided by section 408(b)(1) provided that the conditions of 408(b)(1) are met. A participant loan program which is established to make loans for certain stated purposes (e.g., hardship, college tuition, home purchases, etc.) but which is not otherwise designed to benefit parties in interest (other than plan participants) would not, in itself, cause such program to be ineligible for the relief provided by section 408(b)(1). However, fiduciaries are cautioned that operation of a loan program with limitations may result in loans not being made available to all participants and beneficiaries on a reasonably equivalent basis.

b. Reasonably Equivalent Basis.

1. Loans will not be considered to have been made available to participants and beneficiaries on a reasonably equivalent basis unless:

    i. Such loans are available to all plan participants and beneficiaries without regard to any individual's race, color, religion, sex, age or national origin:
    ii. In making such loans, consideration has been given only to those factors which would be considered in a normal commercial setting by an entity in the business of making similar types of loans. Such factors may include the applicant's creditworthiness and financial need; and
    iii. An evaluation of all relevant facts and circumstances indicates that, in actual practice, loans are not unreasonably withheld from any applicant.

2. A participant loan program will not fail the requirement of paragraph (b)(1) of this section or

section 2550.408b-1(c) if the program establishes a minimum loan amount of up to $1,000, provided that the loans granted meet the requirements of section 2550.408b-1(f).

3. Examples. The following examples illustrate the provisions of section 2550.408b-1(b)(1):

   Example (1): T, a trustee of plan P, has exclusive discretion over the management and disposition of plan assets. T's duties include the administration of a participant loan program which meets the requirements of section 408(b)(1) of the Act. T receives a participant loan at a lower interest rate than the rate made available to other plan participants of similar financial condition or creditworthiness with similar security. The loan by P to T would not be covered by the relief provided by section 408(b)(1) because loans under P's program are not available to all plan participants on a reasonably equivalent basis.

   Example (2): Same facts as in example 1 except that T is a member of a committee of trustees responsible for approving participant loans. T pressures the committee to refuse loans to other qualified participants in order to assure that the assets allocated to the participants loan program would be available for a loan by P to T. The loan by P to T would not be covered by the relief provided by section 408(b)(1) since participant loans have not been made available to all participants and beneficiaries on a reasonably equivalent basis.

   Example (3): T is the trustee of plan P, which covers the employees of E. A, B and C are employees of E, participants in P, and friends of T. The documents governing P provide that T, in his discretion, may establish a participant loan program meeting certain specified criteria. T institutes such a program and tells A, B and C of his decision. Before T is able to notify P's other participants and beneficiaries of the loan program, A, B, and C file loan applications which, if approved, will use up substantially all of the funds set aside for the loan program. Approval of these applications by T would represent facts and circumstances showing that loans under P's program are not available to all participants and beneficiaries on a reasonably equivalent basis.

c. Highly Compensated Employees.

   1. Loans will not be considered to be made available to highly compensated employees, officers or shareholders in an amount greater that the amount made available to other employees if, upon consideration of all relevant facts and circumstances, the program does not operate to exclude large numbers of plan participants from receiving loans under the program.
   2. A participant loan program will not fail to meet the requirement in paragraph (c)(1), of this section, merely because the plan documents specifically governing such loans set forth either (i) a maximum dollar limitation, or (ii) a maximum percentage of vested accrued benefit which no loan may exceed.
   3. If the second alternative in paragraph (c)(2) of this section (maximum percentage of vested accrued benefit) is chosen, a loan program will not fail to meet this requirement solely because maximum loan amounts will vary directly with the size of the participant's accrued benefit.
   4. Examples. The following examples illustrate the provisions of section 2550.408b-1(c).

      Example (1): The documents governing plan P provide for the establishment of a participant loan program in which the amount of any loan under the program (when added to the outstanding balance of any other loans under the program to the same participant) does not exceed the lesser of (i) $50,000, or (ii) one-half of the present value of that participant's vested accrued benefit under the plan (but not less than $10,000). P's participant loan program does not fail to meet the requirement in section 408(b)(1)(B) of the Act, and would be covered by the relief provided by section 408(b)(1) if the other conditions of that section are met.

      Example (2): The documents governing plan T provide for the establishment of a participant loan program in which the minimum loan amount would be $25,000. The documents also require that the only security acceptable under the program would be the participant's vested accrued benefit. A, the plan fiduciary administering the loan program, finds that because of the restrictions in the plan documents only 20 percent of the plan participants, all of whom earn in excess of $75,000 a year, would meet the threshold qualifications for a loan. Most of these participants are high-level supervisors or corporate officers. Based on these facts, it appears that loans under the program would be made available to highly compensated employees in an amount greater than the amount made available to other employees. As a result, the loan program would fail to meet the requirements in section 408(b)(1)(B) of the Act and would not be covered by the relief provided in section 408(b)(1).

d. Specific Plan Provisions. For the purpose of section 408(b)(1) and this regulation, the Department will consider that participant loans granted or renewed at any time prior to the last day of the first plan year beginning on or after January 1, 1989, are made in accordance with specific provisions regarding such loans set forth in the plan if:

1. The plan provisions regarding such loans contain (at a minimum) an explicit authorization for the plan fiduciary responsible for investing plan assets to establish a participant loan program; and
2. For participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989, the participant loan program which is contained in the plan or in a written document forming part of the plan includes, but need not be limited to, the following:

    i. The identify of the person or positions authorized to administer the participant loan program;
    ii. A procedure for applying for loans;
    iii. The basis on which loans will be approved or denied;
    iv. Limitations (if any) on the types and amount of loans offered;
    v. The procedure under the program for determining a reasonable rate of interest;
    vi. The types of collateral which may secure a participant loan; and
    vii. The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.

Example (1): Plan P authorizes the trustee to establish a participant loan program in accordance with section 408(b)1) of the Act. Pursuant to this explicit authority, the trustee establishes a written program which contains all of the information required by section 2550.408b-1(d)(2) . Loans made pursuant to this authorization and the written loan program will not fail under section 408(b)(1)(C) of the Act merely because the specific provisions regarding such loans are contained in a separate document forming part of the plan. The specific provisions describing the loan program whether contained in the plan or in a written document forming part of a plan, do affect the rights and obligations of the participants and beneficiaries under the plan and, therefore, must in accordance with section 102(a)(1) of the Act, be disclosed in the plan's summary plan description.

e. Reasonable Rate of Interest. A loan will be considered to bear a reasonable rate of interest if such loan provides the plan with a return commensurate with the rates of charged by persons in the business of lending money for loans which would be made under similar circumstances.

Example (1): Plan P makes a participant loan to A at the fixed interest rate of 8% for 5 years. The trustees, prior to making the loan, contacted two local banks to determine under what terms the banks would make a similar loan taking into account A's creditworthiness and the collateral offered. One bank would charge a variable rate of 10% adjusted monthly for a similar loan. The other bank would charge a fixed rate of 12% under similar circumstances. Under these facts, the loan to A would not bear a reasonable rate of interest because the loan did not provide P with a return commensurate with interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances. As a result, the loan would fail to meet the requirement of section 408(b)(1)(D) and would not be covered by the relief provided by section 408(b)(1) if the Act.

Example (2): Pursuant to the provisions of plan P's participant loan program, T, the trustee of P, approves a loan to M, a participant and party in interest with respect to P. At the time of execution, the loan meets all of the requirements of section 408(b)(1) of the Act. The loan agreement provides that at the end of two years M must pay the remaining balance in full or the parties may renew for an additional two year period. At the end of the initial two year period, the parties agree to renew the loan for an additional two years. At the time of renewal, however, A fails to adjust the interest rate charged on the loan in order to reflect current economic conditions. As a result, the interest rate on the renewal fails to provide a "reasonable rate of interest" as required by section 408(b)(1)(D) of the Act. Under such circumstance, the loan would not be exempt under section 408(b)(1) of the Act from the time of renewal.

Example (3): The documents governing plan P's participant loan program provide that loans must bear an interest rate no higher than the maximum interest rate permitted under State X's usury law. Pursuant to the loan program, P makes a participant loan to A, a plan participant, at a time when the interest rates charged by financial institutions in the community (not subject to the usury limit) for similar loans are higher than the usury limit. Under these circumstances, the loan would not bear a reasonable rate of interest because the loan does not provide P with a return commensurate with the interest rates

charged by persons in the business of lending money under similar circumstances. In addition, participant loans that are artificially limited to the maximum usury ceiling then prevailing call into question the status of such loans under sections 403(c) and 404(a) where higher yielding comparable investment opportunities are available to the plan.

f. Adequate Security.

1. A loan will be considered to be adequately secured if the security posed for such loan is something in addition to and supporting a promise to pay, which is so pledged to the plan that it may be sold, foreclosed upon, or otherwise disposed of upon default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. The adequacy of such security will be determined in light of the type and amount of security which would be required in the case of an otherwise identical transaction in a normal commercial setting between unrelated parties on arms'-length terms. A participant's vested accrued benefit under a plan may be used as security for a participant loan to the extent of the plan's ability to satisfy the participant's outstanding obligation in the event of default.
2. For purposes of this paragraph -

    i. no more than 50% of the present value of a participant's vested accrued benefit may be considered by a plan as security for the outstanding balance of all plan loans made to that participant;
    ii. a plan will be in compliance with paragraph (f)(2)(i) of this section if, with respect to any participant, it meets the provisions of paragraph (f)(2)(i) of this section immediately after the origination of each participant loan secured in whole in part by that participant's vested accrued benefit; and
    iii. any loan secured in whole or in part by a portion of a participant's vested accrued benefit must also meet the requirements of paragraph (f)(1) of this section.

g. Effective date. This section is effective for all participant loans granted or renewed after October 18, 1989, except with respect to paragraph (d)(2) of this section relating to specific plan provisions. Paragraph (d)(2) of this section is effective for participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989.

Department of Labor

Regulation 2550.408b-2

29 C.F.R. 2550.408b-2

Services or Office Space Class Exemption

Originally issued June 24, 1977 (42 FR 32390)

a. In General. Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406(a) of the Act payment by a plan to a party in interest, including a fiduciary, for office space or any service (or a combination of services) if (1) such office space or service is necessary for the establishment or operation of the plan (2) such office space or service is furnished under a contract or arrangement which is reasonable and (3) no more than reasonable compensation is paid for such office space or service. However, section 408(b)(2) does not contain an exemption from acts described in section 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account), section 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries) or section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the assets of the plan). Such acts are separate transactions not described in section 408(b)(2). See 2550.408b-2(e) and (f) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 406(b)(1) of the Act. Section 408(b)(2) of the Act does not contain an exemption from other provisions of the Act, such as section 404, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 408(b)(2). See, for example, section 401 of the Internal Revenue Code of 1954. The provisions of section 408(b)(2) of the Act are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related

persons).

b. Necessary service. A service is necessary for the establishment or operation of a plan within the meaning of section 408(b)(2) of the Act and 2550.408b-2(a)(1) if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained. A person providing such a service to a plan (or a person who is a party in interest solely by reason of a relationship to such a service provider described in section 3(14)(F), (G), (H), or (I) of the Act) may furnish goods which are necessary for the establishment or operation of the plan in the course of, and incidental to, the furnishing of such service to the plan.
c. Reasonable contract or arrangement. No contract or arrangement is reasonable within the meaning of section 408(b)(2) of the Act and 2550.408b-2(a)(2) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. A long-term lease which may be terminated prior to its expiration (without penalty to the plan) on reasonably short notice under the circumstances is not generally an unreasonable arrangement merely because of its long term. A provision in a contract or other arrangement which reasonably compensates the service provider or lessor for loss upon early termination of the contract, arrangement or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable start-up costs is not a penalty. Similarly, a provision in a lease for a termination fee that covers reasonably foreseeable expenses related to the vacancy and reletting of the office space upon early termination of the lease is not a penalty. Such a provision does not reasonably compensate for loss if it provides for payment in excess of actual loss or if it fails to require mitigation of damages.
d. Reasonable compensation. Section 408(b)(2) of the Act and 2550.408b-2(a)(3) permit a plan to pay a party in interest reasonable compensation for the provision of office space or services described in section 408(b)(2). Section 2550.408c-2 of these regulations contains provisions relating to what constitutes reasonable compensation for the provision of services.
e. Transactions with fiduciaries.

    1. In General. If the furnishing of office space or a service involves an act described in section 406(b) of the Act (relating to acts involving conflicts of interest by fiduciaries), such an act constitutes a separate transaction which is not exempt under section 408(b)(2) of the Act. The prohibitions of section 406(b) supplement the other prohibitions of section 406(a) of the Act by imposing on parties in interest who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a fiduciary may not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction. A person in which a fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary includes, for example, a person who is a party in interest by reason of a relationship to such fiduciary described in section 3(14)(E), (F), (G), (H), or (I).
    2. Transactions not described in Section 406(b)(1). A fiduciary does not engage in an act described in section 406(b)(1) of the Act if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. This may occur, for example, when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, because the authority, control or responsibility which makes a person a fiduciary may be exercised "in effect" as well as in form, mere approval of the transaction by a second fiduciary does not mean that the first fiduciary has not used any of the authority, control or responsibility which makes such person a fiduciary to cause the plan to pay the first fiduciary an additional fee for a service. See paragraph (f) below.
    3. Services without compensation. If a fiduciary provides services to a plan without the receipt of compensation or other consideration [other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of 2550.408c-2(b)(3)],

the provision of such services does not, in and of itself, constitute an act described in section 406(b) of the Act. The allowance of a deduction to an employer under section 162 or 12 of the Code for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

f. Examples. The provisions of 2550.408b-2(e) may be illustrated by the following examples.

Example (1). E, an employer whose employees are covered by plan P, is a fiduciary of P. I is a professional investment adviser in which E has no interest which may affect the exercise of E's best judgment as a fiduciary. E causes P to retain I to provide certain kinds of investment advisory services of a type which causes I to be a fiduciary of P under section 3(21)(A)(ii) of the Act. Thereafter, I proposes to perform for additional fees portfolio evaluation services in addition to the services currently provided. The provision of such services is arranged by I and approved on behalf of the plan by E. I has not engaged in an act described in section 406(b)(1) of the Act, because I did not use any of the authority, control or responsibility which makes I a fiduciary (the provision of investment advisory services) to cause the plan to pay I additional fees for the provision of the portfolio evaluation services. E has not engaged in an act which is described in section 406(b)(1). E, as the fiduciary who has the responsibility to be prudent in this selection and retention of I and the other investment advisers of the plan, has an interest in the purchase by the plan of portfolio evaluation services. However, such an interest is not an interest which may affect the exercise of E's best judgment as a fiduciary.

Example (2). D, a trustee of plan P with discretion over the management and disposition of plan assets, relies on the advice of C, a consultant to P, as to the investment of plan assets, thereby making C a fiduciary of the plan. On January 1, 1978, C recommends to D that the plan purchase an insurance policy from U, an insurance company which is not a party in interest with respect to P. C thoroughly explains the reasons for the recommendation and makes a full disclosure concerning the fact that C will receive a commission from U upon the purchase of the policy by P. D considers the recommendation and approves the purchase of the policy by P. C receives a commission. Under such circumstances, C has engaged in an act described in section 406(b)(1) of the Act (as well as sections 406(b)(2) and (3) of the Act) because C is in fact exercising the authority, control or responsibility which makes C a fiduciary to cause the plan to purchase the policy. However, the transaction is exempt from the prohibited transaction provisions of section 406 of the Act, if the requirements of Prohibited Transaction Exemption 77-9 are met.

Example (3). Assume the same facts as in Example (2) except that the nature of C's relationship with the plan is not such that C is a fiduciary of P. The purchase of the insurance policy does not involve an act described in section 406(b)(1) of the Act (or sections 406(b)(2) or (3) of the Act) because such sections only apply to acts by fiduciaries.

Example (4). E, an employer whose employees are covered by plan P, is a fiduciary with respect to P. A, who is not a party in interest with respect to P, persuades E that the plan needs the services of a professional investment adviser and that A should be hired to provide the investment advice. Accordingly, E causes P to hire A to provide investment advice of the type which makes A a fiduciary under 2510.3-21(c)(1)(ii)(B). Prior to the expiration of A's first contract with P, A persuades E to cause P to renew A's contract with P to provide the same services for additional fees in view of the increased costs in providing such services. During the period of A's second contract, A provides additional investment advice services for which no additional charge is made. Prior to the expiration of A's second contract, A persuades E to cause P to renew his contract for additional fees in view of the additional services A is providing. A has not engaged in an act described in section 406(b)(1) of the Act, because A has not used any of the authority, control or responsibility which makes A a fiduciary (the provision of investment advice) to cause the plan to pay additional fees for A's services.

Example (5). F, a trustee of plan P with discretion over the management and disposition of plan assets, retains C to provide administrative services to P of the type which makes C a fiduciary under section 3(21)(A)(iii). Thereafter, C retains F to provide for additional fees actuarial and various kinds of administrative services in addition to the services F is currently providing to P. Both F and C have engaged in an act described in section 406(b)(1) of the Act. F, regardless of any intent which he may have had at the time he retained C, has engaged in such an act because F has, in effect, exercised the authority, control or responsibility which makes F a fiduciary to cause the plan to pay F additional fees for the services. C, whose continued

employment by P depends on F, has also engaged in such an act, because C has an interest in the transaction which might affect the exercise of C's best judgment as a fiduciary. As a result, C has dealt with plan assets in his own interest under section 406(b)(1).

Example (6). F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 406(b)(1) of the Act because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. Such act is not exempt under section 408(b)(2) of the Act irrespective of whether the provision of the services by S is exempt.

Example (7). T, one of the trustees of plan P, is president of bank B. The bank proposes to provide administrative services to P for a fee. T physically absents himself from all consideration of B's proposal and does not otherwise exercise any of the authority, control or responsibility which makes T a fiduciary to cause the plan to retain B. The other trustees decide to retain B. T has not engaged in an act described in section 406(b)(1) of the Act. Further, the other trustees have not engaged in an act described in section 406(b)(1) merely because T is on the board of trustees of P. This fact alone would not make them have an interest in the transaction which might affect the exercise of their best judgment as fiduciaries.

Department of Labor

Regulation 2550.408b-3

29 C.F.R. 2550.408b-3

Loans to Employee Stock Ownership Plans

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a. Definitions. When used in this section, the terms listed below have the following meanings:

1. ESOP. The term "ESOP" refers to an employee stock ownership plan that meets the requirements of section 407(d)(6) of the Employee Retirement Income Security Act of 1974 (the Act) and 29 C.F.R. 2550.407d-6. It is not synonymous with "stock bonus plan." A stock bonus plan must, however, be an ESOP to engage in an exempt loan. The qualification of an ESOP under section 401(a) of the Internal Revenue Code (the Code) and 26 C.F.R. 54.4975-11 will not be adversely affected merely because it engages in a non-exempt loan.
2. Loan. The term "loan" refers to a loan made to an ESOP by a party in interest or a loan to an ESOP which is guaranteed by a party in interest. It includes a direct loan of cash, a purchase-money transaction, and an assumption of the obligation of the ESOP. "Guarantee" includes an unsecured guarantee and the use of assets of a party in interest as collateral for a loan, even though the use of assets may not be a guarantee under applicable state law. An amendment of a loan in order to qualify as an exempt loan is not a refinancing of the loan or the making of another loan.
3. Exempt Loan. The term "exempt loan" refers to a loan that satisfies the provisions of this section. A "non-exempt loan" is one that fails to satisfy such provisions.
4. Pubicly traded. The term "publicly traded" refers to a security that is listed on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) or that is quoted on a system sponsored by a national securities association registered under section 15A(b) of the Securities Exchange Act (15 U.S.C. 78o).
5. Qualifying Employer Security. The term "qualifying employer security" refers to a security described in 29 C.F.R. 2550.407d-5.

b. Statutory Exemption -

1. Scope. Section 408(b)(3) of the Act provides an exemption from the prohibited transaction provisions of sections 406(a) and 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account) and 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan

on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries). Section 408(b)(3) does not provide an exemption from the prohibitions of [section 406(b)(3) of the Act] (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan).

2. Special scrutiny of transaction. The exemption under [section 408(b)(3)] includes within its scope certain transactions in which the potential for self-dealing by fiduciaries exists and in which the interests of fiduciaries may conflict with the interests of participants. To guard against these potential abuses, the Department of Labor will subject these transactions to special scrutiny to ensure that they are primarily for the benefit of participants and their beneficiaries. Although the transactions need not be arranged and approved by an independent fiduciary, fiduciaries are cautioned to scrupulously exercise their discretion in approving them. For example, fiduciaries should be prepared to demonstrate compliance with the net effect test and the arm's-length standard under paragraphs (c)(2) and (3) of this section. Also, fiduciaries should determine that the transaction is truly arranged primarily in the interest of participants and their beneficiaries rather than, for example, in the interest of certain selling shareholders.

c. Primary benefit requirement --

1. In General. An exempt loan must be primarily for the benefit of the ESOP participants and their beneficiaries. All the surrounding facts and circumstances, including those described in paragraphs (c)(2) and (3) of this section, will be considered in determining whether such loan satisfies this requirement. However, no loan will satisfy such requirement unless it satisfies the requirements of paragraphs (d), (e) and (f) of this section.
2. Net effect on plan assets. At the time that a loan is made, the interest rate for the loan and **the price of securities to be acquired with the loan proceeds should not be such that plan assets might be drained off** (Emphasis added).
3. Arm's-length standard. The terms of a loan, whether or not between independent parties, must, at the time the loan is made, be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties.

d. Use of loan proceeds. The proceeds of an exempt loan must be used, within a reasonable time after their receipt, by the borrowing ESOP only for any or all of the following purposes:

1. To acquire qualifying employer securities.
2. To repay such loan.
3. To repay a prior exempt loan. A new loan, the proceeds of which are so used, must satisfy the provisions of this section. Except as provided in paragraphs (i) and (j) of this section or as otherwise required by applicable law, no security acquired with the proceeds of an exempt loan may be subject to a put, call, or other option, or buy-sell or similar arrangement while held by and when distributed from a plan, whether or not the plan is then an ESOP.

e. Liability and collateral of ESOP for loan. An exempt loan must be without recourse against the ESOP. Furthermore, the only assets of the ESOP that may be given as collateral on an exempt loan are qualifying employer securities of two classes: those acquired with the proceeds of the exempt loan and those that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan. No person entitled to payment under the exempt loan shall have any right to assets of the ESOP other than:

1. Collateral given for the loan,
2. Contributions (other than contributions of employer securities) that are made under an ESOP to meet its obligations under the loan, and
3. Earnings attributable to such collateral and the investment of such contributions.

The payments made with respect to an exempt loan by the ESOP during a plan year must not exceed an amount equal to the sum of such contributions and earnings received during or prior to the year less such payments in prior years. Such contributions and earnings must be accounted for separately in the books of account of the ESOP until the loan is repaid.

f. Default. In the event of default upon an exempt loan, the value of plan assets transferred in satisfaction of the loan must not exceed the amount of default. If the lender is a party in interest, a loan must provide for a transfer of plan assets upon default only upon and to the extent of the failure of the plan to meet the payment schedule of the loan. For purposes of this paragraph, the making of a guarantee

does not make a person a lender.

g. Reasonable rate of interest. The interest rate of a loan must not be in excess of a reasonable rate of interest. All relevant factors will be considered in determining a reasonable rate of interest, including the amount and duration of the loan, the security and guarantee (if any) involved, the credit standing of the ESOP and the guarantor (if any), and the interest rate prevailing for comparable loans. When these factors are considered, a variable interest rate may be reasonable.

h. Release from encumbrance --

   1. General rule. In general, an exempt loan must provide for the release from encumbrance of plan assets used as collateral for the loan under this paragraph. For each plan year during the duration of the loan, the number of securities released must equal the number of encumbered securities held immediately before release for the current plan year multiplied by a fraction. The numerator of the fraction is the amount of principal and interest paid for the year. The denominator of the fraction is the sum of the numerator plus the principal and interest to be paid for all future years. See Section 2550.408b-3(h)(4). The number of future years under the loan must be definitely ascertainable and must be determined without taking into account any possible extensions or renewal periods. If the interest rate under the loan is variable, the interest to be paid in future years must be computed by using the interest rate applicable as of the end of the plan year. If collateral includes more than one class of securities, the number of securities of each class to be released for a plan year must be determined by applying the same fraction to each class.
   2. Special rule. A loan will not fail to be exempt merely because the number of securities to be released from encumbrance is determined solely with reference to principal payments. However, if release is determined with reference to principal payments only, the following three additional rules apply. The first rule is that the loan must provide for annual payments of principal and interest at a cumulative rate that is not less rapid at any time than level annual payments of such amounts for 10 years. The second rule is that interest included in any payment is disregarded only to the extent that it would be determined to be interest under standard loan amortization tables. The third rule is that subdivision (2) is not applicable from the time that, by reason of a renewal, extension, or refinancing, the sum of the expired duration of the exempt loan, the renewal period, the extension period, and the duration of a new exempt loan exceeds 10 years.
   3. Caution against plan disqualification. Under an exempt loan, the number of securities released from encumbrance may vary from year to year. The release of securities depends upon certain employer contributions and earnings under the ESOP. Under [26 C.F.R. 54.4975-11(d)(2)] actual allocations to participants' accounts are based upon assets withdrawn from the suspense account. Nevertheless, for purposes of applying the limitations under section 415 of the Code to these allocations, under [26 C.F.R. 54.4975-11(a)(8)(ii)] contributions used by the ESOP to pay the loan are treated as annual additions to participants' accounts. Therefore, particular caution must be exercised to avoid exceeding the maximum annual additions under section 415 of the Code. At the same time, release from encumbrance in annually varying numbers may reflect a failure on the part of the employer to make substantial and recurring contributions to the ESOP which will lead to loss of qualification under section 401(a) of the Code. The Internal Revenue Service will observe closely the operation of ESOPs that release encumbered securities in varying annual amounts, particularly those that provide for the deferral of loan payments or for balloon payments. See 26 C.F.R. 54.4975-7(b)(8)(iii).
   4. Illustration. The general rule under paragraph (h)(1) of this section operates as illustrated in the following example:

      Example. Corporation X establishes an ESOP that borrows $750,000 from a bank. X guarantees the loan which is for 15 years at 5% interest and is payable in level annual amounts of $72,256.72. Total payments on the loan are $1,083,850.80. The ESOP uses the entire proceeds of the loan to acquire 15,000 shares of X stock which is used as collateral for the loan. The number of securities to be released for the first year is 1,000 shares,

      i.e., 15,000 shares x $72,256.72/$1,083,850.80 = 15,000 shares x 1/15. The number of securities to be released for the second year is 1,000 shares, i.e., 14,000 shares x $72,256.72/$1,011,594.08 = 14,000 shares x 1/14. If all loan payments are made as originally scheduled, the number of securities released in each succeeding year of the loon will also be 1,000.

i. Right of first refusal. Qualifying employer securities acquired with proceeds of an exempt loan may, but need not, be subject to a right of first refusal. However, any such right must meet the requirements of

this paragraph. Securities subject to such right must be stock or an equity security, or a debt security convertible into stock or an equity security. Also, they must not be publicly traded at the time the right may be exercised. The right of first refusal must be in favor of the employer, the ESOP, or both in any order of priority. The selling price and other terms under the right must not be less favorable to the seller than the greater of the value of the security determined under 26 C.F.R. 54.4975-11(d)(5), or the purchase price and other terms offered by a buyer, other than the employer or the ESOP, making a good faith offer to purchase the security. The right of first refusal must lapse no later than 14 days after the security holder gives written notice to the holder of the right that an offer by a third party to purchase the security has been received.

j. Put option. A qualifying employer security acquired with the proceeds of an exempt loan by an ESOP after September 30, 1976, must be subject to a put option if it is not publicly traded when distributed or if it is subject to a trading limitation when distributed. For purposes of this paragraph, a "trading limitation" on a security is a restriction under any Federal or State securities law or any regulation thereunder, or an agreement (not prohibited by this section) affecting the security which would make the security not as freely tradable as one not subject to such restriction. The put option must be exercisable only by a participant, by the participant's donee(s), or by a person (including an estate or its distributes) to whom the security passes by reason of a participant's death. (Under this paragraph "participant" means a participant and the beneficiaries of the participant under the ESOP.) The put option must permit a participant to put the security to the employer. Under no circumstances may the put option bind the ESOP. However, it may grant the ESOP an option to assume the rights and obligations of the employer at the time that the put option is exercised. If it is known at the time a loan is made that Federal or state law will be violated by the employer's honoring such option, the put option must permit the security to be put, in a manner consistent with such law, to a third party (e.g., an affiliate of the employer or a shareholder other than the ESOP) that has substantial net worth at the time the loan is made and whose net worth is reasonably expected to remain substantial.

k. Duration of put option. --

    1. General rule. A put option must be exercisable at least during a 15-month period which begins the date the security subject to the put option is distributed by the ESOP.
    2. Special rule. In the case of a security that is publicly traded without restriction when distributed but ceases to be so traded within 15 months after distribution, the employer must notify each security holder in writing on or before the tenth day after the date the security ceases to be so traded that for the remainder of the 15-month period the security is subject to a put option. The number of days between the tenth day and the date on which notice is actually given, if later than the tenth day, must be added to the duration of the put option. The notice must inform distributee(s) of the terms of the put options that they are to hold. The terms must satisfy the requirements of paragraphs (j) through (i) of this section.

l. Other put option provisions. --

    1. Manner of exercise. A put option is exercised by the holder notifying the employer in writing that the put option is being exercised.
    2. Time excluded from duration of put option. The period during which a put option is exercisable does not include any time when a distributee is unable to exercise it because the party bound by the put option is prohibited from honoring it by applicable Federal or state law.
    3. Price. The price at which a put option must be exercisable is the value of the security, determined in accordance with paragraph (d)(5) of 26 C.F.R. 54.4975-11.
    4. Payment terms. The provisions for payment under a put option must be reasonable. The deferral of payment is reasonable if adequate security and a reasonable interest rate are provided for any credit extended and if the cumulative payments at any time are no less than the aggregate of reasonable periodic payments as of such time. Periodic payments are reasonable if annual installments, beginning with 30 days after the date the put option is exercised, are substantially equal. Generally, the payment period may not end more than 5 years after the date the put option is exercised. However, it may be extended to a date no later than the earlier of 10 years from the date the put option is exercised or the date the proceeds of the loan used by the ESOP to acquire the security subject to such put option are entirely repaid.
    5. Payment restrictions. Payment under a put option may be restricted by the terms of a loan, including one used to acquire a security subject to a put option, made before November 1, 1977. Otherwise, payment under a put option must not be restricted by the provisions of a loan or any other arrangement, including the terms of the employer's articles of incorporation, unless so required by applicable state law.

m. Other terms of loan. An exempt loan must be for a specific term. Such loan may not be payable at the

demand of any person, except in the case of default.

n. Status of paln as ESOP. To be exempt, a loan must be made to a plan that is an ESOP at the time of such loan. However, a loan to a plan formally designated as an ESOP at the time of the loan that fails to be an ESOP because it does not comply with section 401 (a) of the Code or 26 C.F.R. 54.4975-11 will be exempt as of the time of such loan if the plan is amended retroactively under section 401(b) of the Code or 26 C.F.R. 54.4975-11(a)(4).
o. Special rules for certain loans. --

1. Loans made before January 1, 1976. A loan made before January 1, 1976, or made afterwards under a binding agreement in effect on January 1, 1976 (or under renewals permitted by the terms of such an agreement on that date) is exempt for the entire period of such loan if it otherwise satisfies the provisions of this section for such period, even though it does not satisfy the following provisions of this section:

    i. The last sentence of paragraph (d);
    ii. Paragraphs (e), (f), and (h)(1) and (2); and
    iii. Paragraphs (i) through (m), inclusive.

2. Loans made after December 31, 1975, BUT BEFORE November 1, 1977. A loan made after December 31, 1975, but before November 1, 1977, or made afterwards under a binding agreement in effect on November 1, 1977, (or under renewals permitted by the terms of such an agreement on that date) is exempt for the entire period of such loan if it otherwise satisfies the provisions of this section for such period even though it does not satisfy the following provisions of this section:

    i. Paragraph (f);
    ii. The three provisions of paragraph (h)(2): and
    iii. Paragraph (i).

3. Release rule. Notwithstanding paragraphs (o)(1) and (2) of this section, if the proceeds of a loan are used to acquire securities after November 1, 1977, the loan must comply by such date with the provisions of paragraph (h) of this section.
4. Default rule. Notwithstanding paragraphs (o)(1) and (2) of this section, a loan by a party in interest other than a guarantor must satisfy the requirements of paragraph (f) of this section. A loan will satisfy these requirements if it is retroactively amended before November 1, 1977, to satisfy these requirements.
5. Put option rule. With respect to a security distributed before November 1, 1977, the put option provisions of paragraphs (j), (k), and (l) of this section will be deemed satisfied as of the date the security is distributed if by December 31, 1977, the security is subject to a put option satisfying such provisions. For purposes of satisfying such provisions, the security will be deemed distributed on the date the put option is issued. However, the put option provisions need not be satisfied with respect to a security that is not owned on November 1, 1977, by a person in whose hands a put option must be exercisable.

Department of Labor

Regulation 2550.408b-4

29 C.F.R. 2550.408b-4

Investment in Own-Bank Interest-Bearing Deposits

Originally issued June 24, 1977 (42 FR 32392)

a. In General.

Section 408(b)(4) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibition of Section 406 of the Act the investment of all or a part of a plan's assets in deposits bearing a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a State, even though such bank or similar financial institution is a fiduciary or other party in interest with respect to the plan, if the conditions of either Part 2550.408b-4(b)(1) or Part 2550.408b-4(b)(2) are met.

Section 408(b)(4) provides an exemption from Section 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account) and 406(b)(2) of the Act

(relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on behalf of a party -- or representing a party -- whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries), as well as Section 406(a)(1), because Section 408(b)(4) contemplates a bank or similar financial institution causing a plan for which it acts as a fiduciary to invest plan assets in its own deposits if the requirements of Section 408(b)(4) are met.

However, it does not provide an exemption from Section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any part dealing with a plan in connection with a transaction involving the assets of the plan). The receipt of such consideration is a separate transaction not described in the statutory exemption. Section 408(b)(4) does not contain an exemption from other provisions of the Act, such as Section 404, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under Section 408(b)(4) of the Act. See, for example, Section 401 of the Internal Revenue Code of 1954 (Code). The provisions of Section 408(b)(4) of the Act are further limited by Section 408(d) of the Act (relating to transactions with owner-employees and related persons).

b. (1) Plan Covering Own Employees.

Such investment may be made if the plan is one which covers only the employees of the bank or similar financial institution, the employees of any of its affiliates, or the employees of both.

(2) Other Plans.

Such investment may be made if -

- The investment is expressly authorized by a provision of the plan or trust instrument, or
- The investment is expressly authorized (or made) by a fiduciary of the plan (other than the bank or similar financial institution or any of its affiliates) who has authority to make such investments, or to instruct the trustee or other fiduciary with respect to investments, and who has no interest in the transaction which may affect the exercise of such authorizing fiduciary's best judgment as a fiduciary so as to cause such authorization to constitute an act described in Section 406(b) of the Act.

Any authorization to make investments contained in a plan or trust instrument will satisfy the requirement of express authorization for investments made prior to November 1, 1977.

Effective November 1, 1977, in the case of a bank or similar financial institution that invests plan assets in deposits in itself or its affiliates under an authorization contained in a plan or trust instrument, such authorization -

- Must name such bank or similar financial institution, and
- Must state that such bank or similar financial institution may make investments in deposits which bear a reasonable rate of interest in itself (or in an affiliate).

(3) Example.

B, a bank, is the trustee of plan P's assets. The trust instruments give the trustees the right to invest plan assets in its discretion. B invests in the certificates of deposit of bank C, which is a fiduciary of the plan by virtue of performing certain custodial and administrative services. The authorization is sufficient for the plan to make such an investment under Section 408(b)(4). Further, such authorization would suffice to allow B to make investments in deposits in itself prior to November 1, 1977. However subsequent to October 31, 1977, B may not invest in deposits in itself, unless the plan or trust instrument authorizes it to invest in deposits of B.

c. Definitions.

1. The term "bank or similar financial institutions" . . . includes a bank (as defined in Section 581 of the Code), a domestic building and loan association (as defined in Section 7701(a)(19) of the Code) . . .
2. A person is an "affiliate" of a bank or similar financial institution if such person and such bank or similar financial institution would be treated as members of the same controlled group of corporations or as members of two or more trades or businesses under common control within the meaning of Section 414(b) or (c) of the Code and regulations thereunder.

3. The term "deposits" includes any account, temporary or otherwise, upon which a reasonable rate of interest is paid, including a certificate of deposit issued by a bank or similar financial institution.

Note: Also refer to ERISA Section 408(b)(4), "Investment in Own-Bank Interest-Bearing Deposits".

Department of Labor

Regulation 2550.408b-6

29 C.F.R. 2550.408b-6

Ancillary Services by Banks or Similar Financial Institutions

Originally issued June 24, 1977 (42 FR 32392)

Technical corrections of July 18, 1977 (42 FR 36823)

did not contain any changes to this regulation

a. In General. Section 408(b)(6) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406 of the Act the provision of certain ancillary services by a bank or similar financial institution (as defined in 2550.408b-4(c)(1)) supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions of 2550.408b-6(b) are met. Such ancillary services include services which do not meet the requirements of section 408(b)(2) of the Act because the provision of such services involves an act described in section 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account) by the fiduciary bank or similar financial institution or an act described in section 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries). Section 408(b)(6) provides an exemption from sections 406(b)(1) and (2) because section 408(b)(6) contemplates the provision of such ancillary services without the approval of a second fiduciary (as described in 2550.408b-2(e)(2)) if the conditions of 2550.408b-6(b) are met. Thus, for example, plan assets held by a fiduciary bank which are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest-bearing checking account in the bank if the conditions of 2550.408b-6(b) are met, notwithstanding the provisions of section 408(b)(4) of the Act (relating to investments in bank deposits). However, section 408(b)(6) does not provide an exemption for an act described in section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the assets of the plan). The receipt of such consideration is a separate transaction not described in section 408(b)(6). Section 408(b)(6) does not contain an exemption from other provisions of the Act, such as section 404, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 408(b)(6) of the Act. See, for example, section 401 of the Internal Revenue Code of 1954. The provisions of section 408(b)(6) of the Act are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related persons).

b. Conditions. Such service must be provided -

   1. At not more than reasonable compensation;
   2. Under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and
   3. Only to the extent that such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of 2550.408b-6(c).

c. Specific guidelines. (Reserved)

Department of Labor

Regulation 2550.408c-2

29 C.F.R. 2550.408c-2

Compensation for Services

Originally issued June 24, 1977 (42 FR 32393)

a. In General. Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (the Act) refers to the payment of reasonable compensation by a plan to a party in interest for services rendered to the plan. Section 408(c)(2) of the Act and Section 2550.408c-2(b)(1) through 2550.408c-2(b)(4) clarify what constitutes reasonable compensation for such services.
b. (1) General Rule. Generally, whether compensation is "reasonable" under sections 408(b)(2) and 408(c)(2) of the Act depends on the particular facts and circumstances of each case.

    1. Payments to certain fiduciaries. Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation" does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers (any of whose employees are participants in the plan) or from an employee organization (any or whose members are participants in the plan), except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. The restrictions of this paragraph (b)(2) do not apply to a party in interest who is not a fiduciary.
    2. Certain expenses not direct expenses. An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.
    3. Expense advances. Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation" , as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if:

        i. The amount of such advance is reasonable with respect to the amount of the direct expense which is likely to be properly and actually incurred in the immediate future (such as during the next month) and
        ii. The fiduciary or employee accounts to the plan at the end of the period covered by the advance for the expenses properly and actually incurred.

    4. Excessive compensation. Under sections 408(b)(2) and 408(c)(2) of the Act, any compensation which would be considered excessive under 26 C.F.R. 1.162-7 (Income Tax Regulations relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be "reasonable compensation". Depending upon the facts and circumstances of the particular situation, compensation which is not excessive under 26 C.F.R. 1.162-7 may, nevertheless, not be "reasonable compensation" within the meaning of sections 408(b)(2) and 408(c)(2) of the Act.

Department of Labor

Regulation 2550.408e

29 C.F.R. 2550.408e

Qualifying Employer Securities and Real Estate

Acquisition or Sale of Qualifying Employer Securities

Acquisition/Sale/Lease of Qualifying Employer Real Estate

Originally issued August 1, 1980 (45 FR 51197)

a. In General. Section 408(e) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406(a) and 406(b)(1) and (2) of the Act any acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5) of the Act), or any acquisition, sale or lease by a plan of qualifying employer real property (as defined in section 407(d)(4) of the Act) if certain conditions are met. The conditions are that:

    1. The acquisition, sale or lease must be for adequate consideration (which is defined in paragraph (d) of this section);
    2. No commission may be charged directly or indirectly to the plan with respect to the transaction; and
    3. In the case of an acquisition or lease of qualifying employer real property, or an acquisition of qualifying the securities, by a plan other than an eligible individual account plan (as defined in

section 407(d)(3) of the Act), the acquisition or lease must comply with the requirements of section 407(a) of the Act.

b. Acquisition. For purposes of section 408(e) and this section, an acquisition by a plan of qualifying employer securities or qualifying employer real property shall include, but not be limited to, an acquisition by purchase, by the exchange of plan assets, by the exercise of warrants or rights, by the conversion of a security, by default of a loan where the qualifying employer security or qualifying employer real property was security for the loan, or in connection with the contribution of such securities or real property to the plan. However, an acquisition of a security shall not be deemed to have occurred if a plan acquires the security as a result of a stock dividend or stock split.
c. Sale. For purposes of section 408(e) and this section, a sale of qualifying employer real property or qualifying employer securities shall include any disposition for value.
d. Adequate consideration. For purposes of section 408(e) and this section, adequate consideration means:

    1. In the case of a marketable obligation, a price not less favorable to the plan than the price determined under section 407(e)(1) of the Act and
    2. In all other cases, a price not less favorable to the plan than the price determined under section 3(18) of the Act.

e. Commission. For purposes of section 408(e) and this section, the term "commission" includes any fee, commission or similar charge paid in connection with a transaction, except that the term "commission" does not include a charge incurred for the purpose of enabling the appropriate plan fiduciaries to evaluate the desirability of entering into a transaction to which this section would apply, such as an appraisal or investment advisory fee.

Department of Labor

Regulation 2570.30 through .52

29 C.F.R. 2570.30 through .52

Individual and Class Prohibited Transaction Exemption Requests (Replaces ERISA Procedure 75-1)

Originally issued August 10, 1990 (55 FR 32847)

§ .35 Amended through April 12, 1991 (56 FR 14861)

Agency: Pension and Welfare Benefits Administration, Labor.

Action: Final regulation and removal of interim final regulation.

Summary: This document contains a final regulation that describes the procedures for filing and processing applications for exemptions from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA), the Internal Revenue Code of 1986 (the Code), and the Federal Employees' Retirement System Act of 1986 (FERSA). At this time, the Department is also removing an interim regulation which describes the exemption procedures under FERSA because such regulation is superseded by the final regulation contained herein. The Secretary of Labor is authorized to grant exemptions from the prohibited transaction provisions of ERISA, the Code, and FERSA and to establish an exemption procedure to provide for such exemptions. The final regulation updates the description of the Department of Labor's procedures to reflect changes in the Department's exemption authority and to clarify the procedures by providing a more comprehensive description of the prohibited transaction exemption process.

Note
In 1995, the Labor Department also issued a booklet, Exemption Procedures Under Federal Pension Law, explaining how to obtain ERISA exemptions. The text of the exemption request procedure is included in the booklet. The free booklet is available from the Division of Public Affairs; Pension and Welfare Benefits Administration; U.S. Department of Labor; 200 Constitution Avenue, NW; Washington, DC 20210; phone 202/219-8921.

Effective Date: This regulation is effective September 10, 1990, and applies to all exemption applications filed at any time on or after that date.

Explanatory Preamble

(Final Regulation)

For further information contact: Miriam Freund, Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, Washington, DC 20210, (202) 523-8194, or Susan Rees, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Washington, DC 20210, (202) 523-9141.

Supplementary information: Public reporting burden for this collection of information is estimated to average 28.5 hours per response, including the time for reviewing the instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, to Director, Office of Information Management, U.S. Department of Labor, 200 Constitution Avenue NW., Room N-1301, Washington, DC 20210; and to the Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for PWBA, Office of Management and Budget, Room 3001, Washington, DC 20503.

Section 406 of ERISA prohibits certain transactions between employee benefit plans and "Parties in interest" (as defined in section 3(14) of ERISA). In addition, sections 406 and 407(a) of ERISA impose restrictions on plan investments in "employer securities" (as defined in section 407(d)(1) of ERISA) and "employer real property" (as defined in section 407(d)(2) of ERISA). Most of the transactions prohibited by section 406 of ERISA are likewise prohibited by section 4975 of the Code, which imposes an excise tax on those transactions to be paid by each "disqualified person" (defined in section 4975(e)(2) of the Code in virtually the same manner as the term "party in interest") who participates in the transactions.

Both ERISA and the Code contain various statutory exemptions from the. prohibited transaction rules. In addition, section 408(a) of ERISA authorizes the Secretary of Labor to grant administrative exemptions from the restrictions of ERISA sections 406 and 407(a) while section 4975(c)(2) of the Code a authorizes the Secretary of the Treasury or his delegate to grant exemptions from the prohibitions of Code section 4975(c)(1). Sections 408(a) of ERISA and 4975(c)(2) of the Code direct the Secretary of Labor and the Secretary of the Treasury, respectively, to establish procedures to carry out the purposes of these sections.

Under section 3003(b) of ERISA, the Secretary of Labor and the Secretary of the Treasury are directed to consult and coordinate with each other with respect to the establishment of rules applicable to the granting of exemptions from the Prohibited transaction restrictions of ERISA and the Code. Under section 3004 of ERISA, moreover, the Secretaries are authorized to develop jointly rules appropriate for the efficient administration of ERISA. Pursuant to these provisions, the Secretaries jointly issued an exemption procedure on April 28, 1975 (ERISA Proc. 75-1, 40 FR 18471. also issued as Rev. Proc. 75-26, 1975-1 C.B. 722). Under these procedures, a person seeking an exemption under both section 408(a) of ERISA and section 4975(c)(2) of the Code was obliged to file an exemption application with the Rules and Regulations of the Internal Revenue Service as well as with the Department of Labor.

Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1918, effective on December 31, 1978), transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975 of the Code, with certain enumerated exceptions, to the Secretary, of Labor. As a result, the Secretary of Labor now possesses authority under section 4975(c)(2) of the Code, as well as under section 408(a) of ERISA, to issue individual and class exemptions from the prohibited transaction rules of ERISA and the Code. The Secretary has delegated this authority, along with most of his other responsibilities under ERISA, to the Assistant Secretary for Pension and Welfare Benefits. See Secretary of Labor's Order 1-87, 52 FR 13139 (April 21, 1987).

FERSA also contains prohibited transaction rules that are applicable to parties in interest with respect to the Federal Thrift Savings Fund established by ERISA, and the Secretary of Labor is directed to prescribe, by regulation, a procedure for granting administrative exemptions from certain of those prohibited transactions. See 5 USC 8477(c)(3).

On June 28, 1988, the Department published a proposed rule in the Federal Register (53 FR 24422) updating ERISA Procedure 75-1 to reflect the changes made by Reorganization Plan No. 4 and extending the procedure to applications for exemptions from the FERSA prohibited transaction rules. In addition, the

proposed regulation codified various procedures developed by PWBA since the adoption of ERISA Proc. 75-1. Formal adoption of those procedures will facilitate review of exemption applications. These new procedures also fill in some of the gaps left in ERISA Proc. 75-1. thereby providing a more detailed description both of the steps to be taken by applicants in applying for exemptions and the steps normally taken by the Department in processing such applications. Finally, the proposed regulation modified some of the procedures described in ERISA Proc. 75-1 to better serve the needs of the administrative exemption program as demonstrated by the Department's experience with the program over the previous fourteen years. These amendments were intended to promote the prompt and fair consideration of all exemption applications.

The notice of proposed rulemaking gave interested persons an opportunity to comment on the proposal. In response, the Department received three letters of comment regarding several aspects of the proposed regulation. The following discussion summarizes the proposed regulation and the issues raised by the commentators and explains the Department's reasons for adopting the provisions of the final regulation.

The Scope of the Regulation

As explained in the notice of proposed rulemaking, the regulation establishes new procedures to replace ERISA Proc. 75-1. These new procedures reflect changes in the Department of Labor's exemption authority effected by Reorganization Plan No. 4 of 1978. Thus, the procedures apply to all applications for exemption which the Department has authority to issue under section 408(a) of ERISA, or, as a result of Reorganization Plan No. 4, under section 4975(c)(2) of the Code. The procedures reflect current practice under which the Department generally treats any exemption application filed solely under section 408(a) of ERISA or solely under section 4275(c)(2) of the Code as an application for exemption filed under both of these sections if the application relates to a transaction prohibited under corresponding provisions of both ERISA and the Code. The grant of an exemption by the Department in such instances protects disqualified persons covered by the exemption from the excise taxes otherwise assessable under section 4975(a) and (b) of the Code.

However, the procedures do not apply to applications for exemption reserved to the jurisdiction of the Secretary of the Treasury by Reorganization Plan No. 4. To ascertain the correct procedures for filing and processing applications for these exemptions, applicants should consult the Internal Revenue Service.

The Department has also concluded that it is appropriate to apply the procedures provided here to exemption applications filed under FERSA, as well as those filed under ERISA or the Code, as provided by proposed § 2570.30, which has been adopted without change in the final regulation. Although the prohibited transaction provisions of FERSA and the scope of the Department's exemptive authority under FERSA differ somewhat from that under ERISA and the Code, administrative exemption matters under FERSA are likely to involve many of the issues as are presented by similar matters involving private plans. Thus, adopting uniform procedures should help assure uniform administration of the exemption programs.

Applications for Exemption under FERSA

On December 29, 1988, the Department published an interim regulation in the Federal Register (29 C.F.R. part 2585, 53 FR 52088) describing the procedures for filing and processing applications for exemptions from the prohibited transaction provisions of FERSA. For such applications, the interim regulation adopted the procedures then currently followed (pursuant to ERISA Proc. 75-1) by applicants for exemptions from the prohibited transaction provisions of ERISA and the Code. The interim final regulation was effective commencing December 29, 1988 until the effective date of the final regulation contained herein for all prohibited transaction exemption applications (under ERISA, the Code and FERSA).[1]

Section 2585.12 of the interim regulation provides that this regulation shall expire on the effective date of the revised prohibited transaction exemption procedure, published in proposed form on June 28, 1988, 53 FR 24422, and that the Department will publish a document removing these interim regulations when it adopts final regulations based on the published proposal. Accordingly, this notice of final rulemaking removes the interim regulations, as of September 10, 1990, the effective date of the final regulation contained herein.

In regard to FERSA exemption applications, the Department received a comment relating to the adoption of ERISA class exemptions for FERSA purposes. This comment suggested that the final regulation clarify that the Department will follow the procedure authorized under section 8477(c)(3)(E) of FERSA, which permits the Secretary of Labor to determine that an exemption granted for any class of fiduciaries or transactions under section 408(a) of ERISA shall constitute an exemption for FERSA purposes upon publication of notice in the Federal Register without affording interested parties opportunities to present their views (in writing or at a hearing).

The procedures described in the preceding paragraph was not used in conjunction with the Department's adoption for FERSA purposes of a number of specific class exemptions under ERISA (for example, Prohibited Transaction Exemptions (PTE) 75-1, 78-19, 80-26, 80-51, 82-63 and 86-128). In that instance, the Department published in the Federal Register both a notice of proposed adoption of class exemptions under ERISA (53 FR 38105, September 29, 1988), which invited the public to submit written comments or requests for a hearing on the proposed adoption, and also a notice of final adoption of these class exemptions (PTE T88-1, 53 FR 52838, December 29, 1988). In this regard, the Department notes that, with respect to ERISA class exemptions which may be proposed in the future and which may also be relevant under FERSA, the Department will solicit the views of the Executive Director of the Federal Retirement Thrift Investment Board in advance of the publication of the proposed exemption to determine whether such exemption should also be proposed for FERSA purposes.

Also regarding FERSA exemption applications, the Department received another comment requesting clarification that the mere existence of routine audit activity conducted by the Department pursuant to the requirements of section 8477(g) of FERSA[2] will not provide a basis for denial of, or failure to consider, an application for exemption under FERSA. It is the view of the Department that those audits conducted by the Department in carrying out its responsibilities in connection with its regular program of compliance audits under FERSA section 8477(g) would not constitute an "investigation" for purposes of § 2570.33(a)(2) and 2570.37(b) of the regulation[3] or an "examination" for purposes of § 2570.35(a)(7).[4] The Department would not, however, be precluded from denying, or failing to consider, an application based on an investigation prompted by information arising as a result of such a routine audit.

Definitions

Section 2570.31 of the proposed regulation defined the following terms for purposes of the exemption procedures: affiliate, class exemption, Department, exemption transaction, individual exemption, and party in interest. No comments were received regarding these definitions which are adopted in the final regulation as proposed. However, the Department has added to this section a definition of the term "pooled fund" in response to a comment requesting that a special rule be added to the final regulation regarding information to be furnished in exemption applications relating to plans affected by an exemption transaction undertaken by a pooled investment vehicle. (This comment is discussed in more detail below.)

Who May Apply for Exemptions

Section 2570.32(a) of the proposed regulation provided that exemption proceedings may be initiated by the Department either on its own motion or upon the application of: (1) Any party in interest to a plan which is or may be a party to the exemption transaction, (2) any plan which is a party to the exemption transaction, or (3) an association or organization representing parties in interest who may be parties to an exemption transaction covering a class of parties in interest or a class of transactions.

One of the comments received recommended modifying this paragraph of the regulation to permit an exemption application to be filed by any fiduciary or prospective fiduciary with respect to plan assets under such fiduciary's management or control, regardless of whether such fiduciary either represents a specific plan with respect to the exemption application or would be a party to the exemption transaction. The commentator clarified his comment by explaining that he intended this category of applicants to cover prospective fiduciaries, such as persons creating and/or managing a new investment vehicle in which plans are expected to participate if the requested exemption is granted, but in which no plans participate at the time the exemption application is filed. The commentator noted that in the past the Department has granted individual exemptions to institutional investment managers in connection with their investment management of individual plans' investment accounts or pooled investment funds in which several unidentified plans may participate.

In the Department's view, the reference in proposed § 2570.32(a)(1) to "any party in interest to a plan who is or may be a party to the exemption transaction" includes the prospective fiduciaries mentioned by the commentator. Therefore, § 2570.32(a) is adopted in the final regulation without change.

Section 2570.32(b) and (c) of the proposed regulation set forth simplified rules relating to representation of applicants by third parties. No comments were received regarding these paragraphs, which are adopted in the final regulation without change.

Applications the Department Will Not Ordinarily Consider

Section 2570.33(a) of the proposed regulation described the circumstances under which the Department will not ordinarily consider the merits of an exemption application. Thus, this paragraph provided that *the*

Department will not ordinarily consider an incomplete application. In this regard, the Department emphasizes that applicants should not file exemption applications until they have compiled all the information required by § 2570.34 and, if applicable, § 2570.35, and can submit this information in an organized and comprehensive fashion together with all necessary supporting documents and statements. In addition, the proposal made it clear that the Department ordinarily will not consider applications that involve a transaction, or a party in interest with respect to such transaction, that is the subject of an ERISA enforcement action or investigation. In certain cases, however, the Department may exercise its discretion to consider exemption applications in these categories where, for example, deficiencies in the exemption application are merely technical, or where an enforcement matter is clearly unrelated to the exemption transaction.

One comment was received specifically regarding investigations, and it is discussed above under the heading "Applications for Exemption under FERSA." In addition, the Department has amended § 2570.33(a)(2) (relating to certain investigations and enforcement actions) to conform to a similar revision to § 2570.35(a)(7) (discussed below) made in response to two other comments received regarding the proposed requirement to include information in an application concerning certain investigations, examinations, litigation, or continuing controversy involving specified Federal agencies with respect to any plan or party in interest involved in the exemption transaction. The effect of these amendments is to expand the proposed regulation in order to broaden the scope of exemption applications which the Department will ordinarily consider.

No comments were received on paragraphs (b) and (c) of proposed § 2570.33, which are adopted without change in the final regulation. These paragraphs relate to the Department's written explanation to an applicant whose exemption application the Department has decided not to consider, and to applications for individual exemption relating to transaction(s) covered by a class exemption under consideration by the Department.

Exemption Application Contents - General Information

As previously noted in the proposed regulation, the Department's experience to date with the administrative exemption program suggests that the program's efficiency could be increased and *applicants can receive more timely treatment of their applications for exemption if the quality of exemption applications filed were improved. In the past, applications have been incomplete, have omitted or misstated facts or legal analyses needed to justify requests for exemptive relief, and in some cases have been so poorly drafted that the details of the transactions for which exemptive relief is sought ("exemption transactions") are unclear. The time and effort required to deal with such deficient applications and to obtain accurate and complete information about exemption transactions have contributed to processing delays.* Moreover, in many exemption applications, the discussion of the substantive basis for the exemption does not take adequate account of positions adopted by the Department with respect to other similar applications.

The proposed regulation attempted to address these problems in a number of ways. First, the proposal required that applicants provide more complete information in their applications about exemption transactions and about the plans and the parties in interest involved in those transactions. The Department's experience suggests that this additional information is very helpful, and often essential, for a complete understanding of the exemption transaction and of the context surrounding it, and that the omission of such additional information in exemption applications will delay review of these applications on their merits.

For the same reason the proposed regulation required filing with the exemption copies of the relevant portions of documents. By filing comprehensive applications with necessary supporting documentation, applicants can do much to facilitate the Department's review of requested exemptions and to expedite the exemption process as a whole.

To further expedite the exemption process, the proposed regulation required that an applicant include with his application a statement explaining why the requested exemption satisfies requirements set forth in sections 408(a) of ERISA and 4975(c)(2) of the Code and 5 USC 84711(c)(3)(C) that an exemption be:

1. Administratively feasible;
2. In the interests of the plan and of its participants and beneficiaries; and
3. Protective of the rights of the plan's participants and beneficiaries.

This requirement is not new. Under ERISA Proc. 75-1, applicants have been required to include with their applications statements explaining why a requested exemption satisfies the statutory prerequisites for an exemption. Too often, however, applicants have attempted to satisfy this requirement with generalizations and perfunctory assurances about the benefits to be reaped by plans and their participants and beneficiaries from the proposed exemption.

The Department will not seek out reasons to grant an exemption that has not been adequately justified by an

applicant. Indeed, the Department considers that it is the responsibility of applicants to demonstrate clearly that exemptions they are requesting meet statutory criteria. Accordingly, under both the proposed and the final regulation, applicants are expected to review the statutory criteria for granting administrative exemptions and explain with as much specificity as possible why a requested exemption would pose no administrative problems, what benefits affected plans and their participants and beneficiaries can expect to receive from it, and what conditions word be attached to protect the rights of participants and beneficiaries of affected plans.[5]

Under ERISA Proc. 75-1, applicants have been given the option, but have not been required, to submit a draft of the proposed exemption. Both the proposed and the final regulation preserve this option. However, while not requiring the submission of a draft of the proposed exemption, *the Department recommends that applicants include in their exemption applications draft language which defines the scope of the requested exemption, including the specific conditions under which the proposed exemption would apply. A draft which explains the exemption requested in a clear and concise manner and focuses on what the applicant considers to be the essential features of the exemption transaction and the critical safeguards supporting the requested relief is likely to facilitate the process of review.* Obviously, the degree of detail necessary to describe the proposed exemption adequately will vary depending on the complexity of the transaction and the kind of relief requested.

Section 2570.34 of the proposed regulation listed the information that is required in every exemption application, whether it be an application for individual or class exemption. In addition, the information specified in § 2570.35 of the regulation must be included in applications for individual exemptions. Some specific items of information are described below.

Shared Representation

Section 2570.34(a)(3) of the proposed regulation required each exemption application to disclose whether the same person will represent both the plan and the parties in interest involved in an exemption transaction in matters relating to the application. The proposal noted that such shared representation may raise questions under the exclusive purpose and prudence requirements of sections 403(b) and 404(a) of ERISA and under the prohibited transaction provisions of section 406 of ERISA and section 4975(c)(1) of the Code. No comments have been received regarding this subparagraph, which is adopted as proposed.

Third-Party Declarations

Section 2570.34(b)[5)(iii) of the proposed regulation required a declaration under penalty of perjury to accompany specialized statements from third-party experts submitted to support an exemption application, such as appraisals, analyses of market conditions, or opinions of independent fiduciaries. Specifically, the proposal required a declaration under penalty of perjury that to the best of the expert's knowledge and belief, the representations made in the specialized statement are true and correct. This declaration was to be dated and signed by the expert who prepared the statement.

One of the commenters urged deletion of this requirement and expressed concern that it would cause additional expense to applicants because new third-party statements would be required once the appraiser, engineer, financial specialist, or other expert became aware of their intended use as part of an exemption application. The commentator advised subsequently that such experts either may be reluctant to provide any sort of attestation because of unknown liabilities which may arise by using the expert's report as part of an exemption application, or may seek an additional, and perhaps substantial, fee for furnishing an attestation due to the unknown liabilities.

In this regard the Department notes that, with respect to any matter within the jurisdiction of any department or agency of the United States, it is a crime, punishable by a fine of up to $10,000 and/or imprisonment of up to five years, for anyone knowingly and willfully to falsify, conceal or cover up by any trick, scheme or device a material fact; to make any false, fictitious, or fraudulent statements or representations; or to make or use any false writing or document knowing the same contains any false, fictitious, or fraudulent statement or entry (18 USC 1001). It is the view of the Department that this provision applies to applicants for exemptions under ERISA, the Code, or FERSA, to fiduciaries (independent or otherwise) representing the plan in an exemption, transaction, and to third-party experts who prepare statements or reports that such experts know will be included in exemption applications.

Nevertheless, the Department recognizes that third-party experts, such as appraisers, bankers, financial analysts, and other specialized consultants usually do not function as fiduciaries with respect to a plan if such experts authority, responsibility, or contact with respect to the plan is limited to providing an opinion which may be included in an exemption application, and which will be considered by plan fiduciaries who will decide what,

if any, action they will take on behalf of the plan based upon such opinion. The Department believes that such experts need not be held to the same degree of accountability regarding exemption applications covering transactions where a plan fiduciary has the authority and responsibility to make decisions on behalf of a plan. Thus, the Department has decided to modify proposed § 2570.34(b)(5)(iii) to provide that a statement of consent, rather than a declaration under penalty of perjury, is required from each such expert which acknowledges that his or her statement is being submitted to the Department as part of an exemption application. The Department believes that such a consent statement from a third-party expert will not require an applicant to obtain a new report from the expert because the expert's consent statement may refer to his or her previously issued report. (However, the Department may require an updated report in any case if the substantive information contained in a report submitted with an exemption application is out of date.)

Conversely, where an independent fiduciary represents the plan in an exemption transaction, that fiduciary is subject to all of the responsibilities imposed by part 4 of subtitle B of title A of ERISA. None of the comments received questioned the need for such a fiduciary to provide the declaration under penalty of perjury required under the proposed regulation, and the Department has decided to retain this proposed requirement for such plan fiduciaries in the final regulation. As a result, the Department has modified § 2570.34(b)(5)(ii) and has added § 2570.34(b)(5)(iv) to clarify that a declaration is required for such plan fiduciaries,

Pooled Funds

One comment suggested that § 2570.35 of the proposed regulation be modified to provide a special rule regarding information to be included in an application for an individual exemption involving a pooled investment fund, such as a pooled separate account maintained by an insurance company or a collective investment fund maintained by another financial institution. The commentator pointed out that, as proposed, § 2570.35 would require information to be submitted regarding each plan participating in a pooled investment fund, resulting in the submission of an overwhelming volume of information unrelated to the exemption transaction. However, the commentator recognized that information regarding certain plans may be relevant to the exemption application in view of the potential for conflicts of interest involving such plans. Such plans would include any plan maintained for employees of the sponsor or other fiduciary of the pooled investment fund, and a plan whose participation in the pooled fund exceeded a specified percentage of the total fund assets.

The Department agrees with this comment and, accordingly, has added a new paragraph (c) to § 2570.35, which contains a special rule for applications for individual exemptions involving pooled funds [as defined in § 2570.31(g)]. Subparagraph (1) of § 2570.35(c) excepts such applications from including certain information otherwise required relating to among other things: reportable events under section 4043 of ERISA, notice of intent to terminate a plan (section 4041 of ERISA), the number of participants and beneficiaries of each plan participating in the pooled fund, and the percentage of each such plan's assets involved in the exemption transaction.

Subparagraph (2) of the special rule provides that certain information otherwise required by § 2570.35(a) and (b) of the regulation must be furnished by reference to the pooled fund rather than the plans participating in such fund. This information pertains to: Identifying information; any prior violations of the Code's exclusive benefit rule or of the prohibited transaction provisions of the Code, ERISA or FERSA, any prior applications for exemption from such prohibited transaction provisions; any lawsuits or criminal actions regarding conduct with respect to any employee plan; any criminal convictions described in section 411 of ERISA; any investigation or continuing controversy with specified Federal agencies regarding compliance with ERISA, Code provisions relating to employee plans, or FERSA provisions relating to the Federal Thrift Savings Fund; whether the exemption transaction has been consummated and, if so, certain related information regarding correction of the prohibited transaction and payment of excise taxes; the identification of persons with investment discretion over any assets involved in the exemption transaction and each such person's relationship to the parties in interest involved in the exemption transaction; investments involving certain parties in interest, the fair market value of the pooled fund; the identity of the person who will pay the costs of the exemption application, notifying interested persons, and the fee of any independent fiduciary involved in the exemption transaction; and an analysis of the facts relevant to the exemption transaction as reflected in documents submitted with the application. The pooled fund, rather than participating plans, must also furnish copies of all relevant documents, including, for example, the most recent financial statements of the pooled fund.

Subparagraph (3) of the special rule requires information to be furnished with pooled fund exemption applications with respect to: the aggregate number of plans expected to participate in the pooled fund, and the limits (if any) imposed by the pooled fund on the amount or percentage of each participating plan's assets that may be invested in the pooled fund.

Subparagraph (4) of § 2570.35(c) contains additional requirements for applications for individual exemptions involving pooled funds. These requirements apply to plans whose investments in the pooled fund represent more than 20% of the pooled fund's total assets[6] and those plans covering employees of the pooled fund's sponsor, and other fiduciaries with discretion over pooled fund assets. The Department believes that additional information is warranted in those situations where the potential for decision making that may inure to the benefit of a fiduciary or other party in interest is increased. For each of these plans, the additional requirements provide for the furnishing of certain individual plan information described in 2570.35(a), in addition to the information required under § 2570.35(c)(2) and (c)(3). The Department believes this information is necessary for its determination as to whether sufficient protections are incorporated into the exemption transaction.

The Department further notes that the decision by the fiduciaries of certain plans to invest in a pooled fund may involve a separate prohibited transaction, apart from any prohibited transaction which may be entered into by the pooled fund itself In this regard, the Department notes that the information required to be submitted on behalf of such plans is to be provided in accordance with the general rule contained in § 2570.35, rather than the special rule for pooled funds.

Finally, the Department believes that the special rule for pooled funds is less burdensome to applicants than the rules set forth in the proposed regulation. As noted by a commentator, the proposed regulation would have required the submission of voluminous amounts of material, as information would have to be submitted on behalf of each plan investing in a pooled fund. The final regulation limits the amount of material to be submitted since it requires only information relating to the pooled fund and, where applicable, certain plans investing in the pooled fund. In addition, the Department believes that its ability to analyze and process applications for exemption involving pooled funds will be enhanced by this special rule. In this regard, the Department believes that the final regulation eliminates a significant amount of material that otherwise would have been required.

Lawsuits, Certain Criminal Convictions, Investigations, Examinations, Continuing Controversies, etc.

Sections 2570.35(a)(5), (6), and (7) of the proposed regulation ired exemption applications to disclose inf ormation regarding whether the appl lor any of the parties to the exemption transaction is or has been, within specified number of years past, a defendant in any lawsuit or criminal action concerning conduct as a fiduciary or other party in interest with respect to any employee benefit plan (§ 2570.35(a)(5)(b) convicted of a crime described in section 411 of ERISA (§ 2570.35(a)(6)), or under investigation or examination or engaged in litigation or a continuing controversy with certain Federal agencies (§ 2570.35(a)(7)). Proposed § 2570.35(a)(7) also required disclosure of whether any plan affected by the exemption transaction has been under such investigation, examination, litigation, or any controversy, and further required the applicant to submit copies of all correspondence with the specified Federal agencies regarding substantive issues involved in such investigation, etc.

Two of the comments urged deletion of the disclosure requirements of proposed § 2570.35(a)(5) and (7) on the basis that such disclosure is difficult, costly, and almost always irrelevant to the exemption transaction.

The Department continues to believe that the proposed disclosure is relevant to the exemption transaction. With regard to § 2570.35(a)(5) (relating to lawsuits or certain criminal actions), the Department views the disclosure required as directly concerning the conduct of the applicant and other parties in interest participating in the exemption transaction. The Department believes that such information is necessary in evaluating the credibility and integrity of such parties, some of whom may possess substantial discretion regarding the exemption transaction or may make representations upon which the Department must rely in determining whether the statutory criteria for an exemption have been satisfied. In addition, the proposed disclosure assists the Department in ensuring that the exemption contains appropriate safeguards.

Further, the Department does not agree that the disclosure required by § 2570.35(a)(5) imposes any "significant" burdens on applicants. The Department believes that prudent fiduciaries would in the normal course of carrying out their responsibilities, ascertain such information about the parties they intend to deal with in investment and other plan transactions. However, the Department has determined that it would be appropriate to modify proposed § 2570.35(a)(5) in the final regulation to limit disclosure to the applicant or any of the parties in interest involved in the exemption transaction.

Regarding the disclosure required by proposed § 2570.35(a)(7) (relating to, investigations, examinations, litigation, and continuing controversy by or with the specified Federal agencies), the Department believes that such information is necessary to ensure that the Department's exemption activities do not compromise its enforcement efforts. Although the Department is most interested in information involving investigations, etc.

that are directly related to the subject exemption transactions and the participating parties, the Department believes, nevertheless, that its exemption staff, and not the applicants, should determine which investigations, examinations, etc., are relevant.

One of the comments further suggested that it is inappropriate to require applicants to disclose matters which have resulted in no formal allegations of violations of law. The Department notes, however, that the affected parties may include, as part of their disclosure, any qualification or explanations they deem appropriate for consideration by the Department, including information on the final disposition of any matter;

Another commentator suggested that disclosure under § 2570.35(a)(7) be limited to a reference to the investigation or litigation without requiring submission of copies of "all correspondence" involved in the investigation. In this regard, the Department notes that the proposed regulation did not require submission of copies of all correspondence, but only of correspondence relating to the, substantive issues involved in the investigation, examination, litigation, or controversy. Specifically, the Department intended to require submission of copies of correspondence containing only that information directly relevant to determining whether or not the requested exemption should be granted. After considering the comment, the Department has modified § 2570.35(a)(7) to clarify that the phrase "substantive issues" refers to issues related to compliance with the provisions of parts 1 and 4 of subtitle B of title I of ERISA (reporting and disclosure (part 1) and fiduciary responsibility (part 4)), section 4975 of the Code, or sections 8477 or 8478 of FERSA (fiduciary responsibilities, liability and penalties (section 8477) and bonding (section 8478). Copies of correspondence relating to any of these substantive issues is necessary in order for the Department to determine the effect the requested exemption may have on the Department's enforcement activities in each case under investigation, examination, etc.

One of the comments noted that proposed § 2570.35(a)(5), (6) and (7) required the disclosure of information regarding any parties to the exemption transaction and suggested limiting the disclosure to fiduciaries authorizing the transaction and any parties in interest involved in the exemption transaction. This comment pointed out that investment transactions may involve multiple parties, many of wham are neither plan fiduciaries nor parties in interest. After due consideration, the Department agrees with this suggestion and, accordingly, has modified § 2570.35(a)(5), (6) and (7) to limit the required disclosure to any parties in interest involved in the exemption transaction. The Department rates that this group includes, among others, the fiduciary authorizing the exemption transaction.

See the heading "Applications for Exemption under FERSA," above, regarding modification to proposed § 2570.35(a)(7) as applicable to the Federal Thrift Savings Plan established by FERSA.

Party-in-Interest Investments

Proposed § 2570.35(a)(16) required an application for individual exemption to disclose information regarding any plan investments in loans to, property leased to, or securities issued by, any party in interest involved in the exemption transaction. One of the comments suggested deletion of this requirement due to the difficulty of identifying such investments in view of the "look-through" rule contained in the Department's plan asset regulation (29 C.F.R. 2510.101). This comment suggested that the proposed disclosure may invoke many transactions, by an entity whose underlying assets include "plan assets," which are totally unrelated to the exemption transaction. The comment further indicated that this disclosure would be burdensome for exemption transactions involving numerous parties in interest, such as those involving pooled funds.

The Department agrees that, for exemption applications involving pooled funds, furnishing the proposed disclosure could be burdensome inasmuch as such applications generally do not relate to specific plans. Accordingly, the Department has adopted a special rule for applications for individual exemption involving pooled funds, discussed above (under the heading "Pooled Funds"), which limits this type of disclosure to the pooled fund and to certain plans participating therein.

Regarding exemption applications involving specific individual plans, it appears to the Department that the information to be disclosed under proposed § 2570.35(a)(16) must be maintained, in any event, to satisfy the annual reporting requirements of section 103 of ERISA, as well as the recordkeeping requirements of section 107. Therefore, the Department believes that this disclosure requirement should not impose any additional burdens on the applicant. The information to be disclosed will enable the Department to determine whether the exemption transaction, in conjunction with other plan investments involving parties in interest, would unduly concentrate the plan's assets in such investments so as to raise questions under the fiduciary responsibility provisions of section 404 of ERISA. For these reasons, the Department has decided to adopt § 2570.35(a)(16) as proposed, subject to the special rule for applications for individual exemption involving pooled funds in § 2570.35(c).

Costs Related to the Exemption Application

Proposed § 2570.35(a)(18) and (19) required the exemption application to identify the person who will bear the costs of the exemption application, of notifying interested persons, and of the fee charged by any independent fiduciary involved in the exemption transaction. The preamble to the proposed regulation noted that a plan's payment of the expenses associated with the filing or processing of an exemption application raises questions under the fiduciary responsibility and the prohibited transaction restrictions to the extent that any party in interest benefits from the transaction for which an exemption is sought (see section 406(a)(1)(D) of ERISA).

One of the commentators requested that the Department provide a more specific discussion of when it believes such questions will be raised. The comment states that, in many cases, it is appropriate for the plan to pay the expenses attributable to obtaining an exemption, and that an independent fiduciary's fees are generally paid by the plan receiving such fiduciary's services in order to ensure that such fiduciary conducts its activities in a totally independent manner and without any potential influence from persons other than the plan paying such fees.

The proposed disclosure of who pays the fees for an exemption application is intended to enable the Department to review the appropriateness of such payment by a plan in the context of a specific exemption request. Such disclosure is also intended to aid the exemption staff in evaluating whether the economic merits of the transaction, taking into account the costs attributable to the exemption application, support a finding that the proposed transaction is in the interests of the plan and its participants and beneficiaries. While the Department agrees that there may be certain instances in which it would be appropriate for a plan to pay all or part of the costs attendant with obtaining an exemption, such as where it is necessary to ensure the independence of an independent fiduciary or third-party expert, the Department believes that the propriety of such payments by a plan is an inherently factual determination which can be made only on a case-by-case basis.

In this regard, the Department notes that, when evaluating the propriety of the payment by a plan of certain expenses, plan fiduciaries must first consider the general fiduciary responsibility provisions of sections 403 and 404 of ERISA. Section 403(c)(1) provides, in part, that the assets of an employee benefit plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. Similarly, section 404(a)(1)(A) requires, in part, that a fiduciary of a plan discharge his duties for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. Thus, a payment that is not a distribution of benefits to participants or beneficiaries of a plan would not be consistent with the requirements of sections 403(c)(1) and 404(a)(1)(A) unless it was used to defray a reasonable expense of administering the plan.

In addition, section 406(a)(1)(D) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if he knows or should know that such transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest of any assets of the plan. It is the responsibility of appropriate plan fiduciaries to determine whether a particular expense is a reasonable administrative expense under sections 403(c)(1) and 404(a)(1)(A) of ERISA or whether plan payment of an expense would constitute a prohibited use of plan assets for the benefit of a party in interest under section 406(a)(1)(D) of ERISA.

Copies of Documents

Section 2570.35(b)(1) of the proposed regulation required each application for individual exemption to include true copies of all documents bearing on the exemption transaction, such as contracts, deeds, agreements, instruments, and relevant portions of plan documents, including trust agreements.

One comment objected to this requirement on the grounds that having to assemble the required documents is time consuming, costly, and unnecessary if the exemption application properly describes all pertinent plan provisions and other documents in sufficient detail to allow the Department to evaluate the merits of the exemption transaction. In this regard, the Department notes that the documents with respect to which copies are requested are all documents which would be readily available to the parties to the exemption transaction. Accordingly, the Department does not believe that there would be a significant burden in either compiling the documents or in transmitting copies to the Department. Further, the Department notes that it is not uncommon for representations contained in an exemption application to be inconsistent with the provisions of the governing documents or for the latter to contain provisions with respect to which clarifications or other representations are needed in order for the requested exemption to be proposed. On the basis of the Department's experience with exemptions, scrutiny of the relevant documents is, in the large majority of cases, a necessary prerequisite to a complete understanding of the exemption transaction and the implications for

affected plans and parties in interest. Moreover, in the Department's experience, the inclusion of copies of the requested documents, as part of the exemption application, has expedited the processing of the requested exemption.

For these reasons, the final regulation adopts proposed § 2570.35(b)(1) without change. However, the Department wishes to clarify three points regarding this requirement. -

- First, for exemption transactions in which identical documents will be executed by more than one party, the submission of only one specimen document will satisfy the requirements of this paragraph.
- in the case of exemption transactions which are proposed, copies of the documenting to t he proposed transaction need not be executed or dated when they are submitted with the exemption application if the documents are complete in every other respect. In this regard, the Department strongly encourages requesting an administrative exemption before entering into a prohibited transaction because of the ability to incorporate all of the necessary safeguards into the transaction. By contrast, such safeguards cannot be put into place after a prohibited transaction has occurred.
- Third, only copies of documents need be submitted. The Department may not be able to return original documents and, therefore, urges that only true copies of documents be submitted.

Where To File an Application

Although no comments were received regarding this section, which is adopted as proposed, the Department wishes to advise applicants that including the room number of the Division of Exemptions in the address will generally expedite its delivery. The current room number of the Division of Exemptions, Room N-5671, is not included in the regulation to avoid the need to amend the regulation every time the room, number of the Division changes.

Duty To Amend and Supplement Information

The proposed regulation contained the requirement established in ERISA Proc. 75-1 that an applicant promptly notify the Division of Exemptions if he discovers that any material fact or representation contained in his application, or in any supporting documents or testimony, was inaccurate or if any such fact or representation changes. However, the proposed regulation added the requirement that an applicant notify the Division of Exemptions when anything occurs that may affect the continuing accuracy of such facts or representations.

Two comments received indicated confusion as to the expiration date of the duty to update information submitted as part of an exemption application. Accordingly, the final Regulation clarifies § 2570.37(a) and (b) to indicate that such duty applies only during the pendency of the exemption application and expires after the exemption is granted. The Department also wishes to clarify that, in § 2570.37(a), the phrase "continuing accuracy of any such fact or representation" refers to future events or changes known before the exemption is granted that will render inaccurate facts stated or representations made before such grant. The Department wishes to note that exemptions are granted only to transactions as described. Therefore, if an exemption is granted and the transaction is not as described in some material aspect, the exemption does not take effect or protect parties in interest from liability for the transaction. See § 2570.49 of the regulation.

Tentative Denial Letters

Although ERISA Proc. 75-1 established no procedures to be followed by the Department in denying exemption applications or by applicants in responding to such denials, the Department has developed procedures over the years to notify applicants first to the tentative and, later, of the final denial of their applications. In large part, the proposed regulation codified these procedures.

Under the proposed regulation, the Department may decide to deny an exemption request at any of a number of stages in the review process. For example, it may decide after its initial review of an application that the requested exemption does not satisfy the statutory criteria set forth in sections 408(a) of ERISA and 4975(c)(2) of the Code. In that event, the Department will send a tentative denial letter to the applicant pursuant to § 2570.38 of the regulation. That letter will inform the applicant of the Department's tentative decision to deny the application and of the reasons therefore. Under § 2570.38, an applicant has 20 days from the date of this letter to request a conference with the Department and/or to notify the Department of his intern to submit additional information in writing to support the application. If the Department receives no request for a

conference and no notice of intent to submit additional information within that time, it will send the applicant a final denial letter pursuant to § 2570.41 of the regulation.

One of the comments received suggested that: (1) The final regulation should clarify that the Department's exemption staff may request applicants to provide additional information before a tentative denial letter is issued, and (2) rather than a "short statement" of the reasons for a tentative denial, the tentative denial letter should provide a detailed explanation of the basis for the Department's decision. Regarding the first suggestion, the comment indicates that it is unreasonable to expect an applicant to anticipate, when the exemption application is filed, all of the material which the Department may find pertinent to its consideration of an exemption application.

As stated above (under the heading "Exemption Application Contents - General Information), the Department's view is that the applicant bears the responsibility to demonstrate clearly that the requested exemption meets the statutory criteria. While nothing in the proposed regulation would preclude the Department's exemption staff from exercising its discretion and contacting an applicant for a clarification or additional information, the Department anticipates that such contact will be limited to exemption applications which, upon initial review, meet the essential requirements of the regulation. It is not administratively feasible to expect the Department's exemption staff to solicit information in every case. Moreover, such a procedure would, in effect, shift the burden of developing the exemption application from the applicant to the exemption staff.

Similarly, the imposition of a requirement that tentative denial letters detail all the reasons for the denial would, in effect, shift the analytical burden from the applicant to the Department. As with the circumstances under which additional information is solicited from applicants, the Department believes that the degree of detail required for a tentative denial letter should be left to the discretion of the exemption staff. The Department believes that a general statement of the reasons for a tentative denial is sufficient inasmuch as the issuance of a tentative denial letter does not terminate the exemption proceedings. Rather, the tentative denial letter offers the applicant the opportunity to have a conference and/or to submit additional information for consideration. In addition, a requirement to issuer a comprehensive and detailed tentative denial letter in most cases would significantly increase the time required to conclude a final action.

For these reasons, the Department has decided to adopt proposed § 2570.38 without change.

Opportunities To Submit Additional Information

Section 2570.39 of the proposed regulation provided that if an applicant wishes to submit additional information in support of a tentatively denied exemption application, he may notify the Department of his intention to do so within the prescribed 20-day period either by telephone or by letter. After issuing such a notice, an applicant has 30 days from the date of the notice to furnish additional information to the Department. If an applicant notifies the Department of his intent to submit additional information but requests no conference, and subsequently fails to submit the promised information within the prescribed 30-day period, the Department will issue the applicant a final denial letter pursuant to § 2570.41 of the regulation. However, an applicant who realizes that he will be unable to submit his additional information within the allotted time may avoid receiving a final denial letter by withdrawing his application before the end of the 30-day period pursuant to § 2570.44.

As an alternative to withdrawing his application, an applicant who, for reasons beyond his control, is unable to meet the 30-day deadline may request an extension of time for filing additional information, pursuant to § 2570.39 of the regulation. However, the Department will grant such extensions of time only in unusual circumstances.

No comments were received on this section of the proposed regulation which is adopted without change in the final regulation.

Conferences

Section 2570.40 of the proposed regulation described the procedures regarding conferences on exemption applications which the Department has tentatively decided to deny. Under this proposed section, an applicant is entitled to only one conference with respect to any exemption application, and is also given 20 days after the date of any conference to submit to the Department in writing any additional data or arguments discussed at the conference but not previously or adequately presented in writing. Under the proposal, an applicant is deemed to have waived his right to a conference if he fails, without good cause, to appear for a scheduled conference or to schedule a conference for any of the times proposed by the Department within the 45-day period following the receipt of his request for a conference.

Proposed § 2570.40 is adopted without change in the final regulation. The only comment received regarding this proposed section suggested that the Department continue its practice of informally consulting with applicants on exemption applications in addition to holding conferences. In this regard, the Department will continue to informally contact applicants as it deems appropriate.

Final Denial Letters

Proposed § 2570.41 is adopted without change in the final regulation. No comments were received on this section which specifies the circumstances in which the Department may issue a final denial letter denying a requested exemption. In most cases, the same procedure will also be followed in denying exemptions that the Department has already proposed through publication of a notice of proposed exemption in the Federal Register. However, in cases where the Department holds a hearing on an exemption, § 2570.41(a)(3) of the proposed regulation allowed the Department to issue a final denial letter without first issuing a tentative denial letter and without providing the applicant with the opportunity for a conference. In the Department's view, where a hearing on a proposed exemption is conducted, the applicant and other proponents of the exemption have adequate opportunity to present their views and other evidence in support of the exemption.

Notice of Proposed Exemption

The proposed regulation did not significantly alter the procedures established by ERISA Proc. 75-1 for granting an exemption. Under § 2570.42 of the regulation, the Department will publish a notice of proposed exemption in the Federal Register if, after reviewing an exemption application and any additional information submitted by an applicant, the Department tentatively concludes that the requested exemption satisfies the statutory criteria for the granting of an exemption and that the requested exemption is otherwise appropriate. This proposed section also described the contents of the notice of proposed exemption.

No comments were received on proposed § 2570.42, which is adopted without change in the final regulation.

Notifying Interested Persons

Like ERISA Proc. 75-1, the proposed regulation required applicants to provide notice to interested persons in the event that the Department decides to propose the exemption. Section 2570.34 of the proposal required an applicant to submit with his application a description of the interested persons to whom notice will be provided and a description of the manner in which the applicant proposed to provide notice. That section also required an applicant to provide an estimate of the time he will need to furnish notice to interested persons following publication of a notice of proposed exemption.

Section 2570.43 of the proposed regulation provided guidance on methods an applicant may use to notify interested persons of a proposed exemption and indicated what must be included in the notice. In addition to the Notice of Proposed Exemption published in the Federal Register, the applicant must include in the notification to interested persons a supplemental statement. Section 2570.43 also stated that, once the Department has published a notice of proposed exemption, the applicant must notify the interested persons described in his application in the manner indicated in the application unless the Department has informed the applicant beforehand that it considers the method of notification described in the application to be inadequate. Where the Department has so informed an applicant, it will also secure from the applicant an agreement to provide notice in the time and manner and to the persons designated by the Department. After furnishing notification, an applicant must provide the Department with a declaration under penalty of perjury certifying that notice was given to the persons and in the manner and time specified in his application or the superseding agreement with the Department.

One of the comments received concerning notification requested clarification that, in the case of a pooled fund, the notification requirement would be satisfied if the notice to interested persons is furnished to the appropriate fiduciary of each of the plans participating in the pooled fund, but not to all participants and beneficiaries of such plans.

In the Department's view, the individuals or organizations that will constitute erested persons" depends on the nature of the exemption being requd. For this reason, the proposed regulation did not attempt to delinea
ee term "interested persons" for purposes of the notification uirements of § 2570.43. As previously note
d, the applicant is required to i de, as part of the exemption application, a description of the interested persoo w
hom the applicant intends to provide notice (§ 2570.34(b)(2)(i)). If Department finds that either the method of p
roviding notice or the persto whom the applicant proposes to provide notice is inadequate, the Depart will, pu
rsuant to § 2570.43, secure an agreement from the applicant on the appropriate method of providing the notice and/or the scope of the notice to be provided. The Department believes that this approach provides the flexibility necessary to accommodate the varied types of exemption applications, as well as circumstances

unique to a particular applicant.[7]

Accordingly, the Department has decided to adopt § 2570.43 as proposed. However, subparagraph (b)(2) of this section has been modified to insert references to the Code and FERSA and to reflect the current room number of the Division of Exemptions in a footnote to that section. Paragraph (d), of this section has also been modified to clarify that the declaration accompanying the statement to be furnished to the Department regarding the notice to, interested persons must be made under penalty of perjury, as stated in the preamble to the proposed regulation (53 FR 24422, at 24425, June 28,1988).

Withdrawal and Reinstatement of Exemption Applications

Section 2570.44 of the proposed regulation permitted an applicant to withdraw his application at any time and to reinstate the application later. Reinstatement may be requested without resubmitting any information or materials previously furnished if no more than two years has elapsed from the withdrawal date. The request for reinstatement must be accompanied by any additional information that was outstanding at the time of withdrawal.

No comments were received on the proposed section, which is adopted in the final regulation without change.

Requests for Reconsideration of Final Denials

Under § 2570.45 of the proposed regulation, after the Department has issued a final denial letter on an exemption, it will not reconsider an application covering the same transaction unless the applicant presents significant new facts or arguments in support of the exemption which, for good reason, the applicant could not have submitted for consideration during the Department's initial review of the exemption. An applicant must present the significant new facts or arguments in a request for reconsideration within 180 days after the issuance of the final denial letter.

Proposed § 2570.45 also stated that only one request for reconsideration of any finally denied application will be considered by the Department. Although no comments were received on this section of the proposed regulation, the Department has modified this section in the final regulation to clarify that the Department will not limit the number of requests for reconsideration of final denials based solely on the applicant's failure to respond timely to a tentative denial letter or to furnish additional information timely (i.e., within the time frames provided under § 2570.38(b) or 2570.39(e), respectively).

The Department has also clarified in the final regulation that the declaration required under § 2570.45(c) must be made under penalty of perjury. This clarification is consistent with the requirement of § 2570.34(b)(5) that every original exemption application must be accompanied by a similar declaration under penalty of perjury. The Department intends that the same type of declaration should accompany both an original exemption application and request for reconsideration of a final denial based on the merits of such an application.

Hearings

Section 408(a) of ERISA precludes the Department from granting an exemption from the fiduciary self-dealing prohibitions of section 406(b) unless the Department affords an opportunity for a hearing and makes a determination on the record with respect to the three statutory criteria established for granting an exemption.[8] Because these provisions specify that an opportunity for a hearing must be given before an exemption from these prohibitions is granted, but not before such an exemption is denied, the Department interprets these provisions to mean that only opponents of such an exemption must be given an opportunity for a hearing. Moreover, the Department has concluded that it must provide a hearing on the record to opponents of such a proposed exemption only where it appears that there are material factual issues relating to the proposed exemption that cannot be fully explored without such a hearing. Indeed, in the Department's experience, such hearings are not useful where the only issues to be decided are matters of law or where material factual issues can be adequately explored by less costly and more expeditious means, such as written submissions. Accordingly, under § 2570.46 of the proposed regulation, the Department requires that persons who may be adversely affected by the grant of an exemption from the fiduciary self-dealing prohibitions offer some evidence of the existence of issues that can be fully examined only at a hearing before it will grant a request for a hearing. Where persuasive evidence of the existence of such issues is offered, however, the Department will grant the requested hearing.

Under § 2570.47 of the proposed regulation, the Department may schedule a hearing on its own motion if it determines that a hearing would be useful in exploring issues relevant to the requested exemption. Under the proposed procedures, if the Department decides to conduct a hearing on an exemption under either § 2570.46

or § 2570.47, the applicant must notify interested persons of the hearing in the manner prescribed by the Department. Ordinarily, such notice may be provided by furnishing interested persons with a copy of the notice of hearing published by the Department in the Federal Register within 10 days of its publication. After furnishing notice, the applicant must submit to the Department a declaration under penalty of perjury certifying that notice has been provided in the manner prescribed.

Any testimony or other evidence offered at a hearing held under either § 2570.46 or § 2570.47 becomes part of the administrative record to be used by the Department in making its final decision on an exemption application.

No comments were received on proposed § 2570.46 and 2570.47, which are adopted without change in the final regulation.

Grant of Exemption

Section 2570.48 of the proposed regulation provided that if, after considering all of an applicant's submissions, together with any comments received from interested persons and the record of any hearing held in connection with a requested exemption, the Department determines that the exemption should be granted, it will publish a notice in the Federal Register granting the exemption. This proposed section also described the contents of the grant notice.

No comments were received on proposed § 2570.48, which is adopted without change in the final regulation.

Limits on the Effect of Exemptions

Notwithstanding the duty to amend and supplement exemption applications provided under § 2570.37, the Department expressly conditions every exemption on the accuracy and completeness of the facts and representations provided by an applicant in support of the exemption. Therefore, as indicated under § 2570.49 of the proposed regulation, an exemption does not take effect or protect parties in interest from liability unless the material facts and representations contained in the application or in any other materials, documents, or testimony submitted by the applicant in support of the application were true and complete Thus, for example, in the case of a continuing exemption transaction such as a loan or a lease, if any of the material facts described in the application were to change after the exemption is granted, the exemption would cease to apply as of the date of such change even though, pursuant to § 2570.37, the applicant would not be obligated to notify the Department of such change. In the event of any such change, the parties in interest involved in the exemption transaction may apply for a new exemption to protect themselves from liability on or after the date of such change. Such an application should be submitted before such change occurs (see the discussion of prospective, versus retroactive, exemptions under the heading "Copies of Documents," above).

No comments were received on proposed § 2570.49, which is adopted without change in the final regulation.

Revocation or Modification of Exemptions

Section 2570.50 of the proposed regulation described the circumstances under which the Department may revoke or modify a previously granted exemption and the rights afforded to the applicant and to other interested persons in the event such revocation or modification is proposed. This section also provided that ordinarily such revocation or modification will be prospective only. Under this proposed section, one of the circumstances permitting the Department to modify or revoke an exemption was a change in policy which calls into question the continuing validity of the Department's original conclusions regarding the granted exemption.

Two of the comments objected to permitting a change in policy as grounds for revoking or modifying a granted exemption. The commentators argued that disturbing transactions already reviewed and approved by the Department would inject an unneeded element of uncertainty into the exemption process. Moreover, concern was expressed that the revocation of an exemption could severely disrupt an applicant's business and impose great financial hardship. A commentator suggested that the final regulation include a prohibition against revocation of an exemption until the affected party in interest is given both written notice of the facts or conduct which may warrant the revocation and an opportunity to demonstrate compliance with the requirements of the exemption.[9]

Proposed § 2570.50 is intended to provide the Department with the flexibility to undertake appropriate action in those cases where, subsequent to the grant of an exemption, potentially abusive practices or changes in the regulatory environment of an industry are identified which would cause the Department to reconsider its policy with respect to whether the exemption transactions continue to satisfy the statutory criteria under section 408(a) of ERISA.

With regard to the procedural issues raised by one of the comments, the Department notes that paragraph (b) of proposed § 2570.50 provides for notice to interested persons by publication in the Federal Register, notice to the applicant of the proposed revocation or modification, and an opportunity for the interested persons and the applicant to submit comments on the proposed revocation or modification.

After careful consideration of the comments, the Department has decided to adopt § 2570.50 as proposed. However the Department has clarified paragraph (b) to provide that the notice of proposed revocation or modification given to the applicant must be in writing.

Public Inspection and Copies

Section 2570.51 of the proposed regulation provided that the public may examine and copy any exemption application and all correspondence and documents submitted in regard thereto and may receive photocopies of all or any portion of such administrative record for a specified charge per page. For this reason, the Department cannot honor requests to keep confidential any information submitted regarding an exemption application. Therefore, none of the information submitted in regard to a requested exemption should be material that the applicant or other sender does not wish to disclose to the public.

No comments were received on proposed § 2570.51, which is adopted without change in the final regulation.

Executive Order 12291 Statement

The Department has determined that this regulatory action would not constitute a "major rule" as that term is used in Executive Order 12291 because the action would not result in: an annual effect on the economy of $100 million; a major increase in costs or prices for consumers, individual industries, government agencies, or geographical regions; or significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in the domestic or export markets.

Regulatory Flexibility Act Statement

The Department has determined that this regulation would not have a significant economic impact on small plans or other small entities. As stated previously, this regulation would do little more than describe procedures that reflect practices already in place for filing and processing applications for exemptions from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974. the Internal Revenue Code of 1986, and the Federal Employee Retirement System Act of 1986.

Paperwork Reduction Act

This regulation modifies current collection of information requirements. It does so largely by codifying requests for facts and opinions that are routinely addressed to applicants for exemptions under current procedures. Accordingly, the regulation will not increase the paperwork burden for applicants. The regulation has been approved by the Office of Management and Budget under the provisions of the Paperwork Reduction Act of 1980 (Pub. L. 96-511). The final regulation is assigned control number 1210-0060.

Authority

The final regulation set forth herein is issued pursuant to the authority granted in sections 408(a) (Pub. L. 93-406, 88 Stat. 883, 29 USC 1108(a)) and 505 (Pub. L. 93-406, 88 Stat. 894, 29 USC 1135) of ERISA, under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), under 5 USC 8477(c)(3), and under Secretary of Labor's Order No. 187 (52 FR 13139, April 21, 1987).

List of Subjects in 29 C.F.R. Part 2570

Administrative practice and procedure, Employee benefit plans, Employee Retirement Income Security Act, Federal Employees' Retirement System Act, Party in interest, Pensions, Prohibited transactions.

Final Regulation

For the reasons set out in the preamble, parts 2570 and 2585 of chapter XXV of title 29 of the Code of Federal Regulations are amended as follows:

Part 2570-[Amended]

1. The authority for part 2570 is revised to read as follows:

Authority: 29 USC 1108(a), 1135; Reorganization Plan No. 4 of 1978; 5 USC 8477(c)(3); Secretary of Labor's Order No. 187.

Subpart A is also issued under 29 USC 1132(i).

2. By adding in the appropriate place the following new subpart B to part 2570.

Subpart B - Procedures for Filing and Processing Prohibited Transaction Exemption Applications

Sec.

2570.30 Scope of rules.

2570.31 Definitions.

2570.32 Persons who may apply for exemptions.

2570.33 Applications the Department will not ordinarily consider.

2570.34 Information to be included in every exemption application.

2570.35 Information to be included in applications for individual exemptions only.

2570.36 Where to file an application.

2570.37 Duty to amend and supplement exemption applications.

2570.38 Tentative denial letters.

2570.39 Opportunities to submit additional information.

2570.40 Conferences.

2570.41 Final denial letters.

2570.42 Notice of proposed exemption.

2570.43 Notification of interested persons by applicant.

2570.44 Withdrawal of exemption applications.

2570.45 Requests for reconsideration.

2570.46 Hearings in opposition to exemptions from restrictions on fiduciary self-dealing.

2570.47 Other hearings.

2570.46 Decision to grant exemptions.

2570.49 Limits on the effect of exemptions.

2570.50 Revocation or modification of exemptions.

2570.51 Public inspection and copies.

2570.52 Effective date.

Subpart B - Procedures for Filing and Processing Prohibited Transaction Exemption Applications

§ 2570.30 Scope of rules.

a. (1)The rules of procedure set forth in this subpart apply to all applications for exemption which the Department has authority to issue under:

    i. Section 408(a) of the Employee Retirement Income Security Act of 1974 (ERISA);
    ii. Section 4975(c)(2) of the Internal Revenue Code of 1986 (the Code) (see Reorganization Plan No. 4 of 1978); or

    iii. The Federal Employees' Retirement System Act of 1986 (FERSA) (5 USC 8477(c)(3)).

b. The Department will generally treat any exemption application which is filed solely under section 408(a) of ERISA or solely under section 4975(c)(2) of the Code as an exemption filed under both section 408(a) and section 4975(c)(2) if it relates to a transaction that would be prohibited by ERISA and by the corresponding provisions of the Code.
c. The procedures set forth in this subpart represent the exclusive means by which the Department will issue administrative exemptions. The Department will not issue exemptions upon oral request alone. Likewise, the Department will not grant exemptions orally. An applicant for an administrative exemption may request and receive oral advice from Department employees in preparing an exemption application. However, such advice does not constitute part of the administrative record and is not binding on the Department in its processing of an exemption application or in its examination or audit of a plan.

§ 2570.31 Definitions.

For purposes of these procedures, the following definitions apply:

a. An affiliate of a person means -

    1. Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person;
    2. Any director of, relative of, or partner in, any such person;
    3. Any corporation, partnership, trust, or unincorporated enterprise of which such person is an officer, director, or a 5 percent or more partner or owner; and
    4. Any employee or officer of the person who -

        i. Is highly compensated (as defined in section 4975(e)(2)(H) of the Code), or
        ii. Has direct or indirect authority, responsibility, or control regarding the custody, management, or disposition of plan assets.

b. A class exemption is an administrative exemption, granted under section 408(a) of ERISA, section 4975(c)(2) of the Code, and/or 5 USC 8477(c)(3), which applies to any parties in interest within the class of parties in interest specified in the exemption who meet the conditions of the exemption.
c. Department means the U.S. Department of Labor and includes the Secretary of Labor or his delegate exercising authority with respect to prohibited transaction exemptions to which this subpart applies.
d. Exemption transaction means the transaction or transactions for which an exemption is requested.
e. An individual exemption is an administrative exemption, granted under section 408(a) of ERISA, section 4975(c)(2) of the Code, and/or 5 USC 8477(c)(3), which applies only to the specific parties in interest named or otherwise defined in the exemption.
f. A party in interest means a person described in section 3(14) of ERISA or 5 USC 8477(a)(4) and includes a disqualified person, as defined in section 4975(e)(2) of the Code.
g. Pooled fund means an account or fund for the collective investment of the assets of two or more unrelated plans, including (but not limited to) a pooled separate account maintained by an insurance company and a common or collective trust fund maintained by a bank or similar financial institution.

§ 2570.32 Persons who may apply for exemptions.

a. The Department may initiate exemption proceedings on its own motion. In addition, the Department will initiate exemption proceedings upon the application of -

    1. Any party in interest to a plan who is or may be a party to the exemption transaction;
    2. Any plan which is a party to the exemption transaction; or
    3. In the case of an application for an exemption covering a class of parties in interest or a class of transactions, in addition to any person described in paragraphs (a)(1) and (a)(2) of this section, an association or organization representing parties in interest who may be parties to the exemption transaction.

b. An application by or for a person described in paragraph (a) of this section, may be submitted by the applicant or by his authorized representatives. If the application is submitted by a representative of the applicant, the representative must submit proof of his authority in the form of

    1. A power of attorney; or

2. A written certification from the applicant that the representation is authorized.

c. If the authorized representative of an applicant submits an application for an exemption to the Department together with proof of his authority for file the application as required by paragraph (b) of this section, the Department will direct all correspondence and inquiries concerning the application to the representative unless requested to do otherwise by the applicant.

§ 2570.33 Applications the Department will not ordinarily consider -

a. The Department will not ordinarily consider:

  1. An application that fails to include all the information required by § 2570.34 and 2570.35, or otherwise fails to conform to the requirements of these procedures; or
  2. An application for exemption involving a transaction or transactions which are the subject of an investigation for possible violations of part 1 or 4 of subtitle B of title I of ERISA or section 8477 or 8478 of FERSA or an application for an exemption involving a party in interest who is the subject of such an investigation or who is a defendant in an action by the Department or the Internal Revenue Service to enforce the above-mentioned provisions of ERISA or FERSA.

b. If for any reason the Department decides not to consider an exemption application, it will inform the applicant of that decision in writing and of the reasons therefore.
c. An application for an individual exemption relating to a specific transaction or transactions will ordinarily not be considered separately if the Department is considering a class exemption relating to the same type of transaction or transactions.

§ 2570.34 Information to be included in every exemption application.

a. All applications for exemptions must contain the following information:

  1. The name(s) of the applicant(s);
  2. A detailed description of the exemption transaction and the parties in interest for whom an exemption is requested, including a description of any larger integrated transaction of which the exemption transaction is a part;
  3. Whether the affected plan(s) and any parties in interest will be represented by the same person with regard to the exemption application;
  4. Reasons a plan would have for entering into the exemption transaction;
  5. The prohibited transaction provisions from which exemptive relief is requested and the reason why the transaction would violate each such provision;
  6. Whether the exemption transaction is customary for the industry or class involved;
  7. Whether the exemption transaction is or has been the subject of an investigation or enforcement action by the Department or by the Internal Revenue Service; and
  8. The hardship or economic loss, if any, which would result to the person or persons on behalf of whom the exemption is sought, to affected plans and to their participants and beneficiaries from denial of the exemption.

b. All applications for exemption must also contain the following:

  1. A statement explaining why the requested exemption would be -

     i. Administratively feasible;
     ii. In the interests of affected plans and their participants and beneficiaries; and
     iii. Protective of the rights of participants and beneficiaries of affected plans.

  2. With respect to the notification of interested persons required by § 2570.43:

     i. A description of the interested person(s) to whom the applicant intends to provide notice;
     ii. The manner in which the applicant will provide such notice; and
     iii. An estimate of the time the applicant will need to furnish notice to all interested persons following publication of a notice of the proposed exemption in the Federal Register.

  3. If an advisory opinion has been requested with respect to any issue relating to the exemption transaction -

i. A copy of the letter concluding the Department's action on the advisory opinion request; or
ii. If the Department has not yet concluded its action on the request:

A. A copy of the request or the date on which it was submitted together with the Department’s correspondence control number as indicated in the acknowledgment letter; and
B. An explanation of the effect of a favorable advisory opinion upon the exemption transaction.

4. If the application is to be signed by anyone other than an individual party in interest seeking exemptive relief on his own behalf, a statement which -

i. Identifies the individual, who will be signing the application and his position with the applicant; and
ii. Explain briefly the basis of his familiarity with the matters discussed in the application.

5. (i)A declaration in the following form: Under penalty of perjury, I declare that I am familiar with the matters discussed in this application and to the best of my knowledge and belief, the representations made in this application are true and correct.

(ii) This declaration must be dated and signed by:

A. The applicant himself in the case of an individual party in interest seeking exemptive relief on his own behalf;
B. A corporate officer or partner where the applicant is a corporation or partnership;
C. A designated officer or official where the applicant is an association, organization or other unincorporated enterprise;
D. The plan fiduciary who has the authority, responsibility, and control with respect to the exemption transaction where the applicant is a plan.

(iii) Specialized statements from third party experts, such as appraisals or analyses of market conditions, submitted to support an application for exemption must also be accompanied by a statement of consent from such expert acknowledging that he or she knows that his or her statement is being submitted to the Department as part of an application for exemption.

(iv) For those applications requiring an independent fiduciary to represent the plan in the exemption transaction, each statement submitted by said independent fiduciary must contain a signed and dated declaration under penalty of perjury that, to the best of said fiduciary's knowledge and belief the representations made in such statement are true and correct.

c. An application for exemption may also include a draft of the requested exemption which defines the transaction and parties in interest for which exemptive relief is sought and the specific conditions under which the exemption would apply.

§ 2570.35 Information to be included in applications for Individual exemptions only.

a. Except as provided in paragraph (c) of this section, every application for an individual exemption must include, in addition to the information specified in § 2570.34, the following information:

1. The name, address, telephone number, and type of plan or plans to which the requested exemption applies;
2. The Employer Identification Number (EIN) and the plan number (PN) used by such plan or plans in all reporting and disclosure required by the Department;
3. Whether any plan or trust affected by the requested exemption has ever been found by the Department, the Internal Revenue Service, or by a court to have violated the exclusive benefit rule of section 401(a) of the Code, or to have engaged in a prohibited transaction under

section 503(b) of the Code or corresponding provisions of prior law, section 4975(c)(1) of the Code, section 406 or 407(a) of ERISA, or 5 USC 8477(c)(3);

4. Whether any relief under section 408(a) of ERISA, section 4975(c)(2) of the Code, or 5 USC 8477(c)(3) has been requested by, or provided to, the applicant or any of the parties on behalf of whom the exemption is sought and, if so, the exemption application number or the prohibited transaction exemption number;
5. Whether the applicant or any of the parties in interest involved in the exemption transaction is currently, or has been within the last five years, a defendant in any lawsuit or criminal action concerning such person's conduct as a fiduciary or party in interest with respect to any plan;
6. Whether the applicant or any of the parties in interest involved in the exemption transaction has within the last 13 years, been convicted of any crime described in section 411 of ERISA.
7. Whether, within the last five years, any plan affected by the exemption transaction or any party in interest involved in the exemption transaction has been under investigation or examination by, or has been engaged in litigation or a continuing controversy with, the Department, the Internal Revenue Service, the Justice Department, the Pension Benefit Guaranty Corporation, or the Federal Retirement Thrift Investment Board involving compliance with provisions of FERSA, provisions of the Code relating to employee benefit plans, or provisions of FERSA relating to the Federal Thrift Savings Fund. If so, the applicant must submit copies of all correspondence with the Department, the Internal Revenue Service, the Justice Department, the Pension Benefit Guaranty Corporation, or the Federal Retirement Thrift Investment Board regarding the substantive issues involved in the investigation, examination, litigation, or controversy which relate to compliance with the provisions of part 1 or 4 of subtitle B of title I of ERISA, section 4975 of the Code, or section 8477 or 8478 of FERSA. For this purpose, the term "examination" does not include routine audits conducted by the Department pursuant to section 8477(g) of FERSA;
8. Whether any plan affected by the requested exemption has experienced a reportable event under section 4043 of ERISA;
9. Whether a notice of intent to terminate has been filed under section 4041 of ERISA respecting any plan affected by the requested exemption;
10. Names, addresses, and taxpayer identifying numbers of all parties in interest involved in the subject transaction;
11. The estimated number of participants and beneficiaries in each plan affected by the requested exemption as of the date of the application;
12. The percentage of the fair market value of the total assets of each affected plan that is involved in the exemption transaction;
13. Whether the exemption transaction has been consummated or will be consummated only if the exemption is granted;
14. If the exemption transaction has already been consummated:

    i. The circumstances which resulted in plan fiduciaries causing the plan to engage in the subject transaction before obtaining an exemption from the Department;
    ii. Whether the transaction has been terminated;
    iii. Whether the transaction has been corrected as defined in Code section 4975(f)(5);
    iv. Whether Form 5330, Return of Excise Taxes Related to Employee Benefit Plans, has been filed with the Internal Revenue Service with respect to the transaction; and
    v. Whether any excise taxes due under section 4975(a) and (b) of the Code by reason of the transaction have been paid.

15. The name of every person who has investment discretion over any assets involved in the exemption transaction and the relationship of each such person to the parties in interest involved in the exemption transaction and the affiliates of such parties in interest;
16. Whether or not the assets of the affected plan(s) are invested in loans to any party in interest involved in the exemption transaction, in property leased to any such party in interest, or in securities issued by any such party in interest, and, if such investments exist, a statement for each of these three types of investments which indicates:

    i. The type of investment to which the statement pertains;
    ii. The aggregate fair market value of all investments of this type as reflected in the plan's most recent annual report;
    iii. The approximate percentage of the fair market value of the plan's total assets as shown in such annual report that is represented by all investments of this type; and

iv. The statutory or administrative exemption covering these investments, if any.

17. The approximate aggregate fair market value of the total assets of each affected plan;
18. The person(s) who will bear the costs of the exemption application and of notifying interested persons; and
19. Whether an independent fiduciary is or will be involved in the exemption transaction and, if so, the names of the persons who will bear the cost of the fee payable to such fiduciary.

b. Each application for an individual exemption must also include:

1. True copies of all contracts, deeds, agreements, and instruments, as well as relevant portions of plan documents, trust agreements, and any other documents bearing on the exemption transaction;
2. A discussion of the facts relevant to the exemption transaction that are reflected in these documents and an analysis of their bearing on the requested exemption; and
3. A copy of the most recent financial statements of each plan affected by the requested exemption.

c. Special rule for applications for individual exemption involving pooled funds:

1. The information required by paragraphs (a)(8) through (12) of this section is not required to be furnished in an application for individual exemption involving one or more pooled funds;
2. The information required by paragraphs (a)(1) through (7) and (a)(13) through (19) of this section and by paragraphs (b)(1) through (3) of this section must be furnished by reference to the pooled fund, rather than to the plans participating therein. (For purposes of this paragraph, the information required by paragraph (a)(16) of this section relates solely to other pooled fund transactions with, and investments in, parties in interest involved in the exemption transaction which are also sponsors of plans which invest in the pooled fund.);
3. The following information must also be furnished -

    i. The estimated number of plans that are participating (or will participate) in the pooled fund; and
    ii. The minimum and maximum limits imposed by the pooled fund (if any) on the portion of the total assets of each Plan that may be invested in the pooled fund.

4. Additional requirements for applications for individual exemption involving pooled funds in which certain plans participate.

    i. This paragraph applies to any application for individual exemption involving one or more pooled funds in which any plan participating therein -

        A. Invests an amount which exceeds 20% of the total assets of the pooled fund, or
        B. Covers employees of -

            I. The party sponsoring or maintaining the pooled fund, or any affiliate of such party, or
            II. Any fiduciary with investment discretion over the pooled fund's assets, or any affiliate of such fiduciary.

    ii. The exemption application must include, with respect to each plan described in paragraph (c)(4)(i) of this section, the information required by paragraphs (a)(1) through (3), (a)(5) through (7), (a)(10), (a)(12) through (16), and (a)(18) and (19) of this section. The information required by this paragraph must be furnished by reference to the plan's investment in the pooled fund (e.g., the names, addresses and taxpayer identifying numbers of all fiduciaries responsible for the plan's investment in the pooled fund (§ 2570.35(a)(10), the percentage of the assets of the plan invested in the pooled fund [§ 2570.35(a)(12)], whether the plan's investment in the pooled fund has been consummated or will be consummated only if the exemption is granted [§ 2570.35(a)(13), etc.).
    iii. The information required by paragraph (c)(4) of this section is in addition to the information required by paragraphs (c)(2) and (3) of this section relating to information furnished by reference to the pooled fund.

5. The special rule and the additional requirements described in paragraphs (c)(1) through (4) of

this section do not apply to an individual exemption request solely for the investment by a plan in a pooled fund. Such an application must provide the information required by paragraphs (a) and (b) of this section.

§ 2570.36 Where to file an application.

The Department's prohibited transaction exemption program is administered by ension and Welfare Bene fits Administration (PWBA). Any exemption application governed by these procedures should be mailed or otherwise delivered to: Exemption Application, PWBA, Office of Exemption Determinations, Division of Exemptions, US Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210.

§ 2570.37 Duty to amend and supplement exemption applications.

a. During the pendency of his exemption application, an applicant must promptly notify the Division of Exemptions in writing, if he discovers that any material fact or representation contained in his application or any documents or testimony provided in support of the application is inaccurate, if any such fact or representation changes during this period, or if, during the pendency of the application, anything occurs that may affect the continuing accuracy of any such fact or representation.
b. If, at any time during the pendency of his exemption application, an applicant or any other party in interest who would participate in the exemption transaction becomes the subject of an investigation or enforcement action by the Department, the Internal Revenue Service, the Justice Department, the Pension Benefit Guaranty Corporation, or the Federal Retirement Thrift Investment Board involving compliance with provisions of ERISA, provisions of the Code relating to employee benefit plans, or provisions of FERSA relating to the Federal Thrift Savings Fund, the applicant must promptly notify the Division of Exemptions.
c. The Department may require an applicant provide documentation it considers necessary to verify any statements contained in the application or in supporting materials or documents.

§ 2570.38 Tentative denial letters.

a. If, after reviewing an exemption file, the Department concludes that it will not grant the exemption. it will notify the applicant in writing of its tentative denial of the exemption application. At the same time, the Department will provide a short statement of the reasons for its tentative denial.
b. An applicant will have 20 days from the date of a tentative denial letter to request a conference under § 2570.40 of these procedures and/or to notify the Department of its intent to submit additional information in writing, under § 2570.39 of these procedures. If the Department does not receive a request for a conference or a notification of intent to submit additional information within that time, it will issue a final denial letter pursuant to § 2570.41.
c. The Department need not issue a tentative denial letter to an applicant before issuing a final denial letter where the Department has conducted a hearing on the exemption pursuant to either § 2570.46 or § 2570.47 of these procedures.

§ 2570.39 Opportunities to submit additional information.

a. An applicant may notify the Department of its intent to submit additional information supporting an exemption application either by telephone or by letter sent to the address, furnished in, the applicant's tentative denial letter. At the same time, the applicant should indicate generally the type of information that he will submit.
b. An applicant will have 30 days from the date of the notification discussed in paragraph (a) of this section to submit in writing all of the additional information he intends to provide in support of his application. All such information must be accompanied by a declaration under penalty of perjury attesting to the truth and correctness of the information provided, which is dated and signed by a person qualified under § 2570.34(b)(5) of these procedures to sign such a declaration.
c. If, for reasons beyond his control, an applicant is unable to submit in writing all the additional information he intends to provide in support of his application within the 30-day period described in paragraph (b) of this section, he may request an extension of time to furnish the information. Such requests must be made before the expiration of the 30-day period and will be granted only in unusual circumstances and for limited periods of time.
d. If an applicant is unable to submit all of the additional information he intends to provide in support of his exemption application within the 30-day period specified in paragraph (b) of this section or within any additional period of time granted to him pursuant to paragraph (c) of this section, the applicant may withdraw the exemption application before expiration of the applicable time period and reinstate it later pursuant to § 2570.44 of these procedures.

e. The Department will issue without further notice the final denial letter, denying the requested exemption pursuant to § 2570.41 of these procedures where -

    1. The Department has not received the additional information that the applicant indicated he would submit within the 30-day period described in paragraph (b) of this section, or within any additional period of time granted pursuant to paragraph (c) of this section;
    2. The applicant did not request a conference pursuant to § 2570.38(b) of these procedures; and
    3. The applicant has not withdrawn his application as permitted by paragraph (d) of this section.

§ 2570.40 Conferences.

a. Any conference between the Department and an applicant pertaining to a requested exemption will be held in Washington, DC, except that a telephone conference will be held at the applicant's request.
b. An applicant is entitled to only one conference with respect to any exemption application. An applicant will not be entitled to a conference, however, where the Department has held a hearing on the exemption under either § 2570.46 or § 2570.47 of these procedures.
c. Insofar as possible, conferences will be scheduled as joint conferences with all applicants present where:

    1. More than one applicant has requested an exemption with respect to the same or similar types of transactions;
    2. The Department is considering the applications together as a request for a class exemption;
    3. The Department contemplates not granting the exemption; and
    4. More than one applicant has requested a conference.

d. The Department will attempt to schedule a conference under this section for a mutually convenient time during the 45-day period following the later of -

    1. The date the Department receives the applicant's request for a conference, or
    2. The date the Department notifies the applicant, after reviewing additional information submitted pursuant to § 2570.39, that it is still not prepared to propose the requested exemption. If the applicant is unable to attend a conference at any of the times proposed by the Department during this 45-day period or if the applicant fails to appear for a scheduled conference, he will be deemed to have waived his right to a conference unless circumstances beyond his control prevent him from scheduling a conference or attending a scheduled conference within this period.

e. Within 20 days after the date of any conference held under this section, the applicant may submit to the Department a written record of any additional data, arguments, or precedents discussed at the conference but not previously or adequately presented in writing.

§ 2570.41 Final denial letters.

a. The Department will issue a final denial letter denying a requested exemption where:

    1. The conditions for issuing a final denial letter specified in § 2570.38(b) or § 2570.39(e) of these procedures are satisfied;
    2. After issuing a tentative denial letter under § 2570.38 of this part and considering the entire record in the case, including all written information submitted pursuant to § 2570.39 and § 2570.40(e) of these procedures, the Department decides not to propose an exemption or to withdraw an exemption already proposed; or
    3. After proposing an exemption and conducting a hearing on the exemption under either § 2570.46 or § 2570.47 of this part and after considering the entire record in the case, including the record of the hearing, the Department decides to withdraw the proposed exemption.

§ 2570.42 Notice of proposed exemption.

If the Department tentatively decides, based on all the information submitted by an applicant, that the exemption should be granted, it will publish a notice of proposed exemption in the Federal Register. The notice will:

a. Explain the exemption transaction and summarize the information received by the Department in support of the exemption;
b. Specify any conditions under, which the exemption is proposed;

c. Inform interested persons of their right to submit comments in writing to the Department relating to the proposed exemption and establish a deadline for receipt of such comments;
d. If the proposed exemption includes relief from the prohibitions of section 406(b) of ERISA, section 4975(c)(1)(E) or (F) of the Code, or section 8477(c)(2) of FERSA, inform interested persons of their right to request a hearing under § 2570.46 of this part and establish a deadline for receipt of requests for such hearings.

§ 2570.43 Notification of Interested persons by applicant.

a. If, as set forth in the exemption application, the notification that an applicant intends to provide to interested persons upon publication of a notice of proposed exemption in the Federal Register is inadequate, the Department will so inform the applicant and will secure the applicant's written agreement to provide what it considers to be adequate notice under the circumstances.
b. If a notice of proposed exemption is published in the Federal Register in accordance with § 2570.42 of this part, the applicant must notify interested persons of the pendency of the exemption in the manner and time period specified in the application or in any superseding agreement with the Department. Any such notification must include:

    1. A copy of the notice of proposed exemption; and
    2. A supplemental statement in the following form:

> You are hereby notified that the United States Department of Labor is considering granting an exemption from the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974, the Internal Revenue Code of 1986, or the Federal Employees' Retirement System Act of 1986. The exemption under consideration is explained in the enclosed Notice of Proposed Exemption. As a person who may be affected by this exemption, you have the right to comment on the proposed exemption by [date].[1] [If you may be adversely affected by the grant of the exemption, you also have the right to request a hearing on the exemption by [date].][2]
>
> Comments or requests for a hearing should be addressed to: Office of Exemption Determinations, Pension and Welfare Benefits Administration, Room ---,[3] US Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210, Attention: Application No. ---,[4] The Department will make no final decision on the proposed exemption until it reviews all comments received in response to the enclosed notice. If the Department decides to hold a hearing on the exemption before making its final decision, you will be notified of the time and place of the hearing.

c. The method used to furnish notice to interested persons must be reasonably calculated to ensure that interested persons actually receive the notice. In all cases, personal delivery and delivery by first-class mail will be considered reasonable methods of furnishing notice.
d. After furnishing the notice required by this section, an applicant must provide the Department with a statement confirming that notice was furnished to the persons and in the manner and time designated in its exemption application or in any superseding agreement with the Department. This statement must be accompanied by a declaration under penalty of perjury attesting to the truth of the information provided in the statement and signed by a person qualified under § 2570.34(b)(5) of these procedures to sign such a declaration. No exemption will be granted until such a statement and its accompanying declaration have been furnished to the Department.

§ 2570.44 Withdrawal of exemption applications.

a. An applicant may withdraw his application for an exemption at any time by informing the Department, either orally or in writing, of his intent to withdraw.
b. Upon receiving an applicant's notice of intent to withdraw an application for an individual exemption, the Department will confirm by letter the applicant's withdrawal of the application and will terminate all proceedings relating to the application. If a notice of proposed exemption has been published in the Federal Register, the Department will publish a notice withdrawing the proposed exemption.
c. Upon receiving an applicant's notice of intent to withdraw an application for a class exemption or for an individual exemption that is being considered with other applications as a request for a class exemption, the Department will inform any other applicants for the exemption of the withdrawal. The Department

will continue to process other applications for the same exemption. If all applicants for a particular class exemption withdraw their applications, the Department may either terminate all proceedings relating to the exemption or propose the exemption on its own motion.

d. If, following the withdrawal of an exemption application, an applicant decides to reapply for the same exemption, he may submit a letter to the Department requesting that the application be reinstated and referring to the application number assigned to the original application. If, at the time the original application was withdrawn, any additional information to be submitted to the Department under § 2570.39 of these procedures was outstanding, that information must accompany the letter requesting reinstatement of the application. However, the applicant need not resubmit information previously furnished to the Department in connection with a withdrawn application unless reinstatement of the application is requested more than two years after the date of its withdrawal.
e. Any request for reinstatement of a withdrawn application submitted in accordance with paragraph (d) of this section, will be granted by the Department, and the Department will take whatever steps remained at the time the application was withdrawn to process the application.

§ 2570.45 Requests for reconsideration.

a. The Department will entertain one request for reconsideration of an exemption application that has been finally denied pursuant to § 2570.41(a)(2) or (a)(3) of this part if the applicant presents in support of the application significant new facts or arguments which for good reason could not have been submitted for the Department's consideration during its initial review of the exemption application.
b. A request for reconsideration of a previously denied application must be made within 180 days after the issuance of the final denial letter and must be accompanied by a copy of the Department's final letter denying the exemption and a statement setting forth the new information and/or arguments that provide the basis for reconsideration.
c. A request for reconsideration must also be accompanied by a declaration under penalty of perjury attesting to the truth of the new information provided, which is signed by a person qualified under § 2570.34(b)(5) of these procedures to sign such a declaration.
d. If, after reviewing a request for reconsideration, the Department decides that the facts and arguments presented do not warrant reversal of its original decision to deny the exemption, it will send a letter to the applicant reaffirming that decision.
e. If, after reviewing a request for reconsideration, the Department decides, based on the new facts and arguments submitted, to reconsider its denial letter, it will notify the applicant of its intent to reconsider the application in light of the new information provided. The Department will then take wherever steps remained at the time it issued its final denial letter to process the exemption application
f. If, at any point during its subsequent processing of the application, the Department decides again that the exemption is unwarranted, it will issue a letter affirming its final denial.

§ 2570.46 Hearings in opposition to exemptions from restrictions on fiduciary self-dealing.

a. Any interested person who may be adversely affected by an exemption which the Department proposes to grant from the restrictions of section 406(b) of ERISA, section 4975(c)(1)(E) or (F) of the Code, or section 8477(c)(2) of FERSA may request a hearing before the Department within the period of time specified in the Federal Register notice of the proposed exemption Any such request must state:

    1. The name, address, and telephone number of the person making the, request;
    2. The nature of the person's interest in the exemption and the manner in which the person would be adversely affected by the exemption; and
    3. A statement of the issues to be addressed and a general description of the evidence to be presented at the hearing.

b. The Department will grant a request for a hearing made in accordance with paragraph (a) of this section where a hearing is necessary to fully explore material factual issues identified by the person requesting the hearing. However, the Department may decline to hold a hearing where:

    1. The request for the hearing does not meet the requirements of paragraph (a);
    2. The only issues identified for exploration at the hearing are matters of law; or
    3. The factual issues identified can be fully explored through the submission of evidence in written form.

c. An applicant for an exemption must notify interested persons in the event that the Department schedules a hearing on the exemption. Such notification must be given in the form, time, and manner prescribed by the Department. Ordinarily, however, adequate notification can be given by providing to

interested persons a copy of the notice of hearing published by the Department in the Federal Register within 10 days of its publication, using any of the methods approved in § 2570.43(c) of this part.

d. After furnishing the notice required by paragraph (c) of this section, an applicant must submit a statement confirming that notice was given in the form, manner, and time prescribed. This statement must be accompanied by a declaration under penalty of perjury attesting to the truth of the information provided in the statement, which is signed by a person qualified under § 2570.34(b)(5) of these procedures to sign such a declaration.

2570.47 Other hearings.

a. In its discretion, the Department may schedule a hearing on its own motion where it determines that issues relevant to the exemption can be most fully or expeditiously explored at a hearing.
b. An applicant for an exemption must notify interested persons of any hearing on an exemption scheduled by the Department in the manner described in § 2570.46(c). In addition, the applicant must submit a statement subscribed as true under penalty of perjury like that required in § 2570.46(d).

§ 2570.48 Decision to grant exemptions.

a. If, after considering all the facts and representations submitted by an applicant in support of an exemption application, all the comments received in response to a notice of proposed exemption, and the record of any hearing held in connection with the proposed exemption, the Department determines that the exemption should be granted, it will publish a notice in the Federal Register granting the exemption.
b. A Federal Register notice granting an exemption will summarize the transaction or transactions for which exemptive relief has been granted and will specify the conditions under which such exemptive relief is available.

§ 2570.49 Limits on the effect of exemptions.

a. An exemption does not take effect or protect parties in interest from liability with respect to the exemption transaction unless the material facts and representations contained in the application and in any materials and documents submitted in support of the application were true and complete.
b. An exemption is effective only for the period of time specified and only under the conditions set forth in the exemption.
c. Only the specific parties to whom an exemption grants relief may rely on the exemption. If the notice granting an exemption does not limit exemptive relief to specific parties, all parties to the exemption transaction may rely on the exemption.

§ 2570.50 Revocation or modification of exemptions.

a. If, after an exemption takes effect, changes in circumstances, including changes in law or policy, occur which call into question the continuing validity of the Department's original conclusions concerning the exemption, the Department may take steps to revoke or modify the exemption.
b. Before revoking or modifying an exemption, the Department will publish a notice of its proposed action in the Federal Register and provide interested persons with an opportunity to comment on the proposed revocation or modification. In addition, the Department will give the applicant at least 30 days notice in writing of the proposed revocation or modification and the reasons therefore and will provide the applicant with the opportunity to comment on the revocation or modification.
c. Ordinarily the revocation modification of an exemption will have prospective effect only.

§ 2570.51 Public Inspection and copies.

a. The administrative record of each exemption application will be open to public inspection and copying at the Public Disclosure Branch, PWBA, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington, DC 20210.
b. Upon request, the staff of the Public Disclosure Branch will furnish photocopies of an administrative record, or any specified portion of that record, for a specified charge per page.

§ 2570.52 Effective Date.

This regulation is effective with respect to all applications for exemptions filed with the Department under section 408(a) of ERISA, section 4975(c)(2) of the Code, or 5 USC 8477(c)(3) at any time on or after September 10, 1990. Applications for exemptions under section 408(a) of ERISA and/or section 4975 of the Code filed before September 10, 1990, are governed by ERISA Procedure 75-1. Applications for exemption

under 5 USC 8477(c)(3) filed before September 10, 1990, but after December 29, 1988 are governed by part 2585 of chapter XXV of title 29 of the Code of Federal Regulations, (section 29 C.F.R. part 2585 as revised July 1, 1990). Applications under 5 USC 8477(c)(3) filed before December 29, 1988 are governed by ERISA Procedure 75-1.

Part 2585 [Removed)

3. The regulations in part 2585 of chapter XXV of title 29 of the Code of Federal Regulations are removed.

Signed at Washington, DC, this 27th day of July, 1990.

David G. Ball, Assistant Secretary for Pension and Welfare Benefits

U.S. Department of Labor.

- Footnotes to Preamble -

1. Under section 111 of the FERSA Technical Corrections Act of 1986 (Pub.L. 99-566, October 27, 1986), the Department's existing exemption procedures were made applicable to exemption applications under FERSA until the earlier of the date of publication of final regulations adopting an exemption procedure or December 31, 1988.
2. Section 8477(g) of FERSA requires the Secretary of Labor to establish a program to carry out audits to determine the level of compliance with the requirements of this section relating to fiduciary responsibilities and prohibited activities of fiduciaries with respect to the Thrift Savings Fund of the Federal Employees' Retirement System. The Department has interpreted section 8477(g) to mean that the Department has a continuing responsibility to audit the Thrift Savings Fund established by FERSA.
3. These sections, relate, in pertinent part, to the Department's nonconsideration of exemption applications which are the subject of an investigation for possible violations of FERSA or which involve a party in interest who is the subject of such an investigation (§ 2570.33(a)(2)); and to the notification of the Division of Exemptions of certain investigations initiated after the filing of an exemption application (§ 2570.37(b)).
4. This section of the regulation requires certain exemption applications to include copies of correspondence relating to investigations, examinations, litigation, and continuing controversies with specified Federal agencies.
5. The Department must find that the statutory criteria are satisfied before granting a prohibited transaction exemption. The legislative history of ERISA makes it clear, however, that the Department has broad discretion in determining whether or not to grant an exemption. H.R. Rep. 1280, 93 Cong., 2d Sess. 311 (1974).
6. See section 1(e) of PTE 84-14 (49 FR 9494, March 13, 1984) the class exemption involving qualified professional asset managers [QPAM] (See page 5-).
7. The Department notes that the form of the notice is prescribed under § 2570.43(b) of the regulation.
8. Section 4975(c)(2) of the Code and 5 USC 8477(c)(3)(D) (added by FERSA) contain similar hearing requirements. The following discussion of the hearing requirements of section 408(a) of ERISA is equally applicable to those statutory provisions.
9. This comment compares the revocation of an exemption to the revocation of a license granted by an agency of the United States Government pursuant to 5 USC 558(c). The Department is expressing no opinion herein as to the applicability of 5 USC 558(c) to the revocation of prohibited transaction exemptions under ERISA, the Code, or FERSA.

- Footnotes to Regulation -

1. The applicant will write in this space the date of the last day of the time period specified in the notice of proposed exemption.
2. To be added in the case of an exemption that provides relief from section 406(b) of ERISA or corresponding sections of the Code or FERSA.
3. The applicant will fill in the room number of the Division of Exemptions. As of the date of this final regulation, the room number of the Division of Exemptions was N-5671.
4. The applicant will fill in the exemption application number, which is stated in the notice of proposed exemption, as well as in all correspondence from the Department to the applicant regarding the application.

supervision@fdic.gov

Trust Examination Manual

Appendix E — Employee Benefit Law

Internal Revenue Code

Revenue Ruling 59-60

Valuation of Non-Traded Assets

As Modified by 65-193

In valuing the stock of closely held corporations, or the stock of corporations where market quotations are not available, all other available financial data, as well as all relevant factors affecting the fair market value must be considered for estate tax and gift tax purposes. No general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock. However, the general approach, methods, and factors which must be considered in valuing such securities are outlined.

Revenue Ruling 54-77, C.B. 1954-1, 187, superseded.

Section 1. Purpose.

The purpose of this Revenue Ruling is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations for estate tax and gift tax purposes. The methods discussed herein will apply likewise to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

Sec. 2. Background and definitions.

.01 All valuations must be made in accordance with the applicable provisions of the Internal Revenue Code of 1954 and the Federal Estate Tax and Gift Tax Regulations. Sections 2031(a), 2032 and 2512(a) of the 1954 Code (sections 811 and 1005 of the 1939 Code) require that the property to be included in the gross estate, or made the subject of a gift, shall be taxed on the basis of the value of the property at the time of death of the decedent, the alternate date if so elected, or the date of gift.

.02 Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

.03 Closely held corporations are those corporations the shares of which are owned by a relatively limited number of stockholders. Often the entire stock issue is held by one family. The result of this situation is that little, if any, trading is the shares takes place. There is, therefore, no established market for the stock and such sales as occur at irregular intervals seldom reflect all of the elements of a representative transaction as defined by the term "fair market value."

Sec. 3. Approach to valuation.

.01 A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should

maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the-relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

.02 The fair market value of specific shares of stock will vary as general economic conditions change from "normal" to "boom" or "depression," that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company with very uncertain future prospects is highly speculative. The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value.

.03 Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal. As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market.

Sec. 4. Factors to consider.

.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case:

a. The nature of the business and the history of the enterprise from its inception.

a. The economic outlook in general and the condition and outlook of the specific industry in particular.
b. The book value of the stock and the financial condition of the business.
c. The earning capacity of the company.
d. The dividend-paying capacity.
e. Whether or not the enterprise has goodwill or other intangible value.
f. Sales of the stock and the size of the block of stock to be valued.
g. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

.02 The following is a brief discussion of each of the foregoing factors:

a. The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management, all of which should be considered as of the date of the appraisal, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.
b. A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining

a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management- succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

c. Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to recapitalizations and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

d. Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years. Such statements should show:

1. Gross income by principal items;
2. Principal deductions from gross income including major prior items of operating expenses, interest and other expense on each item of long-term debt, depreciation and depletion if such deductions are made, officers' salaries, in total if they appear to be reasonable or in detail if they seem to be excessive, contributions (whether or not deductible for tax purposes) that the nature of its business and its community position require the corporation to make, and taxes by principal items, including income and excess profits taxes;
3. Net income available for dividends;
4. Rates and amounts of dividends paid on each class of stock;
5. Remaining amount carried to surplus; and
6. Adjustments to, and reconciliation with, surplus as stated on the balance sheet.

With profit and loss statements of this character available, the appraiser

should be able to separate recurrent from nonrecurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company. The percentage of earnings retained for business expansion should be noted when dividend-paying capacity is considered. Potential future income is a major factor in many valuations of closely-held stocks, and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation. If, for instance, a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power. It will be helpful, in judging risk and the extent to which a business is a marginal operator, to consider deductions from income and net income in terms of percentage of sales. Major categories of cost and expense to be so analyzed include the consumption of raw materials and supplies in the case of manufacturers, processors and fabricators; the cost of purchased merchandise in the case of merchants; utility services; insurance; taxes; depletion or depreciation; and interest.

e. Primary consideration should be given to the dividend-paying capacity of the company rather than to dividends actually paid in the past. Recognition must be given to the necessity of retaining a reasonable portion of profits in a company to meet competition. Dividend-paying capacity is a factor that must be considered in an appraisal, but dividends actually paid in the past may not have any relation to dividend-paying capacity. Specifically, the dividends paid by a closely held family company may be measured by the income needs of the stockholders or by their desire to avoid taxes on dividend receipts, instead of by the ability of the company to pay dividends. Where an actual or effective controlling interest in a corporation is to be valued, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company. It follows, therefore, that dividends are less reliable criteria of fair market value than other applicable factors.
f. In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value, therefore, rests upon the excess of net earnings over and above a fair return on the net tangible assets. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supportable by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets.
g. Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation. Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.
h. Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors.

> An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded in on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

Sec. 5. Weight to be accorded various factors.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

a. Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
b. The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

Sec. 6. Capitalization rates.

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings.

Sec. 7. Average of factors.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

Sec. 8. Restrictive agreements.

Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer. Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157 C.B. 1953-2, 255, and Rev. Rul. 189, C.B. 1953-2, 294.

Sec. 9. Effect on other documents.

Revenue Ruling 54-77, C.B. 1954-1, 187, is hereby superseded.

Internal Revenue Service

Revenue Bulletin 2003-37

Catch-Up Contributions for Individuals Age 50 or Older

Final regulations implementing "Catch-Up" contribution provisions for Section 401(k) plans, Section 408(p) Simple IRA plans, Section 408(k) Simplified Employee Pensions (SEPs), Section 403(b) tax-sheltered annuity contracts, and Section 457 governmental plans.

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September 15, 2003

T. D. 9072

Catch-Up Contributions for Individuals Age 50 or Older

Department of the treasury

Internal Revenue Service (IRS)

26 CFR Part 1

Agency: Internal Revenue Service (IRS), Treasury

Action: Final regulations

Summary:

This document contains final regulations that provide guidance concerning the requirements for retirement plans providing catch-up contributions to individuals age 50 or older pursuant to the provisions of section 414(v). These final regulations affect section 401(k) plans, section 408(p) SIMPLE IRA plans, section 408(k) simplified employee pensions, section 403(b) tax-sheltered annuity contracts, and section 457 eligible governmental plans, and affect participants eligible to make elective deferrals under these plans or contracts.

Dates:

Effective Date: These final regulations are effective on July 8, 2003.

Applicability Date: These final regulations are applicable to contributions in taxable years beginning on or after January 1, 2004.

Supplementary information:

Background

This document contains amendments to the Income Tax Regulations (26 CFR Part 1) under sections 402(g) and 414(v) of the Internal Revenue Code (Code). Section 414(v), added by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (Public Law 107-16; 115 Stat. 38), effective for years beginning after December 31, 2001, permits an individual age 50 or older to make additional elective deferrals each year, up to a dollar limit, if certain requirements provided under that section are satisfied. Under section 414(v)(3), these additional elective deferrals are not subject to certain otherwise applicable limitations on elective deferrals and are excluded from consideration for certain nondiscrimination tests. Under section 414(v)(4), catch-up contributions generally must be made available to all catch-up eligible individuals who participate under any plan maintained by the employer that provides for elective deferrals.

Adoption of Amendments to the Regulations

26 CFR part 1 is amended as follows:

Part 1-Income Taxes

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.402(g)-2 is added to read as follows:

§1.402(g)-2 Increased limit for catch-up contributions.

(a) General rule. Under section 402(g)(1)(C), in determining the amount of elective deferrals that are includible in gross income under section 402(g) for a catch-up eligible participant (within the meaning of §1.414(v)-1(g)), the otherwise applicable dollar limit under section 402(g)(1)(B) (as increased under section 402(*g)(7*), to the extent applicable) shall be further increased by the applicable dollar catch-up limit as set forth under §1.414(v)-1(c)(2).

(b) Participants in multiple plans. Paragraph (a) of this section applies without regard to whether the applicable employer plans (within the meaning of section 414(v)(6)) treat the elective deferrals as catch-up contributions. Thus, a catch-up eligible participant who makes elective deferrals under applicable employer plans of two or more employers that in total exceed the applicable dollar amount under section 402(g)(1) by an amount that does not exceed the applicable dollar catch-up limit under either plan may exclude the elective deferrals from gross income, even if neither applicable employer plan treats those elective deferrals as catch-up contributions.

(c) Effective date-

(1) Statutory effective date. Section 402(g)(1)(C) applies to contributions in taxable years beginning on or after January 1, 2002.

(2) Regulatory effective date. Paragraphs (a) and (b) of this section apply to contributions in taxable years beginning on or after January 1, 2004.

Par. 3. Section 1.414(v)-1 is added to read as follows:

§1.414(v)-1 Catch-up contributions.

(a) Catch-up contributions-

(1) General rule. An applicable employer plan shall not be treated as failing to meet any requirement of the Internal Revenue Code solely because the plan permits a catch-up eligible participant to make catch-up contributions in accordance with section 414(v) and this section. With respect to an applicable employer plan, catch-up contributions are elective deferrals made by a catch-up eligible participant that exceed any of the applicable limits set forth in paragraph (b) of this section and that are treated under the applicable employer plan as catch-up

contributions, but only to the extent they do not exceed the catch-up contribution limit described in paragraph (c) of this section (determined in accordance with the special rules for employers that maintain multiple applicable employer plans in paragraph (f) of this section, if applicable). To the extent provided under paragraph (d) of this section, catch-up contributions are disregarded for purposes of various statutory limits. In addition, unless otherwise provided in paragraph (e) of this section, all catch-up eligible participants of the employer must be provided the opportunity to make catch-up contributions in order for an applicable employer plan to comply with the universal availability requirement of section 414(v)(4). The definitions in paragraph (g) of this section apply for purposes of this section and §1.402(g)-2.

(2) Treatment as elective deferrals. Except as specifically provided in this section, elective deferrals treated as catch-up contributions remain subject to statutory and regulatory rules otherwise applicable to elective deferrals. For example, catch-up contributions under an applicable employer plan that is a section 401(k) plan are subject to the distribution and vesting restrictions of section 401(k)(2)(B) and (C). In addition, the plan is permitted to provide a single election for catch-up eligible participants, with the determination of whether elective deferrals are catch-up contributions being made under the terms of the plan.

(3) Coordination with section 457(b)(3). In the case of an applicable employer plan that is a section 457 eligible governmental plan, the catch-up contributions permitted under this section shall not apply to a catch-up eligible participant for any taxable year for which a higher limitation applies to such participant under section 457(b)(3). For additional guidance, see regulations under section 457.

(b) Elective deferrals that exceed an applicable limit-

(1) Applicable limits. An applicable limit for purposes of determining catch-up contributions for a catch-up eligible participant is any of the following:

(i) Statutory limit. A statutory limit is a limit on elective deferrals or annual additions permitted to be made (without regard to section 414(v) and this section) with respect to an employee for a year provided in section 401(a)(30), 402(h), 403(b), 408, 415(c), or 457(b)(2) (without regard to section 457(b)(3)), as applicable.

(ii) Employer-provided limit. An employer-provided limit is any limit on the elective deferrals an employee is permitted to make (without regard to section 414(v) and this section) that is contained in the terms of the plan, but which is not required under the Internal Revenue Code. Thus, for example, if, in accordance with the terms of the plan, highly compensated employees are limited to a deferral percentage of 10% of compensation, this limit is an employer-provided limit that is an applicable limit with respect to the highly compensated employees.

(iii) Actual deferral percentage (ADP) limit. In the case of a section 401(k) plan that would fail the ADP test of section 401(k)(3) if it did not correct under section 401(k)(8), the ADP limit is the highest amount of elective deferrals that can be retained in the plan by any highly compensated employee under the rules of section 401(k)(8)(C) (without regard to paragraph (d)(2)(iii) of this section). In the case of a simplified employee pension (SEP) with a salary reduction arrangement (within the meaning of section 408(k)(6)) that would fail the requirements of section 408(k)(6)(A)(iii) if it did not correct in accordance with section 408(k)(6)(C), the ADP limit is the highest amount of elective deferrals that can be made by any highly compensated employee under the rules of section 408(k)(6) (without regard to paragraph (d)(2)(iii) of this section).

(2) Contributions in excess of applicable limit-

(i) Plan year limits-

(A) General rule. Except as provided in paragraph (b)(2)(ii) of this section, the amount of elective deferrals in excess of an applicable limit is determined as of the end of the plan year by comparing the total elective deferrals for the plan year with the applicable limit for the plan year. In addition, except as provided in paragraph (b)(2)(i)(B) of this section, in the case of a plan that provides for separate employer-provided limits on elective deferrals for separate portions of plan compensation within the plan year, the applicable limit for the plan year is the sum

of the dollar amounts of the limits for the separate portions. For example, if a plan sets a deferral percentage limit for each payroll period, the applicable limit for the plan year is the sum of the dollar amounts of the limits for the payroll periods.

(B) Alternative method for determining employer-provided limit-

(*1*) General rule. If the plan limits elective deferrals for separate portions of the plan year, then, solely for purposes of determining the amount that is in excess of an employer-provided limit, the plan is permitted to provide that the applicable limit for the plan year is the product of the employee's plan year compensation and the time-weighted average of the deferral percentage limits, rather than determining the employer-provided limit as the sum of the limits for the separate portions of the year. Thus, for example, if, in accordance with the terms of the plan, highly compensated employees are limited to 8% of compensation during the first half of the plan year and 10% of compensation for the second half of the plan year, the plan is permitted to provide that the applicable limit for a highly compensated employee is 9% of the employee's plan year compensation.

(*2*) Alternative definition of compensation permitted. A plan using the alternative method in this paragraph (b)(2)(i)(B) is permitted to provide that the applicable limit for the plan year is determined as the product of the catch-up eligible participant's compensation used for purposes of the ADP test and the time-weighted average of the deferral percentage limits. The alternative calculation in this paragraph (b)(2)(i)(B)(*2*) is available regardless of whether the deferral percentage limits change during the plan year.

(ii) Other year limit. In the case of an applicable limit that is applied on the basis of a year other than the plan year (*e.g.*, the calendar-year limit on elective deferrals under section 401(a)(30)), the determination of whether elective deferrals are in excess of the applicable limit is made on the basis of such other year.

(c) Catch-up contribution limit-

(1) General rule. Elective deferrals with respect to a catch-up eligible participant in excess of an applicable limit under paragraph (b) of this section are treated as catch-up contributions under this section as of a date within a taxable year only to the extent that such elective deferrals do not exceed the catch-up contribution limit described in paragraphs (c)(1) and (2) of this section, reduced by elective deferrals previously treated as catch-up contributions for the taxable year, determined in accordance with paragraph (c)(3) of this section. The catch-up contribution limit for a taxable year is generally the applicable dollar catch-up limit for such taxable year, as set forth in paragraph (c)(2) of this section. However, an elective deferral is not treated as a catch-up contribution to the extent that the elective deferral, when added to all other elective deferrals for the taxable year under any applicable employer plan of the employer, exceeds the participant's compensation (determined in accordance with section 415(c)(3)) for the taxable year. See also paragraph (f) of this section for special rules for employees who participate in more than one applicable employer plan maintained by the employer.

(2) Applicable dollar catch-up limit-

(i) In general. The applicable dollar catch-up limit for an applicable employer plan, other than a plan described in section 401(k)(11) or 408(p), is determined under the following table:

For Taxable Years Beginning in	Applicable Dollar Catch-up Limit
2002	$1,000

2003	$2,000
2004	$3,000
2005	$4,000
2006	$5,000

(ii) Simple plans. The applicable dollar catch-up limit for a SIMPLE 401(k) plan described in section 401(k)(11) or a Simple IRA plan as described in section 408(p) is determined under the following table:

For Taxable Years Beginning in	Applicable Dollar Catch-up Limit
2002	$500
2003	$1,000
2004	$1,500
2005	$2,000
2006	$2,500

(iii) Cost of living adjustments. For taxable years beginning after 2006, the applicable dollar catch-up limit is the applicable dollar catch-up limit for 2006 described in paragraph (c)(2)(i) or (ii) of this section increased at the same time and in the same manner as adjustments under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 shall be rounded to the next lower multiple of $500.

(3) Timing rules. For purposes of determining the maximum amount of permitted catch-up contributions for a catch-up eligible participant, the determination of whether an elective deferral is a catch-up contribution is made as of the last day of the plan year (or in the case of section 415, as of the last day of the limitation year), except that, with respect to elective deferrals in excess of an applicable limit that is tested on the basis of the taxable year or calendar year (*e.g.*, the section 401(a)(30) limit on elective deferrals), the determination of whether such elective deferrals are treated as catch-up contributions is made at the time they are deferred.

(d) Treatment of catch-up contributions-

(1) Contributions not taken into account for certain limits. Catch-up contributions are not taken into account in applying the limits of section 401(a)(30), 402(h), 403(b), 408, 415(c), or 457(b)(2) (determined without regard to section 457(b)(3)) to other contributions or benefits under an applicable employer plan or any other plan of the employer.

(2) Contributions not taken into account in application of ADP test-

(i) Calculation of ADR. Elective deferrals that are treated as catch-up contributions pursuant to paragraph (c) of this section with respect to a section 401(k) plan

because they exceed a statutory or employer-provided limit described in paragraph (b)(1)(i) or (ii) of this section, respectively, are subtracted from the catch-up eligible participant's elective deferrals for the plan year for purposes of determining the actual deferral ratio (ADR) (as defined in regulations under section 401(k)) of a catch-up eligible participant. Similarly, elective deferrals that are treated as catch-up contributions pursuant to paragraph (c) of this section with respect to a SEP because they exceed a statutory or employer-provided limit described in paragraph (b)(1)(i) or (ii) of this section, respectively, are subtracted from the catch-up eligible participant's elective deferrals for the plan year for purposes of determining the deferral percentage under section 408(k)(6)(D) of a catch-up eligible participant.

(ii) Adjustment of elective deferrals for correction purposes. For purposes of the correction of excess contributions in accordance with section 401(k)(8)(C), elective deferrals under the plan treated as catch-up contributions for the plan year and not taken into account in the ADP test under paragraph (d)(2)(i) of this section are subtracted from the catch-up eligible participant's elective deferrals under the plan for the plan year.

(iii) Excess contributions treated as catch-up contributions. A section 401(k) plan that satisfies the ADP test of section 401(k)(3) through correction under section 401(k)(8) must retain any elective deferrals that are treated as catch-up contributions pursuant to paragraph (c) of this section because they exceed the ADP limit in paragraph (b)(1)(iii) of this section. In addition, a section 401(k) plan is not treated as failing to satisfy section 401(k)(8) merely because elective deferrals described in the preceding sentence are not distributed or recharacterized as employee contributions. Similarly, a SEP is not treated as failing to satisfy section 408(k)(6)(A)(iii) merely because catch-up contributions are not treated as excess contributions with respect to a catch-up eligible participant under the rules of section 408(k)(6)(C). Notwithstanding the fact that elective deferrals described in this paragraph (d)(2)(iii) are not distributed, such elective deferrals are still considered to be excess contributions under section 401(k)(8), and accordingly, matching contributions with respect to such elective deferrals are permitted to be forfeited under the rules of section 411(a)(3)(G).

(3) Contributions not taken into account for other nondiscrimination purposes-

(i) Application for top-heavy. Catch-up contributions with respect to the current plan year are not taken into account for purposes of section 416. However, catch-up contributions for prior years are taken into account for purposes of section 416. Thus, catch-up contributions for prior years are included in the account balances that are used in determining whether the plan is top-heavy under section 416(g).

(ii) Application for section 410(b). Catch-up contributions with respect to the current plan year are not taken into account for purposes of section 410(b). Thus, catch-up contributions are not taken into account in determining the average benefit percentage under §1.410(b)-5 for the year if benefit percentages are determined based on current year contributions. However, catch-up contributions for prior years are taken into account for purposes of section 410(b). Thus, catch-up contributions for prior years would be included in the account balances that are used in determining the average benefit percentage if allocations for prior years are taken into account.

(4) Availability of catch-up contributions. An applicable employer plan does not violate §1.401(a)(4)-4 merely because the group of employees for whom catch-up contributions are currently available (*i.e.*, the catch-up eligible participants) is not a group of employees that would satisfy section 410(b) (without regard to §1.410(b)-5). In addition, a catch-up eligible participant is not treated as having a right to a different rate of allocation of matching contributions merely because an otherwise nondiscriminatory schedule of matching rates is applied to elective deferrals that include catch-up contributions. The rules in this paragraph (d)(4) also apply for purposes of satisfying the requirements of section 403(b)(12).

(e) Universal availability requirement-

(1) General rule-

(i) Effective opportunity. An applicable employer plan that offers catch-up contributions and that is otherwise subject to section 401(a)(4) (including a plan that is subject to section 401(a)(4) pursuant to section 403(b)(12)) will not satisfy the requirements of section 401(a)(4) unless all catch-up eligible participants who participate under any applicable employer plan maintained by the employer are provided with an effective opportunity to make the same dollar amount of catch-up contributions. A plan fails to provide an effective opportunity to make catch-up contributions if it has an applicable limit (*e.g.*, an employer-provided limit) that applies to a catch-up eligible participant and does not permit the participant to make elective deferrals in excess of that limit. An applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) solely because an employer-provided limit does not apply to all employees or different limits apply to different groups of employees under paragraph (b)(2)(i) of this section. However, a plan may not provide lower employer-provided limits for catch-up eligible participants.

(ii) Certain practices permitted-

(A) Proration of limit. A applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because the plan allows participants to defer an amount equal to a specified percentage of compensation for each payroll period and for each payroll period permits each catch-up eligible participant to defer a *pro-rata* share of the applicable dollar catch-up limit in addition to that amount.

(B) Cash availability. An applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because it restricts the elective deferrals of any employee (including a catch-up eligible participant) to amounts available after other withholding from the employee's pay (*e.g.*, after deduction of all applicable income and employment taxes). For this purpose, an employer limit of 75% of compensation or higher will be treated as limiting employees to amounts available after other withholdings.

(2) Certain employees disregarded. An applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because employees described in section 410(b)(3) (*e.g.*, collectively bargained employees) are not provided the opportunity to make catch-up contributions.

(3) Exception for certain plans. An applicable employer plan does not fail to satisfy the universal availability requirement of this paragraph (e) merely because another applicable employer plan that is a section 457 eligible governmental plan does not provide for catch-up contributions to the extent set forth in section 414(v)(6)(C) and paragraph (a)(3) of this section.

(4) Exception for section 410(b)(6)(C)(ii) *period*. If an applicable employer plan satisfies the universal availability requirement of this paragraph (e) before an acquisition or disposition described in §1.410(b)-2(f) and would fail to satisfy the universal availability requirement of this paragraph (e) merely because of such event, then the applicable employer plan shall continue to be treated as satisfying this paragraph (e) through the end of the period determined under section 410(b)(6)(C)(ii).

(f) Special rules for an employer that sponsors multiple plans-

(1) General rule. For purposes of paragraph (c) of this section, all applicable employer plans, other than section 457 eligible governmental plans, maintained by the same employer are treated as one plan and all section 457 eligible governmental plans maintained by the same employer are treated as one plan. Thus, the total amount of catch-up contributions under all applicable employer plans of an employer (other than section 457 eligible governmental plans) is limited to the applicable dollar catch-up limit

for the taxable year, and the total amount of catch-up contributions for all section 457 eligible governmental plans of an employer is limited to the applicable dollar catch-up limit for the taxable year.

(2) Coordination of employer-provided limits. An applicable employer plan is permitted to allow a catch-up eligible participant to defer amounts in excess of an employer-provided limit under that plan without regard to whether elective deferrals made by the participant have been treated as catch-up contributions for the taxable year under another applicable employer plan aggregated with such plan under this paragraph (f). However, to the extent elective deferrals under another plan maintained by the employer have already been treated as catch-up contributions during the taxable year, the elective deferrals under the plan may be treated as catch-up contributions only up to the amount remaining under the catch-up limit for the year. Any other elective deferrals that exceed the employer-provided limit may not be treated as catch-up contributions and must satisfy the otherwise applicable nondiscrimination rules. For example, the right to make contributions in excess of the employer-provided limit is an other right or feature which must satisfy §1.401(a)(4)-4 to the extent that the contributions are not catch-up contributions. Also, contributions in excess of the employer provided limit are taken into account under the ADP test to the extent they are not catch-up contributions.

(3) Allocation rules. If a catch-up eligible participant makes additional elective deferrals in excess of an applicable limit under paragraph (b)(1) of this section under more than one applicable employer plan that is aggregated under the rules of this paragraph (f), the applicable employer plan under which elective deferrals in excess of an applicable limit are treated as catch-up contributions is permitted to be determined in any manner that is not inconsistent with the manner in which such amounts were actually deferred under the plan.

(g) Definitions-

(1) Applicable employer plan. The term applicable employer plan means a section 401(k) plan, a SIMPLE IRA plan as defined in section 408(p), a simplified employee pension plan as defined in section 408(k) (SEP), a plan or contract that satisfies the requirements of section 403(b), or a section 457 eligible governmental plan.

(2) Elective deferral. The term elective deferral means an elective deferral within the meaning of section 402(g)(3) or any contribution to a section 457 eligible governmental plan.

(3) Catch-up eligible participant. An employee is a catch-up eligible participant for a taxable year if-

(i) The employee is eligible to make elective deferrals under an applicable employer plan (without regard to section 414(v) or this section); and

(ii) The employee's 50th or higher birthday would occur before the end of the employee's taxable year.

(4) Other definitions.

(i) The terms employer, employee, section 401(k) plan, and highly compensated employee have the meanings provided in §1.410(b)-9.

(ii) The term section 457 eligible governmental plan means an eligible deferred compensation plan described in section 457(b) that is established and maintained by an eligible employer described in section 457(e)(1)(A).

(h) Examples.

The following examples illustrate the application of this section. For purposes of these examples, the limit under section 401(a)(30) is $15,000 and the applicable dollar catch-up limit is $5,000 and, except as specifically provided, the plan year is the calendar year. In addition, it is assumed that the participant's elective deferrals under all plans of the employer do not exceed the participant's section 415(c)(3) compensation, that the taxable year of the participant is the

calendar year and that any correction pursuant to section 401(k)(8) is made through distribution of excess contributions. The examples are as follows:

Example 1.

(i) Participant A is eligible to make elective deferrals under a section 401(k) plan, Plan P. Plan P does not limit elective deferrals except as necessary to comply with sections 401(a)(30) and 415. In 2006, Participant A is 55 years old. Plan P also provides that a catch-up eligible participant is permitted to defer amounts in excess of the section 401(a)(30) limit up to the applicable dollar catch-up limit for the year. Participant A defers $18,000 during 2006.

(ii) Participant A's elective deferrals in excess of the section 401(a)(30) limit ($3,000) do not exceed the applicable dollar catch-up limit for 2006 ($5,000). Under paragraph (a)(1) of this section, the $3,000 is a catch-up contribution and, pursuant to paragraph (d)(2)(i) of this section, it is not taken into account in determining Participant A's ADR for purposes of section 401(k)(3).

Example 2.

(i) Participants B and C, who are highly compensated employees each earning $120,000, are eligible to make elective deferrals under a section 401(k) plan, Plan Q. Plan Q limits elective deferrals as necessary to comply with section 401(a)(30) and 415, and also provides that no highly compensated employee may make an elective deferral at a rate that exceeds 10% of compensation. However, Plan Q also provides that a catch-up eligible participant is permitted to defer amounts in excess of 10% during the plan year up to the applicable dollar catch-up limit for the year. In 2006, Participants B and C are both 55 years old and, pursuant to the catch-up provision in Plan Q, both elect to defer 10% of compensation plus a *pro-rata* portion of the $5,000 applicable dollar catch-up limit for 2006. Participant B continues this election in effect for the entire year, for a total elective contribution for the year of $17,000. However, in July 2006, after deferring $8,500, Participant C discontinues making elective deferrals.

(ii) Once Participant B's elective deferrals for the year exceed the section 401(a)(30) limit ($15,000), subsequent elective deferrals are treated as catch-up contributions as they are deferred, provided that such elective deferrals do not exceed the catch-up contribution limit for the taxable year. Since the $2,000 in elective deferrals made after Participant B reaches the section 402(g) limit for the calendar year does not exceed the applicable dollar catch-up limit for 2006, the entire $2,000 is treated as a catch-up contribution.

(iii) As of the last day of the plan year, Participant B has exceeded the employer-provided limit of 10% (10% of $120,000 or $12,000 for Participant B) by an additional $3,000. Since the additional $3,000 in elective deferrals does not exceed the $5,000 applicable dollar catch-up limit for 2006, reduced by the $2,000 in elective deferrals previously treated as catch-up contributions, the entire $3,000 of elective deferrals is treated as a catch-up contribution.

(iv) In determining Participant B's ADR, the $5,000 of catch-up contributions are subtracted from Participant B's elective deferrals for the plan year under paragraph (d)(2)(i) of this section. Accordingly, Participant B's ADR is 10% ($12,000 / $120,000). In addition, for purposes of applying the rules of section 401(k)(8), Participant B is treated as having elective deferrals of $12,000.

(v) Participant C's elective deferrals for the year do not exceed an applicable limit for the plan year. Accordingly, Participant C's $8,500 of elective deferrals must be taken into account in determining Participant C's ADR for purposes of section 401(k)(3).

Example 3.

(i) The facts are the same as in *Example 2*, except that Plan Q is amended to change the maximum permitted deferral percentage for highly compensated

employees to 7%, effective for deferrals after April 1, 2006. Participant B, who has earned $40,000 in the first 3 months of the year and has been deferring at a rate of 10% of compensation plus a *pro-rata* portion of the $5,000 applicable dollar catch-up limit for 2006, reduces the 10% of pay deferral rate to 7% for the remaining 9 months of the year (while continuing to defer a *pro-rata* portion of the $5,000 applicable dollar catch-up limit for 2006). During those 9 months, Participant B earns $80,000. Thus, Participant B's total elective deferrals for the year are $14,600 ($4,000 for the first 3 months of the year plus $5,600 for the last 9 months of the year plus an additional $5,000 throughout the year).

(ii) The employer-provided limit for Participant B for the plan year is $9,600 ($4,000 for the first 3 months of the year, plus $5,600 for the last 9 months of the year). Accordingly, Participant B's elective deferrals for the year that are in excess of the employer-provided limit are $5,000 (the excess of $14,600 over $9,600), which does not exceed the applicable dollar catch-up limit of $5,000.

(iii) Alternatively, Plan Q may provide that the employer-provided limit is determined as the time-weighted average of the different deferral percentage limits over the course of the year. In this case, the time-weighted average limit is 7.75% for all participants, and the applicable limit for Participant B is 7.75% of $120,000, or $9,300. Accordingly, Participant B's elective deferrals for the year that are in excess of the employer-provided limit are $5,300 (the excess of $14,600 over $9,300). Since the amount of Participant B's elective deferrals in excess of the employer-provided limit ($5,300) exceeds the applicable dollar catch-up limit for the taxable year, only $5,000 of Participant B's elective deferrals may be treated as catch-up contributions. In determining Participant B's actual deferral ratio, the $5,000 of catch-up contributions are subtracted from Participant B's elective deferrals for the plan year under paragraph (d)(2)(i) of this section. Accordingly, Participant B's actual deferral ratio is 8% ($9,600 / $120,000). In addition, for purposes of applying the rules of section 401(k)(8), Participant B is treated as having elective deferrals of $9,600.

Example 4.

(i) The facts are the same as in *Example 1*. In addition to Participant A, Participant D is a highly compensated employee who is eligible to make elective deferrals under Plan P. During 2006, Participant D, who is 60 years old, elects to defer $14,000.

(ii) The ADP test is run for Plan P (after excluding the $3,000 in catch-up contributions from Participant A's elective deferrals), but Plan P needs to take corrective action in order to pass the ADP test. After applying the rules of section 401(k)(8)(C) to allocate the total excess contributions determined under section 401(k)(8)(B), the maximum deferrals which may be retained by any highly compensated employee in Plan P is $12,500.

(iii) Pursuant to paragraph (b)(1)(iii) of this section, the ADP limit under Plan P of $12,500 is an applicable limit. Accordingly, $1,500 of Participant D's elective deferrals exceed the applicable limit. Similarly, $2,500 of Participant A's elective deferrals (other than the $3,000 of elective deferrals treated as catch-up contributions because they exceed the section 401(a)(30) limit) exceed the applicable limit.

(iv) The $1,500 of Participant D's elective deferrals that exceed the applicable limit are less than the applicable dollar catch-up limit and are treated as catch-up contributions. Pursuant to paragraph (d)(2)(iii) of this section, Plan P must retain Participant D's $1,500 in elective deferrals and Plan P is not treated as failing to satisfy section 401(k)(8) merely because the elective deferrals are not distributed to Participant D.

(v) The $2,500 of Participant A's elective deferrals that exceed the applicable limit are greater than the portion of the applicable dollar catch-up limit ($2,000) that remains after treating the $3,000 of elective deferrals in excess of the section

401(a)(30) limit as catch-up contributions. Accordingly, $2,000 of Participant A's elective deferrals are treated as catch-up contributions. Pursuant to paragraph (d)(2)(iii) of this section, Plan P must retain Participant A's $2,000 in elective deferrals and Plan P is not treated as failing to satisfy section 401(k)(8) merely because the elective deferrals are not distributed to Participant A. However, $500 of Participant A's elective deferrals can not be treated as catch-up contributions and must be distributed to Participant A in order to satisfy section 401(k)(8).

Example 5.

(i) Participant E is a highly compensated employee who is a catch-up eligible participant under a section 401(k) plan, Plan R, with a plan year ending October 31, 2006. Plan R does not limit elective deferrals except as necessary to comply with section 401(a)(30) and section 415. Plan R permits all catch-up eligible participants to defer an additional amount equal to the applicable dollar catch-up limit for the year ($5,000) in excess of the section 401(a)(30) limit. Participant E did not exceed the section 401(a)(30) limit in 2005 and did not exceed the ADP limit for the plan year ending October 31, 2005. Participant E made $3,200 of deferrals in the period November 1, 2005, through December 31, 2005, and an additional $16,000 of deferrals in the first 10 months of 2006, for a total of $19,200 in elective deferrals for the plan year.

(ii) Once Participant E's elective deferrals for the calendar year 2006 exceed $15,000, subsequent elective deferrals are treated as catch-up contributions at the time they are deferred, provided that such elective deferrals do not exceed the applicable dollar catch-up limit for the taxable year. Since the $1,000 in elective deferrals made after Participant E reaches the section 402(g) limit for the calendar year does not exceed the applicable dollar catch-up limit for 2006, the entire $1,000 is a catch-up contribution. Pursuant to paragraph (d)(2)(i) of this section, $1,000 is subtracted from Participant E's $19,200 in elective deferrals for the plan year ending October 31, 2006, in determining Participant E's ADR for that plan year.

(iii) The ADP test is run for Plan R (after excluding the $1,000 in elective deferrals in excess of the section 401(a)(30) limit), but Plan R needs to take corrective action in order to pass the ADP test. After applying the rules of section 401(k)(8)(C) to allocate the total excess contributions determined under section 401(k)(8)(C), the maximum deferrals that may be retained by any highly compensated employee under Plan R for the plan year ending October 31, 2006, (the ADP limit) is $14,800.

(iv) Under paragraph (d)(2)(ii) of this section, elective deferrals that exceed the section 401(a)(30) limit under Plan R are also subtracted from Participant E's elective deferrals under Plan R for purposes of applying the rules of section 401(k)(8). Accordingly, for purposes of correcting the failed ADP test, Participant E is treated as having contributed $18,200 of elective deferrals in Plan R. The amount of elective deferrals that would have to be distributed to Participant E in order to satisfy section 401(k)(8)(C) is $3,400 ($18,200 minus $14,800), which is less than the excess of the applicable dollar catch-up limit ($5,000) over the elective deferrals previously treated as catch-up contributions under Plan R for the taxable year ($1,000). Under paragraph (d)(2)(iii) of this section, Plan R must retain Participant E's $3,400 in elective deferrals and is not treated as failing to satisfy section 401(k)(8) merely because the elective deferrals are not distributed to Participant E.

(v) Even though Participant E's elective deferrals for the calendar year 2006 have exceeded the section 401(a)(30) limit, Participant E can continue to make elective deferrals during the last 2 months of the calendar year, since Participant E's catch-up contributions for the taxable year are not taken into account in applying the section 401(a)(30) limit for 2006. Thus, Participant E can make an additional contribution of $3,400 ($15,000 minus ($16,000 minus $4,400)) without exceeding the section 401(a)(30) for the calendar year and without regard to any additional catch-up contributions. In addition, Participant E may make additional catch-up

contributions of $600 (the $5,000 applicable dollar catch-up limit for 2006, reduced by the $4,400 ($1,000 plus $3,400) of elective deferrals previously treated as catch-up contributions during the taxable year). The $600 of catch-up contributions will not be taken into account in the ADP test for the plan year ending October 31, 2007.

Example 6.

(i) The facts are the same as in *Example 5*, except that Participant E exceeded the section 401(a)(30) limit for 2005 by $1,300 prior to October 31, 2005, and made $600 of elective deferrals in the period November 1, 2005, through December 31, 2005 (which were catch-up contributions for 2005). Thus, Participant E made $16,600 of elective deferrals for the plan year ending October 31, 2006.

(ii) Once Participant E's elective deferrals for the calendar year 2006 exceed $15,000, subsequent elective deferrals are treated as catch-up contributions as they are deferred, provided that such elective deferrals do not exceed the applicable dollar catch-up limit for the taxable year. Since the $1,000 in elective deferrals made after Participant E reaches the section 402(g) limit for calendar year 2006 does not exceed the applicable dollar catch-up limit for 2006, the entire $1,000 is a catch-up contribution. Pursuant to paragraph (d)(2)(i) of this section, $1,000 is subtracted from Participant E's elective deferrals in determining Participant E's ADR for the plan year ending October 31, 2006. In addition, the $600 of catch-up contributions from the period November 1, 2005, to December 31, 2005, are subtracted from Participant E's elective deferrals in determining Participant E's ADR. Thus, the total elective deferrals taken into account in determining Participant E's ADR for the plan year ending October 31, 2006, is $15,000 ($16,600 in elective deferrals for the current plan year, less $1,600 in catch-up contributions).

(iii) The ADP test is run for Plan R (after excluding the $1,600 in elective deferrals in excess of the section 401(a)(30) limit), but Plan R needs to take corrective action in order to pass the ADP test. After applying the rules of section 401(k)(8)(C) to allocate the total excess contributions determined under section 401(k)(8)(C), the maximum deferrals that may be retained by any highly compensated employee under Plan R (the ADP limit) is $14,800.

(iv) Under paragraph (d)(2)(ii) of this section, elective deferrals that exceed the section 401(a)(30) limit under Plan R are also subtracted from Participant E's elective deferrals under Plan R for purposes of applying the rules of section 401(k)(8). Accordingly, for purposes of correcting the failed ADP test, Participant E is treated as having contributed $15,000 of elective deferrals in Plan R. The amount of elective deferrals that would have to be distributed to Participant E in order to satisfy section 401(k)(8)(C) is $200 ($15,000 minus $14,800), which is less than the excess of the applicable dollar catch-up limit ($5,000) over the elective deferrals previously treated as catch-up contributions under Plan R for the taxable year ($1,000). Under paragraph (d)(2)(iii) of this section, Plan R must retain Participant E's $200 in elective deferrals and is not treated as failing to satisfy section 401(k)(8) merely because the elective deferrals are not distributed to Participant E.

(v) Even though Participant E's elective deferrals for calendar year 2006 have exceeded the section 401(a)(30) limit, Participant E can continue to make elective deferrals during the last 2 months of the calendar year, since Participant E's catch-up contributions for the taxable year are not taken into account in applying the section 401(a)(30) limit for 2006. Thus Participant E can make an additional contribution of $200 ($15,000 minus ($16,000 minus $1,200)) without exceeding the section 401(a)(30) for the calendar year and without regard to any additional catch-up contributions. In addition, Participant E may make additional catch-up contributions of $3,800 (the $5,000 applicable dollar catch-up limit for 2006, reduced by the $1,200 ($1,000 plus $200) of elective deferrals previously treated as catch-up contributions during the taxable year). The $3,800 of catch-up contributions will not be taken into account in the ADP test for the plan year ending

October 31, 2007.

Example 7.

(i) Participant F, who is 58 years old, is a highly compensated employee who earns $100,000 per year. Participant F participates in a section 401(k) plan, Plan S, for the first 6 months of the year and then transfers to another section 401(k) plan, Plan T, sponsored by the same employer, for the second 6 months of the year. Plan S limits highly compensated employees' elective deferrals to 6% of compensation for the period of participation, but permits catch-up eligible participants to defer amounts in excess of 6% during the plan year, up to the applicable dollar catch-up limit for the year. Plan T limits highly compensated employees' elective deferrals to 8% of compensation for the period of participation, but permits catch-up eligible participants to defer amounts in excess of 8% during the plan year, up to the applicable dollar catch-up limit for the year. Participant F earned $50,000 in the first 6 months of the year and deferred $6,000 under Plan S. Participant F also deferred $6,500 under Plan T.

(ii) As of the last day of the plan year, Participant F has $3,000 in elective deferrals under Plan S that exceed the employer-provided limit of $3,000. Under Plan T, Participant F has $2,500 in elective deferrals that exceed the employer-provided limit of $4,000. The total amount of elective deferrals in excess of employer-provided limits, $5,500, exceeds the applicable dollar catch-up limit by $500. Accordingly, $500 of the elective deferrals in excess of the employer-provided limits are not catch-up contributions and are treated as regular elective deferrals (and are taken into account in the ADP test). The determination of which elective deferrals in excess of an applicable limit are treated as catch-up contributions is permitted to be made in any manner that is not inconsistent with the manner in which such amounts were actually deferred under Plan S and Plan T.

Example 8.

(i) Employer X sponsors Plan P, which provides for matching contributions equal to 50% of elective deferrals that do not exceed 10% of compensation. Elective deferrals for highly compensated employees are limited, on a payroll-by-payroll basis, to 10% of compensation. Employer X pays employees on a monthly basis. Plan P also provides that elective contributions are limited in accordance with section 401(a)(30) and other applicable statutory limits. Plan P also provides for catch-up contributions. Under Plan P, for purposes of calculating the amount to be treated as catch-up contributions (and to be excluded from the ADP test), amounts in excess of the 10% limit for highly compensated employees are determined at the end of the plan year based on compensation used for purposes of ADP testing (testing compensation), a definition of compensation that is different from the definition used under the plan for purposes of calculating elective deferrals and matching contributions during the plan year (deferral compensation).

(ii) Participant A, a highly compensated employee, is a catch-up eligible participant under Plan P with deferral compensation of $10,000 per monthly payroll period. Participant A defers 10% per payroll period for the first 10 months of the year, and is allocated a matching contribution each payroll period of $500. In addition, Participant A defers an additional $4,000 during the first 10 months of the year. Participant A then reduces deferrals during the last 2 months of the year to 5% of compensation. Participant A is allocated a matching contribution of $250 for each of the last 2 months of the plan year. For the plan year, Participant A has $15,000 in elective deferrals and $5,500 in matching contributions.

(iii) A's testing compensation is $118,000. At the end of the plan year, based on 10% of testing compensation, or $11,800, Plan P determines that A has $3,200 in deferrals that exceed the 10% employer provided limit. Plan P excludes $3,200 from ADP testing and calculates A's ADR as $11,800 divided by $118,000, or 10%. Although A has not been allocated a matching contribution equal to 50% of $11,800, because Plan P provides that matching contributions are calculated based on elective deferrals during a payroll period as a percentage of deferral

compensation, Plan P is not required to allocate an additional $400 of matching contributions to A.

(i) Effective date-

(1) Statutory effective date. Section 414(v) applies to contributions in taxable years beginning on or after January 1, 2002.

(2) Regulatory effective date. Paragraphs (a) through (h) of this section apply to contributions in taxable years beginning on or after January 1, 2004.

Robert E. Wenzel,
Deputy Commissioner for
Services and Enforcement.

Approved June 27, 2003.

Pamela F. Olson,
Assistant Secretary (Tax Policy).

Note

(Filed by the Office of the Federal Register on July 7, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 8, 2003, 68 F.R. 40510)

Internal Revenue Service

Revenue Procedure 2003-13

Deemed Individual Retirement Accounts

" Deemed IRAs" were created under the Economic Growth and Tax Relief Reconciliation Act of 2001 when it added Section 408(q) to the Internal Revenue Code. Section 408q permits employees to make either regular IRA and/or Roth IRA contributions to an individual retirement account (IRA) within a qualified employer plan.

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.201: Rulings and determination letters

Revenue Procedure 2003-13

Section 1. Purpose

This revenue procedure provides guidance for employers that want to amend their plans qualified under § 401(a) of the Internal Revenue Code to include "deemed IRAs" described in § 408(q) . The revenue procedure also provides a sample plan amendment that may be used, in conjunction with IRA language, to amend a qualified plan to provide for deemed IRAs.

Section 2. Background

.01 Section 408(q) was added to the Code by section 602 of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), Pub. L. 107-16, effective for plan years beginning after December 31, 2002. Section 408(q) provides that if a qualified employer plan elects to allow employees to make voluntary employee contributions to a separate account or annuity established under the plan, and under the terms of the qualified employer plan such account or annuity meets the applicable requirements of § 408 or 408A for an individual retirement account or annuity, then such account or annuity shall be treated under the Code in the same manner as an IRA and not as a qualified employer plan. The Internal Revenue Service and Treasury expect to issue regulations under Code § 408(q) in the near future.

.02 Notice 2001-42, 2001-2 C.B. 70, provides a remedial amendment period under § 401(b), ending no earlier than the end of the first plan year beginning on or after January 1, 2005, in which any needed

retroactive EGTRRA plan amendment may be adopted (the "EGTRRA remedial amendment period"). The availability of the EGTRRA remedial amendment period is conditioned on the timely adoption of a good faith EGTRRA plan amendment.

.03 Notice 2001-57, 2001-2 C.B. 279, provides sample plan amendments that satisfy, in form, the "good faith EGTRRA plan amendment" requirement described in the preceding paragraph. Although not containing a sample plan amendment for deemed IRAs under Code § 408(q), the notice provides that the good faith plan amendment requirement applies to § 408(q). The notice also provides that, until further notice, the Service will not consider EGTRRA in issuing determination, opinion or advisory letters.

.04 Rev. Proc. 2002-10, 2002-4 I.R.B. 401, requires all prototype sponsors with currently approved IRAs, SEPs, and SIMPLE IRA plans to amend these documents and submit applications for opinion letters on the amended documents by December 31, 2002.

Section 3. Required language for deemed IRAs

.01 Plan sponsors that want to provide for deemed IRAs must have such provisions in their plan documents and must have deemed IRAs in effect for employees no later than the date deemed IRA contributions are accepted from such employees. Notwithstanding the preceding sentence, plan sponsors that want to provide for deemed IRAs for plan years beginning before January 1, 2004, (but after December 31, 2002) are not required to have such provisions in their plan documents before the end of such plan years. Plan sponsors must otherwise comply with the rules in Notice 2001-57. To satisfy the requirements for the EGTRRA remedial amendment period, the provisions must reflect a reasonable, good-faith interpretation of the statute. The sample plan amendment contained in the appendix to this revenue procedure, when used in conjunction with IRA language described in section 3.02 below, is a reasonable, good-faith interpretation of the statute.

.02 In addition to the sample plan amendment in the Appendix, a plan that intends to comply with Code § 408(q) must also contain language that satisfies § 408 or 408A, relating to traditional and Roth IRAs, respectively. The Service provides sample language (a "Listing of Required Modifications," or "LRMs") that satisfies §§ 408 and 408A on the Service's Web Site at www.irs.gov/ep. A plan will satisfy the "reasonable, good-faith interpretation of the statute" requirement with respect to IRA language if the language addresses every applicable point in the IRA LRMs.

Drafting information

The principal author of this revenue procedure is Roger Kuehnle of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue procedure, please contact Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday. Mr. Kuehnle can be reached at 202-283-9888 (not a toll-free number).

Appendix

Sample Plan Amendment

(The following sample plan amendment may be adopted only by plans trusteed by a person eligible to act as a trustee of an IRA under § 408(a)(2) and plans that designate an insurance company to issue annuity contracts under § 408(b). Additional language that satisfies § 408 or 408A must also be added to the plan.)

Section ------ . Deemed IRAs

1. Applicability and effective date. This section shall apply if elected by the employer in the adoption agreement and shall be effective for plan years beginning after the date specified in the adoption agreement.

2. Deemed IRAs. Each participant may make voluntary employee contributions to the participant's ---------------- [insert "traditional" or "Roth"] IRA under the plan. The plan shall establish a separate ------------- [insert "account" or "annuity"] for the designated IRA contributions of each participant and any earnings properly allocable to the contributions, and maintain separate recordkeeping with respect to each such IRA.

3. Reporting duties. The ----------- [insert "trustee" or "issuer"] shall be subject to the reporting

requirements of section 408(i) of the Internal Revenue Code with respect to all IRAs that are established and maintained under the plan.

4. Voluntary employee contributions. For purposes of this section, a voluntary employee contribution means any contribution (other than a mandatory contribution within the meaning of section 411(c)(2) of the Code) that is made by the participant and which the participant has designated, at or prior to the time of making the contribution, as a contribution to which this section applies.

5. IRAs established pursuant to this section shall be held in ----------- [insert "a trust" or "an annuity"] separate from the trust established under the plan to hold contributions other than deemed IRA contributions and shall satisfy the applicable requirements of sections 408 and 408A of the Code, which requirements are set forth in section ---------- [insert the section of the plan that contains the IRA requirements].

(Adoption agreement provisions)

Section of the plan, Deemed IRAs: (check one)

shall be effective for plan years beginning after December 31, (enter a year later than 2001).

shall not apply.

Internal Revenue Code

2004-67

Roth and Deemed Individual Retirement Account Participation in Group Trusts Described in Revenue Ruling 81-100

Part I

Section 501.--Exemption From Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(a)-1: Exemption from taxation.

(Also, §§ 457; 1.457-8.)

Revenue Ruling 2004-67

Purpose

This revenue ruling extends the ability to participate in group trusts described in Revenue Ruling 81-100, 1981-1 C.B. 326, to eligible governmental plans under § 457(b) of the Internal Revenue Code and clarifies the ability of Roth individual retirement accounts described in § 408A and deemed individual retirement accounts described in § 408(q) to participate in these group trusts. In addition, this revenue ruling provides related model language for eligible governmental plans under § 457(b).

Issue

Whether the assets of eligible governmental plan trusts described in § 457(b) may be pooled with the assets of a group trust described in Revenue Ruling 81-100 , without affecting the tax status of the eligible governmental plan trust or the group trust (including its current participants).

Law and analysis

Section 501(a) provides, in part, that a trust described in § 401(a) is exempt from income tax. Section 401(a)(1) provides that a trust or trusts created or organized in the United States and forming a part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of its employees or their beneficiaries is qualified under § 401(a) if contributions are made to the trust or trusts by the applicable employer, or employees, or both for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated in accordance with such plan. Section 401(a)(2) provides, in part, that under each trust instrument it must be impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the plan and the trust or trusts, for any part of the corpus or income of the trust, to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.

Section 401(a)(24) provides that any group trust that otherwise meets the requirements of § 401(a) will not fail to satisfy such requirements due to the participation or inclusion of a plan or governmental unit described in § 818(a)(6) in the group trust. Section 818(a)(6) provides, in part, that for these purposes the trust of a pension plan contract includes a governmental plan within the meaning of § 414(d) and an eligible deferred compensation plan within the meaning of § 457(b).

Section 401(f) provides that a custodial account, an annuity contract and certain other contracts issued by an insurance company will be treated as a qualified trust if the custodial account or contract would, except for the fact that it is not a trust, constitute a qualified trust under § 401, and, if the assets in any such custodial account are held by a bank or another person who demonstrates that he will hold the assets in a manner consistent with the requirements of § 401.

Section 408(e) provides for the exemption from taxation of an individual retirement account that meets the requirements of § 408 . Section 408(a)(5) provides that the assets of an individual retirement account may not be commingled with other property except in a common trust fund or common investment fund.

Section 408A provides that, except as otherwise provided in § 408A, a Roth IRA is treated for purposes of the Code as an individual retirement plan, which includes an individual retirement account that meets the requirement of § 408. Consequently, a Roth IRA that is an individual retirement account is exempt from tax under § 408(e). Section 408(q) provides, in part, that if a qualified employer plan, as defined in § 408(q)(3)(A), elects to allow employees to make voluntary employee contributions to a separate account established under the plan and, under the terms of the qualified employer plan, the account meets the requirements of § 408 or 408A for an individual retirement account, then that account is treated as an individual retirement account (deemed individual retirement account), and not as a qualified employer plan. An individual retirement account described in § 408(q) is exempt from taxation under § 408(e).

Rev. Rul. 81-100 holds that if certain requirements are satisfied, a group trust is exempt from taxation under § 501(a) with respect to its funds that equitably belong to participating trusts described in § 401(a) and also is exempt from taxation under § 408(e) with respect to its funds that equitably belong to individual retirement accounts that satisfy the requirements of § 408. Also, the status of individual trusts as qualified under § 401(a), or as meeting the requirements of § 408 and as being exempt from tax under § 501(a) or § 408(e), are not affected by the pooling of their funds in a group trust.

Section 457 provides that compensation deferred under an eligible deferred compensation plan of an eligible employer that is a State or political subdivision, agency, or instrumentality thereof (an eligible governmental plan) and any income attributable to the amounts deferred, is includible in gross income only in the taxable year in which it is paid to the plan participant or beneficiary.

Section 457(g)(1) requires an eligible governmental plan under § 457(b) to hold all assets and income of the plan in a trust for the exclusive benefit of participants and their beneficiaries.

Section 457(g)(2) provides, in part, that a trust described in § 457(g)(1) is treated as an organization exempt from federal income tax under § 501(a).

Section 457(g)(3) provides that custodial account and contracts described in § 401(f) are treated as trusts under rules similar to the rules under § 401(f).

This revenue ruling extends the holding of Revenue Ruling 81-100 to eligible governmental plans described in § 457(b). Therefore, if the requirements below are satisfied, the funds from qualified plan trusts, individual retirement accounts (including a Roth individual retirement account described in § 408A and a deemed individual retirement account described in § 408(q)) that are tax-exempt under § 408(e), and eligible governmental plan trusts described in § 457(b) and § 457(g) may be pooled without adversely affecting the tax status of the group trust or the tax status of the separate trusts.

Holding

The assets of eligible governmental plan trusts described in § 457(b) may be pooled with the assets of a group trust described in Revenue Ruling 81-100 without affecting the tax status of the eligible governmental plan trust or the group trust (including its current participants). Accordingly, under Revenue Ruling 81-100 and this revenue ruling, if the five criteria below are satisfied, a trust that is part of a qualified retirement plan, an individual retirement account (including a Roth individual retirement account described in § 408A and a deemed individual retirement account described in § 408(q)) that is exempt from taxation under § 408(e) , or an eligible governmental plan under § 457(b) may pool its assets in a group trust without adversely affecting the tax status of any of the separate trusts or the group trust. For this purpose, a trust includes a custodial

account that is treated as a trust under § 401(f), under § 408(h) , or under § 457(g)(3).

(1) The group trust is adopted as a part of each adopting employer's plan or each adopting individual retirement account.

(2) The group trust instrument expressly limits participation to pension, profit sharing, and stock bonus trusts or custodial accounts qualifying under § 401(a) that are exempt under § 501(a); individual retirement accounts that are exempt under § 408(e); and eligible governmental plan trusts or custodial accounts under § 457(b) that are exempt under § 457(g) (adopting entities).

(3) The group trust instrument prohibits any part of its corpus or income that equitably belongs to any adopting entity from being used for or diverted to any purpose other than for the exclusive benefit of the employees (and the individual for whom an individual retirement account is maintained) and their beneficiaries who are entitled to benefits under such adopting entity.

(4) The group trust instrument prohibits assignment by an adopting entity of any part of its equity or interest in the group trust.

(5) The group trust is created or organized in the United States and is maintained at all times as a domestic trust in the United States.

Model amendments

There are two model amendments set forth below. One is for those group trusts that have received favorable determination letters from the Service that the group trust satisfies Revenue Ruling 81-100 . The other is for those trusts of eligible governmental plans under § 457(b) that have received a letter ruling from the Service (in each instance issued prior to July 12, 2004).

Ammendment 1 - For group trust

A sponsor of a group trust that satisfies Revenue Ruling 81-100 may amend its group trust to include the model language below to reflect this revenue ruling: "This group trust is operated or maintained exclusively for the commingling and collective investment of funds from other trusts that it holds. Notwithstanding any contrary provision in this group trust, the trustee of this group trust is permitted, unless restricted in writing by the named fiduciary, to hold in this group trust funds that consist exclusively of trust assets held under plans qualified under Code section 401(a), individual retirement accounts that are exempt under Code section 408(e), and eligible governmental plans that meet the requirements of Code section 457(b). For this purpose, a trust includes a custodial account that is treated as a trust under Code section 401(f) or under Code section 457(g)(3).

"For purposes of valuation, the value of the interest maintained by the fund with respect to any plan or account in such group trust shall be the fair market value of the portion of the fund held for that plan or account, determined in accordance with generally recognized valuation procedures."

Reliance by trustees with prior determination letter

A trustee entitled to rely on a favorable determination letter issued to it prior to July 12, 2004, regarding eligibility of its group trust under Revenue Ruling 81-100 will not lose its right to rely on its determination letter merely because it adopts Model Amendment 1 set forth above in this revenue ruling on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects). The group trust sponsor may adopt Model Amendment 1 on a word-for-word basis (or adopt an amendment that is substantially similar in all material respects) and continue to rely on the previously issued determination letter regarding its group trust without filing another request with the Service for a new determination letter.

A sponsor that satisfies the above requirements and amends its group trust to include Model Amendment 1 on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects) will also not lose its right to rely on its prior determination letter merely because it becomes necessary, as a result of the adoption of such model amendment (or an amendment that is substantially similar in all material respects), to delete a prior provision that is inconsistent with the model amendment so adopted (or an amendment that is substantially similar in all material respects that is so adopted).

Generally, the group trust instrument will provide that amendments to the group trust will automatically pass through to the trusts of qualified plans under § 401(a); individual retirement accounts that are exempt under § 408(e); and trusts of eligible governmental plans under § 457(b). However, a group trust that has received a

favorable determination letter under Rev. Proc. 2004-6, 2004-1 Internal Revenue Bulletin 204, (or its predecessors) that does not contain such a pass-through provision may not adopt Model Amendment 1 and automatically continue to rely on its determination letter. In addition, further guidance will be issued to address the transition necessary to bring into compliance a group trust that has received a favorable determination letter under Rev. Proc. 2004-6, 2004-1 Internal Revenue Bulletin 204, (or its predecessors) that does not comply with this revenue ruling.

Amendment 2 - For eligible governmental plan under § 457(b)

A plan sponsor of a trust that funds an eligible governmental plan under § 457(b) may amend the trust agreement to include the model language below to reflect this revenue ruling:

"Notwithstanding any contrary provision in the instrument governing the [Name of eligible governmental plan under § 457(b)], the plan trustee may, unless restricted in writing by the named fiduciary, transfer assets of the plan to a group trust that is operated or maintained exclusively for the commingling and collective investment of monies provided that the funds in the group trust consist exclusively of trust assets held under plans qualified under Code section 401(a), individual retirement accounts that are exempt under Code section 408(e), and eligible governmental plans that meets the requirements of Code section 457(b).

For this purpose, a trust includes a custodial account that is treated as a trust under Code section 401(f) or under Code section 457(g)(3).

"For purposes of valuation, the value of the interest maintained by the [Name of eligible governmental plan under §457] in such group trust shall be the fair market value of the portion of the group trust held for the [Name of eligible governmental plan under § 457(b)], determined in accordance with generally recognized valuation procedures."

Reliance by employer on prior § 457(b) ruling

An employer described in section 457(e)(1)(A) entitled to rely on a favorable private letter ruling issued to it prior to July 12, 2004 regarding the eligibility of its plan under § 457(b) will not lose its right to rely on its letter ruling merely because it adopts Model Amendment 2 set forth above on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects). Such an employer may adopt Model Amendment 2 on a word-for-word basis (or adopt an amendment that is substantially similar in all material respects) and continue to rely on the previously issued letter ruling regarding its § 457(b) plan without filing another request with the Service for a new letter ruling.

An employer described in § 457(e)(1)(A) that satisfies the above requirements and amends the trust of its eligible governmental plan under § 457(b) to include Model Amendment 2 on a word-for-word basis (or adopts an amendment that is substantially similar in all material respects) will not lose its right to rely on its prior letter ruling merely because it becomes necessary as a result of the adoption of such model amendment (or an amendment that is substantially similar in all material respects), to delete a prior provision that is inconsistent with the model amendment so adopted.

Effect on other documents

Revenue Ruling 81-100 is clarified and modified.

Drafting information

The principal author of this revenue ruling is Dana A. Barry of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this revenue ruling, please contact the Employee Plans' taxpayer assistance telephone service at 1-877-829-5500 (a toll-free number) between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday (a toll free call). Ms. Barry may be reached at (202) 283-9888 (not a toll-free call).

IRS Self Correction Program Frequently Asked Questions

Summary

IRS published guidance regarding the Self Correction Program

Agency: Internal Revenue Service

IRS Self Correction Program Frequently Asked Questions Guidance

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

Is there a way to attain IRS approval prior to audit regarding the appropriate way to correct a failure under the SCP?

The SCP is a voluntary employer-initiated program that does not involve IRS approval; therefore, the IRS will not approve a Plan Sponsor's method of correction prior to audit. However, Rev. Proc. 2003-44 sets forth General Correction Principles designed to assist a plan sponsor in determining the appropriate method of correction for a failure. In addition, Appendix A and Appendix B of Rev. Proc. 2003-44 provide plan sponsors with sample correction methods for certain failures. To the extent the plan sponsor applies the applicable correction method set forth in either of these appendices, the correction is deemed to be reasonable and appropriate correction for the failure. Upon examination, the IRS has the right to review whether the taxpayer made the correct determination that such failure(s) were eligible under the SCP as well as whether the correction method is acceptable.

What practices and procedures are required to be in place in order for a plan to be eligible for relief under the SCP?

The IRS is concerned that the practices and procedures of a plan foster compliance with the requirements of the Code.

- Practices and procedures may be formal or informal.
- Practices and procedures must be routinely followed.
- Practices and procedures need not be in place for a specific failure (as long as practices and procedures exist that evidence an overall effort on the part of the Plan Sponsor to maintain the plan in compliance with the Code requirements).
- A plan document alone is not sufficient to establish evidence of good practices and procedures.
- An example of an acceptable practice or procedure outside of the plan document is a checksheet routinely followed for determining whether an employee is a key employee for purposes of meeting the top heavy requirements.

If a plan sponsor discovers a failure of the Actual Deferral Percentage (ADP), Actual Deferral Percentage (ACP), or Multiple Use tests in the plan sponsor's profit-sharing plan, may the failures be corrected under the SCP?

Yes. A failure of the ADP, ACP or Multiple Use Tests is treated as an Operational Failure for purposes of EPCRS. Under Code section 401(k) and (m), a Plan Sponsor has until the end of the plan year following the plan year in which an excess contribution or excess aggregate contribution was made to correct the failure; under the SCP , the two-year correction period applicable to Significant Operational Failures does not begin under the expiration of the statutory correction period. (Note that the Multiple Use Test has been repealed for plan years beginning after 12/31/01.)

Example - In 2004, a Plan Sponsor discovers that in 2003, when testing the contributions made in its section 401(k) plan during 2003 for the ADP test, mistakes were made in determining the correct amount of compensation that should have been taken into account under the test. When the ADP test was rerun with the correct data, the plan sponsor discovers that the ADP test was failed. Assuming the other eligibility requirements of Self-Correction Program are satisfied, if the ADP failure is a Significant Operation Failure, the plan sponsor may correct the failure to satisfy the ADP test by the end of the 2006 plan year. If the ADP failure is an Insignificant Operational Failure, the plan sponsor has even longer to correct the failure, and may correct even upon audit of the plan.

What are Insignificant Operational Failures under the SCP?

The SCP permits Plan Sponsors to correct significant Operational Failures within two years of the year in which the failure occurred, provided the other requirements of the SCP are satisfied. A number of factors are considered in determining whether Operational Failures are insignificant. These include, but are not limited to:

- whether other failures occurred during the period being examined (for this purpose, a failure is not considered to have occurred more than once merely because more than one participant is affected by the failure);
- the percentage of plan assets and contributions involved in the failure;
- the number of years the failure occurred;
- the number of participants affected relative to the total number of participants in the plan;
- the number of participants affected as a result of the failure relative to the number of participants who could have been affected by the failure;
- whether correction was made within a reasonable time after discovery of the failure; and
- the reason for the failure (for example, data errors such as errors in the transcription of data, the transposition of numbers, or minor arithmetic errors).

This is not an exclusive list and no single factor is determinative. Failures will not be considered significant merely because they occur in more than one year. In addition, the IRS will apply these factors in a way so as to not preclude small businesses from being eligible for the SCP merely because of their size.

When correcting Significant Operational Failures, what actions must be taken by a plan sponsor by the end of the two-year correction period in order to be entitled to relief under the SCP?

In general, correction must be completed by the end of the two-year correction period in order for a plan to be entitled to relief under the SCP . However, where a Plan Sponsor substantially completes correction within the correction period, the plan sponsor will not lose the relief provided under the SCP merely because correction wasn't completed during the correction period. There are two circumstances under which correction is considered to have been substantially completed:

First, where,

- during the correction period, the Plan Sponsor is reasonably prompt in identifying the Operational Failure , formulating a correction method, and initiating correction in a manner that demonstrates a commitment to completing correction of the Operational Failure as expeditiously as practicable, and
- within 90 days after the last day of the correction period, the Plan Sponsor completes correction of the Operational Failure; and

Second, where,

- during the correction period, correction is completed with respect to 85% of all participants affected by the Operational Failure, and
- thereafter, the Plan Sponsor completes correction of the Operational Failure with respect to the remaining affected participants in a diligent manner.

In addition, a Plan Sponsor will not be considered to have failed to fully correct within the correction period where a plan sponsor takes reasonable action to find but has not located all current and former participants and beneficiaries to whom additional benefits are due. Reasonable action includes the use of the Internal Revenue Service Letter Forwarding Program (see Rev. Proc. 94-22, 1994-1 C.B. 608) or the Social Security Administration Reporting Service. If an individual is later located, the additional benefits must be provided to the individual at that time.

If correction of an Operational Failure is being implemented through adoption of a plan amendment, the required application for a determination letter must be submitted within the two-year correction period in order for correction to be considered to have been timely implemented.

Assume a plan sponsor discovers a vesting problem in which the plan terms were not followed, should the plan sponsor use SCP or the Voluntary Correction Program to correct the problem?

The decision of whether to use the SCP or Voluntary Correction Program to correct an Operational Failure depends on a number of factors, including: (1) the type of failure involved, (2) the practices and procedures under the plan, (3) whether, if the failure is an Operational Failure, it would be considered to be a Significant Operational Failure, (4) whether a Favorable Letter has been issued with respect to the plan, (5) whether the failure is an Egregious Failure, (6) when the failure is discovered, and (7) the amount of comfort the Plan Sponsor has with respect to the method used to correct the failure.

Although the SCP does not require the payment of a fee or notification to the IRS, it is limited to correcting Operational Failures that are not egregious. In addition, if the failure is a Significant Operational Failure, the Plan Sponsor must complete correction of the failure within two years of the year in which the failure occurred. Although a plan sponsor does not necessarily get assurance that the correction method employed under the SCP is acceptable to the IRS, the IRS has provided several examples of failures and acceptable correction methods under Appendix A and Appendix B in Rev. Proc. 2003-44. If a plan sponsor corrects a failure listed in Appendix A or Appendix B in accordance with the method of correction method set forth in the appendix, the plan sponsor may be assured that the IRS will find that correction method to be acceptable.

In this example, an Operational Failure, a vesting failure, has occurred. Appendix B, section 2.03 provides examples of acceptable correction methods for a vesting failure. Therefore, if there are acceptable practices and procedures under the plan (see Q&A 2 above), and the failure is an Insignificant Operational Failure, the Plan Sponsor may use the SCP to correct the failure at any time, even if the plan is Under Examination. Further, if the plan sponsor uses one of the correction methods under Appendix B of the revenue procedure, it will have assurance that the plan would be entitled to relief under the SCP with respect to its correction method. If, however, the failure is a Significant Operational Failure, the plan would be entitled to relief under the SCP only if the failure is identified and corrected within the two-year correction period under the SCP. Also, if the failure is a Significant Operational Failure, the plan would be eligible for relief under the SCP only if a Favorable Letter has been issued with respect to the plan. If the failure would be considered an Egregious Failure, it would be eligible for correction under the Voluntary Correction Program but not under the SCP.

IRS Voluntary Correction Program Frequently Asked Questions

Summary
IRS published guidance regarding the Voluntary Correction Program

Agency: Internal Revenue Service

IRS Voluntary Compliance Program Frequently Asked Questions Guidance

The frequently asked questions and answers provided below are for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

Is there an application form that plan sponsors must use to apply under the VCP?

There is no application form applicable to the VCP; however, the IRS provides Sample Submission Formats in Appendix D of Rev. Proc. 2003-44, which facilitate the submission process. The IRS also provides a Checklist designed to assist the Plan Sponsor and their representatives in preparing a submission that contains the information and documents required under each of those programs. The checklist must be completed, signed, and dated by the employer, plan sponsor, or the plan sponsor's representative, and should be placed on top of the submission.

What is the mailing address for applications submitted under the VCP?

All VCP submissions and accompanying determination letter applications (if applicable) should be mailed to the following address:

Internal Revenue Service
Attention: T:EP:RA:VC
P.O. Box 27063
McPherson Station
Washington, D.C.   20038

Some employers have very little involvement in their employees' 403(b) plans. Who should file a VCP application in these cases?

The employer is the only one who can submit an application to correct failures under the VCP. Although insurers and custodians may have some liability to the employer, they have no liability under the VCP. The employer is responsible for identifying the failures, correcting the failures, and insuring that necessary changes are made to administrative procedures for operating the 403(b) plan. When necessary for correction, the employer must secure the cooperation of the providers prior to submitting an application under the VCP.

For a VCP submission, what information must the plan sponsor supply with respect to correction of the failures?

The letter from the Plan Sponsor or the plan sponsor's representative must contain a detailed description of the method for correcting the failures that the plan sponsor has implemented or proposes to implement.

- Each step of the correction method must be described in narrative form.
- The description must include the specific information needed to support the suggested correction method, including:
  - the number of employees affected;
  - the expected cost of correction;
  - the years involved, and
  - calculations or assumptions the Plan Sponsor used to determine the amounts needed for correction.
- The number of employees affected and the expected cost of correction may be approximated if the exact number cannot be determined at the time of the request.
- A description of the methodology that will be used to calculate earnings or actuarial adjustments on any corrective contributions or distributions (indicating the computation periods and the basis for determining earnings or actuarial adjustments.
- Specific calculations for each affected employee or a representative sample of affected employees.
- The sample calculations must be sufficient to demonstrate each aspect of the correction method proposed. For example, if a Plan Sponsor requests a compliance statement with respect to a failure to satisfy the contribution limits of § 415(c) and proposes a correction method that involves elective contributions (both matched and unmatched) and matching contributions, the plan sponsor must submit calculations illustrating the correction method proposed with respect to each type of contribution. As another example, with respect to a failure to satisfy the actual deferral percentage (ADP) test in § 401(k)(3), the plan sponsor must submit the ADP test results both before the correction and after the correction.
- The method that will be used to locate and notify former employees and beneficiaries, or an affirmative statement that no former employees or beneficiaries were affected by the failures.
- A description of the measures that have been or will be implemented to ensure that the same failures will not recur.

If a plan with a Plan Document Failure is submitted under the VCP, is the plan sponsor required to concurrently submit an application for a determination letter?

"Yes. Anytime a Plan Sponsor is required to file for a determination letter in association with a VCP application, whether it be for the correction of a Plan Document Failure, Demographic Failure, or correction of an Operational Failure by plan amendment, if the amendment is other than the adoption of an amendment designated by the IRS as a model amendment or the adoption of a prototype or volume submitter plan for which the Plan Sponsor has reliance on the plan's opinion or advisory letter (see Rev. Proc. 2003-6, 2003-1 I.R.B. 191), the plan sponsor is required to submit a determination letter application with the appropriate user fee at the same time and to the same address that the VCP submission is sent.

Is there an avenue for plan sponsors to negotiate correction under the VCP on an anonymous basis?

Yes. Rev. Proc. 2003-44, section 10.11 sets forth the provisions of the Anonymous Submission procedure. The Anonymous Submission procedure permits Plan Sponsors to submit Qualified Plans, 403(b) Plans, SEPs , and Simple IRA Plans under VCP without initially identifying the applicable plan(s) or applicant. The

submission requirements relating to VCP apply to anonymous submissions on the same terms they apply to submissions in which the plan and plan sponsor are identified. However, information identifying the plan or the Plan Sponsor may be excluded from the submission until the IRS and the plan representative reach agreement with respect to all aspects of the submission.

Until the plan(s) and Plan Sponsor are identified to the IRS, an anonymous submission does not preclude an examination of the Plan Sponsor or its plan(s). Thus, a plan submitted under the Anonymous Submission procedure that comes Under Examination prior to the date the plan(s) and Plan Sponsor(s) identifying materials are received by the IRS will no longer be eligible under VCP .

Should a plan sponsor that discovers a Plan Document Failure in a plan that has been submitted for a determination letter raise the issue to the Employee Plans agent working the determination letter application?

If the Plan Sponsor knows about the failure prior to submitting a determination letter application, the plan sponsor should submit under the VCP and include the determination letter application with the VCP submission. If the failure is identified and voluntarily raised by the taxpayer to the Employee Plans Agent or Specialist assigned to the determination letter application, the taxpayer will be given an opportunity to perfect a VCP submission and have the issue resolved under the VCP.

What happens if the IRS and plan sponsor fail to reach resolution regarding the appropriate correction of a failure?

Under the VCP , if resolution cannot be reached (for example, where information is not timely provided to the IRS or because agreement cannot be reached on correction or a change in administrative procedures), the compliance fee will not be returned, and the case may be referred to the appropriate EP office for examination consideration.

May a plan sponsor receive an extension of the 150-day correction period under the VCP?

In appropriate circumstances, a Plan Sponsor will be granted an extension of the 150-day correction period under VCP . The plan sponsor should submit a written request explaining the reason for the request to the agent working the case. The request must be made prior to the expiration of the 150-day correction period.

Can trust assets be used for the payment of the fee or sanction under the VCP?

As a rule, fees or sanctions should be paid by parties other than the trust. Exceptions are allowed only in very narrow circumstances.

Has the IRS established a program to verify that plan sponsors are correcting failures in accordance with Compliance Statements that have been issued under the VCP?

Yes, the IRS has established a verification program. The program is not an examination of the Plan Sponsor books and records. The IRS checks available information from the plan sponsor to insure that all corrections were made in accordance with the terms of the compliance statement. If necessary corrections or administrative changes were not timely made, the plan may be referred to EP Examinations.

Are matters relating to excise taxes resolved under the EPCRS?

The correction programs are not available for events for which the Code provides tax consequences other than plan disqualification (such as the imposition of an excise tax or additional income tax). For example, funding deficiencies (failures to make the required contributions to a plan subject to § 412), prohibited transactions, and failures to file the Form 5500 cannot be corrected under the correction programs.

However, it should be noted that excise taxes and additional taxes, to the extent applicable, are not waived merely because the underlying failure has been corrected or because the taxes result from the correction. Thus, for example, the excise tax on certain excess contributions under § 4979 is not waived under these correction programs, even though the underlying Qualification Failure is corrected under the EPCRS.

Under Audit CAP, excise taxes that are reportable on the Form 5330 (e.g., prohibited transactions) may be resolved by the agent securing a Form 5330 providing for 100% of the tax and interest outstanding. The agent may, in his or her discretion, recommend to the Service Center waiver of the failure to file and/or failure to pay penalty, under IRC §6651.

Section 4974(d) provides for waiver of the minimum distribution excise tax under certain circumstances. As part of VCP , if the failure involves the failure to satisfy the minimum required distribution requirements of

§ 401(a)(9), in appropriate cases, the IRS will waive the excise tax under § 4974 applicable to plan participants. The waiver will be included in the compliance statement issued by the IRS. The Plan Sponsor, as part of the submission, must request the waiver and in cases where the participant subject to the excise tax is an owner-employee as defined in § 401(c)(3), or a 10 percent owner of a corporation, the Plan Sponsor must also provide an explanation supporting the request for the waiver.

Assume a plan sponsor discovers a vesting problem in which the plan terms were not followed, should the plan sponsor use the Self-Correction Program or the VCP to correct the problem?

The decision of whether to use the SCP or Voluntary Correction Program to correct an Operational Failure depends on a number of factors, including: (1) the type of failure involved, (2) the practices and procedures under the plan, (3) whether, if the failure is an Operational Failure, it would be considered to be a Significant Operational Failure, (4) whether a Favorable Letter has been issued with respect to the plan, (5) whether the failure is an Egregious Failure, (6) when the failure is discovered, and (7) the amount of comfort the Plan Sponsor has with respect to the method used to correct the failure.

Although the SCP does not require the payment of a fee or notification to the IRS, it is limited to correcting Operational Failures that are not egregious. In addition, if the failure is a Significant Operational Failure, the Plan Sponsor must complete correction of the failure within two years of the year in which the failure occurred. Although a plan sponsor does not necessarily get assurance that the correction method employed under the SCP is acceptable to the IRS, the IRS has provided several examples of failures and acceptable correction methods under Appendix A and Appendix B in Rev. Proc. 2003-44. If a plan sponsor corrects a failure listed in Appendix A or Appendix B in accordance with the method of correction method set forth in the appendix, the plan sponsor may be assured that the IRS will find that correction method to be acceptable.

In this example, an Operational Failure, a vesting failure, has occurred. Appendix B, section 2.03 provides examples of acceptable correction methods for a vesting failure. Therefore, if there are acceptable practices and procedures under the plan, and the failure is an Insignificant Operational Failure, the Plan Sponsor may use the SCP to correct the failure at any time, even if the plan is Under Examination. Further, if the plan sponsor uses one of the correction methods under Appendix B of the revenue procedure, it will have assurance that the plan would be entitled to relief under the SCP with respect to its correction method. If, however, the failure is a Significant Operational Failure, the plan would be entitled to relief under the SCP only if the failure is identified and corrected within the two-year correction period under the SCP. Also, if the failure is a Significant Operational Failure, the plan would be eligible for relief under the SCP only if a Favorable Letter has been issued with respect to the plan. If the failure would be considered an Egregious Failure, it would be eligible for correction under the Voluntary Correction Program but not under the SCP.

Appendix E — Employee Benefit Law

IRS Interpretive Letter EP:R:9

Valuation of IRA Assets

February 24, 1993

Internal Revenue Service Department of the Treasury

Washington, D.C. 20224

Person to Contact:

Laura B. Warshawsky, Esq.

Mr.

Partnership Valuations, Inc. Telephone Number:

(202) 622-8400

Annapolis, Maryland 21404

Refer Reply to:

E:EP:R:9

Date: February 24, 1993

Dear Mr.

This is in response to your letter to Martin Slate , Director of the Employee Plans Technical and Actuarial Division, dated December 24, 1992, in which you requested general information regarding valuation of assets in Individual Retirement Accounts and Individual Retirement Annuities ("IRAs"). In your letter, you posed the following questions: (1) Is an IRA required to value its assets on an annual basis? (2) Is an IRA required to value "hard to value" assets (e.g. partnerships, closely-held stock, collectibles, etc.) as well as exchange-traded securities? (3) Are non-traded asset value standards the same for IRAs as for defined benefit ("DB") plans and defined contribution ("DC") plans? (4) Who is responsible for insuring an IRA's assets are properly valued? (5) Can a fiduciary evade its valuation responsibilities by having the client sign a release, indemnification or other instrument?

Section 408(i) of the Internal Revenue Code of 1986 (the "Code") requires the trustee of an individual retirement account and the issuer of an endowment contract or an individual retirement annuity to make certain reports regarding such account, contract, or annuity to the Secretary of the Treasury and to the individual for whom such account, contract or annuity is maintained. Section 408(i) of the Code gives the Secretary authority to prescribe the manner of providing such reports and to determine the information required to be provided.

Section 1.408-5 of the Income Tax Regulations provides that the trustee of an individual retirement account or the issuer of an individual retirement annuity shall make annual calendar year reports concerning the status of the account or the annuity. The information required in the annual reports by the trustees and issuers of IRAs

includes: the amount of contributions, the amount of distributions, the amount of the premium paid for an endowment contract allocable to the cost of life insurance, the name and address of the trustee or issuer, and such other information as the Commissioner of Internal Revenue may require.

Internal Revenue Service Form 5498, Individual Retirement Arrangement Information, is the prescribed form for satisfying the annual reporting requirements of section 408(i) of the Code and the regulations thereunder. The instructions to Form 5498 require the trustee or issuer to report the fair market value of the IRA account as of December 31 of each year.

In response to your questions, first, based on the fact that the Internal Revenue Service (the "Service) requires that the fair market value of the assets as of December 31 be reported on Form 5498, an IRA is required to value its assets on an annual basis. Similarly, the requirement that fair market value be determined annually for purposes of Form 5498 necessitates the valuation of all IRA assets, including "hard to value" assets.

With respect to your third question, Revenue Ruling 59-60, 1959-1 C.B. 237, as modified by Revenue Ruling 65-193, 1965-2 C.B. 370, sets forth the proper approach to use to value corporate stock for estate and gift tax purposes. Revenue Ruling 68-609, 1968-2 C.B. 327, states that the general approach, methods and factors outlined in Revenue Ruling 59-60 are equally applicable to valuations of corporate stock for income and other tax purposes. The general approach, methods and factors also apply to valuations of corporate stock in IRAs.

With respect to your fourth question, the person responsible for insuring that an IRA's assets are properly valued is the IRA trustee or issuer, because under the Service's reporting requirements that person is responsible for reporting the correct fair market value of the assets.

Finally, the IRA trustee or issuer cannot evade valuation responsibility by having the participant sign a release, indemnification or other instrument, because the trustee's or issuer's responsibility for valuation derives from the Service's reporting requirements, which cannot be waived by participant action.

We believe this information will be of assistance to you. This is not a ruling, however, and may not be relied upon with respect to any specific transaction.

Sincerely,

John G. Riddle, Jr.

Acting Chief, Employee Plans

Rulings Branch

inventories of explosives must be maintained to assure employer and blaster accountability for explosives.

Ira L. Mills,

Departmental Clearance Officer.

[FR Doc. E6–1506 Filed 2–2–06; 8:45 am]

BILLING CODE 4510–26–P

DEPARTMENT OF LABOR

Office of the Secretary

Submission for OMB Review: Comment Request

January 26, 2006.

The Department of Labor (DOL) has submitted the following public information collection request (ICR) to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act of 1995 (Pub. L. 104–13, 44 U.S.C. chapter 35). A copy of this ICR, with applicable supporting documentation, may be obtained by contacting the Department of Labor (DOL). To obtain documentation, contact Darrin King on 202–693–4129 (this is not a toll-free number) or e-mail: *king.darrin@dol.gov.*

Comments should be sent to Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for the Occupational Safety and Health Administration (OSHA), Office of Management and Budget, Room 10235, Washington, DC 20503, 202–395–7316 (this is not a toll-free number), within 30 days from the date of this publication in the **Federal Register**.

The OMB is particularly interested in comments which:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Agency: Occupational Safety and Health Administration.

Type of Review: Extension of currently approved collection.

Title: Longshoring and Marine Terminal Operations (29 CFR Parts 1918 and 1917).

OMB Number: 1218–0196.

Frequency: On occasion; Weekly; Monthly; and Annually.

Type of Response: Recordkeeping and Third party disclosure.

Affected Public: Business or other for-profit; not-for-profit institutions; Federal Government; and State, Local, or Tribal Government.

Number of Respondents: 750.

Number of Annual Responses: 152,458.

Estimated Time per Response: Varies from 1 minute to 1 hour and five minutes.

Total Burden Hours: 35,948.

Total Annualized capital/startup costs: $0.

Total Annual Costs (operating/maintaining systems or purchasing services): $0.

Description: The Standards on Marine Terminals (29 CFR Part 1917) and Safety and Health Regulations for Longshoring (29 CFR Part 1918) contain a number of collections of information which are used by employers to ensure that employees are informed properly about the safety and health hazards associated with marine terminals and longshoring operations. OSHA uses the records developed in response to the collection of information requirements to find out if the employer is complying adequately with the provisions of the standards.

Ira L. Mills,

Departmental Clearance Officer.

[FR Doc. E6–1507 Filed 2–2–06; 8:45 am]

BILLING CODE 4510–26–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Application No. D–11184]

Amendment to Prohibited Transaction Exemption (PTE) 75–1, Exemptions From Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers, Reporting Dealers and Banks

AGENCY: Employee Benefits Security Administration.

ACTION: Final Amendment to PTE 75–1, Part II and Part V.

SUMMARY: This document amends PTE 75–1, Part II and Part V (40 FR 50845, October 31, 1975). PTE 75–1, Part II, permits the purchase or sale of a security in a principal transaction between an employee benefit plan and a broker-dealer, reporting dealer, or bank. PTE 75–1, Part V, permits an extension of credit to a plan by a broker-dealer in connection with the purchase or sale of securities. The amendment affects participants, beneficiaries and fiduciaries of employee benefit plans, and broker-dealers, reporting dealers and banks entering into the described transactions.

DATES: *Effective Date:* This amendment is effective January 1, 1975.

FOR FURTHER INFORMATION CONTACT: Brian Buyniski or Karen Lloyd, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Room N–5649, 200 Constitution Avenue, NW., Washington, DC 20210, 202–693–8540. (This is not a toll free number.)

SUPPLEMENTARY INFORMATION: On April 28, 2004, notice was published in the **Federal Register** (69 FR 23216) of the pendency before the Department of Labor (the Department) of a proposed amendment to PTE 75–1, Part II and Part V. PTE 75–1 provides exemptive relief from certain of the restrictions of section 406 of the Employee Retirement Income Security Act of 1974 (ERISA or the Act), and from certain taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code), by reason of section 4975(c)(1) of the Code. The amendment was proposed by the Department on its own motion, pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).[1]

The notice gave interested persons an opportunity to comment or to request a hearing on the proposed amendment. The Department received three comments which are discussed below. One commenter requested a public hearing if the Department determined to modify a specific provision of the exemption. As the Department has not modified that provision in the final exemption, a public hearing will not be held with regard to this amendment.

Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether the

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[1] Section 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. at 214 (2000 ed.) generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

In the discussion of the exemption, references to specific provisions of the Act should be read to refer as well to the corresponding provisions of section 4975 of the Code.

regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

This amendment has been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. The Department has determined that this amendment is not a ''significant regulatory action'' under Executive Order 12866, section 3(f). Accordingly, it does not require an assessment of potential costs and benefits under section 6(a)(3) of that order.

Paperwork Reduction Act

The information collection request (ICR) included in the existing PTE 75–1 is currently approved under Office of Management and Budget (OMB) control number 1210–0092 (through March 31, 2007). The amendment does not modify the information collection provisions of the exemption. Therefore, the Department has not submitted an ICR to OMB in connection with this Final Amendment to PTE 75–1.

Description of the Exemption

Part I of PTE 75–1 provides relief for agency transactions and services; [2] Part II for principal transactions; Part III for underwritings; Part IV for market-making; and Part V for extension of credit.

PTE 75–1, Part II

Part II of PTE 75–1 provides relief from the restrictions of 406(a) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code, for the purchase or sale of a security between an employee benefit plan and: (1) A broker-dealer registered under the Securities Exchange Act of 1934 (the 1934 Act); (2) a reporting dealer who makes primary markets in securities of the U.S. Government or of any agency thereof and reports daily to the Federal Reserve Bank of New York its positions with respect to Government securities and borrowings thereon; or (3) a bank supervised by the United States or a State.[3]

The exemption further provides relief from the restrictions of section 406(b) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(E) and (F) of the Code, for the purchase or sale by a plan of securities issued by an open-end investment company registered under the Investment Company Act of 1940, provided that a fiduciary with respect to the plan is not a principal underwriter for, or affiliated with, such investment company within the meaning of sections 2(a)(29) and 2(a)(3) of the Investment Company Act of 1940 (the Mutual Fund Exemption).

The conditions of PTE 75–1, Part II, require that a broker-dealer must customarily purchase and sell securities for its own account in the ordinary course of its business as a broker-dealer. The conditions further require that reporting dealers and banks must customarily purchase and sell Government securities for their own accounts in the ordinary course of their businesses, and that any purchase or sale between the plan and such reporting dealer or bank be limited to a purchase or sale of Government securities.

All transactions entered into pursuant to Part II must be at least as favorable to the plan as an arm's length transaction with an unrelated party would be, and must not be, at the time of the transaction, a prohibited transaction within the meaning of section 503(b) of the Code.

Except with respect to the Mutual Fund Exemption, Part II as originally granted provided that the broker-dealer, reporting dealer or bank may not be a fiduciary with respect to the plan, and such broker-dealer, reporting dealer or bank may be a party in interest or disqualified person with respect to the plan solely by reason of section 3(14)(B) of the Act or section 4975(e)(2)(B) of the Code or a relationship to a person described in those sections. For purposes of this condition, a broker-dealer, reporting dealer or bank is not deemed to be a fiduciary with respect to a plan solely by reason of providing securities custodial services for a plan. Lastly, the exemption for principal transactions also contains certain recordkeeping requirements.

PTE 75–1, Part V

Part V of PTE 75–1 provides relief from the restrictions of section 406 of ERISA and the related excise taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1) of the Code, for any extension of credit to a plan by a broker or dealer registered under the 1934 Act.[4] As originally granted, Part V provided that the broker-dealer extending credit may not be a fiduciary with respect to any assets of the plan, unless no interest or other consideration is received by such fiduciary or any affiliate in connection with the extension of credit.

Under Part V, the extension of credit must be made in connection with the purchase or sale of securities, must be lawful under the 1934 Act, and may not be a prohibited transaction within the meaning of section 503(b) of the Code. Lastly, the exemption for extensions of credit also contains certain recordkeeping requirements.

Amendment

As part of the proposed amendment, the Department repositioned the following language found in section (d) of Part II of the exemption:

> Neither the restrictions of this paragraph nor (if the other conditions of this exemption are met) the restrictions of section 406(b) of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(E) and (F) of the Code, shall apply to the purchase or sale by the plan of securities issued by an open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), provided that a fiduciary with respect to the plan is not a principal underwriter for, or affiliated with, such investment company within the meaning of sections 2(a)(29) and 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29) and 80a–2(a)(3)).

The Department included the relief provided by this provision in a new paragraph (2) of Part II of the exemption for principal transactions. The Department also proposed to amend the language of this section to clarify that the fiduciary referenced therein is the

[2] Part I(a) expired on May 1, 1978. It ultimately was replaced by PTE 86–128 (51 FR 41686, Nov. 18, 1986).

[3] The exemption defines the terms ''broker-dealer,'' ''reporting dealer'' and ''bank'' to include such entities and any affiliate thereof. The term ''affiliate'' is defined as in 29 CFR 2510.3–21(e) and 26 CFR 54.4975–9(e).

[4] The exemption defines the terms ''broker'' and ''dealer'' to include such entities and any affiliate thereof. The term ''affiliate'' is defined as in 29 CFR 2510.3–21(e) and 26 CFR 54.4975–9(e).

fiduciary who makes the decision on behalf of the plan to enter into the transaction. The Department also requested public comment on the current utility of this exemption.

The Department additionally proposed to amend another provision of section (d) of Part II, which stated, in relevant part, that:

Such broker-dealer, reporting dealer or bank is not a fiduciary with respect to the plan, and such broker-dealer, reporting dealer or bank is a party in interest or disqualified person with respect to the plan solely by reason of section 3(14)(B) of the Act or section 4975(e)(2)(B) of the Code or a relationship to a person described in such sections. For purposes of this paragraph, a broker-dealer, reporting dealer, or bank shall not be deemed to be a fiduciary with respect to a plan solely by reason of providing securities custodial services for a plan.

Under the proposed amendment, the exemption permits plans to engage in transactions with broker-dealers, reporting dealers, banks and their affiliates except where the broker-dealer, reporting dealer, bank or an affiliate has or exercises any discretionary authority or control (except as a directed trustee) with respect to the investment of plan assets involved in the transaction, or renders investment advice (within the meaning of 29 CFR 2510.3–21(c)) with respect to the investment of those assets.[5]

The Department likewise proposed to amend condition (a)(2) of PTE 75–1, Part V, which required that the party in interest or disqualified person providing the extension of credit to the plan:

[i]s not a fiduciary with respect to any assets of such plan, unless no interest or other consideration is received by such fiduciary or any affiliate thereof in connection with such extension of credit.

Under the proposed amendment, section (a)(2) states that the party in interest or disqualified person extending credit to the plan:

does not have or exercise any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction, nor does it render investment advice (within the meaning of 29 CFR section 2510.3–21(c)) with respect to those assets, unless no interest or other consideration is received by the party in interest or disqualified person or any affiliate thereof in connection with such extension of credit.

[5] Nothing herein should be construed to imply that a directed trustee is not a fiduciary under the Act. See 29 U.S.C. 103(a)(1). A plan may expressly provide that a trustee is subject to the direction of a named fiduciary who is not a trustee, in which case the trustee shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to the Act.

Discussion of Comments

The Department received one comment concerning the effective date of the proposed amendments. The commenter requested that, with respect to the proposed amendments to condition (d) of Part II and condition (a)(2) of Part V, the Department state that it was the intention of the Department at the time of the granting of the final exemption in 1975 to focus only on fiduciaries with respect to the plan assets involved in the transaction, as opposed to any fiduciary of the plan. The commenter referenced the following language in the preamble of the proposed exemption in August 1975 regarding proposed regulations under the definition of fiduciary at section 3(21) of the Act:

It should be noted, moreover, that under the regulations proposed in conjunction with these proposed exemptions relating to the definition of the term ''fiduciary,'' a person who is a plan fiduciary would be deemed to be a fiduciary only with respect to those plan assets with respect to which he exercises those functions which make him a fiduciary.

40 FR 33566. The Department received a follow up submission from this commenter requesting that, in order to avoid confusion and uncertainty, this amendment to PTE 75–1 be made retroactive to October 31, 1975. The Department also has been urged informally to adopt a retroactive effective date.

While the Department acknowledges that some confusion may have arisen from the fact that two conditions of PTE 75–1, Part II and Part V, regarding fiduciaries, were broader than the Department's regulations regarding the definition of a fiduciary under section 3(21) of the Act, the Department is unable to concur with the commenter that its original intent with respect to such conditions was in fact to limit them to fiduciaries with respect to the plan assets involved in the transaction.[6] The conditions contained in the Department's administrative exemptions are designed to ensure that the Department can make findings required pursuant to section 408(a) of ERISA and 4975(c)(2) of the Code that the exemption is administratively feasible, and in the interests of, and protective of the rights of, plan participants and beneficiaries. The Department's regulations do not govern the scope of the conditions of its administrative exemptions. Therefore, the fact that a regulation defining the term ''fiduciary'' may have focused on the plan assets with respect to which a person exercises fiduciary functions does not necessarily govern the meaning of a condition of an administrative exemption. Prior to this amendment, the conditions in PTE 75–1, Part II and V, clearly referred to a fiduciary with respect to a plan.

[6] The Department notes that the language quoted by the commenter appeared in the preamble to Part III of PTE 75–1, which is not the subject of this amendment.

Nevertheless, in the Department's view, an interpretation of the conditions of PTE 75–1, Part II and Part V, which focused on fiduciaries with respect to the plan assets involved in the transaction would not have created an undue risk of loss of plan assets. As the Department has concluded that the amendments are sufficiently protective of plan assets on a prospective basis, the Department believes a similar conclusion would dictate in favor of granting the amendments on a retroactive basis. Accordingly, the Department has determined to make these amendments to PTE 75–1 retroactive to January 1, 1975, which is the effective date of PTE 75–1.

The Department received three comments on the current utility of the Mutual Fund Exemption. Based on the information received, the Department believes that additional time is needed to more fully consider the issues raised by the commenters. However, the Department does not wish to unduly delay finalization of the other amendments to PTE 75–1. Accordingly, this document contains final amendments to Parts II and V of PTE 75–1 and adopts the repositioning of the Mutual Fund Exemption to paragraph (2) of PTE 75–1, Part II, and adopts the clarifying language. As a result, the Mutual Fund Exemption remains in effect pending further action by the Department.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption granted under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with subsection (a)(1)(B) of section 404 of the Act; nor does it affect

the requirement of section 401(a) of the Code that a plan must operate for the exclusive benefit of employees of the employer maintaining the plan and their beneficiaries;

(2) The Department finds that the amended exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan;

(3) The amended exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the exemption; and

(4) The amended exemption is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory and other exemptions and transitional rules. Furthermore, the fact that a transaction is the subject of an exemption is not dispositive of whether the transaction would have been a prohibited transaction in the absence of such exemption.

Amendment

Accordingly, PTE 75–1 is amended as follows under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).

I. PTE 75–1, Part II, is amended in its entirety to read as follows:

(1) The restrictions of section 406(a) of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code), by reason of section 4975(c)(1)(A) through (D) of the Code, shall not apply to any purchase or sale of a security between an employee benefit plan and a broker-dealer registered under the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*), a reporting dealer who makes primary markets in securities of the United States Government or of any agency of the United States Government (''Government securities'') and reports daily to the Federal Reserve Bank of New York its positions with respect to Government securities and borrowings thereon, or a bank supervised by the United States or a State, and

(2) The restrictions of section 406(a) and 406(b) of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (F) of the Code, shall not apply to the purchase or sale by a plan of securities issued by an open-end investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), provided that no fiduciary with respect to the plan who makes the decision on behalf of the plan to enter into the transaction is a principal underwriter for, or affiliated with, such investment company within the meaning of sections 2(a)(29) and 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(29) and 80a–2(a)(3)).

The exemptions set forth in (1) and (2) above are subject to the following conditions:

(a) In the case of such broker-dealer, it customarily purchases and sells securities for its own account in the ordinary course of its business as a broker-dealer.

(b) In the case of such reporting dealer or bank, it customarily purchases and sells Government securities for its own account in the ordinary course of its business and such purchase or sale between the plan and such reporting dealer or bank is a purchase or sale of Government securities.

(c) Such transaction is at least as favorable to the plan as an arm's length transaction with an unrelated party would be, and it was not, at the time of such transaction, a prohibited transaction within the meaning of section 503(b) of the Code.

(d) Except with respect to transactions described in section (2) above, neither the broker-dealer, reporting dealer, bank, nor any affiliate thereof has or exercises any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction, or renders investment advice (within the meaning of 29 CFR 2510.3–21(c)) with respect to those assets.

(e) The plan maintains or causes to be maintained for a period of six years from the date of such transaction such records as are necessary to enable the persons described in paragraph (f) of this exemption to determine whether the conditions of this exemption have been met, except that:

(1) Such broker-dealer, reporting dealer, or bank shall not be subject to the civil penalty which may be assessed under section 502(i) of the Act, or to the taxes imposed by section 4975(a) and (b) of the Code, if such records are not maintained, or are not available for examination as required by paragraph (f) below; and

(2) A prohibited transaction will not be deemed to have occurred if, due to circumstances beyond the control of the plan fiduciaries, such records are lost or destroyed prior to the end of such six-year period.

(f) Notwithstanding anything to the contrary in subsections (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (e) are unconditionally available for examination during normal business hours by duly authorized employees of (1) the Department of Labor, (2) the Internal Revenue Service, (3) plan participants and beneficiaries, (4) any employer of plan participants and beneficiaries, and (5) any employee organization any of whose members are covered by such plan. For purposes of this exemption, the terms ''broker-dealer,'' ''reporting dealer'' and ''bank'' shall include such persons and any affiliates thereof, and the term ''affiliate'' shall be defined in the same manner as that term is defined in 29 CFR 2510.3–21(e) and 26 CFR 54.4975–9(e).

II. PTE 75–1, Part V, is amended in its entirety to read as follows:

The restrictions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code), by reason of section 4975(c)(1) of the Code, shall not apply to any extension of credit to an employee benefit plan by a party in interest or a disqualified person with respect to the plan, provided that the following conditions are met:

(a) The party in interest or disqualified person:

(1) Is a broker or dealer registered under the Securities Exchange Act of 1934; and

(2) Does not have or exercise any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction, nor does it render investment advice (within the meaning of 29 CFR 2510.3–21(c)) with respect to those assets, unless no interest or other consideration is received by the party in interest or disqualified person or any affiliate thereof in connection with such extension of credit.

(b) Such extension of credit:

(1) Is in connection with the purchase or sale of securities;

(2) Is lawful under the Securities Exchange Act of 1934 and any rules and regulations promulgated thereunder; and

(3) Is not a prohibited transaction within the meaning of section 503(b) of the Code.

(c) The plan maintains or causes to be maintained for a period of six years from the date of such transaction such records as are necessary to enable the persons described in paragraph (d) of this exemption to determine whether

the conditions of this exemption have been met, except that:

(1) If such party in interest or disqualified person is not a fiduciary with respect to any assets of the plan, such party in interest or disqualified person shall not be subject to the civil penalty which may be assessed under section 502(i) of the Act, or to the taxes imposed by section 4975(a) and (b) of the Code, if such records are not maintained, or are not available for examination as required by paragraph (d) below; and

(2) A prohibited transaction will not be deemed to have occurred if, due to circumstances beyond the control of the plan fiduciaries, such records are lost or destroyed prior to the end of such six-year period.

(d) Notwithstanding anything to the contrary in subsections (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (c) are unconditionally available for examination during normal business hours by duly authorized employees of (1) the Department of Labor, (2) the Internal Revenue Service, (3) plan participants and beneficiaries, (4) any employer of plan participants and beneficiaries, and (5) any employee organization any of whose members are covered by such plan. For purposes of this exemption, the terms ''party in interest'' and ''disqualified person'' shall include such party in interest or disqualified person and any affiliates thereof, and the term ''affiliate'' shall be defined in the same manner as that term is defined in 29 CFR 2510.3–21(e) and 26 CFR 54.4975–9(e).

Signed at Washington DC, this 30th day of January, 2006.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Employee Benefits Security Administration, Department of Labor.

[FR Doc. E6–1484 Filed 2–2–06; 8:45 am]

BILLING CODE 4520–29–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Exemption Application D–11069]

Amendment to Prohibited Transaction Exemption 84–24 (PTE 84–24) For Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, Investment Companies and Investment Company Principal Underwriters

AGENCY: Employee Benefits Security Administration, U.S. Department of Labor.

ACTION: Adoption of Amendment to PTE 84–24.

SUMMARY: This document amends PTE 84–24, a class exemption that provides relief for certain transactions relating to the purchase, with plan assets, of investment company securities or insurance or annuity contracts, and the payment of associated sales commissions to insurance agents or brokers, pension consultants, or investment company principal underwriters that are parties in interest with respect to such plan. The amendment extends relief to purchase transactions involving insurance agents and brokers, pension consultants, and investment company principal underwriters whose affiliates exercise investment discretion over plan assets that are not involved in the transaction.

DATES: The amendment is effective February 3, 2006.

FOR FURTHER INFORMATION CONTACT: Christopher Motta, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, (202) 693–8540 (this is not a toll-free number).

SUPPLEMENTARY INFORMATION: On September 14, 2004, notice was published in the **Federal Register** (69 FR 55463) of the pendency before the Department of a proposed amendment to PTE 84–24 (49 FR 13208 (April 3, 1984) as corrected at 49 FR 24819 (June 15, 1984)). PTE 84–24 provides an exemption from the restrictions of section 406(a)(1)(A) through (D) and section 406(b) of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (F) of the Code.[1]

The amendment to PTE 84–24 was proposed by the Department on its own motion, pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).[2] The notice of pendency gave interested persons an opportunity to comment or to request a hearing on the proposed amendment. The Department received one comment on the proposed amendment. That comment, from the Investment Company Institute, supported the amendment as proposed. The Department did not receive a request for a public hearing.

For the sake of convenience, the entire text of PTE 84–24, as amended, has been reprinted in this notice.

Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

This amendment has been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. The Department has determined that this amendment is not a ''significant regulatory action'' under Executive Order 12866, section 3(f). Accordingly, it does not require an assessment of potential costs and benefits under section 6(a)(3) of that order.

[1] References to section 406 of ERISA as they appear throughout this amendment should be read to refer as well to the corresponding provisions of section 4975 of the Internal Revenue Code of 1986, as amended (the Code).

[2] Section 102 of the Reorganization Plan No. 4 of 1978 (5 U.S.C. App. at 214, 2000 ed.) generally transferred the authority of the Secretary of the Treasury to issue administrative exemptions under section 4975 of the Code to the Secretary of Labor.

Trust Examination Manual

Appendix E — Employee Benefit Law

Prohibited Transaction Class Exemption 77-3

Class Exemption Involving Mutual Fund In-House Plans Requested by the Investment Company Institute

April 8, 1977 (42 FR 18743)

Recap
Permits an employee benefit plan which covers only employees of a mutual fund, the fund's investment adviser, the principal underwriter, or an affiliate of such persons, to "acquire" or sell shares of a registered open-end investment company .

Class Exemption

Agency: Department of Labor, Labor-Management Services Administration

Action: Grant of Class Exemption

Effective Date: December 31, 1974

Exemption

Effective for transactions occurring after December 31, 1974, the restrictions of sections 406 and 407(a) of the Act and the taxes imposed by section 4975 (a) and (b) of the Code, by reason of section 4975(c)(1) of the Code, shall not apply to the acquisition or sale of shares of an open-end investment company registered under the Investment Company Act of 1940 by an employee benefit plan covering only employees of such investment company, employees of the investment adviser or principal underwriter for such investment company, or employees of any affiliated person (as defined in section 2(a)(3) of the Investment Company Act of 1940) of such investment adviser or principal underwriter, provided that the following conditions are met (whether or not such investment company, investment adviser, principal underwriter or any affiliated person thereof is a fiduciary with respect to the plan):

a. The plan does not pay any investment management, investment advisory or similar fee to such investment adviser, principal underwriter or affiliated person. This condition does not preclude the payment of investment advisory fees by the investment company under the terms of its investment advisory agreement adopted in accordance with section 15 of the Investment Company Act of 1940.

b. The plan does not pay a redemption fee in connection with the sale by the plan to the investment company of such shares unless (1) such redemption fee is paid only to the investment company, and (2) the existence of such redemption fee is disclosed in the investment company prospectus in effect both at the time of the acquisition of such shares and at the time of such sale.
c. In the case of transactions occurring more than 60 days after the granting of this exemption, the plan does not pay a sales commission in connection with such acquisition or sale.
d. All other dealings between the plan and the investment company, the investment adviser or principal underwriter for the investment company, or any affiliated person of such investment adviser or principal underwriter, are on a basis no less favorable to the plan than such dealings are with other shareholders of the investment company.

Signed at Washington, D.C., this 31st day of March, 1977.

J. Vernon Ballard,

Acting Administrator of Pension and Welfare Benefit Programs, Department of Labor.

and

William E. Williams,

Acting Commissioner of Internal Revenue

[FR Doc. 77-10157 Filed 4-1-77; 11:44 AM]

Prohibited Transaction Class Exemption 77-4

Investment in Advised or Affiliated Mutual Funds

March 31, 1977

Recap
Permits investment in mutual funds advised by or affiliated with a fiduciary if: (1) approved by a second, independent, fiduciary, (2) no front-end load is imposed, (3) redemption fees meet certain conditions, and (4) conditions on mutual fund fees are met.
Cross reference: See Advisory Opinion 93-13 regarding application of PTE 77-4 to purchase of affiliated mutual funds. Also see 1994 DOL letter to OCC regarding conversions of collective investment funds into mutual funds.

Class Exemption

To Invest in Mutual Funds Affiliated With or Advised By a Fiduciary

Agency: Department of Labor and Internal Revenue Service.

Action: Grant of class exemption.

Effective Date: Certain retroactive exemption is given for transactions between January 1, 1975 and ninety days after the exemption is granted. Prospective exemption is granted for transactions occurring ninety days after the exemption is granted. [Since the exemption was signed 3-31-77, the prospective exemption should be effective 7-1-77.]

Exemption

Section I - Retroactive.

The Retroactive portion of this Exemption covers transactions between 1-1-75 and 7-1-77. As such, it is not reprinted here.

Section II - Prospective. Effective 90 days after the date of granting of this exemption, the restrictions of section 406 of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1) of the Code, shall not apply to the purchase or sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to the plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan (hereinafter referred to as "fiduciary/investment adviser"), provided that the following conditions are met:

a. The plan does not pay a sales commission in connection with such purchase or sale.

b. The plan does not pay a redemption fee in connection with the sale by the plan to the investment company of such shares, unless:

    1. Such redemption fee is paid only to the investment company, and
    2. The existence of such redemption fee is disclosed in the investment company prospectus in effect both at the time of the purchase of such shares and at the time of such sale.

c. The plan does not pay an investment management, investment advisory, or similar fee with respect to the plan assets invested in such shares for the entire period of such investment.

    - This condition does not preclude the payment of investment advisory fees by the investment company under the terms of its investment advisory agreement adopted in accordance with section 15 of the Investment Company Act of 1940.

    - This condition also does not preclude the payment of an investment advisory fee by the plan based on total plan assets from which a credit has been subtracted representing the plan's pro rata share of investment advisory fees paid by the investment company.

    - If, during any fee period for which the plan prepaid its investment management, investment advisory or similar fee, the plan purchases shares of the investment company, the requirements of this paragraph (c) shall be deemed met with respect to such prepaid fee if, by a method reasonable designed to accomplish the same, the amount of the prepaid fee that constitutes the fee with respect to the plan assets invested in the investment company shares

        1. Is anticipated and subtracted from the prepaid fee at the time of payment of such fee,
        2. Is returned to the plan no later than during the immediately following fee period, or
        3. Is offset against the prepaid fee for the immediately following fee period or for the fee period immediately following thereafter.

        For purposes of this paragraph, a fee shall be deemed to be prepaid for any fee period if the amount of such fee is calculated as of a date not later than the first day of such period.

d. A second fiduciary with respect to the plan, who is independent of and unrelated to the fiduciary/investment adviser or any affiliate thereof, receives

    - A current prospectus issued by the investment company, and

    - Full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan and the investment company, including

        - The nature and extent of any differential between the rates of such fees,
        - The reasons why the fiduciary/investment adviser may consider such purchases to be appropriate for the plan, and
        - Whether there are any limitations on the fiduciary/investment adviser with respect to which plan assets may be invested in shares of the investment company and, if so, the nature of such limitations.

    For purposes of this exemption, such second fiduciary will not be deemed to be independent of and unrelated to the fiduciary/investment adviser or any affiliate thereof if:

    1. Such second fiduciary directly or indirectly controls, is controlled by, or under common control with the fiduciary/investment adviser or any affiliate thereof;
    2. Such second fiduciary or any officer, director, partner, employee or relative of such second fiduciary is an officer, director, partner, employee or relative of such fiduciary/investment adviser or any affiliate thereof; or
    3. Such second fiduciary directly or indirectly receives any compensation or other consideration for his or his own personal account in connection with any transaction described in this exemption.

    If an officer, director, partner, employee or relative of such fiduciary/investment adviser or any affiliate thereof is a director of such second fiduciary, and if he or she abstains from participation in

        i. The choice of the plan's investment adviser,

ii. The approval of any such purchase or sale between the plan and the investment company and
iii. The approval of any change of fees charged to or paid by the plan,

then paragraph (d)(2) of this section shall not apply.

For purposes of this exemption, the term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual, and the term "relative" means a "relative" as that term is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or a sister.

e. On the basis of the prospectus and disclosure referred to in paragraph (d), the second fiduciary referred to in paragraph (d) approves such purchases and sales consistent with the responsibilities, obligations, and duties imposed on fiduciaries by Part 4 of Title I of the Act. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plain and need not relate to any other aspects of such investments. In addition, such approval must be either

1. Set forth in the plan documents or in the investment management agreement between the plan and the fiduciary/investment adviser,
2. Indicated in writing prior to each purchase or sale, or
3. Indicated in writing prior to the commencement of a specified purchase or sale program in the shares of such investment company.

f. The second fiduciary referred to in paragraph (d), or any successor thereto, is notified of any change in any of the rates of fees referred to in paragraph (d) and approves in writing the continuation of such purchases or sales and the continued holding of any investment company shares acquired by the plan prior to such change and still held by the change. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan and need not relate to any other aspects of such investment.

Signed at Washington, D. C. this 31st day of March 1977.

J. Vernon Ballard,

Acting Administrator of Pension and Welfare Benefit Programs

Department of Labor.

William E. Williams

Acting Commissioner of Internal Revenue.

Prohibited Transaction Class Exemption 80-26

Interest-Free Loans (Including Overdrafts)

April 29, 1980 (45 FR 28545)

Recap
Interest-free loans. Permits interest-free loans (including overdrafts) between plans and parties in interest provided certain conditions are met.

Class Exemption for Certain Interest Free Loans to Employee Benefit Plans

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This class exemption permits parties in interest with respect to employee benefit plans to make interest free loans to such plans. Such loans would be prohibited by the Employee Retirement Income Security Act of 1974 (the Act) and the Internal Revenue Code of

1964 (the Code). The exemption affects all employee benefit plans, their participants and beneficiaries, and parties in interest with respect to those plans.

Effective Date: January 1, 1975.

Exemption

Effective January 1, 1975, the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(B) and (D) of the Code, shall not apply to the lending of money or other extension of credit from party in interest or disqualified person to an employee benefit plan, nor to the repayment of such loan or other extension of credit in accordance with its terms or written modifications thereof, if:

a. No interest or other fee is charged to the plan, and no discount for payment in cash is relinquished by the plan in connection with the loan or extension of credit;
b. The proceeds of the loan or extension of credit are used only:
    1. For the payment of ordinary operating expenses of the plan, including the payment of benefits in accordance with the terms of the plan and periodic premiums under an insurance or annuity contract; or
    2. For a period of not more than three days, for a purpose incidental to the ordinary operation of the plan;
c. The loan or extension of credit is unsecured; and
d. The loan or extension of credit is not directly or indirectly made by an employee benefit plan.

Prohibited Transaction Class Exemption 80-51

Collective Investment Funds

June 25, 1980 (45 FR 49709)

Recap
Collective Investment Funds. ERISA plans are permitted to invest in collective investment funds operated by bank fiduciaries, subject to certain limitations and conditions.

Class Exemption Covering Collective Investment Funds

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This exemption allows collective investment funds that are maintained by banks and in which employee benefit plans participate to engage in certain transactions provided that specified conditions are met. In the absence of this exemption, these transactions might be prohibited by the Employee Retirement Income Security Act of 1974 (the Act) and the Internal Revenue Code of 1954 (the Code).

Effective Date: January 1, 1975.

Exemption

Note: This exemption has been replaced by PTE 91-38.

Prohibited Transaction Class Exemption 80-83

Purchase of Securities Where Issuer May Use Proceeds To Reduce or Retire Indebtedness To Parties in Interest

November 4, 1980 (45 FR 73189)

Recap
Permits ERISA plans to invest in securities issued by plan sponsors, when proceeds are used to reduce debt at the fiduciary bank or its affiliates (even if fiduciary personnel know how proceeds will be used) subject to conditions: (1) Issuer has been in business for 3 or more years, or securities are not convertible and are rated in the highest 4 ratings by a nationally-recognized firm; (2) No more than 10% of the offering is subscribed to by the bank as fiduciary; (3) No more than 3% of the offering is subscribed to by an individual ERISA plan; (4) Consideration paid by the plan to acquire the securities does not exceed 3% of an ERISA plan's market value. Note: Covers discretionary, non-discretionary and custodial accounts.

Class Exemption for Certain Transactions Involving Purchase of Securities

Where Issuer May Use Proceeds To Reduce or Retire Indebtedness

To Parties in Interest

Agency: Department of Labor.

Action: Grant of Class Exemption.

Summary: This class exemption permits, under certain conditions, purchases of securities by employee benefit plans when the proceeds from the sale of such securities may be used by the issuer to reduce or retire indebtedness to persons who are parties in interest with respect to such plans. In the absence of the retroactive and prospective relief provided by this exemption, these transactions might be prohibited by the Employee Retirement Income Security Act of 1974 (the Act) and the Internal Revenue Code of 1954 (the Code).

Effective Date: Section I(B) of this exemption is effective December 1, 1980. The remainder of this exemption is effective January 1, 1975.

Exemption

I. Transactions

A. Effective January 1, 1975 the restrictions of section 406(a)(1)(A) through (D) of the Act and the taxes imposed by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the purchase or other acquisition prior to December 1, 1980 in a public offering (defined in Section II(B)) of securities by a fiduciary on behalf of an employee benefit plan solely because the proceeds from the sale were or were to be used by the issuer of the securities to retire or reduce indebtedness owed to a party in interest with respect to the plan other than the fiduciary, provided that the price paid by the plan for the securities does not exceed adequate consideration as defined in section 3(18) of the Act.

B. Subject to the conditions described in section II(A), effective December 1, 1980, the restrictions of section 406(a)(1)(A) through (D) of the Act and the taxes imposed by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the purchase or other acquisition in a public offering (defined in section II(B)) of securities by a fiduciary on behalf of an employee benefit plan solely because the proceeds from the sale may be used by the issuer of the securities to retire or reduce indebtedness owed to a party in interest of the plan other than the fiduciary.

C. Subject to the conditions described in section II(A), effective January 1, 1975, the restrictions of sections 406(a)(1)(A) through (D) and 406(b)(1) and (2) of the Act and the taxes imposed by reason of section 4975(c)(I)(A) through (E) of the Code shall not apply to the purchase or other acquisition in a public offering (defined in section II(B)) of securities by a fiduciary, which is a bank or an affiliate thereof, on behalf of an employee benefit plan solely because the proceeds from the sale may be used by the issuer of the securities to retire or reduce indebtedness owed to such fiduciary or any affiliate thereof provided that, if such fiduciary of the plan knows (as defined in paragraph (7) that the proceeds of this issue will be used in whole or in part by the issuer of the securities to reduce or retire

indebtedness owed to such fiduciary or affiliate thereof the transaction shall have complied with the conditions set forth in paragraph 1 through 6 below:

1. Such securities are purchased prior to the end of the first full business day after the securities have been offered to the public, except that -

    a. If such securities are offered for subscription upon exercise of rights, they may be purchased on or before the fourth day preceding the day on which the rights offering terminates; or
    b. If such securities are debt securities, they may be purchased on a day subsequent to the end of such first full business day, if the effective interest rates on comparable debt securities offered to the public subsequent to such first full business day and prior to the purchase are less than effective interest rate of the debt securities being purchased;

2. Such securities are offered by the issuer pursuant to an underwriting agreement under which the members of the underwriting syndicate are committed to purchase all of the securities being offered, except if the securities

    a. Are purchased by others pursuant to a rights offering, or
    b. Are offered pursuant to an over allotment option;

3. The issuer of such securities has been in continuous operation for not less than three years, including the operations of any predecessors, unless such securities are nonconvertible debt securities rated in one of the four highest rating categories by at least one nationally recognized statistical rating organization;
4. The amount of securities purchased or otherwise acquired on behalf of the plan by the fiduciary does not exceed three percent of the total amount of the securities being offered;
5. The consideration to be paid by any plan in purchasing or otherwise acquiring such securities does not exceed three percent of the fair market value, as of the most recent valuation date of the plan prior to such transaction of the plan assets which are subject to the management and control of such fiduciary;
6. The total amount of securities in any single offering purchased by the fiduciary of behalf of the plan together with the total amount of such securities purchased by such fiduciary acting as a fiduciary on behalf of any other employee benefit plan subject to Title I of the Act does not exceed 10 percent of the amount of the offering;
7. As used in this section I(C), a fiduciary will be deemed to know that the proceeds of an issuance of securities will be used in whole or in part by the issuer of the securities to reduce or retire indebtedness owned [owed] to such fiduciary or an affiliate thereof, if

    a. Such knowledge is actually communicated to, or
    b. Information reasonably sufficient to cause belief that the proceeds will be used in whole or in part by the issuer of the securities to reduce or retire indebtedness owned [owed] to the fiduciary, or an affiliate thereof, is possessed by, the officers or employees of the fiduciary, who are authorized to be involved in carrying out the investment responsibilities, obligations, or duties of the fiduciary, or who in fact are involved in carrying out such responsibilities, obligations, or duties, regarding the purchase or other acquisition.

D. Effective January 1, 1975, the restrictions of sections 406(a)(I)(A) through (D) and 406(b)(1) and (2) of the Act and the taxes imposed by reason of section 4975(c)(I)(A) through (E) of the Code shall not apply to the receipt by a party in interest of any of the proceeds resulting from the issuance, in a public offering (as defined in section II(B)), of securities merely because such proceeds are used by the issuer of the securities to retire or reduce indebtedness owed to the party in interest provided that, when such party in interest is a fiduciary acquiring such securities on behalf of a plan, such fiduciary is a bank or an affiliate thereof (as defined in section II(B)) which meets the provisions of section I(C) of this exemption.

II. General Conditions

A. The following conditions apply to the transactions described in section I(B) and (C) above:

1. The price paid by the plan fiduciary for the securities shall not be in excess of the offering price described in an effective registration statement under the Securities Act of 1933 covering such

securities or in the case of securities described in section II(B)(l)(b), in the offering circular required under applicable federal law;

2. (a) The fiduciary, on behalf of the plan, maintains for a period of six years from the date of the transaction the records necessary to enable the persons described in section II(A)(2)(b) below to determine whether the conditions of this exemption have been met, except that a prohibited transaction will not be deemed to have occurred if, due to circumstances beyond the control of the fiduciary, the records are lost or destroyed prior to the end of the six-year period;

   (b) Notwithstanding any provisions of subsections (a)(2) and (b) of section 504 of the Act, the records referred to in section II(A)(2)(a) above are unconditionally available at their customary location for examination during normal business hours by:

   i. Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service,
   ii. Any fiduciary of a plan who has authority to manage and control the assets of the plan, or to allocate to another fiduciary the authority to manage and control the assets of the plan, or any duly authorized employee or representative of such fiduciary,
   iii. Any contributing employer to the plan or representative of such employer,
   iv. Any participant or beneficiary of the plan or any duly-authorized employee or representative of such participant or beneficiary,
   v. None of the persons described in subparagraph (ii) through (iv) of this paragraph shall be authorized to examine any fiduciary's trade secrets or required to be kept commercial [sic] or financial information which is privileged or required to be kept confidential.

B. For the purposes of the exemptions contained in Part I,

1. The term "public offering" means -

   a. The offering of securities registered under the Securities Act of 1933 (Securities Act), or
   b. The offering of securities exempt from registration under the Securities Act which are -

      (i) Issued by a bank.

      (ii) Issued by a motor carrier if such issuance is subject to the provisions of section 214 of the Interstate Commerce Act, as amended,

      (iii) Exempt from the registration requirements of the Securities Act pursuant to a federal statute other than the Securities Act, or

      (iv) The subject of a distribution and of a class which is required to be registered under section 12 of the Securities Exchange Act of 1934 (15 USC 781), and the issuer of which has been subject to the reporting requirements of section 13 of that Act (15 USC 78m) for a period of at least 90 days immediately preceding the sale of securities and has filed all reports required to be filed thereunder with the Securities and Exchange Commission during the preceding 12 months.

2. An "affiliate" of a bank means any entity directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such bank.

   For the purposes of this paragraph, the term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

3. Each plan participating in a collective or commingled fund shall be considered to own the same proportionate undivided interest in each asset of the collective investment fund as its proportionate interest in the total assets of the collective investment fund as calculated on the most recent preceding valuation date of the fund.

Prohibited Transaction Class Exemption 81-6

Securities Lending

January 23, 1981 (46 FR 7527)

[Amended on May 19, 1987 (52 FR 18754)]

Recap
Securities Lending: Loans by plans to banks and broker-dealers. - The lending of securities by employee benefit plans to broker-dealers and banks who are parties in interest is permitted under this class exemption. In order for such loans to be exempt from ERISA's prohibited transaction provisions, neither the borrower nor an affiliate may have discretionary authority with respect to the investment of the plan assets involved in the transaction. A 1987 amendment, which expanded the exemption to government securities dealers, is included in the Amended Exemption.
Also See:
PTE 82-63 permits payment of compensation to a fiduciary for securities lending services.

Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This exemption will allow the lending of securities by employee benefit plans to banks and broker-dealers who are parties in interest with respect to such plans, if the conditions specified in the exemption are met. The exemption affects participants and beneficiaries of employee benefit plans, persons who manage the assets of such plans, and parties in interest who might engage in securities lending transactions with such plans. In the absence of this exemption, securities lending transactions between a plan and a party in interest would be prohibited by the Employee Retirement Income Security Act of 1974 (the Act) and the Internal Revenue Code of 1954 (the Code).

Effective Date: January 23, 1981. For purposes solely of Prohibited Transaction Exemption 79-23 (the Grumman Corp. Pension Trust, 44 FR 31750, June 1, 1979). The final disposition of this class exemption will be deemed to occur on February 23, 1981.

Amended Exemption

Effective January 23, 1981, the restrictions of section 406(a)(1)(A) through (D) of the Act and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the lending of securities that are assets of an employee benefit plan to a broker-dealer registered under the Securities Exchange Act of 1934 (the 1934 Act) or exempted from registration under section 15(a)(I) of the 1934 Act as a dealer in exempted Government securities (as defined in section 3(a)(12) of the 1934 Act) or to a bank, if:

1. Neither the borrower nor an affiliate of the borrower has discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to those assets;
2. The plan receives from the borrower (either by physical delivery or by, book entry in a securities depository) by the close of the lending fiduciary's business on the day in which the securities lent are delivered to the borrower, collateral consisting of cash, securities issued or guaranteed by the United States Government or its agencies, or irrevocable bank letters of credit issued by a person other than the borrower or an affiliate thereof, or any combination thereof, having, as of

the close of business on the preceding business day, a market value equal to not less than 100 percent of the market value of the securities lent;

3. Prior to the making of any such loan, the borrower shall have furnished the lending fiduciary with (1) the most recent available audited statement of the borrower's financial condition, (2) the most recent available unaudited statement of its financial condition (if more recent than such audited statement), and (3) a representation that, at the time the loan is negotiated, there has been no material adverse change in its financial condition since the date of the most recent financial statement furnished to the plan that has not been disclosed to the lending fiduciary. Such representation may be made by the borrower's agreeing that each such loan shall constitute a representation by the borrower that there has been no such material adverse change;
4. The loan is made pursuant to a written loan agreement, the terms of which are at least as favorable to the plan as an arm's length transaction with an unrelated party, would be. Such agreement may be in the form of a master agreement covering a series of securities lending transactions;
5. (a) The plan (1) receives a reasonable fee that is related to the value of the borrowed securities and the duration of the loan, or (2) has the opportunity to derive compensation through the investment of cash collateral. Where the plan has that opportunity, the plan may pay a loan rebate or similar fee to the borrower, if such fee is not greater than the plan would pay in a comparable transaction with an unrelated party;

   (b) The plan receives the equivalent of all distributions made to holders of the borrowed securities during the term of the loan, including, but not limited to, cash dividends, interest payments, shares of stock as a result of stock splits and rights to purchase additional securities;

6. If the market value of the collateral at the close of trading on a business day is less than 100 percent of the market value of the borrowed securities at the close of trading on that day, the borrower shall deliver, by the close of business on the following business day, an additional amount of collateral (as described in paragraph 2) the market value of which, together with the market value of all previously delivered collateral, equals at least 100 percent of the market value of all the borrowed securities as of such preceding day.

   Notwithstanding the foregoing, part of the collateral may be returned to the borrower if the market value of the collateral exceeds 100 percent of the market value of the borrowed securities, as long as the market value of the remaining collateral equals at least 100 percent of the market value of the borrowed securities;

7. The loan may be terminated by the plan at any time, whereupon the borrower shall deliver certificates for securities identical to the borrowed securities (or the equivalent thereof in the event of reorganization, recapitalization or merger of the issuer of the borrowed securities) to the plan within (1) the customary delivery period for such securities, (2) five business days, or (3) the time negotiated for such delivery by the plan and the borrower, whichever is lesser; and
8. In the event the loan is terminated, and the borrower fails to return the borrowed securities or the equivalent thereof within the time described in paragraph 7 above, (i) the plan may, under the terms of the loan agreement, purchase securities, identical to the borrowed securities (or their equivalent as described above) and may apply, the collateral to the payment of the purchase price, any other obligations of the borrower under the agreement, and any expenses associated with the sale and/or purchase, and (ii) the borrower is obligated, under the terms of the loan agreement, to pay, and does pay to the plan the amount of any remaining obligations and expenses not covered by the collateral plus interest at a reasonable rate.

   Notwithstanding the foregoing, the borrower may, in the event the borrower fails to return borrowed securities as described above, replace non-cash collateral with an amount of cash not less than the then current market value of the collateral, provided such replacement is approved by the lending fiduciary.

   If the borrower fails to comply with any condition of this exemption in the course of engaging in a securities lending transaction, the plan fiduciary who caused the plan to engage in such transaction shall not be deemed to have caused the plan to engage in a transaction prohibited by section 406(a)(1)(A) through (D) of the Act solely by reason of the borrower's failure to comply with the conditions of the exemption.

   For purposes of this class exemption the term "affiliate" of another person shall

include:

i. Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such other person;
ii. Any officer, director, or partner, employee or relative (as defined in section 3(15) of the Act) of such other person; and
iii. Any corporation or partnership of which such other person is an officer, director or partner.

For purposes of this definition the term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

Prohibited Transaction Class Exemption 81-8

Short-term Investments & Repurchase Agreements

January 23, 1981 (46 FR 7511)

[Amended on April 9, 1985 (50 FR 14043)]

Recap
Employee benefit plans: Short-term investments. Employee benefit plans are permitted to engage in transactions involving certain short-term investments, notwithstanding the prohibited transaction provisions of ERISA. The class exemption allows four types of short-term investments: banker's acceptances, commercial paper, repurchase agreements, and certificates of deposit.

Class Exemption Covering Certain Short-Term Investments

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This exemption permits employee benefit plans to engage in transactions involving certain short-term investments notwithstanding the prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA or the Act). The exemption will affect participants and beneficiaries of employee benefit plans, persons who manage the assets of such plans, and other persons who provide services to such plans.

Effective Date: January 1, 1975. (Certain conditions to the availability of the exemption are effective April 23, 1981).

AmendedExemption

Effective January 1, 1975, the restrictions of sections 408(a)(1)(A) (B) and (D) of the Act, and the taxes imposed by reason of section 4975(c)(1)(A), (B) and (D) of the Code shall not apply to an investment of employee benefit plan assets which involves the purchase or other acquisition, holding, sale, exchange or redemption by or on behalf of an employee benefit plan of the following:

I. Banker's Acceptances. A banker's acceptance that is issued by a bank if:

A. The banker's acceptance has a stated maturity date of one year or less from date of issue or has a maturity date of one year or less from the date of purchase on behalf of the plan;
B. Neither the bank nor any affiliate of the bank has discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to those assets;
C. The terms of the transaction are at least as favorable to the plan as those of an arm's length transaction with an unrelated party would be; and,
D. With respect to transactions occurring on or after April 23, 1981 the bank issuing the banker's acceptance is supervised by the United States or a State.

II. Commercial Paper. Commercial paper if:

A. It is not issued by an employer any of whose employees are covered by the plan or by an affiliate of such employer;
B. It has a stated maturity date of nine months or less from the date of issue, exclusive of days of grace, or is a renewal of an issue of commercial paper the maturity of which is likewise limited;
C. Neither the issuer of the commercial paper, any guarantor of the commercial paper, nor an affiliate of such issuer or guarantor, has discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to those assets;
D. With respect to an acquisition or holding of commercial paper (including an acquisition by exchange) occurring on or after April 23, 1981, at the time it is acquired, the commercial paper is ranked in one of the three highest rating categories by at least one nationally recognized statistical rating services.

III. Repurchase Agreement.

A repurchase agreement (or securities or other instruments under cover of a repurchase agreement) in which the seller of the underlying securities or other instruments is a bank which is supervised by the United States or a State; a broker-dealer registered under the Securities Exchange Act of 1934; or a dealer who makes primary markets in securities of the United States government or any agency thereof or in bankers acceptances and reports daily to the Federal Reserve Bank of New York its position with respect to these obligations, if each of the following conditions are satisfied.

A. The repurchase agreement is embodied in, or is entered into pursuant to a written agreement the terms of which are at least as favorable to the plan as an arm's length transaction with an unrelated party would be. For transactions occurring before April 23, 1981 a written confirmation of a repurchase agreement whose terms were at least as favorable to the plan as an arm's length transaction with an unrelated party would have been will be deemed to satisfy this condition.
B. The plan receives interest at a rate no less than that which it would receive in a comparable transaction with an unrelated party.
C. The repurchase agreement has a duration of one year or less.
D. The plan receives securities, banker's acceptances, commercial paper, or certificates of deposit having a market value equal to not less than 100 percent of the purchase price paid by the plan.
E. Upon expiration of the repurchase agreement and return of the securities or other instruments to the bank, broker-dealer or dealer (seller), the seller transfers to the plan an amount equal to the purchase price plus the appropriate interest.
F. Neither the seller nor an affiliate of the seller has discretionary authority or control with respect to the investment of the plan assets involved in the transaction or render investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to those assets.
G. The securities, banker's acceptances, commercial paper or certificates of deposit received by the plan:

    1. Could be acquired directly by the plan in a transaction not covered by this section III without violating sections 406(a)(1)(E), 406(a)(2) or 407(a) of the Act; and,
    2. If the securities are subject to the provisions of the Securities Act of 1933, they are obligations that are not "restricted securities" within the meaning of Rule 144 under that act.

H. With respect to transactions occurring on or after April 23, 1981:

    1. If the market value of the underlying securities or other instruments falls below the purchase price at any time during the term of the agreement, the plan may, under the written agreement required by paragraph A of this section, require the seller to deliver, by the close of business on the following business day, additional securities or other instruments the market value of which, together with the market value of securities previously delivered or sold to the plan under the repurchase agreement, equals at least 100 percent of the purchase price paid by the plan;
    2. If the seller does not deliver additional securities or other instruments as required above, the plan may terminate the agreement, and, if upon termination or expiration of the agreement, the amount owing is not paid to the plan, the plan may sell the securities or other instruments and apply the proceeds against the obligations of the seller under the agreement, and against any expenses associated with the sale; and,
    3. The seller agrees to furnish the plan with the most recent available audited statement of its financial condition as well as its most recent available unaudited statement, agrees to furnish additional audited and unaudited statements of its financial condition as they are issued and either:

A. Agrees that each repurchase agreement transaction pursuant to the agreement shall constitute a representation by the seller that there has been no material adverse change in its financial condition since the date of the last statement furnished that has not been disclosed to the plan fiduciary with whom such written agreement is made; or
B. Prior to each repurchase agreement transaction, the seller represents that, as of the time the transaction is negotiated, there has been no material adverse change in its financial condition since the date of the last statement furnished that has not been disclosed to the plan fiduciary with whom such written agreement is made.

4. In the event of termination and sale as described in (2) above, the seller pays to the plan the amount of any remaining obligations and expenses not covered by the sale of the securities or other instruments, plus interest at a reasonable rate.

If a seller involved in a repurchase agreement covered by this exemption fails to comply with any condition of this exemption in the course of engaging in the repurchase agreement, the plan fiduciary who caused the plan to engage in such repurchase agreement shall not be deemed to have caused the plan to engage in a transaction prohibited by section 406(a)(1)(A) through (D) of the Act solely by reason of the seller's failure to comply with the conditions of the exemption.

IV. Certificates of Deposit.

A certificate of deposit that is issued by a bank which is supervised by the United States or a State if neither the bank nor any affiliate of the bank has discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to those assets.

For purposes of this exemption the term affiliate is defined in 29 C.F.R. 2510.3-21(e).

V. Securities of Banks.

A security issued by a bank or an affiliate of the bank if:

A. The bank is supervised by the United States or a State;
B. The bank is a party in interest or disqualified person with respect to the plan solely by reason of the furnishing of checking account or related services to the plan
C. The terms of the transaction are at least as favorable to the plan as those of an arm's-length transaction with an unrelated party would be; and
D. The investment is not part of an arrangement under which the bank causes a transaction to be made with or for the benefit of a party in interest or disqualified person.

Prohibited Transaction Class Exemption 82-63

Securities Lending Compensation

April 6, 1982 (47 FR 14804)

Recap
Payment of compensation to a fiduciary for securities lending services. This class exemption allows certain compensation arrangements to be made for the provision by a fiduciary of securities lending services to an employee benefit plan, if the conditions specified in the exemption are met.
See Also:
PTE 81-6 permits plans to engage in securities lending with banks, broker-dealers, and government securities dealers.

Class Exemption to Permit Payment of Compensation to Plan Fiduciaries

for the Provision of Securities Lending Services

Agency: Office of Pension and Welfare Benefit Programs, Labor.

Action: Grant of class exemption.

Summary: This exemption will allow certain compensation arrangements to be made for the provision by a fiduciary of securities lending services to an employee benefit plan, if the conditions specified in the exemption are met. The exemption affects participants and beneficiaries of employee benefit plans and fiduciaries who provide securities lending services to such plans. In the absence of this exemption, certain compensation arrangements for the provision of securities lending services by a plan fiduciary to an employee benefit plan would be subject to the prohibitions of section 406(b)(1) of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1954 (the Code) by reason of section 4975(c)(1)(E) of the Code.

Effective Date: April 6, 1982.

The Explanatory Preamble, together with the full Exemption, are available in the PREAMBLE document.

Exemption

I. Transactions

Effective April 6, 1982, the restrictions of section 406(b)(1) of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1954 (the Code) by reason of section 4975(c)(1)(E) of the Code shall not apply to the payment to a fiduciary (the "lending fiduciary") of compensation for services rendered in connection with loans of plan assets that are securities, provided that:

a. The loan of securities is not prohibited by section 406(a) of the Act;
b. The lending fiduciary is authorized to engage in securities lending transactions on behalf of the plan;
c. The compensation is reasonable and is paid in accordance with the terms of a written instrument, which may be in the form of a master agreement covering a series of securities lending transactions;
d. Except as otherwise provided in paragraph (f), the arrangement under which the compensation is paid (1) is subject to the prior written authorization of a plan fiduciary (the "authorizing fiduciary"), who is (other than in the case of a plan covering only employees of the lending fiduciary or affiliates of such fiduciary) independent of the lending fiduciary and of any affiliate thereof, and (2) may be terminated by the authorizing fiduciary within (i) the time negotiated for such notice of termination by the plan and the lending fiduciary, or (ii) five business days, whichever is lesser, in either case without penalty to the plan;
e. No such authorization is made or renewed unless the lending fiduciary shall have furnished the authorizing fiduciary with any reasonably available information which the lending fiduciary reasonably believes to be necessary to determine whether such authorization should be made or renewed, and any other reasonably available information regarding the matter that the authorizing fiduciary may reasonably request; and
f. (Special Rule for Commingled Investment Funds) In the case of a pooled separate account maintained by an insurance company qualified to do business in a state or, a common or collective trust fund maintained by a bank or trust company supervised by a state or federal agency, the requirements of paragraph (d) of this exemption shall not apply: Provided, that -

1. The information described in paragraph (e) (including information with respect to any material change in the arrangement) shall be furnished by the lending fiduciary to the authorizing fiduciary described in paragraph (d) with respect to each plan whose assets are invested in the account or fund, not less than 30 days prior to implementation of the arrangement or material change thereto, and, where requested, upon the reasonable request of the authorizing fiduciary;
2. In the event any such authorizing fiduciary submits a notice in writing to the lending fiduciary objecting to the implementation of, material change in, or continuation of the arrangement, the plan on whose behalf the objection was tendered is given the opportunity to terminate its

investment in the account or fund, without penalty to the plan, within such time as may he necessary to effect such withdrawal in an orderly manner that is equitable to all withdrawing plans and to the nonwithdrawing plans. In the case of a plan that elects to withdraw pursuant to the foregoing, such withdrawal shall be effected prior to the implementation of, or material change in, the arrangement, but an existing arrangement need not be discontinued by reason of a plan electing to withdraw; and

3. In the case of a plan whose assets are proposed to be invested in the account or fund subsequent to the implementation of the compensation arrangement and which has not authorized the arrangement in the manner described in paragraphs (f)(1) and (f)(2), the plan's investment in the account or fund shall be authorized in the manner described in paragraph (d)(1).

Definitions

For purposes of this exemption, the term, "affiliate" of another person means:

1. Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such other person;
2. Any officer, director, partner, employee, relative (as defined in section 3(15) of the Act) of such other person, and
3. Any corporation or partnership of which such other person is an officer, director or partner.

For purposes of this paragraph, the term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

Prohibited Transaction Class Exemption 82-87

Residential Mortgage Loans

May 18, 1982 (47 FR 21331)

Recap
Residential Mortgages. ERISA plans are permitted to invest in 1-to-4 family mortgages and mortgage participations, collect origination fees, and use affiliates to service the mortgages, subject to certain limitations and conditions. The PTE covers first and second liens on homes, townhouses, condominiums, cooperative apartments, and "manufactured housing". Rental housing is not covered.

Class Exemption for Transactions Involving

Certain Residential Mortgage Financing Arrangements

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This document contains a final exemption from certain of the prohibited transactions provisions of the Employee Retirement Security Income Act of 1974 (the Act) and the Internal Revenue Code of 1954 (the Code). The exemption involves the issuance of commitments for the provision of mortgage financing to purchasers of residential dwelling units, the receipt of a fee in exchange for the issuance of such commitment, the making or purchase of loans or participation interests therein pursuant to such commitments, and the direct making, purchase, sale, exchange or transfer of mortgage loans or participation interests therein by employee benefit plans, if the conditions specified in the exemption are met. The exemption affects participants and beneficiaries of employee benefit plans involved in such transactions, certain employers who contribute to such plans and other persons who engage in the described transactions. In the absence of this exemption, certain purchase and sale transactions between the plan and parties in interest and certain extensions of credit transactions between the plan and other parties in interest would be prohibited by the Act and the Code.

Effective Date: January 1, 1975. [Certain conditions, as specified herein, are applicable effective June 17, 1982.]

Exemption

I. Transactions

Accordingly, the following exemption is hereby granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedure set forth in ERISA Procedure 75-1.

Effective January 1, 1975, the restrictions of section 406(a) of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1954 (Code) by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the following transactions if the conditions set forth in Part II below are met:

A. The issuance of a commitment by one or more employee benefit plans to provide mortgage financing to purchasers of residential dwelling units, either by making or participating in loans directly to purchasers or by purchasing mortgage loans or participation interests in mortgage loans originated by a third party;
B. The receipt by the plan of a fee in exchange for issuing such commitment;
C. The actual making or purchase of a mortgage loan or participation interest therein pursuant to such commitment;
D. The direct making or purchase by one or more employee benefit plans of a mortgage loan or a participation interest therein other than where a commitment has been issued; and
E. The sale, exchange or transfer of a mortgage loan or participation interest therein by an employee benefit plan prior to the maturity date of such instrument whether or not acquired pursuant to this exemption, provided that the ownership interest sold, exchanged or transferred represents the plan's entire interest in such investment.

II. Conditions

A. Effective January 1, 1975, the exemption provided for transactions described in Part I is available only if each of the following conditions, as applicable, is met:

    1. General Conditions

        a. Any mortgage loan to be acquired must be a "recognized mortgage loan" (as defined in Section D of Part III) or a participation interest in such loan for the purchase of a "residential dwelling unit" (as defined in Section E of Part III)
        b. Any mortgage loan must be originated (either directly for the plan or by the origination-purchase process) by an "established mortgage lender" (as defined in Section B of Part III) -

            i. Who qualifies the recipient, and
            ii. As to which neither the plan, nor an employer or group of employers contributing to the plan, nor an employee organization any of whose members are covered by the plan, has the power to exercise a controlling influence over the management or policies of such "established mortgage lender";

        c. The price paid or received by the plan must be at least as favorable to the plan as a similar transaction involving unrelated parties; and
        d. No person who is a developer or a builder involved in the development or construction of the units, or a lender who is associated with the construction financing arrangement for the units, or who, at the time the decision to purchase is made by the plan (whether directly or pursuant to a commitment) is the owner of a mortgage or a participation interest therein which is subsequently sold to the plan, shall have exercised any discretionary authority or control or rendered any investment advice that would make that person a fiduciary with respect to the plan's decision to purchase, or to commit to purchase, a mortgage loan or a participation interest therein or setting the terms thereof.

    2. Specific Conditions Applicable to Commitments. Where the decision by the plan involves a commitment to purchase either a mortgage loan or participation interest therein:

        a. The commitment must be in writing and must be at least as favorable to the plan as a commitment involving unrelated parties and consistent with customary practices

in the residential finance industry; and

b. The commitment must provide for the use of underwriting guidelines and mortgage instruments which will ensure that all mortgage loans originated pursuant to such commitment will result in a "recognized mortgage loan";

3. Specific Conditions Applicable to Participations Where the acquisition by the plan involves a participation interest in a mortgage loan(s) (whether directly or pursuant to a commitment):

   a. the participation agreement governing such transaction must provide that:

      i. The rights and interests evidenced by such participation interest not be subordinated to the rights and interests of other holders of the same participation agreement,
      ii. The majority interest in the participation agreement must be owned by parties independent of and not controlled by the person selling the participation interest and servicing the underlying mortgage(s), and
      iii. In the event of an inability to obtain collections on any mortgage loan(s) underlying the participation agreement, decisions regarding foreclosure options must be directed by persons other than the seller/service; and

   b. Such participation agreement must be in writing and must be at least as favorable to the plan as a participation agreement involving unrelated parties and consistent with customary practices in the residential finance industry.

B. Effective 30 days after date of publication of this notice in the Federal Register the exemption provided for transactions described in Part I is available only if each of the following conditions is satisfied in addition to each of the applicable conditions described in Section A of this Part II:

   1. The decision to purchase or sell the mortgage loan or participation interest therein, or to issue a commitment to do so, must be made on behalf of the plan by a "qualified real estate manager" (as defined in Section C of Part III) as to which neither the plan, nor an employer or group of employers contributing to the plan, nor an employee organization any of whose members are covered by the plan, has the power to exercise a controlling influence over the management or policies of such "qualified real estate manager."
   2. (a) The plan shall maintain for the duration of any loan made pursuant to this exemption records necessary to enable the persons described in paragraph (b) of this subsection to determine whether the conditions of this exemption have been met, except that,

      i. A prohibited transaction will not be deemed to have occurred, if due to circumstances beyond the control of the fiduciaries of the plan, records are lost or destroyed prior to the termination of the loan and,
      ii. No party in interest shall be subject to the civil penalty which may be assessed under section 502(i) of ERISA, or to the taxes imposed by section 4975(a) and (b) of the Code, if the records are not maintained or are not available for examination as required by sub-paragraph (b) below.

   b. Notwithstanding any provisions of subsection (a)(2) and (b) of section 504 of the Act, the records referred to in sub-paragraph (a) of this paragraph must be unconditionally available at their customary location for examination during normal business hours by: any trustee, investment manager, participant or beneficiary of the plan, or any duly authorized employee or representative of such person or of the Department or the Internal Revenue Service.

III. Definitions.

For purposes of this exemption:

A. References to persons described in this exemption includes their affiliates. An *affiliate* is defined as:

   1. Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person;

2. Any officer, director, partner, employee or relative (as defined in section 3(15) of the Act) of such person; and
3. Any corporation or partnership of which such person is an officer, director or partner.

B. An "*established mortgage lender*" means an organized business enterprise which has as one of its principal purposes in the normal course of business the origination of loans secured by real estate mortgages or deeds of trust and which has satisfied the qualification requirements of one of the following categories:

1. Approval by the Secretary of the Department of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act;
2. Approval by the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation as a qualified Seller/Servicer; or
3. A State agency or independent State authority empowered by State law to raise capital to provide financing for residential dwelling units.

C. A "*qualified real estate manager*" means a fiduciary as defined in section 3(21) of the Act who:

1. Is a financial institution or business organization, which in the normal course of business advises institutional investors regarding investments similar to those in which the plan desires to engage and which are described in Part I of this exemption; and
2. Acknowledges in writing to the plan that it will make decisions regarding plan investments in mortgage loans or participation interests therein in its capacity as a fiduciary of such plan.

D. A "*recognized mortgage loan*" is any mortgage loan on a "residential dwelling unit" which, at the time of its origination, was eligible, through an established program, for purchase by the Federal National Mortgage Association, the Government National Mortgage Association or the Federal Home Loan Mortgage Corporation;
E. A "*residential dwelling unit*" or "*unit*" means:

1. Owner occupied non-farm property comprising one to four dwelling units, including detached houses, townhouses, manufactured housing, condominiums, units in a housing cooperative, or a unit in a multi unit subdivision (planned unit development) restricted by recorded documents which limit the use of the unit to residential purposes and provide for maintenance of common facilities; or
2. Certain non-owner occupied units where such unit complies with the uniform underwriting standards required for investor loans to qualify as a "recognized mortgage loan" under this exemption.

Signed at Washington, D.C. this 13th day of May 1982.

Prohibited Transaction Class Exemption 84-14

Qualified Professional Asset Managers (QPAMs)

March 13, 1984 (49 FR 9494)

[Amended on October 10, 1985 (50 FR 41430)]

Summary

Permits various parties who are related to employee benefit plans to engage in transactions involving plan assets if, among other conditions, the assets are managed by "qualified professional asset managers" (QPAMs), who are independent of the parties in interest and meet specified financial standards.

Additional exemptive relief is provided for: (1) employers to furnish limited amounts of goods and services in the ordinary course of business, and (2) leases of office or commercial space between managed funds and QPAMs or contributing employers.

Includes 1985 Amendment which clarified the term "Affiliate".

Class Exemption 84-14

for Plan Asset Transactions Determined by

Independent Qualified Professional Asset Managers

Agency: Department of Labor

Action: Grant of Class Exemption.

Summary: This document contains a final exemption from certain prohibited transactions restrictions of the Employee Retirement Income Security Act of 1974 (ERISA) and from certain taxes imposed by the Internal Revenue Code of 1954 (the Code). The exemption permits various parties who are related to employee benefit plans to engage in transactions involving plan assets if, among other conditions, the assets are managed by persons, defined for purposes of this exemption as "qualified professional asset managers" (QPAMs), which are independent of the parties in interest and which meet specified financial standards. Additional exemptive relief is provided for employers to furnish limited amounts of goods and services in the ordinary course of business. Limited relief is also provided for leases of office or commercial space between managed funds and QPAMs or contributing employers. The exemption will affect participants and beneficiaries of employee benefit plans, the sponsoring employers of such plans, QPAMs and other persons engaging in the described transactions.

Effective Date: December 21, 1982.

The Explanatory Preamble for the **original** PTE 84-14, together with the full Amended Exemption, are available in the PREAMBLE document. The Preamble for the Amendment appears in the PREAMBLE documents, immediately following the Amended Exemption.

Amended Exemption

Part I. *General Exemption*. Effective December 21, 1982, the restrictions of ERISA section 406(a)(1)(A) through (D) and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(I)(A) through (D), shall not apply to a transaction between a party in interest with respect to an employee benefit plan and an investment fund (as defined in section V(b)) in which the plan has an interest, and which is managed by a qualified professional asset manager (QPAM) (as defined in section V(a)), if the following conditions are satisfied:

a. At the time of the transaction (as defined in section V(i)) the party in interest, or its affiliate (as defined in section V(c)), does not have, and during the immediately preceding one year has not exercised, the authority to -

    1. Appoint or terminate the QPAM as a manager of any of the plan's assets or
    2. Negotiate the terms of the management agreement with the QPAM (including renewals or modifications thereof) on behalf of the plan;

b. The transaction is not described in -

    1. Prohibited Transaction Exemption 81-6 (46 FR 7527; January 23, 1981) (relating to securities lending arrangements),
    2. Prohibited Transaction Exemption 83-1 (28 FR 895; January 7, 1983) (relating to acquisitions by plans of interests in mortgage pools), or
    3. Prohibited Transaction Exemption 82-87 (47 FR 21331; May 18,1982) (relating to certain mortgage financing arrangements);

c. The terms of the transaction are negotiated on behalf of the investment fund by, or under the authority and general direction of, the QPAM, and either the QPAM, or (so long as the QPAM retains full fiduciary responsibility with respect to the transaction) a property manager acting in accordance with written guidelines established and administered by the QPAM, makes the decision on behalf of the investment fund to enter into the transaction, provided that the transaction is not part of an agreement, arrangement or understanding designed to benefit a party in interest;
d. The party in interest dealing with the investment fund is neither the QPAM nor a person related to the QPAM (within the meaning of section V(h));
e. The transaction is not entered into with a party in interest with respect to any plan whose assets

managed by the QPAM, when combined with the assets of other plans established or maintained by the same employer (or affiliate thereof described in section V(c)(1) of this exemption) or by the same employee organization, and managed by the QPAM, represent more than 20 percent of the total client assets managed by the QPAM at the time of the transaction;

f. At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the QPAM, the terms of the transaction are at least as favorable to the investment fund as the terms generally available in arm's length transactions between unrelated parties;
g. Neither the QPAM nor any affiliate thereof (as defined in section V(d)), nor any owner, direct or indirect, of a 5 percent or more interest in the QPAM is a person who within the 10 years immediately preceding the transaction has been either convicted or released from imprisonment, whichever is later, as a result of any felony involving abuse or misuse of such person's employee benefit plan position or employment, or position or employment with a labor organization; any felony arising out of the conduct of the business of a broker, dealer, investment adviser, bank, insurance company or fiduciary; income tax evasion; any felony involving the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; conspiracy or attempt to commit any such crimes or a crime in which any of the foregoing crimes is an element; or any other crime described in section 411 of ERISA. For purposes of this section (g), a person shall be deemed to have been "convicted" from the date of the judgment of the trial court, regardless of whether that judgment remains under appeal.

Part II. *Specific Exemptions for Employers*. Effective December 21, 1982, the restrictions of sections 406(a), 406(b)(1) and 407(a) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code, by reason of Code section 4975(e)(1)(A) through (E), shall not apply to:

a. The sale, leasing, or servicing of goods (as defined in section V(j)), or to the furnishing of services, to an investment fund managed by a QPAM by a party in interest with respect to a plan having an interest in the fund, if -

    1. The party in interest is an employer any of whose employees are covered by the plan or is a person who is a party in interest by virtue of a relationship to such an employer described in section V(c),
    2. The transaction is necessary for the administration or management of the investment fund,
    3. The transaction takes place in the ordinary course of a business engaged in by the party in interest with the general public,
    4. Effective for taxable years of the party in interest furnishing goods and services after the date this exemption is granted, the amount attributable in any taxable year of the party in interest to transactions engaged in with an investment fund pursuant to section II(a) of this exemption does not exceed one (1) percent of the gross receipts derived from all sources for the prior taxable year of the party in interest, and
    5. The requirements of sections I(c) through (g) are satisfied with respect to the transaction;

b. The leasing of office or commercial space by an investment fund managed by a QPAM to a party in interest with respect to a plan having an interest in the investment fund, if -

    1. The party in interest is an employer any of whose employees are covered by the plan or is a person who is a party in interest by virtue of a relationship to such an employer described in section V(c),
    2. No commission or other fee is paid by the investment fund to the QPAM or to the employer, or to an affiliate of the QPAM or employer (as defined in section V(c)), in connection with the transaction,
    3. Any unit of space leased to the party in interest by the investment fund is suitable (or adaptable without excessive cost) for use by different tenants,
    4. The amount of space covered by the lease does not exceed fifteen (15) percent of the rentable space of the office building, integrated office park, or of the commercial center (if the lease does not pertain to office space),
    5. In the case of a plan that is not an eligible individual account plan (as defined in section 407(d)(3) of ERISA), immediately after the transaction is entered into, the aggregate fair market value of employer real property and employer securities held by investment funds of the QPAM in which the plan has an interest does not exceed 10 percent of the fair market value of the assets of the plan held in those investment funds. In determining the aggregate fair market value of employer real property and employer securities as described herein, a plan shall be considered to own the same proportionate undivided interest in each asset of the investment fund or funds as its

proportionate interest in the total assets of the investment fund(s). For purposes of this requirement, the term "employer real property" means real property leased to, and the term "employer securities" means securities issued by, an employer any of whose employees are covered by the plan or a party in interest of the plan by reason of a relationship to the employer described in subparagraphs (E) or (G) of ERISA section 3(14), and

6. The requirements of sections I(c) through (g) are satisfied with respect to the transaction.

Part III. *Specific Lease Exemption for QPAMs*. Effective December 21, 1982, the restrictions of section 406(a)(1)(A) through (D) and 406(b)(1) and (2) of ERISA and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the leasing of office or commercial space by an investment fund managed by a QPAM to the QPAM, a person who is a party in interest of a plan by virtue of a relationship to such QPAM described in subparagraphs (G), (H), or (I) of ERISA section 3(14) or a person not eligible for the General Exemption of Part I by reason of section I(a), if -

a. The amount of space covered by the lease does not exceed the greater of 7500 square feet or one (1) percent of the rentable space of the office building, integrated office park or of the commercial center in which the investment fund has the investment,
b. The unit of space subject to the lease is suitable (or adaptable without excessive cost) for use by different tenants,
c. At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the QPAM, the terms of the transaction are not more favorable to the lessee than the terms generally available in arm's length transactions between unrelated parties, and
d. No commission or other fee is paid by the investment fund to the QPAM, any person possessing the disqualifying, powers described in section I(a), or any affiliate of such persons (as defined in section V(c)), in connection with the transaction.

Part IV. *Transactions Involving Places of Public Accommodation*. Effective December 21, 1982, the restrictions of section 406(a)(1)(A) through (D) and 406(b)(1) and (2) of ERISA and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the furnishing of services and facilities (and goods incidental thereto) by a place of public accommodation owned by an investment fund managed by a QPAM to a party in interest with respect to a plan having an interest in the investment fund, if the services and facilities (and incidental goods) are furnished on a comparable basis to the general public.

Part V. *Definitions and General Rules.* For the purposes of this exemption:

a. The term "qualified professional asset manager" or "QPAM" means -

    1. A bank, as described in section 202(a)(2) of the Investment Advisers Act of 1940 that has the power to manage, acquire or dispose of assets of a plan, which bank has, as of the last day of its most recent fiscal year, equity capital (as defined in section V(k)) in excess of $1,000,000, or
    2. A savings and loan association, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, that has made application for and been granted trust powers to manage, acquire or dispose of assets of a plan by a State or Federal authority having supervision over savings and loan associations, which savings and loan association has, as of the last day of its most recent fiscal year, equity capital (as defined in section V(k)) or net worth (as defined in section V(l)) in excess of $1,000,000, or
    3. An insurance company which is qualified under the laws of more than one State to manage, acquire, or dispose of any assets of a plan, which company has, as of the last day of its most recent fiscal year, net worth (as defined in section V(l)) in excess of $1,000,000 and which is subject to supervision and examination by a State authority having supervision over insurance companies, or
    4. An investment adviser registered under the Investment Advisers Act of 1940 that has, as of the last day of its most recent fiscal year, total client assets under its management and control in excess of $50,000,000, and either (A) shareholders' or partners' equity (as defined in section V(m)) in excess of $750,000, or (B) payment of all of its liabilities including any liabilities that may arise by reason of a breach or violation of a duty described in sections 404 or 406 of ERISA is unconditionally guaranteed by -

        i. A person with a relationship to such investment adviser described in section V(c)(I) if the investment adviser and such affiliate have, as of the last day of their most recent fiscal year, shareholders' or partners' equity, in the aggregate, in excess of

$750,000, or
ii. A person described in (a)(1), (a)(2) or (a)(3) of section V above, or
iii. A broker-dealer registered under the Securities Exchange Act of 1934 that has, as of the last day of its most recent fiscal year, net worth in excess of $750,000;

Provided that such bank, savings and loan association, insurance company or investment adviser has acknowledged in a written management agreement that it is a fiduciary with respect to each plan that has retained the QPAM.

b. An "investment fund" includes single customer and pooled separate accounts maintained by an insurance company, individual trusts and common, collective or group trusts maintained by a bank, and any other account or fund to the extent that the disposition of its assets (whether or not in the custody of the QPAM) is subject to the discretionary authority of the QPAM.
c. For purposes of section I(a) and Part II, and "affiliate" of a person means -

1. Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the person,
2. Any corporation, partnership, trust or unincorporated enterprise of which such person is an officer, director, 5 percent or more partner, or employee (but only if the employer of such employee is the plan sponsor), and
3. Any director of the person or any employee of the person who is a highly compensated employee, as defined in section 4975(e)(2)(H) of the Code, or who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets. A named fiduciary (within the meaning of section 402(a)(2) of ERISA) of a plan and an employer any of whose employees are covered by the plan will also be considered affiliates with respect to each other for purposes of section I(a) if such employer or an affiliate of such employer has the authority, alone or shared with others, to appoint or terminate the named fiduciary or otherwise negotiate the terms of the named fiduciary's employment agreement.

d. For purposes of section I(g) an "affiliate" of a person means -

1. Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person,
2. Any director of, relative of, or partner in, any such person,
3. Any corporation, partnership, trust or unincorporated enterprise of which such person is an officer, director, or a 5 percent or more partner or owner, and
4. Any employee or officer of the person who -

A. Is a highly compensated employee (as defined in section 4975(e)(2)(H) of the Code) or officer (earning 10 percent or more of the yearly wages of such person), or
B. Has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets.

e. The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.
f. The term "party in interest" means a person described in ERISA section 3(14) and includes a "disqualified person," as defined in Code section 4975(e)(2).
g. The term "relative" means a relative as that term is defined in ERISA section 3(15), or a brother, a sister, or a spouse of a brother or sister.
h. A QPAM is "related" to a party in interest for purposes of section I(d) of this exemption if the party in interest (or a person controlling, or controlled by, the party in interest) owns a five percent or more interest in the QPAM or if the QPAM (or a person controlling, or controlled by, the QPAM) owns a five percent or more interest in the party in interest. For purposes of this definition:

1. The term "interest" means with respect to ownership of an entity -

A. The combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation,
B. The capital interest or the profits interest of the entity if the entity is a partnership, or
C. The beneficial interest of the entity if the entity is a trust or unincorporated enterprise; and

2. A person is considered to own an interest held in any capacity if the person has or shares the authority -

   A. To exercise any voting rights or to direct some other person to exercise the voting rights relating to such interest, or
   B. To dispose or to direct the disposition of such interest.

i. The time as of which any transaction occurs is the date upon which the transaction is entered into. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into on or after December 21, 1982, or a renewal that requires the consent of the QPAM occurs on or after December 21, 1982 and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, the requirements will continue to be satisfied thereafter with respect to the transaction. Notwithstanding the foregoing, this exemption shall cease to apply to a transaction exempt by virtue of Part I or Part II at such time as the percentage requirement contained in section I(e) is exceeded, unless no portion of such excess results from an increase in the assets transferred for discretionary management to a QPAM. For this purpose, assets transferred do not include the reinvestment of earnings attributable to those plan assets already under the discretionary management of the QPAM. Nothing in this paragraph shall be construed as exempting a transaction entered into by an investment fund which becomes a transaction described in section 406 of ERISA or section 4975 of the Code while the transaction is continuing, unless the conditions of this exemption were met either at the time the transaction was entered into or at the time the transaction would have become prohibited but for this exemption.
j. The term "goods" includes all things which are movable or which are fixtures used by an investment fund but does not include securities, commodities, commodities futures, money, documents, instruments, accounts, chattel paper, contract rights and any other property, tangible or intangible, which, under the relevant facts and circumstances, is held primarily for investment.
k. For purposes of section V(a)(1) and (2), the term "equity capital" means stock (common and preferred), surplus, undivided profits, contingency reserves and o her capital reserves.
l. For purposes of section V(a)(3), the term "net worth" means capital, paid-in and contributed surplus, unassigned surplus, contingency reserves, group contingency reserves, and special reserves.
m. For purposes of section V(a)(4), the term "shareholders' or partners' equity" means the equity shown in the most recent balance sheet prepared within the two years immediately preceding a transaction undertaken pursuant to this exemption, in accordance with generally accepted accounting principles.

Prohibited Transaction Class Exemption 86-128

Securities Transactions Involving Employee Benefit Plans and Broker-Dealers

November 18, 1986 (51 FR 41686)

Replaces Temporary PTE 79-9, March 23, 1979 (44 FR 17819)

Recap
Securities Transactions with Brokers. Permits use of affiliated brokerage services under certain conditions. Also covers collective investment fund transactions.

Class Exemption Covering Securities Transactions with Brokers

Explanatory Preamble to PTE 86-128 (Excerpt)

Agency: Department of Labor.

Action: Grant of class exemption.

Summary: This document contains an exemption which allows persons who serve as fiduciaries for employee benefit plans to effect or execute securities transactions under certain circumstances. The exemption also allows sponsors of pooled separate accounts and other pooled investment funds to use their affiliates to effect or execute securities transactions for such accounts when certain conditions are met. The exemption will replace Prohibited Transaction Exemption 79-1 and Prohibited Transaction Exemption 84-46. It affects

participants and beneficiaries of, and fiduciaries with respect to, employee benefit plans which invest in securities, and other persons who engage in the described transactions.

Effective Date: The later of December 18, 1986, or the date on which the Office of Management and Budget approves the information collection requests contained in this exemption under the Paperwork Reduction Act of 1980.

Exemption

In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record including the written comments submitted in response to the notice of January 24, 1985, the Department makes the following determinations:

a. The class exemption set forth herein is administratively feasible;
b. It is in the interests of plans and of their participants and beneficiaries; and
c. It is protective of the rights of participants and beneficiaries of plans.

Accordingly, the following exemption is hereby granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1.

Section I

Definitions and Special Rules

The following definitions and special rules apply to this exemption:

a. The term "person" includes the person and affiliates of the person.
b. An "affiliate" of a person includes the following:

    1. Any person directly or indirectly controlling, controlled by, or under common control with, the person
    2. Any officer, director, partner, employee, relative (as defined in section 3(15) of ERISA), brother, sister, or spouse of a brother or sister, of the person;
    3. Any corporation or partnership of which the person is an officer, director or partner.

A person is not an affiliate of another person solely because one of them has investment discretion over the other's assets. The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

c. An "agency cross transaction" is a securities transaction in which the same person acts as agent for both any seller and any buyer for the purchase or sale of a security.
d. The term "covered transaction" means an action described in section II(a), (b) or (c) of this exemption.
e. The term "effecting or executing a securities transaction" means the execution of a securities transaction as agent for another person and/or the performance of clearance, settlement, custodial or other functions ancillary thereto.
f. A plan fiduciary is independent of a person only if the fiduciary has no relationship to or interest in such person that might affect the exercise of such fiduciary's best judgment as a fiduciary.
g. The term "profit" includes all charges relating to effecting or executing securities transactions, less reasonable and necessary expenses including reasonable indirect expenses (such as overhead costs) properly allocated to the performance of these transactions under generally accepted accounting principles.
h. The term "securities transaction" means the purchase or sale of securities.
i. The term "nondiscretionary trustee" of a plan means a trustee or custodian whose powers and duties with respect to any assets of the plan are limited to -

    1. The provision of nondiscretionary trust services to the plan, and
    2. Duties imposed on the trustee by any provision or provisions of the Act or the Code.

The term "nondiscretionary trust services" means custodial services and services ancillary to custodial services, none of which services are discretionary. For purposes of this exemption, a person does not fail to be a nondiscretionary trustee solely by reason of having been delegated, by the sponsor of a master or prototype plan, the power to amend such plan.

Section II

Covered transactions

Effective the later of December 18, 1986, or the date on which the Office of Management and Budget approves the information collection requests contained in this exemption under the Paperwork Reduction Act of 1980, if each condition of section III of this exemption is either satisfied or not applicable under section IV, the restrictions of section 406(b) of ERISA and the taxes imposed by sections 4975(a) and (b) of the Code by reason of section 4975(c)(1)(E) or (F) of the Code shall not apply to

a. A plan fiduciary's using its authority to cause a plan to pay a fee for effecting or executing securities transactions to that person as agent for the plan, but only to the extent that such transactions are not excessive, under the circumstances, in either amount or frequency;
b. A plan fiduciary's acting as the agent in an agency cross transaction for both the plan and one or more other parties to the transaction; or
c. The receipt by a plan fiduciary of reasonable compensation for effecting or executing an agency cross transaction to which a plan is a party from one or more other parties to the transaction.

Section III

Conditions

Except to the extent otherwise provided in section IV of this exemption, section II of this exemption applies only if the following conditions are satisfied:

a. The person engaging in the covered transaction is not a trustee (other than a nondiscretionary trustee) or an administrator of the plan, or an employer any of whose employees are covered by the plan.
b. The covered transaction is performed under a written authorization executed in advance by a fiduciary of each plan whose assets are involved in the transaction, which plan fiduciary is independent of the person engaging in the covered transaction.
c. The authorization referred to in paragraph (b) of this section is terminable at will by the plan, without penalty to the plan, upon receipt by the authorized person of written notice of termination. A form expressly providing an election to terminate the authorization described in paragraph (b) of this section with instructions on the use of the form must be supplied to the authorizing fiduciary no less than annually. The instructions for such form must include the following information:

    1. The authorization is terminable at will by the plan, without penalty to the plan, upon receipt by the authorized person of written notice from the authorizing fiduciary or other plan official having authority to terminate the authorization; and
    2. Failure to return the form will result in the continued authorization of the authorized person to engage in the covered transactions on behalf of the plan.

d. Within three months before an authorization is made, the authorizing fiduciary is furnished with any reasonably available information that the person seeking authorization reasonably believes to be necessary for the authorizing fiduciary to determine whether the authorization should be made, including (but not limited to) a copy of this exemption, the form for termination of authorization described in section III(c), a description of the person's brokerage placement practices, and any other reasonably available information regarding the matter that the authorizing fiduciary requests.
e. The person engaging in a covered transaction furnishes the authorizing fiduciary with either:

    1. A confirmation slip for each securities transaction underlying a covered transaction within ten business days of the securities transaction containing the information described in Rule 10b-10(a)(1-7) under Securities Exchange Act of 1934, 17 C.F.R. 240.10b-10; or
    2. At least once every three months and not later than 45 days following the period to which it relates, a report disclosing:

        A. A compilation of the information that would be provided to the plan pursuant to subparagraph (e)(1) of this section during the three-month period covered by the report;
        B. The total of all securities transaction-related charges incurred by the plan during such period in connection with such covered transactions; and
        C. The amount of the securities transaction-related charges retained by such person and the amount of such charges paid to other persons for execution or other services.

For purposes of this paragraph (e), the words "incurred by the plan" shall be construed to mean "incurred by the pooled fund" when such person engages in covered transactions on behalf of a pooled fund in which the plan participates.

f. The authorizing fiduciary is furnished with a summary of the information required under paragraph (e)(1) of this section at least once per year. The summary must be furnished within 45 days after the end of the period to which it relates, and must contain the following:

1. The total of all securities transaction-related charges incurred by the plan during the period in connection with covered securities transactions.
2. The amount of the securities transaction-related charges retained by the authorized person and the amount of these charges paid to other persons for execution or other services.
3. A description of the person's brokerage placement practices, if such practices have materially changed during the period covered by the summary.
4. (i)A portfolio turnover ratio, calculated in a manner which is reasonably designed to provide the authorizing fiduciary with the information needed to assist in discharging its duty of prudence. The requirements of this paragraph (f)(4)(i) will be met if the "annualized portfolio turnover ratio", calculated in the manner described in paragraph (f)(4)(ii), is contained in the summary.

    i. The "annualized portfolio turnover ratio" shall be calculated as a percentage of the plan assets consisting of securities or cash over which the authorized person had discretionary investment authority, or with respect to which such person rendered, or had any responsibility to render, investment advice (the "portfolio") at any time or times ("management period(s)") during the period covered by the report. First, the "portfolio turnover ratio" (not annualized) is obtained by dividing (A) the lesser of the aggregate dollar amounts of purchases or sales of portfolio securities during the management period(s) by (B) the monthly average of the market value of the portfolio securities during all management period(s). Such monthly average is calculated by totaling the market values of the portfolio securities as of the beginning and end of each management period and as of the end of each month that ends within such period(s), and dividing the sum by the number of valuation dates so used. For purposes of this calculation, all debt securities whose maturities at the time of acquisition were one year or less are excluded from both the numerator and the denominator.

       The "annualized portfolio turnover ratio" is then derived by multiplying the "portfolio turnover ratio" by an annualizing factor. The annualizing factor is obtained by dividing (C) the number twelve by (D) the aggregate duration of the management period(s) expressed in months (and fractions thereof).

       Examples of the use of this formula are provided in section V of this exemption.

    ii. The information described in this paragraph (f)(4) is not required to be furnished in any case where the authorized person has not exercised discretionary authority over trading in the plan's account during the period covered by the report.

       For purposes of this paragraph (f), the words "incurred by the plan" shall be construed to mean "incurred by the pooled fund" when such person engages in covered transactions on behalf of a pooled fund in which the plan participates.

g. If an agency cross transaction to which section IV(b) does not apply is involved, the following conditions must also be satisfied:

1. The information required under section III(d) or IV(d)(1)(B) of this exemption includes a statement to the effect that with respect to agency cross transactions the person effecting or executing the transactions will have a potentially conflicting division of loyalties and responsibilities regarding the parties to the transactions;
2. The summary required under section III(f) of this exemption includes a statement identifying the total number of agency cross transactions during the period covered by the summary and the total amount of all commissions or other remuneration received or to be received from all sources by the person engaging in the transactions in connection with those transactions during

the period;

3. The person effecting or executing the agency cross transaction has the discretionary authority to act on behalf of, and/or provide investment advice to, either (A) one or more sellers or (B) one or more buyers with respect to the transaction, but not both.
4. The agency cross transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available; and
5. The agency cross transaction is executed or effected at a price that is at or between the independent bid and independent ask prices for the security prevailing at the time of the transaction.

Section IV

Exceptions from conditions

a. Certain plans not covering employees. Section III of this exemption does not apply to covered transactions to the extent they are engaged in on behalf of individual retirement accounts meeting the conditions of 29 C.F.R. 2510.3-2(d), or plans, other than training programs, that cover no employees within the meaning of 29 C.F.R. 2510.3-3.
b. Certain agency cross transactions. Section III of this exemption does not apply in the case of an agency cross transaction, provided that the person effecting or executing the transaction

    1. Does not render investment advice to any plan for a fee within the meaning of section 3(21)(A)(ii) of ERISA with respect to the transaction;
    2. Is not otherwise a fiduciary who has investment discretion with respect to any plan assets involved in the transaction, see 29 C.F.R. 2510.3-21(d); and
    3. Does not have the authority to engage, retain or discharge any person who is or is proposed to be a fiduciary regarding any such plan assets.

c. Recapture of profits. Section III(a) of this exemption does not apply in any case where the person engaging in a covered transaction returns or credits to the plan all profits earned by that person in connection with the securities transactions associated with the covered transaction.
d. Special rules for pooled funds. In the case of a person engaging in a covered transaction on behalf of an account or fund for the collective investment of the assets of more than one plan (pooled fund):

    1. Sections III(b), (c) and (d) of this exemption do not apply if -

        A. The arrangement under which the covered transaction is performed is subject to the prior and continuing authorization, in the manner described in this paragraph (d)(1), of a plan fiduciary with respect to each plan whose assets are invested in the pooled fund who is independent of the person. The requirement that the authorizing fiduciary be independent of the person shall not apply in the case of a plan covering only employees of the person, if the requirements of section IV(d)(2)(A) and (B) are met.
        B. The authorizing fiduciary is furnished with any reasonably available information that the person engaging or proposing to engage in the covered transactions reasonably believes to be necessary to determine whether the authorization should be given or continued, not less than 30 days prior to implementation of the arrangement or material change thereto, including (but not limited to) a description of the person's brokerage placement practices, and, where requested, any reasonably available information regarding the matter upon the reasonable request of the authorizing fiduciary at any time.
        C. In the event an authorizing fiduciary submits a notice in writing to the person engaging in or proposing to engage in the covered transaction objecting to the implementation of, material change in, or continuation of, the arrangement, the plan on whose behalf the objection was tendered is given the opportunity to terminate its investment in the pooled fund, without penalty to the plan, within such time as may be necessary to effect the withdrawal in an orderly manner that is equitable to all withdrawing plans and to the nonwithdrawing plans. In the case of a plan that elects to withdraw under this subparagraph (d)(1)(C), the withdrawal shall be effected prior to the implementation of, or material change in, the arrangement; but an existing arrangement need not be discontinued by reason of a plan electing to withdraw.

D. In the case of a plan whose assets are proposed to be invested in the pooled fund subsequent to the implementation of the arrangement and that has not authorized the arrangement in the manner described in subparagraphs (d)(1)(B) and (C) of this section, the plan's investment in the pooled fund is subject to the prior written authorization of an authorizing fiduciary who satisfies the requirements of subparagraph (d)(1)(A).

2. Section III(a) of this exemption, to the extent that it prohibits the person from being the employer of employees covered by a plan investing in a pool managed by the person does not apply if -

   A. The person is an "investment manager" as defined in section 3(38) of ERISA, and
   B. Either (i) the person returns or credits to the pooled fund all profits earned by the person in connection with all covered transactions engaged in by the person on behalf of the fund, or (ii) the pooled fund satisfies the requirements of paragraph IV(d)(3).

3. A pooled fund satisfies the requirements of this paragraph for a fiscal year of the fund if -

   A. On the first day of such fiscal year, and immediately following each acquisition of an interest in the pooled fund during the fiscal year by any plan covering employees of the person, the aggregate fair market value of the interests in such fund of all plans covering employees of the person does not exceed twenty percent of the fair market value of the total assets of the fund; and
   B. The aggregate brokerage commissions received by the person, in connection with covered transactions engaged in by the person on behalf of all pooled funds in which a plan covering employees of the person participates, do not exceed five percent of the total brokerage commissions received by the person from all sources in such fiscal year.

Section V

Examples illustrating the use of the annualized portfolio turnover ratio described in Section III(F)(4)(ii)

(Note: This section containing examples has been omitted.)

Section VI

Effective dates and Transitional Rule

a. This exemption will be effective on the later of December 18, 1986, or the date on which the Office of Management and Budget approves the information collection requests contained in this exemption under the Paperwork Reduction Act of 1980.
b. PTE 79-1 and PTE 84-46 are revoked effective April 1, 1987.

Prohibited Transaction Class Exemption 91-38

Bank Collective Investment Funds

July 12, 1991 (56 FR 31966)

Summary
Replaces PTE 80-51. Permits investment in collective investment funds operated by bank fiduciaries, subject to certain limitations and conditions. 5% limitations of PTE 80-51 replaced by 10%.

Class Exemption

Amendment to Prohibited Transaction Exemption (PTE) 80-51

Involving Bank Collective Investment Funds

Agency: Pension and Welfare Benefits Administration, Labor Department.

Internal Revenue Service.

Action: Adoption of amendment to PTE 80-51, and redesignation as PTE 91-38.

Summary: This document amends PTE 80-51, a class exemption that permits Bank Collective Investment Funds, in which employee benefit plans have an interest, to engage in certain transactions, provided specified conditions are met. The amendment affects, among others, participants, beneficiaries and fiduciaries of plans that invest in the collective investment funds, banks, and other persons engaging in the described transactions.

Effective Date: The amendment to section I(a)(1)(A) of PTE 80-51 is effective as of July 1, 1990.

Exemption

For the sake of convenience, the entire text of PTE 80-51, as amended, has been reprinted with this notice. The Department has redesignated the exemption as PTE 91-38.

Section I

Exemption for Certain Transactions Involving Bank Collective Investment Funds

a. Effective January 1, 1975, the restrictions of sections 406(a), 406(b)(2) and 407(a) of the Act and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A), (B), (C) or (D) of the Code, shall not apply to the transactions described below if the applicable conditions set forth in section III are met.

    1. Transactions between parties in interest and bank collective investment funds: General. Any transaction between a party in interest with respect to a plan and a collective investment fund that is maintained by a bank and in which the plan has an interest, or any acquisition or holding by the collective investment fund of employer securities or employer real property, if the party in interest is not the bank that maintains the collective investment fund, any other collective fund maintained by the bank or any affiliate of the bank, and if, at the time of the transaction, acquisition or holding, either -

        A. The interest of the plan together with the interests of any other plans maintained by the same employer or employee organization in the collective investment fund does not exceed -

            i. 10 percent of the total of all interests in the collective investment fund, if the transaction occurs prior to October 23, 1980; or
            ii. 5 percent of the total of all assets in the collective investment fund, if the transaction occurs on or after October 23, 1980, and on or before June 30, 1990; or
            iii. 10 percent of the total of all assets in the collective investment fund, if the transaction occurs on or after July 1, 1990; or

        B. The collective investment fund is a specialized fund that has a policy of investing, and invests, substantially all of its assets in short-term obligations (having a stated maturity date of one year or less or having a maturity date of one year or less from the date of acquisition by such specialized fund), including but not necessarily limited to --

            i. Corporate or governmental obligations or related repurchase agreements;
            ii. Certificates of deposit;
            iii. Bankers' acceptances; or
            iv. Variable amount notes of borrowers of prime credit.

    2. Special transactions not meeting the criteria of section I(a)(1)(A) between employers of employees covered by a multiple employer plan and collective investment funds. Any transaction between an employer (or an affiliate of an employer) of employees covered by a multiple employer plan and a collective investment fund maintained by a bank in which the plan has an

interest, or any acquisition or holding by the collective investment fund of employer securities or employer real property, if at the time of the transaction, acquisition or holding --

A. In the case of a transaction occurring prior to October 23, 1980, the employer is not a "substantial employer" with respect to the plan (within the meaning of section 4001(a)(2) of the Act); or
B. In the case of a transaction occurring on or after October 23, 1980:

i. The interest of the multiple employer plan in the collective investment fund does not exceed 10 percent of the total assets in the collective investment fund, and the employer is not a "substantial employer" with respect to the plan (within the meaning of section 4001(a)(2) of the Act); or
ii. The interest of the multiple employer plan in the collective investment fund exceeds 10 percent of the total assets in the collective investment fund, but the employer is not a "substantial employer" with respect to the plan and would not be a "substantial employer" within the meaning of section 4001(a)(2) of the Act if "5 percent" were substituted for "10 percent" in that definition.

3. Acquisition, sale or holding of employer securities and employer real property.

A. Except as provided in subsection (B) of this section (3), any acquisition, sale or holding of employer securities and any acquisition, sale or holding of employer real property by a collective investment fund in which a plan has an interest and which does not meet the requirements of paragraphs (a)(1) and (a)(2) of this section, if no commission is paid to the bank or to the employer or any affiliate of the bank or the employer in connection with the acquisition or sale of employer securities or the acquisition, sale or lease of employer real property; and

i. In the case of employer real property --

(aa) Each parcel of employer real property and the improvements thereon held by the collective investment fund are suitable (or adaptable without excessive cost) for use by different tenants, and

(bb) The property of the collective investment fund that is leased or held for lease to others, in the aggregate, is dispersed geographically.

ii. In the case of employer securities --

(aa) The bank in whose collective investment fund the security is held is not an affiliate of the issuer of the security, and

(bb) If the security is an obligation of the issuer, either

1. The collective investment fund owns the obligation at the time the plan acquires an interest in the collective investment fund, and interests in the collective fund are offered and redeemed in accordance with valuation procedures of the collective investment fund applied on a uniform or consistent basis, or
2. Immediately after acquisition of the obligation: (a) Not more than 25 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by such plan, and (b) in the case of an obligation that is a restricted security within the meaning of rule 144 under the Securities Act of 1933, at least 50 percent of the aggregate amount of obligations issued in the issue and outstanding at the time of acquisition is held by persons independent of the issuer. The bank, its affiliates and any collective investment fund maintained by the bank shall be considered to be persons independent of the issuer if the bank is not an affiliate of the issuer.

B. In the case of a plan that is not an eligible individual account plan (as defined in section 407(d)(3) of the Act), the exemption provided in subsection (A) of this paragraph (3) shall be available only if, immediately after the acquisition of the securities or real property, the aggregate fair market value of employer securities and employer real property with respect to which the bank has investment discretion does not exceed 10 percent of the fair market value of all the assets of the plan with respect to which the bank has such investment discretion.
C. For the purposes of the exemption contained in subsection (A) of this section (3), the term "employer securities" shall include securities issued by, and the term "employer real property" shall include real property leased to, a person who is a party in interest with respect to a plan (participating in the collective investment fund) by reason of a relationship to the employer described in section 3(14) (E), (G), (H) or (I) of the Act.

b. Effective January 1, 1975, the restrictions of section 406(a)(1) (A), (B), (C) and (D) and section 406(b) (1) and (2) of the Act and the taxes imposed by section 4975 (a) and (b) of the Code by reason of section 4975(c)(1) (A), (B), (C), (D) or (E) of the Code, shall not apply to the transactions described below, if the conditions of section III are met.

1. Transactions with persons who are parties in interest with respect to the plan solely by virtue of being certain service providers or certain affiliates of service providers. Any transaction between a collective investment fund and a person who is a party in interest with respect to a plan that has an interest in the collective investment fund, if --

   A. The person is a party in interest (including a fiduciary) solely by reason of providing services to the plan, or solely by reason of a relationship to a service provider described in section 3(14) (F), (G), (H) or (I) of the Act, or both and the person neither exercised nor has any discretionary authority, control, responsibility or influence with respect to the investment of plan assets in, or held by, the collective investment fund, and
   B. The person is not an affiliate of the bank maintaining the collective investment fund.

2. Certain leases and goods. The furnishing of goods to a collective investment fund by a party in interest with respect to a plan participating in the collective investment fund, or the leasing of real property owned by the collective investment fund to such party in interest and the incidental furnishing of goods to such party in interest by the collective investment fund, if--

   A. In the case of goods, they are furnished to or by the collective investment fund in connection with real property owned by the collective investment fund;
   B. The party in interest is not the bank maintaining the collective investment fund, or any affiliate of the bank, or any other collective investment fund maintained by the bank; and
   C. The amount involved in the furnishing of goods or leasing of real property in any calendar year (including the amount under any other lease or arrangement for the furnishing of goods in connection with the real property investments of the collective investment fund with the same party in interest or any affiliate thereof) does not exceed the greater of $25,000 or 0.5 percent of the fair market value of the assets of the collective investment fund on the most recent valuation date of the fund prior to the transaction.

3. Management of real property. Any services provided to a collective investment fund in which a plan has an interest by the bank maintaining that fund or by an affiliate of that bank in connection with the management of the real property owned by the collective investment fund, if the compensation paid to the bank or its affiliate does not exceed the cost of the services to the bank or its affiliate.
4. Transactions involving places of public accommodation. The furnishing of services, facilities and any goods incidental to such services and facilities by a place of public accommodation owned by a bank collective investment fund, to a party in interest with respect to a plan, which plan has an interest in the collective investment fund, if the services, facilities and incidental goods are furnished on a comparable basis to the general public.

Section II

Excess Holdings Exemption for Employee Benefit Plans

a. Effective January 1, 1975, the restrictions of sections 406(a), 406(b)(2) and 407(a) of the Act and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A), (B), (C) or (D) of the Code shall not apply to any acquisition or holding of qualifying employer securities or qualifying employer real property (other than through a collective investment fund), if -

   1. The acquisition or holding contravenes the restrictions of sections 406(a)(1)(E), 406(a)(2) and 407(a) of the Act solely by reason of being aggregated with employer securities or employer real property held by a collective investment fund in which the plan has an interest;
   2. The requirements of either paragraph (a)(1) or paragraph (a)(2) of section I of this exemption are met; and
   3. The applicable conditions set forth in section III of this exemption are met.

Section III

General conditions

a. At the time the transaction is entered into, and at the time of any subsequent renewal thereof that requires the consent of the bank, the terms of the transaction are not less favorable to the collective investment fund than the terms generally available in arm's-length transactions between unrelated parties.
b. The bank maintains for a period of six years from the date of the transaction, the records necessary to enable the persons described in paragraph (c) of this section to determine whether the conditions of this exemption have been met, except that -

   1. a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the bank's control, the records are lost or destroyed prior to the end of the six-year period; and
   2. no party in interest other than the bank shall be subject to the civil penalty that may be assessed under 502(i) of the Act, or to the taxes imposed by section 4975(a) and (b) of the Code, if the records are not maintained, or are not available for examination as required by paragraph (c) below.

c. (1)Except as provided in subsection 2 of this paragraph and notwithstanding any provisions of subsections (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (b) of this section are unconditionally available at their customary location for examination during normal business hours by:

   A. Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service,
   B. Any fiduciary of a plan who has authority to acquire or dispose of the interests of the plan in the collective investment fund, or any duly authorized employee or representative of such fiduciary.
   C. Any contributing employer to any plan that has an interest in the collective investment fund or any duly authorized employee or representative of such employer.
   D. Any participant or beneficiary of any plan that has an interest in the collective investment fund, or any duly authorized employee or representative of such participant or beneficiary.

   (2) None of the persons described in subparagraphs (B) through (D) of this paragraph shall be authorized to examine a bank's trade secrets or commercial or financial information which is privileged or confidential.

Section IV

Definitions and General Rules

For the purposes of this exemption,

a. An "*affiliate*" of a person includes -

   1. Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person;

2. Any officer, director, employee, relative of, or partner in any such person; and
3. Any corporation or partnership of which such person is an officer, director, partner or employee.

b. The term "*control*" means the power to exercise a controlling influence over the management or policies of a person other than an individual.
c. The term "*party in interest*" includes a "*disqualified person*" as defined in section 4975(e)(2) of the Code.
d. The term "*relative*" means a "relative" as that term is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or sister.
e. (1)Except as provided in subparagraph (2) of this paragraph, the term "*collective investment fund*" means a common or collective trust fund or pooled investment fund maintained by a bank or a trust company.

   (2) In the case of a common or collective trust fund or pooled investment fund maintained by a bank or trust company that consists of separate investment accounts, each separate investment account of that fund, rather than the entire fund, shall be considered to be a separate "collective investment fund" for purposes of this exemption.

f. The term "*multiple employer plan*" means an employee benefit plan that satisfies at least the requirements of section 3(37)(A)(i), (ii) and (v) of the Act and section 414(f)(1)(A), (B) and (E) of the Code.
g. The term "*obligation*" means a bond, debenture, note, certificate, or other evidence of indebtedness.
h. The time as of which any transaction, acquisition or holding occurs is the date upon which the transaction is entered into, the acquisition is made or the holding commences. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into, or an acquisition is made, on or after January 1, 1975, or a renewal that requires the consent of the bank occurs on or after January 1, 1975, and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, or at the time the acquisition is made, the requirements will continue to be satisfied thereafter with respect to the transaction or acquisition and the exemption shall apply thereafter to the continued holding of the securities or property so acquired. This exemption also applies to any transaction or acquisition entered into, or holding commencing prior to January 1, 1975, if either the requirements of this exemption would have been satisfied on the date the transaction was entered into or acquisition was made (or on which the holding commenced), or the requirements would have been satisfied on January 1, 1975, if the transaction had been entered into, the acquisition was made, or the holding had commenced, on January 1, 1975. Notwithstanding the foregoing, this exemption shall cease to apply to a holding exempt by virtue of section I(a)(1) at such time as the interest of the plan in the collective investment fund exceeds the percentage interest limitation of section I(a)(1), unless no portion of such excess results from an increase in the assets allocated to the collective investment fund by the plan. For this purpose, assets allocated do not include the reinvestment of fund earnings. Nothing in this paragraph shall be construed as exempting a transaction entered into by a collective investment fund which becomes a transaction described in section 406 of the Act or section 4975 of the Code while the transaction is continuing, unless the conditions of the exemption were met either at the time the transaction was entered into or at the time the transaction would have become prohibited but for this exemption.
i. Each plan participating in a collective investment fund shall be considered to own the same proportionate undivided interest in each asset of the collective investment fund as its proportionate interest in the total assets of the collective investment fund as calculated on the most recent preceding valuation date of the fund.
j. Where any of the assets of a collective investment fund are invested in another collective investment fund, the interest of the plan in the second fund arising from its investment in the first fund shall be established by multiplying the percentage interest of the plan in the first fund by the percentage interest of the first fund in the second fund, such computation to be continued similarly in the event that further investments are made by the second investment fund in one or more other collective investment funds.

Prohibited Transaction Class Exemption 91-55

American Eagle Gold Coins Permitted as IRA Investment

September 27, 1991 (56 FR 49209)

Summary

Permits IRA accounts to invest in *American Eagle*. Other gold coins and "collectibles" still prohibited as investment vehicles.

Class Exemption

Transactions Between Individual Retirement Accounts

and Authorized Purchasers of American Eagle Coins

Agency: Pension and Welfare Benefits Administration, Labor Department.

Internal Revenue Service.

Action: Grant of class exemption.

Summary: This document contains a final class exemption from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The exemption permits purchases and sales by certain "individual retirement accounts," as defined in Code section 408 ("IRAs"), of American Eagle bullion coins ("Coins") in principal transactions from or to broker-dealers in Coins which are "authorized purchasers" of Coins in bulk quantities from the United States Mint (the "Mint") and which are also "disqualified persons," within the meaning of Code section 4975(e)(2), with respect to the IRAs. The exemption would also permit the interest-free extension of credit in connection with such purchases and sales. The exemption affects persons with an interest in the investments of IRAs, including IRA depositors and their beneficiaries, as well as persons who provide custodial services to IRAs.

Effective Date: January 1, 1987.

The Explanatory Preamble, together with the full Exemption, are available in the PREAMBLE document.

Exemption

Section I: Definitions and Special Rules

The following definitions apply to this exemption:

a. "*Authorized purchasers*" are banks or other persons referenced in section 408(a)(2) or (h) of the Internal Revenue Code of 1986 (Code) that are approved by the United States Mint (the Mint), for eligibility to purchase the American Eagle U.S. gold or silver bullion coins which are described in section 5112(a) (7), (8), (9), and (10) or section (e) of Title 31 of the United States Code (Coins), directly from the Mint in bulk quantities.
b. The term "*covered transaction*" means a transaction described in section II of this exemption.
c. "*IRA*" means an individual retirement account described in Code section 408 with respect to which the authorized purchaser is a disqualified person.
d. An "*affiliate*" of a person includes the following:
    1. Any person directly or indirectly controlling, controlled by, or under common control with, the person;
    2. Any officer, director, partner, employee, member of the family (as defined in Code section 4975(e)(6)), brother, sister, or spouse of a brother or sister, of the person;
    3. Any corporation or partnership of which the person is an officer, director or partner.

    The term "*control*" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

e. The term "*execution*" means the acceptance of an offer to purchase or sell a Coin in a covered transaction such that both the IRA and the authorized purchaser are legally obligated to complete the transaction as directed.
f. The term "*accredited person*" means any duly authorized employee of the Department of Labor or the Internal Revenue Service or the person directing the investments of an IRA.
g. The term "*independent third party*" excludes the authorized purchaser and any person affiliated

therewith.

Section II. Covered Transactions

Effective January 1, 1987, if each condition of section III of this exemption is satisfied, the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A), (B) or (D) of the Code shall not apply to -

a. The purchase of Coins by an IRA from an authorized purchaser; or
b. The sale by an IRA of Coins to be authorized purchaser;
c. The extension of credit in connection with the settlement of transactions described in (a) or (b).

Section III. Conditions

a. In the case of an IRA with is an employee benefit plan covered by Title I of the Employee Retirement Income Security Act of 1974 (ERISA), the covered transaction is the type of transaction described in section 404(c) of ERISA.
b. The transaction is directed either by the individual for whose benefit the IRA is maintained or by an independent third party appointed by such individual.
c. Neither the authorized purchaser nor any affiliate thereof has any discretionary authority or control respecting the management or disposition of the IRA assets involved in the transaction, or renders investment advice (within the meaning of 26 C.F.R. 54.4975-9(c)) respecting those assets.
d. Each denomination of Coins offered to IRAs pursuant to this exemption is purchased and sold by the authorized purchaser in transactions with unrelated parties in the ordinary course of its business with customers other than IRAs.
e. At the time the transaction is executed, the terms of the transaction must be not less favorable to the IRA than the terms afforded by the disqualified person or any affiliate thereof in comparable Coin transactions involving unrelated parties.
f. Payment for, and delivery of, Coins in settlement of a covered transaction is made simultaneously and in no event more than 10 business days after execution of the transaction involved, and no interest is charged for the period of time between execution and settlement.
g. The disqualified person provides current price quotations to the person directing the investments of the IRA immediately prior to the time a covered transaction is executed so that such person will know the exact price at which the purchase or sale will occur.
h. A separate written confirmation statement is issued with respect to each covered transaction to the person who directs the transaction for the IRA. The confirmation shall disclose the date, quantity, and price of the Coins bought or sold as well as the fact that the disqualified person acted as a principal in the transaction. The confirmation shall be issued in no event more than 10 business days after the execution of the transaction.
i. With regard to transactions entered into subsequent to (enter date 90 days after grant of the final exemption), prior to its engaging in covered transactions the disqualified person prepares and provides to the person directing the investments of the IRA material information regarding transactions in Coins, and furnishes supplemental information to the person directing the investments of IRAs which have invested in Coins if material changes occur. This information must include:

    1. A general description of the manner in which Coins are priced in the market.
    2. Disclosure of any fees for services or special or minimum transaction costs that will be incurred as the result of the purchase or sale of Coins by an IRA.
    3. Any minimum quantity of Coins which must be brought or sold.
    4. Disclosure of the role of the disqualified person as a principal in the transaction.
    5. An explanation that the purchase or sale of Coins between the IRA and the authorized purchaser would be prohibited in the absence of an exemption, a discussion of the arm's-length pricing standard of this exemption and disclosure that records are accessible which would enable the person directing investments of the IRA to determine whether the conditions of this exemption have been met.

j. The disqualified person maintains or causes to be maintained for a period of at least six years from the date of settlement of a covered transaction such records as are necessary to allow accredited persons to determine whether the conditions of the exemption have been met. The records shall include daily information indicating each customer (including each IRA and each other client) with whom a transaction involving Coins was consummated, the price and number of Coins involved, and the date and the time at which the transaction was executed. The persons directing the investments of an IRA are not authorized to examine a disqualified person's trade secrets or financial information which is

privileged or confidential. The records must be reasonably accessible and must be available for examination during normal business hours. Notwithstanding these recordkeeping requirements, a prohibited transaction will not be deemed to have occurred if, due to circumstances beyond the control of the disqualified person, such records are lost or destroyed prior to the end of the six year period.

Amendment to Prohibited Transaction Class Exemption 93-33 [*Formerly PTE 93-2*]

Receipt of Services by Individuals for Whose Benefit IRAs or Retirement Plans for Self-Employed Individuals are Established

May 11, 1993

Recap
Permits the receipt of services from a bank at reduced or no cost by an IRA or Keogh Plan beneficiary under certain conditions.

Class Exemption

Receipt of Services by an IRA or Keogh Plan from a Bank

Agency: Pension and Welfare Benefits Administration, U.S. Department of Labor.

Action: Adoption of Amendment to PTE 93-33.

Effective Date: The amendment is effective January 1, 1998**.**

Exemption

Accordingly, PTE 93-33 is amended under the authority of section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR Part 2570, Subpart B (55 FR 32836, August 10, 1990).

Section I: Covered Transactions

Effective January 1, 1998, the restrictions of sections 406(a)(1)(D) and 406(b) of ERISA and the sanctions resulting from the application of section 4975 of the Code, including the loss of exemption of an individual retirement account (IRA) pursuant to section 408(e)(2)(A) of the Code, by reason of section 4975(c)(1)(D), (E) and (F) of the Code, shall not apply to the receipt of services at reduced or no cost by an individual for whose benefit an IRA, or, if self-employed, a Keogh Plan, is established or maintained, or by members of his or her family, from a bank pursuant to an arrangement in which the account balance in the IRA or Keogh Plan is taken into account for purposes of determining eligibility to receive such services, provided that each condition of Section II of this exemption is satisfied.

Section II: Conditions

(a) The IRA or Keogh Plan, the balance of which is taken into account for purposes of determining eligibility to receive services at reduced or no cost, is established and maintained for the exclusive benefit of the participant covered under the IRA or Keogh Plan, his or her spouse or their beneficiaries.

(b) The services must be of the type that the bank itself could offer consistent with applicable federal and state banking law.

(c) The services are provided by the bank (or an affiliate of the bank) in the ordinary course of the bank's business to customers who qualify for reduced or no cost banking services but do not maintain IRAs or Keogh Plans with the bank.

(d) For the purpose of determining eligibility to receive services at reduced or no cost, the account balance required by the bank for the IRA or Keogh Plan is equal to the lowest balance required for any other type of account which the bank includes to determine eligibility to receive reduced or no cost services.

(e) The rate of return on the IRA or Keogh Plan investment is no less favorable than the rate of return on an identical investment that could have been made at the same time at the same branch of the bank by a customer of the bank who is not eligible for (or who does not receive) reduced or no cost services.

Section III: Definitions

The following definitions apply to this exemption:

(a) The term bank means a bank described in section 408(n) of the Code.

(b) The term IRA means an individual retirement account described in Code section 408(a) or an education individual retirement account described in section 530 of the Code. For purposes of this exemption, the term IRA shall not include an IRA which is an employee benefit plan covered by Title I of ERISA, except for a Simplified Employee Pension (SEP) described in section 408(k) of the Code or a Simple Retirement Account described in section 408(p) of the Code which provides participants with the unrestricted authority to transfer their balances to IRAs or Simple Retirement Accounts sponsored by different financial institutions.

(c) The term Keogh Plan means a pension, profit sharing, or stock bonus plan qualified under Code section 401(a) and exempt from taxation under Code section 501(a) under which some or all of the participants are employees described in section 401(c) of the Code. For purposes of this exemption, the term Keogh Plan shall not include a Keogh Plan which is an employee benefit plan covered by title I of ERISA.

(d) The term account balance means deposits as that term is defined under 29 CFR 408b-4(c)(3), or i nvestments in securities for which market quotations are readily available. For purposes of this exemption, the term account balance shall not include investments in securities offered by the bank (or its affiliate) exclusively to IRAs and Keogh Plans.

(e) An affiliate of a bank includes any person directly or indirectly controlling, controlled by, or under common control with a bank. The term control means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(f) The term members of his or her family refers to beneficiaries of the individual for whose benefit the IRA or Keogh Plan is established or maintained, who would be members of the family as that term is defined in Code section 4975(e)(6), or a brother, a sister, or spouse of a brother or a sister.

(g) The term service includes incidental products of a de minimis value provided by third persons pursuant to an arrangement with the bank, which are directly related to the provision of banking services covered by the exemption.

Signed at Washington, DC this 26th day of February 1999.

Alan D. Lebowitz,

Deputy Assistant Secretary for Program Operations, Pension and Welfare Benefits Administration

U.S. Department of Labor.

[FR Doc. 99-5572 Filed 3-5-99]

Prohibited Transaction Class Exemption 94-20

Foreign Exchange

February 10, 1994

Summary

Permits ERISA plans to use fiduciary banks and broker-dealers, and their affiliates, to invest in foreign currency and options on foreign currencies, subject to conditions: (1) the fiduciary bank has no discretion to make the investment on its own authority, (2) the transaction is done on an arms-length basis, (3) written policies are maintained to ensure any third party

knows an ERISA account is involved, (4) written confirmations, with specified contents, are provided the independent fiduciary authorizing the transaction within 5 business days, and (5) records are maintained for 6 years on territory in the jurisdiction of US courts.

Class Exemption

Agency: Pension and Welfare Benefits Administration, Labor Department.

Action: Grant of Class Exemption.

Summary: This document contains a final exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act) and from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The class exemption permits the purchase and sale of foreign currencies between an employee benefit plan and a bank or a broker-dealer or an affiliate thereof which is a party in interest with respect to such plan.

The exemption affects participants and beneficiaries of employee benefit plans involved in such transactions, as well as banks and broker-dealers and their affiliates which act as dealers in foreign exchange.

Effective Date: Section I(a) of PTE 94-20 is effective for transactions occurring from January 1, 1975 to June 18, 1991. Section I(b) of PTE 94-20 is effective for transactions occurring on or after June 18, 1991.

The Explanatory Preamble, together with the full Exemption, are available in the PREAMBLE document.

Exemption

Section I. Transactions

a. For the period from January 1, 1975 to June 18, 1991, the restrictions of section 406(a)(1)(A) through (D) of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code) by reason of Code section 4975(c)(1)(A) through (D) shall not apply to any foreign exchange transaction between a bank or broker-dealer or an affiliate thereof and an employee benefit plan with respect to which the bank or broker-dealer or affiliate thereof is a trustee, custodian, fiduciary or other party in interest, provided that (i) the transaction is directed (within the meaning of section IV(e)) on behalf of the plan by a fiduciary which is independent of the bank, the broker-dealer, and any affiliate thereof, and (ii) the conditions set forth in section II are met.
b. Effective June 18, 1991, the restrictions of section 406(a)(1)(A) through (D) of the Act and the taxes imposed by section 4975(a) and (b) of the Code by reason of Code section 4975(c)(1)(A) through (D) shall not apply to any foreign exchange transaction between a bank or broker-dealer or an affiliate thereof and an employee benefit plan with respect to which the bank or broker-dealer or an affiliate thereof is a trustee, custodian, fiduciary, or other party in interest, provided that (i) the transaction is directed (within the meaning of section IV(e)) on behalf of the plan by a fiduciary which is independent of the bank, the broker-dealer, and any affiliate thereof, and (ii) all of the conditions set forth in sections II and III are met.

Section II. General Conditions

Section I of this exemption applies only if the following conditions of this section II are satisfied. In the case of transactions described in section I(b), all of the conditions specified in section III below must also be satisfied.

a. At the time the transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties.
b. Neither the bank, the broker-dealer, nor any affiliate thereof has any discretionary authority or control with respect to the investment of the plan, assets involved in the transaction or renders investment advice (within the meaning of 29 C.F.R. 2510.3-21(c)) with respect to the investments of those assets.

Section III. Specific Conditions

Section I(b) of this exemption applies only if the conditions specified in section II above and the following conditions are satisfied:

a. At the time the transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms afforded by the bank, the broker-dealer, or any affiliate thereof in comparable arm's length foreign exchange transactions involving unrelated parties.
b. The bank, or broker-dealer, maintains at all times written policies and procedures regarding the handling of foreign exchange transactions with plans with respect to which the bank or broker-dealer is a trustee, custodian, fiduciary or other party in interest or disqualified person which assure that the person acting for the bank or broker-dealer knows that he or she is dealing with a plan.
c. A written confirmation statement is issued with respect to each covered transaction to the independent plan fiduciary who directs the transaction for the plan.

   The confirmation shall disclose the following information:

   1. Account name;
   2. Transaction date;
   3. Exchange rates;
   4. Settlement date;
   5. Currencies exchanged:

      i. Identity of the currency sold,
      ii. The amount sold;
      iii. Identity of the currency purchased;
      iv. The amount purchased.

   The confirmation shall be issued in no event more than 5 business days after execution of the transaction.

d. The bank or broker-dealer, or affiliate thereof, maintains within territories under the jurisdiction of the United States Government, for a period of six years from the date of the transaction, the records necessary to enable the persons described in paragraph (e) of this section to determine whether the applicable conditions of this exemption have been met. Notwithstanding these recordkeeping requirements, a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the bank's or broker-dealer's control, the records are lost or destroyed prior to the end of the six-year period, and no fiduciary of a plan who is independent of the bank or broker-dealer or any affiliate thereof, which engages in a transaction covered by the exemption, shall be subject to the civil penalty that may be assessed under 502(i) of the Act, or to the taxes imposed by section 4975(a) and (b) of the Code solely because the records are not maintained by the bank, the broker-dealer, or its affiliate, or are not made available for examination by the bank or broker-dealer or affiliate as required by paragraph (e) below.
e. (i) Except as provided in subparagraph (ii) of this paragraph and notwithstanding any provisions of subsection (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (d) of this Section are available at their customary location for examination, upon reasonable notice, during normal business hours by:

   A. Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service.
   B. Any fiduciary of a plan who has authority to acquire or dispose, of the assets of the plan involved in the foreign exchange transaction or any duly authorized employee and representative of such fiduciary.
   C. Any contributing employer to the plan involved in the foreign exchange transaction or any duly authorized employee or representative of such employer.

      (ii) None of the persons described in subparagraphs (B) and (C) shall be authorized to examine a bank's or broker-dealer's trade secrets or commercial or financial information of a bank or broker-dealer or an affiliate thereof which is privileged or confidential.

Section IV. Definitions and General Rules

For purposes of this exemption.

a. A "foreign exchange transaction" means the exchange of the currency of one nation for the currency of another nation, or a contract for such an exchange. The term foreign exchange transaction includes options contracts on foreign exchange transactions.
b. A "bank" means a bank which is supervised by the United States or a State thereof, or any affiliate thereof.
c. A "broker-dealer" means a broker-dealer registered under the Securities Exchange Act of 1934, or any affiliate thereof.
d. An "affiliate" of a bank or broker-dealer means any entity directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such bank or broker-dealer.
e. The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.
f. A foreign exchange transaction involving assets of an employee benefit plan shall be considered "directed" only where the independent plan fiduciary who has not been appointed by the bank or broker-dealer or affiliate dealer or affiliate thereof, directs such bank or broker-dealer or affiliate thereof to effect the purchase or sale of a specific amount of currency at a specific exchange rate.
g. For purposes of this exemption, the term "employee benefit plan" refers to a pension plan described in 29 C.F.R. 2510.3-2 and/or a welfare benefit plan described In 29 C.F.R. 2510.3-1.

Prohibited Transaction Class Exemption 97-41

Collective Investment Fund Conversion Transactions

August 8, 1997 (62 FR 42830)

Recap
Permits an employee benefit plan (Plan) to purchase shares of a mutual fund, advised by a bank or investment adviser which is also a fiduciary to the Plan, in exchange for assets transferred in-kind from a collective investment fund (CIF), when the Plan's assets are completely withdrawn from the CIF.

Class Exemption

Conversion of Collective Investment Funds into a Registered Investment Company (Mutual Fund)

Agency: Department of Labor, Pension and Welfare Benefits Administration

Action: Grant of Class Exemption

Effective Date: Section I of this exemption is effective for transactions occurring from October 1, 1988 until August 8, 1997. Section II of the exemption is effective for transactions occurring after August 8, 1997.

Exemption

Section I.

Retroactive Exemption for the Purchase of Fund Shares With Assets Transferred In-Kind From a CIFF or the period from October 1, 1988 to August 8, 1997, the restrictions of sections 406(a) and 406 (b)(1) and (b)(2) of the Act and the taxes imposed by section 4975 of the Code, by reason of section 4975(c)(1) (A) through (E), shall not apply to the purchase by an employee benefit plan (the Client Plan) of shares of one or more open-end management investment companies (the Fund or Funds) registered under the Investment Company Act of 1940, in exchange for assets of the Client Plan transferred in-kind to the Fund from a collective investment fund (the CIF) maintained by a bank (the Bank) or a plan adviser (the Plan Adviser), where the Bank or Plan Adviser is the investment adviser to the Fund and also a fiduciary of the Client Plan. The transfer and purchase must be in connection with a complete withdrawal of the Client Plan's assets from the CIF, and the following conditions must be met:

(a) No sales commissions or other fees are paid by the Client Plan in connection with the purchase

of Fund shares.

(b) All transferred assets are securities for which market quotations are readily available, or cash.

(c) The transferred assets constitute the Client Plan's pro rata portion of all assets that were held by the CIF immediately prior to the transfer.

(d) The Client Plan receives Fund shares that have a total net asset value equal to the value of the Client Plan's transferred assets on the date of the transfer, as determined with respect to securities, in a single valuation for each asset, with all valuations performed in the same manner, at the close of the same business day, in accordance with Securities and Exchange Commission Rule 17a-7 (using sources independent of the Bank or Plan Adviser and the Fund) and the procedures established by the Funds pursuant to Rule 17a-7.

(e) An independent fiduciary with respect to the Client Plan (the Independent Fiduciary) receives advance written notice of an in-kind transfer and purchase of assets and full written disclosure of information concerning the Fund which includes the following:

(1) A current prospectus for each Fund to which the CIF assets may be transferred;

(2) A statement describing the fees to be charged to, or paid by, a Client Plan and the Funds to the Bank or Plan Adviser, including the nature and extent of any differential between the rates of the fees;

(3) A statement of the reasons why the Bank or Plan Adviser may consider the transfer and purchase to be appropriate for the Client Plan; and

(4) A statement of whether there are any limitations on the Bank or Plan Adviser with respect to which plan assets may be invested in shares of the Funds, and, if so, the nature of such limitations.

(f) On the basis of the foregoing information, the Independent Fiduciary gives prior approval, in writing, for each purchase of Fund shares in exchange for the Client Plan's assets transferred from the CIF, consistent with the responsibilities, obligations and duties imposed on fiduciaries by Part 4 of Title I of the Act.

(g) The Bank or Plan Adviser sends by regular mail or personal delivery to the Independent Fiduciary of each Client Plan that purchases Fund shares in connection with the in-kind transfer, no later than 105 days after completion of each purchase, a written confirmation of the transaction containing--(1) The number of CIF units held by the Client Plan immediately before the in-kind transfer, the related per unit value and the total dollar amount of such CIF units; and (2) The number of shares in the Funds that are held by the Client Plan immediately following the purchase, the related per share net asset value and the total dollar amount of such shares.

(h) As to each Client Plan, the combined total of all fees received by the Bank or Plan Adviser for the provision of services to the Client Plan, and in connection with the provision of services to a Fund in which a Client Plan holds shares purchased in connection with the in-kind transfer, is not in excess of ``reasonable compensation'' within the meaning of section 408(b)(2) of the Act .

(i) All dealings in connection with the in-kind transfer and purchase between the Client Plan and a Fund are on a basis no less favorable to the Client Plan than dealings between the Fund and other shareholders.

Section II.

Prospective Exemption for the Purchase of Fund Shares With Assets Transferred In-Kind From a CIF Effective after August 8, 1997, the restrictions of sections 406(a) and 406 (b)(1) and (b)(2) of the Act and the taxes imposed by section 4975 of the Code, by reason of section 4975(c)(1) (A) through (E) of the Code, shall not apply to the purchase by an employee benefit plan (the Client Plan) of shares of one or more open-end management investment companies (the Fund or Funds) registered under the Investment Company Act of 1940, in exchange for assets of the Client Plan transferred in-kind to the Fund from a collective investment fund (the CIF) maintained by a bank (the Bank) or a plan adviser (the Plan Adviser),

where the Bank or Plan Adviser is the investment adviser to the Fund and also a fiduciary of the Client Plan. The transfer and purchase must be in connection with a complete withdrawal of the Client Plan's assets from the CIF, and the following conditions must be met:

(a) No sales commissions or other fees are paid by the Client Plan in connection with the purchase of Fund shares.

(b) All transferred assets are securities for which market quotations are readily available, or cash.

(c) The transferred assets constitute the Client Plan's pro rata portion of all assets that were held by the CIF immediately prior to the transfer. Notwithstanding the foregoing, the allocation of fixed-income securities held by a CIF among Client Plans on the basis of each Client Plan's pro rata share of the aggregate value of such securities will not fail to meet the requirements of this subsection if: (1) The aggregate value of such securities does not exceed one (1) percent of the total value of the assets held by the CIF immediately prior to the transfer; and (2) Such securities have the same coupon rate and maturity, and at the time of the transfer, the same credit ratings from nationally recognized statistical rating agencies.

(d) The Client Plan receives Fund shares that have a total net asset value equal to the value of the Client Plan's transferred assets on the date of the transfer, as determined with respect to securities, in a single valuation for each asset, with all valuations performed in the same manner, at the close of the same business day, in accordance with Securities and Exchange Commission Rule 17a-7 (using sources independent of the Bank or Plan Adviser and the Fund) and the procedures established by the Funds pursuant to Rule 17a-7.

(e) An independent fiduciary with respect to the Client Plan (the Independent Fiduciary) receives advance written notice of the in-kind transfer and purchase of assets and full written disclosure of information concerning the Funds which includes the following:

(1)A current prospectus for each Fund to which the CIF assets may be transferred;
(2)A statement describing the fees to be charged to, or paid by, a Client Plan and the Funds to the Bank or Plan Adviser, including the nature and extent of any differential between the rates of the fees paid by the Fund and the rates of the fees paid by the Client Plan in connection with the Client Plan's investment in the CIF;
(3)A statement of the reasons why the Bank or Plan Adviser may consider the transfer and purchase to be appropriate for the Client Plan;
(4)A statement of whether there are any limitations on the Bank or Plan Adviser with respect to which plan assets may be invested in shares of the Funds, and, if so, the nature of such limitations;
(5)The identity of all securities that will be valued in accordance with Rule 17a-7(b)(4) and allocated on the basis of the Client Plan's pro rata portion under section II(c); and
(6)The identity of any fixed-income securities that will be allocated on the basis of each Client Plan's pro rata share of the aggregate value of such securities pursuant to section II(c).

(f) On the basis of the foregoing information, the Independent Fiduciary gives prior approval, in writing, for each purchase of Fund shares in exchange for the Client Plan's assets transferred from the CIF, consistent with the responsibilities, obligations and duties imposed on fiduciaries by Part 4 of Title I of the Act. In addition, the Independent Fiduciary must give prior approval, in writing, for the receipt of confirmation statements described below in paragraph (g)(1) and (g)(2) by facsimile or electronic mail if the Independent Fiduciary elects to receive such statements in that form.

(g) The Bank or Plan Adviser sends by regular mail or personal delivery or, if applicable, by facsimile or electronic mail to the Independent Fiduciary of each Client Plan that purchases Fund shares in connection with the in-kind transfer, the following information:

1. No later than 30 days after the completion of the purchase, a written confirmation which contains--(i) The identity of each transferred security that was valued for purposes of the purchase of Fund shares in accordance with Rule 17a-7(b)(4); (ii) The current market price, as of the date of the in-kind transfer, of each such security involved in the purchase of Fund shares; and (iii) The identity of each pricing service or market-maker consulted in determining the current market price of such securities.
2. No later than 105 days after the completion of each purchase, a written confirmation which contains—

(i) The number of CIF units held by the Client Plan immediately before the in-kind transfer, the related per unit value and the total dollar amount of such CIF units; and (ii) The number of shares in the Funds that are held by the Client Plan immediately following the purchase, the related per share net asset value and the total dollar amount of such shares.

(h) With respect to each of the Funds in which the Client Plan continues to hold shares acquired in connection with the in-kind transfer, the Bank or Plan Adviser provides the Independent Fiduciary of the Client Plan with--(1) A copy of an updated prospectus of such Fund, at least annually; and (2) Upon request of the Independent Fiduciary, a report or statement (which may take the form of the most recent financial report, the current Statement of Additional Information, or some other written statement) containing a description of all fees paid by the Fund to the Bank or Plan Adviser.

(i) As to each Client Plan, the combined total of all fees received by the Bank or Plan Adviser for the provision of services to the Client Plan, and in connection with the provision of services to a Fund in which a Client Plan holds shares acquired in connection with the in-kind transfer, is not in excess of "reasonable compensation" within the meaning of section 408(b)(2) of the Act.

(j) All dealings in connection with the in-kind transfer and purchase between the Client Plan and a Fund are on a basis no less favorable to the Client Plan than dealings between the Fund and other shareholders.

Section III.

Availability of Prohibited Transaction Exemption (PTE) 77-4

Any purchase of Fund shares that complies with the conditions of either Section I or Section II of this class exemption shall be treated as a "purchase or sale" of shares of an open-end investment company for purposes of PTE 77-4 and shall be deemed to have satisfied paragraphs (a), (d) and (e) of section II of that exemption. 42 FR 18732 (April 8, 1977).

Section IV.

Definitions For purposes of this exemption:

(a) The term "Bank" means a bank or trust company, and any affiliate thereof [as defined below in paragraph (b)(1)], which is supervised by a state or federal agency.

(b) An "affiliate" of a person includes--(1) Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person. (2) Any officer, director, employee or relative of such person, or partner in any such person; and (3) Any corporation or partnership of which such person is an officer, director, partner or employee.

(c) The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(d) The term "collective investment fund" or "CIF" means a common or collective trust fund or pooled investment fund maintained by a "Bank" as defined in paragraph (a) of this Section IV or by a "Plan Adviser" as defined in paragraph (m) of this Section IV for the collective investment of the assets attributable to two or more plans maintained by unrelated employers.

(e) The term "Fund" or "Funds" means any open-end management investment company or companies registered under the 1940 Act for which the Bank or Plan Adviser serves as an investment adviser, and may also serve as a custodian, shareholder servicing agent, transfer agent or provide some other secondary service (as defined below in paragraph (i) of this section).

(f) The term "net asset value" means the amount calculated by dividing the value of all securities, determined by a method as set forth in a Fund's prospectus and Statement of Additional Information, and other assets belonging to each of the portfolios in such Fund, less the liabilities chargeable to each portfolio, by the number of outstanding shares.

(g) The term "relative" means a "relative" as that term is defined in section 3(15) of the Act (or a "member of the family" as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or a sister.

(h) The term "Independent Fiduciary" means a fiduciary of a Client Plan who is independent of and unrelated to the Bank or Plan Adviser. For purposes of this exemption, the Independent Fiduciary will not be deemed to be independent of and unrelated to the Bank or Plan Adviser if: (1) Such fiduciary directly or indirectly controls, is controlled by, or is under common control with the Bank or Plan Adviser; (2) Such fiduciary, or any officer, director, partner, employee, or relative of such fiduciary, is an officer, director, partner, employee of the Bank or Plan Adviser (or is a relative of such persons); (3) Such fiduciary, directly or indirectly receives any compensation or other consideration for his or her own personal account in connection with any transaction described in this exemption.

If an officer, director, partner, employee of the Bank or Plan Adviser (or relative of such persons), is a director of such Independent Fiduciary, and if he or she abstains from participation in (i) the choice of the Client Plan's investment adviser, and (ii) the approval of any purchase or sale between the Client Plan and the Funds, as well as any transaction described in Sections I and II above, then paragraph (h)(2) of this Section IV shall not apply.

(i) The term "secondary service" means a service provided by a Bank or Plan Adviser to a Fund other than investment management, investment advisory or similar services.

(j) The term "fixed-income security" means any interest-bearing or discounted government or corporate security with a face amount of $1,000 or more that obligates the issues to pay the holder a specified sum of money, at specific intervals, and to repay the principal amount of the loan at maturity.

(k) The term "Client Plan" means a pension plan described in 29 CFR 2510.3-2, a welfare benefit plan described in 29 CFR 2510.3-1, and a plan described in section 4975(e)(1) of the Code , but does not include an employee benefit plan established or maintained by the Bank or a Plan Adviser for its own employees.

(l) The term "security" shall have the same meaning as defined in section 2(36) of the 1940 Act, as amended, 15 U.S.C. 80a-2(36) (1996).

(m) The term "Plan Adviser" means an investment adviser registered under the Investment Advisers Act of 1940, and any "affiliate" thereof [as defined above in paragraph (b)(1)].

(n) The term "business day" means a banking day as defined by federal or state banking regulations.

(o) The term "unrelated employers" means persons which are not, directly or indirectly, affiliates, as defined above in paragraph (b)(1).

(p) The term "personal delivery" means delivery of the information described in sections I(g) and II(g) above to an individual or individuals designated by the Client Plan to act on behalf of the Independent Fiduciary.

Signed at Washington, D.C., this 1st day of August, 1997.

Alan D. Lebowitz,

Deputy Assistant Secretary for Program Operations, Pension and Welfare

Benefits Administration, Department of Labor.

[FR Doc. 97-21003 Filed 8-7-97; 8:45 AM]

Prohibited Transaction Class Exemption 98-54

Foreign Exchange Transactions Executed Pursuant to Standing Instructions

November 12, 1998 (FR Doc 98-30291)

Recap

Permits foreign exchange transactions between employee benefit plans and banks and broker-dealers, which are parties in interest with respect to such plans, pursuant to standing instructions.

Class Exemption

Foreign Exchange Transactions Executed Pursuant to Standing Instructions

Agency: Department of Labor, Pension and Welfare Benefits Administration

Action: Grant of Class Exemption

Effective Dates: Section II is effective for transactions occurring from June 18, 1991 to January 12, 999. Section III is effective for transactions occurring after January 12, 1999.

Exemption

Effective Dates: Section II is effective for transactions occurring from June 18, 1991 to January 12, 1999. Section III is effective for transactions occurring after January 12, 1999.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 ERISA Procedure 75-1 (40 FR 18471, April 28, 1975).

Section I Covered Transactions

a. For the period from June 18, 1991 to January 12, 1999, the restrictions of sections 406(a)(1)(A) through (D) and 406(b)(1) and (b)(2) of the Employee Retirement Security Act of 1974 (ERISA or the Act) and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code), by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the following foreign exchange transactions, between a bank or broker-dealer and an employee benefit plan with respect to which the bank or broker-dealer is a trustee, custodian, fiduciary or other party in interest, pursuant to a standing instruction, if the conditions set forth in section II below are met:
    1. An income item conversion; or
    2. A de minimis purchase or sale transaction.
b. Effective after January 12, 1999, the restrictions of sections 406(a)(1)(A) through (D) and 406(b)(1) and (b)(2) of the Act and the taxes imposed by section 4975(a) and (b) of Code, by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the following foreign exchange transactions, between a bank or broker-dealer, and an employee benefit plan with respect to which the bank or broker-dealer is a trustee, custodian, fiduciary or other party in interest, pursuant to a standing instruction, if the conditions set forth in section III below are met:
    1. An income item conversion; or
    2. A de minimis purchase or sale transaction.

Section II Retroactive Conditions

a. At the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties.
b. At the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms afforded by the bank or the broker-dealer in comparable arm's length foreign exchange transactions involving unrelated parties.
c. Neither the bank, the broker-dealer nor any foreign affiliate thereof, has any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of 29 CFR 2510.3-21(c)) with respect to the investment of those assets.
d. The bank or broker-dealer maintains at all times written policies and procedures regarding the handling of foreign exchange transactions for plans with respect to which the bank or broker-dealer is a trustee, custodian, fiduciary or other party in interest or disqualified person which assure that

the person acting for the bank or broker-dealer knows that he or she is dealing with a plan.

e. The exchange rate used by the bank or broker-dealer for a particular foreign exchange transaction did not deviate by more than 10% (above or below) the interbank bid and asked rates at the time of the transaction as displayed on Reuters or another independent service in the foreign currency market for such currency; provided, however, that a prohibited transaction shall not be deemed to have occurred solely because records demonstrating compliance with this section with respect to specific transactions have been lost, destroyed or are not available to the bank or broker-dealer. Nothing in this section shall be deemed to relieve the bank or broker-dealer of its responsibility to demonstrate compliance with the conditions of this exemption.
f. A written confirmation statement is furnished with respect to each covered transaction to the independent plan fiduciary that authorized the standing instruction. The confirmation statement shall include:

    A. Account name;
    B. Transaction date;
    C. Exchange rates;
    D. Settlement date;
    E. Currencies exchanged;

    i. Identity of foreign currency sold;
    ii. Amount sold;
    iii. Identity of currency purchased; and
    iv. Amount purchased.

The confirmation shall be issued in no event more than 5 business days after execution of the transaction.

Section III Prospective Conditions

a. At the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's-length foreign exchange transactions between unrelated parties.
b. At the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms afforded by the bank or broker-dealer in comparable arm's-length foreign exchange transactions involving unrelated parties.
c. Neither the bank, the broker-dealer, nor any foreign affiliate thereof has any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of 29 CFR 2510.3-21(c)) with respect to the investment of those assets.
d. The bank or broker-dealer maintains at all times written policies and procedures regarding the handling of foreign exchange transactions for plans with respect to which the bank or broker-dealer is a trustee, custodian, fiduciary or other party in interest or disqualified person which assure that the person acting for the bank or broker-dealer knows that he or she is dealing with a plan.
e. The covered transaction is performed under a written authorization executed in advance by a fiduciary of the plan whose assets are involved in the transaction, which plan fiduciary is independent of the bank or broker-dealer engaging in the covered transaction or any foreign affiliate thereof. The written authorization must specify: (1) The identities of the currencies in which covered transactions may be executed; and (2) That the authorization may be terminated by either party without penalty on no more than ten days notice.
f. (1) Income item conversions are executed within no more than one business day from the date of receipt of notice by the bank or broker-dealer that such items are good funds, and a foreign custodian which is an affiliate of the bank or broker-dealer, provides such notice to the bank or broker-dealer within ``one business day'' of its receipt of good funds;

    (2) De minimis purchase and sale transactions are executed within no more than one business day from the date that either the bank or broker-dealer receives notice from a foreign custodian that the proceeds of a sale of foreign securities denominated in foreign currency are good funds, or the direction to acquire foreign currency was received by the bank or broker-dealer, and a foreign custodian which is an affiliate of the bank or broker-dealer, provides such notice to the bank or broker-dealer within one business day of its receipt of good funds from a sale.

g. (1) At least once each day, at the time(s) specified in its written policies and procedures, the bank or broker-dealer establishes either a rate of exchange or a range of rates to be used for income

item conversions and de minimis purchase and sale transactions covered by this exemption.

(2) Income item conversions are executed at the next scheduled time for conversions following receipt of notice by the bank or broker-dealer from the foreign custodian that such funds are good funds. If it is the policy of the bank or broker-dealer to aggregate small amounts of foreign currency until a specified minimum threshold amount is received, then the conversion may take place at a later time but in no event more than 24 hours after receipt of notice.

(3) De minimis purchase and sale transactions are executed at the next scheduled time for such transactions following receipt of either notice that the sales proceeds denominated in foreign currency are good funds, or a direction to acquire foreign currency. If it is the policy of the bank or broker-dealer to aggregate small transactions until a specified threshold amount is received, then the execution may take place at a later time but in no event more than 24 hours after receipt of either notice that the sales proceeds have been received by the foreign custodian as good funds, or a direction to acquire foreign currency. For purposes of this paragraph (g), the range of exchange rates established by the bank or broker-dealer for a particular foreign currency cannot deviate by more than three percent [above or below] the interbank bid and asked rates as displayed on Reuters or another nationally recognized independent service in the foreign exchange market, for such currency at the time such range of rates is established by the bank or broker-dealer.

h. Prior to the execution of the authorization referred to in paragraph (e), the bank or broker-dealer provides the independent fiduciary with a copy of the bank's or broker-dealer's written policies and procedures regarding the handling of foreign exchange transactions involving income item conversions and de minimis purchase and sale transactions. The policies and procedures must, at a minimum, contain the following information:

1. Disclosure of the time(s) each day that the bank or broker-dealer will establish the specific rate of exchange or the range of exchange rates for the covered transactions to be executed and the time(s) that such covered transactions will take place. The bank or broker-dealer shall include a description of the methodology that the bank or broker-dealer uses to determine the specific exchange rate or range of exchange rates;
2. Disclosure that income item conversions and de minimis purchase and sale transactions will be executed at the first scheduled transaction time after notice that good funds from an income item conversion or a sale have been received, or a direction to purchase foreign currency has been received. To the extent that the bank or broker-dealer aggregates small amounts of foreign currency until a specified minimum threshold amount is met, a description of this practice and disclosure of the threshold amount; and
3. A description of the process by which the bank's or broker-dealer's foreign exchange policies and procedures for income item conversions and de minimis purchase and sale transactions may be amended and disclosed to plans.

i. The bank or broker-dealer engaging in the covered transaction furnishes to the independent fiduciary a written confirmation statement with respect to each covered transaction not more than five business days after execution of the transaction.

1. With respect to income item conversions, the confirmation shall disclose the following information:

    A. Account name;
    B. Date of notice that good funds were received;
    C. Transaction date;
    D. Exchange rate;
    E. Settlement date;
    F. Identity of foreign currency;
    G. Amount of foreign currency sold;
    H. Amount of U.S. dollars or other currency credited to the plan; and

2. With respect to de minimis purchase and sale transactions, the confirmation shall disclose the following information:

    A. Account name;

B. Date of notice that sales proceeds denominated in foreign currency are received as good funds or direction to acquire foreign currency was received;
C. Transaction date;
D. Exchange rates;
E. Settlement date;
F. Currencies exchanged:

i. Identity of the currency sold;
ii. The amount sold;
iii. Identity of the currency purchased; and
iv. The amount purchased;

j. The bank or broker-dealer, maintains, within territories under the jurisdiction of the United States Government, for a period of six years from the date of the transaction, the records necessary to enable the persons described in paragraph (l) of this section to determine whether the applicable conditions of this exemption have been met, including a record of the specific exchange rate or range of exchange rates the bank or broker-dealer established each day for foreign exchange transactions effected under standing instructions for income item conversions and de minimis purchase and sale transactions. However, a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the bank's or broker-dealer's control, the records are lost or destroyed prior to the end of the six-year period, and no party in interest other than the bank or broker-dealer shall be subject to the civil penalty that may be assessed under section 502(i) of the Act, or the taxes imposed by section 4975(a) and (b) of the Code, if the records are not maintained by the bank or broker-dealer, or are not made available for examination by the bank or broker-dealer, or its affiliate as required by paragraph (k) of this section.
k. (1) Except as provided in subparagraph (2) of this paragraph and notwithstanding any provisions of subsection (a)(2) and (b) of section 504 of the Act, the records referred to in paragraph (j) of this Section are available at their customary location for examination, upon reasonable notice, during normal business hours by:

A. Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service.
B. Any fiduciary of a plan who has authority to acquire or dispose of the assets of the plan involved in the foreign exchange transaction or any duly authorized employee or representative of such fiduciary.
C. Any contributing employer to the plan involved in the foreign exchange transaction or any duly authorized employee or representative of such employer.

(2) None of the persons described in subparagraphs (B) and (C) shall be authorized to examine a bank's or broker-dealer's trade secrets or commercial or financial information of a bank or broker-dealer, which is privileged or confidential.

Section IV Definitions and General Rules

For purposes of this exemption,

a. A foreign exchange transaction means the exchange of the currency of one nation for the currency of another nation.
b. The term standing instruction means a written authorization from a plan fiduciary, who is independent of the bank or broker-dealer engaging in the foreign exchange transaction and any foreign affiliate thereof, to the bank or broker-dealer to effect the transactions specified therein pursuant to the instructions provided in such authorization.
c. A bank means a bank which is supervised by the United States or a State thereof, or any domestic affiliate thereof.
d. A broker-dealer means a broker-dealer registered under the Securities Exchange Act of 1934, or any domestic affiliate thereof.
e. A domestic affiliate of a bank or broker-dealer means any entity which is supervised by the United States or a State thereof and which is directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such bank or broker-dealer.
f. The term control means the power to exercise a controlling influence over the management or policies of a person other than an individual.

g. An income item conversion means: (1) The conversion into U.S. dollars of an amount which is the equivalent of no more than 300,000 U.S. dollars of interest, dividends or other distributions or payments with respect to a security, tax reclaims, proceeds from dispositions of rights, fractional shares or other similar items denominated in the currency of another nation that are received by the bank or broker-dealer on behalf of the plan from the plan's foreign investment portfolio; or (2) the conversion into any currency as required and specified by the standing instruction of an amount which is the equivalent of no more than 300,000 U.S. dollars of interest, dividends, or other distributions or payments with respect to a security, tax reclaims, proceeds from dispositions of rights, fractional shares or other similar items denominated in the currency of another nation that are received by the bank or broker-dealer on behalf of the plan from the plan's foreign investment portfolio, provided that the converted funds are either transferred to an interest bearing account which provides a reasonable rate of interest within 24 hours of the conversion and held therein pending reinvestment by the plan or the bank reinvests such proceeds within 24 hours of the conversion at the direction of the plan.
h. A de minimis purchase or sale transaction means the purchase or sale of foreign currencies in an amount of no more than 300,000 U.S. dollars or the equivalent thereof in connection with the purchase or sale of foreign securities by a plan.
i. For purposes of this exemption the term employee benefit plan refers to a pension plan described in 29 CFR Sec. 2510.3-2 and/or a welfare benefit plan described in 29 CFR Sec. 2510.3-1.
j. For purposes of this exemption, the term good funds means funds immediately available in cash with no sovereign or other governmental impediments or restrictions to the exchange or transfer of such funds.
k. For purposes of this exemption, the term business day means a banking day as defined by federal or state banking regulations.
l. For purposes of this exemption, the term foreign affiliate of a bank or broker-dealer means any non-U.S. entity which is directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such bank or broker-dealer.

Signed at Washington, DC this 6th day of November 1998.
Alan D. Lebowitz,

Deputy Assistant Secretary for Program Operations, Pension and Welfare

Benefits Administration, Department of Labor.

[FR Doc. 98-30291 Filed 11-12-98; 8:45 am]

Billing Code 4510-29-P

Prohibited Transaction Class Exemption 2000-14

Amendment to PTE 80-26 for Certain Interest Free Loans to Employee Benefit Plans

April 3, 2000 (65 FR 17540)

Recap
Provides a temporary amendment to PTE 80-26, permitting parties-in-interest to make interest free loans to a plan to continue the plan's ordinary operation, in the event it experiences an inability to liquidate or access assets, or to access data as a result of a Y2K problem, but permits the loans to be repaid no later than December 31, 2000.

Class Exemption

Amendment to PTE 80-26 for Certain Interest Free Loans to Employee Benefit Plans

Agency: Department of Labor, Pension and Welfare Benefits Administration

Action: Grant of Class Exemption

Effective Date: The amendment to PTE 80-26 is effective from November 1, 1999 until

December 31, 2000.

Exemption

Section I: General Exemption

Effective January 1, 1975, the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(B) and (D) of the Code, shall not apply to the lending of money or other extension of credit from a party in interest or disqualified person to an employee benefit plan, nor to the repayment of such loan or other extension of credit in accordance with its terms or written modifications thereof, if:

a. No interest or other fee is charged to the plan, and no discount for payment in cash is relinquished by the plan, in connection with the loan or extension of credit;
b. The proceeds of the loan or extension of credit are used only:

    1. For the payment of ordinary operating expenses of the plan, including the payment of benefits in accordance with the terms of the plan and periodic premiums under an insurance or annuity contract; or
    2. For a period of no more than three business days, for a purpose incidental to the ordinary operation of the plan;

c. The loan or extension of credit is unsecured; and

d. The loan or extension of credit is not directly or indirectly made by an employee benefit plan.

Section II: Temporary Exemption

Effective November 1, 1999 through December 31, 2000, the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(B) and (D) of the Code , shall not apply to the lending of money or other extension of credit from a party in interest or disqualified person to an employee benefit plan, nor to the repayment of such loan or other extension of credit in accordance with its terms or written modifications thereof, if:

a. No interest or other fee is charged to the plan, and no discount for payment in cash is relinquished by the plan, in connection with the loan or extension of credit;

b. The proceeds of the loan or extension of credit are used only for a purpose incidental to the ordinary operation of the plan which arises in connection with the plan's inability to liquidate, or otherwise access its assets or access data as a result of a Y2K problem.

    c. The loan or extension of credit is unsecured;
    d. The loan or extension of credit is not directly or indirectly made by an employee benefit plan;
    e. The loan or extension of credit begins on or after November 1, 1999 and is repaid or terminated no later than December 31, 2000.

For the purposes of section II, a Y2K problem is a disruption of computer operations resulting from a computer system's inability to process data because such system recognizes years only by the last two digits, causing a "00" entry to be read as the year "1900" rather than the year "2000."

Signed at Washington, D.C., this 28th day of March, 2000.

Ivan L. Strasfeld,

Director of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 00-8057 Filed 3-31-00; 8:45 AM]

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requirements. The following sections describe who uses the information collected under each requirement, as well as how they use it. The purpose these requirements is to reduce employees' risk of death or serious injury by ensuring that forging machines used by them are in safe operating condition, and that they are able to clearly and properly identify manually operated valves and switches.

Inspection of Forging Machines, Guards, and Point-of-Operation Protection Devices (paragraphs (a)(2)(i) and (a)(2)(ii)). Paragraph (a)(2)(i) requires employers to establish periodic and regular maintenance safety checks, and to develop and keep a certification record of each inspection. The certification record must include the date of inspection, the signature of the person who performed the inspection, and the serial number (or other identifier) of the forging machine inspected. Under paragraph (a)(2)(ii), employers are to schedule regular and frequent inspections of guards and point-of-operation protection devices, and prepare a certification record of each inspection that contains the date of the inspection, the signature of the person who performed the inspection, and the serial number (or other identifier) of the equipment inspected. These inspection certification records provide assurance to employers, employees, and OSHA compliance officers that forging machines, guards, and point-of-operation protection devices have been inspected, assuring that they will operate properly and safely, thereby preventing impact injury and death to employees during forging operations. These records also provide the most efficient means for the compliance officers to determine that an employer is complying with the Standard.

Identification of Manually Controlled Valves and Switches (paragraphs (c), (h)(3), (i)(1) and (i)(2)). These paragraphs require proper and clear identification of manually operated valves and switches on presses, upsetters, boltheading equipment, and rivet-making machines, respectively. Marking valves and switches provide information to employees to ensure that they operate the forging machines correctly and safely.

Darrin A. King,

Acting Departmental Clearance Officer.

[FR Doc. 05–16679 Filed 8–22–05; 8:45 am]

BILLING CODE 4510–26–P

DEPARTMENT OF LABOR

Office of the Secretary

Senior Executive Service; Appointment of a Member to the Performance Review Board

Title 5 U.S.C. 4314(c)(4) provides that Notice of the Appointment of an individual to serve as a member of the Performance Review Board of the Senior Executive Service shall be published in the **Federal Register**.

The following individuals are hereby appointed to a three-year term on the Department's Performance Review Board: John McWilliam; Felix Quintana; Corlis Sellers.

FOR FURTHER INFORMATION CONTACT: Ms. Anne Bartels, Director, Office of Executive Resources and Personnel Security, Room C5508, U.S. Department of Labor, Frances Perkins Building, 200 Constitution Avenue, NW., Washington, DC 20210, telephone: (202) 693–7628.

Signed at Washington, DC, this 16th day of August, 2005.

Elaine L. Chao,

Secretary of Labor.

[FR Doc. 05–16678 Filed 8–22–05; 8:45 am]

BILLING CODE 4510–23–M

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Application Number D–11047]

Amendment to Prohibited Transaction Exemption (PTE) 84–14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers

AGENCY: Employee Benefits Security Administration.

ACTION: Adoption of amendment to PTE 84–14.

SUMMARY: This document amends PTE 84–14, a class exemption that permits various parties that are related to employee benefit plans to engage in transactions involving plan assets if, among other conditions, the assets are managed by ''qualified professional asset managers'' (QPAMs), which are independent of the parties in interest and which meet specified financial standards. Additional exemptive relief is provided for employers to furnish limited amounts of goods and services to a managed fund in the ordinary course of business. Limited relief is also provided for leases of office or commercial space between managed funds and QPAMs or contributing employers. Finally, relief is provided for transactions involving places of public accommodation owned by a managed fund. The amendment affects participants and beneficiaries of employee benefit plans, the sponsoring employers of such plans, and other persons engaging in the described transactions.

DATES: Except where otherwise indicated herein, the amendment is effective August 23, 2005.

FOR FURTHER INFORMATION CONTACT: Christopher J. Motta or Karen E. Lloyd, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Room N–5649, 200 Constitution Avenue, NW., Washington, DC 20210, (202) 693–8540 (not a toll-free number).

SUPPLEMENTARY INFORMATION: On September 3, 2003, a notice was published in the **Federal Register** (68 FR 52419) of the pendency before the Department of Labor (the Department) of a proposed amendment to PTE 84–14 (49 FR 9494, March 13, 1984, as corrected at 50 FR 41430, October 10, 1985). PTE 84–14 provides an exemption from certain of the restrictions of section 406 of ERISA, and from certain taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1) of the Code. The Department proposed to amend to PTE 84–14 on its own motion, pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).[1]

The notice of pendency gave interested persons an opportunity to comment on the proposed exemption. The Department received six comment letters. In general, the commenters expressed support for the proposed amendments. Upon consideration of all the comments received, the Department has determined to grant the proposed amendment, subject to certain modifications. These modifications and the major comments are discussed below.

Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether the regulatory action is ''significant'' and therefore subject to the requirements of

[1] Section 102 of the Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996), generally transferred the authority of the Secretary of Treasury to issue administrative exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

For purposes of this exemption, references to specific provisions of Title I of the Act, unless otherwise specified, refer also to the corresponding provisions of the Code.

the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule: (1) Having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

This amendment has been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. Pursuant to the terms of the Executive Order, it has been determined that this action is a ''significant regulatory action.'' Accordingly, this action has been reviewed by OMB.

Paperwork Reduction Act

The information collections in the exemption, as re-stated and amended in the adoption of Amendment to PTE 84–14, and in the Proposed Amendment to Prohibited Transaction Exemption 84–14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers have been combined in one ICR that is described in the Paperwork Reduction Act section of the Notice of the Proposed Amendment also published in this issue of the **Federal Register**.

Description of the Exemption

PTE 84–14 consists of four separate parts. The General Exemption, set forth in Part I, permits an investment fund managed by a QPAM to engage in a wide variety of transactions described in ERISA section 406(a)(1)(A) through (D) with virtually all parties in interest except the QPAM which manages the assets involved in the transaction and those parties most likely to have the power to influence the QPAM. In this regard, under section I(a), the exemption would not be available if a QPAM caused the investment fund to enter into a transaction with a party in interest dealing with the fund, if the party in interest or its ''affiliate,'' (1) was authorized to appoint or terminate the QPAM as a manager of any of the plan's assets, (2) was authorized to negotiate the terms of the management agreement with the QPAM (including renewals or modifications thereof) on behalf of the plan, or (3) had exercised such powers in the immediately preceding one year. Additionally, under section I(d), the QPAM may not cause the investment fund which it manages to engage in a transaction with itself or a ''related'' party. Section V(h) provides generally that a party in interest and a QPAM are ''related'' if either entity (or parties controlling or controlled by either entity) owns a five percent or more interest in the other entity.

Part II of the exemption provides limited relief under both section 406(a) and (b) of ERISA for certain transactions involving those employers and certain of their affiliates which could not qualify for the General Exemption provided by Part I. Part III of the exemption provides limited relief under section 406(a) and (b) of ERISA for the leasing of office or commercial space by an investment fund to the QPAM, an affiliate of the QPAM, or a person who could not qualify for the General Exemption provided by Part I because it held the power of appointment described in section I(a). Part IV of the exemption provides limited relief under section 406(a) and 406(b)(1) and (2) of ERISA for the furnishing of services and facilities by a place of public accommodation owned by an investment fund managed by a QPAM, to all parties in interest, if the services and facilities are furnished on a comparable basis to the general public.

In the notice published September 3, 2003, the Department proposed to amend the General Exemption of PTE 84–14 in several respects. With respect to section I(a) (power of appointment), the Department proposed to delete the ''one year look-back rule'' under which the exemption would have been unavailable to a party in interest if it had exercised the power of appointment within the one-year period preceding the transaction. The Department also proposed to clarify that section I(a)'s power of appointment refers only to the power to appoint the QPAM as manager of the assets involved in the transaction, as opposed to any of the plan's assets. In addition, the Department proposed to modify section I(a) to make the class exemption available to a party in interest with respect to a plan investing in a commingled investment fund, notwithstanding that the party in interest has the authority to redeem or acquire units of such a fund on behalf of the plan, if the plan's interest in the fund represents less than 10% of the investment fund's total assets. Finally, the Department proposed to amend section V(c), the definition of affiliate as it applies to section I(a) and Part II, to delete those partnerships in which the person has less than a 10 percent interest and to only include highly compensated employees as defined in section 4975(e)(2)(H) of the Code.

With respect to section I(d) and the definition of ''related'' under section V(h), the Department proposed to amend section V(h) to provide that a QPAM is ''related'' to a party in interest for purposes of section I(d) if:

- The QPAM or the party in interest owns a 10 percent or more interest in the other entity;
- A person controlling or controlled by the QPAM or the party in interest owns a 20 percent or more interest in the other entity; or
- A person controlling, or controlled, by the QPAM or the party in interest owns less than a 20 percent interest in the other entity, but nevertheless exercises control over the management or policies of the other party by reason of its ownership interest.

In addition, the Department proposed to modify section V(h) to provide that generally determinations of whether the QPAM is ''related'' to a party in interest for purposes of section I(d) may be made as of the last day of the most recent calendar quarter. Finally, the Department proposed to amend section V(h)(2) to provide that shares held in a fiduciary capacity need not be considered in applying the percentage limitations.

With respect to the definition of QPAM, the Department proposed to clarify that the phrase in section V(a)(4) ''as of the last day of its most recent fiscal year'' only modifies the term ''total client assets under its management and control in excess of $50,000,000,'' and does not refer to the shareholders' or partners' equity requirement.

The Department also proposed to adjust the $50 million of client assets under management standard utilized in section V(a)(4) to $85 million, to reflect the change in the Consumer Price Index. Additionally, the Department proposed to increase the shareholders' and partners' equity requirement from $750,000 to $1,000,000, to correspond to the preceding subsections of section V(a).

Finally, the Department proposed to clarify the exemption to specifically provide that a QPAM must be independent of an employer with respect to a plan whose assets are managed by the QPAM.

Written Comments

Comments on Proposed Amendments

QPAM Independence

A number of commenters addressed the Department's proposed clarification of the QPAM requirement that it must be independent of an employer with respect to a plan whose assets are managed by the QPAM. According to the commenters, many employers in the financial services industry believed, based on the advice of counsel, that they were eligible to serve as QPAMs for their own plans. One commenter stated that as in-house counsel it obtained written legal advice from outside ERISA counsel and, in good faith reliance on such advice, determined that the class exemption allowed an employer to act as QPAM for its own plan. According to the advice memorandum submitted to the Department for the record, the ERISA counsel noted that there are several exceptions to the availability of relief under Part I of the class exemption. The general exemption will not apply to transactions with parties in interest who have the power to appoint the QPAM. In addition, no relief is available for transactions with the QPAM or a person ''related to'' the QPAM. The memorandum concluded that there is no exception from the availability of Part I relief for situations in which the QPAM is both employer and asset manager.

Another comment submitted on behalf of an asset manager stated that its in-house counsel initially determined that the class exemption did not preclude the manager from acting as QPAM for its own plan based on legal advice from outside counsel; and, subsequently, this determination was confirmed by discussions in-house counsel had with outside counsel and with potential plan counterparties. Another commenter stated that, as in-house counsel to a large financial services organization, it concluded based upon its analysis that the class exemption permitted an investment manager to act as a QPAM for its own plan. In considering the issue, the commenter noted that the class exemption focuses on the relationship between the investment manager and the party in interest. According to the commenter, neither Part I, nor the related definitions and the general rules under Part V, make mention of the relationship between the plan sponsor and the investment manager.

The commenters stated further that they are unaware of any examples of abuse associated with an advisor acting as a QPAM for its own plan. In addition, these commenters argued that the other conditions of the exemption are sufficient to protect plans from abuse. These commenters urged the Department to reverse its position that a QPAM must be independent of an employer with respect to a plan whose assets are managed by the QPAM.

As to the assertion that many practioners were ''unaware'' of the scope of the independence requirement discussed in the paragraph above, the Department notes that the preamble to PTE 84–14 (49 FR 9497) states:

> This class exemption was developed, and is being granted, by the Department based on the essential premise that broad exemptive relief from the prohibitions of section 406(a) of ERISA can be afforded for all types of transactions in which a plan engages only if the commitments and the investments of plan assets and the negotiations leading thereto, are the sole responsibility of an independent investment manager. [Emphasis added.]

In addition, the Department has received informal comments from other practitioners who were aware of the requirement that a QPAM must be independent of an employer with respect to a plan whose assets are managed by the QPAM and so advised their clients.

After carefully considering the entire record, the Department acknowledges that good faith efforts appear to have been made by the regulated community to comply with the QPAM independence requirement, based on advice of counsel. Although the Department is not revising the final amendment to permit financial services entities to act as QPAMs for their own plans, we are providing limited retroactive and transitional relief herein.[2] Accordingly, the independent fiduciary requirement of the QPAM definition will not apply for the period from December 21, 1982, through the date on which the Department grants a final amendment to the QPAM class exemption which specifically addresses relief for a financial institution to act as investment manager for its own in-house plan. In addition, by notice appearing elsewhere in this issue of the **Federal Register**, the Department is publishing a notice of proposed amendment to PTE 84–14 that would permit a financial institution to act as a QPAM for its own plan.

[2] The Department notes that the definition of independent fiduciary in the final amendment has been re-designated section V(o). The Department has inserted as section V(n) the amendment to the QPAM class exemption pursuant to PTE 2002–13 (67 FR 9483, March 1, 2002) which defines the term ''employee benefit plan'' or ''plan.''

Definition of QPAM

As part of the proposed amendment, the Department clarified that the language in section V(a)(4) ''as of the last day of its most recent fiscal year'' only modified the term ''total client assets under its management * * *'' and not the term ''shareholders' or partners' equity.'' A commenter noted that the language ''as of the last day of its most recent fiscal year'' also appears in connection with the shareholders'/ partners' equity requirement in another portion of section V(a)(4), and requested that the Department delete that language. The Department concurs with the commenter and has deleted the language.

Assets Involved in the Transaction

The Department proposed to amend section I(a), the power of appointment rule, to focus only on the power of appointment over the plan assets involved in the transaction. One commenter requested that the definition of affiliate in section V(c) be similarly amended. In this regard, an affiliate of a person is defined in section V(c) to include:

> (3) Any director of the person or any employee of the person who is a highly compensated employee, as defined in section 4975(e)(2)(H) of the Code, or who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets. A named fiduciary (within the meaning of section 402(a)(2) of ERISA) of a plan and an employer any of whose employees are covered by the plan will also be considered affiliates with respect to each other for purposes of section I(a) if such employer or an affiliate of such employer has the authority, alone or shared with others, to appoint or terminate the named fiduciary or otherwise negotiate the terms of the named fiduciary's employment agreement.

The commenter requested that the portion of the definition that refers to ''any employee * * * who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets'' be amended to refer only to the plan assets involved in the transaction. Likewise, the commenter requested a similar amendment with respect to the language that refers to ''a named fiduciary of a plan * * *'' The Department concurs with this comment and has revised the final exemption accordingly.

''Related'' Definition

The Department has proposed to amend the definition in section V(h) for purposes of determining whether a QPAM is ''related'' to a party in interest, as follows:

A QPAM is ''related'' to a party in interest * * * if, as of the last day of its most recent calendar quarter, (i) the QPAM owns a ten percent or more interest in the party in interest; (ii) a person controlling, or controlled by, the QPAM owns a twenty percent or more interest in the party in interest; (iii) the party in interest owns a ten percent or more interest in the QPAM; or (iv) a person controlling, or controlled by, the party in interest owns a twenty percent or more interest in the QPAM. Notwithstanding the foregoing, a party in interest is ''related'' to a QPAM if: (i) a person controlling, or controlled by, the party in interest owns less than a twenty percent interest in the QPAM and such person exercises control over the management or policies of the QPAM by reason of its ownership interest, or (ii) a person controlling, or controlled by, the QPAM owns less than a twenty percent interest in the party in interest and such person exercises control over the management or policies of the party in interest by reason of its ownership interest.

One commenter suggested that the threshold for determining whether a QPAM and a party in interest are related be increased from a 10 percent or more interest to a 20 percent or more interest. Another commenter suggested that the last sentence of the definition under which the QPAM and a party in interest are considered related parties with an ownership interest of less than 20 percent due to the exercise of actual control, be amended so that only ownership interests of less than 20 percent but greater than 10 percent would be excluded under this part of the definition.

The Department has determined not to adopt the commenter's suggestion to raise the ownership interest from 10 percent to 20 percent. The Department believes that it is not overly burdensome for the QPAM and the party in interest to keep track of ownership interests in each other. In addition, the Department views a 10 percent interest in either the QPAM or the party in interest by the other entity as a meaningful measure for determining whether a QPAM is related to a party in interest. Lastly, the Department has determined to adopt the second comment for ease of administration of this provision. However, the Department cautions that a QPAM that engages in a transaction with a party that has actual control over it (regardless of the percentage of ownership involved) might be engaging in a violation of 406(b) of ERISA for which the General Exemption does not provide relief.

Transitional Relief

Several commenters urged the Department to delay the effective date for certain of the proposed amendments in order to give parties more time to comply with the changes. In particular, transitional relief was requested for the client assets under management requirement and the shareholders/partners' equity requirement for QPAMs that are investment advisers registered under the Investment Advisers Act of 1940 (section V(a)(4)). One commenter requested that the client assets under management and shareholders' or partners' equity standards be effective as of the first fiscal year following the publication of the final amendment in the **Federal Register**. Another commenter requested two fiscal years for a QPAM to comply with the increased assets under management standard and one fiscal year for the increased shareholders'/partners' equity standard.

The Department concurs that transitional relief is appropriate in these cases to permit QPAMs to conform to the amended exemption. Accordingly, the effective date of the new client assets under management and the shareholders'/partners' equity standards of section V(a)(4) will be as of the last day of the first fiscal year beginning on or after the date of publication of this amendment in the **Federal Register**. The coordination of this transitional relief with section V(m) of the exemption, which defines ''shareholders'' or partners' equity,'' may be illustrated by the following example:

As of December 31, 2004, QPAM A had $55,000,000 in total client assets under its management and control, and $800,000 in shareholders' equity as demonstrated by the most recent balance sheet prepared within the immediately preceding two years. Based on these amounts, QPAM A, which operates on a calendar year basis and prepares audited balance sheets as of the last day of each calendar year, may continue to act as a QPAM until December 30, 2006 [assuming that this final amendment is published during 2005]. If QPAM A wishes to continue operating as a QPAM after that date, QPAM A: (i) must have total client assets under management in excess of $85,000,000 as of the last day of the most recent fiscal year preceding the transaction, and (ii) must have, as of the date of the transaction, shareholders' equity in excess of $1,000,000 as shown in the most recent balance sheet prepared within the immediately preceding two years.

Securities Lending Class Exemption Amendment

In October 2003, the Department proposed to amend and restate Prohibited Transaction Exemptions 81–6 and 82–63, relating to securities lending arrangements (68 FR 60715, October 23, 2003). The class exemption, if granted, would incorporate both PTEs 81–6 and 82–63 and would expand those class exemptions to additional parties, subject to modified conditions. It was brought to the attention of the Department that PTE 81–6 is referenced in section I(b)(1) of the QPAM class exemption. The Department intends that, following the finalization of the proposed amendment and restatement of PTEs 81–6 and 82–63, section I(b)(1) will continue to exclude transactions described therein from relief under the QPAM class exemption. Accordingly, the reference to PTE 81–6 in section I(b), as well as the references to other class exemptions therein, have been amended to include the phrase ''as amended or superseded.''

Comments Requesting Additional Amendments

Newly Formed Entities Serving as QPAMs

Under PTE 84–14, a QPAM that is an investment adviser registered under the Investment Advisers Act of 1940 must satisfy the assets under management test of section V(a)(4) as of the last day of the QPAM's most recent fiscal year. A commenter noted that it is difficult for newly-formed entities to satisfy this test and requested instead that the QPAM be permitted to satisfy the test based on its last fiscal quarter as demonstrated on a quarterly balance sheet.

The Department notes that the original QPAM class exemption required the QPAM to satisfy the client assets under management standard as of the last day of its most recent fiscal year to ensure that entities serving as QPAMs are established financial institutions which are large enough to discourage the exercise of undue influence upon their decisionmaking processes. Therefore, the Department has determined not to revise this condition.

Veto or Approval Power

Commenters on the original QPAM class exemption requested that plan officials be permitted to retain ultimate investment decision-making authority with respect to transactions negotiated by a QPAM. The Department did not adopt the suggestions of the commenters because of its view that retention of a veto or approval power would be inconsistent with the underlying concept of the QPAM exemption. The Department noted in the preamble to the QPAM class exemption that if exemptive relief were to be provided where the QPAM has less than ultimate discretion over acquisitions for an investment fund that it manages, the potential for decision making with regard to plan assets that would inure to the benefit of a party in interest would

be increased. A commenter with respect to the proposed amendments noted that in the INHAM class exemption, which was granted subsequent to the QPAM class exemption, approval power is reserved to the plan sponsor for transactions involving $5 million or more. The commenter requested that the Department likewise amend the QPAM class exemption to permit approval or veto by plan officials.

The Department is not persuaded by the argument in favor of retention of a veto or approval power by the plan sponsor or its designee. The relief contained in the QPAM class exemption was predicated upon the existence of an independent, professional asset manager who is solely responsible for the discretionary management of plan assets that are transferred to its control. The QPAM class exemption did not provide relief for transactions involving the assets of plans managed by in-house asset managers. Conversely, the INHAM class exemption provided more limited relief for plan assets managed by an in-house manager, subject to a number of conditions, which reflected the differences between the QPAM and the INHAM class exemptions. Thus, for example, relief under the INHAM class exemption is predicated upon an annual exemption audit conducted by an independent auditor to assure compliance with the conditions of the exemption. Although the INHAM class exemption permits the plan sponsor to retain a veto or approval power, the Department notes that the plan's assets under the INHAM class exemption, unlike the QPAM class exemption, remain under the management of an affiliate of the plan sponsor. Accordingly, the Department has determined not to revise this condition.

Section I(e)—20% Limitation

Section I(e) provides that a QPAM may not enter into a transaction with a party in interest with respect to any plan whose assets managed by the QPAM, when combined with the assets of other plans maintained by the same employer or affiliates of the employer, represent more than 20 percent of the total client assets managed by the QPAM at the time of the transaction. One commenter suggested that the Department's grant of the INHAM class exemption indicated that it was no longer concerned about the potential for undue influence by plan sponsors on managers with large amounts of plan assets under management. As a result, the commenter proposed that the 20 percent limitation contained in section I(e) of the QPAM class exemption be eliminated or increased.

The Department notes that the relief provided under both the QPAM exemption and the INHAM exemption, as well as the conditions and restrictions contained in each exemption, were designed to address the issues unique to in-house management and the retention of an independent manager. Since in-house managers primarily manage the assets of in-house plans, it would not have been practical for the Department to impose a 20 percent limitation similar to that found in the QPAM exemption. However, the Department developed other conditions and safeguards that enabled it to provide relief to in-house managers, consistent with the findings under section 408(a) of the Act. In this regard, the Department continues to believe that the 20 percent limitation plays a role in ensuring that the investment decisions of a QPAM are not improperly influenced by any one large plan client. Therefore, the Department has determined not to modify the 20 percent limitation in the QPAM class exemption.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of ERISA and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan from certain other provisions of ERISA and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of ERISA which require, among other things, that a fiduciary discharge his or her duties respecting plan solely in the interests of the participants and beneficiaries of the plan. Additionally, the fact that a transaction is the subject of an exemption does not affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) The Department finds that the amended exemption is administratively feasible, in the interests of plans and of their participants and beneficiaries, and protective of the rights of participants and beneficiaries of plans;

(3) The amended exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the exemption; and

(4) The amended exemption is supplemental to, and not in derogation of, any other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

Exemption

Under section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990), effective August 23, 2005, the Department amends PTE 84–14 as set forth below:

Part I—General Exemption

Effective as of August 23, 2005, the restrictions of ERISA section 406(a)(1)(A) through (D) and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(1)(A) through (D), shall not apply to a transaction between a party in interest with respect to an employee benefit plan and an investment fund (as defined in section V(b)) in which the plan has an interest, and which is managed by a qualified professional asset manager (QPAM) (as defined in section V(a)), if the following conditions are satisfied:

(a) At the time of the transaction (as defined in section V(i)) the party in interest, or its affiliate (as defined in section V(c)), does not have the authority to—

(1) Appoint or terminate the QPAM as a manager of the plan assets involved in the transaction, or

(2) Negotiate on behalf of the plan the terms of the management agreement with the QPAM (including renewals or modifications thereof) with respect to the plan assets involved in the transaction;

Notwithstanding the foregoing, in the case of an investment fund in which two or more unrelated plans have an interest, a transaction with a party in interest with respect to an employee benefit plan will be deemed to satisfy the requirements of section I(a) if the assets of the plan managed by the QPAM in the investment fund, when combined with the assets of other plans established or maintained by the same employer (or affiliate thereof described in section V(c)(1) of the exemption) or by the same employee organization, and managed in the same investment fund, represent less than 10 percent of the assets of the investment fund;

(b) The transaction is not described in—

(1) Prohibited Transaction Exemption 81–6 (46 FR 7527; January 23, 1981) (relating to securities lending arrangements) (as amended or superseded),

(2) Prohibited Transaction Exemption 83–1 (48 FR 895; January 7, 1983) (relating to acquisitions by plans of interests in mortgage pools) (as amended or superseded), or

(3) Prohibited Transaction Exemption 82–87 (47 FR 21331; May 18, 1982) (relating to certain mortgage financing arrangements) (as amended or superseded);

(c) The terms of the transaction are negotiated on behalf of the investment fund by, or under the authority and general direction of, the QPAM, and either the QPAM, or (so long as the QPAM retains full fiduciary responsibility with respect to the transaction) a property manager acting in accordance with written guidelines established and administered by the QPAM, makes the decision on behalf of the investment fund to enter into the transaction, provided that the transaction is not part of an agreement, arrangement or understanding designed to benefit a party in interest;

(d) The party in interest dealing with the investment fund is neither the QPAM nor a person related to the QPAM (within the meaning of section V(h));

(e) The transaction is not entered into with a party in interest with respect to any plan whose assets managed by the QPAM, when combined with the assets of other plans established or maintained by the same employer (or affiliate thereof described in section V(c)(1) of this exemption) or by the same employee organization, and managed by the QPAM, represent more than 20 percent of the total client assets managed by the QPAM at the time of the transaction;

(f) At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the QPAM, the terms of the transaction are at least as favorable to the investment fund as the terms generally available in arm's length transactions between unrelated parties;

(g) Neither the QPAM nor any affiliate thereof (as defined in section V(d)), nor any owner, direct or indirect, of a 5 percent or more interest in the QPAM is a person who within the 10 years immediately preceding the transaction has been either convicted or released from imprisonment, whichever is later, as a result of: any felony involving abuse or misuse of such person's employee benefit plan position or employment, or position or employment with a labor organization; any felony arising out of the conduct of the business of a broker, dealer, investment adviser, bank, insurance company or fiduciary; income tax evasion; any felony involving the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; conspiracy or attempt to commit any such crimes or a crime in which any of the foregoing crimes is an element; or any other crime described in section 411 of ERISA. For purposes of this section (g), a person shall be deemed to have been "convicted" from the date of the judgment of the trial court, regardless of whether that judgment remains under appeal.

Part II—Specific Exemption for Employers

Effective as of August 23, 2005, the restrictions of sections 406(a), 406(b)(1) and 407(a) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code, by reason of Code section 4975(c)(1)(A) through (E), shall not apply to:

(a) The sale, leasing, or servicing of goods (as defined in section V(j)), or to the furnishing of services, to an investment fund managed by a QPAM by a party in interest with respect to a plan having an interest in the fund, if—

(1) The party in interest is an employer any of whose employees are covered by the plan or is a person who is a party in interest by virtue of a relationship to such an employer described in section V(c),

(2) The transaction is necessary for the administration or management of the investment fund,

(3) The transaction takes place in the ordinary course of a business engaged in by the party in interest with the general public,

(4) Effective for taxable years of the party in interest furnishing goods and services after August 23, 2005, the amount attributable in any taxable year of the party in interest to transactions engaged in with an investment fund pursuant to section II(a) of this exemption does not exceed one (1) percent of the gross receipts derived from all sources for the prior taxable year of the party in interest, and

(5) The requirements of sections I(c) through (g) are satisfied with respect to the transaction;

(b) The leasing of office or commercial space by an investment fund maintained by a QPAM to a party in interest with respect to a plan having an interest in the investment fund, if—

(1) The party in interest is an employer any of whose employees are covered by the plan or is a person who is a party in interest by virtue of a relationship to such an employer described in section V(c),

(2) No commission or other fee is paid by the investment fund to the QPAM or to the employer, or to an affiliate of the QPAM or employer (as defined in section V(c)), in connection with the transaction,

(3) Any unit of space leased to the party in interest by the investment fund is suitable (or adaptable without excessive cost) for use by different tenants,

(4) The amount of space covered by the lease does not exceed fifteen (15) percent of the rentable space of the office building, integrated office park, or of the commercial center (if the lease does not pertain to office space),

(5) In the case of a plan that is not an eligible individual account plan (as defined in section 407(d)(3) of ERISA), immediately after the transaction is entered into, the aggregate fair market value of employer real property and employer securities held by investment funds of the QPAM in which the plan has an interest does not exceed 10 percent of the fair market value of the assets of the plan held in those investment funds. In determining the aggregate fair market value of employer real property and employer securities as described herein, a plan shall be considered to own the same proportionate undivided interest in each asset of the investment fund or funds as its proportionate interest in the total assets of the investment fund(s). For purposes of this requirement, the term "employer real property" means real property leased to, and the term "employer securities" means securities issued by, an employer any of whose employees are covered by the plan or a party in interest of the plan by reason of a relationship to the employer described in subparagraphs (E) or (G) of ERISA section 3(14), and

(6) The requirements of sections I(c) through (g) are satisfied with respect to the transaction.

Part III—Specific Lease Exemption for QPAMs

Effective as of August 23, 2005, the restrictions of section 406(a)(1)(A) through (D) and 406(b)(1) and (2) of ERISA and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the leasing of office or commercial space by an investment fund managed by a QPAM to the QPAM, a person who is a party in interest of a

plan by virtue of a relationship to such QPAM described in subparagraphs (G), (H), or (I) of ERISA section 3(14) or a person not eligible for the General Exemption of Part I by reason of section I(a), if—

(a) The amount of space covered by the lease does not exceed the greater of 7500 square feet or one (1) percent of the rentable space of the office building, integrated office park or of the commercial center in which the investment fund has the investment,

(b) The unit of space subject to the lease is suitable (or adaptable without excessive cost) for use by different tenants,

(c) At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the QPAM, the terms of the transaction are not more favorable to the lessee than the terms generally available in arm's length transactions between unrelated parties, and

(d) No commission or other fee is paid by the investment fund to the QPAM, any person possessing the disqualifying powers described in section I(a), or any affiliate of such persons (as defined in section V(c)), in connection with the transaction.

Part IV—Transactions Involving Places of Public Accommodation

Effective as of August 23, 2005, the restrictions of section 406(a)(1)(A) through (D) and 406(b)(1) and (2) of ERISA and the taxes imposed by Code section 4975(a) and (b), by reason of Code section 4975(c)(1)(A) through (E), shall not apply to the furnishing of services and facilities (and goods incidental thereto) by a place of public accommodation owned by an investment fund managed by a QPAM to a party in interest with respect to a plan having an interest in the investment fund, if the services and facilities (and incidental goods) are furnished on a comparable basis to the general public.

Part V—Definitions and General Rules

For purposes of this exemption:

(a) The term ''qualified professional asset manager'' or ''QPAM'' means an independent fiduciary (as defined in section V(o)) which is—

(1) A bank, as defined in section 202(a)(2) of the Investment Advisers Act of 1940 that has the power to manage, acquire or dispose of assets of a plan, which bank has, as of the last day of its most recent fiscal year, equity capital (as defined in section V(k)) in excess of $1,000,000 or

(2) A savings and loan association, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation, that has made application for and been granted trust powers to manage, acquire or dispose of assets of a plan by a State or Federal authority having supervision over savings and loan associations, which savings and loan association has, as of the last day of its most recent fiscal year, equity capital (as defined in section V(k)) or net worth (as defined in section V(l)) in excess of $1,000,000 or

(3) An insurance company which is qualified under the laws of more than one State to manage, acquire, or dispose of any assets of a plan, which company has, as of the last day of its most recent fiscal year, net worth (as defined in section V(l)) in excess of $1,000,000 and which is subject to supervision and examination by a State authority having supervision over insurance companies, or

(4) An investment adviser registered under the Investment Advisers Act of 1940 that has total client assets under its management and control in excess of $50,000,000 as of the last day of its most recent fiscal year, and either (A) shareholders' or partners' equity (as defined in section V(m)) in excess of $750,000, or (B) payment of all of its liabilities including any liabilities that may arise by reason of a breach or violation of a duty described in sections 404 and 406 of ERISA is unconditionally guaranteed by—(i) A person with a relationship to such investment adviser described in section V(c)(1) if the investment adviser and such affiliate have shareholders' or partners' equity, in the aggregate, in excess of $750,000, or (ii) A person described in (a)(1), (a)(2) or (a)(3) of section V above, or (iii) A broker-dealer registered under the Securities Exchange Act of 1934 that has, as of the last day of its most recent fiscal year, net worth in excess of $750,000; and (C) effective as of the last day of the first fiscal year of the investment adviser beginning on or after August 23, 2005, substitute ''$85,000,000'' for ''$50,000,000'' and ''$1,000,000'' for ''$750,000'' in (a)(4)(A) or (B) of section V above;

Provided that such bank, savings and loan association, insurance company or investment adviser has acknowledged in a written management agreement that it is a fiduciary with respect to each plan that has retained the QPAM.

(b) An ''investment fund'' includes single customer and pooled separate accounts maintained by an insurance company, individual trusts and common, collective or group trusts maintained by a bank, and any other account or fund to the extent that the disposition of its assets (whether or not in the custody of the QPAM) is subject to the discretionary authority of the QPAM.

(c) For purposes of section I(a) and Part II, an ''affiliate'' of a person means—

(1) Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the person,

(2) Any corporation, partnership, trust or unincorporated enterprise of which such person is an officer, director, 10 percent or more partner (except with respect to Part II this figure shall be 5 percent), or highly compensated employee as defined in section 4975(e)(2)(H) of the Code (but only if the employer of such employee is the plan sponsor), and

(3) Any director of the person or any employee of the person who is a highly compensated employee, as defined in section 4975(e)(2)(H) of the Code, or who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets involved in the transaction. A named fiduciary (within the meaning of section 402(a)(2) of ERISA) of a plan with respect to the plan assets involved in the transaction and an employer any of whose employees are covered by the plan will also be considered affiliates with respect to each other for purposes of section I(a) if such employer or an affiliate of such employer has the authority, alone or shared with others, to appoint or terminate the named fiduciary or otherwise negotiate the terms of the named fiduciary's employment agreement.

(d) For purposes of section I(g) an ''affiliate'' of a person means—

(1) Any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the person,

(2) Any director of, relative of, or partner in, any such person,

(3) Any corporation, partnership, trust or unincorporated enterprise of which such person is an officer, director, or a 5 percent or more partner or owner, and

(4) Any employee or officer of the person who—

(A) Is a highly compensated employee (as defined in section 4975(e)(2)(H) of the Code) or officer (earning 10 percent or more of the yearly wages of such person), or

(B) Has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets.

(e) The term ''control'' means the power to exercise a controlling influence over the management or

policies of a person other than an individual.

(f) The term ''party in interest'' means a person described in ERISA section 3(14) and includes a ''disqualified person,'' as defined in Code section 4975(e)(2).

(g) The term ''relative'' means a relative as that term is defined in ERISA section 3(15), or a brother, a sister, or a spouse of a brother or sister.

(h) A QPAM is ''related'' to a party in interest for purposes of section I(d) of this exemption if, as of the last day of its most recent calendar quarter: (i) the QPAM owns a ten percent or more interest in the party in interest; (ii) a person controlling, or controlled by, the QPAM owns a twenty percent or more interest in the party in interest; (iii) the party in interest owns a ten percent or more interest in the QPAM; or (iv) a person controlling, or controlled by, the party in interest owns a twenty percent or more interest in the QPAM. Notwithstanding the foregoing, a party in interest is ''related'' to a QPAM if: (i) a person controlling, or controlled by, the party in interest has an ownership interest that is less than twenty percent but greater than ten percent in the QPAM and such person exercises control over the management or policies of the QPAM by reason of its ownership interest; (ii) a person controlling, or controlled by, the QPAM has an ownership interest that is less than twenty percent but greater than ten percent in the party in interest and such person exercises control over the management or policies of the party in interest by reason of its ownership interest. For purposes of this definition:

(1) The term ''interest'' means with respect to ownership of an entity—

(A) The combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation,

(B) The capital interest or the profits interest of the entity if the entity is a partnership, or

(C) The beneficial interest of the entity if the entity is a trust or unincorporated enterprise; and

(2) A person is considered to own an interest if, other than in a fiduciary capacity, the person has or shares the authority—

(A) To exercise any voting rights or to direct some other person to exercise the voting rights relating to such interest, or

(B) To dispose or to direct the disposition of such interest.

(i) The time as of which any transaction occurs is the date upon which the transaction is entered into. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into on or after December 21, 1982, or a renewal that requires the consent of the QPAM occurs on or after December 21, 1982 and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, the requirements will continue to be satisfied thereafter with respect to the transaction. Notwithstanding the foregoing, this exemption shall cease to apply to a transaction exempt by virtue of Part I or Part II at such time as the percentage requirement contained in section I(e) is exceeded, unless no portion of such excess results from an increase in the assets transferred for discretionary management to a QPAM. For this purpose, assets transferred do not include the reinvestment of earnings attributable to those plan assets already under the discretionary management of the QPAM. Nothing in this paragraph shall be construed as exempting a transaction entered into by an investment fund which becomes a transaction described in section 406 of ERISA or section 4975 of the Code while the transaction is continuing, unless the conditions of this exemption were met either at the time the transaction was entered into or at the time the transaction would have become prohibited but for this exemption.

(j) The term ''goods'' includes all things which are movable or which are fixtures used by an investment fund but does not include securities, commodities, commodities futures, money, documents, instruments, accounts, chattel paper, contract rights and any other property, tangible or intangible, which, under the relevant facts and circumstances, is held primarily for investment.

(k) For purposes of section V(a)(1) and (2), the term ''equity capital'' means stock (common and preferred), surplus, undivided profits, contingency reserves and other capital reserves.

(l) For purposes of section V(a)(3), the term ''net worth'' means capital, paid-in and contributed surplus, unassigned surplus, contingency reserves, group contingency reserves, and special reserves.

(m) For purposes of section V(a)(4), the term ''shareholders' or partners' equity'' means the equity shown in the most recent balance sheet prepared within the two years immediately preceding a transaction undertaken pursuant to this exemption, in accordance with generally accepted accounting principles.

(n) The terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

(o) For purposes of section V(a), the term ''independent fiduciary'' means a fiduciary managing the assets of a plan in an investment fund that is independent of and unrelated to the employer sponsoring such plan. For purposes of this exemption, the independent fiduciary will not be deemed to be independent of and unrelated to the employer sponsoring the plan if such fiduciary directly or indirectly controls, is controlled by, or is under common control with the employer sponsoring the plan. Notwithstanding the foregoing, for the period from December 21, 1982, through the date on which the Department grants a final amendment which addresses relief for financial institutions that serve as investment managers for their own plans, a QPAM managing the assets of a plan in an investment fund will not fail to satisfy the requirements of section V(a) solely because such fiduciary is the employer sponsoring the plan or directly or indirectly controls, is controlled by, or is under common control with the employer sponsoring the plan.

Signed at Washington, DC, this 11th day of August, 2005.

Ivan L. Strasfeld,

Director, Office of Exemption, Determinations, Employee Benefits Security Administration, Department of Labor.

[FR Doc. 05–16702 Filed 8–22–05; 8:45 am]

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DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Application Number D–11270]

Proposed Amendment to Prohibited Transaction Exemption (PTE) 84–14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers

AGENCY: Employee Benefits Security Administration, DOL.

ACTION: Notice of proposed amendment to PTE 84–14.

SUMMARY: This document contains a notice of pendency before the Department of Labor (the Department) of a proposed amendment to PTE 84–14. The exemption permits various parties that are related to employee benefit plans to engage in transactions involving plan assets if, among other

DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

[Prohibited Transaction Exemption 96-23;

Application Number D-09602]

Class Exemption for Plan Asset Transactions Determined by

In-House Asset Managers

Agency: Pension and Welfare Benefits Administration, Labor.

Action: Grant of class exemption.

Summary: This document contains a final exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The exemption permits various transactions involving employee benefit plans whose assets are managed by in-house managers (INHAMS), provided that the conditions of the exemption are met. The exemption affects participants and beneficiaries of employee benefit plans, the sponsoring employers of such plans, INHAMS, and other persons engaging in the described transactions.

EFFECTIVE DATE: The effective date of the exemption is April 10, 1996.

FOR FURTHER INFORMATION CONTACT: Lyssa Hall or Virginia J. Miller, Pension and Welfare Benefits Administration, Office of Exemption Determinations, U.S. Department of Labor, Washington, DC 20210, (202) 219-8971 (not a toll-free number) or Paul D. Mannina, Plan Benefits Security Division, Office of the Solicitor, (202) 219-9141 (not a toll-free number).

Supplementary Information: Exemptive relief for the transactions described herein was requested in an application dated December 16, 1993 submitted by the Committee on Investment of Employee Benefit Assets (CIEBA), pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR section 2570 subpart B (55 FR 32836 August 10, 1990).

On March 24, 1995, the Department published a notice in the Federal Register (60 FR 15597) of the pendency of a proposed class exemption from certain of the restrictions of sections 406 and 407(a) of ERISA and from certain taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1) of the Code.1

The notice gave interested persons an opportunity to submit written comments or requests for a hearing on the proposed class exemption to the Department. The Department received fourteen written comments and no requests for a public hearing. Upon consideration of all of the comments received, the Department has determined to grant the proposed class exemption, subject to certain modifications. These modifications and the major comments are discussed below.

Discussion of the Comments

A. Basic Exemption

1. INHAM as Decision Maker (Section I(a)). The proposed general exemption, set forth in Part I, permitted that portion of a plan that is managed by an INHAM to engage in all transactions described in section 406(a)(1)(A) through (D) with virtually all party in interest service providers except the INHAM or a person related to the INHAM. Under section I(a) of the proposed exemption, the INHAM must function as the decision maker for the plan in all covered transactions. Specifically, section I(a) requires that the terms of the transaction be

negotiated by, or under the authority and general direction of, the INHAM and that the INHAM make the decision to enter into the transaction.

Under section I(a) of the proposal, the exemption would be available for a transaction involving an amount in excess of $5,000,000 notwithstanding the fact that the transaction that had been negotiated by the INHAM was subject to a veto or approval by the plan sponsor. A commenter suggested that section I(a) should be modified to permit the plan sponsor or its designee to retain the right to veto or approve any transaction, regardless of the size of the transaction. Although the exemption permits the retention of a veto power for large transactions, the exemption was developed based on the premise that independent decisionmaking was more likely to be assured if day to day transactions are negotiated and approved by an INHAM. Therefore, the Department has determined not to adopt the commenter's suggestion.

A commenter is concerned that the requirement under section I(a) of the proposal that the INHAM negotiate and make the decision on behalf of the plan to enter into the transaction may foreclose a transaction where an INHAM retains a QPAM to locate and negotiate the terms of a possible plan investment. According to the commenter, it is frequently advantageous for a plan to retain a QPAM to identify investment opportunities and to negotiate the terms of these types of investments, while permitting the INHAM to perform its own "due diligence" review of each investment opportunity presented and evaluate the appropriateness of the investment for the plan's particular investment needs. The Department does not believe that it would be appropriate in the context of this exemption proceeding to modify the INHAM exemption to, in effect, permit a transaction that was previously rejected by the Department during its consideration of the final QPAM class exemption.2

A commenter questioned whether Part I of the exemption would apply to "drag along" and similar transactions that are not actually negotiated by the INHAM. According to the commenter, when a plan makes an investment in a non-publicly traded entity, both the plan and other investors want to be able to dispose of their investment at a favorable price. In order to accomplish this objective, plans and other investors may negotiate certain rights at the time they make their initial investments. One such right would be the ability of the plan to "tag along" and sell out its interest at the same price as the majority investors if the majority investors sell their interests to a third party. The converse of this right would be the ability of the majority investors to "drag along" the plan if they sell their interest to a third party. When these rights are exercised, it may turn out that the party to whom the interests are sold is a party in interest. The commenter argues that the "drag along" or similar transactions should be treated as subordinate to the initial investment transaction and, therefore, subject to the authority or general direction of the INHAM for purposes of section I(a) of the exemption. The commenter represents that, while the INHAM is not involved in selecting the party to whom the plan's interest is sold, the transaction is determined by an independent party pursuant to rights negotiated by the INHAM at arm's- length at the outset of the investment transaction. The commenter further represents that these rights would be taken into account by the INHAM in determining whether the initial investment would be prudent. It is the view of the Department that section I(a) of the exemption will be deemed satisfied in the case of "drag along" or similar transactions that are entered into pursuant to rights that were negotiated by the INHAM as part of the primary investment transaction. The Department notes, however, that it does not interpret section I(a) as exempting a "drag along" or similar transaction unless such transaction is itself subject to relief under the exemption and the applicable conditions are otherwise met. In this regard, the Department expects that any determination regarding the appropriate price to be paid for the investment would reflect the effect on the value of such investment of rights which may be exercised in the future at the discretion of unrelated third persons.

One commenter requested that the Department clarify that the requirements of section I(a) would be met if an officer of the INHAM also serves as a member of the employer's investment committee or other named fiduciary under the plan. Nothing contained in section I(a) would preclude an officer of the INHAM from also serving as a member of the employer's investment committee or other named fiduciary under the plan, provided that the INHAM otherwise meets the definition set forth in section IV(a), including the requirement that the INHAM must be a separate entity that is registered as an investment adviser.

A commenter requested that the Department clarify that the requirements of section I(a) will be satisfied notwithstanding the fact that the INHAM also manages assets of outside clients.

In the Department's view, nothing contained in the exemption would preclude the INHAM from providing services to outside clients who have no affiliation with the INHAM.

In response to a comment regarding typical investment increments used in financial transactions, the Department has revised section I(a) by replacing "an amount in excess of $5,000,000" to "$5,000,000 or more" in connection with the plan sponsor's right to veto or approve such transactions.

2. Transactions Involving Arrangements Designed to Benefit Parties in Interest (Section I(c)). Section I(c) of the proposal requires that the transaction not be part of an agreement, arrangement or understanding designed to benefit a party in interest. A commenter suggested that the Department clarify that to the extent that the INHAM's purpose in entering into a transaction is not to benefit a party in interest, so that any benefit to the party in interest is incidental to the purpose of the transaction, the transaction should not give rise to an agreement, arrangement or understanding designed to benefit a party in interest which is described in section I(c). The Department concurs with the commenter and notes that the intent of the condition in section I(c) was not to deny direct benefits to other parties to a transaction but, rather, to exclude relief for transactions that are part of a broader overall agreement, arrangement or understanding designed to benefit parties in interest.

3. Transactions with Service Providers (Section I(e)). Under section I(e) of the proposed exemption, relief was limited to transactions with party in interest service providers who do not have discretionary authority or control with respect to the assets involved in the transaction or otherwise render investment advice with respect to such assets. A commenter urged the Department to expand the scope of the final exemption to include relief for all parties in interest. The Department does not believe that a sufficient showing has been made that the safeguards contained in the proposed exemption would adequately discourage the exercise of undue influence upon the INHAM if the final exemption were expanded as requested by the commenter. Accordingly, the Department cannot conclude that further relief is warranted.

Several commenters suggested that the Department clarify that section I(e) of the proposal would not preclude a directed trustee of a plan or a trustee with discretionary authority over plan assets not involved in the transaction from engaging in transactions with the plan. In the Department's view, a nondiscretionary trustee subject to the direction of an INHAM, and that does not otherwise render investment advice with respect to the plan assets involved in the transaction may carry out proper directions that are not contrary to ERISA with respect to the transactions covered by the class exemption. Similarly, the exemption would be available for transactions with a trustee that exercises investment discretion with respect to a portion of plan assets not involved in the transaction.

Another commenter objected to the requirement in section I(e)(2) that the party in interest dealing with the plan not have discretionary authority or control with respect to the investment of the plan assets involved in the transaction and not render investment advice (within the meaning of 29 CFR 2510.3-21(c)) with respect to those assets. According to the commenter, the first part of this condition regarding discretionary authority or control is unnecessary in view of the requirement under section I(a) that the terms of the transaction must be negotiated by the INHAM, and that the INHAM make the decision on behalf of the plan to enter into the transaction. The commenter further believed that the requirement contained in section I(e)(2) that the party in interest dealing with the plan not render "investment advice" would create uncertainty and is unnecessary in view of the limited scope of relief provided. Accordingly, the commenter requests that the Department eliminate this requirement from the final exemption.

This class exemption was developed, and is being granted by the Department, based on the essential premise that broad exemptive relief from the prohibitions of section 406(a) of ERISA can be afforded for all types of service provider transactions in which a plan engages only if the INHAM independently negotiates the transaction and makes the decision on behalf of the plan to enter into the transaction. The limitations contained in section I(e)(2) were included in the proposal in order to further emphasize that the INHAM must be the decision-maker in order for transactions to be covered by the class exemption. In addition, the Department believes that, if exemptive relief were to be provided where the party in interest renders investment advice to the plan, with respect to the transaction at issue, the potential for decision making with regard to the plan assets that would inure to the benefit of a party in interest would be increased. For these reasons, the Department believes that a separate condition is warranted and has determined not to revise the exemption as requested by the commenter.

4. Fiduciary Audit (Section I(g)). Section I(g) of the proposed exemption required that an independent auditor conduct an annual fiduciary audit to determine whether the written procedures adopted by the INHAM are designed to assure compliance with the conditions of the exemption. Section IV(f) defined fiduciary audit as including: (1) a determination by the auditor as to whether or not the plan has developed adequate internal policies and procedures designed to assure compliance with the terms of the exemption; (2) a test of a representative sample of the plan's transactions to determine operational compliance with such policies and procedures; (3) a determination as to whether the INHAM meets the definition of INHAM set forth in the exemption; and (4) a written report describing the steps performed by the auditor during the course of its review and the auditor's findings and recommendations.

Several commenters requested that the Department clarify the types of "policies and procedures" that the INHAM is required to adopt for purposes of sections I(g) and IV(f) of the proposal, and the criteria the

independent auditor should apply in conducting the audit. Another commenter recommended that the audit be conducted in accordance with standards established by the American Institute of Certified Public Accountants (AICPA), and that the Department establish criteria against which the independent auditor can make a determination that the procedures are designed to operate in the manner contemplated by the exemption. In this regard, a commenter raised a related question concerning whether the proposed audit condition would require that the policies and procedures include substantive criteria regarding expected risk, gross return and expenses of a proposed transaction that the INHAM should consider. One commenter suggested that the scope of the audit should be expanded to include a determination by the auditor regarding compliance with section 404(a) of ERISA. Lastly, a commenter urged the Department to delete this requirement entirely.

As noted in the preamble to the proposed exemption, the Department proposed the audit requirement in order to address the lack of independence of the INHAM. The Department continues to believe that an annual fiduciary audit is necessary to address this lack of independence and, accordingly, has determined not to delete this requirement. In this regard, it was the Department's intent that the role of the auditor would be limited to determining whether the written procedures adopted by the INHAM are designed to assure compliance with the conditions of the exemption. Since the sole purpose of the audit requirement is to assure compliance with the exemption, the Department does not believe that it would be appropriate to expand the scope of this requirement to include either determinations under section 404 of the Act or determinations regarding the appropriateness of investments entered into under the exemption. In response to the comment concerning the adoption of AICPA standards as part of the audit requirement, the Department does not believe that it would be appropriate to adopt a definition that would require compliance with standards developed by certain professional organizations. However, in consideration of the concerns expressed by the commenters, the Department has adopted a new section I(g) which specifically requires that the INHAM adopt written policies and procedures designed to assure compliance with the conditions of the exemption. (The fiduciary audit requirement, set forth in section I(g) of the proposal, has been renumbered as section I(h) under the final exemption.) The Department has also adopted a new definition, under section IV(g), that contains a list of the objective requirements of the exemption that must be described in the written policies and procedures and that must be reviewed by the auditor.3 In addition, the Department notes that, although the exemption provides flexibility with respect to the specific procedures adopted by the INHAM, it expects such procedures to be designed in a manner that assures that the INHAM's operations are consistent with the requirements of the exemption.

On a related issue, another commenter noted that the role of the auditor under the exemption should be limited to determining compliance with policies and procedures designed by the INHAM and should not include a determination by the auditor as to whether the plan has developed adequate policies and procedures as required under section IV(f) of the proposal. According to the commenter, having the auditor review the adequacy of the procedures would expand the auditor's role beyond the typical role of an independent auditor. In response to the commenter, the Department has determined to modify section IV(f) to delete the requirement that the auditor make a determination regarding the adequacy of the policies and procedures adopted by the INHAM. Under the revised section IV(f)(1), the auditor would be required to review the policies and procedures for consistency with the objective requirements of the exemption. In light of the decision to revise section (IV)(f)(1), the Department has also determined to expand section IV(f)(2) to require the auditor to test for compliance with both the written policies and procedures adopted by the INHAM and the objective requirements of the exemption. In the Department's view, this revised condition will help to assure that the INHAM properly carries out its responsibilities under the exemption.

A commenter noted that the proposal did not make clear the consequences on existing transactions of an unsatisfactory audit. In response to the comment, the Department notes that an adverse finding in the auditor's report would not, in itself, render the exemption unavailable for any transaction engaged in by the INHAM on behalf of the plan.4 However, if a transaction did not meet a condition of the exemption (e.g., because relief was not available for transactions with the party with whom the INHAM dealt), the exemption would not be available for that transaction, but the exemption would continue to be available for those transactions that did satisfy its conditions. Conversely, a failure to comply with the general terms of the exemption applicable to all transactions would render the exemption unavailable, regardless of whether the failure is identified in the audit. Thus, if the INHAM failed to adopt policies and procedures that complied with the requirements of section I(g) or if no audit were conducted, the exemption would not cover transactions engaged in on behalf of the plan by the INHAM.

Several commenters were concerned that the exemption could be interpreted to mean that only financial accounting firms or auditing firms could conduct the fiduciary audit required under section I(g) of the proposal. According to the commenters, other types of financial service organizations may well be capable of conducting a fiduciary audit. The Department did not intend to limit eligibility to serve as independent auditors under the exemption solely to accounting or auditing firms. Accordingly, any person who otherwise possesses the

requisite technical training and proficiency with ERISA's fiduciary responsibility provisions may conduct a fiduciary audit.

A number of commenters also requested that we clarify the requirement that the person performing the fiduciary audit must be "independent". In the Department's view, whether an auditor is independent for purposes of the exemption would depend on the particular facts and circumstances of each case. However, the Department would not view an auditor as independent under circumstances where the auditor has a financial interest, including an ownership interest, in the INHAM , the employer, any parties dealing with the plan under the exemption, or any affiliates thereof, or otherwise receives more than a de minimis amount of its compensation from the INHAM, the employer, its affiliates, or the plan.

One commenter questioned whether the auditor performing the fiduciary audit can be an entity or individual who provides other services to the plan, e.g., the firm that audits the plan in connection with preparation of the plan's annual report (Form 5500). In the Department's view, the provision of other services would not, in itself, preclude a firm from meeting the requirement under the exemption that the person performing the fiduciary audit must be independent. However, the Department notes that the provision of other services could raise questions regarding the independence of the auditor if the aggregate services result in the auditor deriving more than a de minimis amount of its compensation from the INHAM, the employer, its affiliates, or the plan.

One of the commenters expressed concern about how the audit requirement would apply to the condition, contained in section I(b), that the transaction not be described in certain specified class exemptions. The commenter suggested that the auditor's role regarding this condition should be limited to a finding as to whether the transaction is of the type described in the specified class exemptions, rather than a finding regarding compliance with the terms and conditions of such class exemptions. The Department concurs with this comment. The Department believes, however, that it is the ongoing responsibility of the INHAM to determine whether a transaction is covered by one of the specified class exemptions or the INHAM exemption.

A commenter suggested that the Department revise the requirement under section I(g) of the proposal that the independent auditor must have appropriate technical training and proficiency with ERISA's fiduciary responsibility provisions. According to the commenter, the most likely candidates to conduct an audit are people who have experience with ERISA's fiduciary responsibility provisions rather than technical training. On the basis of this comment, the Department has determined to modify section I(g) to provide that the independent auditor must have appropriate technical training or experience, and proficiency with ERISA's fiduciary responsibility provisions. Another commenter urged the Department to delete this requirement entirely. In response to this comment, the Department believes that the requirement that the auditor be familiar with ERISA's fiduciary responsibility provisions provides an additional protection under the class exemption. Therefore, the Department has determined not to further revise this condition.

According to a commenter, the language in section IV(f)(4) of the proposal, which provides that the auditor must make recommendations in its written report, would require the auditor to go beyond its auditing role of providing findings regarding compliance. The Department concurs with this comment and, accordingly, has deleted the words "and recommendations" from section IV(f). In response to a related comment, the Department has deleted the words "among other things" from the definition of fiduciary audit in order to clarify that the definition sets out the specific steps for a fiduciary audit. The Department cautions that the auditor would be responsible for taking any actions necessary to adequately perform the steps described in the definition of fiduciary audit.

A commenter suggested that the Department modify sections I(g) and IV(f) by deleting the word "fiduciary" from "fiduciary audit" wherever it appears in those sections and substituting the word "exemption" to reflect the fact that the auditor's role is to assure compliance with the policies and procedures established for purposes of the exemption and does not otherwise involve examining for compliance with ERISA's fiduciary responsibility provisions. The Department concurs with the commenter's suggestion and has modified the exemption accordingly.

The following examples illustrate the types of transactions which would be covered by Part I of the exemption:

(1) Corporation C designates INHAM X to manage a portion of Plan P's assets. Assume that X meets the criteria for an INHAM under the exemption. X uses Plan P assets to purchase a building from Y, a wholly-owned subsidiary of a broker-dealer that provides services to the Plan. Absent this exemption, the purchase of the building from Y, a party in interest described in ERISA section 3(14)(G), would violate the restrictions contained in section 406(a)(1)(A), and the transaction could not proceed until exempted by the Department. The general exemption set forth in Part I would allow such transaction if the conditions contained therein are met.

(2) INHAM X invests part of a pension fund's assets to acquire a parcel of unimproved real property from the president of the employer sponsoring the Plan. Part I does not provide an exemption for the purchase of the property since relief is limited under that Part to transactions with service providers and their affiliates. In addition, no relief would be provided under the exemption for the act of self-dealing described in section 406(b)(1) arising in connection with X's use of the fund's assets in a transaction that benefits a person in whom X has an interest that may affect the exercise of its best judgement as a fiduciary.

(3) Corporation C is the named fiduciary of Plan P. C chooses INHAM X to manage the portion of P's assets allocated for real estate investments. X, using its discretionary authority, locates and negotiates the purchase for $6 million of a commercial building in New York that is being offered for sale by Corporation Z. Z provides accounting services to Plan P. Pursuant to its arrangement with C, X is required to seek the approval of C for all real estate transactions involving amounts of $5 million or more. On the basis of X's recommendation, C approves the transaction. Despite the retention of approval power by C, Part I of the exemption would be available for the purchase of the building provided there is no arrangement with C that requires X to buy the building from Z and the conditions of Part I are otherwise met.

(4) Corporation C allocates part of the assets of its Plan P to a master trust managed by INHAM X. X uses master trust assets to purchase an office building that is subsequently leased to M. M provides administrative services to Plan P. During the term of the lease, M becomes a wholly-owned subsidiary of Corporation C. Although M is no longer a party in interest with respect to Plan P solely by reason of providing services to such Plan, Part I will continue to be available for the entire lease term since, at the time the transaction was entered into (as defined in section IV(e)), M was not affiliated with the plan sponsor and its relationship to Plan P was solely that of a service provider.

(5) INHAM X retains Broker-Dealer B to provide brokerage services to Plan P. In a separate transaction, X uses Plan P assets to purchase corporate bonds directly from B. The bonds were originally issued by Corporation Z, an investment manager for a portion of the Plan's assets that are not controlled by INHAM X. Since the Department expects that, as part of its fiduciary responsibilities, the INHAM would have analyzed the terms of the bonds prior to purchase, the relief provided by Part I could extend to both the acquisition of the bonds and the underlying extension of credit. Thus, Part I could cover a subsidiary transaction with a party in interest if such transaction is itself subject to relief under the exemption and the applicable conditions are otherwise met.

(6) Corporation C designates INHAM X to manage a portion of Plan P's assets. X uses plan assets to purchase an office building that is subsequently leased to Broker-Dealer BD, a non-party in interest with respect to Plan P. During the term of the lease, BD becomes a service provider to Plan P. Although BD was not a party in interest service provider at the time the lease was executed, section IV(e) provides that Part I of the exemption would be available for the entire lease term provided that the remaining conditions of the exemption were met at the time the transaction was entered into. Alternatively, section IV(e) provides that Part I of the exemption would be available to exempt the transaction if the conditions of the exemption were met as of the time the transaction would have become prohibited.

B. Specific Exemptions for Employers

A commenter urged the Department to expand the relief provided under Part II of the proposal to permit an INHAM to select an affiliate to provide telecommunications related goods and services to any real property that may be considered an asset of the plan or to an entity in which the plan owns a controlling interest and that is managed by an INHAM. While the commenter has identified the need for exemptive relief, the Department does not believe that it has sufficient information on the record at this time to provide additional relief for a class of transactions that would otherwise violate section 406(b) of ERISA. Finally, the Department believes that adoption of the commenter's suggestion would arbitrarily favor one specific industry over another under similar circumstances.

C. Definitions

1. INHAM (Section IV(a)). A commenter requested that the definition of an INHAM be revised to include a division or group within the employer's management structure. The Department believes that an INHAM that is organized as a separate legal entity, is separately managed, and is subject to oversight by the Securities and Exchange Commission as a result of registration as an investment adviser under the Investment Advisers Act of 1940 provides an important safeguard under the exemption. Therefore, the Department cannot conclude that further relief is warranted.

Another commenter suggested that the Department modify the definition of INHAM to permit a majority-owned

subsidiary of an employer, or a direct or indirect majority-owned subsidiary of a parent organization of such an employer to serve as an INHAM. The Department does not believe that a sufficient showing has been made that the requirement that the INHAM be wholly-owned under the proposal would raise compliance problems for those persons intending to use the exemption. Accordingly, the Department has determined not to revise the final exemption as requested.

Several commenters urged the Department to expand the definition of an INHAM to include an entity established by a multiemployer plan or its plan sponsor. A commenter further noted that the definition of an affiliate of the INHAM contained in sections IV(a) and IV(b) of the proposal should be broadened to include families of multiemployer plans. The Department notes that the exemption application requested relief for transactions involving the assets of single employer plans managed by in-house managers. Accordingly, the Department does not believe that it has sufficient information regarding the operation and management of multiemployer plans to make the findings necessary to grant exemptive relief. Moreover, the Department does not believe that a sufficient showing has been made by the commenters that the conditions contained in the exemption would adequately protect the interests of participants and beneficiaries of internally managed multiemployer plans. Of course, the Department would be prepared to consider additional relief upon proper demonstration that the findings can be made under section 408(a) of ERISA with respect to such plans.

A commenter requested that the Department clarify that the relief provided for employee benefit plans whose assets are managed by INHAMs extends, not only to plans sponsored by affiliates of the INHAM, but also includes plans sponsored by the INHAM itself. According to the commenter, the INHAM may establish a stand-alone plan to cover its employees, or its employees may participate in a plan established and maintained by an affiliate of the INHAM. Therefore, the commenter urged that the Department adopt a definition of "plan", which would include plans maintained by the INHAM or an affiliate of the INHAM. In consideration of the concerns raised by the commenter, the Department has determined to adopt a definition of plan under section IV(h) that includes plans maintained by the INHAM and affiliates of the INHAM. The commenter further requested that the requirements under section IV(a) that the INHAM have $50 million of plan assets under management and control, and that plans maintained by affiliates of the INHAM have $250 million of aggregate plan assets also should be modified to clarify that these requirements are not intended to exclude any plan maintained by the INHAM. The requirement that the INHAM be affiliated with a plan sponsor (or group of related plan sponsors) whose plan(s) hold in the aggregate assets of at least $250 million, $50 million of which is under the direct management and control of the INHAM was imposed because the Department believes that INHAMs of large plans are more likely to have an appropriate level of expertise in financial and business matters. In this regard, the Department believes that the requirement that the INHAM have a significant dollar amount of assets under its management and control attributable to plans maintained by affiliates which are separately accountable for the operation of their respective plans provides an additional safeguard under the exemption. Accordingly, the Department has determined not to revise the $50 million requirement. However, the Department has determined that it would be appropriate to include the assets of plans maintained by the INHAM in determining compliance with the $250 million standard.

Finally, a commenter requested that the $50 million requirement be revised to permit the $50 million threshold to be met during the INHAM's first fiscal year as a separate legal entity. According to the commenter, the requirement that the INHAM have in excess of $50 million of plan assets under its management and control as of the last day of its most recent fiscal year could unintentionally prevent the exemption from being immediately available for an employer's in-house management group in its first year as a separate wholly-owned subsidiary of the employer. In response to this comment, the Department has revised section IV(a)(2) to specify that an existing asset management group that is newly-incorporated as a separate subsidiary of the employer may satisfy the $50 million requirement in its initial fiscal year if the requirement is met as of the date during its initial fiscal year as a separate legal entity that responsibility for the management of such assets in excess of $50 million was transferred to it from the employer.

2. Continuing Transactions (Section IV(e)). A commenter asserted that the last sentence of section IV(e), which deals with transactions which are continuing in nature, is unclear. This sentence addresses the issue of whether a continuing transaction that is not prohibited and, therefore, not subject to the exemption at the outset, may become covered by the exemption during the course of the transaction if it later becomes prohibited. According to the commenter, certain of the conditions of the exemption can be met only at the time the transaction is entered into, such as the condition in section I(d) dealing with arms-length terms. Conversely, the requirements of section I(e)(1) dealing with the party in interest relationships permitted under the exemption can only be determined at the time the transaction would have become prohibited. It is the view of the Department that section I(d) will be deemed satisfied in the case of a continuing transaction that later becomes prohibited if the transaction negotiated by the INHAM satisfied such section at the time the transaction was entered into. The Department notes that it does not interpret section IV(e) as exempting a continuing transaction that becomes prohibited subsequent to a renewal or modification that required the

consent of the INHAM, unless the renewal or modification otherwise met the arm's-length requirement of section I(d). Lastly, the Department has modified section IV(e) to clarify that in determining compliance with the conditions of the exemption at the time that the transaction was entered into, section I(e) will be deemed satisfied if the transaction was entered into between a plan and a person who was not then a party in interest.

D. Miscellaneous

1. In response to a comment, the Department has added section IV(d)(3) to the exemption in order to define "control" for purposes of determining whether or not an INHAM is "related" to a party in interest under section IV(d).

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which require, among other things, that a fiduciary discharge his duties respecting the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record, the Department finds that the exemption is administratively feasible, in the interests of plans and of their participants and beneficiaries and protective of the rights of participants and beneficiaries;

(3) The exemption is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction; and

(4) The exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the class exemption.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).

Part I--Basic Exemption

Effective April 10, 1996, the restrictions of section 406(a)(1) (A) through (D) of the Act and the taxes imposed by Code section 4975 (a) and (b) of the Code, by reason of 4975(c)(1) (A) through (D), shall not apply to a transaction between a party in interest with respect to a plan (as defined in section IV(h)) and such plan, provided that an in- house asset manager (INHAM) (as defined in section IV(a)) has discretionary authority or control with respect to the plan assets involved in the transaction and the following conditions are satisfied:

(a) The terms of the transaction are negotiated on behalf of the plan by, or under the authority and general direction of, the INHAM, and either the INHAM, or (so long as the INHAM retains full fiduciary responsibility with respect to the transaction) a property manager acting in accordance with written guidelines established and administered by the INHAM, makes the decision on behalf of the plan to enter into the transaction. Notwithstanding the foregoing, a transaction involving an amount of $5,000,000 or more, which has been negotiated on behalf of the plan by the INHAM will not fail to meet the requirements of this section I(a) solely because the plan sponsor or its designee retains the right to veto or approve such transaction;

(b) The transaction is not described in--

(1) Prohibited Transaction Exemption 81-6 (46 FR 7527; January 23, 1981) (relating to securities lending arrangements),

(2) Prohibited Transaction Exemption 83-1 (48 FR 895; January 7, 1983) (relating to acquisitions by plans of interests in mortgage pools), or

(3) Prohibited Transaction Exemption 88-59 (53 FR 24811; June 30, 1988) (relating to certain mortgage financing arrangements);

(c) The transaction is not part of an agreement, arrangement or understanding designed to benefit a party in interest;

(d) At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the INHAM, the terms of the transaction are at least as favorable to the plan as the terms generally available in arm's length transactions between unrelated parties;

(e) The party in interest dealing with the plan: (1) is a party in interest with respect to the plan (including a fiduciary) solely by reason of providing services to the plan, or solely by reason of a relationship to a service provider described in section 3(14) (F), (G), (H), or (I) of ERISA; and (2) does not have discretionary authority or control with respect to the investment of the plan assets involved in the transaction and does not render investment advice (within the meaning of 29 CFR 2510.3-21(c)) with respect to those assets;

(f) The party in interest dealing with the plan is neither the INHAM nor a person related to the INHAM (within the meaning of section IV(d));

(g) The INHAM adopts written policies and procedures that are designed to assure compliance with the conditions of the exemption; and

(h) An independent auditor, who has appropriate technical training or experience and proficiency with ERISA's fiduciary responsibility provisions and so represents in writing, conducts an exemption audit (as defined in section IV(f)) on an annual basis. Following completion of the exemption audit, the auditor shall issue a written report to the plan presenting its specific findings regarding the level of compliance with the policies and procedure adopted by the INHAM in accordance with section I(g).

Part II--Specific Exemptions

Effective April 10, 1996, the restrictions of sections 406(a), 406(b)(1), 406(b)(2) and 407(a) of the Act and the taxes imposed by section 4975 (a) and (b) of the Code, by reason of Code section 4975(c)(1) (A) through (E), shall not apply to:

(a) The leasing of office or commercial space owned by a plan managed by an INHAM to an employer any of whose employees are covered by the plan or an affiliate of such an employer (as defined in section 407(d)(7) of the Act), if--

(1) The plan acquires the office or commercial space subject to an existing lease with an employer, or its affiliate as a result of foreclosure on a mortgage or deed of trust;

(2) The INHAM makes the decision on behalf of the plan to foreclose on the mortgage or deed of trust as part of the exercise of its discretionary authority;

(3) The exemption provided for transactions engaged in with a plan pursuant to section II(a) is effective until the later of the expiration of the lease term or any renewal thereof which does not require the consent of the plan lessor;

(4) The amount of space covered by the lease does not exceed fifteen (15) percent of the rentable space of the office building or the commercial center; and

(5) The requirements of sections I(c), I(g) and I(h) are satisfied with respect to the transaction.

(b) The leasing of residential space by a plan to a party in interest if--

(1) The party in interest leasing space from the plan is an employee of an employer any of whose employees are covered by the plan or an employee of an affiliate of such employer (as defined in section 407(d)(7) of the Act);

(2) The employee who is leasing space does not have any discretionary authority or control with respect to the investment of the assets involved in the lease transaction and does not render investment advice (within the meaning of 29 CFR 2510.3-21(c)) with respect to those assets;

(3) The employee who is leasing space is not an officer, director, or a 10% or more shareholder of the employer or an affiliate of such employer;

(4) At the time the transaction is entered into, and at the time of any subsequent renewal or modification thereof that requires the consent of the INHAM, the terms of the transaction are not less favorable to the plan than the terms afforded by the plan to other, unrelated lessees in comparable arm's length transactions;

(5) The amount of space covered by the lease does not exceed five percent (5%) of the rentable space of the apartment building or multi- unit residential subdivision [townhouses or garden apartments], and the aggregate amount of space leased to all employees of the employer or an affiliate of such employer does not exceed ten percent (10%) of such rentable space; and

(6) The requirements of sections I(a), I(c), I(d), I(g) and I(h) are satisfied with respect to the transaction.

Part III--Places of Public Accommodation

Effective April 10, 1996, the restrictions of sections 406(a)(1) (A) through (D) and 406(b) (1) and (2) of ERISA and the taxes imposed by Code section 4975 (a) and (b), by reason of Code section 4975(c)(1) (A) through (E), shall not apply to the furnishing of services and facilities (and goods incidental thereto) by a place of public accommodation owned by a plan and managed by an INHAM to a party in interest with respect to the plan, if the services and facilities (and incidental goods) are furnished on a comparable basis to the general public.

Part IV--Definitions

For the purposes of this exemption:

(a) The term "in-house asset manager" or "INHAM" means an organization which is--

(1) either (A) a direct or indirect wholly-owned subsidiary of an employer, or a direct or indirect wholly-owned subsidiary of a parent organization of such an employer, or (B) a membership nonprofit corporation a majority of whose members are officers or directors of such an employer or parent organization; and

(2) an investment adviser registered under the Investment Advisers Act of 1940 that, as of the last day of its most recent fiscal year, has under its management and control total assets attributable to plans maintained by affiliates of the INHAM (as defined in section IV(b)) in excess of $50 million; provided that if it has no prior fiscal year as a separate legal entity as a result of it constituting a division or group within the employer's organizational structure, then this requirement will be deemed met as of the date during its initial fiscal year as a separate legal entity that responsibility for the management of such assets in excess of $50 million was transferred to it from the employer.

In addition, plans maintained by affiliates of the INHAM and/or the INHAM, must have, as of the last day of each plan's reporting year, aggregate assets of at least $250 million.

(b) For purposes of sections IV(a) and IV(h), an "affiliate" of an INHAM means a member of either (1) a controlled group of corporations (as defined in section 414(b) of the Code) of which the INHAM is a member, or (2) a group of trades or businesses under common control (as defined in section 414(c) of the Code) of which the INHAM is a member; provided that "50 percent" shall be substituted for "80 percent" wherever "80 percent" appears in section 414(b) or 414(c) or the rules thereunder.

(c) The term "party in interest" means a person described in Act section 3(14) and includes a "disqualified person" as defined in Code section 4975(e)(2).

(d) An INHAM is "related" to a party in interest for purposes of section I(f) of this exemption if the party in interest (or a person controlling, or controlled by, the party in interest) owns a five percent or more interest in the INHAM or if the INHAM (or a person controlling, or controlled by, the INHAM) owns a five percent or more interest in the party in interest. For purposes of this definition:

(1) The term "interest" means with respect to ownership of an entity--

(A) The combined voting power of all classes of stock entitled to vote or the total value of the shares of all classes of stock of the entity if the entity is a corporation.

(B) The capital interest or the profits interest of the entity if the entity is a partnership, or

(C) The beneficial interest of the entity if the entity is a trust or unincorporated enterprise;

(2) A person is considered to own an interest held in any capacity if the person has or shares the authority--

(A) To exercise any voting rights or to direct some other person to exercise the voting rights relating to such interest, or

(B) To dispose or to direct the disposition of such interest; and

(3) The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(e) For purposes of this exemption, the time as of which any transaction occurs is the date upon which the transaction is entered into. In addition, in the case of a transaction that is continuing, the transaction shall be deemed to occur until it is terminated. If any transaction is entered into on or after April 10, 1996, or any renewal that requires the consent of the INHAM occurs on or after April 10, 1996, and the requirements of this exemption are satisfied at the time the transaction is entered into or renewed, respectively, the requirements will continue to be satisfied thereafter with respect to the transaction. Nothing in this paragraph shall be construed as exempting a transaction entered into by a plan which becomes a transaction described in section 406 of the Act or section 4975 of the Code while the transaction is continuing, unless the conditions of the exemption were met either at the time the transaction was entered into or at the time the transaction would have become prohibited but for this exemption. In determining compliance with the conditions of the exemption at the time that the transaction was entered into for purposes of the preceding sentence, section I(e) will be deemed satisfied if the transaction was entered into between a plan and a person who was not then a party in interest.

(f) Exemption Audit. An "exemption audit" of a plan must consist of the following:

(1) A review of the written policies and procedures adopted by the INHAM pursuant to section I(g) for consistency with each of the objective requirements of this exemption (as described in section IV(g)).

(2) A test of a representative sample of the plan's transactions in order to make findings regarding whether the INHAM is in compliance with (i) the written policies and procedures adopted by the INHAM pursuant to section I(g) of the exemption and (ii) the objective requirements of the exemption.

(3) A determination as to whether the INHAM has satisfied the definition of an INHAM under the exemption; and

(4) Issuance of a written report describing the steps performed by the auditor during the course of its review and the auditor's findings.

(g) For purposes of section IV(f), the written policies and procedures must describe the following objective requirements of the exemption and the steps adopted by the INHAM to assure compliance with each of these requirements:

(1) The definition of an INHAM in section IV(a).

(2) The requirements of Part I and section I(a) regarding the discretionary authority or control of the INHAM with respect to the plan assets involved in the transaction, in negotiating the terms of the transaction, and with regard to the decision on behalf of the plan to enter into the transaction.

(3) That any procedure for approval or veto of the transaction meets the requirements of section I(a).

(4) For a transaction described in Part I:

(A) that the transaction is not entered into with any person who is excluded from relief under section I(e)(1), section I(e)(2), to the extent such person has discretionary authority or control over the plan assets involved in the transaction, or section I(f), and

(B) that the transaction is not described in any of the class exemptions listed in section I(b).

(5) For a transaction described in Part II:

(A) If the transaction is described in section II(a),

(i) that the transaction is with a party described in section II(a);

(ii) that the transaction occurs under the circumstances described in section II(a) (1) and (2);

(iii) that the transaction does not extend beyond the period of time described in section II(a)(3); and

(iv) that the percentage test in section II(a)(4) has been satisfied or

(B) If the transaction is described in section II(b),

(i) that the transaction is with a party described in sections II(b)(1);

(ii) that the transaction is not entered into with any person excluded from relief under section II(b)(2) to the extent such person has discretionary authority or control over the plan assets involved in the lease transaction or section II(b)(3); and

(iii) that the percentage test in section II(b)(5) has been satisfied.

(h) The term "plan" means a plan maintained by the INHAM or an affiliate of the INHAM.

Signed at Washington,DC, 4th day of April 1996.

ALAN D. LEBOWITZ
Deputy Assistant Secretary of
Program Operations
Pension and Welfare Benefits
Administration

U.S. Department of Labor

1. Section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978 (44 F.R. 1063, January 3, 1978), generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor. In the discussion of the exemption, references to sections 406 and 408 of the Act should be read to refer as well to the corresponding provisions of section 4975 of the Code.
2. In this regard, see PTE 84-14, 49 FR 9497 (March 13, 1984).
3. Although the Department has limited the auditor's responsibilities under the final exemption to making findings on the INHAM's compliance with the objective requirements of the exemption, the INHAM remains responsible for assuring compliance with all of the conditions of the exemption. Accordingly, the failure of the INHAM to comply with a condition of the exemption not described in section IV(g) would render the exemption unavailable.
4. The Department cautions that the failure of the INHAM to take appropriate steps to address any adverse findings in an unsatisfactory audit would raise issues under ERISA's fiduciary responsibility provisions.

DEPARTMENT OF LABOR

Employment and Training Administration

[NAFTA–006531]

Venice T-Shirt and Medical Corporation, Venice, CA; Notice of Termination

Pursuant to Title V of the North American Free Trade Agreement Implementation Act (Pub. L. 103–1) concerning transitional adjustment assistance, hereinafter called NAFTA–TAA and in accordance with section 250(a), subchapter D, chapter 2, Title II, of the Trade Act of 1974, as amended (19 U.S.C. 2331), an investigation was initiated on August 30, 2002, in response to a petition filed on behalf of workers at Venice T-Shirt and Medical Corporation, Venice, California. Workers produced knit t-shirts.

The petitioner has requested that the petition be withdrawn. Consequently, further investigation in this case would serve no purpose, and the investigation has been terminated.

Signed in Washington, DC, this 18th day of November, 2002.

Elliott S. Kushner,

Certifying Officer, Division of Trade Adjustment Assistance.

[FR Doc. 02–31291 Filed 12–11–02; 8:45 am]

BILLING CODE 4510–30–P

DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

[Application Number: D–10934]

Amendment to Prohibited Transaction Exemption 97–11 (PTE 97–11) for the Receipt of Certain Investment Services by Individuals for Whose Benefit Individual Retirement Accounts or Retirement Plans for Self-Employed Individuals Have Been Established or Maintained

AGENCY: Pension and Welfare Benefits Administration, U.S. Department of Labor.

ACTION: Adoption of amendment to PTE 97–11.

SUMMARY: This document amends PTE 97–11, a class exemption that permits the receipt of services at reduced or no cost by an individual for whose benefit an individual retirement account (IRA) [1] or, if self-employed, a Keogh Plan, is established or maintained, or by members of his or her family, from a broker-dealer, provided that the conditions of the exemption are met. The amendment affects individuals with beneficial interests in such plans who receive such services as well as the broker-dealers who provide such services.

FOR FURTHER INFORMATION CONTACT: Ms. Allison Padams Lavigne or Mr. Christopher Motta, Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, (202) 693–8540, (this is not a toll-free number).

SUPPLEMENTARY INFORMATION: On June 18, 2002, the Department proposed an amendment to PTE 97–11 (67 FR 41504) [2] PTE 97–11 provides relief from the restrictions of sections 406(a)(1)(D) and 406(b) of ERISA and the sanctions resulting from the application of sections 4975(a) and (b), 4975(c)(3) and 408(e)(2) of the Code by reason of section 4975(c)(1)(D), (E) and (F) of the Code.[3] The amendment to PTE 97–11 was requested in an exemption application dated September 26, 2000, filed on behalf of American Funds Distributors, Inc. (AFD), a broker-dealer registered under the Securities Exchange Act of 1934.

The notice of pendency gave interested persons an opportunity to comment on the proposed amendment. Two comments were received pursuant to the provisions of section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B. No requests for a public hearing were received.

For the sake of convenience, the entire text of PTE 97–11, as amended, has been reprinted.

1. Description of the Exemption

PTE 97–11 permits the receipt of services at reduced or no cost by an individual for whose benefit an IRA or Keogh Plan is established or maintained or by members of his or her family, from a broker-dealer registered under the Securities Exchange Act of 1934 pursuant to an arrangement in which the account value of, or the fees incurred for services provided to, the IRA or Keogh Plan is/are taken into account for purposes of determining eligibility to receive such services, provided that certain conditions are met.

Relief under PTE 97–11, as originally amended, was limited to transactions involving IRAs, as defined in section III(b) of the class exemption. In this regard, section III(b) defined the term ‘‘IRA’’ as ‘‘an individual retirement account described in Code section 408(a) or an education individual retirement account described in section 530 of the Code.’’ The exemption stated further that ‘‘(f)or purposes of the exemption, the term IRA shall not include an IRA which is an employee benefit plan covered by Title I of ERISA, except for a Simplified Employee Pension (SEP) described in section 408(k) of the Code or a Simple Retirement Account described in section 408(p) of the Code which provides participants with the unrestricted authority to transfer their balances to IRAs or Simple Retirement Accounts sponsored by different financial institutions.’’

AFD requested that PTE 97–11 be amended to expand the definition of IRA contained in section III(b) of PTE 97–11 to include Individual Retirement Annuities, as such term is defined in section 408(b) of the Code.

2. Discussion of the Comments Received

The Department received two comments on the proposed amendment to PTE 97–11. One of the commenters, the American Council of Life Insurers (ACLI), supported the amendment. The second commenter sought clarification with respect to the reduction of commissions in connection with the aggregation of variable annuity contracts and mutual funds that are offered and/or managed by unaffiliated entities. Specifically, the commenter asked the Department whether the amendment to PTE 97–11 is applicable to situations where the distributor of the annuity contract, the investment manager of the variable annuity separate account and mutual funds, and the provider of the annuity contracts are not affiliated.

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[1] In Advisory Opinion 98–03A (March 6, 1998), the Department stated that a Roth IRA which satisfies the definition of an individual retirement plan contained in section 7701(a)(37)(A) of the Internal Revenue Code of 1986 (the Code) is an ‘‘individual retirement account’’ described in section 408(a) of the Code. Therefore, a Roth IRA which is not an employee benefit plan covered by Title I of ERISA (except for certain Simplified Employee Pensions and Simple Retirement Accounts described in section 408(k) and 408(p) of the Code, respectively) would be covered by the relief provided in PTE 97–11, if all conditions therein are met. In this regard, the Department wishes to clarify that this proposed modification of section III(b) of PTE 97–11 would include Roth individual retirement annuities described in section 7701(a)(37)(B) of the Code.

[2] PTE 97–11 was granted on February 7, 1997 (62 FR 5855) and amended on March 8, 1999 (64 FR 11042). Any references to PTE 97–11 include the 1999 amendment.

[3] Section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978 (5 U.S.C. App. 1 (1996)) generally transferred the authority of the Secretary of the Treasury to issue administrative exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

As stated above, PTE 97–11 permits a broker-dealer to offer reduced or no cost services to individuals for whose benefit an IRA or Keogh Plan is established or maintained, provided that the conditions of the exemption have been met. The Department notes that the exemption does not limit relief to those services that are offered pursuant to an arrangement involving only affiliated entities.

Accordingly, a broker-dealer offering reduced commissions to an individual in connection with the purchase of a variable annuity contract under circumstances where the broker-dealer, the investment manager of the variable annuity separate account and mutual funds, and the provider of the annuity contracts are unaffiliated would be covered by the class exemption are met. In particular, the Department notes that PTE 97–11 requires, among other things, that the services offered under the relationship brokerage arrangement must be of the type that the broker-dealer itself could offer consistent with all applicable federal and state laws regulating broker-dealers. Additionally, the services offered under the arrangement must be provided by the broker-dealer or its affiliate in the ordinary course of the broker-dealer's business to customers who qualify for reduced or no cost services, but do not maintain IRAs or Keogh Plans with the broker-dealer.

General Information

The attention of interested persons is directed to the following:

(1) The Department finds that the amendment is administratively feasible, in the interest of the IRAs and Keogh Plans and their participants and beneficiaries and protective of the rights of the participants and beneficiaries of such plans.

(2) The amendment is supplemental to, and not in derogation of, any other provisions of ERISA and the Code including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(3) The amendment is applicable to a transaction only if the conditions specified in the class exemption are met.

Exemption

Accordingly, PTE 97–11 is amended under the authority of section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, Subpart B (55 CFR 32836, August 10, 1990).

Section I: Covered Transactions

Effective January 1, 1998, the restrictions of sections 406(a)(1)(D) and 406(b) of ERISA and the sanctions resulting from the application of section 4975 of the Code, including the loss of exemption of an IRA pursuant to section 408(e)(2)(A) of the Code, by reason of the section 4975(c)(1)(D), (E) and (F) of the Code, shall not apply to the receipt of services at reduced or no cost by an individual for whose benefit an IRA or, if self-employed, a Keogh Plan, is established or maintained, or by members of his or her family, from a broker-dealer registered under the Securities Exchange Act of 1934 pursuant to an arrangement in which the account value of, or the fees incurred for services provided to, the IRA or Keogh Plan is taken into account for purposes of determining eligibility to receive such services, provided that each condition of Section II of this exemption is satisfied.

Section II: Conditions

(a) The IRA or Keogh Plan whose account value or whose fees are taken into account for purposes of determining eligibility to receive services under the arrangement is established and maintained for the exclusive benefit of the participant covered under the IRA or Keogh Plan, his or her spouse or their beneficiaries.

(b) The services offered under the relationship brokerage arrangement must be of type that the broker-dealer itself could offer consistent with all applicable federal and state laws regulating broker-dealers.

(c) The services offered under the arrangement are provided by the broker-dealer (or an affiliate of the broker-dealer) in the ordinary course of the broker-dealer's business to customers who qualify for reduced or no cost services, but do not maintain IRAs or Keogh Plans with the broker-dealer.

(c) For the purpose of determining eligibility to receive services, the arrangement satisfies one of the following:

(i) Eligibility requirements based on the account value of the IRA or Keogh Plan are as favorable as any such requirements based on the value of any other type of account which the broker-dealer includes to determine eligibility; or

(ii) Eligibility requirements based on the amount of fees incurred by the IRA or Keogh Plan are as favorable as any requirements based on the amount of fees incurred by any other type of account which the broker-dealer includes to determine eligibility.

(e) The combined total of all fees for the provision of services to the IRA or Keogh Plan is not in excess of reasonable compensation within the meaning of section 4975(d)(2) of the Code.

(f) The investment performance of the IRA or Keogh Plan investment is no less favorable than the investment performance of an identical investment(s) that could have been made at the same time by a customer of the broker-dealer who is not eligible for (or who does not receive) reduced or no cost services.

(g) The services offered under the arrangement to the IRA or Keogh Plan customer must be the same as are offered to non-IRA or non-Keogh Plan customers with account values of the same amount or the same amount of fees generated.

Section III: Definitions

The following definitions apply to this exemption:

(a) The term ''broker-dealer'' means a broker-dealer registered under the Securities Exchange Act of 1934.

(b) The term ''IRA'' means an individual retirement account described in Code section 408(a), an individual retirement annuity described in Code section 408(b) or an education individual retirement account described in section 530 of the Code. For purposes of this exemption, the term IRA shall not include an IRA which is an employee benefit plan covered by Title I of ERISA, except for a Simplified Employee Pension (SEP) described in section 408(k) of the Code or a Simple Retirement Account described in section 408(p) of the Code which provides participants with the unrestricted authority to transfer their balances to IRAs or Simple Retirement Accounts sponsored by different financial institutions.

(c) The term ''Keogh Plan'' means a pension, profit-sharing, or stock bonus plan qualified under Code section 401(a) and exempt from taxation under Code section 501(a) under which some or all of the participants are employees described in section 401(c) of the Code. For purposes of this exemption, the term Keogh Plan shall not include a Keogh Plan which is an employee benefit plan covered by Title I of ERISA.

(d) The term ''account value'' means investments in cash or securities held in the account for which market quotations are readily available. For purposes of this exemption, the term cash shall include savings accounts that are insured by a federal deposit insurance

agency that constitute deposits as that term is defined in section 29 CFR 2550.408b–4(c)(3). The term account value shall not include investments in securities that are offered by the broker-dealer [or its affiliate] exclusively to IRAs and Keogh Plans.

(e) An affiliate or a broker-dealer includes any person directly or indirectly controlling, controlled by, or under common control with the broker-dealer. The term control means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(f) The term ''members of his or her family'' refers to beneficiaries of the individual for whose benefit the IRA or Keogh Plan is established or maintained, who would be members of the family as that term is defined in Code section 4975(e)(6), or a brother, a sister, or a spouse of a brother or sister.

(g) The term ''service'' includes incidental products of a de minimis value which are directly related to the provision of services covered by the exemption.

(h) The term ''fees'' means commissions and other fees received by the broker-dealer from the IRA or Keogh Plan for the provision of services, including, but not limited to, brokerage commissions, investments management fees, custodial fees, and administrative fees.

Dated: Signed at Washington, DC, this 9th day of December, 2002.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Pension and Welfare Benefits Administration, Department of Labor.

[FR Doc. 02–31366 Filed 12–11–02; 8:45 am]

BILLING CODE 4520–29–M

NATIONAL COUNCIL ON DISABILITY

Youth Advisory Committee Meeting (Teleconference)

Time and Date: 12 p.m., EST, January 24, 2003.

Place: National Council on Disability, 1331 F Street, NW, Suite 850, Washington, DC.

AGENCY: National Council on Disability (NCD).

Status: All parts of this meeting will be open to the public. Those interested in participating in the meeting (teleconference) call should contact the appropriate staff member listed below. Due to limited resources, only a few telephone lines will be available for the conference call.

Agenda: Roll call, announcements, reports, new business, adjournment.

FOR FURTHER INFORMATION CONTACT: Geraldine Drake Hawkins, Ph.D., Program Specialist, National Council on Disability, 1331 F Street NW, Suite 850, Washington, DC 20004; 202–272–2004 (voice), 202–272–2074 (TTY), 202–272–2022 (fax), *ghawkins@ncd.gov* (e-mail).

Youth Advisory Committee Mission: The purpose of NCD's Youth Advisory Committee is to provide input into NCD activities consistent with the values and goals of the Americans with Disabilities Act.

Dated: December 6, 2002.

Ethel D. Briggs,

Executive Director.

[FR Doc. 02–31379 Filed 12–11–02; 8:45 am]

BILLING CODE 6820–MA–P

NATIONAL SCIENCE FOUNDATION

Sunshine Act Meeting Notice

AGENCY HOLDING MEETING: National Science Foundation, National Science Board, Task Force on National Workforce Policies for Science & Engineering.

DATE AND TIME: December 17, 2002, 1:30 p.m.–2:30 p.m. Open Session.

PLACE: The National Science Foundation, Stafford One Building, 4201 Wilson Boulevard, Room 120, Arlington, VA 22230.

STATUS: This meeting will be open to the public.

MATTERS TO BE CONSIDERED:

Tuesday, December 17, 2002.

Open Session (1:30 p.m. to 2:30 p.m.)—Discussion of comments on the draft report of the NSB/EHR Task Force on National Workforce Policies for S&E.

FOR FURTHER INFORMATION CONTACT: Gerald Glaser, Executive Officer, NSB, (703) 292–7000, *http://www.nsf.gov/nsb.*

Gerard Glaser,

Executive Officer.

[FR Doc. 02–31428 Filed 12–10–02; 10:55 am]

BILLING CODE 7555–01–M

OFFICE OF MANAGEMENT AND BUDGET

Budget Analysis Branch; Final Sequestration Report

AGENCY: Office of Management and Budget, Budget Analysis Branch.

ACTION: Notice of transmittal of the Final Sequestration Report to the President and Congress for Fiscal Year 2003.

SUMMARY: Pursuant to Section 254(b) of the Balanced Budget and Emergency Control Act of 1985, as amended, the Office of Management and Budget hereby reports that it has submitted the Final Sequestration Report for Fiscal Year 2003 to the President, the Speaker of the House of Representatives, and the President of the Senate.

FOR FURTHER INFORMATION CONTACT: Sarah Lee, Budget Analysis Branch—202/395–3674.

Dated: December 6, 2002.

Richard P. Emery, Jr.,

Assistant Director for Budget Review.

[FR Doc. 02–31357 Filed 12–11–02; 8:45 am]

BILLING CODE 4810–25–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 35–27611]

Filings Under the Public Utility Holding Company Act of 1935, As Amended (''Act'')

December 6, 2002.

Notice is hereby given that the following filing(s) has/have been made with the Commission pursuant to provisions of the Act and rules promulgated under the Act. All interested persons are referred to the application(s) and/or declaration(s) for complete statements of the proposed transaction(s) summarized below. The application(s) and/or declaration(s) and any amendment(s) is/are available for public inspection through the Commission's Branch of Public Reference.

Interested persons wishing to comment or request a hearing on the application(s) and/or declaration(s) should submit their views in writing by December 31, 2002, to the Secretary, Securities and Exchange Commission, Washington, DC 20549–0609, and serve a copy on the relevant applicant(s) and/or declarant(s) at the address(es) specified below. Proof of service (by affidavit or, in the case of an attorney at law, by certificate) should be filed with the request. Any request for hearing should identify specifically the issues of facts or law that are disputed. A person who so requests will be notified of any hearing, if ordered, and will receive a copy of any notice or order issued in the matter. After December 31, 2002, the application(s) and/or declaration(s), as filed or as amended, may be granted and/or permitted to become effective.

System Energy Resources, Inc. et al. (70–7561)

Entergy Corporation (''Entergy''), a registered holding company, 639 Loyola Avenue, New Orleans, Louisiana 70113;

Federal Register

Tuesday,
February 12, 2002

Part III

Department of Labor

Pension and Welfare Benefits Administration

Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds; Notice

DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

[Prohibited Transaction Exemption 2002–12; Application No. D–10851]

Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds

AGENCY: Pension and Welfare Benefits Administration, Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This document contains a final exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (the Act or ERISA), the Federal Employees' Retirement System Act (FERSA), and from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The exemption permits cross-trades of securities among Index and Model-Driven Funds (Funds) managed by investment managers, and among such Funds and certain large accounts which engage such managers to carry out a specific portfolio restructuring program or to otherwise act as a ''trading adviser'' for such a program. The exemption affects participants and beneficiaries of employee benefit plans whose assets are invested in Index or Model-Driven Funds, large pension plans and other large accounts involved in portfolio restructuring programs, as well as the Funds and their investment managers. This exemption does not address cross-trades of securities among ''actively-managed'' accounts. The Department is considering additional safeguards to protect participants in plans that engage in active cross-trading prior to publishing a proposal to permit such cross-trades.

EFFECTIVE DATE: The effective date of the exemption is April 15, 2002.

FOR FURTHER INFORMATION CONTACT: Karen E. Lloyd or Christopher J. Motta of the Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, Washington, DC 20210 at (202) 693–8540; or Michael Schloss, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, Washington, DC 20210, at (202) 693–5600. (These are not toll-free numbers.)

Paperwork Reduction Act Analysis

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520)(PRA 95), the Department submitted the information collection request (ICR) included in the Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds to the Office of Management and Budget (OMB) for review and clearance at the time the Notice of proposed class exemption was published in the **Federal Register** (December 15, 1999, 64 FR 70057). OMB subsequently approved the ICR under OMB control number 1210–0115. The approval will expire on April 30, 2003. The public is not required to respond to an information collection request unless it displays a currently valid OMB control number.

As described in detail in the **SUPPLEMENTARY INFORMATION** section which follows, the Department of Labor (Department) has made certain modifications to the terms of the proposed class exemption in response to comments received from the public. Although the recordkeeping and information disclosure requirements which constitute the information collection provisions of the final class exemption have been clarified in certain respects, the information collection provisions have not been substantively or materially changed from the proposed exemption. The Department has, however, made certain adjustments to its burden estimates and underlying assumptions in response to comments on the proposal. These adjustments relate to the numbers of entities offering Index and Model-Driven Funds and their client plans, and the number of Large Accounts that may make use of the exemption, and the estimated burden of the record-keeping requirement.

The Department's original estimates of the number of users of the exemption were based on the number of individual exemptions granted and applications received, and information received from exemption applicants about the number of plans involved, resulting in estimates of 10 entities with an average of 20 client plans for each. One commenter expressed the view that at least 50 entities with an average of 40 client plans would make use of the exemption. Because the Department acknowledges that the grant of this final exemption may affect the number of entities that would consider implementing a program of cross trading involving index and model funds, the assumed numbers of entities and plans have been increased for purposes of burden estimates to 20 entities and 40 plans, respectively. Similarly, the number of Large Accounts assumed for purposes of estimating burden has been increased from 10 to 40. While the assumed number of Large Accounts is smaller than the 1,000 offered by the commenter, the Department believes that a number approximating 18% of all plans with $50 million in assets would substantially overstate the number likely to make use of the exemption in connection with a portfolio restructuring program in a given year.

The commenter also indicated that the Department's estimates of the time required to establish and maintain the record-keeping systems that would be needed to comply with the exemption were significantly low. The comment states that a significant investment of $4 to $5 million would be required for each user to establish the necessary record-keeping systems, and that substantial amounts of time would be required daily for ongoing record-keeping, and annually for ongoing disclosures. Upon consideration of the comment, the Department has concluded that its original estimates did omit the impact of the initial investment of resources that would be required to enhance existing software and systems to track cross-trades to triggering events. As a result, the Department has revised its estimates to include the hours, or costs as applicable, of 1,040 hours of systems analyst time at $51 per hour (based on Occupational Employment Survey data and 1999 Employment Cost Index, adjusted for non-wage compensation and overhead.) This change adds approximately 12,500 hours and $424,000 to the estimated burden of the final exemption. These totals are distributed over a three year period for purposes of the annual burden shown below.

Given that record-keeping systems for securities transactions are primarily electronic in nature, and that the Department's burden estimates now take into account the start-up cost of modifying automated record-keeping systems, the Department has decided not to revise the estimated time required to maintain the required records of trades and to prepare disclosure materials. In the Department's view, the original estimates are reasonable in light of the degree to which record-keeping is automated, the industry's existing record-keeping practices involving cross-trading, and the information provided by other commenters.

In addition, the final exemption clarifies that the annual disclosures are required to be made with respect to only those Funds that hold plan assets and in which a given plan invests. The commenter had indicated that eliminating the annual disclosure requirement with respect to Funds in which a plan had no investments would substantially reduce the burden. This clarification, therefore, further supports retention of the original assumptions.

Finally, the commenter expressed the view that certain of the information required to be disclosed by the terms of the proposed exemption was duplicative and unnecessary. As noted earlier, with the exception of certain clarifications, the information collection provisions of the final exemption are unchanged from the proposal. The Department's basis for its conclusions with respect to the need for the disclosure and record-keeping provisions of the final exemption are discussed in detail in the **SUPPLEMENTARY INFORMATION** section that follows.

The burden estimates that result from the revised assumptions are presented below:

Title: Prohibited Transaction Class Exemption for Cross-Trades of Securities by Index and Model-Driven Funds.

Agency: Department of Labor, Pension and Welfare Benefits Administration.

Affected Entities: Business or other for-profit.

Respondents: 60 (20 entities and 40 Large Accounts).

Responses: 840.

Annual Hour Burden: $9,100.

Annualized Capital/Start-up Cost: $141,000.

Annual Cost (Operating and Maintenance): $280,000.

Annual Cost Burden: $421,000.

Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

Pursuant to the terms of the Executive Order, it was determined that this action is ''significant'' under section 3(f)(1) of the Executive Order. Accordingly, this action has been reviewed by OMB.

Economic Analysis

Establishing a class exemption that permits plans to cross-trade can be expected to have a variety of positive economic effects that will considerably exceed the direct costs incurred by plans to comply with the record keeping and reporting requirements enumerated in the PRA section of the final class exemption. By removing existing barriers to these types of transactions, the exemption will significantly increase the utilization of cross-trading among index and model-driven portfolios. This will result in substantial savings to plans by lowering the transaction costs in a number of ways. Although there is currently no source of data that can be used to precisely estimate the level of these savings or the distribution of these effects among various parties, extrapolating from several sources can provide a reasonable estimate of their overall magnitude.

Limiting the exemption to index and model-driven portfolio management techniques should preclude any changes in the incidence of trading activity. In contrast to active management techniques, index and model funds will continue to execute trades at the same levels that they would in the absence of the exemption because their trading is motivated by the need to remain within their tracking parameters rather than in response to marginal changes in expected transaction costs. It is therefore reasonable to assume that the changes in costs will result solely from a decrease in the cost of executing many individual trades rather than from a change in the levels of trades.

Changes in the costs of individual trades will result from (1) the elimination of commission costs that would otherwise be associated with a trade, (2) the avoidance of bid-ask spreads that impose costs for transactions executed through dealers, (3) the absence of fees and taxes that might otherwise apply, and (4) the avoidance of the market impact of large trades which might otherwise require price concessions to execute or effect the trade which would directly impact the market value of the resulting holdings.

Only the first three of these effects are considered in the analysis. The last, market impact, is not included because it can reasonably be expected to have largely offsetting effects. ERISA plans are equally likely to be on either side of a cross trade and in most cases are likely to represent both parties to a transaction. In some instances, they will be advantaged by avoiding the changes in an individual securities price that might otherwise have resulted from a trade executed through another venue. In other circumstances, they will be disadvantaged. An equal probability of either will result in essentially offsetting effects in the aggregate.

A similarly conservative approach is taken in regard to two other aspects of the analysis. These are a result of the limitations in the available data and the absence of any experience with the full scope of relief afforded by the exemption on which to base an estimate. Although some data on the amount of ERISA plan assets in index funds is available, there is no similar source of reliable information to estimate the size of ERISA model driven assets to which the exemption would apply. There is also no experience with more extensive opportunities for cross-trading that are available under the exemption resulting from increased flexibility in allocating cross-trading opportunities, the extension of relief to a broader range of entities, and the inclusion of debt securities in the allowable transactions. Consequently the analysis is limited to index funds and does not incorporate increases in savings resulting from the extension of relief to circumstances with which there is no prior experience. As such, it should be interpreted as an extremely conservative estimate that is likely to represent a lower bound of the level of savings that can be expected to accrue to plans.

Two large financial services firms currently operating under individual exemptions that permit cross-trading among ERISA plans provided estimates of the savings in commissions, spreads, and fees that they have experienced managing both ERISA and non-ERISA indexed assets. These two estimates represent a significant portion of the ERISA plan universe and are therefore likely to be representative of the cost savings likely to occur. One of the firms estimated the cost savings to be approximately $275 million per year for a total indexed portfolio of $400 billion. The other estimated a savings of $207 million for $441 billion of indexed assets under management. Both of these include ERISA and non-ERISA assets, however, the experience should be indicative of expected results because the nature of trading costs for indexed funds should be virtually identical. Averaging these figures yields an estimate that costs savings of .057% or 5.7 basis points for each dollar of affected ERISA plan assets can be expected.

A recent survey of pension funds indicates that among the largest private sector defined benefit pension funds, 14% of the total assets were held in index funds. Among defined contribution plans, index funds constituted 12% of total assets. Applying these percentages to the most recent estimates of the total value of private pension funds yields an estimate of approximately $584 billion of ERISA pension funds that are currently managed as indexed funds.

Applying the estimate of $.00057 of savings for each dollar of assets under management results in an estimated level of cost reductions of approximately $332 million per year that will result from the class exemption. This total cost savings estimate overlaps, in part, current costs savings experienced by plans whose managers have cross-trading programs covered under existing individual exemptions. While certain large index fund managers are successfully operating cross-trading programs for ERISA plans at this time, the class exemption is expected to create additional cost savings for these plans by increasing the number and frequency of cross-trading opportunities among the managers' client accounts. In addition, new cross-trading opportunities will be made available for plans whose assets are managed by entities that currently do not have individual exemptions. Finally, the conservative nature of the total estimate is highlighted by the fact that cost savings associated with cross-trading by model-driven funds have not been factored into the estimate of total cost savings due to the absence of available data.

SUPPLEMENTARY INFORMATION: On December 15, 1999, the Department of Labor (the Department) published a notice in the **Federal Register** (64 FR 70057) of the pendency of a proposed class exemption from the restrictions of sections 406(a)(1)(A) and 406(b)(2) of the Act, section 8477(c)(2)(B) of FERSA,[1] and from the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) of the Code.

The Department proposed the class exemption on its own motion pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B, (55 FR 32836, August 10, 1990).[2] The Department's determination to proceed with the proposed class exemption was based, in part, on information received from interested persons in response to a notice (the Notice) published in the **Federal Register** on March 20, 1998 (63 FR 13696).

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. Fourteen (14) public comments were received by the Department. Upon consideration of all the comments received, the Department has determined to grant the proposed class exemption subject to certain modifications. These modifications and the major comments are discussed below.

Discussion of Comments Received

The comments received by the Department were generally supportive of the issuance of a separate class exemption for cross-trading of securities by Index and Model-Driven Funds. However, many of the commenters requested specific modifications to the proposal in the following areas:

1. *Accounts Permitted to Cross-Trade.* Several comments noted that section I(a) and (b) of the proposal does not explicitly permit cross-trades between two or more Large Accounts. These comments noted that when more than one Large Account is buying or selling a particular security as part of a manager's cross-trading program, that security could be traded between two Large Accounts, two Index or Model-Driven Funds, or any combination thereof. In the operation of a cross-trading program, the matching of the buyer and seller would be coincidental. The commenters believe that a manager should be permitted to submit trade lists from each Large Account to its cross-trade allocation system and allow trades submitted on behalf of one Large Account to be crossed with trades submitted on behalf of another Large Account.

The Department notes that section I(a) and (b) of the proposal does not provide relief for cross-trades exclusively between two or more Large Accounts. The Department is of the view that such cross-trading would be outside the scope of the exemption because, among other things, there would be no ''triggering event'' to limit the amount of discretion exercised by the manager where such transactions occurred solely between Large Accounts.

The Department does recognize, however, that a manager's cross-trading program that complies with the requirements of the proposal may produce cross-trade opportunities that result from both triggering events of particular Index and Model-Driven Funds as well as from the decision of an independent fiduciary to restructure all or a portion of a Large Account's portfolio. Under such circumstances, the Department anticipates that the allocation of buying and selling opportunities across all Funds and Accounts participating in the cross-trading program may result in some individual cross-trades between two Large Accounts. In such an event, the exemption would permit the ''coincidental'' matching of a buyer and seller of particular securities where both buyer and seller are Large Accounts since such cross trades would be part of a unified process-driven cross-trading program where the allocations of available securities (from all Funds and/or Large Accounts) resulted from an objective process which did not permit the exercise of discretion by the manager, as required under section II(d) of the exemption. The Department has revised section I of the exemption to clarify this point.

Another commenter noted that no specific relief for cross-trades between two Large Accounts may be necessary where the decision to liquidate or restructure is made by an independent fiduciary or independent Account representative, and, therefore, the manager would not be acting as a fiduciary for either side of the transaction. Thus, the commenter suggested that the Department may wish to clarify whether additional relief for cross-trades exclusively between two or more Large Accounts is necessary. Alternatively, the commenter suggested that section I(b) of the proposal be modified to explicitly permit cross-trades solely between Large Accounts.

In response to this comment, the Department notes that violations of section 406(b)(2) of the Act would occur if the manager used its discretionary authority to determine whether to cross-trade securities between two Large Accounts at least one of which holds plan assets, which securities to cross-trade, the timing of such cross-trades,

[1] The Department has responsibility for the administration and enforcement of section 8477 of FERSA. Section 8477 establishes the standards of fiduciary responsibility and requirements relating to the activities of fiduciaries with respect to the Federal Thrift Savings Fund. All references herein to the fiduciary responsibility provisions of Part 4 of Title I of ERISA also apply to the corresponding provisions of FERSA. Accordingly, the relief provided under this class exemption applies to cross-trades of securities by the Federal Thrift Savings Fund.

[2] Section 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996) generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

In the discussion of the exemption, references to specific provisions of the Act should be read to refer as well to the corresponding provisions of section 4975 of the Code.

and the amount of securities to cross-trade notwithstanding that the overall determination to restructure the accounts was made by independent fiduciaries.

Accordingly, except as provided above, the Department has determined not to expand the relief provided under this exemption to include cross-trades solely between two or more Large Accounts. The Department notes that the final exemption provides a manager with a significant amount of time in which to conduct cross-trades for a Large Account in connection with a specific portfolio restructuring program. A manager's discretion to time specific cross-trades for two Large Accounts, absent the limitations provided by a process-driven cross-trading program involving ''triggering events'' for Index and Model-Driven Funds, would entail the type of discretion commonly exercised by managers for ''actively-managed'' accounts. In this regard, relief for cross-trades by ''actively-managed'' accounts and pooled funds containing ''plan assets'' will be considered by the Department in a separate proceeding.

2. *Use of closing prices.* One commenter suggested that the Department modify the requirement that all cross-trades occur at the closing prices for the securities on the relevant market in order to allow for alternate pricing methodologies (*e.g.,* ''volume weighted average price'' or ''VWAP''), after appropriate disclosure to the affected plans. Section II(a) of the proposal requires that the cross-trade be executed at the closing price, as defined in section IV(h). Section IV(h) of the proposal defines ''closing price'' as the price for a security on the date of the transaction, as determined by objective procedures disclosed to Fund investors in advance and consistently applied with respect to securities traded in the same market, which procedures shall indicate the independent pricing source used to establish the closing price and the time frame after the close of the market in which the closing price will be determined. The commenter does note that ''closing prices'' are the most appropriate prices currently in use for cross-trades of securities by Index and Model-Driven Funds, whose objective is to track the return of an index, since the calculation of an Index Fund's ''tracking error'' is based on closing prices for the securities listed in the relevant index. However, the commenter states that index providers may utilize alternative pricing methodologies in the future and suggests that the Department should consider broadening the exemption to include such pricing methodologies.

The Department notes that many commenters have indicated that the use of closing prices for cross-trades of securities by Index and Model-Driven Funds is common industry practice at the present time. The Department does not believe that it has sufficient information at this time to determine which types of alternative pricing methodologies may be used by managers in the future or how such pricing systems would enable Index and Model-Driven Funds to better achieve their investment goals and strategies. Therefore, the Department has determined not to modify the requirement that cross-trades be executed at the closing price. The Department would be prepared to consider additional relief at a later date upon proper demonstration that the appropriate findings can be made under section 408(a) of the Act with respect to other pricing methods for cross-traded securities.

3. *''Triggering Events'' and Cross-Trade Executions.* Several of the comments objected to the requirement in section II(b) of the proposal that any cross-trade of securities by a Fund be executed no later than the close of the second business day following a ''triggering event.'' These comments noted that previously issued individual exemptions for cross-trades by Index and Model-Driven Funds allowed cross-trades to be executed within three (3) business days of a ''triggering event'' and that the proposal's reduction of this requirement to two days is inconsistent with the stated premise of the proposal that cross-trading is beneficial to plans. Other comments noted that, once an investment decision is made, a manager should have 5 days to trade after a ''triggering event''—the same period of time to execute the trade as is permitted under the safe harbor provided in the Department's regulations for determining whether a broker-dealer is a fiduciary when it executes a securities transaction on behalf of a plan (see 29 CFR 2510.3–21(d)). Another comment requested that section II(b) be revised to require that cross-trades be executed either within three (3) days of a ''triggering event,'' or within such other period of time as the manager may disclose to the independent plan fiduciary pursuant to the disclosure requirements under section II(l) of the proposal.

In response to the comments, the Department has determined that it would be appropriate to modify section II(b) of the final exemption to require that all cross-trades by a Fund be executed no later than the close of the third business day following a Fund's ''triggering event.'' The Department notes that a three-day limit for cross-trades by a Fund following the relevant ''triggering event(s)'' has worked successfully in the past for managers who were granted individual exemptions.[3]

4. *Blackout Period for Cross-Trades by Model-Driven Funds.* Many of the comments objected to the requirement in section II(c) of the proposal that no cross-trades by a Model-Driven Fund may take place within ten (10) business days following any change made by the manager to the model underlying the Fund. The preamble to the proposal indicated that this restriction is intended to prevent model changes which might be made by managers, in part, to deliberately create additional cross-trading activity. The comments suggested that such a long delay on the ability of a manager to cross-trade after a change in the computer model was unnecessarily restrictive. According to the commenters, this condition would prevent cross-trading during the 10-day ''blackout'' period even though other ''triggering events'' were occurring in the Fund. Other commenters noted that there are already sufficient restrictions on a manager's discretion built into the proposal.

While most comments objected to the 10-day ''blackout'' period, several of the comments indicated that a 5-day period would be sufficient to safeguard against the Department's concerns regarding model changes that may be timed to create additional cross-trading opportunities. Other commenters suggested that, rather than imposing a ''blackout'' period for an arbitrary period of time (*e.g.,* 5 or 10 days), a more flexible approach could be used where a Model-Driven Fund would be able to cross-trade following the period of time necessary to complete the first re-balancing of the Fund's portfolio after the change is made by the manager to the Fund's model. Thus, under this approach, the ''blackout'' period could be less than three (3) days. One comment suggested that any cross-trading ''hiatus'' for a Fund should not be more than three (3) days. Other comments simply requested that the condition for a ''blackout'' period after a model change be deleted. Still other comments noted that, in the absence of a ''blackout'' period, a requirement for 10-day prior notice of a model change to each relevant plan's independent fiduciary should suffice. Finally, some

[3] See, for example, Prohibited Transaction Exemption (PTE) 95–56, 60 FR 35933 (July 12, 1999), regarding Mellon Bank, N.A., and its Affiliates.

commenters requested clarification that model changes made either (i) at the direction of a client plan, or (ii) as a direct result of input changes furnished by a third party data vendor (*e.g.,* BARRA or Vestek), would not invoke a ''blackout'' period because such model changes would not be the result of an exercise of discretion on the part of the manager.

The Department continues to believe that some ''blackout'' period is necessary to prevent managers from exercising their discretion over the criteria or data used for a model to generate specific cross-trade opportunities. However, in recognition that a 10-day restriction may be too long a period to prevent a Model-Driven Fund from cross-trading, the Department has decided to modify the final exemption to require that cross-trades not take place within three (3) business days following any change made by the manager to the model underlying the Fund.

In addition, with respect to the one commenter's concerns that model changes resulting from independent events should not invoke a ''blackout'' period for a Model-Driven Fund, the Department acknowledges that any change to a model which is not the result of an exercise of discretion by the manager (*e.g.,* changes directed by an independent plan fiduciary or furnished by a third party data vendor whose model is being used by the manager) would not require a ''blackout'' period for cross-trades by such Fund.

5. *Restrictions on Cross-Trades by a Manager Plan.* One comment objected to, and requested the deletion of, the requirement in section II(e) of the proposal that no more than ten (10) percent of the assets of any Fund or Large Account engaging in a cross-trade may be comprised of assets of employee benefit plans maintained by the manager for its own employees (*i.e.,* a Manager Plan), for which the manager exercises investment discretion. The comment stated that this condition would create a disincentive to in-house management and may cause investment managers to place assets of a Manager Plan with outside managers solely on the basis of the potential cost savings that the outside managers could derive from cross-trades.

The comment noted that for large plans, in-house management is frequently more cost-effective and keeps the asset management function closer to the people who have the most to gain from maximizing investment performance and minimizing investment risk. The comment further noted that larger in-house fiduciaries also manage assets for unaffiliated plans and other institutional investors, often as a result of a corporate spin-off with an accompanying plan restructuring. The comment stated that it understood the Department's concern regarding a manager's potential ability, through cross-trades, to unduly benefit a Manager Plan at the expense of its outside clients. However, the commenter believes that the other conditions of the proposal, including ''triggering events'' for cross-trades, detailed disclosures of cross-trading procedures and reporting of cross-trades resulting from a portfolio restructuring, would serve as a check on the manager's ability to favor a Manager Plan. Moreover, the commenter notes that to the extent that a Manager Plan's assets are commingled with assets of outside clients that are held in an Index or Model-Driven Fund managed as a collective investment fund, it would not be possible for the manager to ''favor'' only the Manager Plan in that Fund, even if the Manager Plan's assets represented more than 10 percent of the Fund's total assets. In any event, the comment noted that the 10 percent limitation should not apply to cross-trades that are made solely between Manager Plans.

With respect to the commenter's request to delete the 10% limitation in section II(e) of the proposal, the Department notes that, without such a percentage limitation, a substantial majority of the investors in a Fund could be comprised of Manager Plans. The Department does not believe that deletion of this percentage requirement would ensure a sufficient level of independent investor oversight of the manager's cross-trading program.

However, in consideration of the arguments raised by the commenters, the Department believes that a 20% limitation would still ensure a sufficient level of independent investor oversight in a Fund and would not unduly restrict the investment opportunities available for a Manager Plan with respect to such Funds. Therefore, the Department has modified section II(e) to increase the percentage limitation to 20%.

Accordingly, this exemption does not provide relief for cross-trades of securities of Index and Model-Driven Funds maintained by a manager under circumstances where the assets of the Manager Plans comprise all or a high percentage of the assets of the Fund. As noted above, the Department believes that the presence of independent fiduciaries to approve of plan participation in cross-trading programs following receipt of meaningful disclosures and the ability of such fiduciaries to periodically monitor the arrangements provide important protections under the exemption. However, in response to several comments, the Department wishes to take the opportunity to state that the granting of this exemption does not foreclose future consideration of additional relief for cross-trading transactions that do not fit within the framework developed by the Department for this exemption. For example, the Department is currently considering additional relief for transactions involving assets of plans managed by in-house managers, as well as for transactions involving discretionary asset managers.

With respect to the comments requesting that the exemption allow cross-trades to occur solely between two or more Manager Plans, the Department notes that relief for these transactions could involve the exercise of discretion on both sides to a transaction that is inconsistent with the underlying concept of the proposal—which is to provide relief for cross-trades made pursuant to ''process-driven'' investment strategies. For this reason, the Department has determined not to revise the exemption in this regard.

Another comment stated that section II(e) of the proposal does not adequately address how the independent authorization conditions in section II(i) through (n) of the proposal would apply to a Manager Plan, given that the plan fiduciary responsible for the plan's investment matters is unlikely to be independent of the manager. This comment suggested that the Department not require an independent fiduciary authorization for a Manager Plan's participation in the manager's cross-trading program. The commenter stated that the suggested modification would be consistent with other exemptions that do not apply an independent authorization requirement to plans of the fiduciary for whom relief is provided.[4] Accordingly, the commenter requests that the Department adopt a similar provision under the final exemption.

The Department concurs with the comments and has determined to modify section II(h) of the final exemption (formerly section II(i) of the proposal) to clarify that the requirement that the authorizing fiduciary be independent of the manager shall not apply in the case of a Manager Plan. Nevertheless, the appropriate fiduciary for the Manager Plan must still receive the proper disclosures and provide an

[4] In this regard, see section IV(d)(1)(A) of PTE 86–128 (51 FR at 41696, November 18, 1986).

authorization for the Manager Plan to participate in the manager's cross-trading program. This clarification modifies the disclosure and authorization requirements applicable to a plan's participation in a manager's cross-trading program, as described in section II(h) through (l) of the final exemption (formerly section II(i) through (m) of the proposal).

In addition, the Department has also determined to modify the requirements contained in section II(n) of the proposal, relating to disclosures to, and authorization by, a fiduciary of a Large Account who is independent of the manager for cross-trades in connection with a portfolio restructuring for the Large Account. To clarify this matter, the Department has revised section II(m) of the final exemption (formerly section II(n) of the proposal) by adding the parenthetical phrase ''* * * (other than in the case of any assets of a Manager Plan)'' to the requirements for an independent fiduciary discussed in section II(m)(1) through (4). In this regard, the Department notes that the final exemption still requires that proper disclosures be made to, and written authorization be made by, a Manager Plan's fiduciary in order for the Manager Plan to participate in a specific portfolio restructuring program.

6. *Exclusion of Thinly-Traded Equity Securities.* A number of commenters objected to the condition contained in section II(f)(1) of the proposal that required that cross-trades of equity securities involve only securities that are widely-held, actively-traded, and for which market quotations are readily available from independent sources. In this regard, the terms ''widely-held'' and ''actively-traded'' are deemed to include any security listed in an ''Index'' (as that term is defined in section IV(c) of the proposal).

The comments stated that this requirement was not necessary for an exemption for cross-trading by Index and Model-Driven Funds. According to the comments, security selection for such Funds is driven solely by objective factors. The commenters argued that the level of trading and diversity of holdings for securities are not relevant to security selections made by Funds and that such factors should not serve as a constraint on the ability of such Funds to cross-trade. Generally, the comments noted that if market prices are readily available, the exclusion of ''closely-held'' and ''thinly-traded'' equity securities is unduly restrictive. They further argued that such limitations would prevent use of the exemption for many ''small-cap'' and foreign equity securities. Thus, the commenters urged the Department to delete the requirement that cross-traded equity securities be ''widely-held'' and ''actively-traded.''

As an alternative approach, one commenter suggested a limitation based on a comparison of the size of the cross-trade to the prior public trading volume in the security over a reasonable period of time prior to the date of the transaction. Such a volume limitation would prevent cross-trades of equity securities where the total volume of shares being cross-traded would exceed a certain percentage of the total number of shares publicly traded on the market during a particular period of time.

The Department is not persuaded by the arguments submitted in favor of deletion of the requirements contained in section II(f)(1) that equity securities that are cross-traded must be ''widely-held'' and ''actively-traded.'' The Department continues to believe that cross-trades of ''thinly-traded'' securities raise issues as to whether both sides of the cross-trade have benefitted equally from the avoidance of adverse market impact. The avoidance of market impact would be more dramatic with ''thinly-traded'' equity securities than with equity securities that are ''widely-held'' and ''actively-traded.''[5] Similarly, the avoidance of liquidity restraints would be more dramatic with ''thinly-traded'' equity securities than with equity securities that are ''widely-held'' and ''actively-traded.''

In order to address its concerns without unnecessarily restricting the scope of relief under the proposal, the Department determined to deem equity securities that are included in an Index (as defined in section IV(c) of the exemption) to be ''widely-held'' and ''actively-traded'' for purposes of the exemption. However, the Department notes that the exemption does not preclude a manager from cross-trading a particular equity security not included in an index if the manager otherwise determines that such security is ''widely-held'' and ''actively-traded.''[6]

With respect to the comment suggesting a trading volume limitation, the Department notes that other commenters have discouraged it from addressing its concerns about cross-trades of ''thinly-traded'' securities through volume limitations, based on arbitrary percentages of the average daily trading volume for the securities. These commenters noted that the systems used by managers to allocate cross-trades among various Funds would have difficulty monitoring and re-allocating cross-traded securities to conform to such volume limitations.

In consideration of the above, the Department has determined not to modify section II(f)(1) in the final exemption.

7. *Cross-Trades of Securities Issued By the Manager.* Several comments objected to the requirement in section II(h) of the proposal that cross-trades not involve securities issued by the manager, unless the manager has obtained a separate prohibited transaction exemption for the acquisition of such security. One commenter noted that, although some institutions have obtained individual exemptions to deal with issues relating to acquisitions and dispositions of the manager's own stock by its Index and Model-Driven Funds,[7] others have concluded that no exemptive relief is necessary based on the facts and circumstances surrounding their individual situations. The commenter noted that, with regard to certain Index Funds, the manager does not exercise discretion in choosing the individual stocks to buy or sell, but rather seeks to mechanically purchase stocks selected through objective criteria which is outside of the manager's control. For example, in an Index Fund that is designed to replicate the exact capitalization-weighted composition of the Standard & Poor's 500 Composite Stock Price Index (the S&P 500 Index), if the manager's stock is included in the index, that stock will be purchased in the proportion dictated by the index without the manager exercising any investment discretion. In such instances, the commenter stated that a manager's failure to acquire the stock would cause ''tracking error,'' thereby subverting the goal of plan investors in

[5] The Department notes that these concerns would also arise with ''thinly-traded'' debt securities. However, since ''thinly-traded'' debt securities of different issuers with the same coupon rate, maturity, and credit rating are relatively fungible, the Department did not believe that it would be appropriate to apply these concepts to such securities for purposes of this exemption.

[6] With respect to the selection criteria for securities included in a Fund's portfolio which are not included in an Index, the Department assumes that any screening criteria and/or weighting procedures used to create the portfolio will be determined using purely mathematical computations based upon objective raw data. In addition, the Department assumes that the investment management agreement relating to each Fund, as approved by plan investors in the Fund, would set forth the specific dates on which the Fund's portfolio will be re-balanced. In this regard, the Department notes that no relief would be provided under this exemption for violations of section 406(b)(1) of the Act which may occur as a result of a manager's exercise of fiduciary authority or discretion to affect the components of an Index.

[7] For example, see Prohibited Transaction Exemption (PTE) 2000–30, 65 FR 37166 (June 13, 2000), regarding Barclays Bank PLC and its Affiliates.

the Fund to replicate the performance of the index. Other comments stated that it was not clear why a restriction for cross-trades of a manager's own stock is necessary and that there appears to be no reason to exclude such securities from the exemption. The Department accepts these comments and has determined to delete section II(h) of the proposal from the final exemption.

However, the Department notes that the exemption does not provide relief for any discretionary changes in an Index or Model-Driven Fund made by a manager, or any other discretionary decisions by the manager, which are designed to result in cross-trades of the manager's own stock for the benefit of the manager. Only cross-trades generated by non-discretionary changes in a Fund (*e.g.,* changes in the capitalization weighting of the manager's stock within an index, or the addition or removal of the manager's stock from an index) are covered by this exemption. Accordingly, no relief is provided for such discretionary changes regarding the manager's own stock.

As noted previously, all conditions in the final exemption have been re-designated to reflect the deletion of section II(h) of the proposal.

8. *Disclosure and Authorization Requirements.* Many comments raised concerns about the scope of the disclosure and authorization requirements contained in section II(j), (k), (l) and (m) of the proposal. In this regard, the comments noted that section II(i) of the proposal expressly states that the written authorization requirement for a plan's participation in a manager's cross-trading program only applies to plans investing in an Index or Model-Driven Fund that holds ''plan assets'' subject to the Act. The commenters urged the Department to clarify that the notice and disclosure requirements contained in section II(j), (k), (l) and (m) of the proposal similarly apply only to independent fiduciaries of employee benefit plans that invest in Funds holding plan assets.

The Department acknowledges the commenters' concerns regarding the intended scope of the disclosure and authorization requirements of the proposal and wishes to clarify that such requirements were meant to apply only to those Index and Model-Driven Funds which hold ''plan assets,'' as defined under the Department's regulations (*see* 29 CFR 2510.3–101). Therefore, the Department has revised section II(i) and (l) of the final exemption (formerly section II(j) and (m) of the proposal) accordingly.

Other comments objected to the prior written authorization requirement contained in section II(i) of the proposal, noting that prior individual exemptions granted by the Department for cross-trades by Index and Model-Driven Funds did not contain a similar requirement. These comments expressed the view that requiring prior written consent from an independent plan fiduciary as a condition for the plan to invest in a Fund that is part of a manager's cross-trading program serves no useful purpose. The comments noted that if a plan fiduciary were to develop any objections to cross-trading on philosophical grounds, then the plan would be free to withdraw from the Fund without penalty. The commenters believed that imposition of such a requirement will be perceived negatively by plan sponsors as an unnecessary obstacle to their ability to freely invest and reinvest plan assets in a manager's Funds.

The Department disagrees with the commenters' assertion that prior written consent from an independent plan fiduciary is unnecessary. The Department notes that part of the reason for proposing a class exemption for cross-trades of securities by Index and Model-Driven Funds was to address issues which had come to the Department's attention subsequent to its granting of a number of individual cross-trading exemptions.

As stated in the Notice published on March 20, 1998, the Department recognizes that it is important to retain the flexibility to periodically review its exemption policy in the context of changed circumstances or new facts that may be brought to its attention (*see* 63 FR at 13698, first paragraph of section entitled ''Issues and Developments''). The Department became aware of new issues involving cross-trades, including cross-trades by certain ''passive'' investment managers, through enforcement proceedings that raised concerns about whether plan fiduciaries were being provided with adequate disclosures regarding a manager's cross-trading program.

The Department continues to believe that adequate disclosures are necessary in order to enable a plan fiduciary to understand a manager's cross-trading program and how that program may affect the investment goals and objectives of Funds in which the plan may invest. The Department notes that the written authorization required by section II(i) of the proposal will apply to all of the Funds which participate in a manager's cross-trading program. Thus, once an authorization is provided by an independent fiduciary, a plan will be able to invest in any of the Funds without any additional authorization. The Department further notes that the authorizations required under the exemption for existing plan investors in any Funds may be obtained through a separate notice which describes the Funds' participation in the manager's cross-trading program. Under this requirement, failure to return the termination form by the date specified in the notice will be deemed to be an approval by the independent plan fiduciary of the plan's participation in the cross-trading program. Therefore, the Department has determined not to revise the authorization requirements in the final exemption.

With respect to the required content for the disclosures that must be furnished pursuant to sections II(l) and (m) of the proposal, the commenters were concerned that the initial and annual notices must identify all Index and Model-Driven Funds participating in the manager's cross-trading program, together with detailed information regarding the ''triggering events'' and other information relating to each Fund. The comments noted that requiring such disclosures would cause managers to violate confidentiality restrictions contained in many client agreements and would also raise privacy concerns for clients who do not wish their identity, or the fact that they maintain an investment account with the manager, to be disclosed. In this regard, the comments noted that managers are restricted from disclosing confidential information about clients, particularly the Funds in which clients invest. In addition, the comments stated that such detailed disclosure would be of little practical value to plan fiduciaries when deciding whether to authorize or maintain plan investments in a particular Fund. As an alternative, several comments suggested that the initial and annual notices should include only general descriptions of the types of Funds that participate in the manager's cross-trading program and of the ''triggering events'' that give rise to cross-trade opportunities.

The Department acknowledges the concerns expressed by the commenters regarding the confidentiality restrictions contained in client agreements and privacy concerns relating to the identity of such clients and the Funds in which they may invest. Nevertheless, the Department continues to believe that the required disclosures will be useful to a plan fiduciary in understanding the scope and operation of the manager's cross-trading program and whether participation in the program remains in the plan's best interests. However, the Department does not intend for the disclosures in section II(k) of the

exemption (relating to a manager's ongoing disclosures of information about the cross-trading program) or section II(l) of the exemption (relating to disclosures for an annual re-authorization of the cross-trading program by an independent plan fiduciary) to require that privileged or confidential information be revealed by the manager. For example, these provisions, as revised herein, do not require a manager to furnish to independent plan fiduciaries the identity of any clients of the manager that are invested in other Funds that are added to the cross-trading program. In addition, any information disclosed by the manager regarding new ''triggering events'' for existing Funds need only provide such information with respect to Funds in which the plans are invested. With respect to disclosures regarding new ''triggering events'' which must be provided to the relevant independent plan fiduciaries of the affected Funds (as discussed further below), the Department does not believe that the final exemption requires the disclosure of privileged or confidential information.

Other commenters requested that the Department clarify that portion of section II(l) of the proposal which requires that the manager notify each relevant independent plan fiduciary of the addition of Funds to the manager's cross-trading program, or changes to, or additions of, ''triggering events'' regarding Funds, following a plan's initial authorization of participation in the program. Specifically, the comments requested clarification as to whether the phrase ''each relevant independent plan fiduciary'' was intended by the Department to be limited to fiduciaries of plans invested in those specific Funds that are added to a manager's cross-trading program or whose ''triggering events'' have been modified. The comments noted that it would be burdensome to require managers to notify all plans regarding modifications to ''triggering events'' that may occur in all Funds, including Funds in which such plans are not invested, just because such Funds participate in the cross-trading program. In addition, it would be difficult to provide notice to all plans prior to, or within 10 days following, such events affecting any of the Funds.

In consideration of such comments, the Department has modified section II(k) of the final exemption (formerly section II(l) of the proposal) to provide that the ongoing notices of information that must be furnished to ''each relevant independent plan fiduciary'' are required to be made only to those fiduciaries whose plans are invested in the affected Funds (*i.e.*, the Funds added to the program or whose ''triggering events'' have been changed).

Other commenters stated that certain of the disclosures are unnecessary. For example, several comments objected to the statement required by section II(k) of the proposal, relating to investment decisions for a Fund not being based on the availability of cross-trade opportunities. These comments noted that this statement would be duplicative of other information required in the proposal and would provide no added protection to plans, other than the manager's promise to follow the conditions of the exemption. Certain comments objected to the disclosures described in section II(l) of the proposal including the required statement that ''* * * the Manager will have a potentially conflicting division of loyalties and responsibilities to the parties to any cross-trade transaction * * *.'' In addition, section II(l) of the proposal required that the Manager explain how its cross-trading practices and procedures will mitigate such conflicts. According to the comments, following the terms of the exemption should be viewed as precisely what is necessary to mitigate the conflicts. Thus, the commenters believed that it will be misleading to inform client plans that the operation of a manager's cross-trading program, even with adherence to the terms of the proposed exemption, will still create conflicts.

The Department believes that specific statements relating to the fact that investment decisions for a Fund will not be based on cross-trade opportunities (as described in section II(k) of the proposal), and that there are potential conflicts of interest in such cross-trades (as described in section II(l) of the proposal), are important to an independent plan fiduciary's understanding of the issues involved with cross-trades of securities. The Department notes that, in any cross-trading program, including cross-trading programs maintained by ''passive'' investment managers, there would be a potential for abuse if a manager were able to control cross-trade opportunities to favor the interests of particular clients. Therefore, the Department has determined not to revise the exemption as requested.

Section II(l) of the proposal requires that independent plan fiduciaries be furnished with detailed disclosure of the procedures to be implemented under the manager's cross-trading program (including the ''triggering events'' that will create cross-trading opportunities, the independent pricing services that will be used by the manager to price the cross-traded securities, and the methods that will be used for determining closing price). The comments noted that the preamble to the proposal suggests with respect to foreign securities that the applicable independent pricing source should provide the price in local currency rates and, if that currency is other than U.S. dollars, also provide the U.S. dollar exchange rate (*see* first paragraph of Section IV.B. of the preamble, 64 FR at 70062). In this regard, the comments noted that most pricing services that price foreign securities do not provide currency conversion rates. These commenters suggested that managers be allowed to use another independent service to provide such conversion rates, so long as the service is disclosed to plan investors.

The Department acknowledges the commenter's concerns, based on the language contained in the preamble to the proposal. However, the Department did not intend to prevent a manager from using another independent service to provide the appropriate currency exchange rates for a foreign security. Thus, the Department notes that no modification to section II(k) of the final exemption (formerly section II(l) of the proposal) is necessary.

A number of the comments noted that Section II(m) of the proposal (relating to a plan's annual re-authorization of its participation in the manager's cross-trading program) appears to require, among other things, that each plan fiduciary be notified annually of: (i) Any change in the ''triggering events'' in the Funds in which their plans are invested; (ii) any change in the ''triggering events'' in the Funds in which their plans are not invested; and (iii) any ''triggering events'' and other disclosure items for new Funds added to the cross-trading program since the last annual notice. These comments stated that the latter two categories of disclosures noted above are irrelevant to a plan fiduciary who has no assets invested in those Funds. The commenters believe that such information in the annual disclosures will make it more difficult for plans to properly analyze data which is relevant to an annual re-authorization of the plan's participation in the manager's cross-trading program. The comments suggested that annual disclosures to a plan fiduciary should be limited to that material which is relevant to its plan's investments in the manager's Funds. If a plan fiduciary determines to invest in other Funds for which no annual disclosure information has been previously provided, the fiduciary would then be provided with

the material relevant to the new Funds in such annual disclosures.[8]

Upon consideration of these comments, the Department believes that some plan fiduciaries may still find information about other Funds to be useful and should be provided that information by the manager upon request. Therefore, in order to limit the scope of the annual disclosures required in section II(l) of the exemption (formerly section II(m) of the proposal), the Department has modified that section to read as follows:

> ''* * * Such annual re-authorization must *provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested as well as explicit notification that the plan fiduciary may upon request obtain* disclosures regarding any new Funds *in which the plan is not invested* that are added to the cross-trading program, or any new triggering events that may have been added to existing Funds *in which the plan is not invested,* since the time of the initial authorization * * * etc.'' [emphasis added]

A commenter requested that the annual re-authorization requirement contained in section II(m) of the proposal be deleted in its entirety. The commenter stated that coordinating such a re-authorization would entail the same administrative burdens as a requirement for periodic notice of new Funds to all plan fiduciaries investing in Funds which participate in the manager's cross-trading program. According to the commenter, a plan could request that the plan's investment in any Fund that participates in the cross-trading program be terminated without penalty. Thus, the commenter maintained that a plan's participants and beneficiaries should be adequately protected without having to re-authorize participation in the cross-trading program every year.

In the event that the Department determined to retain the annual re-authorization requirement, the commenter requested two modifications to section II(m) of the proposal. First, the commenter believed that providing a plan fiduciary with a list of new Funds participating in the manager's cross-trading program would not provide the fiduciary with any useful information. Therefore, the commenter requested that the requirement in section II(m) of the proposal for disclosure regarding new Funds added to the manager's cross-trading program or any new triggering events be modified to permit the manager to make such information available upon request. Second, the commenter noted that section II(m) of the proposal requires the use of a ''special termination form'' in the annual re-authorization. The commenter noted that there are other methods of communication which would be easier and more efficient for a plan fiduciary to use in the event that the fiduciary decides to terminate its prior authorization.

The Department has determined that it would not be appropriate to delete the requirement for plan fiduciaries of affected Funds to provide an annual re-authorization of their plan's participation in the manager's cross-trading program. The Department believes that annual re-authorization will help ensure effective monitoring of a cross-trading program by the affected plans. Therefore, the Department has retained this requirement in section II(l) of the exemption.

However, in response to the comments regarding the need for a special termination form to be sent to each plan fiduciary, the Department has modified section II(l) of the exemption (formerly section II(m) of the proposal) to permit other forms of written communication to be used to terminate an authorization. Thus, the following new sentence has been added to section II(l) of the final exemption:

> ''* * * In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request.''

In response to the comments regarding the requirement in the proposal for the annual disclosures to include a list of any new Funds participating in the manager's cross-trading program in which the plan is not invested, or any new triggering events for a manager's Funds in which the plan is not invested, the Department has previously noted above that section II(l) of the exemption has been modified to require that such information need only be provided by a manager upon request.

9. *Authorizations for Large Account Restructures.* Under section II(n)(3) of the proposal, a portfolio restructuring program must be completed within the later of: (i) 30 days of the initial authorization by an independent fiduciary of the Large Account; or (ii) 30 days of the manager's initial receipt of assets associated with the portfolio restructuring, unless such fiduciary agrees to extend this period for another 30-days. The comments requested a number of revisions and clarifications to this provision. First, the commenters noted that most portfolio restructuring programs are completed within a thirty (30) day period. However, very large portfolio restructurings may take considerably longer. In such instances, the commenters believe that it would be more efficient to allow the manager to obtain authorization to extend the 30-day restructure period at the time of the Large Account fiduciary's initial authorization. Second, one commenter questioned whether securities that cannot be cross-traded with the manager's Funds and, therefore, must be traded on the open market, are affected by the 30-day deadline. Third, another commenter suggested that the 30-day period should begin for each asset on the date on which the asset is included as part of the restructuring account. According to the comment, this change would be responsive to the fact that the manager or trading adviser for a Large Account may not receive all assets to be restructured at the same time.

In response to these comments, the Department has determined to modify section II(m)(3) of the exemption (formerly section II(n)(3) of the proposal) to allow the initial authorization by an independent fiduciary of the Large Account for a specific portfolio restructuring to be effective for 60 days. The 60-day restructure period can be extended for another 30 days if the independent fiduciary for the Large Account agrees to the extension. In addition, the Department wishes to clarify that only securities that are cross-traded are affected by the requirements of section II(m) of the final exemption.

Accordingly, the Department has revised section II(m)(3) of the exemption (formerly section II(n)(3) of the proposal) to provide that:

> ''* * **All cross-trades made in connection with* the portfolio restructuring program must be completed by the Manager within *sixty (60) days* of the initial authorization * * *'' [emphasis added]

In light of the Department's revision to section II(m)(3), the Department does not believe that any further relief is warranted.

10. *Record-keeping.* Several comments expressed concerns regarding the record-keeping requirements contained in section III(a) of the proposal. In this regard, section III(a)(2)

[8] With respect to such annual disclosures, it should be noted that all relevant independent plan fiduciaries of plans invested in a Fund that is added to a manager's cross-trading program, or has changed or added any ''triggering events'' for cross-trades by such Fund after the Fund is included in the program, will already have been provided a separate notice of such event(s) prior to, or within ten (10) days following, each event, as required by section II(k) of the exemption.

requires, among other things, that each manager retain, on a Fund by Fund basis, trade lists which specify the amounts of each security to be purchased or sold for a Fund. This information should be provided in sufficient detail to allow an independent plan fiduciary to verify that each of the investment decisions for the Fund were made in response to specific triggering events. Section III(a)(3) of the proposal requires that, on a Fund by Fund basis, the manager must record the actual trades executed on a particular day, noting which of those trades (including all cross-trades) resulted from triggering events. The comments noted that the preamble to the proposal does not seem to require that the notations necessary to meet the requirements of section III(a)(3) specify which specific triggering event caused each trade (or cross-trade), provided that it is clear that a triggering event(s) caused such trades.

Other commenters stated that the record-keeping requirements of section III(a) are unnecessary because, under the proposed exemption, an Index or Model-Driven Fund can only cross-trade as a result of a triggering event. In addition, these commenters suggested that such a record-keeping requirement would be extremely burdensome if it became necessary to ''tag'' each purchase or sale of a security to a specific triggering event. In such instances, the comments stated that the exemption would involve so much additional record-keeping and costs (*i.e.,* millions of dollars worth per year per manager) that no manager will be able to economically maintain or operate a cross-trading program for its client accounts. Conversely, the comments noted that if the Department believes that ''tagging'' is not required under the proposal, this record-keeping requirement should be deleted since all cross-trades by a manager's Funds will result from at least one ''triggering event'' in order to meet the conditions of the exemption. Other comments noted that records regarding specific triggering events should be retained only if the triggering event resulted in actual cross-trading.

In response to these comments, the Department notes that other commenters have indicated that the record-keeping requirements contained in section III of the proposal are consistent with their current record-keeping practices. In this regard, the Department understands that under the individual exemptions granted for cross-trades by Index and Model-Driven Funds, managers have established record-keeping and monitoring systems designed to ensure compliance with the terms and conditions of those exemptions.

The Department notes that the record-keeping requirements contained in the proposal, while more specific than those of the individual exemptions, were designed to be consistent with the record-keeping systems of managers operating cross-trading programs under the individual exemptions. Thus, the Department is not persuaded by the arguments submitted in favor of deletion of this record-keeping requirement. The Department continues to believe that records must be maintained with sufficient specificity to permit an independent plan fiduciary to verify compliance with the conditions of the exemption.

In response to the commenter's request for clarification as to whether the record-keeping requirements contained in section III(a) of the proposal would mandate that a manager's records demonstrate that each cross-trade by a Fund resulted from a specific ''triggering event,'' the Department believes that the following discussion will be helpful.

When more than one bona fide ''triggering event'' has occurred, the Department expects that a manager's record-keeping system will be able to demonstrate that the cross-trades by the Fund resulted from such ''triggering events.'' For example, if a manager's record-keeping system enables the manager to ''link'' purchases and sales of specific amounts of securities in each cross-trade by a Fund to ''triggering events'' within the 3-day period, then such a system would satisfy the record-keeping requirements of the exemption.

As discussed by the Department in the preamble to the proposal, the record-keeping requirements are intended to assure that independent plan fiduciaries will be able to determine whether Funds and their underlying models or indexes operate consistently in following the input of triggering event information. This information should be kept in sufficient detail to enable a replication of specific historical events in order to satisfy an inquiry by interested persons (as described in section III(b)(1) of the exemption). The Department further notes that records regarding specific triggering events need only be maintained if such events resulted in cross-trades that are subject to the conditions of this exemption.

Another comment noted that section III(a) of the proposal requires that the records must be ''* * * readily available to assure accessibility and maintained so that an independent fiduciary'' may obtain them within a reasonable period of time. The comment noted that most of the required records would be maintained electronically and archived after a few months. The commenter maintained that, while such records are retrievable within a period of days or weeks, the exemption should recognize that the volume of trading and records involved would make faster retrieval impossible. Another comment requested that the Department acknowledge that a ''reasonable period of time'' in this context would be thirty (30) days. In this regard, the Department acknowledges that thirty (30) days may be a reasonable period of time for obtaining and assembling the required information for interested persons if the volume and complexity of the cross-trading records that must be assembled for such persons is significant.

Other comments noted that making records available to plan participants and beneficiaries would be unduly burdensome and would add no significant additional protections.

The Department has determined that it would be appropriate to modify section III(b)(1) to exclude plan participants and beneficiaries unless such persons are participants or beneficiaries in a Manager Plan.

11. *Definition of ''Index Fund'' and ''Model-Driven Fund.''* Several comments noted that, unlike prior individual exemptions for cross-trading, the definition of the term ''Index Fund'' in the proposal (*see* section IV(a) below) requires not only that a Fund be designed to track the rate of return, risk profile and other characteristics of an independently maintained securities index, but also that such tracking occur either by ''* * * replicating the same combination of securities which compose such index'' or by ''* * * sampling the securities which compose such index based on objective criteria and data.'' The commenters urged the Department to clarify that this definition was not intended to preclude an Index Fund from holding cash, cash equivalents or other equitizing cash investments.

The Department concurs with this comment. The definition of the term ''Index Fund'' under section IV(a) of the exemption is not intended to prevent a Fund from holding cash, cash equivalents or other equitizing cash investments. For example, the Department notes that the definition of ''triggering event'' contained in section IV(d)(3) of the exemption specifically contemplates that a Fund may have an accumulation of cash which is attributable to interest or dividends on,

and/or tender offers for, portfolio securities.

In this regard, the Department recognizes that significant levels of cash or cash equivalents in an Index Fund generally will create ''tracking error'' vis-a-vis the independently maintained securities index which the Fund is designed to track. Therefore, assets other than securities which are included in the designated index will only be held by a Fund for a limited period of time.

However, the Department also understands that many managers use temporary cash investments to buy index futures contracts (*e.g.,* S&P 500 futures) in order to more precisely replicate the rate of return and other characteristics of the index prior to investing in the actual securities. It is the view of the Department that the term ''Index Fund'' would allow the use of futures contracts by an Index Fund in order to reduce ''tracking error'' and to achieve the designated investment objectives of the Fund provided that such use is disclosed to plan investors. The disclosures should adequately describe the appropriate parameters and limitations on a manager's use of futures contracts for a Fund.

In this regard, the Department's conclusion is based upon its understanding that ''passive'' investment strategies employed by managers for Index Funds do not primarily rely on futures contracts to achieve a Fund's investment objectives, but rather rely on such contracts as a means for temporarily investing cash accumulations in the Fund prior to actually investing in and holding securities contained in the index. Conversely, the Department is unable to conclude that an Index Fund which invests primarily in index futures contracts as a means of achieving its investment objectives would meet the definition of ''Index Fund'' under section IV(a) of this exemption.

Several comments noted that the definition of the term ''Model-Driven Fund'' under the proposal (see section IV(b) below) requires that the identity and amount of a Fund's securities be ''* * * selected by a computer model that is based on prescribed objective criteria using independent third party data, not within the control of the Manager * * *'' These comments expressed concern that the definition does not appear to include separately managed Index Fund portfolios that exclude specific securities based on independent plan sponsor direction (as opposed to the determination of a computer model). In this regard, the comments noted that the Department has recognized in the past that the composition of a Model-Driven Fund may be influenced by client-initiated instructions to delete certain securities (*e.g.,* tobacco stocks) from an index that is otherwise being tracked. The comments suggested that the definition should be modified to include plan sponsor direction. According to the comments, this modification will not affect the intended purpose of the definition, which is to limit the amount of discretion a manager may exercise to affect the identity or amount of securities to be purchased or sold and to assure that such transactions are not part of an arrangement to benefit the manager.

In response to these comments, the Department notes that the definition of ''Model-Driven Fund'' in section IV(b)(1) of the exemption would include separately managed Fund portfolios which exclude specific securities based upon an independent plan fiduciary's (*e.g.,* a plan sponsor's) direction. The Department understands that managers will often use computer models which are designed to ''screen'' certain securities that are listed in an index from the acquisitions that a Fund would otherwise make, in order to accommodate plan sponsor direction. The definition of ''Model-Driven Fund,'' by allowing the identity of the securities which compose the Fund to be selected by a computer model, can accommodate Fund portfolios which are specifically designed to meet the guidelines dictated by plan sponsors. Thus, the Department does not believe that any further modification to this definition is necessary.

Another commenter noted that the definition of ''Model-Driven Fund'' in section IV(b) of the proposal is limited to Funds which use a computer model to ''transform an Index.'' The commenter stated that many Model-Driven Funds do not seek merely to ''transform an index'' by limiting their investment universe to those securities contained in a single Index, but rather seek to apply quantitative techniques using various forms of publicly available data across a wide spectrum of securities. For example, the Fund may seek to design a portfolio based on the largest 2500 stocks in the United States, based on market capitalization. These stocks may be contained in various independently maintained indexes, but not all 2500 stocks will be contained in a single index. The commenter urged the Department to delete the phrase ''* * * to transform an Index'' from section IV(b)(1) of the proposal and to substitute in its place the following ''* * * to achieve an investment return that is either based upon or measured by an Index.''

The Department does not believe that it would be appropriate in the context of a passive cross-trading exemption to permit managers to use indexes merely as a benchmark for the performance of a portfolio of a Model-Driven Fund. Accordingly, the Department has determined not to revise this definition.

Another comment related to both the definitions of ''Index Fund'' and ''Model-Driven Fund.'' The commenter noted that sections IV(a)(3) and IV(b)(2) of the proposal provide that each definition includes any investment fund, account or portfolio which either contains ''plan assets,'' is an investment company registered under the Investment Company Act of 1940, ''* * * or is an institutional investor.'' The comment noted that many index and model-driven funds are structured as common trust funds, limited liability companies, New Hampshire trusts or other forms of collective investment vehicles. Many of these funds do not contain ''plan assets'' subject to the Act, but are managed in the exact same manner as Funds that do contain ''plan assets.'' The commenter is concerned that the definitions of ''Index Fund'' and ''Model-Driven Fund'' will not include such funds unless the phrase ''* * * or is an institutional investor'' contained in sections IV(a)(3) and IV(b)(2) is modified to provide ''* * * or contains assets of one or more institutional investors.''

The Department concurs with the commenter's suggestion and, accordingly, has modified sections IV(a)(3) and IV(b)(2) of the final exemption.

12. *Definition of ''Triggering Event.''* Section IV(d) of the proposal defines the term ''triggering event'' by listing four specific ''events'' that are included within the definition. In this regard, the comments noted that the preamble to the proposal states that if a computer model used to create a portfolio for a Model-Driven Fund is designed to exclude particular securities for reasons specified by a plan client or the plan's investment guidelines, such exclusions would not be considered a separate triggering event. However, the comments noted that some of the Department's prior individual exemptions for cross-trading included, as a separate triggering event, the following:

''* * * a change in the composition or weighting of a portfolio used for a Model-Driven Fund which results from an independent fiduciary's decision to exclude certain stocks or types of stocks from the

Fund even though such stocks are part of the index used by the Fund.''[9]

The commenters requested that the Department modify the definition of ''triggering event'' to include a similar provision under the final exemption.

In response to the comments, the Department has added a fifth ''triggering event'' to section IV(d) of the exemption to incorporate the suggestion made by the commenters. Thus, section IV(d)(5) of the exemption includes within the definition of the term ''triggering event'' purchases and sales of securities made by Funds after changes to the portfolio of an Index or Model-Driven Fund solely as a result of an independent fiduciary's decision to exclude certain securities from the Fund.

In this regard, the Department notes that with respect to a Model-Driven Fund, if the exclusion of certain securities is ''built into'' the original design of the model, the operation of that model by the manager should not create additional cross-trade opportunities for the Fund, since the Fund was not designed to buy the specific securities which are excluded. Similarly, if an ''excluded security'' is added to an index which has been used by the model to create a portfolio for a Model-Driven Fund, the model should have been already programed to ''screen'' such securities from the acquisitions made by the Fund. Moreover, the additional triggering event would not apply with respect to any Index Fund or Model-Driven Fund that is a collective investment fund maintained by the manager, if the decision to exclude certain securities from the Fund's portfolio was made by the manager.

Lastly, the Department notes that the ''triggering event'' contained in section IV(d) would be effective on the date that the independent fiduciary directed the manager to exclude the securities from the Index or Model-Driven Fund, and, accordingly, the cross-trades of such securities would have to occur within three (3) business days, pursuant to the requirements of section II(b) of the exemption.

Another comment suggested a further modification to the definition of ''triggering event'' in the proposal. The commenter objected to the requirement in section IV(d)(2) of the proposal that a triggering event include a ''specific amount'' of net change in the overall level of assets in a Fund, as a result of investments and withdrawals, and the requirement in section IV(d)(3) of a ''specified amount'' of accumulated cash or stock in a Fund. The commenter suggested that the references to ''specific amount'' and ''specified amount'' be changed to ''material amount'' in both section IV(d)(2) and (3). In connection with this modification, the commenter also requested that a manager be allowed to either (i) identify such material amount in advance as a specified amount of net change (or accumulated cash or securities) relating to such Fund, or (ii) disclose, in the description of the manager's cross-trading practices, pursuant to section II(l) of the proposal, the parameters for determining a material amount of net change (or accumulated cash or stock), including any amount of discretion retained by the manager that may affect such net change (or accumulated cash or securities), in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given.

The Department has considered the commenter's suggestions for changes to the definition of ''triggering event,'' as contained in section IV(d)(2) and (3) of the proposal, and has determined that it would be appropriate to modify the final exemption. Thus, section IV(d)(2) and (3) of the exemption now reads as follows:

''(d) Triggering Event:

(2) A *material* amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that: (A) such *material* amount has either been *identified in advance as a specified amount of net change relating to such Fund and* disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a ''triggering event'' for such Fund, *or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given;* and * * *.'' [emphasis added]

(3) An accumulation in the Fund of a *material* amount of either:

(A) cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) stock attributable to dividends on portfolio securities; provided that such *material* amount has *either* been *identified in advance as a specified amount relating to such Fund and* disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a ''triggering event'' for such Fund, *or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given* * * * '' [emphasis added]

In connection with the modification noted above, the Department cautions managers that any parameters established for determining a material amount of net change (or accumulated cash or securities), and any discretion retained by the manager which may affect such amounts, must be sufficiently limited and described in enough detail to enable proper identification and monitoring of such triggering events by plan fiduciaries.

Further, with respect to the ''triggering events'' that must be disclosed to client plans, certain comments noted that section III(b)(2) of the proposal permits a manager, under certain circumstances, to refuse to disclose to clients any trade secrets, or commercial or financial information that is privileged or confidential, where such information is contained in the manager's record-keeping system. However, these comments noted that the proposal does not include a similar protection for privileged or confidential information included within the mandated client disclosures for triggering events. For example, the triggering event contained in section IV(d)(4) of the proposal (*i.e.,* a change in the model-prescribed portfolio solely by operation of the formulae contained in the computer model underlying the Fund) can only be utilized if certain disclosures are made to an independent fiduciary of each of the plans participating in the Model-Driven Fund. The comments stated that certain of these disclosures may involve highly proprietary information that the investment manager is reluctant to disclose to clients, particularly through a written communication that a client could easily transmit to others. Thus, the comments requested that the Department allow a manager to refuse to disclose trade secrets, or commercial or financial information that is privileged or confidential, so long as the manager notes the reason for non-disclosure in its general disclosure to clients.

In this regard, the Department does not believe that the disclosure of basic factors for making changes in a portfolio for a Model-Driven Fund would require that privileged or confidential information be revealed by the manager to independent plan fiduciaries. Therefore, the Department has not modified the language of section IV(d)(4) in the final exemption.

13. *Definition of ''Large Account.''* One comment noted that section IV(e) of the proposal excludes from the definition of ''Large Account'' any ''

[9] *See,* for example, condition (c)(2) of PTE 94–36 (59 FR 19249, April 22, 1994) regarding The Northern Trust Company.

* * * Index Fund or Model-Driven Fund sponsored, maintained, *trusteed* or managed by the Manager * * *'' [emphasis added] The commenter noted that some banks act as a directed trustee for group trusts which are managed by third party investment managers. In these situations, the bank acts as a non-discretionary trustee and its primary role is to provide custody and record-keeping services for the group trust. The commenter stated that there is no reason that an independent investment manager should be precluded from retaining the bank as a trading adviser for the liquidation or restructuring of the Large Account since, in its capacity as a non-discretionary trustee, the bank will not be making the underlying investment decisions for the portfolio restructuring of the Large Account. Therefore, the commenter requested that the word ''trusteed'' be deleted from the definition of ''Large Account'' in section IV(e) of the proposal.

In this regard, the Department does not believe that it would be appropriate to include all investment funds trusteed by the manager in the definition of ''Large Account'' contained in the exemption. However, the Department has determined it would be appropriate to modify the language of section IV(e) of the final exemption to include an Index Fund or a Model-Driven Fund for which the manager is a nondiscretionary trustee. Consequently, the Department has added a definition of the term ''nondiscretionary trustee'' to the exemption under section IV(m).

Other comments suggested that the definition of ''Large Account'' in section IV(e) of the proposal should be modified by deleting entirely the phrase which provides that a Large Account '' * * * is not an Index Fund or a Model-Driven Fund sponsored, maintained, trusteed or managed by the Manager.'' These comments stated that, if the decision to liquidate a Fund's portfolio is made by an independent plan fiduciary, and such decision is entirely out of the manager's control, it should not matter whether the portfolio is an Index or Model-Driven Fund that is managed by the manager.

In response to these comments, the Department has determined that it would not be appropriate to make the requested modification to the definition of the term ''Large Account'' in section IV(e) of the exemption. The Department continues to believe that cross-trades by a manager's Index and Model-Driven Funds should be subject to the requirements and limitations applicable to Funds under the exemption, such as specified ''triggering events'' for cross-trade opportunities.

Another comment noted that section IV(e) of the proposal defines a ''Large Account'' as any investment fund, account or portfolio that, among other things, holds assets of a registered investment company other than an investment company advised or sponsored by the manager. The commenter believes that the limitation excluding investment companies advised or sponsored by the manager should be deleted. The commenter argued that the Large Account would not be participating in the manager's cross-trading program unless it were advised by the manager, and that the definition in the proposal excludes the very category of investment companies for which relief was intended.

The Department notes that the commenter's argument that a Large Account could be, and most likely would be, a registered investment company advised or sponsored by the manager is not consistent with the record upon which the exemption was developed by the Department. In this regard, the category of investment companies for which relief was intended under this exemption, as well as under prior individual exemptions, were those entities that are independent of the manager operating the cross-trading program, but who decide to hire the manager in order to carry out a specific portfolio restructuring program. In such instances, the restructured portfolio will often become an ''Index Fund'' or ''Model-Driven Fund'' (as defined herein) that will be managed by the manager.

However, the situation described by the commenter, which would permit the inclusion within a manager's cross-trading program for Large Accounts of ''actively-managed'' investment company portfolios advised by the manager, would expand the scope of the exemption beyond that intended by the Department. As discussed further below, the Department is not providing relief at this time for cross-trading programs involving ''actively-managed'' accounts or funds. Therefore, in response to this comment, the Department has determined not to modify section IV(e)(3) of the final exemption.

Other comments noted that the definition of ''Large Account'' in section IV(e) of the proposal requires that the plan or institutional investor whose assets are held by the Large Account have $50 million or more in total assets. The commenter suggested that the definition be revised to permit assets of affiliated plans maintained by the same employer, or controlled group of employers, to be aggregated for purposes of meeting the $50 million threshold.

In consideration of the commenter's suggestion, the Department has modified the definition of ''Large Account'' in section IV(e)(1) of the exemption to permit the aggregation of assets of employee benefit plans maintained by the same employer, or controlled group of employers, provided that such assets are pooled for investment purposes in a single master trust.

14. *Definition of ''Portfolio Restructuring Program.''* Several comments noted that the term ''portfolio restructuring program'' is defined in section IV(f) of the proposal to include the buying and selling of securities on behalf of a Large Account in order to produce a portfolio of securities which will be an Index Fund or a Model-Driven Fund ''managed by the Manager * * *'' In this regard, the comments noted that portfolio restructuring assignments occasionally contemplate that a manager will construct an Index Fund or Model-Driven Fund portfolio or some other type of portfolio which, once formed, will be managed on an ongoing basis by either the plan sponsor or an independent third party manager. In addition, the comments stated that since the terms ''Index Fund'' and ''Model-Driven Fund'' are already defined in the proposal, the phrase ''* * * managed by the Manager'' in the definition of ''portfolio restructuring program'' is unnecessary. Accordingly, the commenters suggested that the phrase ''managed by the Manager'' be deleted from the definition in section IV(f) of the final exemption.

In response to the comments, the Department has modified the definition of the term ''portfolio restructuring program'' in section IV(f) of the exemption to reads as follows:

''(f) Portfolio restructuring program—Buying and selling the securities on behalf of a Large Account in order to produce a portfolio of securities which will be an Index Fund or a Model-Driven Fund managed by the Manager *or by another investment manager, or in order to produce a portfolio of securities the composition of which is designated by a party independent of the Manager,* without regard to the requirements of * * * etc.'' [emphasis added]

15. *Volume Restrictions for Cross-Traded Securities.* A number of commenters responded to the Department's request for information on whether Index and Model-Driven Funds may hold a significant amount of the outstanding shares of a particular security, whether cross-trades of securities by a manager's Funds may represent a high percentage of the

outstanding daily trading volume for such securities, and whether some volume limitation for cross-traded securities would be appropriate. The commenters expressed the view that, even if a manager's Funds were cross-trading securities representing a high percentage of the average daily trading volume, there is no reason to impose a volume limitation in the exemption so long as the purchase or sale of such securities is mandated by a triggering event of an Index or Model-Driven Fund and the securities can be crossed at the closing market price, as established through an independent pricing source. These comments noted that such cross-trades are beneficial to plans regardless of whether the securities involved are thinly-traded, whether the Index and Model-Driven Funds hold significant amounts of the outstanding shares of the securities, or whether the manager's trading represents a high percentage of the trading volume for the securities. The commenters again noted the significant savings which are incurred by avoiding brokerage commissions and bid-ask spreads.

Thus, most commenters expressed the view that if a manager's Index and Model-Driven Funds have a bona fide need to buy or sell specific amounts of securities on any particular business day, in response to various triggering events, there should not be an arbitrary percentage limitation that would inhibit the manager from taking advantage of all cross-trade opportunities for such securities. However, another commenter expressed the view that the Department's exclusion of ''thinly-traded'' equity securities (by requiring in section II(f)(1) of the proposal that all cross-traded equity securities must be ''widely-held'' and ''actively-traded'') is unduly burdensome and unnecessary. As an alternative, this commenter recommended that the Department include ''thinly-traded'' equity securities, but impose some reasonable limitation on cross-trades of such securities, based on a comparison of the size of the cross-trade to the prior trading volume in the security over a reasonable period of time prior to the date of the transaction.

After considering the comments regarding the inclusion of ''thinly-traded'' equity securities in the exemption if an appropriate volume limitation is imposed, the Department has determined not to adopt this approach. The Department's decision is based, in part, on its understanding that, since a process-driven cross-trading program must allocate cross-trade opportunities in a mechanical fashion, it would not be economically feasible to override such allocations whenever the equity securities involved exceeded a specified volume limitation. Therefore, the Department continues to believe that it is more appropriate to allow cross-trades of all equity securities that are listed in an independently maintained third party index (*see* definition of ''Index'' in section IV(c) of the exemption), without any volume limitations. Under the exemption, the Department deemed all equity securities listed in an index to be ''widely-held'' and ''actively-traded'' for purposes of this exemption in order to allow the largest possible universe of equity securities to be cross-traded within the parameters of the conditions of the exemption. In the Department's view, the inclusion of ''thinly-traded'' equity securities that are not listed in an index would require additional safeguards, such as volume information and limitations, which may not be economically feasible in connection with the operation of a manager's cross-trading program.

16. *Avoidance of Adverse Market Impact; Savings in Transaction Costs; A Computer Model's Consideration of Liquidity.* In response to specific questions posed by the Department in the preamble to the proposal on the avoidance of market impact through cross-trades (*see* Section IV.B. of the preamble, 64 FR at 70063), several commenters noted that, by cross-trading at the close of market price, both sides of the cross-trade benefit by avoiding the potential for adverse market impact. The comments stated that adverse market impact occurs each time an investor trades through the market as the market price moves away from the offered price, meaning that the price decreases when the investor wants to sell and increases when the investor wants to buy.

One commenter stated that the Department appears to have concerns about the fact that a manager's avoidance of market impact may not be beneficial to plans at certain times. These concerns originate from the assumption that a manager could benefit certain plans by using a particular trade's market impact as an opportunity for obtaining a better price for a security on the open market. In this regard, the commenter noted that market impact is unpredictable and cannot be forecast by the manager. The commenter stated that managers believe that in most cases market impact is to be avoided, if possible. Thus, the commenter expressed the view that cross-trading, by avoiding the uncertainty of market impact, enables a manager to avoid the possibility of harm to certain clients which would result if trades were placed on the open market, and also eliminate transaction costs and custody costs.

Most commenters noted that a ''passive'' manager would have no incentive to use the limited amount of discretion allowed by its cross-trading program to favor one Fund or Account over another. One commenter stated that each manager would have the same trading goals for all Funds and Large Accounts—i.e., to maximize cross-trading and to minimize transaction costs for open market transactions.

Another commenter noted that Index and Model-Driven Funds are often buying and selling the same securities because there are many different Funds maintained by a manager that are tracking the same index (*e.g.,* the S&P 500 Index). Many managers also design portfolios for Model-Driven Funds that are based on the same index. Moreover, many large capitalization stocks are listed in more than one index. The commenters noted that cross-trades of such stocks between Index and Model-Driven Funds, pursuant to triggering events that occur without a manager's exercise of any investment discretion, at an objectively determined ''closing price'' as reported from a reputable third party source, are an efficient and effective way of meeting the investment objectives of plans which invest in such Funds.

In response, the Department recognizes the merits of cross-trading to reduce or eliminate transaction costs in the context of ''passively managed'' assets. In such instances, a manager has limited investment discretion as a result of independently determined triggering events.

With respect to the Department's concerns that the avoidance of market impact through cross-trades may not equally benefit both sides of such transactions, the Department notes that the potential for abuse appears to be significantly less with ''passively-managed'' assets than with ''actively-managed'' assets. However, the Department does not believe that the commenters have demonstrated that cross-trading creates market impact savings, if any, for both sides to any given cross-trade. The Department has been provided with data by one commenter demonstrating some market impact savings for one side in cross-trades of significant amounts of securities (*i.e.* market impact savings were measured where the cross-trades involved a large capitalization security traded in amounts averaging one and a quarter days of the average public trading volume of the security). No data

was provided to the Department measuring market impact savings for smaller cross-trades, nor was data provided measuring the market impact savings, if any, for each side in a particular cross-trade. Even so, as noted below, certain commenters have concluded that there has been significant transaction cost savings with cross-trading ''passively-managed'' assets and that these savings are attributable solely to the reduction or elimination of brokerage commissions and bid-ask spreads.

Another commenter noted that the preamble to the proposal suggests that relief would not be available under the exemption if the computer model used for a Fund considered the liquidity or availability of securities that are in the cross-trading ''network'' of Funds managed by the manager (*see* the sixth paragraph of Section IV.A. of the preamble, 64 FR at 70062). This commenter expressed the view that such a restriction is harmful to plans and misapprehends the operation of some ''passively-managed'' Funds. The commenter stated that truly ''passive'' Index Funds track the relevant indices and attempt to reduce or eliminate ''tracking error'' between the value of the Fund's portfolio vis-a-vis the value of the index's portfolio. The more identical an Index Fund's portfolio looks when compared to the underlying index's portfolio, and the cheaper the acquisition and disposition costs of the securities in the index, the lower the ''tracking error'' becomes. Thus, a successful ''passive'' manager is one who has the least amount of tracking error in its Index Funds. The commenter noted that the model used for such an Index Fund will always start with the proposition that the portfolio wants each security in the index in its precise capitalization-weighting, as determined by the index. The more information the model has about the costs of acquisition of any security, the less the tracking error will be for the Fund's portfolio and the more successful the manager will be in meeting the plan's investment objectives.

The Department's concerns regarding a computer model's consideration of liquidity or availability of certain securities that are in the manager's cross-trading ''network'' are best illustrated by the following example:

A computer model for a Model-Driven Fund identifies three possible securities for acquisition by the Fund in an attempt to achieve the optimal portfolio for the Fund within the specified guidelines dictated by the Fund's investors. These securities are identified, for purposes of this example, as ''A'', ''B'', and ''C''. Security ''A'' is the most liquid of the three securities, based on third party data, and security ''C'' is the least liquid. The model considers each security's liquidity factor, among other factors, and the estimated transaction costs which would be incurred to acquire the security, as part of its determination as to which security to buy and how much of the security to buy.

Assume that the model is programmed to make the selection of which security to buy, and the amount to buy, by considering only the liquidity information about each security that is available based on third party market data. Let's also assume that, based on such data, the model chooses security ''A'' and does not choose securities ''B'' or ''C''. The exemption would apply for acquisition of security ''A'' to be made by the Fund through cross-trades.

However, let's assume that the model is programmed to make the selection of which security to buy, and the amount to buy, by considering cross-trade opportunities that are available for each security, in addition to other liquidity information that is available based on third party data. Let's also assume that security ''C'' is available through a cross-trade and that the Fund can acquire all the securities it needs through cross-trades of that security. The model has been programmed to ''view'' security ''C'' as having ''infinite liquidity'' because the data within the control of the manager suggests that it can be acquired without incurring any transaction costs. However, this circumstance results from the fact that the necessary number of shares of security ''C'' which the model has determined that the Fund needs is available through cross-trades. Under this example, security ''C'' is considerably less liquid than security ''A'' based upon available third party data. The exemption would not apply for acquisitions of security ''C'' to be made by the Fund through cross-trades because the selection of security ''C'' was based upon the manager's own liquidity information at that time and not liquidity information based solely on third party data.

The Department believes that adoption of the commenter's liquidity approach could result in cross-trading opportunities within the control of the manager impacting upon the investment determinations of the Fund. In this regard, the Department notes that investment decisions made by a Fund may not be based in whole or in part by the manager on the availability of cross-trade opportunities and must be made prior to the identification and determination of any cross-trade opportunities, pursuant to the statement required under section II(j) of the exemption. Therefore, any model's consideration of information relating to cross-trade opportunities for particular securities, as part of the model's determination of which securities to buy or sell, how much of a security to buy or sell, or when to execute a sale or purchase of the securities for the Fund, would not be permitted under the exemption. The Department continues to believe that liquidity considerations and other factors considered by a computer model must be based on independent third party data, not within the control of the manager, as described under section IV(b) of the exemption.

Other commenters noted that the transaction cost savings attributable to cross-trades, pursuant to cross-trading programs operating under the Department's existing individual exemptions, are significant. In response to the Department's questions about whether such cost savings are attributable to the avoidance of market impact or only commission savings, one commenter stated that its clients have saved over $300 million annually through cross-trading and that this calculation is based entirely on the avoidance of brokerage commissions and bid-ask spreads. Another commenter stated that its clients saved approximately $282 million in the calendar year 1999, based on the total number of shares that were cross-traded during the year, broken down by the market in which each share would have been traded if it went to the open market. This commenter also confirmed that these savings are attributable to savings in brokerage commissions, bid-ask spreads and taxes, as applicable in each market. Thus, in both instances, the commenters noted significant cost savings even without taking into consideration whatever measurable ''savings'' may have been attributable to the avoidance of market impact.

17. *Effect of Class Exemption on Individual Exemptions; Appropriate Scope of Relief for the Exemption.* The commenters expressed many different points of view in response to the Department's invitation for comments on the effect that the continuation of current individual exemptions, for cross-trades by Index and Model-Driven Funds, would have in offering an advantage to those investment managers granted such relief compared to those managers which would utilize this exemption (*see* Section IV.H. of the preamble to the proposal, 64 FR at 70066).

One comment noted that the proposal would expand the relief for cross-trading beyond the relief currently available under the individual exemptions, particularly by permitting cross-trades of debt securities and by expanding the definitions of Funds and Large Accounts that are permitted to cross-trade. However, the comment also noted that the proposal imposes a number of additional disclosure, authorization and operational requirements on cross-trading programs. Thus, the comment stated that it is not

clear whether managers who continue to utilize their individual exemptions would have an advantage over those utilizing the class exemption.

Another comment stated that some individual exemptions have been relied upon by managers for more than a decade and that such exemptions should remain in place after the class exemption is granted. This commenter noted that managers have invested substantial time and resources in the current cross-trading systems, and other programmatic features in such systems have been developed in reliance upon the conditions of the individual exemptions. Any revocation of the existing exemptions would mandate conformance with the new exemption's requirements and features, and the manager's cross-trading procedures and systems would have to be significantly revised. The commenter stated that such revisions would place an undue burden on the managers, would add significant costs to the operation of the existing cross-trading programs, and would not provide any added benefits to the managers' client plans.

However, other commenters stated that, by permitting firms to continue to rely on individual exemptions that have, in some respects, less stringent conditions than the proposal, the Department would create a competitive advantage for advisers who already have exemptions. Some commenters further stated that, by granting the class exemption, the Department is already creating a competitive advantage for firms that ''passively manage'' plan assets over those which ''actively manage'' such assets. These commenters urged the Department to hold all firms to the same standard, at least with respect to the class exemption, and eliminate the existing individual exemptions to ensure an ''equal playing field'' for all similarly situated managers that ''passively-manage'' assets.

In this regard, the Department has not made a determination at the present time whether to revoke any past individual exemptions for cross-trading programs involving Index and Model-Driven Funds. It is not clear whether managers who continue to utilize their individual exemptions will have an advantage over those utilizing the class exemption since cross-trades may only be performed if they conform with either all of the provisions of an individual exemption or all of the provisions of the class exemption (*i.e.,* managers who hold individual exemptions may not pick and choose selected provisions from their own exemptions and the class exemption). As noted in the preamble to the proposal, prior to modifying or revoking any individual exemption, the Department must publish a notice of its proposed action in the **Federal Register** and provide interested persons with an opportunity to comment on any proposed revocation or modification of such exemptions.

Other commenters requested that the Department expand the proposal to permit cross-trades by ''actively-managed'' plan accounts of a manager. These commenters noted that the clear advantages of cross-trading should be available to both actively and passively managed funds, and that the Department's exclusion of ''actively-managed'' funds from the current exemption is unfair.

Other commenters stated that it was appropriate for the Department to handle cross-trades by ''passively-managed'' funds separately. Such commenters noted that ''passive'' managers have far less discretion than ''active'' managers. One comment stated that a class exemption attempting to address both ''actively'' and ''passively'' managed funds would be confusing and could lead to the application of unnecessarily burdensome conditions on ''passively-managed'' funds to address concerns applicable only to ''actively-managed'' funds.

The Department has determined to grant this exemption for cross-trading programs involving Index and Model-Driven Funds and to separately proceed with its consideration of relief for cross-trades by ''actively-managed'' plan accounts or pooled funds containing ''plan assets'' covered by the Act.[10] The Department acknowledges that appropriate cross-trades of securities by ''actively-managed'' accounts or funds would be beneficial to employee benefit plans in saving transaction costs and avoiding adverse market impact for both sides of the transactions. However, the Department believes that adequate safeguards must be developed in order to prevent abuses which could occur when an investment manager has significant investment discretion which could be used to benefit certain clients or the manager itself at the expense of its ERISA-covered accounts.

The Department is currently considering what conditions may be necessary to address potential abuses in cross-trading programs that would involve ''actively-managed'' plan accounts. The Department continues to receive and review additional information from various interested persons which will assist the Department in developing a separate class exemption for cross-trades by ''actively-managed'' plan accounts.

Description of the Exemption

A. Scope and General Rule

The exemption consists of four parts. Section I sets forth the general exemption and describes the transactions covered by the exemption. Sections II and III contain specific and general conditions applicable to transactions described in section I. Section IV contains definitions for certain terms used in the exemption.

The exemption set forth in section I provides relief from the restrictions of sections 406(a)(1)(A) and 406(b)(2) of ERISA and section 8477(c)(2)(B) of FERSA for: (a) The purchase and sale of securities between an Index or Model-Driven Fund and another such Fund, at least one of which holds ''plan assets'' subject to the Act; and (b) the purchase and sale of securities between such Funds and certain large accounts (Large Accounts) pursuant to portfolio restructuring programs of the Large Accounts. The exemption also would apply to cross-trades between two or more Large Accounts if such cross-trades occur as part of a single cross-trading program involving both Funds and Large Accounts pursuant to which securities are cross-traded solely as a result of the objective operation of the program.

The exemption under section I(a) applies to cross-trades of securities among Index or Model-Driven Funds managed by the same investment manager where both Funds contain plan assets. However, as stated above, a violation of section 406(b)(2) occurs when an investment manager has investment discretion with respect to both sides of a cross-trade of securities and at least one side is an entity which contains plan assets. As a result, the exemption is also applicable to situations where the investment manager has investment discretion for both Funds involved in a cross-trade but one Fund does not contain plan assets

[10] Interested persons may wish to review the information received by the Department in response to the Notice published in the **Federal Register** on March 20, 1998 (63 FR 13696) and in the testimony provided at the public hearing on cross-trades of securities by ''actively-managed'' plan accounts and pooled funds (the Hearing), which was held at the Department on February 10 and 11, 2000. Copies of the comments received by the Department in response to the Notice, and the testimony received at the Hearing, are available for public inspection in the Public Documents Room, Pension and Welfare Benefits Administration, U.S. Department of Labor, Room N–1513, 200 Constitution Avenue NW, Washington, DC 20210. For copies of the comments relating to the Notice, interested persons should request File No. M–9043. For copies of the testimony received at the Hearing, interested persons should request File No. D–10851 (Cross-Trades of Securities Hearing).

because, for example, it is registered as an investment company under the Investment Company Act of 1940 (*e.g.,* a mutual fund). Any mutual fund or other institutional investor covered by the exemption under section I(a) must meet the definition of an Index Fund or a Model-Driven Fund, contained in section IV(a) and (b). Institutional investors which meet the definitions contained in section IV(a) and (b) may include, but are not limited to, entities such as insurance company separate accounts or general accounts, governmental plans, university endowment funds, charitable foundation funds, trusts or other funds exempt from taxation under section 501(a) of the Code.

The exemption under section I(b) applies to the purchase and sale of securities between a Fund and a Large Account, at least one of which holds ''plan assets'' subject to ERISA or FERSA, pursuant to portfolio restructuring programs initiated on behalf of certain Large Accounts. The term ''Large Account'' is defined in section IV(e) to include certain large employee benefit plans or other large institutional investors with at least $50 million in total assets, including certain insurance company separate and general accounts and registered investment companies. For purposes of the $50 million requirement, the assets of one or more employee benefit plans maintained by the same employer, or controlled group of employers, may be aggregated, provided that such assets are pooled for investment purposes in a single master trust. A portfolio restructuring program, as defined in section IV(f), involves the buying and selling of securities on behalf of a Large Account in order to produce a portfolio of securities which either becomes an Index Fund or a Model-Driven Fund or resembles such a Fund, or to carry out a liquidation of a specified portfolio of securities for a Large Account. The Fund or other portfolio resulting from the restructuring program will be either managed by the manager of the Fund or by an investment manager that is independent of the Fund manager. The definition of a Large Account requires that an independent fiduciary authorize a Fund manager (*i.e.,* a Manager, as defined in section IV(i)) to restructure all or part of the portfolio or to act as a ''trading adviser'' as defined in section IV(g) with respect to the restructuring of such portfolio. The trading adviser's role is limited under the exemption to the disposition within a stated period of time of a securities portfolio of a Large Account and/or the creation of the required portfolio.

Under this definition, the manager may not have any discretionary authority for any asset allocation, restructuring or liquidation decisions or otherwise provide investment advice with respect to such transactions. In this regard, the Department notes that it expects the investment manager to comply with the applicable securities laws in connection with any portfolio restructuring program.

Section IV(a) and (b) require that the Index or Model-Driven Fund be based upon an index which represents the investment performance of a specific segment of the public market for equity or debt securities. Section IV(c) requires that the index be established and maintained by an independent organization which is: in the business of providing financial information or brokerage services to institutional clients; a publisher of financial news or information; or a public stock exchange or association of securities dealers. The index must be a standardized index of securities which is not specifically tailored for the use of the Fund manager.

Section IV(a) and (b) specifically define Index and Model-Driven Funds for purposes of the exemption. These definitions are designed to limit the amount of discretion the manager can exercise to affect the identity or amount of securities to be purchased or sold and to assure that the purchase or sale of any security is not part of an arrangement, agreement or understanding designed to benefit the manager. Under the definition of ''Index Fund'' contained in section IV(a), the investment manager must track the rate of return of an independently maintained securities index by either replicating the same combination of securities which compose such index or by investing in a representative sample of such portfolio based on objective criteria and data designed to recreate the projected return, risk profile and other characteristics of the index. Under the definition of ''Model-Driven Fund'' contained in section IV(b), trading decisions are passive or process-driven since the identity and the amount of the securities contained in the Fund must be selected by a computer model. Although the manager can use its discretion to design the computer model, the model must be based on prescribed objective criteria using third party data, not within the control of the manager, to transform an independently maintained index. Thus, for example, no exemptive relief would be available if the manager designed the computer model to consider the liquidity or the availability of a security based on information that was solely within the control of the manager. In such instances, the computer model would be considering data that was not from a third party source, and that was within the control of the manager.

B. Price and Securities

Section II(a) of the exemption requires that each cross-trade be executed at the closing price for that security. In addition, section II(g) of the exemption requires that the manager may not receive any brokerage fees or commissions as a result of the cross-trades.

Closing price is defined in section IV(h) as the price for the security on the date of the transaction, as determined by objective procedures disclosed to Fund investors in advance and consistently applied with respect to securities traded in the same market. The procedures shall indicate the independent pricing source (and alternates, if the designated pricing source is unavailable) used to establish the closing price and the time frame after the close of the market in which the closing price will be determined. The pricing source must be independent of the manager and must be engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and must be widely recognized as an accurate and reliable source for such information. In this regard, some managers may use one pricing service for pricing domestic securities and another pricing service for pricing foreign securities. With respect to foreign securities, the applicable independent pricing source should provide the price in local currency rates and, if that currency is other than U.S. dollars, may also provide the U.S. dollar exchange rate. Thus, securities must be cross-traded in all cases at the closing prices received by the manager from the relevant independent pricing source.

The Department has adopted this definition of the term ''closing price'' in an effort to be consistent with the methods for determining the price of cross-traded securities currently utilized by Index and Model-Driven Fund investment managers, according to both the comments received in response to the proposal published on December 15, 1999 and the comments received in response to the Notice published on March 20, 1998. In addition, the Department believes that this pricing approach will ensure that the pricing procedures utilized are objective and not subject to the discretion or

manipulation of any of the involved parties.

Section II(f) of the exemption requires that cross-trades of either equity securities or fixed income securities involve only securities for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information. Section II(f)(1) further requires that cross-trades of equity securities only involve securities which are widely-held and actively-traded. In this regard, the Department notes that equity securities will be deemed to be ''widely-held'' and ''actively-traded'' under this exemption if such securities are included in an independently maintained index, as defined in section IV(c) herein. The Department expects that managers, in making their determinations regarding the types of securities included within the scope of this condition, would consider information about the average daily trading volume for equities traded on any recognized securities exchange or automated broker-dealer quotation system which would be readily available from independent pricing sources or other independent sources which publish financial news and information.

C. Triggering Events

Section II(b) of the exemption requires that any purchase or sale of securities by a Fund in a cross-trade with another Fund or with a Large Account occur as a direct result of a ''triggering event,'' as defined in section IV(d), and that such cross-trade be executed no later than the close of the third business day following such ''triggering event.'' The Department believes that trading pursuant to triggering events limits the discretion of the manager to affect the identity or amount of securities to be purchased or sold. Triggering events, as defined in section IV(d), are outside the control of the manager and will ''automatically'' cause the buy or sell decision to occur.

Triggering events are defined in section IV(d) as:

(1) A change in the composition or weighting of the index underlying the Fund by the independent organization creating and maintaining the index;

(2) A material amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that:

(A) Such material amount has either been identified in advance as a specified amount of net change relating to such Fund and disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a ''triggering event'' for such Fund or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given; and

(B) Investments or withdrawals as a result of the manager's discretion to invest or withdraw assets of a Manager Plan, other than a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options, including such Fund, will not be taken into account in determining the specified amount of net change;

(3) An accumulation in the Fund of a material amount of either:

(A) Cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) Stock attributable to dividends on portfolio securities;

provided that such material amount has either been identified in advance as a specified amount relating to such Fund and disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a ''triggering event'' for such Fund, or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given;

(4) A change in the composition of the portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model underlying the Fund where the basic factors for making such changes (and any fixed frequency for operating the computer model) have been disclosed in writing to an independent fiduciary of each plan having assets held in the Fund, prior to, or within ten (10) days after, its inclusion as a ''triggering event'' for such Fund; or

(5) A change in the composition or weighting of a portfolio for an Index Fund or a Model-Driven Fund which results from an independent fiduciary's direction to exclude certain securities or types of securities from the Fund, notwithstanding that such securities are part of the index used by the Fund.

The first three triggering events have been adopted based upon those triggering events utilized in prior individual exemptions, with an additional requirement in the second and third triggering events for the amounts involved, or the parameters for determining such amounts, to be specified and disclosed to independent fiduciaries of plans investing in the Funds. In addition, the fourth triggering event has been added in order to clarify that a triggering event also occurs as a result of a change in the composition of a Fund's portfolio mandated solely by operation of the computer model underlying the Fund. For example, if a model contained a formula for a Fund requiring only stocks with a certain price/earnings ratio and some of the originally prescribed stocks now were above the specified tolerances of the formula relating to that model, a triggering event would occur requiring that those stocks be sold by the Fund. The Department has included this triggering event under this exemption in order to clarify that Model-Driven Funds may need to buy or sell securities to conform to changes to the portfolio prescribed by the model that differ from changes to a portfolio necessitated as a result of changes to the underlying index. The exemption does not require that a computer model be operated according to any fixed frequency. However, the Department is of the view that the exemption would not be available unless the formulae contained in the computer model underlying a Fund were operated by the manager on an objective basis rather than being used for the purpose of creating cross-trade opportunities in response to the needs of other Funds or certain Large Accounts.

The Department further notes that under section II(k), disclosures must be made to independent plan fiduciaries of the affected Funds regarding the triggering events that would create cross-trading opportunities for such Funds under the manager's cross-trading program. Under the model-driven triggering event contained in the exemption, the basic factors for making changes in the composition of the

portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model must be included in these disclosures.

The Department notes that a fifth triggering event has been added to the final exemption, based on comments received, which permits plan sponsors to direct the manager to delete certain securities from an Index or Model-Driven Fund where the Fund otherwise would hold such securities based upon the particular index or computer model. The Department understands that this triggering event is consistent with practices utilized by certain managers in prior individual exemptions and will facilitate additional cross-trade opportunities.

D. Modifications to the Computer Model

Section II(c) requires that, if the model or the computer program used to generate the model underlying the Fund is changed by the manager, no cross-trades of any securities can be engaged in pursuant to the exemption for three (3) business days following the change. This restriction recognizes the authority of the manager to change assumptions involving computer models after the model's activation.

The Department notes that the three (3) business day ''blackout'' period for cross-trades by a Fund after any change made by the manager to the model underlying the Fund is intended to prevent model changes which might be made by managers, in part, to deliberately create additional cross-trading activity.

In addition, under section IV(b), a computer model for a Model-Driven Fund must use independent third party data, not within the control of the manager, to transform an index.

E. Allocation of Cross-Trade Opportunities

The Department notes that frequently the amount of a security which all of the Funds need to buy may be less than the amount of such security which all of the Funds will need to sell, or vice versa. Thus, section II(d) of the exemption requires that all cross-trade opportunities be allocated by the manager among potential buyers, or sellers, on an objective basis. Under section II(d), this basis for allocation must have been previously disclosed to independent fiduciaries on behalf of each plan investor, and must not permit the exercise of any discretion by the manager. In previous individual exemptions, applicants have relied on different systems (*e.g.* pro rata or queue) to objectively allocate cross-trade opportunities. While it appears to the Department that a pro rata basis of allocation would be the method least subject to scrutiny, the Department recognizes the validity of other workable objective systems. However, the Department cautions that such systems may not permit the exercise of discretion by the manager.

F. Requirements for Cross-Trades by a Manager Plan

Section II(e) of the exemption requires that no more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade may be comprised of assets of employee benefit plans maintained by the Manager for its own employees (Manager Plans) for which the Manager exercises investment discretion. In this regard, the Department wishes to note that this percentage limitation would not apply to any Manager Plan(s) for which the Manager does not exercise investment discretion. For example, a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options would not be subject to the twenty (20) percent limit.

G. Disclosures and Authorizations

Section II(h) of the exemption requires that a plan's participation in a cross-trade program of a manager involving Index and Model-Driven Funds at least one of which holds ''plan assets'' subject to the Act will be subject to the prior written authorization of a plan fiduciary who is independent of the manager. However, for purposes of this exemption, the requirement that the authorizing fiduciary be independent of the manager shall not apply in the case of a Manager Plan. In this regard, section II(e) of the exemption requires that no more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade may be comprised of assets of a Manager Plan for which the Manager exercises investment discretion.

The authorization described in section II(h), once given, would apply to all Funds that comprise the manager's cross-trading program at the time of the authorization. Thus, a new authorization by an independent plan fiduciary for investment in a different Fund, in which the plan did not invest at the time of its initial written authorization, would not be necessary to the extent that such Fund was part of the program at the time of the original authorization. However, where a manager makes new Funds available for plan investors or changes triggering events relating to Funds subject to the initial authorization, and such Funds or triggering events were not previously disclosed as being part of the manager's cross-trading program, section II(k) of the exemption requires that the manager furnish additional disclosures to an independent plan fiduciary. The Manager shall provide a notice to each relevant independent plan fiduciary of plans invested in the affected Funds prior to, or within ten (10) days following, such addition of Funds or change to, or addition of, triggering events, which contains a description of such Fund(s) or triggering event(s). Such notice will also include a statement that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner.

As noted below, section II(l) requires that disclosures be made to the relevant independent plan fiduciaries regarding each Fund in which the plan is invested as part of the notice required for a plan's annual re-authorization of its participation in the manager's cross-trading program. In addition, section II(l) requires that disclosures regarding any new Funds, or new triggering events in any existing Funds, in which a plan is not invested be made available, upon request, as part of the notice required for a plan's annual re-authorization of its participation in the manager's cross-trading program.

Section II(i) clarifies the meaning of Section II(h) with respect to existing plan investors in any of the Funds, which hold plan assets subject to the Act, prior to a manager's implementation of a cross-trading program. Under section II(i), the authorizing independent fiduciary must be furnished notice and an opportunity to object to that plan's participation in the program not less than forty-five (45) days prior to the implementation of the cross-trade program. Section II(i) further states that the failure of the authorizing fiduciary to return a special termination form provided in the notice by a specified date that is at least thirty (30) days from receipt shall be deemed to be approval of the plan's participation in the program. If the authorizing plan fiduciary objects to the plan's inclusion in the program, the plan will be given the opportunity to withdraw without penalty prior to the program's implementation.

Sections II(j) and II(k) describe the type of information that is required to be disclosed to a plan fiduciary prior to the authorization defined in sections II(h)

and II(i). Important among these disclosures is a statement describing the conflicts that will exist as a result of the manager's cross-trading activities. This statement must also detail and explain how the manager's practices and procedures will mitigate such conflicts. Such writing must include a statement that:

Investment decisions will not be based in whole or in part by the manager on the availability of cross-trade opportunities. These investment decisions include:

- Which securities to buy or sell;
- How much of each security to buy or sell; and,
- When to execute a sale or purchase of each security.

Investment decisions will be made prior to the identification and determination of any cross-trade opportunities. In addition, all cross-trades by a Fund will be based solely upon triggering events set forth in the exemption. Records documenting each cross-trade transaction will be retained by the manager.

Section II(l) further requires that notice be provided to the authorizing plan fiduciary at least annually of the plan's right to terminate its participation in the cross-trading program and its investment in any of the Funds without penalty. Such notice must be accompanied by a special termination form. Failure to return the form by a specified date that is at least thirty (30) days from the receipt will be deemed approval of the plan's continued participation in the cross-trading program. In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request. Such annual re-authorization will provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested, as well as explicit notification that the plan fiduciary may request and obtain disclosures regarding any new Funds in which the plan is not invested that are added to the cross-trading program, or any new ''triggering events'' (as defined in Section IV(d) below) that may have been added to existing Funds in which the plan is not invested, since the time of the initial authorization described in Section II(h), or the time of the notice described in Section II(i).

Section II(m) of the exemption details specific requirements for cross-trades of securities which will occur in connection with a Large Account restructuring. In particular, section II(m)(2) requires that the authorization for such cross-trades must be made in writing prior to the cross-trade transactions by fiduciaries of the Large Account who are independent of the manager (except in the case of a Manager Plan). Such authorization must follow full written disclosure of information regarding the cross-trading program. Such authorization may be terminated at will upon receipt by the manager of written notice of termination. A termination form must be supplied to the Large Account fiduciary concurrent with the written description of the cross-trading program. Under section II(m)(3), the portfolio restructuring program must be completed within sixty (60) days of the initial authorization made by the Large Account's fiduciary (or initial receipt of assets associated with the restructuring, if later), unless the Large Account's fiduciary agrees in writing to extend this period for another thirty (30) days. Large Account fiduciaries may utilize the termination form or any other written instrument at any time within the 60-day period, or the additional 30-day period, to terminate their prior written authorization for cross-trading related to the portfolio restructuring program. Under section II(m)(4), within thirty (30) days of the completion of the restructuring program, the Large Account fiduciary must be fully apprised in writing of the results of the transactions. Such writing may include, upon request by the Large Account fiduciary, additional information sufficient to allow the independent fiduciary for the Large Account to verify the need for each cross-trade and the determination of the above decisions. However, pursuant to section III(b)(2) the manager may refuse to disclose to a Large Account fiduciary or other person any such information which is deemed confidential or privileged if the manager is otherwise permitted by law to withhold such information from such person, provided that by the close of the thirtieth (30th) day following the request, the manager gives a written notice to such person advising that person both the reasons for the refusal and that the Department may request such information.

H. Recordkeeping

Section III(a) requires that the manager maintain records necessary to allow a determination of whether the conditions of the exemption have been met. These records must be maintained for a period of six (6) years from the date of the transactions. These records must include records which identify the following:

(1) On a Fund by Fund basis, the specific triggering events which result in the creation of the model prescribed output or trade list of specific securities to be cross-traded;

(2) On a Fund by Fund basis, the model prescribed output or trade list which describes: (A) which securities to buy or sell; (B) how much of each security to buy or sell; in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events; and

(3) On a Fund by Fund basis, the actual trades executed by the Fund on a particular day and which of those trades were associated with triggering events.

As explained to the Department, the triggering event relating to net investments in, or withdrawals from, a Fund results in new cash to invest in the Fund or the need to liquidate securities from a Fund. The model or index underlying the Fund determines which securities to purchase or sell based on the amount of net investments or withdrawals. This process results in the creation of a trade list or a model prescribed output of securities to be purchased or sold. The manager then applies its objective allocation system to the trade lists or model prescribed outputs used for other Funds participating in the cross-trade program to determine which particular cross-trades will occur between Funds. For those securities which cannot be cross-traded after application of the manager's allocation system, the necessary purchases and sales are made through other means.

In the view of the Department, records must be maintained of this cross-trading activity with enough specificity to allow an independent plan fiduciary to verify whether the safeguards of this exemption have been met. Section II(b) requires that any cross-trade of securities by a Fund occur as a direct result of a ''triggering event'' as defined in section IV(d) and is executed no later than the close of the third business day following such ''triggering event.'' Among the records needed to verify that this condition has been satisfied, section III(a)(1) requires that, on a Fund by Fund basis, the manager maintain a record of the specific triggering events which result in the creation of the list of specific securities for the manager's cross-trading system. Section III(a)(2) further requires that, on a Fund by Fund basis, the manager maintain records of

the model prescribed output or trade list, as well as the procedures utilized by the manager to determine which securities to buy or sell and how much of each security to buy or sell, in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events. As provided by section III(b)(2), if such material is viewed as a trade secret, or privileged or confidential, the manager may refuse to disclose such information if reasons for the refusal are given and the person is also notified that the Department of Labor may request such information.

This record-keeping requirement is intended to assure that independent plan fiduciaries will be able to determine whether Funds and their underlying models or indexes operate consistently in following the input of triggering event information. The Department does not intend to prescribe a detailed list of records that are necessary to enable a determination of compliance with the exemption because the necessary records will depend on the nature of the Index or Model-Driven Funds involved and other factors. This information, however, should be kept in sufficient detail to enable a replication of specific historical events in order to satisfy an inquiry by persons identified in section III(b)(1). Section III(a)(3) requires that, on a Fund by Fund basis, records be maintained of the actual trades executed by the Fund on a particular day and which of those trades resulted from triggering events.

Further, Section III(a) requires that the records must be readily available to assure accessibility and maintained so that an independent fiduciary, or other persons identified in section III(b)(1), may obtain them within a reasonable time. This requirement should permit the records to be retrieved and assembled quickly, regardless of the location in which they are maintained. For those records which are not maintained electronically, the records should be maintained in a central location to facilitate assembly and examination.

All records must be unconditionally available at their customary location for examination during normal business hours by the persons described in section III(b)(1). However, as noted with respect to information which may be disclosed to a Large Account fiduciary or other person, the manager may refuse to disclose to a person, other than a duly authorized employee or representative of the Department or the Internal Revenue Service, any such information which is deemed confidential or privileged if the manager is otherwise permitted by law to withhold such information from such person. In such instances, the manager shall provide, by the close of the thirtieth (30th) day following the request, a written notice to such person advising that person of the reasons for the refusal and that the Department may request such information.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which require, among other things, that a fiduciary discharge his duties with respect to the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record, the Department finds that the exemption is administratively feasible, in the interests of the plans and their participants and beneficiaries and protective of the rights of participants and beneficiaries of such plans;

(3) The exemption is applicable to a particular transaction only if the conditions specified in the class exemption are met; and

(4) The exemption is supplemental to, and not in derogation of, any other provisions of the Code and the Act, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990.)

Section I—Exemption for Cross-Trading of Securities by Index and/or Model-Driven Funds

Effective April 15, 2002, the restrictions of sections 406(a)(1)(A) and 406(b)(2) of the Act, section 8477(c)(2)(B) of FERSA, and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) of the Code, shall not apply to the transactions described below if the applicable conditions set forth in Sections II and III below are satisfied.

(a) The purchase and sale of securities between an Index Fund or a Model-Driven Fund (a ''Fund''), as defined in Sections IV(a) and (b) below, and another Fund, at least one of which holds ''plan assets'' subject to the Act or FERSA; or

(b) The purchase and sale of securities between a Fund and a Large Account, as defined in Section IV(e) below, at least one of which holds ''plan assets'' subject to the Act or FERSA, pursuant to a portfolio restructuring program, as defined in Section IV(f) below, of the Large Account;

Notwithstanding the foregoing, this exemption shall apply to cross-trades between two or more Large Accounts pursuant to a portfolio restructuring program if such cross-trades occur as part of a single cross-trading program involving both Funds and Large Accounts for which securities are cross-traded solely as a result of the objective operation of the program.

Section II. Specific Conditions

(a) The cross-trade is executed at the closing price, as defined in Section IV(h) below.

(b) Any cross-trade of securities by a Fund occurs as a direct result of a ''triggering event,'' as defined in Section IV(d) below, and is executed no later than the close of the third business day following such ''triggering event.''

(c) If the cross-trade involves a Model-Driven Fund, the cross-trade does not take place within three (3) business days following any change made by the Manager to the model underlying the Fund.

(d) The Manager has allocated the opportunity for all Funds or Large Accounts to engage in the cross-trade on an objective basis which has been previously disclosed to the authorizing fiduciaries of plan investors, and which does not permit the exercise of discretion by the Manager (*e.g.,* a pro rata allocation system).

(e) No more than twenty (20) percent of the assets of the Fund or Large Account at the time of the cross-trade is

comprised of assets of employee benefit plans maintained by the Manager for its own employees (Manager Plans) for which the Manager exercises investment discretion.

(f)(1) Cross-trades of equity securities involve only securities that are widely-held, actively-traded, and for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information. For purposes of this requirement, the terms ''widely-held'' and ''actively-traded'' shall be deemed to include any security listed in an Index, as defined in Section IV(c) below; and

(2) Cross-trades of fixed-income securities involve only securities for which market quotations are readily available from independent sources that are engaged in the ordinary course of business of providing financial news and pricing information to institutional investors and/or the general public, and are widely recognized as accurate and reliable sources for such information.

(g) The Manager receives no brokerage fees or commissions as a result of the cross-trade.

(h) As of the date this exemption is granted, a plan's participation in the Manager's cross-trading program as a result of investments made in any Index or Model-Driven Fund that holds plan assets is subject to a written authorization executed in advance of such investment by a fiduciary of the plan which is independent of the Manager engaging in the cross-trade transactions. For purposes of this exemption, the requirement that the authorizing fiduciary be independent of the Manager shall not apply in the case of a Manager Plan.

(i) With respect to existing plan investors in any Index or Model-Driven Fund that holds plan assets as of the date this exemption is granted, the independent fiduciary is furnished with a written notice, not less than forty-five (45) days prior to the implementation of the cross-trading program, that describes the Fund's participation in the Manager's cross-trading program, provided that:

(1) Such notice allows each plan an opportunity to object to the plan's participation in the cross-trading program as a Fund investor by providing the plan with a special termination form;

(2) The notice instructs the independent plan fiduciary that failure to return the termination form to the Manager by a specified date (which shall be at least 30 days following the plan's receipt of the form) shall be deemed to be an approval by the plan of its participation in the Manager's cross-trading program as a Fund investor; and

(3) If the independent plan fiduciary objects to the plan's participation in the cross-trading program as a Fund investor by returning the termination form to the Manager by the specified date, the plan is given the opportunity to withdraw from each Index or Model-Driven Fund without penalty prior to the implementation of the cross-trading program, within such time as may be reasonably necessary to effectuate the withdrawal in an orderly manner.

(j) Prior to obtaining the authorization described in Section II(h), and in the notice described in Section II(i), the following statement must be provided by the Manager to the independent plan fiduciary:

Investment decisions for the Fund (including decisions regarding which securities to buy or sell, how much of a security to buy or sell, and when to execute a sale or purchase of securities for the Fund) will not be based in whole or in part by the Manager on the availability of cross-trade opportunities and will be made prior to the identification and determination of any cross-trade opportunities. In addition, all cross-trades by a Fund will be based solely upon a ''triggering event'' set forth in this exemption. Records documenting each cross-trade transaction will be retained by the Manager.

(k) Prior to any authorization set forth in Section II(h), and at the time of any notice described in Section II(i) above, the independent plan fiduciary must be furnished with any reasonably available information necessary for the fiduciary to determine whether the authorization should be given, including (but not limited to) a copy of this exemption, an explanation of how the authorization may be terminated, detailed disclosure of the procedures to be implemented under the Manager's cross-trading practices (including the ''triggering events'' that will create the cross-trading opportunities, the independent pricing services that will be used by the manager to price the cross-traded securities, and the methods that will be used for determining closing price), and any other reasonably available information regarding the matter that the authorizing fiduciary requests. The independent plan fiduciary must also be provided with a statement that the Manager will have a potentially conflicting division of loyalties and responsibilities to the parties to any cross-trade transaction and must explain how the Manager's cross-trading practices and procedures will mitigate such conflicts.

With respect to Funds that are added to the Manager's cross-trading program or changes to, or additions of, triggering events regarding Funds, following the authorizations described in section II(h) or section II(i), the Manager shall provide a notice to each relevant independent plan fiduciary of each plan invested in the affected Funds prior to, or within ten (10) days following, such addition of Funds or change to, or addition of, triggering events, which contains a description of such Fund(s) or triggering event(s). Such notice will also include a statement that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner.

(l) At least annually, the Manager notifies the independent fiduciary for each plan that has previously authorized participation in the Manager's cross-trading program as a Fund investor, that the plan has the right to terminate its participation in the cross-trading program and its investment in any Index Fund or Model-Driven Fund that holds plan assets without penalty at any time, as soon as is necessary to effectuate the withdrawal in an orderly manner. This notice shall also provide each independent plan fiduciary with a special termination form and instruct the fiduciary that failure to return the form to the Manager by a specified date (which shall be at least thirty (30) days following the plan's receipt of the form) shall be deemed an approval of the subject plan's continued participation in the cross-trading program as a Fund investor. In lieu of providing a special termination form, the notice may permit the independent plan fiduciary to utilize another written instrument by the specified date to terminate the plan's participation in the cross-trading program, provided that in such case the notice explicitly discloses that a termination form may be obtained from the Manager upon request. Such annual re-authorization must provide information to the relevant independent plan fiduciary regarding each Fund in which the plan is invested, as well as explicit notification that the plan fiduciary may request and obtain disclosures regarding any new Funds in which the plan is not invested that are added to the cross-trading program, or

any new triggering events (as defined in Section IV(d) below) that may have been added to any existing Funds in which the plan is not invested, since the time of the initial authorization described in Section II(h), or the time of the notice described in Section II(i).

(m) With respect to a cross-trade involving a Large Account:

(1) The cross-trade is executed in connection with a portfolio restructuring program, as defined in Section IV(f) below, with respect to all or a portion of the Large Account's investments which an independent fiduciary of the Large Account (other than in the case of any assets of a Manager Plan) has authorized the Manager to carry out or to act as a ''trading adviser,'' as defined in Section IV(g) below, in carrying out a Large Account-initiated liquidation or restructuring of its portfolio;

(2) Prior to the cross-trade, a fiduciary of the Large Account who is independent of the Manager (other than in the case of any assets of a Manager Plan) [11] has been fully informed of the Manager's cross-trading program, has been provided with the information required in Section II(k), and has provided the Manager with advance written authorization to engage in cross-trading in connection with the restructuring, provided that—

(A) Such authorization may be terminated at will by the Large Account upon receipt by the Manager of written notice of termination.

(B) A form expressly providing an election to terminate the authorization, with instructions on the use of the form, is supplied to the authorizing Large Account fiduciary concurrent with the receipt of the written information describing the cross-trading program. The instructions for such form must specify that the authorization may be terminated at will by the Large Account, without penalty to the Large Account, upon receipt by the Manager of written notice from the authorizing Large Account fiduciary;

(3) All cross-trades made in connection with the portfolio restructuring program must be completed by the Manager within sixty (60) days of the initial authorization (or initial receipt of assets associated with the restructuring, if later) to engage in such restructuring by the Large Account's independent fiduciary, unless such fiduciary agrees in writing to extend this period for another thirty (30) days; and,

(4) No later than thirty (30) days following the completion of the Large Account's portfolio restructuring program, the Large Account's independent fiduciary must be fully apprised in writing of all cross-trades executed in connection with the restructuring. Such writing shall include a notice that the Large Account's independent fiduciary may obtain, upon request, the information described in Section III(a), subject to the limitations described in Section III(b). However, if the program takes longer than sixty (60) days to complete, interim reports containing the transaction results must be provided to the Large Account fiduciary no later than fifteen (15) days following the end of the initial sixty (60) day period and the succeeding thirty (30) day period.

[11] However, proper disclosures must be made to, and written authorization must be made by, an appropriate fiduciary for the Manager Plan in order for the Manager Plan to participate in a specific portfolio restructuring program as part of a Large Account.

Section III—General Conditions

(a) The Manager maintains or causes to be maintained for a period of six (6) years from the date of each cross-trade the records necessary to enable the persons described in paragraph (b) of this Section to determine whether the conditions of the exemption have been met, including records which identify:

(1) On a Fund by Fund basis, the specific triggering events which result in the creation of the model prescribed output or trade list of specific securities to be cross-traded;

(2) On a Fund by Fund basis, the model prescribed output or trade list which describes: (A) Which securities to buy or sell; and (B) how much of each security to buy or sell; in detail sufficient to allow an independent plan fiduciary to verify that each of the above decisions for the Fund was made in response to specific triggering events; and

(3) On a Fund by Fund basis, the actual trades executed by the Fund on a particular day and which of those trades resulted from triggering events.

Such records must be readily available to assure accessibility and maintained so that an independent fiduciary, or other persons identified below in paragraph (b) of this Section, may obtain them within a reasonable period of time. However, a prohibited transaction will not be considered to have occurred if, due to circumstances beyond the control of the Manager, the records are lost or destroyed prior to the end of the six-year period, and no party in interest other than the Manager shall be subject to the civil penalty that may be assessed under section 502(i) of the Act or to the taxes imposed by sections 4975(a) and (b) of the Code if the records are not maintained or are not available for examination as required by paragraph (b) below.

(b)(1) Except as provided in paragraph (b)(2) and notwithstanding any provisions of sections 504(a)(2) and (b) of the Act, the records referred to in paragraph (a) of this Section are unconditionally available at their customary location for examination during normal business hours by—

(A) Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service,

(B) Any fiduciary of a Plan participating in a cross-trading program who has the authority to acquire or dispose of the assets of the Plan, or any duly authorized employee or representative of such fiduciary,

(C) Any contributing employer with respect to any Plan participating in a cross-trading program or any duly authorized employee or representative of such employer, and

(D) Any participant or beneficiary of any Manager Plan participating in a cross-trading program, or any duly authorized employee or representative of such participant or beneficiary.

(2) If in the course of seeking to inspect records maintained by a Manager pursuant to this exemption, any person described in paragraph (b)(1)(B) through (D) seeks to examine trade secrets, or commercial or financial information of the Manager that is privileged or confidential, and the Manager is otherwise permitted by law to withhold such information from such person, the Manager may refuse to disclose such information provided that, by the close of the thirtieth (30th) day following the request, the Manager gives a written notice to such person advising the person of the reasons for the refusal and that the Department of Labor may request such information.

(3) The information required to be disclosed to persons described in paragraph (b)(1)(B) through (D) shall be limited to information that pertains to cross-trades involving a Fund or Large Account in which they have an interest.

Section IV—Definitions

The following definitions apply for purposes of this exemption:

(a) *Index Fund*—Any investment fund, account or portfolio sponsored, maintained, trusteed, or managed by the Manager or an Affiliate, in which one or more investors invest, and—

(1) Which is designed to track the rate of return, risk profile and other characteristics of an Index, as defined in Section IV(c) below, by either (i) replicating the same combination of securities which compose such Index or

(ii) sampling the securities which compose such Index based on objective criteria and data;

(2) For which the Manager does not use its discretion, or data within its control, to affect the identity or amount of securities to be purchased or sold;

(3) That either contains ''plan assets'' subject to the Act, is an investment company registered under the Investment Company Act of 1940, or contains assets of one or more institutional investors, which may include, but not be limited to, such entities as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund which is exempt from taxation under section 501(a) of the Code; and,

(4) That involves no agreement, arrangement, or understanding regarding the design or operation of the Fund which is intended to benefit the Manager, its Affiliates, or any party in which the Manager or an Affiliate may have an interest.

(b) *Model-Driven Fund*—Any investment fund, account or portfolio sponsored, maintained, trusteed, or managed by the Manager or an Affiliate, in which one or more investors invest, and—

(1) Which is composed of securities the identity of which and the amount of which are selected by a computer model that is based on prescribed objective criteria using independent third party data, not within the control of the Manager, to transform an Index, as defined in Section IV(c) below;

(2) Which either contains ''plan assets'' subject to the Act, is an investment company registered under the Investment Company Act of 1940, or contains assets of one or more institutional investors, which may include, but not be limited to, such entities as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund which is exempt from taxation under section 501(a) of the Code; and

(3) That involves no agreement, arrangement, or understanding regarding the design or operation of the Fund or the utilization of any specific objective criteria which is intended to benefit the Manager, its Affiliates, or any party in which the Manager or an Affiliate may have an interest.

(c) *Index*—A securities index that represents the investment performance of a specific segment of the public market for equity or debt securities in the United States and/or foreign countries, but only if—

(1) The organization creating and maintaining the index is—

(A) Engaged in the business of providing financial information, evaluation, advice or securities brokerage services to institutional clients,

(B) A publisher of financial news or information, or

(C) A public securities exchange or association of securities dealers; and,

(2) The index is created and maintained by an organization independent of the Manager, as defined in Section IV(i) below; and,

(3) The index is a generally accepted standardized index of securities which is not specifically tailored for the use of the Manager.

(d) *Triggering Event*:

(1) A change in the composition or weighting of the Index underlying a Fund by the independent organization creating and maintaining the Index;

(2) A material amount of net change in the overall level of assets in a Fund, as a result of investments in and withdrawals from the Fund, provided that: (A) Such material amount has either been identified in advance as a specified amount of net change relating to such Fund and disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days following, its inclusion as a ''triggering event'' for such Fund or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of net change, including any amount of discretion retained by the Manager that may affect such net change, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given; and

(B) Investments or withdrawals as a result of the Manager's discretion to invest or withdraw assets of a Manager Plan, other than a Manager Plan which is a defined contribution plan under which participants direct the investment of their accounts among various investment options, including such Fund, will not be taken into account in determining the specified amount of net change;

(3) An accumulation in the Fund of a material amount of either:

(A) Cash which is attributable to interest or dividends on, and/or tender offers for, portfolio securities; or

(B) Stock attributable to dividends on portfolio securities; provided that such material amount has either been identified in advance as a specified amount relating to such Fund and disclosed in writing as a ''triggering event'' to an independent fiduciary of each plan having assets held in the Fund prior to, or within ten (10) days after, its inclusion as a ''triggering event'' for such Fund, or the Manager has otherwise disclosed in the description of its cross-trading practices pursuant to section II(k) the parameters for determining a material amount of accumulated cash or securities, including any amount of discretion retained by the Manager that may affect such accumulated amount, in sufficient detail to allow the independent fiduciary to determine whether the authorization to engage in cross-trading should be given;

(4) A change in the composition of the portfolio of a Model-Driven Fund mandated solely by operation of the formulae contained in the computer model underlying the Fund where the basic factors for making such changes (and any fixed frequency for operating the computer model) have been disclosed in writing to an independent fiduciary of each plan having assets held in the Fund, prior to, or within ten (10) days after, its inclusion as a ''triggering event'' for such Fund; or

(5) A change in the composition or weighting of a portfolio for an Index Fund or a Model-Driven Fund which results from an independent fiduciary's direction to exclude certain securities or types of securities from the Fund, notwithstanding that such securities are part of the index used by the Fund.

(e) *Large Account*—Any investment fund, account or portfolio that is not an Index Fund or a Model-Driven Fund sponsored, maintained, trusteed (other than a Fund for which the Manager is a nondiscretionary trustee) or managed by the Manager, which holds assets of either:

(1) An employee benefit plan within the meaning of section 3(3) of the Act that has $50 million or more in total assets (for purposes of this requirement, the assets of one or more employee benefit plans maintained by the same employer, or controlled group of employers, may be aggregated provided that such assets are pooled for investment purposes in a single master trust);

(2) An institutional investor that has total assets in excess of $50 million, such as an insurance company separate account or general account, a governmental plan, a university endowment fund, a charitable foundation fund, a trust or other fund

which is exempt from taxation under section 501(a) of the Code; or

(3) An investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund) other than an investment company advised or sponsored by the Manager;

provided that the Manager has been authorized to restructure all or a portion of the portfolio for such Large Account or to act as a ''trading adviser'' (as defined in Section IV(g) below) in connection with a portfolio restructuring program (as defined in Section IV(f)) for the Large Account.

(f) *Portfolio restructuring program*—Buying and selling the securities on behalf of a Large Account in order to produce a portfolio of securities which will be an Index Fund or a Model-Driven Fund managed by the Manager or by another investment manager, or in order to produce a portfolio of securities the composition of which is designated by a party independent of the Manager, without regard to the requirements of Section IV(a)(3) or (b)(2), or to carry out a liquidation of a specified portfolio of securities for the Large Account.

(g) *Trading adviser*—A person whose role is limited with respect to a Large Account to the disposition of a securities portfolio in connection with a portfolio restructuring program that is a Large Account-initiated liquidation or restructuring within a stated period of time in order to minimize transaction costs. The person does not have discretionary authority or control with respect to any underlying asset allocation, restructuring or liquidation decisions for the account in connection with such transactions and does not render investment advice [within the meaning of 29 CFR 2510.3–21(c)] with respect to such transactions.

(h) *Closing price*—The price for a security on the date of the transaction, as determined by objective procedures disclosed to investors in advance and consistently applied with respect to securities traded in the same market, which procedures shall indicate the independent pricing source (and alternates, if the designated pricing source is unavailable) used to establish the closing price and the time frame after the close of the market in which the closing price will be determined.

(i) *Manager*—A person who is:

(1) A bank or trust company, or any Affiliate thereof, as defined in Section IV(j) below, which is supervised by a state or federal agency; or,

(2) An investment adviser or any Affiliate thereof, as defined in Section IV(j) below, which is registered under the Investment Advisers Act of 1940.

(j) *Affiliate*—An ''affiliate'' of a Manager includes:

(1) Any person, directly or indirectly, through one or more intermediaries, controlling, controlled by or under common control with the person;

(2) Any officer, director, employee or relative of such person, or partner of any such person; and

(3) Any corporation or partnership of which such person is an officer, director, partner or employee.

(k) *Control*—The power to exercise a controlling influence over the management or policies of a person other than an individual.

(l) *Relative*—A ''relative'' is a person that is defined in section 3(15) of the Act (or a ''member of the family'' as that term is defined in section 4975(e)(6) of the Code), or a brother, a sister, or a spouse of a brother or a sister.

(m) *Nondiscretionary trustee*—A plan trustee whose powers and duties with respect to any assets of the plan are limited to (1) the provision of nondiscretionary trust services to the plan, and (2) duties imposed on the trustee by any provision or provisions of the Act or the Code. The term ''nondiscretionary trust services'' means custodial services and services ancillary to custodial services, none of which services are discretionary. For purposes of this exemption, a person who is otherwise a nondiscretionary trustee will not fail to be a nondiscretionary trustee solely by reason of having been delegated, by the sponsor of a master or prototype plan, the power to amend such plan.

Signed at Washington, DC, this 6th day of February, 2002.

Alan D. Lebowitz,

Deputy Assistant Secretary for Program Operations, Pension and Welfare Benefits Administration, Department of Labor.

[FR Doc. 02–3341 Filed 2–11–02; 8:45 am]

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Signed at Washington, DC, this 19th day of February 2002.

Carl J. Poleskey,

Chief, Branch of Construction Wage Determinations.

[FR Doc. 02–4372 Filed 2–28–02; 8:45 am]

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DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

[Prohibited Transaction Exemption 2002–13 Application Number: D–10616]

Amendment to Prohibited Transaction Exemption (PTE) 79–15 (44 FR 26979, May 8, 1979); PTE 80–26 (45 FR 28545, April 29, 1980); PTE 80–83 (45 FR 73189, November 4, 1980); PTE 81–6 (45 FR 7527, January 23, 1981 (as Amended at 52 FR 18754, May 19, 1987)); PTE 81–8 (46 FR 7511, January 23, 1981 (as Amended by 50 FR 14043, April 9, 1985)); PTE 82–63 (47 FR 14804, April 6, 1982); PTE 83–1 (48 FR 895, January 7, 1983); PTE 84–14 (49 FR 9494, March 13, 1984) PTE 88–59 (53 FR 24811, June 30, 1988); PTE 91–38 (56 FR 31966, July 12, 1991); PTE 95–60 (60 FR 35925, July 12, 1995); PTE 96–62 (61 FR 39988, July 31, 1996)

AGENCY: Pension and Welfare Benefits Administration, Department of Labor.

ACTION: Adoption of amendment to certain class exemptions.

SUMMARY: This document amends certain class exemptions to define the term ''employee benefit plan,'' as such term is used therein, to include plans described in section 4975(e)(1) of the Internal Revenue Code of 1986 (the Code). The amendment affects individuals with beneficial interests in such plans, as well as the financial institutions that provide services and products to the plans.

EFFECTIVE DATES: The amendment is effective as of: May 1, 1979 with respect to PTE 79–15; January 1, 1975 with respect to PTE 80–26; December 1, 1980 with respect to Section I(B) of PTE 80–83 (the amendment is effective January 1, 1975 with respect to the remainder of PTE 80–83); January 23, 1981 with respect to PTE 81–6; January 1, 1975 with respect to PTE 81–8; April 6, 1982 with respect to PTE 82–63; January 1, 1975 with respect to PTE 83–1; December 21, 1982 with respect to PTE 84–14; January 1, 1975 with respect to PTE 88–59; July 1, 1990 with respect to PTE 91–38; January 1, 1975 with respect to PTE 95–60; and July 31, 1996 with respect to PTE 96–62.

FOR FURTHER INFORMATION CONTACT: Christopher J. Motta, Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, (202) 693–8544, (this is not a toll-free number); or Paul Mannina, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor (202) 693–5600. (This is not a toll-free number).

SUPPLEMENTARY INFORMATION: On October 29, 2001, notice was published in the **Federal Register** (66 FR 54541) of the pendency before the Department of Labor (the Department) of a proposed amendment to PTE 79–15; PTE 80–26; PTE 80–83; PTE 81–6; PTE 81–8; PTE 82–63; PTE 83–1; PTE 84–14; PTE 88–59; PTE 91–38; PTE 95–60; and PTE 96–62. These class exemptions provide relief from certain of the restrictions described in section 406 of the Employee Retirement Income Security Act of 1974 (ERISA), and the taxes imposed by sections 4975(a) and (b) of the Code, by reason of a parallel provision described in section 4975(c)(1)(A) through (F) of the Code, provided that the conditions of the relevant exemption have been met. The amendment to the above-described exemptions adopted by this notice was proposed by the Department on its own motion, pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).

The notice gave interested persons an opportunity to submit written comments or requests for a public hearing on the proposed amendment to the Department. No public comments or requests for a hearing were received.

As noted in the proposed amendment, after consultation with the Internal Revenue Service (the Service), the Department determined that plans described in 4975(e)(1) of the Code are included within the scope of relief provided by certain class exemptions issued jointly by the Department and the Service. These exemptions are as follows:

PTE 75–1, 40 FR 50845 (1975);
PTE 77–4, 42 FR 18732 (1977);
PTE 77–7, 42 FR 31575 (1977), amended and redesignated as PTE 92–5 by 57 FR 5019 (1992);
PTE 77–8, 42 FR 31574 (1977), amended and redesignated as PTE 92–6, 57 FR 5189 (1992);
PTE 77–9, 42 FR 32395 (1977), amended and redesignated as PTE 84–24, 49 FR 13208 (1984); and
PTE 78–19, 43 FR 59915 (1978), amended and redesignated as PTE 90–1, 55 FR 2891 (1990).

The class exemptions amended by this notice were issued pursuant to the sole authority of the Department. These exemptions did not always expressly define the terms ''employee benefit plan'' and ''plan'' as used therein.[1] The amendment adopted by this notice expressly defines the terms ''employee benefit plan'' and ''plan'', as such terms are found in such exemptions, to include an employee benefit plan described in ERISA section 3(3)[2] and/or a plan described in section 4975(e)(1) of the Code.[3]

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of ERISA and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of ERISA and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which require, among other things, that a fiduciary discharge his duties with respect to the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of ERISA; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries,

(2) In accordance with section 408(a) of ERISA and 4975(c)(2) of the Code, the Department makes the following determinations:

(i) The amendment set forth herein is administratively feasible;

(ii) The amendment set forth herein is in the interests of plans and of their participants and beneficiaries; and

(iii) The amendment set forth herein is protective of the rights of participants and beneficiaries of plans,

(3) Each exemption amended herein is applicable to a particular transaction only if the transaction satisfies the conditions specified in such exemption, and

(4) The amendment is supplemental to, and not in derogation of, any other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

Paperwork Reduction Act

This proposed amendment to the class exemptions specifically enumerated does not contain a collection of information as that term is defined in 44 U.S.C. 3502(3), nor does it substantially or materially modify the terms of any collection of information included in the class exemptions that would be amended as to the definition of ''employee benefit plan'' and ''plan'' (specifically, PTE 80–83, PTE 81–6, PTE 81–8, PTE 82–63, PTE 88–59, PTE 91–38, and PTE 96–62). The amendment would clarify definitions already relied upon in the analyses of these information collections conducted in pursuant to the Paperwork Reduction Act of 1995.

Amendment

Under section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990), the Department amends the following class exemptions as set forth below:

1. PTE 79–15 is amended by adding the following paragraph at the end of the exemption to read as follows: For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

2. PTE 80–26 is amended by adding the following paragraph at the end of the exemption to read as follows: For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

3. PTE 80–83 is amended by adding the following paragraph 4. to Section II. b. to read as follows: 4. For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

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[1] Section 102 of the Reorganization Plan No. 4 of 1978 (5 U.S.C. App. 1 [1996]) generally transferred the authority of the Secretary of the Treasury to issue administrative exemptions under section 4975 of the Code to the Secretary of Labor.

[2] Section 3(3) of ERISA provides that the term ''employee benefit plan'' or ''plan'' means an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and an employee pension benefit plan.

[3] Section 4975(e)(1) of the Code provides that, for purposes of that Code section, the term ''plan'' means: (A) A trust described in Code section 401(a) which forms a part of a plan, or a plan described in Code section 403(a), which trust or plan is exempt from tax under section 501(a); (B) an individual retirement account described in Code section 408(a); (C) an individual retirement annuity described in section Code 408(b); (D) an Archer MSA described in Code section 220(d); (E) an education individual retirement account described in Code section 530, or (f) a trust, plan, account, or annuity which, at any time, has been determined by the Secretary to be described in any preceding subparagraph of this paragraph.

4. PTE 81–6 is amended by adding the following paragraph at the end of the exemption to read as follows: For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

5. PTE 81–8 is amended by adding the following paragraph at the end of the exemption to read as follows: For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

6. PTE 82–63 is amended by adding the following paragraph (4) to section II. Definitions to read as follows: (4) For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

7. PTE 83–1 is amended by adding the following paragraph I. to Section III. Definitions to read as follows: I. For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in ERISA section 3(3) and/or a plan described in section 4975(e)(1) of the Code.

8. PTE 84–14 is amended by adding the following paragraph (n) to Part V. Definitions and General Rules to read as follows: (n) The terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

9. PTE 88–59 is amended by adding the following paragraph (F) to Section III. Definitions to read as follows: (F) The terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

10. PTE 91–38 is amended by adding the following paragraph (k) to Section IV. Definitions and General Rules to read as follows: The terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

11. PTE 95–60 is amended by adding the following paragraph (j) to Section V. Definitions to read as follows: (j) The terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

12. PTE 96–62 is amended by adding paragraph (g) to Section IV. Definitions to read as follows: (g) For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

Signed at Washington, DC, this 25th day of February, 2002.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Pension and Welfare Benefits Administration, Department of Labor.

[FR Doc. 02–4872 Filed 2–28–02; 8:45 am]

BILLING CODE 4510–29–P

DEPARTMENT OF LABOR

Pension and Welfare Benefits Administration

[Prohibited Transaction Exemption 2002–14 Application Number D–11034]

Amendment to Prohibited Transaction Exemption 80–26 (PTE 80–26) for Certain Interest Free Loans to Employee Benefit Plans

AGENCY: Pension and Welfare Benefits Administration, Department of Labor.

ACTION: Adoption of amendment to PTE 80–26.

SUMMARY: This document amends PTE 80–26, a class exemption that permits parties in interest with respect to employee benefit plans to make interest free loans to such plans, provided the conditions of the exemption are met. The amendment affects all employee benefit plans, the participants and beneficiaries of such plans, and parties in interest with respect to those plans engaging in the described transactions.

DATES: The amendment is effective from September 11, 2001 until January 9, 2002.

FOR FURTHER INFORMATION CONTACT: Christopher Motta, Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, (202) 693–8544. (This is not a toll-free number); or Charles Jackson, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, (202) 693–5600. (This is not a toll-free number).

SUPPLEMENTARY INFORMATION: On September 28, 2001, notice was published in the **Federal Register** (66 FR 49703) of the pendency before the Department of a proposed amendment to PTE 80–26 (45 FR 28545, April 29, 1980, as amended at 65 FR 17540, April 3, 2000).[1] PTE 80–26 provides an exemption from the restrictions of section 406(a)(1)(B) and (D) and section 406(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986 (the Code), by reason of section 4975(c)(1)(B) and (D) of the Code.

The amendment to PTE 80–26 adopted by this notice was proposed by the Department on its own motion pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).[2]

The notice of pendency gave interested persons an opportunity to comment or to request a hearing on the proposed amendment. No public comments or requests for a hearing were received.

For the sake of convenience, the entire text of PTE 80–26, as amended, has been reprinted with this notice.

Description of the Exemption

Section I of PTE 80–26 permits the lending of money or other extension of credit from a party in interest or disqualified person to an employee benefit plan, and the repayment of such loan or other extension of credit in accordance with its terms or other written modifications thereof, if:

(a) No interest or other fee is charged to the plan, and no discount for payment in cash is relinquished by the plan, in connection with the loan or extension of credit;

(b) The proceeds of the loan or extension of credit are used only—

(1) For the payment of ordinary operating expenses of the plan, including the payment of benefits in accordance with the terms of the plan and periodic premiums under an insurance or annuity contract, or

(2) For a period of no more than three days, for a purpose incidental to the ordinary operation of the plan;

(c) The loan or extension of credit is unsecured; and

(d) The loan or extension of credit is not directly or indirectly made by an employee benefit plan.

On April 3, 2000, PTE 80–26 was amended through the addition of

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[1] A minor correction was made to the title of the final exemption in a notice published in the **Federal Register** on May 23, 1980. (45 FR 35040).

[2] Section 102 of the Reorganization Plan No. 4 of 1978 (5 U.S.C. App. 1 [1996]) generally transferred the authority of the Secretary of the Treasury to issue administrative exemptions under section 4975 of the Code to the Secretary of Labor.

their capacity, develop new and improved products, and focus on improving overall customer service. No firm could provide superior products to customers at a sustained loss.

The government understands this, though they're loathe to admit it. In paragraph 17 of the complaint in this case, the Department of Justice describes some of the reasons for the dominance of just three firms in the boom truck market: ''superior production capacity and capability, strong dealer networks, broad product lines and strong reputation for safety and reliability.'' The government notes, correctly, that it would be difficult for any new competitor to quickly enter the market because they would need to ''establish a strong reputation'' in order to effectively compete with the dominant firms.[7] But this is not a weakness of the market, but a strength. Every factor the government lists above is the result of honest, ethical activity. Manitowoc's superior production capacity is not the result of coercion. National Crane's strong reputation is not derived from violent acts against competitors. This, essentially, is the difference between ''market power'' derived from free trade, and ''political power'' derived from the use of force. The government's case fails to make this crucial distinction.

The remedy in the proposed final judgment replaces market power with political power. The defendants are forced to divest one of their crane businesses to a yet-to-be-determined third party. The government says this will protect competition. It does no such thing. ''Competition'' only exists in a capitalist economy; a forced divestiture is hardly capitalist, since it's neither voluntary nor based on respect for property rights. In a capitalist system, the marketplace decides economic outcomes. In the Department of Justice's system, however, economic outcomes are decided by government mandates. Such is the case here. The government dislikes the potential post-merger structure of the boom truck market, so they brought this case to rearrange things to their liking. If the government did not have a monopoly on the use of political force, it would not be able to obtain this result.

And far from ''protecting'' consumers, the government's remedy here denies consumers the fundamental right to act for themselves. The government assumes consumers won't pay any price increase that may result from the merger. But there's no proof of this hypothesis in the record. Consumers often pay higher prices if they feel the product is worth it, or it they believe that the product will improve in the future. Consumers are certainly a far better judge of these things than attorneys at the Department of Justice. The final judgment's remedy wrecks all that, however. By employing its political power, the government has stripped consumers of their economic power.

Finally, there is an obvious contradiction in the government recognizing the factors behind Manitowoc's dominance on the one hand, but ignoring these same factors in fashioning the final judgment's remedy. The government says a new firm is unlikely to enter the market because of the need to ''establish a strong reputation,'' among other things. So how does creating a new competitor by force accomplish this? Does the government believe that a reputation can be established simply by handing a corporation assets and customers they didn't actually earn? If that's the case, why doesn't the Department of Justice simply allocate resources and market shares in all sectors of American industry? They obviously consider their judgment superior to consumers.

[7] Complaint at 7.

Conclusion

The government claims to serve the ''public interest'' in presenting this proposed final judgment. But it's unclear what those interests are. It's certainly not legal interests, since no constitutional or statutory right of consumers was violated by the defendants. And it's not economic interests, since a capitalist economy is built on voluntary actions free of government interference. ''Free competition enforced by law is a grotesque contradiction in terms,''[8] not to mention a highly unstable way to govern an economy. The companies prosecuted in this case did compete and are competing. The government just doesn't like the outcome of that competition, so they've come to court seeking to overrule the judgment of consumers and producers. The result of the government's actions is to introduce fear and uncertainty into a market that previously functioned well. It's hard to see how that serves any identifiable ''public interest.''

Since it is unlikely the Department of Justice will see the error of its ways, CVT respectfully asks the Court to consider our comments and take appropriate action. We believe the only just action here is to reject entry of the proposed final judgment, and to dismiss the government's complaint with prejudice.

Dated: October 18, 2002.

Respectfully Submitted,

Citizens for Voluntary Trade

S.M. Oliva,

President, 2000 F Street, N.W., Suite 315, Washington, DC 20006; Telephone: (202) 223–0071; Facsimile: (760) 418–9010; E-mail: *info@voluntarytrade.org.*

[FR Doc. 02–29779 Filed 11–22–02; 8:45 am]

BILLING CODE 4410–11–M

[8] Ayn Rand, Antitrust: The Rule of Unreason, in The Voice of Reason 255 (Leonard Peikoff, ed., 1990).

PENSION AND WELFARE BENEFITS ADMINISTRATION

[Prohibited Transaction Exemption 2002–51; Application No. D–10933]

Class Exemption to Permit Certain Transactions Identified in the Voluntary Fiduciary Correction Program

AGENCY: Pension and Welfare Benefits Administration, U.S. Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This document contains a final exemption from certain prohibited transaction restrictions of the Internal Revenue Code of 1986 (the Code). The exemption was proposed in conjunction with the Department's Voluntary Fiduciary Correction (VFC) Program, the final version of which was published in the March 28, 2002, issue of the **Federal Register**. The VFC Program allows certain persons to avoid potential civil actions under the Employee Retirement Income Security Act of 1974 (ERISA) initiated by the Department and the assessment of civil penalties under section 502(l) of ERISA in connection with investigation or civil action by the Department. The exemption will affect plans, participants and beneficiaries of such plans and certain other persons engaging in such transactions.

EFFECTIVE DATE: The exemption is effective November 25, 2002.

FOR FURTHER INFORMATION CONTACT: Karen E. Lloyd, Office of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor, Room N–5649, 200 Constitution Avenue, NW., Washington, DC 20210, (202) 693–8540 (not a toll free number) or Cynthia Weglicki, Plan Benefits Security Division, Office of the Solicitor, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210, (202) 693–5600 (not a toll free number).

SUPPLEMENTARY INFORMATION: On March 28, 2002, the Department published a notice in the **Federal Register** (67 FR 15083) of the pendency of a proposed class exemption from the sanctions resulting from the application of section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code. The Department proposed the class exemption on its own motion pursuant to section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).[1]

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. Two (2) public comments were received by the Department. Upon consideration of the comments received, the Department has determined to grant the proposed class exemption subject to certain modifications. These

[1] Section 102 of the Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996) generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

modifications and the comments are discussed below.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

Pursuant to the terms of the Executive Order, it was determined that this action is ''significant'' under Section 3(f)(4) of the Executive Order. Accordingly, this action has been reviewed by OMB.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520)(PRA 95), the Department submitted the information collection request (ICR) included in the Proposed Class Exemption to Permit Certain Transactions Identified in the Voluntary Fiduciary Correction to the Office of Management and Budget (OMB) for review and clearance at the time the Notice of the Proposed Class Exemption was published in the **Federal Register** (March 28, 2002, 67 FR 15083). OMB approved the Notice under OMB control number 1210–0118. The approval will expire on November 30, 2003.

The Department solicited comments concerning the ICR in connection with the Notice of Proposed Class Exemption. The Department received no comments addressing its burden estimates and no substantive changes have been made in the final exemption that would affect the Department's earlier burden estimates.

Agency: Pension and Welfare Benefits Administration, Department of Labor.

Title: Voluntary Fiduciary Correction Program.

OMB Number: 1210–0118.

Affected Public: Business or other for-profit; Not-for-profit institutions.

Respondents: 700.

Frequency of Response: On occasion.

Responses: 700.

Estimated Total Burden Hours: 5,710 hours.

Total Burden Cost (Operating and Maintenance): $272,928.

Discussion of Comments Received

The Department received two comments regarding the proposed class exemption. The commenters requested specific modifications to the proposal in the following areas:

1. Notice to Interested Persons

Both commenters addressed Section IV of the proposed exemption which required applicants to provide notice to interested persons of the transaction and the method of correction. It was noted that, in many cases, applicants who may be subject to the excise taxes under section 4975 of the Code will not be the employer whose employees are covered by the plan, and may be unrelated to the employer.

In this regard, one of the commenters stated that, without the cooperation of the employer, applicants might find it difficult to provide notice to participants and beneficiaries because they would not have access to the participants' and beneficiaries' names and addresses. The commenter further noted that employers might not be willing to provide access to such information due to privacy concerns or concerns that receipt of the notice might cause confusion among the participants and beneficiaries.

In the commenter's view, relief under the exemption should not be conditioned on the cooperation of an employer or other person that is unrelated to the applicant, particularly since the underlying prohibited transaction will have been corrected pursuant to the VFC Program. The commenter proposed that, in the case of an applicant unrelated to the employer whose employees are covered by the plan, the exemption permit notice to be provided to the employer or other plan fiduciary unrelated to the applicant who was not involved in the transaction that is the subject of the VFC Program application, rather than each participant and beneficiary. The commenter noted that the unrelated fiduciary could then determine whether plan participants and beneficiaries should be notified of the underlying transaction and its correction under the VFC Program.

The other commenter stated generally that the notice requirement was unnecessary and burdensome, but subsequently clarified that it had the same concerns as the first commenter.

The Department concurs with the commenters' views on the notice issue. In this regard, the Department notes that the proposed exemption does not contain a definition of interested persons to whom notice must be provided. It is the view of the Department that, where an applicant is unaffiliated with, and unrelated to, the employer whose employees are covered by the plan, the notice requirement will be deemed satisfied if the applicant provides notice to a fiduciary of the plan who is unrelated to the applicant and all other parties involved in the prohibited transaction. In many cases, this may be the employer or an administrative committee composed of officers and employees of the employer. However, the Department cautions that the notice requirement will not be considered satisfied if notice is given to an employer who is not unrelated to all parties involved in the prohibited transaction. Under no circumstances should plan assets be used to pay for the notice.

2. Three Year Rule

One of the commenters also was concerned about Section II.F. of the proposed exemption, which provided that an applicant seeking relief under the exemption could not have taken advantage of the relief provided under the VFC Program and this exemption for a similar type of transaction identified in the current application during the period which is three years prior to the submission of the current application. The commenter argued that applicants that are service providers, as opposed to plan officials, should be permitted to take advantage of the VFC Program as often as necessary without regard to the three year rule.

The commenter stated that subjecting service providers to the three year rule would not, in all cases, further the rule's purpose of ensuring that relief is not provided to fiduciaries who repeatedly make the same legal mistake. In contrast to plan sponsors, for example, service providers such as broker-dealers, banks and insurance companies may engage in numerous transactions with plans each day which could be prohibited except for the availability of a statutory or administrative exemption. The commenter noted that, if the plan fiduciary directing the transaction is relying on an exemption to deal with a party in interest, and that fiduciary is factually incorrect on an element of the exemption, the broker-dealer may

engage in many transactions that would need relief under this exemption.

As an example, the commenter explained that a service provider could enter into a transaction that otherwise would be prohibited based on a fiduciary's representation that the QPAM class exemption (PTE 84–14) (49 FR 9494, March 13, 1984) applied. The QPAM class exemption requires, among other things, that neither the QPAM, an affiliate, nor any owner of a 5% or more interest in the QPAM, have been convicted or released from imprisonment as a result of certain crimes within the ten years immediately preceding the transaction. Information regarding past crimes of affiliates and 5% owners of the QPAM is not likely to be within the knowledge of the service provider, and the service provider must rely on the QPAM for assurance that the condition is satisfied.

The commenter suggested that Section II.F. be modified to provide an exception from the three year rule for applicants that are banks, broker-dealers or insurance companies (or affiliates thereof) which did not exercise discretionary authority or control to cause the plan to enter into the transaction. The commenter proposed that the exception be limited to applicants that were parties in interest (including fiduciaries) solely by reason of providing services to the plan (or solely by reason of a relationship to such service provider described in section 3(14)(F), (G), (H), or (I) and the corresponding provisions of the Code), and that ''did not believe that an exemption was unavailable'' with respect to the transaction. The commenter suggested that the applicant must have established written policies and procedures reasonably designed to ensure compliance with the prohibited transaction rules, and have engaged in periodic monitoring for compliance, at the time of the transaction.

The Department agrees that, in the narrow circumstances described above, such service providers should not be excluded from obtaining relief under the exemption by the three year rule. Accordingly, the Department has modified Section II.F. to clarify that the exemption will continue to be available notwithstanding the applicant's inability to satisfy the three year rule, provided that:

- The applicant was a broker-dealer registered under the Securities Exchange Act of 1934, a bank supervised by the United States or a State thereof, a broker-dealer or bank subject to foreign government regulation, an insurance company qualified to do business in a State, or any affiliate thereof;
- The applicant was a party in interest (including a fiduciary) solely by reason of providing services to the plan or solely by reason of a relationship to such service provider described in section 3(14)(F), (G), (H) or (I) (and/or the corresponding provisions of section 4975 of the Code);
- Neither the applicant nor any affiliate (i) was a fiduciary (within the meaning of section 3(21)(A) of ERISA) with respect to the assets of the plan involved in the transaction, and (ii) used its discretion to cause the plan to engage in the transaction;
- The individuals acting on behalf of the applicant in connection with the transaction had no actual knowledge or reason to know that the transaction was not exempt pursuant to a statutory or administrative exemption under ERISA and/or the Code; and
- Prior to the transaction, the applicant established written policies and procedures that were reasonably designed to ensure compliance with the prohibited transaction rules and the applicant engaged in periodic monitoring for compliance.

3. Participant Loan Repayments

The Department has made one additional modification to the final exemption. As discussed more fully below, the exemption provides relief for certain transactions described in the VFC Program, including the failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulations at 29 CFR 2510.3–102. Subsequent to the publication of the final VFC Program, the Department issued guidance stating that applicants may correct the failure to forward participant loan repayments to a plan in a timely fashion under the VFC Program in the same manner.[2] Accordingly, the Department revised the language of Section I.A. of the exemption to explicitly cover the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer.

[2] *See* Frequently Asked Questions on the VFC Program, at *http://www.dol.gov/pwba/faqs/faq_vfcp2.html.* For the Department's views on the time frames for repayment of participant loans to pension plans, *see* the preamble to the final participant contribution regulation, 29 CFR section 2510.3–102, published at 61 FR 41220, 41226 (August 7, 1996). *See* also DOL Advisory Opinion No. 2002–02A (May 17, 2002).

Description of the Exemption

1. Scope

The exemption provides relief from the sanctions imposed under section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, for certain eligible transactions identified in the VFC Program. The exemption does not provide relief for any transactions identified in the VFC Program that are not specifically described as eligible transactions under Section I of the exemption.

The four eligible transactions described in the exemption are as follows:

(A) The failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulations at 29 CFR section 2510.3–102 and/or the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer.

(B) The making of a loan by a plan at a fair market interest rate to a party in interest with respect to the plan.

(C) The purchase or sale of an asset (including real property) between a plan and a party in interest at fair market value.

(D) The sale of real property to a plan by the employer and the leaseback of such property to the employer, at fair market value and fair market rental value, respectively.

The eligible transactions may be illustrated by the following examples:

Example (1): Corporation A sponsors a pension plan for its employees. Corporation A borrowed $100,000 from the plan. The loan was made at an interest rate no less than that available for a loan with similar terms (for example, the amount of the loan, amount and type of security, repayment schedule, and duration of loan) obtainable in an arm's-length transaction between unrelated parties.

Example (2): Corporation B sponsors a pension plan for its employees. The plan sold a parcel of real property to Corporation B. The price Corporation B paid to the plan was the fair market value of the property as determined by a qualified independent appraiser as of the date of the transaction and reflected in a qualified appraisal report. (If there is a generally recognized market for the property, such as the New York Stock Exchange, the fair market value of the property is the value objectively determined by reference to the price on such market on the date of the transaction, and a determination by a qualified independent appraiser is not required.)

Example (3): Corporation C sponsors a pension plan for its employees. Corporation C sold a parcel of real property to the plan which was simultaneously leased back to Corporation C. The price paid by the plan for the property was its fair market value, and

the rent paid by Corporation C to the plan is the fair market rental value, as determined by a qualified independent appraiser and reflected in a qualified appraisal report. The terms of the lease (for example, rent, duration and allocation of expenses) are not less favorable to the plan than those obtainable in an arm's-length transaction between unrelated parties.

2. General Conditions

Section II of the exemption contains general conditions, as discussed below, which the Department views as necessary to ensure that any transaction covered by the exemption would be in the interests of plan participants and beneficiaries, and to support a finding that the exemption met the statutory requirements of section 4975(c)(2) of the Code.

With respect to a transaction involving delinquent transmittal of participant contributions and/or participant loan repayments to a pension plan, the exemption requires that the contributions or repayments be transmitted to the pension plan not more than 180 calendar days from the date the amounts were received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the date the amount otherwise would have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

Second, the exemption requires that, with respect to the transactions described in Sections I.B., I.C. and I.D., the amount of plan assets involved in the transaction did not exceed 10 percent of the fair market value of all the assets of the plan at the time of the transaction. For purposes of this requirement, the 10 percent limitation would apply after aggregating the value of a series of related transactions.

Third, under the exemption, the fair market value of any plan asset involved in a transaction described in Sections I.C. or I.D. must have been determined in accordance with section 5 of the VFC Program. Section 5 of the VFC Program requires that the valuation meet the following conditions: (1) If there is a generally recognized market for the property (*e.g.*, the New York Stock Exchange), the fair market value of the asset is the average value of the asset on such market on the applicable date, unless the plan document specifies another objectively determined value (*e.g.*, the closing price); and (2) if there is no generally recognized market for the asset, the fair market value of that asset must be determined in accordance with generally accepted appraisal standards by a qualified independent appraiser and reflected in a written appraisal report signed by the appraiser. For purposes of these requirements under the VFC Program, an appraiser is considered qualified if the appraiser has met the education, experience and licensing requirements that are generally recognized for appraisal of the type of asset being appraised. An appraiser is ''independent'' if the appraiser is not one of the following, does not own or control any of the following, and is not owned or controlled by, or affiliated with, any of the following: (i) The prior owner of the asset, if the asset was purchased by the plan; (ii) the purchaser of the asset, if the asset was or is now being sold by the plan; (iii) any other owner of the asset, if the plan is not the sole owner; (iv) a fiduciary of the plan; (v) a party in interest with respect to the plan (except to the extent the appraiser becomes a party in interest when retained to perform this appraisal for the plan); or (vi) the VFC Program applicant.

Fourth, under the exemption, the terms of a transaction described in Sections I.B., I.C., or I.D., must have been at least as favorable to the plan as the terms generally available in arm's-length transactions between unrelated parties.

Fifth, with respect to all of the eligible transactions, the transaction may not have been part of an agreement, arrangement or understanding designed to benefit a party in interest. The Department notes that the intent of this condition is not to deny a direct benefit to the party in interest but, rather, to exclude relief for transactions that are part of a broader overall agreement, arrangement or understanding designed to benefit parties in interest.

Sixth, with respect to all of the eligible transactions, the applicant may not have taken advantage of the relief provided by the VFC Program and the exemption for a similar type of transaction identified in the application during the three-year period prior to the submission of the application. As modified, however, the final exemption contains a limited exception from this condition for service providers. Pursuant to the amended Section II.F., a broker-dealer, bank or insurance company that is a service provider to a plan would not be subject to this condition if it engaged in a prohibited transaction described in Section I, provided that: it was not a fiduciary that used its discretion to cause the plan to engage in the transaction; individuals acting on its behalf in connection with the transaction had no actual knowledge or reason to know that the transaction was not exempt pursuant to a statutory or administrative exemption under ERISA and/or the Code; and, prior to the transaction, it established written policies and procedures that were reasonably designed to ensure compliance with the prohibited transaction rules and it engaged in periodic monitoring for compliance.

3. Compliance with VFC Program

In addition to compliance with the general conditions set forth above, Section III of the exemption requires that the applicant meet the requirements set forth in the VFC Program that are applicable to the particular transaction. The exemption also requires that the applicant have received a no action letter issued by PWBA with respect to such transaction, which must be an eligible transaction otherwise described in Section I of the exemption. However, the fact that an applicant receives a no action letter issued by PWBA should not be viewed as a determination by PWBA that the applicant has satisfied all of the conditions of the exemption. Each applicant must determine whether the pertinent conditions of the exemption have been met.

4. Notice

Notice under the exemption must be given to interested persons within 60 calendar days following the date of the submission of an application under the VFC Program to the Department. Plan assets may not be used to pay for the notice. The exemption does not specify the format or specific content of the notice. However, the notice must include an objective description of the transaction and the steps taken to correct it, written in a manner reasonably calculated to be understood by the average plan participant or beneficiary. The notice also must provide for a period of 30 calendar days, beginning on the date the notice is distributed, for interested persons to provide comments to the appropriate Regional Office of the United States Department of Labor, Pension and Welfare Benefits Administration. The notice must include the address and telephone number of such Regional Office.

A copy of the notice to interested persons, along with an indication of the date on which it was distributed, must be provided to the appropriate Regional Office within the same 60-day period following the date of the submission of the application. Accordingly, applicants under the VFC Program who intend to take advantage of the relief provided under this exemption would indicate on the checklist submitted as part of the VFC Program application that they will, within 60 calendar days following the

date of the submission of the application, provide the Department's Regional Office with a copy of the notice to interested persons.

Notice may be given in any manner that is reasonably calculated, taking into consideration the particular circumstances of the plan, to result in the receipt of such notice by interested persons, including but not limited to posting, regular mail, or electronic mail, or any combination thereof.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan from certain other provisions of ERISA and the Code, including any prohibited transaction provisions to which the exemption does not apply, the requirement that all assets of an employee benefit plan be held in trust by one or more trustees, and the general fiduciary responsibility provisions of ERISA which require, among other things, that a fiduciary discharge his or her duties respecting the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries.

(2) The exemption does not extend to transactions prohibited under section 4975(c)(1)(F) of the Code.

(3) In accordance with section 4975(c)(2) of the Code, the Department finds that the exemption is administratively feasible, in the interests of plans and their participants and beneficiaries, and protective of the rights of participants and beneficiaries of such plans.

(4) The exemption is supplemental to, and not in derogation of other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(5) The exemption is applicable to a transaction only if the conditions specified in the class exemption are satisfied.

Exemption

Accordingly, the following exemption is granted under the authority of section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).

Section I: Eligible Transactions

The sanctions resulting from the application of section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to the following eligible transactions described in section 7 of the Voluntary Fiduciary Correction (VFC) Program (67 FR 15061, March 28, 2002), provided that the applicable conditions set forth in Sections II, III and IV are met:

A. Failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulation at 29 CFR section 2510.3–102, (*see* VFC Program, section 7.A.1.), and/or the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer.

B. Loan at a fair market interest rate to a party in interest with respect to a plan. (*See* VFC Program, section 7.B.1.).

C. Purchase or sale of an asset (including real property) between a plan and a party in interest at fair market value. (*See* VFC Program, sections 7.C.1. and 7.C.2.).

D. Sale of real property to a plan by the employer and the leaseback of the property to the employer, at fair market value and fair market rental value, respectively. (*See* VFC Program, section 7.C.3.).

Section II: Conditions

A. With respect to a transaction involving participant contributions or loan repayments to pension plans described in Section I.A., the contributions or repayments were transmitted to the pension plan not more than 180 calendar days from the date the amounts were received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the date the amounts otherwise would have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

B. With respect to the transactions described in Sections I.B., I.C., or I.D., the plan assets involved in the transaction, or series of related transactions, did not, in the aggregate, exceed 10 percent of the fair market value of all the assets of the plan at the time of the transaction.

C. The fair market value of any plan asset involved in a transaction described in Sections I.C. or I.D. was determined in accordance with section 5 of the VFC Program.

D. The terms of a transaction described in Sections I.B., I.C., or I.D. were at least as favorable to the plan as the terms generally available in arm's-length transactions between unrelated parties.

E. With respect to any transaction described in Section I, the transaction was not part of an agreement, arrangement or understanding designed to benefit a party in interest.

F. (1) With respect to any transaction described in Section I, the applicant has not taken advantage of the relief provided by the VFC Program and this exemption for a similar type of transaction(s) identified in the current application during the period which is three years prior to submission of the current application.

(2) Notwithstanding the foregoing, Section II.F.(1) shall not apply to an applicant provided that:

(a) The applicant was a broker-dealer registered under the Securities Exchange Act of 1934, a bank supervised by the United States or a State thereof, a broker-dealer or bank subject to foreign government regulation, an insurance company qualified to do business in a State, or an affiliate thereof;

(b) The applicant was a party in interest (including a fiduciary) solely by reason of providing services to the plan or solely by reason of a relationship to such service provider described in section 3(14)(F), (G), (H) or (I) (and/or the corresponding provisions of section 4975 of the Code);

(c) Neither the applicant nor any affiliate (i) was a fiduciary (within the meaning of section 3(21)(A) of ERISA) with respect to the assets of the plan involved in the transaction and (ii) used its discretion to cause the plan to engage in the transaction;

(d) Individuals acting on behalf of the applicant had no actual knowledge or reason to know that the transaction was not exempt pursuant to a statutory or administrative exemption under ERISA and/or the Code; and

(e) Prior to the transaction, the applicant established written policies and procedures that were reasonably designed to ensure compliance with the prohibited transaction rules and the applicant engaged in periodic monitoring for compliance.

Section III: Compliance with VFC Program

A. The applicant has met all of the applicable requirements of the VFC Program.

B. PWBA has issued a no action letter to the applicant pursuant to the VFC Program with respect to a transaction described in Section I.

Section IV: Notice

A. Written notice of the transaction(s) for which the applicant is seeking relief pursuant to the VFC Program and this exemption, and the method of correcting the transaction, was provided to interested persons within 60 calendar days following the date of the submission of an application under the VFC Program. A copy of the notice was provided to the appropriate Regional Office of the United States Department of Labor, Pension and Welfare Benefits Administration within the same 60-day period, and the applicant indicated the date upon which notice was distributed to interested persons. Plan assets were not used to pay for the notice. The notice included an objective description of the transaction and the steps taken to correct it, written in a manner reasonably calculated to be understood by the average plan participant or beneficiary. The notice provided for a period of 30 calendar days, beginning on the date the notice was distributed, for interested persons to provide comments to the appropriate Regional Office. The notice included the address and telephone number of such Regional Office.

B. Notice was given in a manner that was reasonably calculated, taking into consideration the particular circumstances of the plan, to result in the receipt of such notice by interested persons, including but not limited to posting, regular mail, or electronic mail, or any combination thereof. The notice informed interested persons of the applicant's participation in the VFC Program and intention of availing itself of relief under the exemption.

Signed at Washington, DC, this 11th day of November, 2002.

Ivan L. Strasfeld,

Director of Exemption Determinations, Pension and Welfare Benefits Administration, U.S. Department of Labor.

[FR Doc. 02–29799 Filed 11–22–02; 8:45 am]

BILLING CODE 4510–29–P

NATIONAL LABOR RELATIONS BOARD

Order Delegating Authority to the General Counsel; Before Members Wilma B. Liebman, William B. Cowen, and Michael J. Bartlett

November 19, 2002.

The Board is faced with the prospect that it may for a temporary period have fewer than three Members of its statutorily prescribed full complement of five Members. The Board recognizes that it has a continuing responsibility to fulfill its statutory obligations in the most effective and efficient manner possible. To assure that the Agency will be able to meet its obligations, the Board has decided to temporarily delegate to the General Counsel full authority to certify the results of any secret ballot election conducted under the National Emergency provisions of the Labor Management Relations Act, sections 206–210, 29 U.S.C. 176–180.[1] This delegation shall be effective during any time when the Board has fewer than three Members and is made under the authority granted to the Board under sections 3, 4, 6, and 10 of the National Labor Relations Act.

Accordingly, the Board delegates to the General Counsel full and final authority and responsibility on behalf of the Board to certify to the Attorney General the results of any secret ballot elections held among employees on the question of whether they wish to accept the final offer of settlement made by their employer pursuant to section 209(b) of the Labor Management Relations Act, 29 U.S.C. 179(b). This delegation shall cease to be effective whenever the Board has at least three Members.

This delegation relates to the internal management of the National Labor Relations Board and is therefore, pursuant to 5 U.S.C. 553, exempt from the notice and comment requirements of the Administrative Procedure Act. Further, public notice and comment is impractical because of the immediate need for Board action. The public interest requires that this delegation take effect immediately.

All existing delegations of authority to the General Counsel and to staff in effect prior to the date of this order remain in full force and effect, including the December 14, 2001, delegation regarding court litigation authority and the April 1, 1955, delegation by the Board to the General Counsel of the authority and responsibility to conduct secret ballots pursuant to section 209(b) of the Labor Management Relations Act, 29 U.S.C. 179(b). For the reasons stated above, the Board finds good cause to make this order effective immediately in accordance with 5 U.S.C. 553(d).

By direction of the Board.

[1] On December 14, 2001, the Board previously delegated to the General Counsel, on the same basis, full authority on all court litigation matters that would otherwise require Board authorization, effective during any time when the Board has fewer than three Members. *See* 66 FR 65998 (December 21, 2001).

Dated in Washington, DC, November 19, 2002.

Lester A. Heltzer,

Acting Executive Secretary, National Labor Relations Board.

[FR Doc. 02–29917 Filed 11–22–02; 8:45 am]

BILLING CODE 7545–01–P

NATIONAL SCIENCE FOUNDATION

Notice of Permits Issued Under the Antarctic Conservation Act of 1978

AGENCY: National Science Foundation.

ACTION: Notice of permits issued under the Antarctic Conservation of 1978, Public Law 95–541.

SUMMARY: The National Science Foundation (NSF) is required to publish notice of permits issued under the Antarctic Conservation Act of 1978. This is the required notice.

FOR FURTHER INFORMATION CONTACT: Nadene G. Kennedy, Permit Office, Office of Polar Programs, Rm. 755, National Science Foundation, 4201 Wilson Boulevard, Arlington, VA 22230.

SUPPLEMENTARY INFORMATION: On October 11, 2002, the National Science Foundation published a notice in the **Federal Register** of a permit applications received. Permits were issued on November 19, 2002 to: Arthur L. DeVries, Permit No. 2003–013; Joan Myers, Permit No. 2003–2003–015.

Nadene G. Kennedy,

Permit Officer.

[FR Doc. 02–29875 Filed 11–22–02; 8:45 am]

BILLING CODE 7555–01–M

NUCLEAR REGULATORY COMMISSION

Notice of Issuance of Director's Decision Under 10 CFR 2.206

Notice is hereby given that the Director, Office of Nuclear Reactor Regulation, has issued a Director's Decision with regard to a petition dated March 11, 2002, and supplements dated March 21, 22, and 27, 2002 (the Petition), submitted by Mr. David A. Lochbaum, a Nuclear Safety Engineer in the Washington, DC Office of the Union of Concerned Scientists (UCS), and the co-petitioners identified in the petition supplements dated March 21 and March 22, 2002 (the Petitioners). The Petitioners have requested that the U.S. Nuclear Regulatory Commission (NRC or the Commission) take action with regard to the nuclear power facilities listed in Attachment 1 to the Petition (multiple nuclear power facilities). The

September 11, 1993. These Customer Satisfaction Surveys provide information on customer attitudes about the delivery and quality of agency products/services and are used as part of an ongoing process to improve DOL programs. This generic clearance allows agencies to gather information from both Federal and non-Federal users.

In addition to conducting Customer Satisfaction Surveys, the Department also includes the use of evaluation forms for those DOL agencies conducting conferences. These evaluations are helpful in determining the success of the current conference, in developing future conferences, and in meeting the needs of the Department's product/service users.

II. Current Actions

Over the past three years the DOL has conducted more than two dozen customer satisfaction surveys and conference evaluations, which have helped assess the Department's products and services and has led to improvements in areas deemed necessary. Office of Management and Budget approval for this collection of information expires July 31, 2006. DOL proposes to seek continued approval for this collection of information for an additional three years.

Type of Review: Extension of a currently approved collection.

Agency: Office of the Assistant Secretary for Administration and Management.

Title: Customer Satisfaction Surveys and Conference Evaluations Generic Clearance.

OMB Number: 1225–0059.

Affected Public: Individuals and households; business or other for-profit; not-for-profit institutions; Farms; Federal Government; and State, Local, or Tribal Government.

Estimated Total Respondents/Responses: 200,000.

Frequency: On occasion and usually only one-time per respondent.

Average Time per Response: Varies by survey/evaluation generally ranging from 3 to 15 minutes with an average of approximately 6 minutes.

Total Burden Hours: 20,000.

Total Burden Cost (Capital/Startup): $0.

Total Burden Cost (Operating/Maintenance): $0.

Comments submitted in response to this notice will be summarized and/or included in the request for Office of Management and Budget approval of the information collection request; they also will become a matter of public record.

Signed at Washington, DC, this 13th day of April, 2006.

Darrin A. King,

Agency Clearance Officer, Office of the Assistant Secretary for Administration and Management.

[FR Doc. E6–5860 Filed 4–18–06; 8:45 am]

BILLING CODE 4510–23–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Application No. D–11261]

RIN 1210–A05

Amendment to Prohibited Transaction Exemption 2002–51 (PTE 2002–51) to Permit Certain Transactions Identified in the Voluntary Fiduciary Correction Program

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Adoption of Amendment to PTE 2002–51.

SUMMARY: This document amends PTE 2002–51 (67 FR 70623 November 25, 2002), a class exemption that provides relief from certain prohibited transaction restrictions imposed by section 4975 of the Internal Revenue Code of 1986 (the Code) for certain eligible transactions identified in the Department of Labor's (the Department) Voluntary Fiduciary Correction (VFC) Program, which was adopted on March 28, 2002. This amendment is being adopted in conjunction with the Department's adoption of the updated VFC Program (final VFC Program), which is being published simultaneously in this issue of the **Federal Register**. The VFC Program allows certain persons to avoid potential civil actions under the Employee Retirement Income Security Act of 1974 (ERISA) initiated by the Department and the assessment of civil penalties under section 502(l) or 502(i) of ERISA in connection with an investigation or civil action by the Department. The amendment affects plans, participants and beneficiaries of such plans and certain other persons engaging in such transactions.

EFFECTIVE DATE: The class exemption is effective May 19, 2006.

FOR FURTHER INFORMATION CONTACT: Brian J. Buyniski, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Room N–5649, 200 Constitution Avenue, NW., Washington, DC 20210, (202) 693–8545 (this is not a toll free number).

SUPPLEMENTARY INFORMATION: On April 6, 2005, a notice was published in the **Federal Register** (70 FR 17476) of the pendency before the Department of a proposed amendment to PTE 2002–51. PTE 2002–51 provides relief from the sanctions resulting from the application of section 4975 (a) and (b) of the Code, by reason of section 4975(c)(1) (A) through (E) of the Code. The amendment expands the relief under the exemption to additional transactions included in the final VFC Program. The amendment to PTE 2002–51 adopted by this notice was proposed by the Department on its own motion pursuant to section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR 2570, subpart B (55 FR 32836, 32847, August 10, 1990).[1]

The notice of pendency gave interested persons an opportunity to comment on the proposed amendment. The Department received two comment letters. Upon consideration of all the comments received, the Department has determined to grant the proposed amendment, subject to certain modifications. These modifications and the comments are discussed below.

Executive Order 12866 Statement

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f) of the Executive Order, a ''significant regulatory action'' is an action that is likely to result in a rule: (1) Having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. OMB has determined that the final VFC Program is significant under

[1] Section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978, 5 U.S.C. App. 1 [1996]) generally transferred the authority of the Secretary of the Treasury to issue administrative exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

section 3(f)(4) because it raises novel legal or policy issues arising from the President's priorities.

The amended PTE 2002–51 provides excise tax relief for six of the transactions identified in the final VFC Program. Parties who wish to take advantage of the exemption must have met all of the applicable requirements of the final VFC Program and the conditions of the exemption. One of those conditions is receipt of a no action letter from the Employee Benefits Security Administration (EBSA) with respect to the transaction at issue. In conjunction with the final VFC Program, PTE 2002–51, as amended, has also been determined to be significant under section 3(f)(4) of the Executive Order. Accordingly the Department has assessed the costs and benefits of this amendment to PTE 2002–51.

PTE 2002–51 provides relief from the sanctions resulting from the application of section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code. In general, the exemption enhances the benefits of participation in the VFC Program by granting relief from excise taxes under section 4975 for certain breaches of fiduciary duty that are prohibited transactions. The purpose of the VFC Program is to encourage the correction of breaches of fiduciary duty, resulting in the recovery of lost earnings or profits for the benefit of plan participants and beneficiaries. The class exemption will have positive economic effects by eliminating excise taxes and promoting increased participation in the VFC Program.

The amendment to PTE 2002–51 is being adopted in connection with the final VFC Program, which is published in this issue of the **Federal Register**. The class exemption has been amended to provide relief for two additional transactions. One of the transactions was introduced in the April 2005 VFC Program and the proposed Amendment to PTE 2002–51. That transaction has now become effective in the amended exemption. The transaction concerns the purchase of an asset (including real property) by a plan where the asset has later been determined to be illiquid as described in the final VFC Program, and/or the subsequent sale of the illiquid asset by the plan in a transaction that was prohibited pursuant to section 4975(c)(1) of the Code. The second transaction included in this amendment covers the use of plan assets to pay expenses to a service provider for services that are properly characterized as settlor expenses, provided such payments were not expressly prohibited in the plan documents.

The Department has assumed, based on experience, that not all applicants who apply to the final VFC Program will take advantage of the excise tax relief provided under the exemption, either by choice or because the exemption does not provide relief for the transaction they are correcting under the final VFC Program. The Department has more specifically calculated that the number of applicants who will rely on the class exemption will equal approximately one-fifth of the total number of applicants, or 250 applicants (.2 × 1,250).

Paperwork Reduction Act

The amendment to PTE 2002–51 engenders no significant new paperwork burden for the notification and other written documentation requirements in comparison with the previous version of this exemption. Applicants to the final VFC Program who rely on the amended class exemption may be eligible, as well, for a new optional provision. Under this option, qualifying applicants may choose not to send notices to interested persons. The conditions of the optional provision are described in detail in the amendment to PTE 2002–51. However, while these particular parties would be relieved of the responsibility to send notices to interested persons, they do need to provide the Department with certain additional documentation on their calculations and the payment they remitted to the plan when submitting their application to the VFC Program. Documentation of the calculation of the amount of excise tax otherwise due consists of a copy of a completed IRS Form 5330 or equivalent written evidence containing the information required by IRS Form 5330; proof of payment to the plan is required. The Department has determined that the difference between the paperwork burden of plans using the optional provision versus the burden of those that do not is negligible.

Service providers will likely do the work on behalf of parties relying on PTE 2002–51. For parties who do not rely on the optional provision, service providers will prepare and send out notices to interested persons. A copy of the notice must be provided to the Department. As to those parties that opt not to provide notice, service providers will submit to the Department evidence of the required calculations described in IRS Form 5330 and evidence of the payment to the plan of the excise tax otherwise payable along with the application to the final VFC program. These respective tasks should require no more than an hour for each service provider to complete. Assuming that as many as one-fifth of the annual 1,250 applicants to the VFC Program (250) also use the class exemption, the burden cost posed by PTE 2002–51 equals $8,625 ($34.50 × 1 hr. × 250). One-half of the parties using the exemption (125) are estimated to be eligible to take advantage of PTE 2002–51's new optional provision, thereby being relieved of the notice requirement, while the other half of the parties using the exemption (125) are estimated as being required to send notices to interested persons. Notices will be sent, on average, to 136 interested persons for each plan. PTE 2002–51 permits notification of interested persons by electronic means. The Department assumes that only 62 percent of the parties using the exemption will send notices to interested persons by first class mail. Therefore, the total number of notices sent by mail will be 10,540 (136 × 125 × 62 percent). The remaining 38 percent will be delivered electronically. The total mailing costs arising from the class exemption will equal roughly $4,427 ($0.42 × 10,540 mailings). The Department assumes, however, that all applicants who send interested party notices will send the Department its copy of the notice by mail, using certified or overnight delivery services and that this copy will be included in the application package described above under costs for the VFC Program. The annual mailing costs for notice to interested persons and the Department is therefore estimated at $4,427. In sum, the burden costs attributable to the amended PTE 2002–51 will be approximately $13,052 ($8,625 + $4,427).

Persons are not required to respond to the revised information collection unless it displays a currently valid OMB control number 1210–0118.

Description of the Exemption

Title I of ERISA, which establishes certain standards of conduct for fiduciaries of employee benefit plans covered by ERISA, includes provisions prohibiting fiduciaries from causing a plan to engage in certain classes of transactions with persons defined as parties in interest. Similarly, Title II of ERISA prohibits plans described in section 4975(e)(1) of the Code from engaging in certain classes of transactions with persons defined under the Code as disqualified persons. Generally, such transactions are subject to taxation under section 4975 of the Code.

The VFC Program was adopted by the Department on a permanent basis in

March 2002.[2] Under the VFC Program, persons who are potentially liable for a breach of fiduciary duty can avoid the possibility of civil investigations and/or civil actions initiated by the Department for that breach and the imposition of civil penalties under section 502(l) or 502(i) of ERISA if they satisfy the conditions for correcting the breach as described in the VFC Program. The VFC Program was based on the Department's experience with the Pension Payback Program, 61 FR 9203 (March 7, 1996), and continued public interest in such correction programs. In response to comments received on the VFC Program requesting that the Department provide relief from the excise taxes imposed by section 4975 of the Code for prohibited transactions, the Department proposed a class exemption for four of the eligible transactions described in the VFC Program. A final exemption, PTE 2002–51, was published in the **Federal Register** on November 25, 2002. The four eligible transactions described in the exemption are as follows:

(A) The failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulations at 29 CFR section 2510.3–102 and/or the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer.

(B) The making of a loan by a plan at a fair market interest rate to a disqualified person[3] with respect to the plan.

(C) The purchase or sale of an asset (including real property) between a plan and a disqualified person at fair market value.

(D) The sale of real property to a plan by the employer and leaseback of such property to the employer, at fair market value and fair market rental value, respectively.

Based on growing public utilization and experience in administering the VFC Program, EBSA decided to amend and modify the VFC Program to expand the categories of eligible transactions and to make it more useful to employers and others who wish to avail themselves of the relief provided. Specifically, the VFC Program now includes relief under Title I of ERISA for the purchase of an asset by a plan where the asset was later determined to be illiquid as described under the final VFC Program.

In this regard, the final VFC Program provides relief for both the plan's original acquisition of the asset that was later determined to be illiquid under the final VFC Program, as well as the correction involving the sale of such asset in a transaction that violates the prohibited transaction rules under Title I of ERISA, and section 4975 of the Code provides that all of the requirements of the final VFC Program are met. Similarly, the class exemption has been amended to provide relief from the excise taxes imposed by section 4975 of the Code for both the plan's original acquisition and/or the subsequent sale of the illiquid asset by the plan in a transaction prohibited pursuant to section 4975(c)(1), provided all the requirements of the class exemption are met. Moreover, as distinguished from the other eligible transactions covered in the VFC Program[4] and PTE 2002–51, correction in the VFC Program for this category of eligible transactions will involve a prohibited transaction.

The other category of transactions being restructured under the final VFC Program (see Section 7.6) includes the use of plan assets to pay expenses, including commissions or fees, that should have been paid by the plan sponsor, to a service provider for: (i) services provided in connection with the administration and maintenance of the plan, in circumstances where a plan provision requires that such plan expenses be paid by the plan sponsor, or (ii) services provided in connection with the establishment, design, or termination, of the plan, which relate to the activities of the plan sponsor in its capacity as settlor. The class exemption is being amended to provide excise tax relief where plan assets are used to pay for services appropriately characterized as settlor expenses, which relate to the activities of the plan sponsor in its capacity as settlor.

Discussion of Written Comments Received

The Department received two letters commenting on the proposed amendments to PTE 2002–51. One commenter suggested expanding the scope of the VFC Program to include relief for plans that are subject to the prohibited transaction excise tax described in section 4975 of the Code, but are not subject to Title I of ERISA, including individual retirement accounts (IRAs) described in section 408 of the Code. This commenter suggested that certain VFC Program applicants (e.g., financial institutions) may have caused ERISA–covered plans, as well as plans that are subject only to the prohibited transaction provisions of the Code, to engage in prohibited transactions. According to the commenter, plan officials with respect to these IRAs and certain other plans are unable to participate in the VFC Program and, therefore, are not eligible for relief under PTE 2002–51. Accordingly, these plan officials must seek excise tax relief through an individual exemption application submitted to the Department.[5] The commenter believes that it would be administratively convenient if the Department extended VFC Program eligibility to encompass the full range of plans that are subject to section 4975 of the Code. The Department has determined that it cannot expand the VFC Program as requested by the commenter, since it lacks jurisdiction to issue a no action letter under the VFC Program with respect to violations of the prohibited transaction provisions under the Code. Consequently, in light of the decision not to expand the VFC Program to include plans only subject to section 4975 of the Code, the Department does not believe that it would be appropriate to modify the final exemption as requested by the commenter. Notwithstanding the foregoing, the Department wishes to take the opportunity to state that the grant of this amendment does not foreclose its future consideration of individual exemption requests for transactions involving IRAs that are outside the scope of relief provided by both the VFC Program and the class exemption under circumstances when, for example, a financial institution received a no action letter applicable only to plans subject to the Program for a transaction(s) that involved both plans and such IRAs. The Department cannot provide assurances in advance that an individual exemption will be issued with respect to a particular transaction involving an IRA, however, interested persons are encouraged to contact the Department to discuss the particular facts of their case.

[2] 67 FR 15062 (Mar. 28, 2002). Prior to adoption in March 2002, the VFC Program was made available on an interim basis during which the Department invited and considered public comments on the Program. (See 65 FR 14164, Mar. 15, 2000).

[3] The Department notes that the term ''party in interest'' was used in the description of the eligible transactions covered under PTE 2002–51 although that exemption provided, and this amendment will provide, relief only from the sanctions imposed under section 4975 of the Code, which prohibits certain transactions between a plan and a ''disqualified person.'' For purposes of clarity, references in the exemption to a ''party in interest'' are changed to ''disqualified person.''

[4] Under the VFC Program prior to the current revision, correction could not be achieved by engaging in a new prohibited transaction. *See* VFC Program, 67 FR 15073 (Mar. 28, 2002) Section 2(d).

[5] PTE 2002–51 requires that a VFC Program applicant comply with all of the applicable requirements of the VFC Program and receive a no action letter with respect to transactions corrected under the VFC Program.

The Internal Revenue Service (the Service) submitted a comment requesting a modification to the current requirement in PTE 2002–51 which provides that an applicant must notify interested persons in writing of the transactions for which relief is being sought pursuant to the VFC Program and this exemption.[6] The Service requested that the notice requirement not apply in those situations where: (a) The excise tax due under section 4975 of the Code for a failure to timely transmit participant contributions and loan repayments is less than or equal to $100.00; (b) the excise tax that otherwise would be owed and payable to the United States Treasury is contributed to the plan; and (c) the contribution is allocated to the accounts of the plan's participants and beneficiaries in a manner consistent with the plan's provisions concerning the allocation of plan earnings. Lastly, the Service noted that, under the circumstances outlined above, employers that meet the applicable conditions of the class exemption would not be required to file a Return of Excise Taxes Related to Employee Benefit Plans (IRS Form 5330) with the IRS. After considering the issue, the Department has determined to modify the final exemption as requested by the Service. The Department notes that, for the purpose of determining whether the excise tax due under section 4975 of the Code for failing to timely transmit participant contributions and loan repayments is less than or equal to $100, and determining the amount to be contributed to the plan, an applicant may calculate the excise tax that would otherwise be imposed by section 4975 of the Code based upon the Lost Earnings amount computed using the Online Calculator.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 4975(c)(2) of the Code does not relieve a fiduciary or other disqualified person with respect to a plan from certain other provisions of ERISA and the Code, including any prohibited transaction provisions to which the exemption does not apply, the requirement that all assets of an employee benefit plan be held in trust by one or more trustees, and the general fiduciary responsibility provisions of ERISA which require, among other things, that a fiduciary discharge his or her duties respecting the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries.

(2) The amendment will not extend to transactions prohibited under section 4975(c)(1)(F) of the Code.

(3) In accordance with section 4975(c)(2) of the Code, the Department finds that the amendment is administratively feasible, in the interests of plans and their participants and beneficiaries, and protective of the rights of participants and beneficiaries of such plans.

(4) The amendment is supplemental to and not in derogation of other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(5) The amendment is applicable to a transaction only if the conditions specified in the class exemption are satisfied.

Amendment

Accordingly, the following amendment to Sections I and II of PTE 2002–51 is granted under the authority of section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR 2570, subpart B (55 FR 32836, Aug. 10, 1990).

Section I. Eligible Transactions

The sanctions resulting from the application of section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to the following eligible transactions described in Section 7 of the Voluntary Fiduciary Correction (VFC) Program, published simultaneously in this issue of the **Federal Register**, provided that the applicable conditions set forth in Sections II., III. and IV. are met:

A. Failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulation at 29 CFR section 2510.3–102, and/or the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer. (*See* VFC Program, Section 7.1(a)).

B. Loan at a fair market interest rate to a disqualified person with respect to a plan. (*See* VFC Program, Section 7.2(a)).

C. Purchase or sale of an asset (including real property) between a plan and a disqualified person at fair market value. (*See* VFC Program, Sections 7.4(a) and 7.4(b)).

D. Sale of real property to a plan by the employer and the leaseback of the property to the employer, at fair market value and fair market rental value, respectively. (*See* VFC Program, Section 7.4(c)).

E. Purchase of an asset (including real property) by a plan where the asset has later been determined to be illiquid as described under the VFC Program in a transaction which was a prohibited transaction pursuant to section 4975(c)(1) of the Code, or in which the asset was acquired from an unrelated third party, and/or the subsequent sale of such asset in a transaction prohibited pursuant to section 4975(c)(1). (*See* VFC Program, Section 7.4(f)).

F. Use of plan assets to pay expenses, including commissions or fees, to a service provider (*e.g.*, attorney, accountant, recordkeeper, actuary, financial advisor, or insurance agent) for services provided in connection with the establishment, design or termination of the plan (settlor expenses)[7], which relate to the activities of the plan sponsor in its capacity as settlor, provided that the payment of the settlor expense was not expressly prohibited by a plan provision relating to the payment of expenses by the plan. (*See* VFC Program, section 7.6(b)).

Section II. Conditions

A. With respect to a transaction involving participant contributions or loan repayments to pension plans described in Section I.A., the contributions or repayments were transmitted to the pension plan not more than 180 calendar days from the date the amounts were received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the date the amounts otherwise would have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

B. With respect to the transactions described in Sections I.B., I.C., I.D., or I.E., the plan assets involved in the transaction, or series of related transactions, did not, in the aggregate, exceed 10 percent of the fair market value of all the assets of the plan at the time of the transaction.

C. The fair market value of any plan asset involved in a transaction described

[6] The class exemption mandates that notice be provided to interested persons of the transaction and the method of correction.

[7] See Advisory Opinion 2001–01A (Jan. 18, 2001).

in Sections I.C., I.D., or I.E. was determined in accordance with section 5 of the VFC Program.

D. The terms of a transaction described in Sections I.B., I.C., I.D., I.E., or I.F., were at least as favorable to the plan as the terms generally available in arm's-length transactions between unrelated parties.

E. With respect to any transaction described in Section I., the transaction was not part of an agreement, arrangement or understanding designed to benefit a disqualified person.

F. (1) With respect to any transaction described in Section I., the applicant has not taken advantage of the relief provided by the VFC Program and this exemption for a similar type of transaction(s) identified in the current application during the period which is three years prior to submission of the current application.

(2) Notwithstanding the foregoing, Section II.F.(1) shall not apply to an applicant provided that:

(a) The applicant was a broker-dealer registered under the Securities Exchange Act of 1934, a bank supervised by the United States or a State thereof, a broker-dealer or bank subject to foreign government regulation, an insurance company qualified to do business in a State, or an affiliate thereof;

(b) The applicant was a disqualified person (including a fiduciary) solely by reason of providing services to the plan or solely by reason of a relationship to such service provider described in section 4975(e)(2)(F) and (G) of the Code;

(c) Neither the applicant nor any affiliate (i) was a fiduciary (within the meaning of section 3(21)(A) of ERISA and 4975(e)(3)of the Code) with respect to the assets of the plan involved in the transaction and (ii) used its discretion to cause the plan to engage in the transaction;

(d) Individuals acting on behalf of the applicant had no actual knowledge or reason to know that the transaction was not exempt pursuant to a statutory or administrative exemption under ERISA and/or the Code; and

(e) Prior to the transaction, the applicant established written policies and procedures that were reasonably designed to ensure compliance with the prohibited transaction rules and the applicant engaged in periodic monitoring for compliance.

G. With respect to a transaction involving a sale of an illiquid asset under the VFC Program described in Section I.E., the plan paid no brokerage fees, or commissions in connection with the sale of the asset.

H. With respect to any transaction described in Section I.F., the amount of plan assets involved in the transaction or series of related transactions did not, in the aggregate, exceed the lesser of $10,000 or 5% of the fair market value of all the assets of the plan at the time of the transaction.

Section III. Compliance With the VFC Program

A. The applicant has met all of the applicable requirements of the VFC Program.

B. EBSA has issued a no action letter to the applicant pursuant to the VFC Program with respect to a transaction described in Section I.

Section IV. Notice

A. Written notice of the transaction(s) for which the applicant is seeking relief pursuant to the VFC Program, and this exemption, and the method of correcting the transaction, was provided to interested persons within 60 calendar days following the date of the submission of an application under the VFC Program. A copy of the notice was provided to the appropriate Regional Office of the United States Department of Labor, Employee Benefits Security Administration, within the same 60-day period, and the applicant indicated the date upon which notice was distributed to interested persons. Plan assets were not used to pay for the notice. The notice included an objective description of the transaction and the steps taken to correct it, written in a manner reasonably calculated to be understood by the average Plan participant or beneficiary. The notice provided for a period of 30 calendar days, beginning on the date the notice was distributed, for interested persons to provide comments to the appropriate Regional Office. The notice included the address and telephone number of such Regional Office.

B. Notice was given in a manner that was reasonably calculated, taking into consideration the particular circumstances of the plan, to result in the receipt of such notice by interested persons, including but not limited to posting, regular mail, or electronic mail, or any combination thereof. The notice informed interested persons of the applicant's participation in the VFC Program as amended and intention of availing itself of relief under the exemption.

C. Notwithstanding the foregoing, Section IV.A. and B. shall not apply to a transaction described in Section I.A., provided that (i) the applicant under the VFC Program has met all of the other Program requirements; (ii) the amount of the excise tax that otherwise would be imposed by section 4975 of the Code with respect to any transaction(s) described in Section I.A. would be less than or equal to $100.00; (iii) the amount of the excise tax that otherwise would be imposed by section 4975 of the Code was paid to the plan and allocated to the participants and beneficiaries in the same manner as provided under the plan with respect to plan earnings; and (iv) the applicant under the VFC Program provides a copy of a completed IRS Form 5330 or written documentation containing the information required by IRS Form 5330 and proof of payment with the submission of the application to the appropriate EBSA Regional Office. For the sole purpose of determining whether the excise tax due under section 4975 of the Code on the ''amount involved'' with respect to the prohibited transaction involving the failure to timely transmit participant contributions and loan repayments is less than or equal to $100, an applicant may calculate the excise tax due based upon the Lost Earnings amount computed using the Online Calculator.

Signed at Washington, DC, this 12th day of April, 2006.

Ivan L. Strasfeld,

Director of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. 06–3675 Filed 4–18–06; 8:45 am]

BILLING CODE 4510–29–P

DEPARTMENT OF LABOR

Bureau of Labor Statistics

Proposed Collection; Comment Request

ACTION: Notice.

SUMMARY: The Department of Labor, as part of its continuing effort to reduce paperwork and respondent burden, conducts a pre-clearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and/or continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA95) [44 U.S.C. 3506(c)(2)(A)]. This program helps to ensure that requested data can be provided in the desired format, reporting burden (time and financial resources) is minimized, collection instruments are clearly understood, and the impact of collection requirements on respondents can be properly assessed. Currently, the Bureau of Labor Statistics (BLS) is soliciting

abstract: Primary: Individuals or households. Other: Business or other for-profit, Not-for-profit institutions. The data provided by this information collection request is used by ATF to determine if articles imported meet the statutory and regulatory criteria for importation and if the articles shown on the permit application have been actually imported.

(5) An estimate of the total number of respondents and the amount of time estimated for an average respondent to respond: It is estimated that 20,000 respondents will complete a 24-minute form.

(6) An estimate of the total public burden (in hours) associated with the collection: There are 8,000 estimated annual total burden hours associated with this collection.

FOR FURTHER INFORMATION CONTACT: Brenda E. Dyer, Deputy Clearance Officer, United States Department of Justice, Policy and Planning Staff, Justice Management Division, Suite 1600, Patrick Henry Building, 601 D Street NW., Washington, DC 20530.

Dated: December 19, 2003.

Brenda E. Dyer,

Deputy Clearance Officer, United States Department of Justice.

[FR Doc. 03–32143 Filed 12–30–03; 8:45 am]

BILLING CODE 4410–FY–M

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Prohibited Transaction Exemption 2003–39; Application No. D–11100]

Class Exemption for the Release of Claims and Extensions of Credit in Connection With Litigation

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This document contains a final class exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from certain taxes imposed by the Internal Revenue Code of 1986, as amended (the Code). The exemption permits transactions engaged in by a plan, in connection with the settlement of litigation. This exemption was proposed in response to concerns raised by the pension community regarding the impact of ERISA's prohibited transaction provisions on the settlement of litigation by employee benefit plans with parties in interest. The exemption affects all employee benefit plans, the participants and beneficiaries of such plans, and parties in interest with respect to those plans engaging in the described transactions.

EFFECTIVE DATE: The exemption is effective January 1, 1975.

FOR FURTHER INFORMATION CONTACT: Andrea W. Selvaggio, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Room N–5649, 200 Constitution Avenue NW., Washington, DC 20210 (202) 693–8540 (not a toll-free number).

SUPPLEMENTARY INFORMATION: On February 11, 2003, the Department published a notice in the **Federal Register** (68 FR 6953) of the pendency of a proposed class exemption from the restrictions of section 406(a)(1)(A), (B) and (D) of the Act and from the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A), (B) and (D) of the Code. The Department proposed the class exemption on its own motion, pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR Part 2570 Subpart B (55 FR 32836, August 10, 1990).[1]

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. The Department received five (5) public comments. Upon consideration of all the comments received, the Department has determined to grant the proposed class exemption, subject to certain modifications. These modifications and the major comments are discussed below.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

Pursuant to the terms of the Executive Order, it was determined that this action is ''significant'' under Section 3(f)(4) of the Executive Order. Accordingly, this action has been reviewed by OMB.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) (PRA 95), the Department submitted the information collection request (ICR) included in the Class Exemption For Release of Claims and Extensions of Credit in Connection With Litigation to the Office of Management and Budget (OMB) for review and clearance at the time the proposed class exemption was published in the **Federal Register** (February 11, 2003, 68 FR 6953). The ICR for the proposed class exemption was combined with the ICR in PTCE 94–71,[2] also approved under OMB control number 1210–0091, because of the similarity of subject matter between the two exemptions. No comments were received about the burden estimates and no substantial or material changes have been made in the grant of the exemption that would affect the burden estimates in the proposal. The approval for each of the ICRs included in the two exemptions will expire on April 30, 2006.

In order to grant an exemption pursuant to section 408(a) of the Act, the Department must, among other things, make a finding that the terms of the exemption are protective of the rights of participants and beneficiaries of a plan. To support making such a finding, the Department normally imposes certain conditions on fiduciaries and parties in interest that may make use of the exemption. The information collection provisions of the exemption are among these conditions. The information collection provisions are found in sections III(c), (e), (g), and

[1] Section 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996), generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code ot the Secretary of Labor. For purposes of this exemption, references to specific provisions of Title I of the Act, unless otherwise specified, refer also to the corresponding provisions of the Code.

[2] PTCE 94–71, 59 FR 51216, October 7, 1994, as corrected, 59 FR 60837, November 28, 1994—Settlement Agreements Resulting From An Investigation, involving remedial settlements resulting from an investigation of an employee benefit plan conducted by the Department.

(h). These requirements are summarized as follows:

Written Agreement. The exemption requires that the terms of the settlement be specifically described in a written agreement or consent decree. In the exemption as granted, the Department has added that, with regard to transactions involving assets other than cash, the assets and their fair market value, including the date for such valuation, must be described in writing in the settlement agreement. Because a description and valuation of the assets involved in a settlement transaction are usually included in a settlement agreement, the requirement serves only as a clarification about assets that are not cash for the parties seeking to use the class exemption. In addition, because the Department believes that the ability to make changes with regard to a settlement allows more flexibility to the parties involved, it has also provided in the final exemption that certain adjustments, such as the right to amend the plan, are permissible if written into the agreement. These two new requirements are only operative for certain provisions and under certain conditions that may or may not be included in the settlement. Where appropriate, including the provisions in the agreement enables interested parties described in the exemption to verify that the conditions of the exemption have been met. However, neither requirement produces a measurable burden beyond that which would be considered usual business practice, and no additional burden has been accounted for in this ICR.

Acknowledgement by a Fiduciary. On a prospective basis, the exemption also requires that a fiduciary acting on behalf of the plan acknowledge in writing that it is a fiduciary with respect to the settlement of the litigation. Under the Act, a person that exercises ''any authority or control respecting disposition of [the plan's] assets,'' is considered a fiduciary. It is anticipated that the applicable plan fiduciary will incorporate this acknowledgement in the written agreement outlining the terms and conditions of its retention as a plan service provider, and already in existence, as part of usual and customary business practice. As such, a written acknowledgement is not expected to impose any measurable additional burden.

Recordkeeping. Prospectively, the exemption requires a plan to maintain for a period of six years the records necessary to enable certain persons to determine whether the conditions of the exemption had been met. The six-year recordkeeping requirement is consistent with the requirements in section 107 of the Act as well as general record-keeping requirements for tax information under the Code. As such, the Department has not accounted for a burden related to recordkeeping for this exemption.

The exemption may affect employee benefit plans, the participants and beneficiaries of those plans, and parties in interest to plans engaging in the specified transactions. It is not possible to estimate the number of respondents or frequency of response to the information collection requirements of the exemption due to the wide variety of litigation involving plans, parties to that litigation, and jurisdictions in which litigation occurs. However, the lack of an ascertainable number of settlements does not impact the hour or cost burden because no additional burden is associated with the information collection requirements of the exemption.

I. Discussion of Comments Received

The comments received by the Department were generally supportive of the issuance of a class exemption for the release of claims and extensions of credit in connection with litigation. However, commenters requested specific modifications to the proposal in the following areas:

A. Whether the settlement of litigation with a party in interest is a prohibited transaction. Several commenters argued that settling litigation is not a transaction, and, therefore, not prohibited under section 406 of the Act. Other commenters requested that the Department clarify that only a fiduciary, a participant or beneficiary, or the Secretary of Labor, may bring suit to enforce ERISA's fiduciary duties. These commenters asserted that, because the statute does not identify a plan as a party with standing to pursue ERISA litigation, an ERISA claim is not a plan asset and the release of such an asset, in exchange for consideration from a party in interest, would not be a prohibited sale or exchange of any property under section 406 of ERISA. Other commenters asserted that the settlement of litigation with a party in interest is a prohibited transaction and urged stricter conditions for the provision of retroactive relief because the Department's position on this issue was clearly articulated in its 1995 Opinion Letter, AO 95–26A (October 17, 1995).

As the Department noted in proposing this exemption, the fact that a transaction is subject to an administrative exemption is not dispositive of whether the transaction is, in fact, a prohibited transaction. Rather, the exemption is being granted in response to uncertainty expressed on the part of plan fiduciaries charged with the responsibility under ERISA for determining whether it is in the interests of a plan's participants and beneficiaries to enter into a settlement agreement with a party in interest. The comments have confirmed the Department's earlier conclusion that there was considerable uncertainty surrounding this issue. After considering all of the comments, the Department has determined that the exemption, as revised, appropriately balances the concerns of these commenters while allowing plan fiduciaries to properly carry out their responsibilities under ERISA.

In response to the comments that ERISA civil actions for breach of fiduciary duty may only be brought by participants, beneficiaries, fiduciaries, and the Secretary of Labor, the Department has modified the final class exemption to include the release of claims by both the plan and a plan fiduciary. As the Department noted in the preamble to the proposed exemption, many situations in which a plan settles litigation may not give rise to a prohibited transaction or may be covered by an existing statutory or administrative exemption. For example, correction of a prohibited transaction that complies with section 4975(f)(5) of the Code [3]; reimbursement of a plan without a release of the plan's claim; settlement with a service provider of a dispute related to the provision of services or incidental goods to the plan that is otherwise exempt under ERISA 408(b)(2) (*See*, Opinion Letter, AO 95–26A); settlements authorized by the Department pursuant to PTE 94–71 (59 FR 51216, October 7, 1994, as corrected, 59 FR 60837, November 28, 1994); and judicially approved settlements where the Labor Department or the Internal Revenue Service is a party pursuant to PTE 79–15 (44 FR 26979, May 8, 1979).

In addition, the Department notes that this class exemption would be available for settlement agreements relating to an employer's failure to timely remit participant contributions to a plan, including a collectively bargained multiemployer or multiple employer plan, to the extent the conditions contained in this final exemption are

[3] IRC Reg. sec. 141.4975–13 provides that for purposes of the excise taxes on prohibited transactions, the definition of the term ''correction'' under IRC Reg. sec. 53.4941(e)–1 (concerning excise taxes on self-dealing with foundations) is controlling.

met.[4] In this regard, the Department notes that the relief provided by this exemption is limited to the prohibited transactions that arise where a plan trustee and an employer enter into a settlement involving the employer's failure to timely forward participant contributions to the plan as required under ERISA. Thus, nothing in this class exemption should be construed as exempting any of the prohibited transactions described in section 406(a) or 406(b) of ERISA that arise solely in connection with an employer's failure to timely forward participant contributions to a plan.[5]

This exemption does not, however, apply to transactions described in PTE 76–1, A.I. (41 FR 12740, March 26, 1976, as corrected, 41 FR 16620, April 20, 1976) relating to delinquent employer contributions to a collectively bargained multiemployer or multiple employer plan. Finally, PTE 76–1, A.I. does not extend relief to those settlement arrangements that arise from the failure of an employer to timely forward participant contributions to a multiemployer or multiple employer plan.

Section 502(d)(1) of the Act provides that ''an employee benefit plan may sue or be sued under this title as an entity.'' This exemption covers settlement of any type of suit the plan has brought. However this exemption is not available for settlement of claims brought by a party in interest against a plan. This exemption does not cover a plan's payment of money or other things of value to a party in interest in exchange for the dropping of claims against the plan. As with exchanges made for the release of claims in favor of the plan, the Department's determination in this regard is not dispositive of whether such an exchange constitutes a prohibited transaction.

Finally, the Department notes that a settlement between a plan and a participant or beneficiary made solely to resolve claims against a plan for the recovery of benefits, by a participant or beneficiary, may not involve a prohibited transaction. If the plan makes payment to a participant who is a party in interest to settle a benefits dispute, such payment generally would be viewed by the Department as the payment of a plan benefit that would not trigger the need for an exemption. As the Supreme Court noted in *Lockheed Corp.* v. *Spink*, 517 U.S. 882, 892–893 (1996), the payment of benefits is not a prohibited transaction.

B. The plan must obtain advice from an attorney representing the plan that a genuine controversy exists. Several commenters were concerned that imposing this requirement on past settlements would effectively limit the availability of the exemption. These commenters asserted that, prior to publication of the Department's proposed exemption, many fiduciaries were unaware that the settlement of litigation might be considered a prohibited transaction by the Department. Even if an attorney was retained in connection with the litigation, it is unlikely that the attorney would have opined as to whether or not there was a genuine controversy. Other commenters argued that: the filing of a lawsuit should be sufficient to find the existence of a genuine controversy; and class action settlements should not have to meet this requirement. Another commenter suggested retaining the requirement for a genuine controversy, but without requiring an attorney's determination. This commenter also suggested that the attorney review be permitted, but not required, as a safe harbor in certain situations. He explained that fiduciaries might find it prudent and in the interests of participants and beneficiaries to settle a frivolous case for a *de minimus* amount, rather than incur the cost of litigation. In this situation, such fiduciaries should be able to meet the condition of the class exemption by demonstrating that they sought and obtained advice of counsel before settling the case.

Several commenters asserted that the genuine controversy condition was unnecessary as the concern raised by the Department, the possibility of a collusive settlement, was addressed by the condition that the settlement is not an arrangement to benefit a party in interest. Another commenter suggested that independent legal advice and a written agreement or consent decree should be mandatory for all retroactive relief because, even if the fiduciary was unaware of the prohibited transaction issue, a prudent fiduciary would have obtained such written documentation before entering into a settlement.

On the basis of these comments, the Department has decided to amend the genuine controversy condition. No finding of genuine controversy will be required where the case has been certified as a class action by the court. In addition, for transactions entered into prior to the publication of the final exemption, and the first 30 days thereafter, no attorney review will be required to determine whether the genuine controversy exists. On a prospective basis, attorney review will be required. In response to a question from one of the commenters, the Department confirms that the independent fiduciary's in-house attorneys, as well as its outside counsel, could provide the appropriate advice concerning the existence of a genuine controversy.

C. The decision-making fiduciary has no interest in any of the parties involved in the litigation that might affect the exercise of its best judgment as a fiduciary (independent fiduciary). Several commenters suggested that the Department eliminate the requirement for an independent fiduciary or, in the alternative, limit its application to prospective relief. Among the suggestions were: limit the requirement for an independent fiduciary to material claims where there are no alternative safeguards; and eliminate the independent fiduciary requirement where a judge reviews the fairness of a class action settlement. Other commenters expressed concern that the plan's directed trustee, even if not a defendant, should not be considered sufficiently independent to make decisions settling a case. They suggested that an entirely independent fiduciary be retained. Another commenter argued that relief in large cases should be conditioned upon the retention of an independent fiduciary with no prior relationship to the plan, or the defendants, and no future relationship with the plan for three years after the engagement.

Except as noted above in connection with the finding of genuine controversy, the Department does not believe that it would be appropriate to make a distinction between the requirements applicable to class action settlements and other settlements. However, in response to comments, the Department has decided to eliminate the requirement that the independent fiduciary ''negotiate'' the settlement. The Department realizes that many of the settlements to which this class exemption would apply are class action settlements. Where the plan is not a lead plaintiff, the plan fiduciary's role in negotiating the terms of the settlement may be limited. The Department recognizes, however, that even where negotiation does not take place between the plan and the defendant, a fiduciary will be compelled, consistent with ERISA's fiduciary responsibility provisions, to make a decision regarding

[4] The Department notes that the relief provided by this exemption would be available for settlements involving participant or employer contributions to a single employer plan or to a non-collectively bargained multiple employer plan.

[5] In this regard, the failure of an employer to timely remit contributions made to a plan by an employee of such employer violates ERISA sections 403(a), 403(c)(1), 404(a)(1)(A), 406(a)(1)(D), and 406(b)(1).

the settlement on behalf of the plan, even if that decision is merely to accept or reject a proposed settlement negotiated by other class members.

As modified, the final class exemption covers settlements authorized by a fiduciary that are reasonable, in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone. Such settlements must be no less favorable to the plan than comparable arm's-length terms and conditions that would have been agreed to by unrelated parties in similar circumstances. In addition, the transaction must not be part of an agreement, arrangement or understanding designed to benefit a party in interest. Thus, an independent fiduciary could satisfy the authorization requirements under the final exemption by deciding not to opt out of class action litigation if, after a review of the settlement, such fiduciary concludes that the chances of obtaining any further relief for the plan are not justified by the expense involved in pursuing such relief. Although the Department has determined to delete the requirement for negotiation as a specific condition of the class exemption, the Department notes that this modification does not diminish the fiduciary's responsibilities with respect to the settlement terms.

As noted above, several of the commenters expressed concern about the degree of independence of institutional fiduciaries, such as directed trustees, that may serve as the fiduciary contemplated by the class exemption. Without agreeing or disagreeing with this comment, the Department emphasizes that this class exemption does not provide relief from section 406(b) of the Act. In addition, the fiduciary's decisions in authorizing a settlement are subject to the fiduciary responsibility provisions of the Act.

D. Plans must select an independent fiduciary. Several commenters expressed concern about the additional cost of hiring independent fiduciaries in connection with settlements. The Department believes that plans often will not need to retain fiduciaries specifically to comply with this exemption. In most cases, the plan will be able to use a current fiduciary who is not a party to the action and who is not so closely allied with a party (other than the plan) as to create a conflict of interest. As with any other expense, the Department expects that fiduciaries will engage in prudent cost/benefit analysis to select the appropriate independent fiduciary in each case. In some cases, the cost of the independent fiduciary may be included in the damages claimed by the plan and may be reimbursed by the defendant in settling the litigation.

One of the commenters suggested that to avoid duplication, the independent fiduciary should be permitted to rely on the opinion of plaintiffs' class counsel or experts hired to assist class counsel. The Department agrees that the fiduciary should not spend plan resources unnecessarily. Whether and to what extent a fiduciary should rely on a particular attorney or expert hired by one of the other parties are decisions that the fiduciary must make in accordance with its fiduciary responsibilities under ERISA.

In this regard, the Department notes that on occasion the independent fiduciary may wish to retain outside experts to assist the fiduciary in determining whether or not to settle litigation. The following are some of the factors that may assist the fiduciary in its determination: the size of the claim, the expertise of the fiduciary, and the subject matter of the litigation.

Several of the commenters asked the Department to clarify that the mere fact that a party in interest pays for an attorney, an independent fiduciary, or other expert hired by the plan, does not mean that these professionals are not independent for purposes of the exemption. The Department agrees with this assertion, assuming that the professional being paid by the party in interest understands that the plan is their client, not the party paying their bill. In addition, the amount of compensation paid to the professional by the party in interest constitutes no more than a small percentage of such professional's annual gross income.

E. What is the role of the independent fiduciary where there is judicial approval of a settlement? Several commenters recommended that judicial approval of a settlement should eliminate the need for an independent fiduciary. One of the commenters suggested that where the settlement is judicially approved, relief from section 406(b) of the Act should be available under the exemption for those fiduciaries that were defendants in the litigation. The Department has determined not to adopt these suggestions. The court, in reaching its conclusion that the settlement is fair, must balance the interests of all the litigants. ERISA, on the other hand, requires that a fiduciary make its decisions with an ''eye single to the interests of the participants and beneficiaries.'' *Donovan* v. *Bierwirth,* 680 F.2d 263, 271 (2d Cir. 1982), cert. denied, 459 U.S. 1069 (1982). In response to the request for relief from section 406(b), the Department does not believe that a sufficient showing has been made that such relief would be appropriate under the circumstances.

F. Should there be special rules for settling class action litigation? Several of the commenters explained that, with respect to certain types of class actions, class members do not have the option of opting out of the class—all are bound by the decision. The commenters explained that ERISA class actions are often non-opt out cases. According to the commenters, this means that where class action litigation is brought by the participants, the plan fiduciary may, without taking any action, be bound by the class action settlement. In light of this, the commenters asked how such a fiduciary could cause a prohibited transaction where it took no action and yet was bound by the settlement. The Department does not regard this exemption proceeding to be the appropriate setting for resolving questions concerning what types of settlement are more or less likely to be prohibited transactions.

The Department notes, however, that the fiduciary is unlikely to remain uninvolved in the settlement of an ERISA lawsuit initiated by participants for two reasons. First, the fiduciary will, in all likelihood, be named as a party to the lawsuit and the court will almost certainly require the plan fiduciary's input on the settlement. Alternatively, the party in interest likely will seek the involvement of the fiduciary because the party in interest (disqualified person) may need to take advantage of the relief provided by the class exemption in order to avoid the possible imposition of excise taxes under section 4975 of the Code. Under the Code, such excise taxes are paid by the disqualified person who participates in the prohibited transaction, not the fiduciary who caused the plan to engage in the transaction.

In order to meet the conditions of the class exemption, the fiduciary faced with a non-opt out class action must take such actions as are appropriate under the particular circumstances. For example, before such a settlement is imposed on a non-opt out class, generally there is an opportunity to object to its terms. If the fiduciary does not believe that the proposed terms and conditions of the settlement are as favorable to the plan as comparable arm's-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances, it should object to the settlement.

In securities fraud class action cases, there is often an option to opt out of the class. Where the plan or the plan

trustee, as the holder of record of the securities, is a class member, whatever action or inaction that fiduciary determines to undertake has consequences for the plan. If the fiduciary takes no action, and the case is settled for far less than the full value of the plan's losses, the burden will be on the fiduciary to justify its inaction. The fiduciary responsible for authorizing settlement of class action claims must decide, not only whether or not to opt out of the class action, but also whether to protest the proposed settlement during the fairness hearing.[6]

G. Only cash may be received in exchange for the release, unless the transaction at issue is being rescinded. The commenters were universal in their objection to this condition. They pointed out that frequently, in cases involving investment in employer securities, the settlement consists of additional employer securities. In addition, settlements with plan sponsors often include nonmonetary relief, such as a promise of future contributions and plan amendments improving participants' rights, for example, the right to diversify their investments.

In response to these comments, the Department notes that the conditions for retroactive relief do not specify the type of the consideration that may be provided in exchange for the release. On a prospective basis, the Department has decided to modify the final exemption to permit assets other than cash to be provided in exchange for the plan's or the plan fiduciary's release of a claim. As modified, the final exemption permits contributions of qualifying employer securities, or other marketable securities, in certain instances. Any assets contributed to the plan, in connection with a settlement, must consist of securities that can be objectively valued to determine fair market value, in accordance with Section 5 of the Voluntary Fiduciary Correction (VFC) Program (67 FR 15062, March 28, 2002). The final exemption has also been modified to provide that plan amendments, additional employee benefits, and the promise of future contributions may be included as part of a settlement agreement covered by this exemption.

H. When is a settlement reasonable? One commenter urged the Department to apply this condition to all transactions and to include the costs of litigation among the factors to be considered in determining whether a settlement is reasonable. Another commenter asked to include the value of claims foregone. The Department has adopted these suggestions. The final exemption requires that the settlement must be reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone. How these factors are weighed by fiduciaries will differ, depending on the type of case, but will always involve a prudent decision-making process, given the facts and circumstances of the particular situation.

I. Should an interest rate be specified? Most of the commenters urged the Department to eliminate the requirement that a reasonable interest rate be charged for an extension of credit in connection with a settlement covered by the exemption. The commenters explained that often a settlement requires a payment of the promised sum over several years, without specifying an interest rate. In response to these comments, the Department has modified this condition to delete the reference to interest in connection with the loan or extension of credit. As modified, any extensions of credit must be made on terms that are reasonable. Although the final exemption provides more flexibility, fiduciaries that agree to an extension of credit with a party in interest nonetheless must consider that party's creditworthiness and the time value of money in evaluating the settlement.

As noted above, the settlement of litigation with a plan sponsor often involves the promise of future contributions. Another commenter requested that the Department clarify that the promise of future contributions is not loan or other extension of credit. The Department agrees with the commenter.

The Department encountered a case where the trustees had agreed to accept payments over time in order to collect amounts misappropriated by a party in interest. In this case, the trustees extended credit to the party in interest, but did not release their cause of action against him. In such a case, the class exemption will apply if the extension of credit is being made in connection with a settlement and both the settlement and the extension of credit meet all of the conditions of this exemption.

Several commenters urged the Department to require that extensions of credit be secured by property or a letter of credit. Although the Department has decided not to adopt this suggestion as a condition of the final exemption, the Department encourages fiduciaries to seek security for an extension of credit, wherever feasible, to protect the plan against the risk of default.

J. Certain applicants request that the scope of AO 95–26A (October 17, 1995) be extended. In AO 95–26A, the Department opined that settlement of litigation with a service provider may be covered by the statutory exemption for service providers provided under section 408(b)(2) of the Act. Several commenters asked whether the same rationale extended to the settlement of cases where the transaction at issue in the litigation is of the type addressed by a statutory or administrative exemption. The Department notes that the issues raised by the commenters, with respect to the scope of AO 95–26A, are beyond the scope of this exemption proceeding.

K. Who bears the burden of proof? Several commenters expressed concern that, if the retroactive conditions of the exemption are too subjective or difficult to meet, fiduciaries who acted in good faith in settling cases, particularly complex securities fraud cases, may be subject to litigation. According to the commenters, most practitioners were unaware of the Department's position that settling litigation with a party in interest might result in a prohibited transaction until the Department published the proposal for this class exemption. These commenters argued that, without a broad retroactive exemption, frivolous litigation may ensue.

Other commenters asserted that whether or not the fiduciaries were aware of potential prohibited transactions, these fiduciaries knew they were making decisions involving plan assets. If they acted prudently and in the interests of participants and

[6] For example, in *Great Neck Capital Appreciation Investment Partnership* v. *PriceWaterhouseCoopers,* In re Harnischfeger Industries, Inc. Securities Litigation, 212 F.R.D. 400 (E.D. Wisc. 2002), the original securities law class action settlement proposal included release of ERISA claims against the fiduciaries of the Harnischfeger employee benefit plans, even though the lawsuit had not alleged ERISA claims. At the fairness hearing, a participant protested that the participants' ERISA claims might be extinguished if this release was approved as part of the settlement. After considering the parties positions, the judge, during a conference call, "advised the parties that [he] was inclined to view the proposed settlement as unfair if its effect would be to extinguish the Plan participants' ERISA claims without compensation and that it also appeared to be unfair to require Plan participants to give up their right to participate in the settlement as a condition of asserting ERISA claims." 212 F.R.D. at 406. The securities law parties took the judge's hint and voluntarily agreed to exclude the ERISA claims from the release. In re IKON Office Solutions, Inc. Securities Litigation, 194 F.R.D. 166 (E.D.Pa. 2000), on the other hand, involved a securities law release that arguably released at least some of the ERISA claims and participants protested this at the fairness hearing. The court held that it would be premature, in the context of a settlement, for the court to address such issues—participants could either opt out and not be bound by the settlement, or take their chances pursuing what was left of their ERISA claims after receiving their portion of the securities class action settlement.

beneficiaries in settling the litigation with the party in interest, these fiduciaries should have no trouble meeting the retroactive requirements of the exemption. These commenters argued that, given the Department's guidance on this issue in 1995, it is appropriate to shift the burden of proving substantive and procedural prudence from the person challenging the settlement to the fiduciary seeking the protection of the exemption.

In light of these comments, the Department confirms that the party seeking to take advantage of any administrative exemption granted by the Department has the burden of proving that it met each condition of the exemption. Nonetheless, the Department has been persuaded that many practitioners were unaware of the prohibited transaction issues involved in settlements. The Department is also aware that some attorneys may have advised their clients that the settlement of litigation with a party in interest is not the type of transaction intended to be covered by section 406 of the Act. After considering these comments, the Department believes that it is appropriate to modify the retroactive relief under the final exemption. Accordingly, for settlements entered into on or before 30 days after the date of publication of the final exemption, the determination that there was a genuine controversy need not have been made by an attorney.

L. Should notice be required? Several commenters urged the Department to require notice to all participants and beneficiaries in connection with the settlement of litigation. One commenter pointed out that the Department requires notice in connection with PTE 94–71 (59 FR 51216, October 7, 1994, as corrected, 59 FR 60837, November 28, 1994) (settlement agreements between the U.S. Department of Labor and plans) where the Department is a party to the settlement. This commenter argued that without the involvement of the Department, notice is even more important to the participants and beneficiaries because their rights to pursue their own ERISA litigation could be compromised or waived entirely by the plan fiduciary. The commenter recommended that notice to participants of the nature of the allegations leading to the settlement and the terms of the proposed settlement should be required. This commenter also urged that all settlements should take the form of a proposed consent decree filed after, or contemporaneous with, the Complaint. In addition, the analytical basis for the settlement should be open to inspection by participants for a stated period of time. Another commenter explained that, in his experience, participants are not aware of litigation, or at least the plan's involvement, until after the settlement is final. Other commenters strongly oppose notice. These commenters asserted that such an undertaking could be very costly and disruptive, especially for minor litigation.

The Department has determined not to add a notice requirement as a condition of this class exemption. Requiring notice at the point where litigation is about to be settled could result in unnecessary delays and additional costs. The Department believes that the interests of the participants and beneficiaries will be sufficiently protected by the conditions of this class exemption, especially the requirement that the settlement is authorized by a fiduciary who is independent of the parties involved in the litigation.

M. Discussion of other comments. One of the commenters requested the Department's concurrence that, if ERISA claims are not covered by the release given by the plan or the plan fiduciary in settlement of litigation, the fiduciary need not obtain additional consideration to account for such claims. The Department agrees with this statement.

One commenter urged the Department to opine that, where a plan fiduciary causes a plan to release all the plan's non-ERISA claims arising out of a transaction, the fiduciary does not automatically release the fiduciary's own claims for breach of fiduciary duty arising out of the same transaction. The commenter explained that the proposed exemption did not distinguish between claims brought by the plan, *i.e.*, with the plan itself as a named party, and claims brought on behalf of the plan by a fiduciary. ERISA § 502(d)(1), 29 U.S.C. 1132(d)(1), provides that an employee benefit plan may sue and be sued as an entity. Claims for violations of title I of ERISA, however, may be brought by a fiduciary, participant or beneficiary of the plan or by the Secretary of Labor. ERISA §§ 502(a)(2), 502(a)(3), 502(a)(4), 502(a)(5), and 502(e)(1), 29 U.S.C. 1132(a)(2), 1132(a)(3), 1132(a)(4), 1132(a)(5) and 1132(e)(1). Some courts have concluded that plans may bring actions under other laws, but may not bring an action for a fiduciary breach under title I of ERISA. *E.g., Pressroom Unions-Printers League Income Security Fund* v. *Continental Assurance Co.*, 700 F.2d 889, 893 (2nd Cir. 1983). Other courts have not adopted this distinction. *E.g., Saramar Aluminum Co.* v. *Pension Plan for Employees of the Aluminum Indus. and Allied Indus.*, 782 F.2d 577, 581 (6th Cir. 1986). The commenter believes that a failure to distinguish between claims that a plan can make in its own name and those that must be made by a plan fiduciary, for example, could cause courts to conclude that releasing a plan's non-ERISA claims automatically releases a plan fiduciary's, or participant's or beneficiary's ERISA claims on behalf of the plan.

The Department amended the proposed exemption to clarify that it applies to releases by the plan or by a plan fiduciary. The issue of how a release of claims by a plan or plan fiduciary may affect ERISA claims that could otherwise be brought by a fiduciary, participant or beneficiary is beyond the scope of this exemption proceeding. In the Department's view, a fiduciary should understand, in advance of signing, the legal effect that a settlement agreement may have on all claims that might be brought by or on behalf of the plan or its participants and beneficiaries. Plan fiduciaries may need to obtain legal advice on the scope of claims affected by a proposed settlement agreement. The Department notes that it has long held the view that a fiduciary's release of ERISA claims does not bind the Secretary.

It is not uncommon for the same transactions to give rise to both ERISA and securities fraud claims. The plan, and by extension, the participants and beneficiaries of the plan, are entitled to the same recovery as other shareholders in the securities fraud settlement. However, the participants and beneficiaries may have another avenue of recovery not available to other shareholders. They are authorized, under ERISA, along with the plan fiduciary and the Secretary of Labor, to bring suit to make the plan whole for all losses caused by a breach of fiduciary duty. As noted above, the Department recognizes that, in a number of securities fraud class action settlements, the participants and/or plan fiduciaries have successfully objected to the original release and were able to modify the terms of the release to permit the plan to receive its share of the securities fraud settlement without releasing its ERISA claims against the parties in interest. In other instances, fiduciaries have successfully negotiated additional relief for the plan beyond that provided to shareholders who did not have ERISA claims against the defendants. The Department notes that plan fiduciaries should consider whether additional relief may be available for the ERISA claims before agreeing to a broad release.

In conclusion, the Department encourages participants, beneficiaries, fiduciaries, parties in interest and other interested persons to take advantage of the wide range of compliance assistance offered by the Department. Those with questions about their rights and responsibilities in particular situations should look first to our web site: *http://www.dol.gov/EBSA/*. You may also call, toll-free, the Employee & Employer Hotline 1–866–444–EBSA (3272). To discuss substantive ERISA issues in connection with particular cases, please contact your local EBSA field office. The EBSA web site mentioned above includes a state-by-state list of phone numbers and addresses for these offices. Click on ''About EBSA/EBSA Offices.''

II. Description of the Exemption

The exemption provides retroactive and prospective relief from the restrictions of section 406(a)(1)(A), (B) and (D) of the Act and from the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A), (B) and (D) of the Code, for the following transactions, effective January 1, 1975:

(1) The release by the plan or by a plan fiduciary of a legal or equitable claim against a party in interest in exchange for consideration, given by, or on behalf of, a party in interest to the plan in partial or complete settlement of the plan's or the fiduciary's claim; and

(2) An extension of credit by a plan to a party in interest in connection with a settlement whereby the party in interest agrees to repay, over time, an amount owed to the plan in settlement of a legal or equitable claim by the plan or a plan fiduciary against the party in interest.

A. Conditions Applicable to All Transactions

The exemption is conditioned upon the existence of a genuine controversy involving the plan unless the case has been certified as a class action by the court. The Department believes that this condition is necessary to prevent the plan and parties in interest from engaging in a sham transaction purporting to fall within this class exemption, thus shielding a transaction, such as an extension of credit or other transaction with a party in interest, that would otherwise be prohibited.

The fiduciary that authorizes the settlement must have no relationship to, or interest in, any of the other parties involved in the litigation, other than the plan, that might affect its best judgment as a fiduciary. The Department intends a flexible standard for fiduciary independence, recognizing that the exemption will encompass a wide range of situations, both in terms of the type of litigation and the cost of pursuing such litigation. For example, in some instances where there are complex issues and significant amounts of money involved, it may be appropriate to hire an independent fiduciary having no prior relationship to the plan, its trustee, any parties in interest, or any other parties to the litigation. In other instances, the plan's current trustee or investment manager, assuming that fiduciary's conduct is not at issue, may be an appropriate party to make the decision on behalf of the plan as to whether to settle the litigation.

In response to comments received by the Department regarding the settlement of class action litigation in which the ability to negotiate may be limited, the Department eliminated the requirement that the settlement be ''negotiated'' by the fiduciary. In lieu of this requirement, the exemption provides that the fiduciary may authorize a settlement if its terms and conditions are no less favorable to the plan than comparable arm's-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances.

The exemption is conditioned upon the settlement being reasonable given the likelihood of full recovery, the costs and risks of litigation, and the value of claims foregone. The claims foregone may include additional causes of action not available to the other plaintiffs in the same case. For example, where shareholders have brought a class action securities fraud case against the Company and its officers, the Company's employee benefit plan or the trustee, as the holder of record, may be named as a member of the class because it holds employer securities. The plan or trustee may also have ERISA claims against the Company and some or all of its officers, as well as against other parties. Before entering into a settlement with any defendant, the plan fiduciary should consider the value of these additional claims against that defendant. The plan fiduciaries may also be able to pursue claims against defendants not named in the securities fraud case, including knowing participants in the breach. Under certain circumstances, the plan will have additional sources of recovery, including fiduciary liability insurance, the plan's fidelity bond, and the personal assets of the defendants, including their own employee benefit plan accounts.[7]

The exemption also provides that the settlement must not be part of an agreement, arrangement, or understanding designed to benefit a party in interest. The intent of this condition is not to deny direct benefits to other parties to a transaction but, rather, to exclude transactions that are part of a broader overall agreement, arrangement or understanding designed to benefit parties in interest.

Where a settlement includes an extension of credit by a plan to a party in interest for purposes of repaying an amount owed in settlement of litigation, the exemption requires that the credit terms be reasonable. Fiduciaries must consider the creditworthiness of the party in interest and the time value of money in evaluating extensions of credit to settle litigation. The settling fiduciary should also consider security for such loans, such as a third party guarantee or letter of credit, to protect against default.

The Department has added a new condition which clarifies that this class exemption does not cover those transactions that are described in PTE 76–1, A.I. (41 FR 12740, March 26, 1976, as corrected, 41 FR 16620, April 20, 1976) (relating to delinquent employer contributions to multiemployer and multiple employer collectively bargained plans).

Finally, in response to a question received during the comment period, the Department has defined the terms ''employee benefit plan'' and ''plan'' to include an employee benefit plan described in section 3(3) of ERISA and/or plans as defined in section 4975(e)(1) of the Code.

B. Conditions Applicable to Prospective Transactions

On a prospective basis, the existence of a genuine controversy must be determined by an attorney retained to advise the plan unless the case has been certified as a class action by the court. That attorney must be independent of the other parties to the litigation. All terms of the settlement must be specifically described in a written agreement or consent decree and the fiduciary authorizing the settlement must acknowledge its fiduciary status in writing.

The exemption provides that in certain instances assets, other than cash,

[7] Section 206(d)(4) of the Act permits a plan to offset the benefits of a participant under an employee pension plan against an amount that the participant is ordered or required to pay, if the order or requirement to pay arises under a judgment of conviction of a crime involving the plan, a civil judgment, including a consent order or decree, entered into by a court, or where there is a settlement agreement between the participant and the Secretary of Labor or the PBGC in connection with a violation of Part IV of ERISA.

may be received by the plan from a party in interest. Assets may be received by the plan if necessary to rescind transactions. The conditions for retroactive relief do not specify the nature of the consideration exchanged for the release. On a prospective basis, securities with a generally recognized market may be exchanged for the release, provided that such securities can be objectively valued. In addition, the contribution of additional qualifying employer securities is permitted in settlement of the dispute involving such qualifying employer securities. Where assets, other than cash, are provided to the plan in exchange for a release, such assets must be specifically described in the written settlement agreement and valued at their fair market value as determined in accordance with section 5 of the Voluntary Fiduciary Correction (VFC) Program (67 FR 15062 March 28, 2002). The final exemption also provides that the settlement may also include a written agreement to: make future contributions, adopt amendments to the plan, or provide additional employee benefits.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act which require, among other things, that a fiduciary discharge his duties with respect to the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, and based upon the entire record, the Department finds that the exemption is administratively feasible, in the interests of the plans and their participants and beneficiaries, and protective of the rights of participants and beneficiaries of such plans;

(3) The exemption is applicable to a particular transaction only if the conditions specified in the class exemption are met; and

(4) The exemption is supplemental to, and not in derogation of, any other provisions of the Code and the Act, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990.)

Section I. Covered Transactions

Effective January 1, 1975, the restrictions of section 406(a)(1)(A), (B) and (D) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A), (B) and (D) of the Code, shall not apply to the following transactions, if the relevant conditions set forth in sections II through III below are met:

(a) The release by the plan or a plan fiduciary, of a legal or equitable claim against a party in interest in exchange for consideration, given by, or on behalf of, a party in interest to the plan in partial or complete settlement of the plan's or the fiduciary's claim.

(b) An extension of credit by a plan to a party in interest in connection with a settlement whereby the party in interest agrees to repay, over time, an amount owed to the plan in settlement of a legal or equitable claim by the plan or a plan fiduciary against the party in interest.

Section II. Conditions Applicable to All Transactions

(a) There is a genuine controversy involving the plan. A genuine controversy will be deemed to exist where the court has certified the case as a class-action.

(b) The fiduciary that authorizes the settlement has no relationship to, or interest in, any of the parties involved in the litigation, other than the plan, that might affect the exercise of such person's best judgment as a fiduciary.

(c) The settlement is reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of claims foregone.

(d) The terms and conditions of the transaction are no less favorable to the plan than comparable arms-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances.

(e) The transaction is not part of an agreement, arrangement, or understanding designed to benefit a party in interest.

(f) Any extension of credit by the plan to a party in interest in connection with the settlement of a legal or equitable claim against the party in interest is on terms that are reasonable, taking into consideration the creditworthiness of the party in interest and the time value of money.

(g) The transaction is not described in Prohibited Transaction Exemption (PTE) 76–1, A.I. (41 FR 12740, March 26, 1976, as corrected, 41 FR 16620, April 20, 1976) (relating to delinquent employer contributions to multiemployer and multiple employer collectively bargained plans).

Section III. Prospective Conditions

In addition to the conditions described in section II, the following conditions apply to the transactions described in section I (a) and (b) entered into after January 30, 2004:

(a) Where the litigation has not been certified as a class action by the court, an attorney or attorneys retained to advise the plan on the claim, and having no relationship to any of the parties, other than the plan, determines that there is a genuine controversy involving the plan.

(b) All terms of the settlement are specifically described in a written settlement agreement or consent decree.

(c) Assets other than cash may be received by the plan from a party in interest in connection with a settlement only if:

(1) necessary to rescind a transaction that is the subject of the litigation; or

(2) such assets are securities for which there is a generally recognized market, as defined in ERISA section 3(18)(A), and which can be objectively valued. Notwithstanding the foregoing, a settlement will not fail to meet the requirements of this paragraph solely because it includes the contribution of additional qualifying employer securities in settlement of a dispute involving such qualifying employer securities.

(d) To the extent assets, other than cash, are received by the plan in exchange for the release of the plan's or the plan fiduciary's claims, such assets must be specifically described in the written settlement agreement and valued at their fair market value, as determined in accordance with section 5 of the Voluntary Fiduciary Correction (VFC) Program, 67 FR 15062 (March 28, 2002). The methodology for determining

fair market value, including the appropriate date for such determination, must be set forth in the written settlement agreement.

(e) Nothing in section III (c) shall be construed to preclude the exemption from applying to a settlement that includes a written agreement to: (1) Make future contributions; (2) adopt amendments to the plan; or (3) provide additional employee benefits.

(f) The fiduciary acting on behalf of the plan has acknowledged in writing that it is a fiduciary with respect to the settlement of the litigation on behalf the plan.

(g) The plan fiduciary maintains or causes to be maintained for a period of six years the records necessary to enable the persons described below in paragraph (h) to determine whether the conditions of this exemption have been met, including documents evidencing the steps taken to satisfy sections II (b), such as correspondence with attorneys or experts consulted in order to evaluate the plan's claims, except that:

(1) if the records necessary to enable the persons described in paragraph (h) to determine whether the conditions of the exemption have been met are lost or destroyed, due to circumstances beyond the control of the plan fiduciary, then no prohibited transaction will be considered to have occurred solely on the basis of the unavailability of those records; and

(2) No party in interest, other than the plan fiduciary responsible for record-keeping, shall be subject to the civil penalty that may be assessed under section 502(i) of the Act or to the taxes imposed by section 4975(a) and (b) of the Code if the records are not maintained or are not available for examination as required by paragraph (h) below;

(h)(1) Except as provided below in paragraph (h)(2) and notwithstanding any provisions of section 504(a)(2) and (b) of the Act, the records referred to in paragraph (g) are unconditionally available at their customary location for examination during normal business hours by—

(A) any duly authorized employee or representative of the Department or the Internal Revenue Service;

(B) any fiduciary of the plan or any duly authorized employee or representative of such fiduciary;

(C) any contributing employer and any employee organization whose members are covered by the plan, or any authorized employee or representative of these entities; or

(D) any participant or beneficiary of the plan or the duly authorized employee or representative of such participant or beneficiary.

(2) None of the persons described in paragraph (h)(1)(B)–(D) shall be authorized to examine trade secrets or commercial or financial information which is privileged or confidential.

Section III. Definition

For purposes of this exemption, the terms ''employee benefit plan'' and ''plan'' refer to an employee benefit plan described in section 3(3) of ERISA and/or a plan described in section 4975(e)(1) of the Code.

Signed at Washington, DC this 24th of December, 2003.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. 03–32191 Filed 12–30–03; 8:45 am]

BILLING CODE 4520–29–P

DEPARTMENT OF LABOR

Employment and Training Administration

[TA–W–53,551]

Allegheny Ludlum Corporation, Brackenridge Works, Brackenridge, PA

Notice of Termination of Investigation Pursuant to Section 221 of the Trade Act of 1974, as amended, an investigation was initiated on November 17, 2003 in response to a petition filed by a company official on behalf of workers at Allegheny Ludlum Corporation, Brackenridge Works, Brackenridge, Pennsylvania.

The petitioning group of workers is covered by an earlier petition instituted on November 14, 2003 (TA–W–53,538) that is the subject of an ongoing investigation for which a determination has not yet been issued. Further investigation in this case would duplicate efforts and serve no purpose; therefore the investigation under this petition has been terminated.

Signed at Washington, DC this 19th day of November, 2003.

Linda G. Poole,

Certifying Officer, Division of Trade Adjustment Assistance.

[FR Doc. 03–31982 Filed 12–30–03; 8:45 am]

BILLING CODE 4510–30–P

DEPARTMENT OF LABOR

Employment and Training Administration

[TA–W–42,222 and TA–W–42,222A]

EHV–Weidmann Industries, Inc., a Subsidiary of Wicor Americas, St. Johnsbury, Vermont; and Weidmann Systems International, Inc., St. Johnsbury, Vermont; Amended Certification Regarding Eligibility To Apply for Worker Adjustment Assistance

In accordance with section 223 of the Trade Act of 1974 (19 U.S.C. 2273) the Department of Labor issued a Notice of Certification Regarding Eligibility to Apply for Worker Adjustment Assistance on November 25, 2002, applicable to workers of EHV–Weidmann Industries, Inc., a subsidiary of Wicor Americas, St. Johnsbury, Vermont. The notice was published in the **Federal Register** on December 23, 2002 (67 FR 78258).

At the request of the company, the Department reviewed the certification for workers of the subject firm. The workers are engaged in the production of electrical insulation boards and components.

Information from the company shows that worker separations occurred at Weidmann Systems International, St. Johnsbury, Vermont a sister company of the subject firm. Workers at Weidmann Systems International, Inc. provide sales and customer services supporting the production of electrical insulation boards and components at the subject firm.

Based on these findings, the Department is amending the certification to include workers of Weidmann Systems International, Inc., St. Johnsbury, Vermont.

The intent of the Department's certification is to include all workers of EHV–Weidmann Industries, Inc., a subsidiary of Wicor Americas, St. Johnsbury, Vermont, who were adversely affected by increased imports.

The amended notice applicable to TA–W–42,222 is hereby issued as follows:

''All workers of EHV–Weidmann Industries, Inc., a subsidiary of Wicor Americas, St. Johnsbury, Vermont (TA–W–42,222) and Weidmann Systems International, Inc. St. Johnsbury, Vermont (TA–W–42,222A), who became totally or partially separated from employment on or after September 17, 2001, through November 25, 2004, are eligible to apply for adjustment assistance under Section 223 of the Trade Act of 1974.''

Cite/reference	Total respondents	Frequency	Total responses	Average time per response (hours)	Burden (hours)
Account Summary	53	Annually	53	4	212
RJM 1 through 6 series	53	Annually	53	3	159
Narrative	53	Annually	53	8	424
Totals			212	33.75	7,155

Total Burden Hours: 7,155.

Total Annualized Capital/Startup Costs: $0.

Total Annual Costs (Operating/Maintaining Systems or Purchasing Services): $375,000.

Description: This program would replace the current methodologies for budget formulation and grant allocation to the states for unemployment insurance program.

Ira L. Mills,

Departmental Clearance Officer.

[FR Doc. 04–21657 Filed 9–27–04; 8:45 am]

BILLING CODE 4510–30–P

DEPARTMENT OF LABOR

Office of the Secretary

Submission for OMB Review: Comment Request

September 22, 2004.

The Department of Labor (DOL) has submitted the following public information collection requests (ICRs) to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act of 1995 (Pub. L. 104–13, 44 U.S.C. chapter 35). A copy of each ICR, with applicable supporting documentation, may be obtained by contacting the Department of Labor (DOL). To obtain documentation, contact Darrin King on 202–693–4129 (this is not a toll-free number) or email: *king.darrin@dol.gov*.

Comments should be sent to Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for the Mine Safety and Health Administration (MSHA), Office of Management and Budget, Room 10235, Washington, DC 20503, 202–395–7316 (this is not a toll-free number), within 30 days from the date of this publication in the **Federal Register**.

The OMB is particularly interested in comments which:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, permitting electronic submission of responses.

Agency: Mine Safety and Health Administration.

Type of Review: Extension of currently approved collection.

Title: Record of Results of Examinations of Self-Rescuers (Underground Coal Mines).

OMB Number: 1219–0044.

Frequency: Quarterly.

Type of Response: Recordkeeping.

Affected Public: Business or other for-profit.

Number of Respondents: 773.

Number of Annual Responses: 143,592.

Estimated Time Per Response: 30 minutes to certify and document that an examination was conducted and 1 minute to document why a device was taken out of service.

Total Burden Hours: 71,748.

Total Annualized capital/startup costs: $0.

Total Annual Costs (operating/maintaining systems or purchasing services): $0.

Description: Title 30, CFR 75.1714–3(b), (c), (d), and (e) require that self-rescuers be examined regularly at intervals not to exceed 90 days by a qualified person who certifies by date and signature that the tests were conducted. A record must be made when a self-rescue device is removed from service and when corrective action is taken as a result of the examination. The records are used as an enforcement tool to insure that the devices have been examined and are maintained in operable and usable condition.

Agency: Mine Safety and Health Administration.

Type of Review: Extension of currently approved collection.

Title: Escape and Evacuation Plans 30 CFR 57.11053.

OMB Number: 1219–0046.

Frequency: On occasion and semi-annually.

Type of Response: Recordkeeping and Third party disclosure.

Affected Public: Business or other for-profit.

Number of Respondents: 243.

Number of Annual Responses: 486.

Estimated Time Per Response: 8.5 hours.

Total Burden Hours: 4,131.

Total Annualized capital/startup costs: $0.

Total Annual Costs (operating/maintaining systems or purchasing services): $0.

Description: Title 30 CFR 57.11053 requires the development of an escape and evacuation plan specifically addressing the unique conditions of each underground metal and nonmetal mine. Section 57.11053 also requires that revisions be made as mining progresses. The plan must be available to the inspector and conspicuously posted at locations convenient to all persons on the surface and underground. The information is prepared by the mine operator for use by miners, MSHA, and persons involved in rescue operations.

Darrin A. King,

Acting Departmental Clearance Officer.

[FR Doc. 04–21658 Filed 9–27–04; 8:45 am]

BILLING CODE 4510–43–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Prohibited Transaction Exemption 2004–16; Application No. D–11203]

Class Exemption for the Establishment, Investment and Maintenance of Certain Individual Retirement Plans Pursuant to a Mandatory Distribution

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This document contains a final class exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA) and from certain taxes imposed by the Internal Revenue Code of 1986 (the Code). The exemption permits a fiduciary of a plan who is also the employer maintaining the plan to establish, on behalf of its separated employees, an individual retirement plan at a financial institution which is the employer or an affiliate, in connection with a Mandatory Distribution, as defined herein. Relief also is provided for a plan fiduciary to select a proprietary product as the initial investment for such individual retirement plan. Finally, relief is provided for the receipt of certain fees by the Individual Retirement Plan Provider in connection with the establishment or maintenance of the individual retirement plan and the initial investment of the Mandatory Distribution. The class exemption affects plan sponsors, plan fiduciaries, Individual Retirement Plan Providers and individual retirement plan account holders.

EFFECTIVE DATE: The exemption is effective for Mandatory Distributions made on or after March 28, 2005.

FOR FURTHER INFORMATION CONTACT: Allison Padams Lavigne or Karen Lloyd, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Washington, DC 20210, at (202) 693–8540 (this is not a toll-free number).

SUPPLEMENTARY INFORMATION: On March 2, 2004, the Department published a notice in the **Federal Register** (69 FR 9846[1]) of the pendency before the Department of a proposed class exemption from the restrictions of sections 406(a), 406(b)(1) and 406(b)(2) of ERISA and from the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code. The proposed exemption was published concurrently with the proposed Fiduciary Responsibility under the Employee Retirement Income Security Act of 1974 Automatic Rollover Safe Harbor to be promulgated at 29 CFR 2550.404a–2 (defined herein as ''Automatic Rollover Regulation''), which also was published on March 2, 2004 (69 FR 9899).

The Department proposed this class exemption on its own motion pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR 2570, Subpart B (55 FR 32836, August 10, 1990).[2] The notice gave interested persons an opportunity to comment or request a public hearing on the proposed exemption. Four comments were received by the Department regarding the proposed class exemption. No requests for a public hearing were received. Upon consideration of the comments received, the Department has determined to grant the proposed exemption subject to certain modifications. These modifications and the comments are discussed below.

[1] As corrected at 69 FR 11043 (March 9, 2004).

Executive Order 12866

Under Executive Order 12866, the Department must determine whether the regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. Pursuant to the terms of the Executive Order, it has been determined that this action is ''significant'' and therefore subject to review by the Office of Management and Budget (OMB). Accordingly, this action has been reviewed by OMB.

This final prohibited transaction class exemption is being published concurrently with a final regulation titled ''Fiduciary Responsibility under the Employee Retirement Income Security Act of 1974 Automatic Rollover Safe Harbor.'' The exemption permits plan fiduciaries that are also employers maintaining a pension plan to establish, for separated employees, individual retirement plans at financial institutions that are the employer or an affiliate, in connection with a Mandatory Distribution as that term is defined in this exemption. The exemption also permits plan fiduciaries to select a proprietary product as the initial investment for an individual retirement plan. Finally, the exemption provides relief from what would otherwise be a prohibited transaction for the receipt of certain fees by Individual Retirement Plan Providers in connection with the establishment or maintenance of the individual retirement plan and the initial investment of a Mandatory Distribution.

[2] Section 102 of Reorganization Plan No. 4 of 1978 generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

The modifications made to the exemption following the Department's consideration of comments received on both the proposed exemption and the proposed Automatic Rollover Regulation are described in detail in the discussion that follows this summary of costs and benefits. An overview of the economic impacts of those modifications is presented in this section.

In general, the costs and benefits that may accrue to fiduciaries have been described and quantified in connection with the economic impact of the final regulation describing the safe harbor for automatic rollovers of mandatory distributions also published in today's issue of the **Federal Register**. Although they are not separately identified, the fiduciaries of pension plans who are also employers maintaining the plan who would establish these individual retirement plans at a financial institution which is the employer or affiliate pursuant to this exemption are included within the estimates of affected plans and separated employees presented in the final regulation.

The estimates presented in the final regulation have been revised from the proposal to reflect the provision of the final rule with respect to the applicability of the safe harbor to mandatory distributions of $1,000 or less described in section 411(a)(11) of the Code, provided there is no affirmative distribution election by the participant and the fiduciary makes a rollover distribution into an individual retirement plan in accordance with the other conditions of the regulation, without regard to the fact that such a rollover is not described in section 401(a)(31) of the Code.

When the Department originally estimated the costs and benefits of the proposed regulation, which included the potential impact on the plans of financial institutions and affiliates that might make use of this exemption, the conditions of both the proposed regulation and the proposed exemption

provided that fees and expenses attendant to the individual retirement plan, other than establishment fees, could be charged only against the income earned by the individual retirement plan. This condition has not been modified in the final exemption. Although the condition has been revised in the final regulation, the change has no impact on the total estimated fees and expenses attendant to these individual retirement plans, regardless of whether they are established in accordance with the conditions of the regulation or exemption. This difference between the regulation and exemption with respect to this condition is expected to result in a difference in only the way in which fees and expenses are allocated between the individual retirement plan and the Individual Retirement Plan Provider. It is likely that the fees and expenses attendant to the individual retirement plan offered by the plan fiduciary or an affiliate will be allocated at least in part to the Individual Retirement Plan Provider due to the limitation on the amount that can be charged to the individual retirement plan. The likelihood of the provider incurring such a limit on the recovery of its cost is greater when rates of return are low.

Certain other costs may be allocated in connection with the conditions of the exemption to plan fiduciaries that select the proprietary products of an employer or an affiliate for investment of individual retirement plans, that would not be allocated to plan fiduciaries absent the prohibited transaction that would otherwise occur. Specifically, in connection with the acquisition of an Eligible Investment Product, section I(h) of the exemption provides that plan fiduciaries are not permitted to charge a sales commission to the individual retirement plans of their separated employees. Foregone sales commissions may result in costs in the form of a reduction in profit margin or an operating loss to some Individual Retirement Plan Providers.

The Department has no basis for estimating a wide array of factors that would affect costs, such as the amount of fees or expenses that might not be fully charged to the individual retirement plans, the extent to which plan fiduciaries will use one or more proprietary products, the number of accounts that could be rolled over into such products, or the lost income, if any, that may result from unpaid sales commissions. Therefore, the Department has not estimated a cost for these provisions of the exemption. However, fiduciaries are in no event required to make use of individual retirement plans offered by the plan fiduciary or an affiliate. In addition, many of the proprietary products permitted under the exemption generally do not charge a sales commission in connection with an initial purchase. In any case, it is likely that a plan fiduciary will use the individual retirement plans of itself or an affiliate, or a proprietary product for these individual retirement plans only if it is financially beneficial to do so, for example, as a way to retain deposits and increase earnings.

Paperwork Reduction Act

The final exemption permits a fiduciary of a pension plan that is also the employer maintaining the plan to establish, on behalf of its separated employees, an individual retirement plan at a financial institution that is the employer or an affiliate, in connection with a Mandatory Distribution. Relief is also being provided for a plan fiduciary to select a proprietary product as the initial investment for such an individual retirement plan. Finally, relief is provided for the receipt of certain fees by the Individual Retirement Plan Provider.

The exemption includes notice and recordkeeping requirements that are meant to inform separated employees and allow for verification by interested persons that the terms of the exemption have been met. Specifically, prior to an automatic rollover of a Mandatory Distribution, a plan fiduciary is required to notify a participant that the distribution may be rolled over into a proprietary investment selected by the plan fiduciary. Notification that a proprietary investment may be selected is to be provided in connection with a written explanation required under section 402(f) of the Code or in the plan's summary plan description or summary of material modifications thereto.

In the Department's view, neither alternative will result in a measurable burden. The additional information required to be included to meet this condition, though important, would require only a minor alteration to an existing disclosure. The fiduciary would also retain flexibility under the exemption as to the most efficient method of conveying the required information. As such, no burden for plan fiduciaries is expected to arise from the notice requirement in the exemption.

Similarly, because the records required to be maintained to enable verification of adherence to the conditions of the exemption would customarily be maintained as a part of usual business practices, this condition is not expected to impose a burden on Individual Retirement Plan Providers.

Accordingly, the Department has made no submission to OMB for approval of an information collection request in connection with the proposed or final exemption. Although the Department requested comments on any potential impact within the terms of the Paperwork Reduction Act of the notice and recordkeeping requirements of the exemption, no comments were received.

Discussion of Comments Received

The Department received four comments in response to the notice of proposed exemption. Additionally, the Department received a number of comments in connection with the proposed Automatic Rollover Regulation. Interested persons should refer to the final Automatic Rollover Regulation, published in this issue of the **Federal Register**, for discussion of these comments.

With respect to the proposed exemption, one commenter stated that the definition of Eligible Investment Product should not be limited to money market funds because such investments might not keep pace with inflation. The commenter asserted that a better safe harbor investment would be any diversified fund that invests in a substantial number of stocks and/or bonds. Another commenter asked that the definition of Eligible Investment Product be revised to include alternative default portfolio allocations for the assets, similar to what is permitted by the Internal Revenue Service (IRS) for automatic enrollments (*i.e.*, balanced funds). The same commenter suggested that the individual retirement plans should replicate the asset allocation that workers selected while in active employment. Upon consideration of the comments, the Department believes that given the nature and the amount of the automatic rollover, investments should be designed to minimize risk, preserve assets for retirement and maintain liquidity. Further, the Department does not believe that an investment strategy adopted by a participant while in a defined contribution plan would necessarily continue to be the appropriate strategy for the participant in the context of an automatic rollover, particularly given the small account balances covered under this exemption. Accordingly, the Department has determined not to modify the definition of ''Eligible Investment Product.''

One commenter on the proposed exemption requested that the dollar limit on accounts affected by the exemption be raised from $5,000 to $10,000, and that the $1,000 floor be

eliminated. The Department has determined to eliminate the $1,000 floor but retain the $5,000 limit.[3] In this regard, the Department has added a new section IV(i) to the exemption to define the term, ''Mandatory Distribution,'' which includes both an automatic rollover of a mandatory distribution described in section 401(a)(31)(B) of the Code and a mandatory distribution of one thousand dollars ($1,000) or less described in section 411(a)(11) of the Code.

Finally, a commenter asked that the Department address ''whether a credit union, or other 'Regulated Financial Institution' * * * can establish [individual retirement plans] at its own institution in order to satisfy the automatic rollover requirement with respect to distributions from qualified plans which it maintains for its own employees.'' The commenter also asked whether such credit union or ''Regulated Financial Institution'' could charge fees in connection with the establishment and maintenance of such individual retirement plans. The Department notes that the exemption currently permits a fiduciary of a plan to designate itself or an affiliate to provide an individual retirement plan and to receive fees in connection with the establishment and maintenance of the individual retirement plan, if the conditions of the exemption are met. Accordingly, a credit union or other ''Regulated Financial Institution'' may establish individual retirement plans for distributions from qualified plans it sponsors for its own employees, provided the credit union or ''Regulated Financial Institution'' meets the definition of Individual Retirement Plan Provider.[4]

The Department did not receive any comments on the proposed exemption regarding the amount of fees and expenses attendant to the individual retirement plan, including the investment of the assets thereof. However, the Department notes that such comments were received in connection with the parallel provisions of the proposed Automatic Rollover Regulation, and that the fee provisions of the final Automatic Rollover Regulation were revised in response to the commenters. Unlike the Automatic Rollover Regulation, the Department has determined to retain the condition of the exemption (section II(j)(2)) that limits fees and expenses other than establishment charges to the income earned by the individual retirement plan. The Department believes that the removal or modification of this requirement would increase the potential for self dealing. This situation presents potential violations of section 406(b) of the Act for which the Department is not prepared to provide additional relief. However, in accordance with the modifications made to the Automatic Rollover Regulation, the Department has revised the language of section II(j)(1). In the proposal, this condition stated that the fees and expenses attendant to the individual retirement plan could not exceed fees and expenses charged by the Individual Retirement Plan Provider for comparable individual retirement plans established for eligible rollover distributions that are not subject to the automatic rollover provisions of section 401(a)(31)(B) of the Code. As revised, the condition requires an Individual Retirement Plan Provider to charge fees and expenses that do not exceed the fees and expenses it charges to comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code. The Department has made the same revision to similar language in conditions II(e) and II(g).

Description of the Exemption

Section I of the exemption describes the transactions that are covered by the exemption. The plan fiduciary who provides the notice in section II(a) and meets the additional requirements described below would be able to be the Individual Retirement Plan Provider for its separated employees and to make an initial decision to invest the Mandatory Distribution in an investment product in which such plan fiduciary or its affiliate has an interest. Additionally, relief is provided for the receipt of fees by the Individual Retirement Plan Provider in connection with the establishment or maintenance of the individual retirement plan, and as a result of the investment of the Mandatory Distribution in an investment product in which the plan fiduciary or its affiliate has an interest.

Under the exemption, a plan fiduciary must, in connection with the written explanation provided pursuant to section 402(f) of the Code or in the plan's summary plan description or summary of material modifications thereto, notify the participant prior to the Mandatory Distribution that, absent his or her election, the Mandatory Distribution will be rolled over to an individual retirement plan provided by the plan fiduciary or an affiliate, and that the plan fiduciary may select its own proprietary investment as the initial investment of the Mandatory Distribution. In any case, the plan's summary plan description or summary of material modifications thereto will describe the plan's rollover provisions effectuating the requirements of sections 401(a)(31)(B) and 411(a)(11) of the Code.

The plan fiduciary must comply with the requirements of the Automatic Rollover Regulation. The term ''Automatic Rollover Regulation'' refers to the regulation promulgated by the Department at 29 CFR 2550.404a–2, which is published elsewhere in this issue of the **Federal Register**.

The plan fiduciary must be the employer, any of whose employees are covered by the plan from which the Mandatory Distribution is made, or an affiliate.

Under the exemption, the individual retirement plan must be established and maintained for the exclusive benefit of the account holder of the individual retirement plan, his or her spouse or their beneficiaries. Under section IV(a) of the exemption, the term individual retirement plan is defined in section 7701(a)(37) of the Code. Section 7701(a)(37) defines individual retirement plan as an individual retirement account described in section 408(a) of the Code and an individual retirement annuity described in section 408(b) of the Code. For purposes of this exemption, the term individual retirement plan shall not include an individual retirement plan which is an employee benefit plan covered by Title I of ERISA. *See* 29 CFR 2510.3–2(d).

The exemption requires that the terms of the individual retirement plan, including the fees and expenses for establishing and maintaining the individual retirement plan, be no less favorable than those available to comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code. The exemption further requires that all fees and expenses not be in excess of reasonable compensation within the meaning of section 4975(d)(2) of the Code. Corresponding service provider regulations under the Code provide guidance on the meaning of reasonable compensation under section 4975(d)(2). *See* 26 CFR 54.4975–6.

[3] For a further discussion of this issue, refer to the preamble to the final Automatic Rollover Regulation, published in this issue of the **Federal Register**.

[4] The Department notes that the term ''Regulated Financial Institution'' is defined in section IV(f) of the exemption and refers to the entity that can provide the initial investment product for the Mandatory Distribution. This term is separate from the term ''Individual Retirement Plan Provider,'' defined at section IV(d), which refers to the entity that may provide the individual retirement plan for the Mandatory Distribution.

Under the exemption, the individual retirement plan must be invested in an "Eligible Investment Product." Section IV(e) defines the term "Eligible Investment Product" to mean an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. For this purpose, the product must be offered by a Regulated Financial Institution and shall seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the individual retirement plan. Such term includes money market funds maintained by registered investment companies, and interest-bearing savings accounts and certificates of deposit of a bank or a similar financial institution. In addition, the term includes "stable value products" issued by a financial institution that are fully benefit-responsive to the individual retirement plan account holder, *i.e.*, that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for liquidations or transfers initiated by the individual retirement plan account holder exercising his or her right to withdraw or transfer funds under the terms of an arrangement that does not include substantial restrictions to the account holder's access to the assets of the individual retirement plan.

The exemption would not apply to the initial investment transaction entered into by an individual retirement plan unless the Eligible Investment Product is offered by a Regulated Financial Institution. A Regulated Financial Institution is defined under the exemption as an entity that: (i) Is subject to state or federal regulation, and (ii) is a bank or savings association, the deposits of which are insured by the Federal Deposit Insurance Corporation; a credit union, the member accounts of which are insured within the meaning of section 101(7) of the Federal Credit Union Act; an insurance company, the products of which are protected by state guaranty associations; or an investment company registered under the Investment Company Act of 1940.

In addition, the exemption requires that the rate of return or the investment performance of the individual retirement plan investment(s) be no less favorable than the rate of return or investment performance of an identical investment that could have been made at the same time by a comparable individual retirement plan established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code.

The exemption does not permit the individual retirement plan to pay a sales commission in connection with the acquisition of an Eligible Investment Product.

Under the exemption, the individual retirement plan account holder must be able to, within a reasonable time after request and without penalty to the principal amount of the investment, transfer his individual retirement plan balance to a different investment offered by the Individual Retirement Plan Provider, or transfer his or her individual retirement plan balance to another individual retirement plan sponsored at a different financial institution. The Department wants to ensure that, once the account holder discovers that an individual retirement plan has been established on his or her behalf, he or she is able to make appropriate investment decisions with respect to the assets of the individual retirement plan or to change Individual Retirement Plan Providers without penalty.

Section II(j) of the exemption limits the fees that may be paid by the individual retirement plan, as follows: (1) The fees and expenses attendant to the individual retirement plan, including the investment of the assets of such plan, (*e.g.*, establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges) shall not exceed the fees and expenses charged by the Individual Retirement Plan Provider for comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code; (2) the fees and expenses, other than establishment charges, attendant to the individual retirement plan, may be charged only against the income earned by the individual retirement plan; and (3) the fees and expenses shall not exceed reasonable compensation within the meaning of section 4975(d)(2) of the Code. In this regard, an Individual Retirement Plan Provider who has not previously offered comparable individual retirement plans will not be able to satisfy condition II(j)(1) of the exemption.

Lastly, the exemption contains a recordkeeping requirement. The Individual Retirement Plan Provider must maintain records to enable certain persons to determine whether the applicable conditions of the exemption have been met. The records must be available for examination by the IRS, the Department, and account holders and their beneficiaries for at least six years from the date of each automatic rollover.

General Information

The attention of interested persons is directed to the following:

(1) In accordance with section 408(a) of ERISA and section 4975(c)(2) of the Code, the Department finds that the exemption is administratively feasible, in the interests of the plan and of its participants and beneficiaries and protective of the rights of participants and beneficiaries of such plan;

(2) The exemption is supplemental to, and not in derogation of, any other provisions of ERISA and the Code including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction;

(3) The exemption does not extend to transactions prohibited under section 406(b)(3) of ERISA and section 4975(c)(1)(F) of the Code; and

(4) The class exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the exemption.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of ERISA and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, 32847, August 10, 1990).

I. Transactions

The restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to (i) the fiduciary of an Employee Pension Benefit Plan (plan) using its authority to designate itself or an affiliate as Individual Retirement Plan Provider to receive a Mandatory Distribution, (ii) the initial investment of the Mandatory Distribution by the plan fiduciary in an investment product in which the plan fiduciary or its affiliate has an interest, (iii) the receipt of fees by the Individual Retirement Plan Provider in connection with the establishment or maintenance of the individual retirement plan, and (iv) the receipt of investment fees by the Individual Retirement Plan Provider or an affiliate as a result of the initial investment of the Mandatory Distribution in an investment product in which the plan fiduciary or an affiliate

has an interest, provided that the conditions set forth in sections II and III are satisfied.

II. Conditions

(a) In connection with the written explanation provided to the separating participant pursuant to section 402(f) of the Code, or in the plan's summary plan description or summary of material modifications thereto, the plan fiduciary notifies the participant that, absent his or her election, the Mandatory Distribution will be rolled over to an individual retirement plan offered by the plan fiduciary or an affiliate, and that the plan fiduciary may select its own proprietary investment for the initial investment of the Mandatory Distribution.

(b) The requirements of the Automatic Rollover Regulation are met.

(c) The plan fiduciary is the employer any of whose employees are covered by the plan from which the Mandatory Distribution is made, or an affiliate.

(d) The individual retirement plan is established and maintained for the exclusive benefit of the individual retirement plan account holder, his or her spouse or their beneficiaries.

(e) The terms of the individual retirement plan, including the fees and expenses for establishing and maintaining the individual retirement plan, are no less favorable than those available to comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code.

(f) The Mandatory Distribution is invested in an Eligible Investment Product(s), as defined in section IV(e).

(g) The rate of return or the investment performance of the individual retirement plan investment(s) is no less favorable than the rate of return or investment performance of an identical investment(s) that could have been made at the same time by comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code.

(h) The individual retirement plan does not pay a sales commission in connection with the acquisition of an Eligible Investment Product.

(i) The individual retirement plan account holder may, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, transfer his individual retirement plan balance to a different investment offered by the Individual Retirement Plan Provider, or transfer his individual retirement plan balance to an individual retirement plan sponsored at a different financial institution.

(j)(1) Fees and expenses attendant to the individual retirement plan, including the investment of the assets of such plan, (*e.g.*, establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges) shall not exceed the fees and expenses charged by the Individual Retirement Plan Provider for comparable individual retirement plans established for reasons other than the receipt of a Mandatory Distribution made pursuant to section 401(a)(31)(B) of the Code;

(2) Fees and expenses attendant to the individual retirement plan, with the exception of establishment charges, may be charged only against the income earned by the individual retirement plan; and

(3) Fees and expenses are not in excess of reasonable compensation within the meaning of section 4975(d)(2) of the Code.

(k) The present value of the nonforfeitable accrued benefit, as determined under section 411(a)(11) of the Code, does not exceed the maximum amount required to be rolled over under section 401(a)(31)(B) of the Code.

III. Recordkeeping

(a) The Individual Retirement Plan Provider maintains or causes to be maintained for a period of six (6) years from the date of each Mandatory Distribution the records necessary to enable the persons described in paragraph (b) of this section to determine whether the applicable conditions of this exemption have been met. Such records must be readily available to assure accessibility by the persons identified in paragraph (b) of this section.

(b) Notwithstanding any provisions of section 504(a)(2) and (b) of the Act, the records referred to in paragraph (a) of this section are unconditionally available at their customary location for examination during normal business hours by—

(1) Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service; and

(2) Any account holder of an individual retirement plan established pursuant to this exemption, or any duly authorized representative of such account holder.

(c) A prohibited transaction will not be considered to have occurred if, due to circumstances beyond the control of the Individual Retirement Plan Provider, the records are lost or destroyed prior to the end of the six-year period, and no party in interest other than the Individual Retirement Plan Provider shall be subject to the civil penalty that may be assessed under section 502(i) of ERISA or to the taxes imposed by sections 4975(a) and (b) of the Code if the records are not maintained or are not available for examination as required by paragraph (b).

IV. Definitions

(a) The term ''individual retirement plan'' means an individual retirement plan described in section 7701(a)(37) of the Code. For purposes of this exemption, the term individual retirement plan shall not include an individual retirement plan which is an employee benefit plan covered by Title I of ERISA.

(b) The term ''Employee Pension Benefit Plan'' refers to an employee pension benefit plan defined in ERISA section 3(2)(A).

(c) The term ''Automatic Rollover Regulation'' refers to the regulation promulgated by the Department at 29 CFR 2550.404a–2.

(d) The term ''Individual Retirement Plan Provider'' means an entity that is eligible to serve as an individual retirement account trustee under section 408(a)(2) of the Code, or for purposes of an individual retirement annuity described in section 408(b) of the Code, an insurance company which is qualified to do business under the law of the jurisdiction in which the annuity contract, or endowment contract (described in 26 CFR 1.408–3(e)), is sold.

(e) The term ''Eligible Investment Product'' means an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. For this purpose, the product must be offered by a Regulated Financial Institution and shall seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the individual retirement plan. Such term includes money market funds maintained by registered investment companies, and interest-bearing savings accounts and certificates of deposit of a bank or similar financial institution. In addition, the term includes ''stable value products'' issued by a financial institution that are fully benefit-responsive to the individual retirement plan account holder, *i.e.*, that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for

liquidations or transfers initiated by the individual retirement plan account holder exercising his or her right to withdraw or transfer funds under the terms of an arrangement that does not include substantial restrictions to the account holder's access to the individual retirement plan's assets.

(f) The term ''Regulated Financial Institution'' means an entity that: (i) Is subject to state or federal regulation, and (ii) is a bank or savings association, the deposits of which are insured by the Federal Deposit Insurance Corporation; a credit union, the member accounts of which are insured within the meaning of section 101(7) of the Federal Credit Union Act; an insurance company, the products of which are protected by state guaranty associations; or an investment company registered under the Investment Company Act of 1940.

(g) An ''affiliate'' of a person includes:

(1) Any person directly or indirectly controlling, controlled by, or under common control with, the person; or

(2) Any officer, director, partner or employee of the person;

(h) The term ''control'' means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(i) The term ''Mandatory Distribution'' means the automatic rollover of a mandatory distribution described in section 401(a)(31)(B) of the Code, or a mandatory distribution of one thousand dollars ($1,000) or less described in section 411(a)(11) of the Code provided there is no affirmative distribution election by the participant.

Signed at Washington, DC, this 20th day of September, 2004.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. 04–21592 Filed 9–27–04; 8:45 am]

BILLING CODE 4510–29–P

DEPARTMENT OF LABOR

Employment and Training Administration

Solicitation for Grant Applications (SGA); High-Growth Job Training Initiative Grants Correction

AGENCY: Employment and Training Administration (ETA), Labor.

ACTION: Notice; correction.

SUMMARY: The Employment and Training Administration published a document in the **Federal Register** of September 17, 2004, concerning the availability of grant funds for address labor shortages, innovative training strategies, and other workforce challenges in the healthcare and biotechnology industries. The document contained incorrect application requirements.

FOR FURTHER INFORMATION CONTACT: Kevin Brumback, Grants Management Specialist, Division of Federal Assistance, Fax (202) 693–2879.

Corrections

In the **Federal Register** of September 17, 2004, in FR Volume 69, Number 180:

- On page 56087, in the third column, remove ''• Assurances and Certifications Signature Page (Appendix C).''
- On page 56091, in the third column, add ''Appendix E: OMB N. 0348–0046: Disclosure of Lobbying Activities. This form will be required upon selection for award.''
- On page 56087, in the second column, is corrected to add: The Budget Information Form (Appendix B): ''If applying through grants.gov the Budget information Form is to be added as an attachment to the application. This form can be found on *http://www.doleta.gov/sga/sga.cfm.*''

Dated: September 22, 2004.

Signed at Washington, DC, this 22nd day of September, 2004.

Eric D. Luetkenhaus,

Grant Officer.

BILLING CODE 4510–30–P

Federal Register

Friday,
April 21, 2006

Part V

Department of Labor

Employee Benefits Security Administration

Class Exemption for Services Provided in Connection With the Termination of Abandoned Individual Account Plans; Notice

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[ZRIN 1210–ZA05; Prohibited Transaction Exemption 2006–06; Application No. D–11201]

Class Exemption for Services Provided in Connection With the Termination of Abandoned Individual Account Plans

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Grant of class exemption.

SUMMARY: This document contains a final exemption from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from certain taxes imposed by the Internal Revenue Code of 1986, as amended (the Code). The exemption permits a ''qualified termination administrator'' (QTA) of an individual account plan that has been abandoned by its sponsoring employer to select itself or an affiliate to provide services to the plan in connection with the termination of the plan, to pay itself or an affiliate fees for those services, and to pay itself for services provided prior to the plan's deemed termination. The exemption also permits a qualified termination administrator of an abandoned plan to: (1) Designate itself or an affiliate as the provider of an individual retirement plan or other account for the distribution of a participant or beneficiary who fails to make an election regarding the disposition of such benefits; (2) select a proprietary investment product as the initial investment for such plan or account; (3) provide a federally insured bank or savings association account for small distributions; and (4) pay itself or its affiliate fees in connection therewith. This exemption is being granted in connection with the Department's final regulation at 29 CFR 2578.1, relating to the Termination of Abandoned Individual Account Plans, the Department's final regulation at 29 CFR 2550.404a–3, relating to the Safe Harbor for Distributions From Terminated Individual Account Plans, and the Department's final regulation at 29 CFR 2520.103–13, relating to the Terminal Report for Abandoned Individual Account Plans, which are being published simultaneously in this issue of the **Federal Register**. The exemption will affect individual account plans, the participants and beneficiaries of such plans, certain plan service providers, and the fiduciaries of such plans.

DATES: *Effective Date:* The class exemption is effective May 22, 2006.

FOR FURTHER INFORMATION CONTACT: Brian Buyniski, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, Washington, DC 20210, (202) 693–8545. This is not a toll free number.

SUPPLEMENTARY INFORMATION: On March 10, 2005, the Department published a notice in the **Federal Register** (70 FR 12074) of the pendency of a proposed class exemption from the restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and (b)(2) of the Act and from the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code. The Department proposed the class exemption on its own motion pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).[1]

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. Five (5) public comments were received by the Department. No requests for a public hearing were received. Upon consideration of the comments received, the Department has determined to grant the proposed class exemption subject to certain modifications. These modifications and the comments are discussed below.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether a regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order. It has been determined that this exemption is significant for ''raising novel policy issues'' under section 3(f)(4) of the Executive Order. Accordingly, the exemption has been reviewed by OMB.

This exemption is being published simultaneously with a group of three regulatory actions (the Abandoned Plan Regulations) that are also being issued in final form. In the Department's view, the conditional relief provided by the exemption is necessary in order to effectuate the purposes underlying the Abandoned Plan Regulations. Accordingly, the Department's basic statement regarding the economic benefits and costs of encouraging efficient, effective termination of abandoned plans, which is described in detail in the preamble to the Abandoned Plan Regulations, published elsewhere in this issue of the **Federal Register**, applies equally to this exemption. The following provides more specific analysis of the exemption and its specific economic costs and benefits.

The purpose of the Abandoned Plan Regulations is to facilitate the orderly, efficient termination of abandoned individual account plans in order to give participants and beneficiaries of those plans access to the amounts held in their individual accounts, which are frequently unavailable to them because of the abandonment. The relief provided by the exemption facilitates this goal by permitting a QTA, under the conditions of the exemption, to select itself or an affiliate to provide services to the plan, to pay itself or an affiliate fees for those services, and to pay itself fees for services provided prior to the plan's deemed termination, in connection with terminating the abandoned plan. Without the availability of the exemptive relief, QTAs and their affiliates would be unable to use plan assets as a source of compensation for their services; since those plan assets are usually the only available source of payment, QTAs would be highly unlikely to undertake abandoned plan terminations.

The exemption also permits a QTA to designate itself or an affiliate as the provider of an individual retirement plan or other account for distributions of benefits for which the participant or beneficiary has failed to make an election; select a proprietary investment product as the initial investment for the distributed benefits of a participant or

[1] Section 102 of Reorganization Plan No. 4 of 1978, 5 U.S.C. App. 1 (1996) generally transferred the authority of the Secretary of the Treasury to issue exemptions under section 4975(c)(2) of the Code to the Secretary of Labor.

For purposes of this exemption, references to specific provisions of Title I of the Act, unless otherwise specified, refer also to the corresponding provisions of the Code.

beneficiary of a terminated plan who fails to make an election regarding the disposition of such benefits; provide federally insured bank or savings association accounts for small distributions of such benefits; and pay itself or its affiliate in connection with such distributions. By removing the barrier to use of proprietary or affiliated investment vehicles for distributions for which the participant or beneficiary has failed to make investment decisions, the exemption facilitates the winding-up of abandoned plan terminations. Because some proportion of the participants or beneficiaries in virtually every termination of an abandoned plan will fail to make decisions regarding the disposition of their benefits, QTAs will need to make distribution decisions for those benefits. Allowing QTAs to use their own or affiliated investment products to receive the distributions will accelerate and simplify the orderly termination and winding-up of a plan's affairs.

The exemption imposes certain conditions on use of proprietary or affiliated investments, including (1) the condition that fees other than establishment fees and expenses attendant to an individual retirement plan or account may be charged only against the income earned by the individual retirement plan or account and (2) the condition that no sales commissions may be imposed in connection with acquiring an Eligible Investment Product. The exemption also conditions relief for payment for services provided prior to a plan's deemed termination on the services' being provided in good faith pursuant to a written agreement and the QTA's providing the Department with a copy of the written agreement and a statement under penalty of perjury that such services were actually performed.

In response to comments on the proposed regulations concerning the limitations on fees, the Department has revised one of the Abandoned Plan Regulations (the QTA Regulation, discussed below under ''Discussion of Comments Received'') to permit QTAs to transfer certain small accounts to bank or savings association accounts or the unclaimed property fund of the relevant state, but has determined not to make further changes in the conditions imposed on transactions under the exemption. The Department believes that these conditions, which shape the transactions for which relief will be available, are justified by the protection they provide to participants and beneficiaries.

The conditions appropriately limit the extent to which a QTA may pay itself or its affiliate. Although the conditions restrict the fees that QTAs and their affiliates may receive for their services, they protect against potential self-dealing and depletion of account balances. In these circumstances, the fee limitations substitute for an independent fiduciary's assessment of the value of using products or services of the QTA or its affiliate. Further, QTAs are not required to make use of proprietary or affiliated individual retirement plans or accounts, but are merely permitted by the exemption to choose voluntarily whether to do so. The Department believes that the fee limitations will encourage a QTA to make decisions regarding whether to use its own or an affiliate's individual retirement plans or accounts and investment products based not on the availability of a pool of assets for payment of fees, but on whether it will be in the best interests of the participants and beneficiaries to do so.

Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA 95) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that respondents will be able to provide the requested data in the desired format; that the public understands the Department's collection instruments; that the Department minimizes the reporting burden it imposes, both in time and financial resources; and that the Department properly assesses the impact of its collection requirements on respondents.

Because QTAs that rely on the exemption are required, as a condition for the relief, to comply with the requirements of the Abandoned Plan Regulations, published elsewhere in this issue of the **Federal Register**, the Department has combined the paperwork burden arising from the exemption with the paperwork burden attributable to the Abandoned Plan Regulations, including specifically the QTA Regulation, the Safe Harbor for Distributions From Terminated Individual Account Plans, and the Terminal Report for Abandoned Individual Account Plans, under one Information Collection Request (ICR). By combining these collections of information, the Department believes that the general public will gain a better understanding of the burden impact as it relates to terminating plans. The specific burden for the exemption includes a recordkeeping requirement for a QTA that terminates an abandoned plan and chooses to distribute the account balances of missing or nonresponsive participants into proprietary or affiliated individual retirement plans or accounts and a reporting requirement for a QTA that intends to pay itself for services provided to a plan prior to its deemed termination. The reporting requirement includes submitting to the Department a copy of the written agreement under which the services were provided, together with a representation, under penalty of perjury, that the services for which reimbursement is sought were in fact rendered. The hour and cost burdens for the ICR are described more fully in the preamble to the Abandoned Plan Regulations under the section on the Paperwork Reduction Act.

Discussion of Comments Received

The Department received five comment letters regarding the proposed class exemption.[2] Additionally, the Department received a number of comments in connection with the regulation relating to the Termination of Abandoned Individual Account Plans (the QTA Regulation) and the regulation relating to the Safe Harbor for Distributions from Terminated Individual Account Plans (the Safe Harbor Regulation). Interested persons should refer to these regulations, published elsewhere in this issue of the **Federal Register**, for a discussion of those comments.

The Department received several comments regarding the fees associated with the establishment of an account for participants and beneficiaries who fail to provide direction as to the disposition of their account balances. Two commenters requested that the Department eliminate the requirement in section III(i)(2) of the proposed exemption that fees and expenses attendant to the individual retirement plan or other account, with the exception of establishment charges, may be charged only against the income earned by the individual retirement plan or other account.

The Department recognizes that the fee limitations in the class exemption may serve as a disincentive to a QTA providing an individual retirement plan for distributions from abandoned

[2] The Department received one request for a public hearing which was subsequently withdrawn by the commenter after the Department informed the commenter that the issues raised in the comment letter would be addressed in the final exemption.

individual account plans, particularly with respect to accounts with small balances.[3] In such cases, the QTA Regulation permits the distribution to be made to an interest-bearing federally insured bank account in the name of the participant or beneficiary, to the unclaimed property fund of the state in which the participant's or beneficiary's last known address is located, or to an individual retirement plan provided by an unrelated financial institution. In light of this modification to the QTA Regulation, the Department does not believe that further relief is warranted. However, the Department has determined to modify the final exemption to provide relief for a QTA (or its affiliate) that is a provider of an interest-bearing, federally insured bank or savings association account, to designate itself or its affiliate as provider of such an account for the distribution of the account balances of participants or beneficiaries who do not provide direction as to the disposition of such balances, and to receive fees in connection with the establishment and maintenance of such accounts for distributions $1,000 or less.

A commenter also requested that the Department clarify that a one-time closing fee would be treated the same as an establishment fee which, under the exemption, is not limited to the amount of income earned by the account. The Department continues to believe that only establishment fees may be charged against the principal balance of the account. All other fees, including termination costs, can only be charged against the income earned.

The commenter further requested that the Department clarify whether an IRA owner's ability to transfer his or her account to a different institution must be made without penalty to principal. Section III(h) of the proposed exemption provided that the IRA owner may, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, transfer his or her account balance to a different investment offered by the QTA or its affiliate. The commenter asked for clarification of how this rule would apply if the transfer was made to a different financial institution. In response to this comment, the Department does not believe that a participant who determines to transfer his or her account balance to a different financial institution should be faced with a penalty deducted from the principal amount of the investment. Thus, the final exemption has been clarified to provide that the IRA owner must be able to transfer his or her account balance to a different financial institution without penalty to the principal.

Several comments addressed the definitions contained in section V of the proposed exemption. One commenter recommended that the definition of ''Eligible Investment Product'' be expanded to permit investments in lifestyle, retirement date and other balanced fund options. The commenter stated that these options are designed for long-term investors who choose not to actively manage their accounts. The Department notes that, given the nature of the accounts governed by this exemption, investments should be designed to minimize risk, preserve assets for retirement and maintain liquidity until the IRA owner becomes available to take control of his or her account. Accordingly, the Department has determined not to expand the definition of ''Eligible Investment Product'' as requested.

Several commenters requested expansion of the definition of QTA in the Regulation, as well as certain related changes to the class exemption. For reasons more fully set forth in the QTA Regulation, the Department has determined not to expand the definition of QTA. In light of the determination not to modify this final definition under the QTA Regulation, no changes have been made to the class exemption.

As proposed, the class exemption permitted a QTA to select itself to furnish services to the plan in its capacity as a QTA, and to pay itself for those services. It was suggested to the Department that the final exemption also should permit a QTA to pay itself for services rendered prior to becoming a QTA. Such services may have been rendered in connection with a determination of plan abandonment under the QTA Regulation or pursuant to an existing written contract previously entered into with the plan sponsor or other independent fiduciary prior to the time the service provider became the plan's QTA.

After considering the issues, the Department has expanded the class exemption to permit a QTA to pay itself for services rendered before becoming a QTA. In this regard, the exemption applies to two scenarios involving the payment of fees. First, the exemption permits the payment for services provided pursuant to the terms of a written contract previously entered into with the plan sponsor, or other independent fiduciary. This modification recognizes that a service provider might be viewed as exercising authority or control with respect to the disposition of a plan's assets, and therefore acting as a fiduciary, when paying itself fees from plan assets for services under circumstances where the service provider knows that there is no plan fiduciary monitoring plan services or otherwise responsible for the management of the plan, as would be the case in a plan that is determined to have been abandoned by the plan sponsor. Second, the exemption also permits payment for services that were not provided pursuant to a written contract, but were rendered in connection with a determination of plan abandonment under the QTA Regulation. Such services will generally take place prior to the service provider becoming a QTA.

One commenter on the QTA Regulation requested clarification on how a QTA would be able to effect a distribution on behalf of a missing or non-responsive participant in circumstances when the benefit payable is subject to the Code's survivor annuity requirements. The Department has modified the final QTA Regulation by adding a provision that provides that if a QTA determines that the survivor annuity requirements in section 401(a)(11) and 417 of the Code prevent a distribution in accordance with the Safe Harbor Regulation, the QTA shall distribute benefits in any manner reasonably determined to achieve compliance with the survivor annuity requirements of the Code.

Although the commenter did not request exemptive relief for the purchase of annuity contracts from the QTA or an affiliate, it does not foreclose future consideration of additional exemptive relief if the requisite findings under section 408(a) of the Act can be made. Specifically, the Department is interested in information with regard to the types of products that are currently available in the marketplace to annuitize benefits, and the standards and safeguards that the Department would include in an exemption for the purchase of such annuities.

Description of the Exemption

The class exemption has five sections. Section I describes the transactions that are covered by the exemption. Section II contains conditions for the provision of termination services and the receipt of fees. Section III contains the conditions for distributions. Section IV contains the general recordkeeping provisions imposed on the QTA, and section V contains definitions.

Under section I(a), relief is provided from the restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and

[3] See the Safe Harbor Regulation at 2550.404a–3 at d(1)(iii).

406(b)(2) of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, for a ''qualified termination administrator'' (QTA) within the meaning of section V(a) of the exemption to use its authority in connection with the termination of an abandoned individual account plan to select itself or an affiliate to provide services to the plan, to receive fees for services provided as a QTA, and to pay itself fees for services provided to the plan prior to the deemed termination of the plan.

Section I(b) of the exemption provides relief from the restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and 406(b)(2) of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, for a QTA to use its authority in connection with the termination of an abandoned individual account plan to designate itself or an affiliate as provider of an individual retirement plan or other account to receive the account balance of a participant that does not provide direction as to the disposition of such assets. The other accounts authorized by the exemption include an account, other than an individual retirement account, as described in section (d)(1)(ii) of the Safe Harbor Regulation, for a distribution made to a distributee other than a participant or spouse, and an interest-bearing, federally insured bank or savings association account for distributions of less than $1,000, as described in section (d)(1)(iii) of the Safe Harbor Regulation.

Section I(b) of the class exemption further permits the QTA to make the initial investment of the distributed proceeds in a proprietary investment product, receive fees in connection with the establishment or maintenance of the individual retirement plan or other account, and receive investment fees as a result of the investment of the individual retirement plan or other account's assets in a proprietary investment product in which the QTA or an affiliate has an interest.

Section II of the exemption describes the conditions that apply to a transaction described in section I(a) of the exemption. The QTA must comply with the requirements of the QTA Regulation, which is published elsewhere in this issue of the **Federal Register**. Additionally, the QTA is required to provide, in a timely manner, any other reasonably available information requested by the Department regarding the proposed termination.

Under the exemption, fees and expenses paid to the QTA and its affiliate must be consistent with industry rates for such or similar services, based on the experience of the QTA, and must not be in excess of rates charged by the QTA (or its affiliate) for the same or similar services provided to customers that are not individual account plans terminated pursuant to the QTA Regulation, if the QTA (or its affiliate) provides the same or similar services to such other customers. The reference to ''industry rates'' and ''based on the experience of the QTA'' are intended to enable a QTA who possesses knowledge about the services needed for a plan termination and industry rates for such or similar services, to engage or retain itself, an affiliate, and other service providers without going through a potentially timely and costly bidding process.

With respect to payment to the QTA for services provided to the plan prior to its deemed termination, the exemption provides relief in two situations. First, the exemption covers payment for services performed by a service provider pursuant to the QTA Regulation prior to the deemed termination of the plan and the service provider becoming a QTA. Such services will generally have been performed by the service provider in determining that a plan has been abandoned and in preparing the notice of plan abandonment as required by section (c)(3) of the QTA Regulation.

Second, the exemption covers payment for services provided in good faith pursuant to the terms of a written agreement prior to the service provider becoming a QTA. This includes services provided under a valid, unexpired contract, as well as the continuation of such services after the contract had expired. With respect to such services, the QTA must demonstrate to the Department, in its initial notification of plan abandonment (as required in section (c)(3) of the QTA Regulation), by a representation under penalty of perjury, that such services were actually performed. The QTA also must provide a copy of the executed contract between the QTA and the plan fiduciary or plan sponsor that authorized such services.

Section III contains conditions for transactions described in section I(b) of the exemption. In this regard, the conditions of the QTA Regulation must be met. In addition, the QTA must inform the participant or beneficiary in the notice required by section (d)(2)(vi) of the QTA Regulation that: (1) Absent his or her election within the 30-day period from receipt of the notice, the QTA will directly distribute the account balance of the participant or beneficiary to an individual retirement plan or other account offered by the QTA or its affiliate; and (2) the account balance may be invested in the QTA's own proprietary investment product, which is designed to preserve principal and provide a reasonable rate of return and liquidity.

The exemption also requires that the individual retirement plan or other account must be established and maintained for the exclusive benefit of the individual retirement plan or other account holder, his or her spouse or their beneficiaries.

The terms of the individual retirement plan or other account, including the fees and expenses for establishing and maintaining the individual retirement plan or other account, must be no less favorable than those available to comparable individual retirement plans or other accounts established for reasons other than the receipt of a distribution described in the QTA Regulation.

In addition, the exemption requires that, other than in the case of a bank or savings account described in section I(b)(1)(iii) of the exemption for distributions of less than $1,000, the distribution must be invested in an Eligible Investment Product, as defined in section V(c) of the exemption. The rate of return or the investment performance received by the individual retirement plan or other account from an investment product must be no less than that received by comparable individual retirement plans or other accounts that are not established pursuant to the QTA Regulation but are invested in the same product. For example, the rate of return received by the individual retirement plan for an investment in a one-year certificate of deposit which is an Eligible Investment Product cannot be less than the rate of return received by an individual retirement plan or other account established for reasons other than the receipt of a distribution that is invested in an identical one-year certificate of deposit.

The exemption does not permit the individual retirement plan or other account to pay a sales commission in connection with the acquisition of an Eligible Investment Product.

Under the exemption, the individual retirement plan or other account holder must be able, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, to transfer his or her individual retirement plan or other account balance to a different

investment offered by the QTA or its affiliate. Also, the individual retirement plan holder or other account holder must be able, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, to transfer his or her individual retirement plan or other account balance to a different financial institution not related to the QTA or its affiliate.

Under the exemption, fees and expenses attendant to the individual retirement plan or other account, including the investment of the assets of such plan or account, (e.g., establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges) must not exceed the fees and expenses charged by the QTA for comparable individual retirement plans or other accounts established for reasons other than the receipt of a distribution made pursuant to the QTA regulation. Additionally, fees and expenses attendant to the individual retirement plan or other account, other than establishment charges, may be charged only against the income earned by the individual retirement plan or other account. Finally, fees and expenses shall not exceed reasonable compensation within the meaning of section 4975(d)(2) of the Code.

Section IV of the exemption contains a recordkeeping requirement. The QTA must maintain records to enable certain persons to determine whether the applicable conditions of the class exemption have been met. The records must be made available for examination by the IRS, the Department, and any account holder or duly authorized representative of such account holder of an individual retirement plan or other account, for at least six years from the date the QTA provides notice to the Department of its determination of plan abandonment and its election to serve as the QTA.

Lastly, section V of the exemption contains certain definitions. The term ''qualified termination administrator'' is defined in section V(a) as an entity that is eligible to serve as a trustee or issuer of an individual retirement plan within the meaning of section 7701(a)(37) of the Code and that holds the assets of the abandoned plan.

The term ''Eligible Investment Product'' is defined in section V(c) to mean an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. In this regard, the product must be offered by a Regulated Financial Institution as defined in section V(d) and must seek to maintain, over the term of the investment, a dollar value that is equal to the amount invested in the product by the individual retirement plan or other account. Such term includes money market funds maintained by registered investment companies and interest-bearing savings accounts and certificates of deposit of a bank or similar financial institution. In addition, the term includes stable value products issued by a financial institution that are fully benefit-responsive to the individual retirement plan or other account holder. For purposes of this class exemption, the term ''benefit responsive'' means a stable value product that provides a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for liquidations or transfers initiated by the individual retirement plan or other account holder exercising his or her right to withdraw or transfer funds under the terms of an arrangement that does not include substantial restrictions to the account holder's access to the individual retirement plan or other account assets.

The term ''Regulated Financial Institution'' is defined in section V(d) to mean an entity that: (i) Is subject to state or federal regulation, and (ii) is a bank or savings association, the deposits of which are insured by the Federal Deposit Insurance Corporation; a credit union, the member accounts of which are insured within the meaning of section 101(7) of the Federal Credit Union Act; an insurance company, the products of which are protected by state guaranty associations; or an investment company registered under the Investment Company Act of 1940.

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of the Act and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of the Act and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of the Act, which require, among other things, that a fiduciary discharge his duties with respect to the plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of the Act;

(2) In accordance with section 408(a) of the Act and section 4975(c)(2) of the Code, the Department finds that the exemption is administratively feasible, in the interests of plans and their participants and beneficiaries and protective of the rights of participants and beneficiaries of such plans;

(3) The exemption is applicable to a transaction only if the conditions specified in the exemption are met; and

(4) The exemption is supplemental to and not in derogation of any other provisions of the Act and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code, and in accordance with the procedures set forth in 29 CFR 2570, subpart B (55 FR 32836, 32847, August 10, 1990).

I. Covered Transactions

(a) The restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to a QTA, (as defined in section V(a) of this class exemption), using its authority in connection with the termination of an abandoned individual account plan pursuant to the Department's regulation at 2550.404a–3, relating to the Termination of Abandoned Individual Account Plans (the QTA Regulation) to:

(1) Select itself or an affiliate to provide services to the plan;

(2) Receive fees for the services performed as a QTA; and

(3) Pay itself fees for services provided to the plan prior to the deemed termination of the plan, provided that the conditions set forth in sections II and IV of this exemption are satisfied.

(b) The restrictions of sections 406(a)(1)(A) through (D), 406(b)(1) and 406(b)(2) of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to a QTA, using its authority in connection with the termination of an abandoned individual account plan pursuant to the QTA Regulation to:

(1) Designate itself or an affiliate as: (i) Provider of an individual retirement plan; (ii) provider of an account (other

than an individual retirement plan) under the limited circumstances described in section (d)(1)(ii) of the Safe Harbor Regulation for Terminated Plans (2550.404a–3) (Safe Harbor Regulation); or (iii) provider of an interest-bearing, federally insured bank or savings association account maintained in the name of the participant or beneficiary, in the case of a distribution described in section (d)(1)(iii) of the Safe Harbor Regulation, for the distribution of the account balance of the participant or beneficiary of the abandoned individual account plan who does not provide direction as to the disposition of such assets;

(2) Make the initial investment of the account balance of the participant or beneficiary in the QTA's or its affiliate's proprietary investment product;

(3) Receive fees in connection with the establishment or maintenance of the individual retirement plan or other account; and

(4) Pay itself or an affiliate investment fees as a result of the investment of the individual retirement plan or other account assets in the QTA's or its affiliate's proprietary investment product, provided that the conditions set forth in sections III and IV of this exemption are satisfied.

II. Conditions for Provision of Termination Services and Receipt of Fees in Connection Therewith

(a) The requirements of the QTA Regulation are met. The QTA provides, in a timely manner, any other reasonably available information requested by the Department regarding the proposed termination.

(b) Fees and expenses paid to the QTA, and its affiliate, in connection with the termination of the plan and the distribution of benefits:

(1) Are consistent with industry rates for such or similar services, based on the experience of the QTA, and

(2) Are not in excess of rates ordinarily charged by the QTA (or affiliate) for the same or similar services provided to customers that are not plans terminated pursuant to the QTA regulation, if the QTA (or affiliate) provides the same or similar services to such other customers.

(c) In the case of a transaction described in section I(a)(3):

(1) Such services: (i) Were performed in good faith pursuant to the terms of a written agreement executed prior to the service provider becoming a QTA, or (ii) were performed pursuant to the QTA Regulation; and

(2) The QTA, in the initial notification of plan abandonment described in section (c)(3) of the QTA Regulation: (i) Represents under penalty of perjury that such services were actually performed and (ii) in the case of section II(c)(1)(i) above, provides the Department with a copy of the executed contract between the QTA and a plan fiduciary or the plan sponsor that authorized such services.

III. Conditions for Distributions

(a) The conditions of the QTA Regulation are met.

(b) In connection with the notice to participants and beneficiaries described in the QTA Regulation, a statement is provided explaining that:

(1) If the participant or beneficiary fails to make an election within the 30-day period referenced in the QTA Regulation, the QTA will directly distribute the account balance to an individual retirement plan or other account offered by the QTA or its affiliate;

(2) The proceeds of the distribution may be invested in the QTA's (or affiliate's) own proprietary investment product, which is designed to preserve principal and provide a reasonable rate of return and liquidity.

(c) The individual retirement plan or other account is established and maintained for the exclusive benefit of the individual retirement plan account holder or other account holder, his or her spouse, or their beneficiaries.

(d) The terms of the individual retirement plan or other account, including the fees and expenses for establishing and maintaining the individual retirement plan or other account, are no less favorable than those available to comparable individual retirement plans or other accounts established for reasons other than the receipt of a distribution described in the QTA Regulation.

(e) Except in the case of a QTA providing a bank or savings account pursuant to section I(b)(1)(iii) of the exemption, the distribution proceeds are invested in an Eligible Investment Product(s), as defined in section V(c) of this class exemption.

(f) The rate of return or the investment performance of the individual retirement plan or other account is no less favorable than the rate of return or investment performance of an identical investment(s) that could have been made at the same time by comparable individual retirement plans or other accounts established for reasons other than the receipt of a distribution described in the QTA Regulation.

(g) The individual retirement plan or other account does not pay a sales commission in connection with the acquisition of an Eligible Investment Product.

(h) The individual retirement plan account holder or other account holder must be able, within a reasonable period of time after his or her request and without penalty to the principal amount of the investment, to transfer his or her account balance to a different investment offered by the QTA or its affiliate, or to a different financial institution not related to the QTA or its affiliate.

(i)(1) Fees and expenses attendant to the individual retirement plan or other account, including the investment of the assets of such plan or account, (e.g., establishment charges, maintenance fees, investment expenses, termination costs, and surrender charges) shall not exceed the fees and expenses charged by the QTA for comparable individual retirement plans or other accounts established for reasons other than the receipt of a distribution made pursuant to the QTA Regulation;

(2) Fees and expenses attendant to the individual retirement plan or other account, with the exception of establishment charges, may be charged only against the income earned by the individual retirement plan or other account; and

(3) Fees and expenses attendant to the individual retirement plan or other account are not in excess of reasonable compensation within the meaning of section 4975(d)(2) of the Code.

IV. Recordkeeping

(a) The QTA maintains or causes to be maintained, for a period of six (6) years from the date the QTA provides notice to the Department of its determination of plan abandonment and its election to serve as the QTA described in the QTA Regulation, the records necessary to enable the persons described in paragraph (b) of this section to determine whether the applicable conditions of this exemption have been met. Such records must be readily available to assure accessibility by the persons identified in paragraph (b) of this section.

(b) Notwithstanding any provisions of section 504(a)(2) and (b) of the Act, the records referred to in paragraph (a) of this section are unconditionally available at their customary location for examination during normal business hours by—

(1) Any duly authorized employee or representative of the Department of Labor or the Internal Revenue Service; and

(2) Any account holder of an individual retirement plan or other account established pursuant to this

exemption, or any duly authorized representative of such account holder.

(c) A prohibited transaction will not be considered to have occurred if due to circumstances beyond the control of the QTA, the records necessary to enable the persons described in paragraph (b) to determine whether the conditions of the exemption have been met are lost or destroyed, and no party in interest other than the QTA shall be subject to the civil penalty that may be assessed under section 502(i) of the Act or to the taxes imposed by sections 4975(a) and (b) of the Code if the records are not maintained or are not available for examination as required by paragraph (b).

(3) None of the persons described in paragraph (b)(2) of this section shall be authorized to examine the trade secrets of the QTA or its affiliates or commercial or financial information that is privileged or confidential.

V. Definitions

(a) A termination administrator is ''qualified'' for purposes of the QTA Regulation and this exemption if:

(1) The QTA is eligible to serve as a trustee or issuer of an individual retirement plan or other account, within the meaning of section 7701(a)(37) of the Code, and

(2) The QTA holds plan assets of the plan that is considered abandoned.

(b) The term ''individual retirement plan'' means an individual retirement plan described in section 7701(a)(37) of the Code. For purposes of this exemption, the term individual retirement plan shall not include an individual retirement plan which is an employee benefit plan covered by Title I of ERISA.

(c) The term ''Eligible Investment Product'' means an investment product designed to preserve principal and provide a reasonable rate of return, whether or not such return is guaranteed, consistent with liquidity. For this purpose, the product must be offered by a Regulated Financial Institution as defined in paragraph (d) of this section and shall seek to maintain, over the term of the investment, the dollar value that is equal to the amount invested in the product by the individual retirement plan or other account. Such term includes money market funds maintained by registered investment companies, and interest-bearing savings accounts and certificates of deposit of a bank or similar financial institution. In addition, the term includes ''stable value products'' issued by a financial institution that are fully benefit-responsive to the individual retirement plan account holder or other account holder, *i.e.*, that provide a liquidity guarantee by a financially responsible third party of principal and previously accrued interest for liquidations or transfers initiated by the individual retirement plan account holder or other account holder exercising his or her right to withdraw or transfer funds under the terms of an arrangement that does not include substantial restrictions to the account holder access to the individual retirement plan or other account's assets.

(d) The term ''Regulated Financial Institution'' means an entity that: (i) Is subject to state or federal regulation, and (ii) is a bank or savings association, the deposits of which are insured by the Federal Deposit Insurance Corporation; a credit union, the member accounts of which are insured within the meaning of section 101(7) of the Federal Credit Union Act; an insurance company, the products of which are protected by state guaranty associations; or an investment company registered under the Investment Company Act of 1940.

(e) An ''affiliate'' of a person includes:

(1) Any person directly or indirectly controlling, controlled by, or under common control with, the person; or

(2) Any officer, director, partner or employee of the person.

(f) The term ''control'' means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(g) The term ''individual account plan'' means an individual account plan as that term is defined in section 3(34) of the Act.

Signed at Washington, DC, this 17th day of April, 2006.

Ivan L. Strasfeld,

Director of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. 06–3815 Filed 4–20–06; 8:45 am]

BILLING CODE 4150–29–P

I. Background

Section 104(b) of the Employee Retirement Income Security Act of 1974 (ERISA) requires the administrator of an employee benefit plan to furnish plan participants and certain beneficiaries with a Summary Plan Description (SPD) that describes, in language understandable to an average plan participant, the benefits, rights, and obligations of participants in the plan. The information required to be contained in the SPD is set forth in section 102(b) of ERISA. To the extent that there is a material modification in the terms of the plan or a change in the required content of the SPD, section 104(b)(1) of ERISA requires the administrator to furnish participants and specified beneficiaries a summary of material modifications (SMM) or summary of material reductions (SMR). The Department of Labor (Department) has issued regulations providing guidance on compliance with the requirements to furnish SPDs, SMMs, and SMRs. These regulations, which are codified at 29 CFR 2520.102–2,102–3, and 29 CFR 104b–2 and 104b–3, contain information collections for which the Department has obtained OMB approval under the OMB Control No. 1210–0039. The current approval is scheduled to expire on January 31, 2007, and the Department intends, following receipt of comments pursuant to this notice, to submit an ICR to OMB requesting an extension of its approval of these information collections. The public is not required to respond to an information collection unless it displays a valid control number. No change to the existing ICR is being proposed or made at this time.

II. Desired Focus of Comments

The Department is particularly interested in comments that:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., by permitting electronic submissions of responses.

III. Current Actions

This notice requests comments on an extension of OMB's approval of the information collections included in 29 CFR 2520.102–2,102–3, and 29 CFR 104b–2 and 104b–3. The Department is not proposing or implementing changes to the existing ICR at this time. A summary of the ICR and the current burden estimates follows:

Agency: Employee Benefits Security Administration, Department of Labor.

Title: Summary Plan Description Requirements under ERISA.

Type of Review: Extension of a currently approved collection of information.

OMB Number: 1210–0039.

Affected Public: Business or other for-profit; Not-for-profit institutions.

Respondents: 900,000.

Responses: 50,000,000.

Estimated Total Burden Hours: 1,100,000.

Estimated Total Burden Cost (Operating and Maintenance): $400,000,000.

Comments submitted in response to this notice will be summarized and/or included in the request for OMB approval; they will also become a matter of public record.

Joseph S. Piacentini,

Director, Office of Policy and Research, Employee Benefits Security Administration.

[FR Doc. E6–18233 Filed 10–30–06; 8:45 am]

BILLING CODE 4510–29–P

DEPARTMENT OF LABOR

Employee Benefits Security Administration

[Application Nos. D–08295 and D–10365]

RIN 1210–ZA10

Prohibited Transaction Exemption (PTE) 2006–16; Class Exemption To Permit Certain Loans of Securities by Employee Benefit Plans

AGENCY: Employee Benefits Security Administration, Department of Labor.

ACTION: Adoption of Amendment and Revocation of PTEs 81–6 and 82–63.

SUMMARY: This document amends and replaces Prohibited Transaction Exemption (PTE) 81–6 (46 FR 7527, January 23, 1981) and PTE 82–63 (47 FR 14804, April 6, 1982). PTE 81–6 exempts the lending of securities by employee benefit plans to certain banks and broker-dealers, and PTE 82–63 exempts certain compensation arrangements for the provision of securities lending services by a plan fiduciary to an employee benefit plan. The final amendment incorporates the exemptions into one renumbered exemption, and expands the relief that was provided in PTEs 81–6 and 82–63 to include additional parties and additional forms of collateral subject to the specified conditions. The exemption affects participants and beneficiaries of employee benefit plans, persons who lend securities on behalf of such plans, and parties in interest who engage in securities lending transactions with such plans.

DATES: The effective date of this amendment is January 2, 2007. The revocation of PTEs 81–6 and 82–63 is effective on January 2, 2007.

FOR FURTHER INFORMATION CONTACT: Allison Padams Lavigne, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor, (202) 693–8540 (This is not a toll-free number.)

SUPPLEMENTARY INFORMATION: On October 23, 2003, the Department proposed a notice in the **Federal Register** of a proposed class exemption to amend PTEs 81–6 and 82–63 by incorporating PTEs 81–6 and 82–63 into a new class exemption and expanding the existing relief from the restrictions of sections 406(a)(1)(A) through (D) and 406(b)(1) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) through (E) of the Code to additional parties under modified conditions.[1] The notice also proposed the revocation of PTEs 81–6 and 82–63. The proposal was published in response to two exemption applications. One application was submitted by the American Bankers Association (ABA) (D–08295), and the second application was submitted by the Robert Morris Associates, now known as the Risk Management Association (RMA) (D–10365). The applications were filed pursuant to section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR 2570, subpart B (55 FR 32836, August 10, 1990).

The notice of pendency gave interested persons an opportunity to comment or request a public hearing on the proposal. The Department received six public comments. No request for a hearing was received. Upon

[1] Section 102 of Reorganization Plan No. 4 of 1978 (5 U.S.C. App. 1 (1996)) generally transferred the authority of the Secretary of the Treasury to issue exemptions under Code section 4975(c)(2) to the Secretary of Labor.

consideration of the comments received, the Department has determined to grant the proposed class exemption, subject to certain modifications. These modifications and the comments are discussed below.

Executive Order 12866

Under Executive Order 12866, the Department must determine whether the regulatory action is ''significant'' and therefore subject to the requirements of the Executive Order and subject to review by the Office of Management and Budget (OMB). Under section 3(f), the order defines a ''significant regulatory action'' as an action that is likely to result in a rule (1) having an annual effect on the economy of $100 million or more, or adversely and materially affecting a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or State, local or tribal governments or communities (also referred to as ''economically significant''); (2) creating serious inconsistency or otherwise interfering with an action taken or planned by another agency; (3) materially altering the budgetary impacts of entitlement grants, user fees, or loan programs or the rights and obligations of recipients thereof; or (4) raising novel legal or policy issues arising out of legal mandates, the President's priorities, or the principles set forth in the Executive Order.

This class exemption has been drafted and reviewed in accordance with Executive Order 12866, section 1(b), Principles of Regulation. The Department has determined that this exemption is not a ''significant regulatory action'' under section 3(f) of the Executive Order. Accordingly, it does not require an assessment of potential costs and benefits under section 6(a)(3) of that Order.

Paperwork Reduction Act

As part of its continuing effort to reduce paperwork and respondent burden, the Department of Labor conducts a preclearance consultation program to provide the general public and Federal agencies with an opportunity to comment on proposed and continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA 95) (44 U.S.C. 3506(c)(2)(A)). This helps to ensure that requested data will be provided in the desired format, that the reporting burden (time and financial resources) imposed on respondents is minimized, that the public can clearly understand the Department's collection instruments, and that the Department can properly assess the impact of its collection requirements on respondents.

The Department previously solicited comments concerning the information collection request (ICR) included in the Proposed Amendment to PTE 81–6 and Proposed Restatement and Redesignation of PTE 82–63 (the Proposal) when that document was published in the **Federal Register** on October 23, 2003 (68 FR 60715). The ICR re-stated and combined then-existing ICRs previously approved under OMB Control Numbers 1210–0065 (PTE 81–6) and 1210–0062 (PTE–82–63) and requested approval for the program changes set forth in the Proposal, as well as an adjustment in the burden estimates based on updated information. The ICR was reviewed by OMB and approved on April 11, 2004, under the control number 1210–0065, and that approval is currently scheduled to expire on December 31, 2006.

The class exemption published in this notice has been revised from the Proposal in two basic ways. First, the categories of eligible foreign banks and broker dealers have been broadened to include foreign banks and broker dealers located in additional specified foreign countries, provided that such entities meet the additional specified conditions. Second, the permitted types of collateral for loans of securities by plans to eligible banks and broker dealers have been enlarged to include additional types of collateral. Currently, the Department is soliciting comments concerning revisions in the burden estimates for the ICR resulting from these modifications and from further changes in the Department's assumptions and estimation methodology, which are due to better understanding of the existing market for foreign and domestic securities lending. After consideration of any public comments received in response to this solicitation, the Department intends to submit an ICR to OMB for review of the paperwork burden modifications and changes described in this section. Under 5 CFR 1320.5(b), an Agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number. The Department will publish notice in the **Federal Register** of OMB's decision upon review of the Department's ICR.

A copy of the ICR may be obtained by contacting Susan G. Lahne, Office of Policy and Research, U.S. Department of Labor, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Room N–5647, Washington, DC 20210. Telephone: (202) 693–8410; Fax: (202) 219–5333. These are not toll-free numbers. The ICR also may be viewed via the internet at *http://www.reginfo.gov/public/do/PRAMain*. The Department and OMB are particularly interested in comments that:

- Evaluate whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, *e.g.*, by permitting electronic submission of responses.

Comments should be sent to the Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10235, New Executive Office Building, Washington, DC 20503; Attention: Desk Officer for the Employee Benefits Security Administration. Although comments may be submitted through January 2, 2007, OMB requests that comments be received within 30 days of publication of this class exemption to ensure their consideration.

The Department has consulted with industry experts and has received additional information on the nature and operation of the foreign and domestic securities lending markets. Based on this new information, the Department is revising its prior paperwork burden analysis to reflect its better understanding of the likely impact of the exemption.

In its prior paperwork burden analysis, the Department based its estimates conservatively on the assumption that all domestic broker dealers and banks with trust powers would take advantage of the exemption. This led to an estimate of 13,900 domestic entities that would be respondents to the information collections of the Proposal. Given the highly sophisticated nature of the securities lending market in general and the specific limitations of the exemption in particular, including the required indemnification agreements, equity capital minimums, and levels of collateralization, the Department believes that its original estimate

overstated the likely incidence of reliance. The Department now assumes that the exemption will be relied upon only by the limited group of large, sophisticated domestic broker dealers and banks currently active in the securities lending market, which the Department estimates at approximately 140 separate entities. In addition, the Department estimates that in total 60 foreign broker dealers and banks will begin to rely upon the exemption in its final form, including the 13 entities located in the United Kingdom that were previously included in the Department's paperwork burden analysis for the Proposal. This produces a total estimate of 200 respondents.

Given the nature of securities lending practices, which require expert knowledge, efficient and sophisticated communications systems, and careful monitoring and control of the timing of securities loan transactions, the Department further believes that each of the borrowing entities will establish securities lending relationships with only a limited number of plans. For purposes of this estimate, the Department has assumed that each borrower will sign a contract with no more than 10 employee benefit plans.

The specific information collections of this exemption have not changed from the Proposal. As described in the prior ICR, the exemption provides that, before a plan can lend securities, the borrower must provide the plan with a financial statement. In addition, the agreements regarding the loan transaction or series of transactions and the compensation arrangement for the Lending Fiduciary must be described in a written document. The Department continues to assume that these documents are routinely prepared by the respondent entities in-house as part of usual and customary business practice. The Department has therefore treated the preparation and review of these documents as an hour burden for purposes of this analysis; the cost burden derives solely from material and postage costs for distribution. These costs were estimated at $4.00 per priority or overnight domestic mailing of the documents. Discussions with industry experts indicated that nearly all of the foreign-based institutions likely to rely on the exemption have established domestic branches. The Department assumes, therefore, that all mailings will be handled by the domestic-based operations and that there will be few, if any, respondents using foreign mail services.

The Department has also assumed that the respondents, all of which are large, sophisticated financial entities, will generally communicate by electronic means. Because electronic communications will be undertaken through existing electronic systems and databases, the Department has not added any additional burden for documents that are assumed to be distributed by electronic means.

Financial statements. The Department assumes that each of the 200 respondents will provide each plan with which it has a master lending agreement (10 plans each) with a new financial statement on a quarterly basis, resulting in an estimate of 8,000 financial statements distributed annually (200 respondents × 10 plans × 4 quarterly financial statements). No preparation burden for these statements is assumed, however, since the financial statements will have been prepared for other purposes. The Department has assumed that only 10 percent of the respondents will distribute the financial statements in paper by mail. For the 800 financial statements that are therefore assumed to be distributed annually by mail (10 percent of 8,000 = 800), the Department assumes an hour burden of 5 minutes per statement, consisting of the preparation of an overnight or priority delivery package, resulting in an annual hour burden of 67 hours of clerical time (800 mailings × 5 min./60 min.). For these purposes, each statement is assumed, based on financial statements filed with the Securities and Exchange Commission, to consist of 10 pages. For the 800 financial statements delivered via mail, the Department further assumes a total annual cost of $3,200 (800 mailings × $4.00 per mailing).

For the remaining 90 percent of the financial statements distributed annually, or 7,200 statements (8,000 − 800 = 7,200), the Department has assumed electronic distribution and has not estimated any additional distribution burden.

Lending and compensation agreements. The Department assumes that each respondent will use master agreements for both the lending agreement and the lending fiduciary compensation agreement and will review and distribute them on an annual basis. For purposes of burden analysis, the Department has assumed that each respondent will annually require 30 minutes to review each of these two agreements for compliance (1 hour total per respondent), resulting in an annual hour burden of 200 hours (200 respondents × 1 hour per respondent).

The respondents are further assumed to require 5 minutes to package and mail the agreements. Because of the nature of these agreements, the Department assumes that the respondents will provide each of their plan partners with a single mailing annually containing both the lending agreement and the compensation agreement for that partner and that all agreements will be distributed in paper form by priority or overnight mail. The total time for preparation is 167 hours (200 respondents × 10 lending partners × 5 minutes per agreement)/60). The cost for the distribution of these 2,000 documents (2,000 = 200 respondents × 10 lending partners each) by overnight or priority mail is estimated at $8,000.

The total annual hour burden for this information collection, based on these assumptions, is therefore 434 hours (67 hours + 200 hours + 167 hours). The equivalent cost of the annual hour burden is estimated at $21,514, based on $16,600 for legal staff review of the agreements (200 hours × $83 per hour = $16,600) and $4,914 for clerical time to prepare and distribute the documents (234 hours × $21 per hour = $4,914).

The total annual cost burden for this information collection is estimated at $11,200 ($8,000 for the agreements + $3,200 for the financial statements = $11,200).

The following summarizes the Department's paperwork burden estimates for this information collection:

Type of Review: Revision of a currently approved collection.

Agency: Employee Benefits Security Administration, Department of Labor.

Title: Securities Lending Prohibited Transaction Exemption.

OMB Number: 1210–0065.

Affected Public: Business or other for-profit, Not-for-profit institutions.

Total Respondents: 200.

Frequency: On occasion.

Total Responses: 2,000.

Estimated Total Burden Hours: 434.

Estimated Burden Cost: $11,200.

Discussion of Comments Received

The Department received six comments regarding the proposed class exemption. The commenters requested specific modifications to the proposal in the following areas:

1. Definition of "Foreign Broker-Dealer" and "Foreign Bank"

One commenter asked the Department to expand the definition of Foreign Broker-Dealers and Foreign Banks to include those foreign broker-dealers or foreign banks that are located in a foreign country in which a foreign broker-dealer or a foreign bank has received an individual exemption involving the lending of securities by plans. The commenter notes that, in each of these exemptions, the foreign

banks and foreign broker-dealers were under their country's governmental regulation and oversight, which provided a sufficient level of protection for plans. Another commenter asked the Department to expand relief to include broker-dealers and banks of Germany and the Netherlands within the definitions of Foreign Bank and Foreign Broker-Dealer. In the alternative, the commenter requested that relief be extended to broker-dealers and banks of Germany and the Netherlands, provided that the Lending Fiduciary is a U.S. Broker-Dealer or U.S. Bank and such fiduciary indemnifies the plan against losses that arise from a borrower's default. This commenter states that this type of indemnification agreement is present in most securities lending transactions.

The Department notes that the terms and conditions of the individual exemptions generally require that the foreign borrower be affiliated with a U.S. Bank or a U.S. Broker-Dealer that indemnifies the plan in the United States against potential loss resulting from a borrower's default. In addition, those exemptions require that the collateral be maintained in the United States in U.S. dollars or U.S. denominated securities. The Department notes that while these conditions were appropriate and protective of the plan in the context of an individual exemption, they may not be feasible in the context of a class exemption.[2] Thus, for purposes of the class exemption, it may be difficult for a plan to readily assess the risk of lending securities to broker-dealers and banks located in the various foreign jurisdictions. The Department believes that the presence of governmental regulation and oversight by the foreign countries that were involved in the individual exemptions, and an indemnification by a U.S. regulated entity, provide a significant degree of protection for plans. Accordingly, the Department has determined to expand the definition of Foreign Broker-Dealer (as defined in section V(c)) and Foreign Bank (as defined in section V(d)) under limited circumstances.

Under the final exemption, the definition of Foreign Broker-Dealer has been expanded to include those broker-dealers registered and regulated under the relevant securities laws of a governmental entity of a country other than the United States where such securities laws were applicable to a broker-dealer that received: (i) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a broker-dealer or (ii) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended, (61 FR 39988 (July 31, 1996); 67 FR 44622 (July 3, 2002)) involving the loan of securities by a plan to a broker-dealer. The term ''Foreign Bank'' has been expanded to include those banks subject to regulation by the relevant governmental banking agency(ies) of a country other than the United States, where the regulation and oversight of these banking agencies were applicable to a bank that received: (i) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a bank or (ii) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended, (61 FR 39988 (July 31, 1996); 67 FR 44622 (July 3, 2002)) involving the loan of securities by a plan to a bank.[3]

However, to further protect the plans from any unnecessary costs and risks associated with the lending of securities in the different foreign jurisdictions, a new condition has been added to section III(c) of the exemption. This condition requires, in the case of a securities lending transaction involving a Foreign Broker-Dealer or a Foreign Bank that is described above (as defined in section V(c)(2) and V(d)(2) of the exemption), the Lending Fiduciary to be a U.S. Bank or U.S. Broker-Dealer that indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under this provision) which the plan may incur or suffer directly arising out of a borrower default. In this regard, it is the Department's understanding that in a default situation, the plan will be able to recover the money it is owed under this indemnification agreement from the lending fiduciary in the United States.

Another commenter asked the Department to expand the definition of borrower to include Canadian broker-dealers and Canadian banks. The commenter described a strong similarity in the type of government oversight between broker-dealers and banks in Canada and the United States. In particular, the commenter described the regulation of Canadian broker-dealers. In Canada, securities regulation is within the jurisdiction of the Provinces. In Ontario, the Ontario Securities Commission (OSC) is responsible for regulating the securities markets with the purpose of protecting investors, ensuring optimal allocation of financial resources and maintaining public confidence in the markets. The OSC regulates market participants by notices and orders. It has an enforcement role in the market. It has the power to ensure that trading activities are carried out in accordance with applicable regulations. It can investigate, prosecute and impose penalties on individuals who do not comply with such regulations. Other provincial securities commissions operate similarly. All powers of all the commissions are subject to the oversight of the Ministers of Finance in each Province.

In addition, the commenter notes that the Canadian Securities Administration (CSA) reviews the activities of the provincial securities commissions to ensure consistency in the regulatory framework among the Provinces. The commenter adds that Canadian broker-dealers are subject to oversight by self-regulatory organizations (SRO's), which are subject to the supervision of the provincial commissions. According to the commenter, the Market Regulation Services is the independent regulation services provider for Canadian equity markets and is a recognized SRO by the CSA. Its mandate is to foster and protect investor confidence and market integrity through the administration, interpretation and enforcement of a

[2] The terms and conditions of the individual exemptions generally involve the lending of securities by a plan to a foreign affiliate of a U.S. broker-dealer or U.S. bank and require the U.S. affiliate to indemnify the plan in the United States against any potential losses arising from a default. In addition, these exemptions require that the collateral be maintained in U.S. dollars or U.S. denominated securities and be held in the U.S. The proposed class exemption did not contain an affiliate requirement and permitted non-U.S. forms of collateral that may be maintained outside the U.S.

[3] To date, individual exemptions have been granted and transactions have received final authorization under PTE 96–62, as amended, that involve securities loans by plans to broker-dealers and banks regulated under the applicable laws of Japan, Germany, the Netherlands, Sweden, Switzerland, France, Australia, Canada and the United Kingdom. Thus, any broker-dealer or bank that is subject to government regulation in any one of these countries would be able to utilize the relief provided in this exemption, if all applicable conditions are met. In this regard, if in the future, the Department grants individual exemptions or final authorizations under PTE 96–62 for transactions involving securities loans by plans to broker-dealers or banks regulated under the applicable laws of additional foreign countries, broker-dealers and banks subject to such government regulation would be able to utilize the final exemption provided all applicable conditions are met.

common set of market integrity principles.

The commenter also described the regulation of Canadian banks. The commenter noted that the Office of Superintendent of Financial Institutions (OSFI) regulates Canadian banks. OSFI is an independent agency of the Government of Canada and reports to the Minister of Finance. Its principal role is to safeguard depositors and other banking clients. OSFI imposes capital requirements to ensure that Canadian banks are able to meet their financial obligations as well as strict reporting, managing, accounting and auditing requirements.

Lastly, the commenter represented that under Canadian law, counterparties may agree to submit to the jurisdiction of the courts of the United States and the judgments of the courts in the United States are readily enforceable in Canada. Based on the representations of the commenter regarding the regulatory supervision of Canadian broker-dealers and banks, the Department has expanded the definition of ''Foreign Broker-Dealer'' to include any broker-dealer that: (i) Is regulated by a securities commission of a Province of Canada that is a ''member'' of the Canadian Securities Administration, and (ii) is subject to the oversight of a Canadian SRO; and has expanded the definition of ''Foreign Bank'' to include any bank that is regulated by the Office of the Superintendent of Financial Institutions in Canada.

Finally, one commenter requested that plans be permitted to loan securities to entities other than those permitted under the proposed exemption, provided that all obligations of the borrower are fully guaranteed by an entity that could have borrowed the securities itself. To the extent the commenter is referring to entities other than broker-dealers and banks for which the Department has previously granted relief, this comment raises issues that are beyond the scope of our original consideration, and the commenter has not provided sufficient information for the Department to consider this request. Accordingly, the Department has determined not to adopt this comment.

2. Level of Foreign Collateral That Must Be Pledged

One commenter expressed support for the collateral requirements found in the proposed exemption. Three commenters (including the Applicant) requested that the collateralization requirements (described in section II(b) of the proposed exemption) be made consistent with those in SEC Rule 15c3–3 (17 CFR 240.15c3–3).[4] The Applicant states that regulatory and market developments have occurred since the Applicant first filed its exemption application. The Applicant expressed concern that, if the exemption requires different collateralization levels for plans than what is required for other investors by Rule 15c3–3, plans would be placed at a competitive disadvantage. Another commenter suggested that the level of collateralization required in SEC Rule 15c3–3 be required for those transactions in which the lending fiduciary is a U.S. Bank and such lending fiduciary indemnifies the plan against losses resulting from the borrower's default. According to the commenter, most securities lending transactions include these types of indemnification arrangements. Lastly, a commenter suggested that the collateralization requirements stated in the proposed exemption only be modified for those transactions involving plans with total assets in excess of $500 million.

Rule 15c3–3 requires 100% collateralization if the collateral and securities are denominated in the same currency; 101% if the collateral and securities are denominated in a different currency (*i.e.*, Euros, British pounds, Swiss francs, Canadian dollars, and Japanese yen); and 105% if the collateral and securities are denominated in a different currency and such currency is other than those specified above.

On the basis of the comments, the Department has determined to adopt the collateralization requirements in Rule 15c3–3 for certain transactions where the lending fiduciary is a U.S. Broker-Dealer or U.S. Bank, and such fiduciary indemnifies the plan against loss in the event of borrower default.

Specifically, the Department has expanded section II(b) of the exemption to provide that: In the case of a securities lending transaction in which the Lending Fiduciary is a U.S. Bank or U.S. Broker-Dealer, and such Lending Fiduciary indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default, the plan receives from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower: ''Foreign Collateral'' having, as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than: (i) 100 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent; or (ii) 101 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is in a different currency than the securities lent and such currency is denominated in Euros, British pounds, Japanese yen, Swiss francs or Canadian dollars; or (iii) 105 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) if the collateral posted is in a different currency than the securities lent and is denominated in a currency other than those specified above.

Lastly, the Department believes that the Lending Fiduciary indemnification requirement discussed above provides a sufficient safeguard to protect a plan's interest under the revised collateralization levels making the $500 million plan asset test unnecessary. Accordingly, the Department has not modified the exemption in this respect.

3. Expand The Types of Collateral Permitted Under The Exemption

Several commenters requested that the class exemption permit plans to accept the types of collateral permitted under SEC Rule 15c3–3. Another commenter requested that the definition of foreign collateral be broadened to include equity securities and fixed income securities.

Rule 15c3–3 permits the following forms of collateral:

1. Government securities as defined in section 3(42)(A) and (B) of the Securities Exchange Act of 1934 (the Exchange Act) (15 U.S.C. 78c(42)(A) and (B)) may be pledged when borrowing any securities.

2. Government securities as defined in section 3(42)(C) of the Exchange Act (15 U.S.C. 78c(42)(C)) and issued or guaranteed as to principal or interest by the following corporations may be pledged when borrowing any securities: (i) Federal Home Loan Mortgage Corporation, (ii) the Federal

[4] On April 16, 2003, the SEC issued the Order Regarding the Collateral Broker-Dealers Must Pledge When Borrowing Customer Securities (Release No. 47683). Rule 15c3–3 specifies the types and amount of collateral that may be offered by broker-dealers who borrow fully paid and excess margin securities from customers. For purposes of this exemption, the term ''Rule 15c3–3'' shall also refer to the SEC Order contained in Release No. 47683.

National Mortgage Corporation, (iii) the Student Loan Marketing Association and (iv) the Financing Corporation.

3. Securities issued by, or guaranteed as to principal and interest by, the following Multinational Banks—the obligations of which are backed by participating countries, including the United States—may be pledged when borrowing any securities: (i) International Bank for Reconstruction and Development, (ii) the Inter-American Development Bank, (iii) the Asian Development Bank, (iv) the African Development Bank, (v) the European Bank for Reconstruction and Development, and (vi) the International Finance Corporation.

4. Mortgage-backed securities that meet the definition of a ''mortgage related security'' as defined by section 3(a)(41) of the Exchange Act (15 U.S.C. 78c(a)(41)) may be pledged when borrowing any securities.

5. Negotiable certificates of deposit and bankers acceptances issued by a ''bank'' as that term is defined in section 3(a)(6) of the Exchange Act (15 U.S.C. 78c(a)(6)), and which are payable in the United States and deemed to have a ''ready market'' as that term is defined in 17 CFR 240.15c3–1, may be pledged when borrowing any securities.

6. Foreign sovereign debt securities may be pledged when borrowing any securities, provided that: (i) At least one nationally recognized statistical rating agency (NRSRO) has rated in one of its two highest rating categories either the issue, the issuer or guarantor, or other outstanding unsecured long-term debt securities issued or guaranteed by the issuer or guarantor; and (ii) if the securities pledged are denominated in a different currency than those borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirements in paragraph (b)(3) of Rule 15c3–3 (100%) by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

7. Foreign sovereign debt securities that do not meet the NRSRO rating condition set forth in Item 6 above may be pledged only when borrowing non-equity securities issued by a person organized or incorporated in the same jurisdiction (including other debt securities issued by the foreign sovereign); provided that, if such foreign sovereign debt securities have been assigned a rating lower than the securities borrowed, such foreign sovereign debt securities must be rated in one of the four highest rating categories by at least one NRSRO. If the securities pledged are denominated in a different currency than those borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3–3 by 1% when the collateral is denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when it is denominated in another currency.

8. The Euro, British pound, Swiss franc, Canadian dollar or Japanese yen may be pledged when borrowing any securities, provided that, when the securities borrowed are denominated in a different currency than that pledged, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3–3 by 1%. Any other foreign currency may be pledged when borrowing any non-equity securities denominated in the same currency.

9. Non-governmental debt securities may be pledged when borrowing any securities, provided that, in the relevant cash market they are not traded flat or in default as to principal or interest, and are rated in one of the two highest rating categories by at least one NRSRO. If such securities are not denominated in U.S. dollars or in the currency of the securities being borrowed, the broker-dealer shall provide collateral in an amount that exceeds the minimum collateralization requirement in paragraph (b)(3) of Rule 15c3–3 by 1% when the securities pledged are denominated in the Euro, British pound, Swiss franc, Canadian dollar or Japanese yen, or by 5% when they are denominated in any other currency.

The Department agrees with the commenters that the types of the collateral allowed under the class exemption should be expanded. Although the SEC concluded that the designation of additional categories of permissible collateral will add liquidity to the securities lending market and lower borrowing costs for broker-dealers, the Department does not believe that the commenters have made a sufficient showing that adopting all the categories of collateral described in Rule 15c3–3 would be protective of the interests of participants and beneficiaries if a borrower were to default.

In this regard, the Department notes that the collateral described in categories 1 and 2 of Rule 15c3–3 satisfies the definition of ''U.S. Collateral'' under the proposed exemption. For the sake of clarity, the Department has revised the definition of ''U.S. Collateral'' to specifically include: Government securities as defined in section 3(42)(A) and (B) of the Securities Exchange Act of 1934 (the Exchange Act); and Government securities as defined in section 3(42)(C) of the Exchange Act and issued or guaranteed as to principal or interest by the following corporations: (i) Federal Home Loan Mortgage Corporation, (ii) the Federal National Mortgage Corporation, (iii) the Student Loan Marketing Association and (iv) the Financing Corporation.

Additionally, the Department believes that it would be appropriate to expand the definition of ''U.S. Collateral'' to include: ''Mortgage-backed securities'' as described in category 4 of Rule 15c3–3, and ''negotiable certificates of deposit and banker acceptances'' as described in category 5 of Rule 15c3–3.

Further, the Department has determined that it would be appropriate to expand the definition of ''Foreign Collateral'' to include all other types of collateral that are specified under Rule 15c3–3, as amended by the SEC from time to time, provided the Lending Fiduciary is a U.S. Broker-Dealer or U.S. Bank, and such entity provides the plan with an indemnification with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs which a plan may incur or suffer directly arising out of a borrower default. In the absence of an indemnification by a U.S. Broker-Dealer or U.S. Bank, the definition of ''Foreign Collateral'' in the final exemption has been revised to include the types of collateral described in categories 3 of Rule 15c3–3, rated foreign sovereign debt described in category 6, and the British pound, the Canadian dollar, the Swiss franc, the Japanese yen or the Euro.

In response to a comment, the Department has determined not to revise the exemption to include equity securities and fixed-income securities as these items appear to be outside the scope of Rule 15c3–3, and the Department has insufficient information about how these items would function as collateral.

4. Issues Relating to the Lending Fiduciary's Indemnification of the Plan From Loss Upon a Borrower's Default

Two commenters requested that the Department revise the indemnification provision of section III(b) to limit the lending fiduciary's indemnification obligation to losses resulting from a borrower's default, and not from any shortfall in the earnings on the collateral. The Department notes that the indemnification by the Lending Fiduciary is only applicable when the borrower defaults and there is a difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under this provision) which the plan may incur or suffer directly arising out of a borrower default. The indemnification requirement, under the proposal, was never intended to encompass losses arising out of the investment of the collateral by a Lending Fiduciary or other party. Accordingly, the Department has clarified section III(b)(2) of the exemption to reflect this intent.

Another commenter asked the Department to expand section III(b)(2) of the proposed exemption to permit a parent corporation (which may or may not be domiciled in the United States) of a U.S. subsidiary acting as a Lending Fiduciary to provide the indemnity in lieu of the Lending Fiduciary itself. The Department believes that this request raises issues that are beyond the scope of the proposed exemption and has determined not to modify the exemption as requested by the commenter.

One commenter requested clarification regarding the scope of the indemnification provisions under the exemption. Specifically, the commenter questioned whether, in accordance with the provisions in an indemnification agreement, a Lending Fiduciary can stand in the shoes of the plan, and seek recovery from the borrower. Nothing in the final exemption would preclude a Lending Fiduciary from entering into an indemnification agreement that permits the Lending Fiduciary to seek recovery against a defaulting borrower after the Lending Fiduciary has made the plan whole pursuant to the indemnification agreement.

5. Miscellaneous Comments

Another commenter questioned whether the exemption would apply to repurchase agreements (repos). The commenter states that in the context of securities loans that are structured and documented as repos, a Master Repurchase Agreement is utilized instead of a Master Securities Lending Agreement. Except for the difference in the form of the arrangement, such an agreement contains all of the same information and substantive requirements that would be found in a typical Master Securities Lending Agreement. The commenter indicates that the Master Repurchase Agreement contains terms and conditions that satisfy all of the substantive requirements of the exemption, including the requirement that the securities be returned at termination of the loan (*i.e.*, repurchase transaction) in consideration for the return of the cash, the requirement that any interest or dividends on the securities lent (*i.e.*, sold) be paid by the securities borrower (*i.e.*, the purchaser) to the securities lender (*i.e.*, the seller) as and when paid, and the requirement that the securities lender (*i.e.*, the seller) receive reasonable compensation for the loan of the securities (which may consist of the ability to retain investment earnings on the cash collateral in excess of a pre-specified rebate amount).

The Department notes that the exemption permits securities loans that are structured as repos, provided that all of the other terms and conditions of the exemption are otherwise met. For the sake of clarity, the Department has added a definition of the terms ''lending of securities'' or ''loan of securities'' to include securities loans that are structured as repurchase agreements, provided that all terms of the exemption are otherwise met (section V(l) of the exemption).

Another commenter expressed concern that the exemption prevents plans from lending certain fixed income securities when a plan accepts foreign collateral by requiring the collateralization level for foreign collateral to be determined by reference to the market value of the securities lent on a ''recognized securities exchange,'' or an ''automated trading system.'' (*See* section II(b)(1)(B) and II(b)(2)(B))) The commenter requests that market value be determined in the same manner as set out under the 2000 version of the Master Securities Loan Agreement which was jointly published by the commenter and the Securities Industry Association. The Department believes that the objective standard contained in the proposal is an important safeguard, and is not persuaded by the comment.

One commenter requested that the Department clarify section IV(c) of the proposal. Section IV(c) of the proposal requires that the compensation be reasonable and be paid to the Lending Fiduciary in accordance with the terms of a written instrument, which may be in the form of a master agreement covering a series of securities lending transactions. The commenter was concerned that this provision could require that the aggregate compensation for all loans be reasonable. Thus, if one loan's compensation failed, then all loans would fail this condition. The Department intended that this condition apply on a loan-by-loan basis. Thus, the failure of one loan to meet this requirement would not cause all loans entered into pursuant to a master agreement to fail such requirement.

A commenter requested clarification on whether the exemption covers ''fee-for-hold'' arrangements. The commenter describes ''fee-for-holds'' as the following. The borrower pays a fee in exchange for the guaranteed availability of a particular security for a specified period of time or until the arrangement is terminated by either party. If a fee-for-hold arrangement is in place and the holding borrower chooses to borrow any such held securities, the fee-for-hold arrangement with respect to such securities terminates and the borrower will enter into a securities loan arrangement. These arrangements may take two forms: (1) The plan may grant the borrower the right of first refusal essentially giving the borrower an option to borrow the securities if the lending plan is approached by another party seeking to borrow the same held securities; or (2) the plan may grant the borrower the exclusive right to borrow the securities. The commenter stated that title to the securities does not transfer until securities are actually delivered. The borrower pays a fee related to the type, quantity and duration of the fee-for-hold arrangement. Once loaned, the lending fee paid is based on market conditions at the time of the loan. The plan may terminate the arrangement at any time so that it may dispose of the securities at any time. The Department is of the view that these arrangements are within the scope of the exemption, provided that all terms and conditions are otherwise met.

One commenter requested that relief be extended to transactions covered by the Federal Employee's Retirement System Act of 1986 (FERSA). The Department notes that relief from the prohibited transaction provisions of FERSA is provided for transactions described in section I(c) of the final amendment by reason of PTE T88–1, as amended (53 FR 52838 (December 29, 1988), 57 FR 8689 (March 11, 1992).) No additional exemptive relief is necessary under the final amendment for those prohibited transactions described in FERSA which parallel those described in section 406(a) of ERISA, if the plan receives no less than adequate consideration.

In this regard, PTE T88–1, as amended, adopted six prohibited transaction class exemptions (including PTE 82–63) for purposes of section 8477(c)(2) of FERSA. The amendment to PTE T88–1 extended such relief to any amendments of these class exemptions which are granted by the Department pursuant to section 408(a) of ERISA unless the Department determines that PTE T88–1, as amended does not apply to such amendment. Accordingly, the Department determines that PTE T88–1, as amended shall apply to this final amendment for purposes of FERSA.

One commenter noted that the requirements in section II(d) that the loan agreement identify the currency in which payment of any fees will be made to the plan would be burdensome. The commenter noted that, in the context of securities loans secured by cash collateral, it is industry practice that the lender pays a rebate to the borrower rather than receiving a fee. Secondly, it is industry practice that the borrower's rebate will be in the same currency as

the currency of the cash collateral. In addition, many loans are covered by a master agreement and, in the context of a securities loan secured by non-cash collateral, parties may need to offer different forms of collateral on a loan-by-loan basis. Thus, the commenter requests that the parties be permitted to specify the currency of the fees in the loan confirmation. The Department concurs with the comment, and has modified the final exemption accordingly.

A commenter asked the Department to clarify how the final exemption would apply to securities loans that were entered into pursuant to PTEs 81–6 and 82–63 prior to the effective date of the final exemption. The Department notes that loan transactions entered into prior to the effective date of this exemption would be covered by PTE 81–6 and PTE 82–63, provided all conditions of the exemption are met. Transactions entered into on or after the effective date of the final exemption would be covered by this exemption, provided that the conditions therein are met. The Department notes that the conditions of PTE 81–6 and PTE 82–63 have been incorporated into this class exemption.

Description of the Exemption

Section I of the exemption describes the transactions that are covered by the exemption. Section I(a) tracks the language of PTE 81–6 by permitting the lending of securities that are assets of an employee benefit plan to a U.S. Broker-Dealer or U.S. Bank, if the general conditions set forth in section II are met. However, the conditions contained in PTE 81–6 have been amended to permit additional types of collateral to be used for the securities loan. Section I(b) of the exemption expands PTE 81–6 by permitting the lending of securities that are assets of an employee benefit plan to a Foreign Broker-Dealer or a Foreign Bank. A Foreign Broker-Dealer or a Foreign Bank must meet both the general conditions set forth in section II of the proposed exemption, as well as the specific conditions described in section III.

Under the final exemption, a Foreign Broker-Dealer is defined in section V(c) as a broker-dealer that has, as of the last day of its most recent fiscal year, equity capital that is the equivalent of no less than $200 million and is: (1)(i) Registered and regulated under the laws of the Financial Services Authority in the United Kingdom, or (ii)(a) registered and regulated under the laws of a securities commission of a Province of Canada that is a member of the Canadian Securities Administration, and (b) is subject to the oversight of a Canadian self-regulatory authority; or (2) registered and regulated, under the relevant securities laws of a governmental entity of a country other than the United States, and such securities laws and regulation were applicable to a broker-dealer that received: (i) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a broker-dealer or (ii) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended involving the loan of securities by a plan to a broker-dealer.

Section V(d) of the final exemption defines the term ''Foreign Bank'' to mean: An institution that has, substantially similar powers to a bank as defined in section 202(a)(2) of the Investment Advisers Act, has as of the last day of its most recent fiscal year, equity capital which is the equivalent of no less than $200 million, and is subject to: (1) Regulation by the Financial Services Authority in the United Kingdom or the Office of the Superintendent of Financial Institutions in Canada, or (2) regulation by the relevant governmental banking agency(ies) of a country other than the United States, and the regulation and oversight of these banking agencies were applicable to a bank that received: (i) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a bank or (ii) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended involving the loan of securities by a plan to a bank.

Section I(c) permits the payment to a lending fiduciary of compensation for services rendered in connection with loans of plan assets that are securities, provided that the conditions set forth in section IV are met. The conditions found in section IV mirror the conditions that were found in PTE 82–63. Although the relief provided by section I(c) would apply to a broader range of lending activities, no changes have been made with respect to any of the conditions that are contained in PTE 82–63.

Section II(a) of the final exemption remains as proposed and requires that neither the borrower nor any affiliate of the borrower have or exercise discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or render investment advice (within the meaning of 29 CFR 2510.3–21(c)) with respect to those assets.

Under the final exemption, section II(b)requires that the plan receive from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower, (1) ''U.S. Collateral'' having, as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than 100 percent of the then market value of the securities lent; or (2) ''Foreign Collateral'' having as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than: (i) 102 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent, or(ii) 105 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in V(k)) on which the securities are primarily traded if the collateral posted is denominated in a different currency than the securities.

In addition, section II(b) has been expanded to include new collateralization requirements in the case of a securities lending transaction in which the Lending Fiduciary is a U.S. Bank or U.S. Broker-Dealer, and such Lending Fiduciary indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default. For those securities transactions involving such an indemnification, the plan may receive from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower: Foreign Collateral having, as of the close of business on the preceding day, a market value or in the case of bank letters of credit, a stated amount, equal to not less than:

(i) 100 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent; or (ii) 101 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined

in section V(k)) on which the securities are primarily traded if the collateral posted is in a different currency than the securities lent and such currency is denominated in Euros, British pounds, Japanese yen, Swiss francs or Canadian dollars; or (iii) 105 percent of the then market value of the securities lent as valued on a recognized securities exchange or an automated trading system (as defined in section V(k)) if the collateral posted is in a different currency than the securities lent and is denominated in a currency other than those specified above.[5]

The final exemption contains a revised definition of ''U.S. Collateral'' that incorporates additional forms of collateral described in Rule 15c3–3. The term ''U.S. Collateral'' is defined in section V(e) as:

(1) U.S. currency,

(2) ''government securities'' as defined in section 3(a)(42)(A) and (B) of the Securities Exchange Act of 1934 (the Exchange Act),

(3) ''government securities'' as defined in section 3(a)(42)(C) of the Exchange Act issued or guaranteed as to principal or interest by the following corporations: The Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Student Loan Marketing Association and the Financing Corporation,

(4) mortgage-backed securities meeting the definition of a ''mortgage related security'' set forth in section 3(a)(41) of the Exchange Act,

(5) negotiable certificates of deposit and bankers' acceptances issued by a ''bank'' as that term is defined in section 3(a)(6) of the Exchange Act, and which are payable in the United States and deemed to have a ''ready market'' as that term is defined in 17 CFR 240.15c3–1, or

(6) irrevocable letters of credit issued by a U.S. Bank other than the borrower or an affiliate thereof, or any combination thereof.

The final exemption contains a revised definition of ''Foreign Collateral'' that permits U.S. Banks, U.S. Broker-Dealers, Foreign Banks and Foreign Broker-Dealers to accept a broader range of collateral. The term ''Foreign Collateral'' is defined in section V(f) as:

(1) Securities issued by or guaranteed as to principal and interest by the following Multilateral Development Banks—the obligations of which are backed by the participating countries, including the United States: The International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development and the International Finance Corporation.

(2) Foreign sovereign debt securities provided that at least one nationally recognized statistical rating organization has rated in one of its two highest categories either the issue, the issuer or guarantor;

(3) the British pound, Canadian dollar, Swiss franc, Japanese yen or the Euro;

(4) irrevocable letters of credit issued by a Foreign Bank, other than the borrower or an affiliate thereof, which has a counterparty rating of investment grade or better as determined by a nationally recognized statistical rating organization; or

(5) any type of collateral described in Rule 15c3–3 of the Exchange Act, as amended from time to time, provided that the lending fiduciary is a U.S. Bank or U.S. Broker-Dealer and such fiduciary indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs which a plan may incur or suffer directly arising out of a borrower default.

The Department notes that section II(c) of the exemption remains unchanged from the proposal and requires that plans receive collateral from borrowers by physical delivery, by wire transfer or by book entry in a securities depository located in the United States. For borrowers that are Foreign Banks and Foreign Broker-Dealers, the exemption requires that the plan receive either collateral by physical delivery, by wire entry or by book entry in a securities depository located in the United States or held on behalf of the plan at an Eligible Securities Depository as defined in section V(i)of the exemption.

Section II(d) of the exemption has been modified in light of the expanded definition of ''Foreign Broker-Dealer'' and ''Foreign Bank.'' That section requires that the borrower furnish the Lending Fiduciary with its most recent available audited statement of the borrower's financial condition, as audited by a United States certified public accounting firm or in the case of a borrower that is a Foreign Broker-Dealer or Foreign Bank, a firm which is eligible or authorized to issue audited financial statements in conformity with accounting principles generally accepted in the primary jurisdiction that governs the borrowing Foreign Broker-Dealer or Foreign Bank.

Under section II(e) of the exemption, the loan must be made pursuant to a written loan agreement. Section II(e) further requires that the securities lending agreement must give the plan a continuing security interest in, title to, or the rights of a secured creditor with respect to the collateral received by the plan. In section (f) of the exemption, the plan may receive a reasonable fee in connection with the securities loan or have the opportunity to derive compensation through the investment of the currency collateral. The plan may pay a loan rebate or similar fee to the borrower where the plan invests the currency collateral.

Section II(g) of the exemption requires that the fees and other consideration received by the plan in connection with the loan of securities must be reasonable. The identity of the currency in which payment of fees and rebates will be made must be disclosed to the plan either in the written loan agreement or the loan confirmation as agreed to by the borrower and the plan (or Lending Fiduciary) prior to the making of the loan.

Under the exemption, section II(h) requires that the plan receive the equivalent of all distributions made to holders of the borrower securities during the term of the loan including, but not limited to, dividends, interest payments, shares of stock as a result of stock splits and rights to purchase additional securities. Section II(i) requires that, if the market value of the collateral at the close of trading on a business day is less than the applicable percentage of the market value of the borrowed securities at the close of trading on that day, then the borrower shall deliver, by the close of business on the following business day, an additional amount of U.S. Collateral or Foreign Collateral, the market value of which, together with the market value of all previously delivered collateral, equals at least the applicable percentage of the market value of all borrowed securities as of such preceding day. Notwithstanding the foregoing, part of the U.S. Collateral or Foreign Collateral may be returned to the borrower if the market value of the collateral exceeds the applicable percentage described in this exemption as long as the market value of the remaining collateral equals the applicable percentage described in the exemption of the market value of the borrowed securities.

Under section II(j) of the exemption, a plan may terminate a loan at any time. Section II(k) of the exemption permits a plan to purchase securities identical to the loaned securities if the borrower does not return the loaned securities, and obligates the borrower to pay to the plan any amount of remaining obligation and expenses not covered by the collateral. Section II(l) of the

[5] The Department notes that this requirement would not preclude the Lending Fiduciary from requiring additional collateral should the circumstances so warrant.

exemption states that if a borrower fails to comply with any provision of a loan agreement which requires compliance with this exemption, the plan fiduciary who caused the plan to engage in such transaction shall not be deemed to have caused the plan to engage in a transaction prohibited by section 406(a)(1)(A) through (D) of ERISA solely by reason of the borrower's failure to comply with the conditions of the exemption.

Section III of the exemption contains conditions that are applicable to securities lending transactions with Foreign Broker-Dealers and Foreign Banks. Section III(a) requires that the lending fiduciary maintain the situs of the loan agreement in accordance with the indicia of ownership requirements under section 404(b) of ERISA and the regulations promulgated under 29 CFR 2550.404(b)-1. Further, section III(b) requires that a foreign borrower agree to submit to the jurisdiction of the district courts of the United States, and agree that the plan may in its sole discretion enforce the agreement in a U.S. court. It is the Department's understanding that in the event the borrower were to default, the plan would be able to secure a judgment in the United States which would be enforceable in a UK or a Canadian court. As an alternative to the requirement that the Foreign Broker-Dealer or Foreign Bank must agree to submit to the jurisdiction of the United States courts, the lending fiduciary may, if a U.S. Bank or U.S. Broker-Dealer, indemnify the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction cost incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under the exemption) which the plan may incur or suffer directly arising out of a borrower's default.

The final exemption contains a new condition in section III(c) which requires that in the case of a securities lending transaction involving a Foreign Broker-Dealer or a Foreign Bank that is described in section V(c)(2) or V(d)(2), the Lending Fiduciary must be a U.S. Bank or U.S. Broker-Dealer and prior to entering into the loan transaction, such fiduciary must agree to indemnify the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under this provision) which the plan may incur or suffer directly arising out of a borrower default. It is the Department's understanding that, in the event of a borrower default, the plan would be able to recover from the lending fiduciary, in the United States, the amount it is entitled to under the indemnification agreement.

As in the proposal, section IV of the exemption incorporates the conditions of PTE 82–63. Section V of the exemption contains the definitions. Unless noted above, the definitions of the exemption remain as they were in the proposed exemption.

The Department has added section VI that specifies the effective dates of the final exemption and the revocation of PTEs 81–6 and 82–63.

Lastly, the Department notes that section 611(d)(1) of the Pension Protection Act of 2006 (Pub. L. 109–280) (the PPA) amended the Employee Retirement Income Security Act of 1974 (ERISA) in part, by adding a new section 408(b)(17) which provides relief from ERISA section 406(a)(1)(A), (B) and (D) for any transaction between a plan and a person that is a party in interest other than fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or renders investment advice (within the meaning of section 3(21)(A)(ii)) with respect to those assets, solely by reason of providing services to the plan or solely by reason of a relationship to such a service provider described in ERISA section 3(14)(F), (G), (H) or (I), or both, but only if in connection with such transaction the plan receives no less, nor pays more, than adequate consideration.[6] The Department notes that to the extent that a transaction involving a loan of securities by a plan to a party in interest meets the requirements of ERISA section 408(b)(17), such transaction does not need to comply with the terms of this class exemption. The Department further notes that the new section 408(b)(17) will not be available for the payment of compensation to a plan's securities lending agent. In this regard, see 408(b)(2) of ERISA and section I(c) of this final exemption for relief permitting the payment of compensation related to foreign securities lending services.

[6] Section 611(d)(2) of the PPA provided similar exemptive relief in amending section 4975 of the Code to add the new section 4975(c)(20).

General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of ERISA and section 4975(c)(2) of the Code does not relieve a fiduciary or other party in interest or disqualified person from certain other provisions of ERISA and the Code. These provisions include any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of ERISA which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of ERISA; nor does it affect the requirement of section 401(a) of the Code that the plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries;

(2) In accordance with section 408(a) of ERISA and section 4975(c)(2) of the Code, and based on the entire record, the Department finds that the exemption is administratively feasible, in the interests of the plan(s) and of its participants and beneficiaries, and protective of the rights of the participants and beneficiaries of the plan;

(3) This exemption is supplemental to, and not in derogation of, any other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction; and

(4) The class exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the class exemption.

Exemption

Accordingly, the following exemption is granted under the authority of section 408(a) of ERISA and section 4975(c)(2) of the Code and in accordance with the procedures set forth in 29 CFR part 2570, subpart B (55 FR 32836, August 10, 1990).

I. Transactions

(a) Effective January 2, 2007, the restrictions of section 406(a)(1)(A) through (D) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the lending of securities that are assets of an employee benefit plan to a ''U.S. Broker-Dealer'' or to a ''U.S. Bank,'' provided that the conditions set forth in section II below are met.

(b) Effective January 2, 2007, the restrictions of section 406(a)(1)(A) through (D) of ERISA and the taxes imposed by section 4975(a) and (b) of

the Code by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the lending of securities that are assets of an employee benefit plan to a ''Foreign Broker-Dealer'' or ''Foreign Bank'', provided that the conditions set forth in sections II and III below are met.

(c) Effective January 2, 2007, the restrictions of section 406(b)(1) of ERISA and the taxes imposed by section 4975(a) and (b) of the Code by reason of section 4975(c)(1)(E) of the Code shall not apply to the payment to a fiduciary (the Lending Fiduciary) of compensation for services rendered in connection with loans of plan assets that are securities, provided that the conditions set forth in section IV below are met.

II. General Conditions For Transactions Described in Sections I(a) and I(b)

(a) Neither the borrower nor any affiliate of the borrower has or exercises discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice (within the meaning of 29 CFR 2510.3–21(c)) with respect to those assets;

(b) The plan receives from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower, (1) ''U.S. Collateral'' having, as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than 100 percent of the then market value of the securities lent; or

(2) ''Foreign Collateral'' having as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than:

(i) 102 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent, or

(ii) 105 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in V(k)) on which the securities are primarily traded if the collateral posted is denominated in a different currency than the securities lent.

Notwithstanding the foregoing, if the Lending Fiduciary is a U.S. Bank or U.S. Broker-Dealer, and such Lending Fiduciary indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default, the plan receives from the borrower by the close of the Lending Fiduciary's business on the day in which the securities lent are delivered to the borrower, ''Foreign Collateral'' having as of the close of business on the preceding business day, a market value or, in the case of bank letters of credit, a stated amount, equal to not less than:

(i) 100 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in section V(k)) on which the securities are primarily traded if the collateral posted is denominated in the same currency as the securities lent; or

(ii) 101 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in V(k)) on which the securities are primarily traded if the collateral posted is denominated in a different currency than the securities lent and such currency is denominated in Euros, British pounds, Japanese yen, Swiss francs or Canadian dollars; or

(iii) 105 percent of the then market value of the securities lent as valued on a recognized securities exchange (as defined in section V(j)) or an automated trading system (as defined in V(k)) if the collateral posted is denominated in a different currency than the securities lent and such currency is other than those specified above.

(c)(1) If the borrower is a U.S. Bank or U.S. Broker-Dealer, the Plan receives such U.S. Collateral or Foreign Collateral from the borrower by the close of the Lending Fiduciary's business on the day in which the securities are delivered to the borrower. Such collateral is received by the plan either by physical delivery, wire transfer or by book entry in a securities depository located in the United States. or,

(2) If the borrower is a Foreign Bank or Foreign Broker-Dealer, the plan receives U.S. Collateral or Foreign Collateral from the borrower by the close of the Lending Fiduciary's business on the day in which the securities are delivered to the borrower. Such collateral is received by the plan either by physical delivery, wire transfer or by book entry in a securities depository located in the United States or held on behalf of the plan at an Eligible Securities Depository. The indicia of ownership of such collateral shall be maintained in accordance with section 404(b) of ERISA and 29 CFR 2550.404b–1.

(d) Prior to making of any such loan, the borrower shall have furnished the Lending Fiduciary with:

(1) The most recent available audited statement of the borrower's financial condition, as audited by a United States certified public accounting firm or in the case of a borrower that is a Foreign Broker-Dealer or Foreign Bank, a firm which is eligible or authorized to issue audited financial statements in conformity with accounting principles generally accepted in the primary jurisdiction that governs the borrowing Foreign Broker-Dealer or Foreign Bank;

(2) The most recent available unaudited statement of its financial condition (if the unaudited statement is more recent than such audited financial statement); and

(3) A representation that, at the time the loan is negotiated, there has been no material adverse change in its financial condition since the date of the most recent financial statement furnished to the plan that has not been disclosed to the Lending Fiduciary. Such representations may be made by the borrower's agreement that each loan shall constitute a representation by the borrower that there has been no such material adverse change.

(e) The loan is made pursuant to a written loan agreement, the terms of which are at least as favorable to the plan as an arm's-length transaction with an unrelated party would be. Such loan agreement states that the plan has a continuing security interest in, title to, or the rights of a secured creditor with respect to the collateral. Such agreement may be in the form of a master agreement covering a series of securities lending transactions.

(f) In return for lending securities, the plan:

(1) Receives a reasonable fee (in connection with the securities lending transaction), and/or

(2) Has the opportunity to derive compensation through the investment of the currency collateral. Where the plan has that opportunity, the plan may pay a loan rebate or similar fee to the borrower, if such fee is not greater than the plan would pay in a comparable transaction with an unrelated party.

(g) All fees and other consideration received by the plan in connection with the loan of securities are reasonable. The identity of the currency in which the payment of fees and rebates will be made shall be disclosed to the plan either in the written loan agreement or the loan confirmation as agreed to by the borrower and the plan (or Lending Fiduciary) prior to the making of the loan.

(h) The plan receives the equivalent of all distributions made to holders of the borrowed securities during the term of the loan including, but not limited to, dividends, interest payments, shares of stock as a result of stock splits and rights to purchase additional securities;

(i) If the market value of the collateral at the close of trading on a business day is less than the applicable percentage of the market value of the borrowed

securities at the close of trading on that day (as described in section II(b) of this exemption), then the borrower shall deliver, by the close of business on the following business day, an additional amount of U.S. Collateral or Foreign Collateral the market value of which, together with the market value of all previously delivered collateral, equals at least the applicable percentage of the market value of all the borrowed securities as of such preceding day.

Notwithstanding the foregoing, part of the U.S. Collateral or Foreign Collateral may be returned to the borrower if the market value of the collateral exceeds the applicable percentage (described in section II(b)) of the exemption) of the market value of the borrowed securities, as long as the market value of the remaining U.S. Collateral or Foreign Collateral equals at least the applicable percentage of the market value of the borrowed securities;

(j) The loan may be terminated by the plan at any time, whereupon the borrower shall deliver certificates for securities identical to the borrowed securities (or the equivalent thereof in the event of reorganization, recapitalization or merger of the issuer of the borrowed securities) to the plan within the lesser of:

(1) The customary delivery period for such securities,

(2) Five business days, or

(3) The time negotiated for such delivery by the plan and the borrower.

(k) In the event that the loan is terminated, and the borrower fails to return the borrowed securities or the equivalent thereof within the applicable time described in section II(j) above, the plan may, under the terms of the loan agreement:

(1) Purchase securities identical to the borrowed securities (or their equivalent as described above) and may apply the collateral to the payment of the purchase price, any other obligations of the borrower under the agreement, and any expenses associated with the sale and/or purchase, and

(2) The borrower is obligated, under the terms of the loan agreement, to pay, and does pay to the plan the amount of any remaining obligations and expenses not covered by the collateral, including reasonable attorney's fees incurred by the plan for legal action arising out of default on the loans, plus interest at a reasonable rate.

Notwithstanding the foregoing, the borrower may, in the event the borrower fails to return borrowed securities as described above, replace collateral, other than U.S. currency, with an amount of U.S. currency that is not less than the then current market value of the collateral, provided such replacement is approved by the Lending Fiduciary.

(l) If the borrower fails to comply with any provision of a loan agreement which requires compliance with this exemption, the plan fiduciary who caused the plan to engage in such transaction shall not be deemed to have caused the plan to engage in a transaction prohibited by section 406(a)(1)(A) through (D) of ERISA solely by reason of the borrower's failure to comply with the conditions of the exemption.

III. Specific Conditions For Transactions Described in Section I(b)

(a) The Lending Fiduciary maintains the written documentation for the loan agreement at a site within the jurisdiction of the courts of the United States.

(b) Prior to entering into a transaction involving a Foreign Broker-Dealer that is described in section V(c)(1) or a Foreign Bank that is described in section V(d)(1) either:

(1) The Foreign Broker-Dealer or Foreign Bank agrees to submit to the jurisdiction of the United States; agrees to appoint an agent for service of process in the United States, which may be an affiliate (the Process Agent); consents to service of process on the Process Agent; and agrees that any enforcement by a plan of its rights under the securities lending agreement will, at the option of the plan, occur exclusively in the United States courts; or

(2) The Lending Fiduciary, if a U.S. Bank or U.S. Broker-Dealer, agrees to indemnify the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under this provision) which the plan may incur or suffer directly arising out of a borrower default by the Foreign Broker-Dealer or Foreign Bank.

(c) In the case of a securities lending transaction involving a Foreign Broker-Dealer that is described in section V(c)(2) or a Foreign Bank that is described in section V(d)(2), the Lending Fiduciary must be a U.S. Bank or U.S. Broker-Dealer, and prior to entering into the loan transaction, such fiduciary must agree to indemnify the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs incurred (including attorney's fees of such plan arising out of the default on the loans or the failure to indemnify properly under this provision) which the plan may incur or suffer directly arising out of a borrower default by the Foreign Broker-Dealer or Foreign Bank.

IV. Specific Conditions for Transactions Described in Section I(c)

(a) The loan of securities is not prohibited by section 406(a) of ERISA or otherwise satisfies the conditions of this exemption.

(b) The Lending Fiduciary is authorized to engage in securities lending transactions on behalf of the plan.

(c) The compensation is reasonable and is paid in accordance with the terms of a written instrument, which may be in the form of a master agreement covering a series of securities lending transactions.

(d) Except as otherwise provided in section IV(f), the arrangement under which the compensation is paid:

(1) Is subject to the prior written authorization of a plan fiduciary (the "authorizing fiduciary"), who is (other than in the case of a plan covering only employees of the Lending Fiduciary or any affiliates of such fiduciary) independent of the Lending Fiduciary and of any affiliate thereof, and

(2) May be terminated by the authorizing fiduciary within:

(A) The time negotiated for such notice of termination by the plan and the Lending Fiduciary, or

(B) five business days, whichever is less, in either case without penalty to the plan.

(e) No such authorization is made or renewed unless the Lending Fiduciary shall have furnished the authorizing fiduciary with any reasonably available information which the Lending Fiduciary reasonably believes to be necessary to determine whether such authorization should be made or renewed, and any other reasonably available information regarding the matter that the authorizing fiduciary may reasonably request.

(f) (Special Rule for Commingled Investment Funds) In the case of a pooled separate account maintained by an insurance company qualified to do business in a State or a common or collective trust fund maintained by a bank or trust company supervised by a State or Federal agency, the requirements of section IV(d) of this exemption shall not apply, provided that:

(1) The information described in section IV(e) (including information with respect to any material change in the arrangement) shall be furnished by the Lending Fiduciary to the authorizing fiduciary described in section IV(d) with respect to each plan whose assets are invested in the account or fund, not less than 30 days prior to implementation of the arrangement or material change thereto, and, where requested, upon the reasonable request of the authorizing fiduciary;

(2) In the event any such authorizing fiduciary submits a notice in writing to the Lending Fiduciary objecting to the implementation of, material change in, or continuation of the arrangement, the plan on whose behalf the objection was tendered is given the opportunity to terminate its investment in the account or fund, without penalty to the plan, within such time as may be necessary to effect such withdrawal in an orderly manner that is equitable to all withdrawing plans and to the non-withdrawing plans. In the case of a plan that elects to withdraw pursuant to the foregoing, such withdrawal shall be effected prior to the implementation of, or material change in, the arrangement; but an existing arrangement need not be discontinued by reason of a plan electing to withdraw; and

(3) In the case of a plan whose assets are proposed to be invested in the account or fund subsequent to the implementation of the compensation arrangement and which has not authorized the arrangement in the manner described in sections IV(f)(1) and IV(f)(2), the plan's investment in the account or fund shall be authorized in the manner described in section IV(d)(1).

V. Definitions

For purposes of this exemption:

(a) The term ''U.S. Broker-Dealer'' means a broker-dealer registered under the Securities Exchange Act of 1934 (the 1934 Act or the Exchange Act) or exempted from registration under section 15(a)(1) of the 1934 Act as a dealer in exempted government securities (as defined in section 3(a)(12) of the 1934 Act).

(b) The term ''U.S. Bank'' means a bank as defined in section 202(a)(2) of the Investment Advisers Act.

(c) The term ''Foreign Broker-Dealer'' means a broker-dealer that has, as of the last day of its most recent fiscal year, equity capital that is equivalent of no less than $200 million and is:

(1) (i) Registered and regulated under the laws of the Financial Services Authority in the United Kingdom, or

(ii)(a) registered and regulated by a securities commission of a Province of Canada that is a member of the Canadian Securities Administration, and (b) is subject to the oversight of a Canadian self-regulatory authority; or

(2) registered and regulated under the relevant securities laws of a governmental entity of a country other than the United States, and such securities laws and regulation were applicable to a broker-dealer that received: (i) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a broker-dealer or (ii) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended, involving the loan of securities by a plan to a broker-dealer.

(d) The term ''Foreign Bank'' means an institution that has substantially similar powers to a bank as defined in section 202(a)(2) of the Investment Advisers Act, has as of the last day of its most recent fiscal year, equity capital which is equivalent of no less than $200 million, and is subject to:

(1) Regulation by the Financial Services Authority in the United Kingdom or the Office of the Superintendent of Financial Institutions in Canada, or

(2) regulation by the relevant governmental banking agency(ies) of a country other than the United States, and the regulation and oversight of these banking agencies were applicable to a bank that received: (a) An individual exemption, granted by the Department under section 408(a) of ERISA, involving the loan of securities by a plan to a bank or (b) a final authorization by the Department to engage in an otherwise prohibited transaction pursuant to PTE 96–62, as amended, involving the loan of securities by a plan to a bank.

(e) The term ''U.S. Collateral'' means:

(1) U.S. currency;

(2) ''government securities'' as defined in section 3(a)(42)(A) and (B) of the Exchange Act;

(3) ''government securities'' as defined in section 3(a)(42)(C) of the Exchange Act issued or guaranteed as to principal or interest by the following corporations: The Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, the Student Loan Marketing Association and the Financing Corporation

(4) mortgage-backed securities meeting the definition of a ''mortgage related security'' set forth in section 3(a)(41) of the Exchange Act;

(5) negotiable certificates of deposit and bankers acceptances issued by a ''bank'' as that term is defined in section 3(a)(6) of the Exchange Act, and which are payable in the United States and deemed to have a ''ready market'' as that term is defined in 17 CFR 240.15c3–1; or

(6) irrevocable letters of credit issued by a U.S. Bank other than the borrower or an affiliate thereof, or any combination, thereof.

(f) The term ''Foreign Collateral'' means:

(1) Securities issued by or guaranteed as to principal and interest by the following Multilateral Development Banks—the obligations of which are backed by the participating countries, including the United States: The International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development and the International Finance Corporation;

(2) foreign sovereign debt securities provided that at least one nationally recognized statistical rating organization has rated in one of its two highest categories either the issue, the issuer or guarantor;

(3) the British pound, the Canadian dollar, the Swiss franc, the Japanese yen or the Euro;

(4) irrevocable letters of credit issued by a Foreign Bank, other than the borrower or an affiliate thereof, which has a counterparty rating of investment grade or better as determined by a nationally recognized statistical rating organization; or

(5) any type of collateral described in Rule 15c3–3 of the Exchange Act as amended from time to time provided that the lending fiduciary is a U.S. Bank or U.S. Broker-Dealer and such fiduciary indemnifies the plan with respect to the difference, if any, between the replacement cost of the borrowed securities and the market value of the collateral on the date of a borrower default plus interest and any transaction costs which a plan may incur or suffer directly arising out of a borrower default. Notwithstanding the foregoing, collateral described in any of the categories enumerated in section V(e) will be considered U.S. Collateral for purposes of the exemption.

(g) The term ''affiliate'' of another person means:

(1) Any person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with such person;

(2) Any officer, director, partner, employee, or relative (as defined in section 3(15) of ERISA) of such other person; and

(3) Any corporation or partnership of which such other person is an officer, director, partner or employee.

(h) The term ''control'' means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(i) The term ''Eligible Securities Depository'' means an eligible securities depository as that term is defined under Rule 17f-7 of the Investment Company Act of 1940 [15 U.S.C. 80a], as such definition may be amended from time to time.

(j) The term ''recognized securities exchange'' means a U.S. securities exchange that is registered as a ''national securities exchange'' under section 6 of the Exchange Act of 1934 (15 U.S.C. 78f) or a designated offshore securities market as defined in Regulation S of the Securities Act of 1933 [17 CFR part 230.902(B)], as such definition may be amended from time to time, which performs with respect to securities, the functions commonly performed by a stock exchange within the meaning of the definitions under the applicable securities laws (*e.g.*, 17 CFR part 240.3b-16).

(k) The term ''automated trading system'' means an electronic trading system that functions in a manner intended to simulate a securities exchange by electronically matching orders on an agency basis from multiple buyers and sellers such as an ''alternative trading system'' within the meaning of SEC's Reg. ATS [17 CFR part 242.300] as such definition may be amended from time to time, or an ''automated quotation system'' as described in section 3(a)(51)(A)(ii) of the Securities and Exchange Act of 1934 [15 U.S.C. 78c(a)(51)(A)(ii)].

(l) The term ''lending of securities'' or ''loan of securities'' shall include securities loans that are structured as repurchase agreements provided, that all terms of the exemption are otherwise met.

VI. Effective Dates

(a) This exemption is effective on January 2, 2007.

(b) PTEs 81–6 and 82–63 are revoked effective January 2, 2007.

Signed at Washington, DC, this 25th day of October, 2006.

Ivan L. Strasfeld,

Director, Office of Exemption Determinations, Employee Benefits Security Administration, U.S. Department of Labor.

[FR Doc. E6–18238 Filed 10–30–06; 8:45 am]

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DEPARTMENT OF LABOR

Employment and Training Administration

Notice of Determinations Regarding Eligibility To Apply for Worker Adjustment Assistance and Alternative Trade Adjustment Assistance

In accordance with Section 223 of the Trade Act of 1974, as amended (19 U.S.C. 2273) the Department of Labor herein presents summaries of determinations regarding eligibility to apply for trade adjustment assistance for workers (TA–W) number and alternative trade adjustment assistance (ATAA) by (TA–W) number issued during the period of October 2 through October 6, 2006.

In order for an affirmative determination to be made for workers of a primary firm and a certification issued regarding eligibility to apply for worker adjustment assistance, each of the group eligibility requirements of Section 222(a) of the Act must be met.

I. Section (a)(2)(A) all of the following must be satisfied:

A. A significant number or proportion of the workers in such workers' firm, or an appropriate subdivision of the firm, have become totally or partially separated, or are threatened to become totally or partially separated;

B. The sales or production, or both, of such firm or subdivision have decreased absolutely; and

C. Increased imports of articles like or directly competitive with articles produced by such firm or subdivision have contributed importantly to such workers' separation or threat of separation and to the decline in sales or production of such firm or subdivision; or

II. Section (a)(2)(B) both of the following must be satisfied:

A. A significant number or proportion of the workers in such workers' firm, or an appropriate subdivision of the firm, have become totally or partially separated, or are threatened to become totally or partially separated;

B. There has been a shift in production by such workers' firm or subdivision to a foreign country of articles like or directly competitive with articles which are produced by such firm or subdivision; and

C. One of the following must be satisfied:

1. The country to which the workers' firm has shifted production of the articles is a party to a free trade agreement with the United States;

2. The country to which the workers' firm has shifted production of the articles to a beneficiary country under the Andean Trade Preference Act, African Growth and Opportunity Act, or the Caribbean Basin Economic Recovery Act; or

3. There has been or is likely to be an increase in imports of articles that are like or directly competitive with articles which are or were produced by such firm or subdivision.

Also, in order for an affirmative determination to be made for secondarily affected workers of a firm and a certification issued regarding eligibility to apply for worker adjustment assistance, each of the group eligibility requirements of Section 222(b) of the Act must be met.

(1) Significant number or proportion of the workers in the workers' firm or an appropriate subdivision of the firm have become totally or partially separated, or are threatened to become totally or partially separated;

(2) The workers' firm (or subdivision) is a supplier or downstream producer to a firm (or subdivision) that employed a group of workers who received a certification of eligibility to apply for trade adjustment assistance benefits and such supply or production is related to the article that was the basis for such certification; and

(3) Either—

(A) The workers' firm is a supplier and the component parts it supplied for the firm (or subdivision) described in paragraph (2) accounted for at least 20 percent of the production or sales of the workers' firm; or

(B) A loss of business by the workers' firm with the firm (or subdivision) described in paragraph (2) contributed importantly to the workers' separation or threat of separation.

In order for the Division of Trade Adjustment Assistance to issue a certification of eligibility to apply for Alternative Trade Adjustment Assistance (ATAA) for older workers, the group eligibility requirements of Section 246(a)(3)(A)(ii) of the Trade Act must be met.

1. Whether a significant number of workers in the workers' firm are 50 years of age or older.

2. Whether the workers in the workers' firm possess skills that are not easily transferable.

3. The competitive conditions within the workers' industry (*i.e.*, conditions within the industry are adverse).

Affirmative Determinations for Worker Adjustment Assistance

The following certifications have been issued. The date following the company name and location of each determination references the impact date for all workers of such determination.

The following certifications have been issued. The requirements of Section 222(a)(2)(A) (increased imports) of the Trade Act have been met.

None.

The following certifications have been issued. The requirements of Section 222(a)(2)(B) (shift in production) of the Trade Act have been met.

None.

The following certifications have been issued. The requirements of Section 222(b) (supplier to a firm whose workers are certified eligible to apply for TAA) of the Trade Act have been met.

None.

The following certifications have been issued. The requirements of Section 222(b) (downstream producer for a firm whose workers are certified eligible to apply for TAA based on increased imports from or a shift in production to Mexico or Canada) of the Trade Act have been met.

None.

Affirmative Determinations for Worker Adjustment Assistance and Alternative Trade Adjustment Assistance

The following certifications have been issued. The date following the company name and location of each determination references the impact date for all workers of such determination.

The following certifications have been issued. The requirements of Section 222(a)(2)(A) (increased imports) and Section 246(a)(3)(A)(ii) of the Trade Act have been met.

TA–W–60,003; Central Products Co., Brighton, CO: September 1, 2005.

TA–W–60,084; Hekman Furniture Co., Grand Rapids, MI: September 13, 2005.

TA–W–60,177; Hooker Furniture Corp., Martinsville, VA: September 29, 2005.

TA–W–59,980; Mechanical Products Manufacturing, Co., Lucasville, OH: August 18, 2005.

The following certifications have been issued. The requirements of Section 222(a)(2)(B) (shift in production) and Section 246(a)(3)(A)(ii) of the Trade Act have been met.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

29 CFR 2509.75-2 - Interpretive bulletin relating to prohibited transactions.

Section Number: 2509.75-2
Section Name: Interpretive bulletin relating to prohibited transactions.

On February 6, 1975, the Department of Labor issued an interpretive bulletin, ERISA IB 75-2, with respect to whether a party in interest has engaged in a prohibited transaction with an employee benefit plan where the party in interest has engaged in a transaction with a corporation or partnership (withinthe meaning of section 7701 of the Internal Revenue Code of 1954) in which the plan has invested.On November 13, 1986 the Department published a final regulation
dealing with the definition of ``plan assets''. See Sec. 2510.3-101 of this title. Under that regulation,theassets of certain entities in which plans invest would include ``plan assets'' for purposes of the fiduciary responsibility provisions of the Act. Section 2510.3-101 applies only for purposes of identifying plan assets on or after the effective date of that section, however, and Sec. 2510.3-101 does not apply to plan investments in certain entities that qualify for the transitional relief provided for in paragraph (k) of that section. The principles discussed in paragraph (a) of this Interpretive Bulletin continue to be applicable for purposes of identifying assets of a plan for periods prior to the effective date of Sec. 2510.3-101 and for investments that are subject to the transitional rule in Sec. 2510.3-
101(k). Paragraphs (b) and (c) of this Interpretive Bulletin, however, relate to matters outside the scope of Sec. 2510.3-101, and nothing in that section affects the continuing application of the principles discussed in those parts.

(a) Principles applicable to plan investments to which Sec. 2510.3-101 does not apply. Generally, investment by a plan in securities (within the meaning of section 3(20) of the Employee Retirement Income Security Act of 1974) of a corporation or partnership will not, solely by reason of such investment, be considered to be an investment in the underlying assets of such corporation or partnership so as to make such assets of the entity ``plan assets'' and thereby make a subsequent
transaction between the party in interest and the corporation or partnership a prohibited transaction under section 406 of the Act. For example, where a plan acquires a security of a corporation or a
limited partnership interest in a partnership, a subsequent lease or sale of property between such corporation or partnership and a party in interest will not be a prohibited transaction solely by reason of the plan's investment in the corporation or partnership. This general proposition, as applied to corporations and partnerships, is consistent with section 401(b)(1) of the Act, relating to plan investments in investment companies registered under the Investment Company Act of 1940. Under section 401(b)(1), an investment by a plan in securities of such an investment company may be made
without causing, solely by reason of such investment, any of the assets of the investment company to be considered to be assets of the plan.

(b) [Reserved]

(c) Applications of the fiduciary responsibility rules. The preceding paragraphs do not mean that an investment of plan assets in a security of a corporation or partnership may not be a prohibited
transaction. For example, section 406(a)(1)(D) prohibits the direct or indirect transfer to, or use by or for the benefit of, a party in interest of any assets of the plan and section 406(b)(1) prohibits a
fiduciary from dealing with the assets of the plan in his own interest or for his own account.
Thus, for example, if there is an arrangement under which a plan invests in, or retains its investment in, an

investment company and as part of the arrangement it is expected that the investment company will purchase securities from a party in interest, such arrangement is a prohibited transaction. Similarly, the purchase by a plan of an insurance policy pursuant to an arrangement under which it is expected that the insurance company will make a loan to a party in interest is a prohibited transaction. Moreover, notwithstanding the foregoing, if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and such corporation or partnership will ordinarily be a prohibited transaction if the plan may, by itself, require the corporation or partnership to engage in such transaction. Similarly, if a transaction between a party in interest and a plan would be a prohibited transaction, then such a transaction between a party in interest and such corporation or partnership will ordinarily be a prohibited transaction if such party in interest, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14)(E) through (I)) to such party in interest may, with the aid of the plan but without the aid of any other persons, require the corporation or partnership to engage in such a transaction. However, the preceding sentence does not apply if the parties in interest engaging in the transaction, together with one or more persons who are parties in interest by reason of such persons' relationship (within the meaning of section 3(14)(E) through (I)) to such party in interest, may, by themselves, require the corporation or partnership to engage in the transaction. Further, the Department of Labor emphasizes that it would consider a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act.

[51 FR 41280, Nov. 13, 1986, as amended at 61 FR 33849, July 1, 1996]

Trust Examination Manual

29 CFR 2509.75-3 - Interpretive bulletin relating to investments by employee benefit plans in securities of registered investment companies.

Section Number: 2509.75-3
Section Name: Interpretive bulletin relating to investments by employee benefit plans in securities of registered investment companies.

On March 12, 1975, the Department of Labor issued an interpretive bulletin, ERISA IB 75-3, with regard to its interpretation of section 3(21)(B) of the Employee Retirement Income Security Act of 1974. That section provides that an investment by an employee benefit plan in securities issued by an investment company registered under the Investment Company Act of 1940 shall not by itself cause the investment company, its investment adviser or principal underwriter to be deemed to be a fiduciary or party in interest ``except insofar as such investment company or its investment adviser or principal underwriter acts in connection with an employee benefit plan covering employees of the investment company, the investment adviser, or its principal underwriter.''

The Department of Labor interprets this section as an elaboration of the principle set forth in section 401(b)(1) of the Act and ERISA IB 75-2 (issued February 6, 1975) that the assets of an investment company shall not be deemed to be assets of a plan solely by reason of an investment by such plan in the shares of such investment company. Consistent with this principle, the Department of Labor interprets this section to mean that a person who is connected with an investment company, such as the investment company itself, its investment adviser or its principal underwriter, is not to be deemed to be a fiduciary of or party in interest with respect to a plan solely because the plan has invested in the investment company's shares. This principle applies, for example, to a plan covering employees of an investment adviser to an investment company where the plan invests in the securities of the investment company. In such a case the investment company or its principal underwriter is not to be deemed to be a fiduciary of or party in interest with respect to the plan solely because of such investment.On the other hand, the exception clause in section 3(21) emphasizes that if an investment company, its investment adviser or its principal underwriter is a fiduciary or party in interest for a reason other than
the investment in the securities of the investment company, such a person remains a party in interest or fiduciary. Thus, in the preceding example, since an employer is a party in interest, the investment adviser remains a party in interest with respect to a plan covering its employees.

The Department of Labor emphasized that an investment adviser, principal underwriter or investment company which is a fiduciary by virtue of section 3(21)(A) of the Act is subject to the fiduciary responsibility provisions of part 4 of title I of the Act, including those relating to fiduciary duties under section 404.

[40 FR 31599, July 28, 1975. Redesignated at 41 FR 1906, Jan. 13, 1976]

29 CFR 2509.75-4 - Interpretive bulletin relating to indemnification of fiduciaries.

Section Number: 2509.75-4
Section Name: Interpretive bulletin relating to indemnification of fiduciaries.

On June 4, 1975, the Department of Labor issued an interpretive bulletin, ERISA IB 75-4, announcing the Department's interpretation of section 410(a) of the Employee Retirement Income Security Act of 1974, insofar as that section relates to indemnification of fiduciaries.
Section 410(a) states, in relevant part, that ``any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.'' The Department of Labor interprets this section to permit indemnification agreements which do not relieve a fiduciary of responsibility or liability under part 4 of title I. Indemnification provisions which leave the fiduciary fully responsible and liable, but
merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance purchased under section 410(b)(3), are therefore not void under section 410(a).
Examples of such indemnification provisions are:

(1) Indemnification of a plan fiduciary by (a) an employer, any of whose employees are covered by the plan, or an affiliate (as defined in section 407(d)(7) of the Act) of such employer, or (b) an employee
organization, any of whose members are covered by the plan; and (2) Indemnification by a plan fiduciary of the fiduciary's employees who actually perform the fiduciary services.

The Department of Labor interprets section 410(a) as rendering void any arrangement for indemnification of a fiduciary of an employee benefit plan by the plan. Such an arrangement would have the same result as an exculpatory clause, in that it would, in effect, relieve the fiduciary of responsibility and liability to the plan by abrogating the plan's right to recovery from the fiduciary for breaches of fiduciary obligations. While indemnification arrangements do not contravene the provisions
of section 410(a), parties entering into an indemnification agreement should consider whether the agreement complies with the other provisions of part 4 of title I of the Act and with other applicable laws.

[40 FR 31599, July 28, 1975. Redesignated at 41 FR 1906, Jan. 13, 1976]

29 CFR 2509.75-6 - Interpretive bulletin relating to section 408(c)(2) of the Employee Retirement Income Security Act of 1974.

Section Number: 2509.75-6
Section Name: Interpretive bulletin relating to section 408(c)(2) of the Employee Retirement Income Security Act of 1974.

The Department of Labor today announced guidelines for determining when a party in interest with respect to an employee benefit plan may receive an advance for expenses to be incurred on behalf of the plan without engaging in a transaction prohibited by section 406 of the Employee Retirement Income Security Act of 1974. That section prohibits, among other things, any lending of money from a plan to a party in interest, or transfer to, or use by or for the benefit of, a party in interest of any assets of the plan, as well as any act whereby a fiduciary deals with the assets of a plan in his own interest or for his own account. However, section 408(c)(2) of the Act provides that nothing in section 406 of the Act shall be construed to prohibit the reimbursement by a plan of expenses properly and actually incurred by a fiduciary in the performance of his duties with the plan. Questions have arisen under
section 408(c)(2) of the Act as to whether a plan may reimburse a party in interest in the performance of his duties with the plan and as to whether a plan might make an advance to a fiduciary or other party in interest for expenses to be incurred in the future. The Department of Labor views the relevant provisions of section 408(c)(2) as clarifying the scope of section 406 so as to permit
reimbursement of fiduciaries for expenses incurred in the performance of their duties with a plan. Similarly, consistent with section 408(c)(2), section 406 is construed to permit the reimbursement by the plan of expenses properly and actually incurred by a party in interest in the
performance of his duties with the plan. If a plan makes an advance to a fiduciary or other party in interest to cover expenses to be properly and actually incurred by such person in
the performance of his duties with the plan, a prohibited transaction within the meaning of section 406 shall not occur when the plan makes the advance if--
(a) The amount of such advance is reasonable with respect to the amount of the expense which is likely to be properly and actually incurred in the immediate future (such as during the next month), and
(b) The party in interest accounts to the plan at the end of the period covered by the advance for the expenses actually incurred (whether computed on the basis of actual expenses incurred or on the
basis of actual transportation costs plus a reasonable per diem
allowance, where appropriate).

It should be noted, however, that despite the reasonableness of the amount of the advance and of the expenses underlying it, the question of whether incurring such expenses was prudent, and thus whether the advance was for reasonable expenses, is to be judged pursuant to section 404 of the Act (relating to fiduciary responsibilities).

[40 FR 31755, July 29, 1975. Redesignated at 41 FR 1906, Jan. 13, 1976]

29 CFR 2509.75-8 - Questions and answers relating to fiduciary responsibility under the Employee Retirement Income Security Act of 1974.

Section Number: 2509.75-8
Section Name: Questions and answers relating to fiduciary responsibility under the Employee Retirement Income Security Act of 1974.

The Department of Labor today issued questions and answers relating to certain aspects of fiduciary responsibility under the Act, thereby supplementing ERISA IB 75-5 (29 CFR 2555.75-5) which was issued on June 24, 1975, and published in the Federal Register on July 28, 1975 (40 FR 31598). Pending the issuance of regulations or other guidelines, persons may rely on the answers to these questions in order to resolve the issues that are specifically considered. No inferences should be drawn regarding issues not raised which may be suggested by a particular question and answer or as to why certain questions, and not others, are included. Furthermore, in applying the questions and answers, the effect of subsequent legislation, regulations, court decisions, and interpretive bulletins must be considered. To the extent that plans utilize or rely on these answers and the requirements of regulations subsequently adopted vary from the answers relied on, such plans may have to be amended. An index of the questions and answers, relating them to the appropriate sections of the Act, is also provided.

Index

Key to question prefixes: D--refers to definitions; FR--refers to fiduciary responsibility.

Section No.	Question No.
3(21)(A)	D-2, D-3, D-4, D-5.
3(38)	FR-15.
402(c)(1)	FR-12.
402(c)(2)	FR-15.
402(c)(3)	FR-15.
403(a)(2)	FR-15.
404(a)(1)(B)	FR-11, FR-17.
405(a)	FR-13, FR-14, FR-16.
405(c)(1)	FR-12, FR-15.
405(c)(2)	D-4, FR-13, FR-14, FR-16.
412	D-2.

Note: Questions D-2, D-3, D-4, and D-5 relate to not only section 3(21)(A) of title I of the Act, but also section 4975(e)(3) of the Internal Revenue Code (section 2003 of the Act). The Internal Revenue Service has indicated its concurrence with the answers to these questions.

D-2 Q: Are persons who have no power to make any decisions as to plan policy, interpretations, practices or procedures, but who perform the following administrative functions for an employee benefit plan, within a framework of policies, interpretations, rules, practices and procedures made by other persons,

fiduciaries with respect to the plan:
(1) Application of rules determining eligibility for participation or benefits;
(2) Calculation of services and compensation credits for benefits;
(3) Preparation of employee communications material;
(4) Maintenance of participants' service and employment records;
(5) Preparation of reports required by government agencies;
(6) Calculation of benefits;
(7) Orientation of new participants and advising participants of their rights and options under the plan;
(8) Collection of contributions and application of contributions as provided in the plan;
(9) Preparation of reports concerning participants' benefits;
(10) Processing of claims; and
(11) Making recommendations to others for decisions with respect to plan administration?

A: No. Only persons who perform one or more of the functions described in section 3(21)(A) of the Act with respect to an employee benefit plan are fiduciaries. Therefore, a person who performs purely ministerial functions such as the types described above for an employee benefit plan within a framework of policies, interpretations, rules, practices and procedures made by other persons is not a fiduciary because such person does not have discretionary authority or discretionary control respecting management of the plan, does not exercise any authority or control respecting management or disposition of the assets of the plan, and does not render investment advice with respect to any money or other property of the plan and has no authority or responsibility to do so. However, although such a person may not be a plan fiduciary, he may be subject to the bonding requirements contained in section 412 of the Act if he handles funds or other property of the plan within the meaning of applicable regulations. The Internal Revenue Service notes that such persons would not be considered plan fiduciaries within the meaning of section 4975(e)(3) of the Internal Revenue Code of 1954.

D-3 Q: Does a person automatically become a fiduciary with respect to a plan by reason of holding certain positions in the administration of such plan?

A: Some offices or positions of an employee benefit plan by their very nature require persons who hold them to perform one or more of the functions described in section 3(21)(A) of the Act. For example, a plan administrator or a trustee of a plan must, be the very nature of his position, have ``discretionary authority or discretionary responsibility in the administration'' of the plan within the meaning of section 3(21)(A)(iii) of the Act. Persons who hold such positions will therefore be fiduciaries. Other offices and positions should be examined to determine whether they involve the performance of any of the functions described in section 3(21)(A) of the Act. For example, a plan might designate as a ``benefit supervisor'' a plan employee whose sole function is to calculate the amount of benefits to which each plan participant is entitled in accordance with a mathematical formula contained in the written instrument pursuant to which the plan is maintained. The benefit supervisor, after calculating the benefits, would then inform the plan administrator of the results of his calculations, and the plan administrator would authorize the payment of benefits to a particular plan participant. The benefit supervisor does not perform any of the functions described in section 3(21)(A) of the Act and is not, therefore, a plan fiduciary. However, the plan might designate as a ``benefit supervisor'' a plan employee who has the final authority to authorize or disallow benefit payments in cases where a dispute exists as to the interpretation of plan provisions relating to eligibility for benefits. Under these circumstances, the benefit supervisor would be a fiduciary within the meaning of section 3(21)(A) of the Act. The Internal Revenue Service notes that it would reach the same answer to this question under section 4975(e)(3) of the Internal Revenue Code of 1954.

D-4 Q: In the case of a plan established and maintained by an employer, are members of the board of directors of the employer fiduciaries with respect to the plan?

A: Members of the board of directors of an employer which maintains an employee benefit plan will be

fiduciaries only to the extent that they have responsibility for the functions described in section 3(21)(A) of the Act. For example, the board of directors may be responsible for the selection and retention of plan fiduciaries. In such a case, members of the board of directors exercise ``discretionary authority or discretionary control respecting management of such plan'' and are,
therefore, fiduciaries with respect to the plan. However, their responsibility, and, consequently, their liability, is limited to the selection and retention of fiduciaries (apart from co-fiduciary liability arising under circumstances described in section 405(a) of the Act). In addition, if the directors are made named fiduciaries of the plan, their liability may be limited pursuant to a procedure provided
for in the plan instrument for the allocation of fiduciary responsibilities among named fiduciaries or for the designation of persons other than named fiduciaries to carry out fiduciary
responsibilities, as provided in section 405(c)(2).The Internal Revenue Service notes that it would reach the same answer to this question under section 4975(e)(3) of the Internal Revenue
Code of 1954.

D-5 Q: Is an officer or employee of an employer or employee organization which sponsors an employee benefit plan a fiduciary with respect to the plan solely by reason of holding such office or employment if he or she performs none of the functions described in section 3(21)(A) of the Act?

A: No, for the reasons stated in response to question D-2. The Internal Revenue Service notes that it would reach the same answer to this question under section 4975(e)(3) of the Internal Revenue
Code of 1954.

FR-11 Q: In discharging fiduciary responsibilities, may a fiduciary with respect to a plan rely on information, data, statistics or analyses provided by other persons who perform purely ministerial functions for such plan, such as those persons described in D-2 above?

A: A plan fiduciary may rely on information, data, statistics or analyses furnished by persons performing ministerial functions for the plan, provided that he has exercised prudence in the selection and retention of such persons. The plan fiduciary will be deemed to have acted prudently in such selection and retention if, in the exercise of ordinary care in such situation, he has no reason to doubt the competence, integrity or responsibility of such persons.

FR-12 Q: How many fiduciaries must an employee benefit plan have?

A: There is no required number of fiduciaries that a plan must have. Each plan must, of course, have at least one named fiduciary who serves as plan administrator and, if plan assets are held in trust, the plan must have at least one trustee. If these requirements are met, there is no limit on the number of fiduciaries a plan may have. A plan may have as few or as many fiduciaries as are necessary for its operation and administration. Under section 402(c)(1) of the Act, if the plan so provides, any person or group of persons may serve in more than one fiduciary capacity, including serving both as trustee and administrator. Conversely, fiduciary responsibilities not involving management and control of plan assets may, under section 405(c)(1) of the Act, be allocated among named fiduciaries and named fiduciaries may designate persons other than named fiduciaries to carry out such fiduciary responsibilities, if the plan instrument expressly provides procedures for such allocation or designation.

FR-13 Q: If the named fiduciaries of an employee benefit plan allocate their fiduciary responsibilities among themselves in accordance with a procedure set forth in the plan for the allocation of responsibilities for operation and administration of the plan, to what extent will a named fiduciary be relieved of liability for acts and omissions of other named fiduciaries in carrying out fiduciary
responsibilities allocated to them?

A: If named fiduciaries of a plan allocate responsibilities in accordance with a procedure for such allocation set forth in the plan, a named fiduciary will not be liable for acts and omissions of other named fiduciaries in carrying out fiduciary responsibilities which have been allocated to them, except as provided in section 405(a) of the Act, relating to the general rules of co-fiduciary responsibility, and section 405(c)(2)(A) of the

Act, relating in relevant part to standards for establishment and implementation of allocation procedures. However, if the instrument under which the plan is maintained does not provide for a procedure for the allocation of fiduciary responsibilities among named fiduciaries, any allocation which the named fiduciaries may make among themselves will be ineffective to relieve a named fiduciary from responsibility or liability for the performance of fiduciary responsibilities allocated to other named fiduciaries.

FR-14 Q: If the named fiduciaries of an employee benefit plan designate a person who is not a named fiduciary to carry out fiduciary responsibilities, to what extent will the named fiduciaries be relieved of liability for the acts and omissions of such person in the performance of his duties?

A: If the instrument under which the plan is maintained provides for a procedure under which a named fiduciary may designate persons who are not named fiduciaries to carry out fiduciary responsibilities, named fiduciaries of the plan will not be liable for acts and omissions of a person who is not a named fiduciary in carrying out the fiduciary responsibilities which such person has been designated to carry out, except as provided in section 405(a) of the Act, relating to the general rules of co-fiduciary liability, and section 405(c)(2)(A) of the Act, relating in relevant part to the designation of persons to carry out fiduciary responsibilities. However, if the instrument under which the plan is maintained does not provide for a procedure for the designation of persons who are not named fiduciaries to carry out fiduciary responsibilities, then any such designation which the named fiduciaries may make will not relieve the named fiduciaries from responsibility or liability for the acts and omissions of the persons so designated.

FR-15 Q: May a named fiduciary delegate responsibility for management and control of plan assets to anyone other than a person who is an investment manager as defined in section 3(38) of the Act so as to be relieved of liability for the acts and omissions of the person to whom such responsibility is delegated?

A: No. Section 405(c)(1) does not allow named fiduciaries to delegate to others authority ordiscretion to manage or control plan assets. However, under the terms of sections 403(a)(2) and 402(c)(3) of the Act, such authority and discretion may be delegated to persons who are investment managers as defined in section 3(38) of the Act. Further, under section 402(c)(2) of the Act, if the plan so provides, a named fiduciary may employ other persons to render advice to the named fiduciary to assist the named fiduciary in carrying out his investment responsibilities under the plan.

FR-16 Q: Is a fiduciary who is not a named fiduciary with respect to an employee benefit plan personally liable for all phases of the management and administration of the plan?

A: A fiduciary with respect to the plan who is not a named fiduciary is a fiduciary only to the extent that he or she performs one or more of the functions described in section 3(21)(A) of the Act. The personal liability of a fiduciary who is not a named fiduciary is generally limited to the fiduciary functions, which he or she performs with respect to the plan. With respect to the extent of liability of a named fiduciary of a plan where duties are properly allocated among named fiduciaries or where named fiduciaries properly designate other persons to carry out certain fiduciary duties, see question FR-13 and FR-14. In addition, any fiduciary may become liable for breaches of fiduciary responsibility committed by another fiduciary of the same plan under circumstances giving rise to co fiduciary liability, as provided in section 405(a) of the Act.

FR-17 Q: What are the ongoing responsibilities of a fiduciary who has appointed trustees or other fiduciaries with respect to these appointments?

A: At reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs ofthe plan. No single procedure will be appropriate in all cases; the procedure adopted may vary in accordance with

the nature of the plan and other facts and circumstances relevant to the choice of the procedure.

[40 FR 47491, Oct. 9, 1975. Redesignated at 41 FR 1906, Jan. 13, 1976]

Appendix E — Employee Benefit Law

Interpretive Bulletin 94-1

Economically Targeted Investments (Social Investing)

June 23, 1994 (59 FR 32606)

Summary
Establishes DOL position on permissibility of making investments which achieve a social goal in addition to a financial return. Indicates that ETIs are not prohibited by ERISA, and that their choice as an investment must follow DOL ERISA regulation 2550.404a-1 (Investment Duties), be prudent, not be a prohibited transaction, and not provide less return to a plan than a normal investment.

Interpretive Bulletin

Agency: Pension and Welfare Benefits Administration, Labor Department

Action: Interpretive Bulletin

Summary: This document sets forth the view of the Department of Labor (the Department) concerning the legal standard imposed by sections 403 and 404 of Part 4 of Title I of the Employee Retirement Income Security Act of 1974 (ERISA) with respect to a plan fiduciary's decision to invest plan assets in "economically targeted investments" (ETIs). ETIs are generally defined as investments that are selected for the economic benefits they create in addition to the investment return to the employee benefit plan investor. In this document, the Department states that the requirements of sections 403 and 404 do not prevent plan fiduciaries from deciding to invest plan assets in an ETI if the ETI has an expected rate of return that is commensurate to rates of return of alternative investments with similar risk characteristics that are available to the plan, and if the ETI is otherwise an appropriate investment for the plan in terms of such factors as diversification and the investment policy of the plan.

Effective Date: January 1, 1975

Interpretive Bulletin

Section 2509.94-1

Interpretive Bulletin Relating to the fiduciary standard under ERISA

in considering economically targeted investments

This Interpretive Bulletin sets forth the Department of Labor's interpretation of sections 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA), as applied to employee benefit plan investments in "economically targeted investments" (ETIs), that is, investments selected for the economic benefits they create apart from their investment return to the employee benefit plan. Sections 403 and 404, in part, require that a fiduciary of a plan act prudently, and to diversify plan investments so as to minimize the risk of large losses, unless under the circumstances, it is clearly prudent not to do so. In addition, these sections require that a fiduciary act solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to their participants and beneficiaries. The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to,

participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.

With regard to investing plan assets, the Department has issued a regulation, at 29 C.F.R. 2550.404a-1, interpreting the prudence requirements of ERISA as they apply to the investment duties of fiduciaries of employee benefit plans. The regulation provides that the prudence requirements of section 404(a)(1)(B) are satisfied if -

1. The fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and
2. The fiduciary acts accordingly.

This includes giving appropriate consideration to the role that the investment or investment course of action plays (in terms or such factors as diversification, liquidity and risk/return characteristics) with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility.

Other facts and circumstances relevant to an investment or investment course of action would, in the view of the Department, include consideration of the expected return on alternative investments with similar risks available to the plan. It follows that, because every investment necessarily causes a plan to forgo other investment opportunities, an investment will not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk or is riskier than alternative available investments with commensurate rates of return.

The fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally. Therefore, if the above requirements are met, the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate section 404(a)(1)(A) and (B) and the exclusive purpose requirements of section 403.

Interpretive Bulletin 94-2

Voting of Proxies and Investment Policies

July 29, 1994 (59 FR 38860)

Summary
Establishes DOL position on (1) the desirability of plan investment policies, and when such policies must be followed as a "plan document" under ERISA 404(a)(1)(D); and (2) responsibilities by trustees, named fiduciaries, and investment managers (including collective investment funds) to vote proxies.

Interpretive Bulletin

Agency: Department of Labor.

Action: Interpretive Bulletin.

Summary: This document summarizes the Department of Labor's (the

Department) statements with respect to the duty of employee benefit plan fiduciaries to vote proxies appurtenant to shares of corporate stock held by their plans. In these statements, the Department has explained, among other things, that the voting of proxies is a fiduciary act of plan asset management This document also describes the Department's view of the legal standards imposed by sections 402(c)(3), 403(a) and 404(a)(1)(B) of part 4 of title I of the Employee Retirement Income Security Act of 1974 (ERISA) on the use of written statements of investment policy, including statements of proxy voting policy or guidelines. The bulletin makes clear that a named fiduciary who appoints an investment manager may, consistent with its fiduciary obligations, issue written statements of investment policy, including guidelines as to the voting of proxies by the investment manager. Moreover, an investment manager may be required to comply with such investment policies to the extent that any given investment decision (including a proxy voting decision) is consistent with the provisions of title I or title IV of ERISA. Finally, this document provides guidance concerning the appropriateness under ERISA of more active monitoring of corporate management by fiduciaries of plans that own corporate securities.

Effective Date: January 1, 1975

Interpretive Bulletin

This interpretive bulletin sets forth the Department of Labor's (the Department) interpretation of sections 402, 403 and 404 of the Employee Retirement Income Security Act of 1974 (ERISA) as those sections apply to voting of proxies on securities held in employee benefit plan investment portfolios and the maintenance of and compliance with statements of investment policy, including proxy voting policy. In addition, this interpretive bulletin provides guidance on the appropriateness under ERISA of active monitoring of corporate management by plan fiduciaries.

1. Proxy Voting

    The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock. As a result, the responsibility for voting proxies lies exclusively with the plan trustee except to the extent that either (1) the trustee is subject to the directions of a named fiduciary pursuant to ERISA § 403(a)(1); or (2) the power to manage, acquire or dispose of the relevant assets has been delegated by a named fiduciary to one or more investment managers pursuant to ERISA § 403(a)(2). Where the authority to manage plan assets has been delegated to an investment manager pursuant to § 403(a)(2), no person other than the investment manager has authority to vote proxies appurtenant to such plan assets except to the extent that the named fiduciary has reserved to itself (or to another named fiduciary so authorized by the plan document) the right to direct a plan trustee regarding the voting of proxies. In this regard, a named fiduciary, in delegating investment management authority to an investment manager, could reserve to itself the right to direct a trustee with respect to the voting of all proxies or reserve to itself the right to direct a trustee as to the voting of only those proxies relating to specified assets or issues.

    If the plan document or investment management agreement provides that the investment manager is not required to vote proxies, but does not expressly preclude the investment manager from voting proxies, the investment manager would have exclusive responsibility for voting proxies. Moreover, an investment manager would not be relieved of its own fiduciary responsibilities by following directions of some other person regarding the voting of proxies, or by delegating such responsibility to another person. If, however, the plan document or the investment management contract expressly precludes the investment manager from voting proxies, the responsibility for voting proxies would lie exclusively with the trustee. The trustee, however, consistent with the requirements of ERISA § 403(a)(1), may be subject to the directions of a named fiduciary if the plan so provides.

    The fiduciary duties described at ERISA § 404(a)(1)(A) and (B), require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives. These duties also require that the named fiduciary appointing an investment manager periodically monitor the activities of the investment manager with respect to the management of plan assets, including decisions made and actions taken by the investment manager with regard to proxy voting decisions. The named fiduciary must carry out this responsibility solely in the interest of the participants and beneficiaries and without regard to its relationship to the plan sponsor.

    It is the view of the Department that compliance with the duty to monitor necessitates proper documentation of the activities that are subject to monitoring. Thus, the investment manager or other responsible fiduciary would be required to maintain accurate records as to proxy voting. Moreover, if the named fiduciary is to be able to carry out its responsibilities under ERISA § 404(a) in determining whether the investment manager is fulfilling its fiduciary obligations in investing plans assets in a manner that justifies the continuation of the management appointment, the proxy voting records must enable the named fiduciary to review not only the investment manager's voting procedure with respect to plan-owned stock, but also to review the actions taken in individual proxy voting situations.

    The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment. Although the same principles apply for proxies appurtenant to shares of foreign corporations, the Department recognizes that in voting such proxies, plans may, in some cases, incur additional costs. Thus, a fiduciary should consider whether the plan's vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan's investment that will outweigh the cost of voting. Moreover, a fiduciary, in deciding whether to purchase shares of a foreign corporation, should consider whether the difficulty and expense in voting the shares is reflected in their

market price.

2. Statements of Investment Policy

The maintenance by an employee benefit plan of a statement of investment policy designed to further the purposes of the plan and its funding policy is consistent with the fiduciary obligations set forth in ERISA § 404(a)(1)(A) and (B). Since the fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock, a statement of proxy voting policy would be an important part of any comprehensive statement of investment policy. For purposes of this document, the term "statement of investment policy" means a written statement that provides the fiduciaries who are responsible for plan investments with guidelines or general instructions concerning various types or categories of investment management decisions, which may include proxy voting decisions. A statement of investment policy is distinguished from directions as to the purchase or sale of a specific investment at a specific time or as to voting specific plan proxies.

In plans where investment management responsibility is delegated to one or more investment managers appointed by the named fiduciary pursuant to ERISA § 402(c)(3), inherent in the authority to appoint an investment manager, the named fiduciary responsible for appointment of investment managers has the authority to condition the appointment on acceptance of a statement of investment policy. Thus, such a named fiduciary may expressly require, as a condition of the investment management agreement, that an investment manager comply with the terms of a statement of investment policy which sets forth guidelines concerning investments and investment courses of action which the investment manager is authorized or is not authorized to make. Such investment policy may include a policy or guidelines on the voting of proxies on shares of stock for which the investment manager is responsible. In the absence of such an express requirement to comply with an investment policy, the authority to manage the plan assets placed under the control of the investment manager would lie exclusively with the investment manager. Although a trustee may be subject to the directions of a named fiduciary pursuant to ERISA § 403(a)(1), an investment manager who has authority to make investment decisions, including proxy voting decisions, would never be relieved of its fiduciary responsibility if it followed directions as to specific investment decisions from the named fiduciary or any other person.

Statements of investment policy issued by a named fiduciary authorized to appoint investment managers would be part of the "documents and instruments governing the plan" within the meaning of ERISA § 404(a)(1)(D). An investment manager to whom such investment policy applies would be required to comply with such policy, pursuant to ERISA § 404(a)(1)(D) insofar as the policy directives or guidelines are consistent with titles I and IV of ERISA. Therefore, if, for example, compliance with the guidelines in a given instance would be imprudent then the investment manager's failure to follow the guidelines would not violate ERISA § 404(a)(1)(D). Moreover, ERISA § 404(a)(1)(D) does not shield the investment manager from liability for imprudent actions taken in compliance with a statement of investment policy.

The plan document or trust agreement may expressly provide a statement of investment policy to guide the trustee or may authorize a named fiduciary to issue a statement of investment policy applicable to a trustee. Where a plan trustee is subject to an investment policy, the trustee's duty to comply with such investment policy would also be analyzed under ERISA § 404(a)(1)(D). Thus, the trustee would be required to comply with the statement of investment policy unless, for example, it would be imprudent to do so in a given instance.

Maintenance of a statement of investment policy by a named fiduciary does not relieve the named fiduciary of its obligations under ERISA § 404(a) with respect to the appointment and monitoring of an investment manager or trustee. In this regard, the named fiduciary appointing an investment manager must periodically monitor the investment manager's activities with respect to management of the plan assets. Moreover, compliance with ERISA § 404(a)(1)(B) would require maintenance of proper documentation of the activities of the investment manager and of the named fiduciary of the plan in monitoring the activities of the investment manager. In addition, in the view of the Department, a named fiduciary's determination of the terms of a statement of investment policy is an exercise of fiduciary responsibility and, as such, statements may need to take into account factors such as the plan's funding policy and its liquidity needs as well as issues of prudence, diversification and other fiduciary requirements of ERISA.

An investment manager of a pooled investment vehicle that holds assets of more than one employee benefit plan may be subject to a proxy voting policy of one plan that conflicts with the proxy voting

policy of another plan. Compliance with ERISA § 404(a)(1)(D) would require such investment manager to reconcile, insofar as possible, the conflicting policies (assuming compliance with each policy would be consistent with ERISA § 404(a)(1)(D)) and, if necessary and to the extent permitted by applicable law, vote the relevant proxies to reflect such policies in proportion to each plan's interest in the pooled investment vehicle. If, however, the investment manager determines that compliance with conflicting voting policies would violate ERISA § 404(a)(1)(D) in a particular instance, for example, by being imprudent or not solely in the interest of plan participants, the investment manager would be required to ignore the voting policy that would violate ERISA § 404(a)(1)(D) in that instance. Such an investment manager may, however, require participating investors to accept the investment manager's own investment policy statement, including any statement of proxy voting policy, before they are allowed to invest. As with investment policies originating from named fiduciaries, a policy initiated by an investment manager and adopted by the participating plans would be regarded as an instrument governing the participating plans, and the investment manager's compliance with such a policy would be governed by ERISA § 404(a)(1)(D).

3. Shareholder Activism

An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved. Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment. Active monitoring and communication activities would generally concern such issues as the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalization, the nature of long-term business plans, the corporation's investment in training to develop its work force, other workplace practices and financial and nonfinancial measures of corporate performance. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder.

Interpretive Bulletin 94-3

In-Kind Contributions to Employee Benefit Plans

December 28, 1994 (59 FR 66735)

Summary	
Covers non-cash ("in-kind") contributions to ERISA plans. Establishes DOL positions on whether the contributions constitute a prohibited transaction and what a fiduciary must consider before accepting them.	
I	For defined benefit plans, indicates that an in-kind contribution is a prohibited transaction.
I	For defined contribution plans, in-kind contributions may be acceptable, depending on the circumstances and provisions of the plan document. For these plans, a fiduciary must consider the fiduciary responsibility factors in ERISA § 404 in weighing whether to accept an in-kind contribution.

Interpretive Bulletin

Agency: Pension and Welfare Benefits Administration, Department of Labor

Action: Interpretive Bulletin.

Summary: This document provides guidance on in-kind contributions to employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA) and plans under section 4975 of the Internal Revenue Code (the Code). The Supreme Court addressed certain in-kind contributions to defined benefit pensions plans in *Commissioner of Internal Revenue v. Keystone Consolidated Industries, Inc.*, U.S. 113 S. Ct. 2006 (1993). The Court in *Keystone* held that an employer's contribution of unencumbered real properties to a tax-qualified defined benefit pension plan in satisfaction of the employer's funding obligation is a "sale or exchange" prohibited by section 4975(c)(1)(A) of the Code. Section 406(a)(1)(A) of ERISA is a parallel provision to section 4975(c)(1)(A) of the Code but applies to a different group of plans. This document sets forth the Department's view that in-kind contributions (for example, contributions of any property other than cash) that reduce an obligation to the plan constitute prohibited transactions under section 4975(c)(1)(A) of the Code and section 406(a)(1)(A) of ERISA.

Effective Date: The guidance announced in this bulletin is effective January 1, 1975.

Interpretive Bulletin

Part 2509

Interpretive Bulletin

Relating to In-Kind Contributions to Employee Benefit Plans.

a. *General*. This bulletin sets forth the views of the Department of Labor (the Department) concerning in-kind contributions (for example, contributions of property other than cash) in satisfaction of an obligation to contribute to an employee benefit plan to which part 4 of Title I of the Employee Retirement income Security Act of 1974 (ERISA) or a plan to which section 4975 of the Internal Revenue Code (the Code) applies. (For purposes of this document the term "plan" shall refer to either or both types of such entities as appropriate). Section 406(a)(1)(A) of ERISA provider that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction if the fiduciary knows or should know that the transaction constitutes a direct or indirect sale or exchange of any property between a plan and a party in interest" as defined in section 3(14) of ERISA. The Code imposes a two-tier excise tax under section 4975(c)(1)(A) an any direct or indirect sale or exchange of any property between a plan and a "disqualified person" as defined in section 4975(e)(2) of the Code. An employer or employee organization that maintains a plan is included within the definitions of "party in interest" and "disqualified person."[1]

   In *Commissioner of Internal Revenue v. Keystone Consolidated Industries, Inc.*, U.S. , 113 S. Ct. 2006 (1993), the Supreme Court held that an employer's contribution of unencumbered real property to a tax-qualified defined benefit pension plan was a sale or exchange prohibited under section 4975 of the Code where the stated fair market value of the property was credited against the employer's obligation to the defined benefit pension plan. The parties stipulated that the property was contributed to the plan free of encumbrances and the stated fair market value of the property was not challenged. 113 S. Ct. at 2009. In reaching its holding the Court construed section 4975(f)(3) of the Code (and therefore section 406(c) of ERISA), regarding transfers of encumbered property, not as a limitation but rather as extending the reach of section 4975(c)(1)(A) of the Code (and thus section 406(a)(1)(A) of ERISA) to include contributions of encumbered property that do not satisfy funding obligations. *Id*. at 2013. Accordingly, the Court concluded that the contribution of unencumbered property was prohibited under section 4975(c)(1)(A) of the Code (and thus section 406(a)(1)(A) of ERISA) as "at least both an indirect type of sale and a form of exchange, since the property is exchanged for diminution of the employer's funding obligation." 113 S. Ct. at 2012.

b. *Defined benefit plans*. Consistent with the reasoning of the Supreme Court in *Keystone*, because an employer's or plan sponsor's in-kind contribution to a defined benefit pension plan is credited to the plan's funding standard account it would constitute a transfer to reduce an obligation of the sponsor or employer to the plan. Therefore, in the absence of an applicable exemption, such a contribution would be prohibited under section 406(a)(1)(A) of ERISA and section 4975(c)(1)(A) of the Code. Such an in-kind contribution would constitute a prohibited transaction even if the value of the contribution is in excess of the sponsor's or employer's funding obligation for the plan year in which the contribution is made and thus is not used to reduce the plan's accumulated funding deficiency for that plan year because the contribution would result in a credit against funding obligations which might arise in the future.
c. *Defined contribution and welfare plans*. In the context of defined contribution pension plans and welfare plans, it is the view of the Department that an in-kind contribution to a plan that reduces an obligation of

a plan sponsor or employer to make a contribution measured in terms of cash amounts would constitute a prohibited transaction under section 406(a)(1)(A) of ERISA (and section 4975(c)(1)(A) of the Code) unless a statutory or administrative exemption under section 408 of ERISA (or sections 4975(c)(2) or (d) of the Code) applies. For example, if a profit sharing plan required the employer to make annual contributions "in cash or in kind" equal to a given percentage of the employer's net profits for the year, an in-kind contribution used to reduce this obligation would constitute a prohibited transaction in the absence of an exemption because the amount of the contribution obligation is measured in terms of cash amounts (a percentage of profits) even though the terms of the plan purport to permit in-kind contributions.

Conversely, a transfer of unencumbered property to a welfare benefit plan that does not relieve the sponsor or employer of any present or future obligation to make a contribution that is measured in terms of cash amounts would not constitute a prohibited transaction under section 406(a)(1)(A) of ERISA or section 4975(c)(1)(A) of the Code . The same principles apply to defined contribution plans that are not subject to the minimum funding requirements of section 302 of ERISA or section 412 of the Code. For example, where a profit sharing or stock bonus plan, by its terms, is funded solely at the discretion of the sponsoring employer, and the employer is not otherwise obligated to make a contribution measured in terms of cash amounts, a contribution of unencumbered real property would not be a prohibited sale or exchange between the plan and the employer. If, however, the same employer had made an enforceable promise to make a contribution measured in terms of cash amounts to the plan, a subsequent contribution of unencumbered real property made to offset such an obligation would be a prohibited sale or exchange.

d. *Fiduciary standards*. Independent of the application of the prohibited transaction provisions, fiduciaries of plans covered by part 4 of Title I of ERISA must determine that acceptance of an in-kind contribution is consistent with ERISA's general standards of fiduciary conduct. It is the view of the Department that acceptance of an in-kind contribution is a fiduciary act subject to section 404 of ERISA. In this regard, Sections 406(a)(1)(A), and (B) of ERISA require that fiduciaries discharge their duties to a plan solely in the interests of the participants and beneficiaries, for the exclusive purpose of providing benefits and defraying reasonable administrative expenses, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. In addition, section 404(a)(1)(C) requires generally that fiduciaries diversify plan assets so as to minimize the risk of large losses. Accordingly, the fiduciaries of a plan must act "prudently," "solely in the interest" of the plan's participants and beneficiaries and with view to the need to diversify plan assets when deciding whether to accept in-kind contributions. If accepting an in-kind contribution is not "prudent," not "solely in the interest" of the participants and beneficiaries of the plan, or would result in an improper lack of diversification of plan assets, the responsible fiduciaries of the plan would be liable for any losses resulting from such a breach of fiduciary responsibility, even if a contribution in kind does not constitute a prohibited transaction under section 406 of ERISA. In this regard a fiduciary, should consider any liabilities appurtenant to the in-kind contribution to which the plan would be exposed as a result of acceptance of the contribution.

Footnote

1 Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under the prohibited transactions provisions of section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Except with respect to the types of plans covered, the prohibited transaction provisions of section 406 of ERISA generally parallel the prohibited transaction provisions of section 4975 of the Code.

Interpretive Bulletin 96-1

29 C.F.R. Part 2509.96-1

Participant Investment Education for Individual Account [404(c)] Plans

June 11, 1996 (61 FR 29586)

Summary

Applicable to "individual account plans" (employer-sponsored plans which provide for self-directed investments), such as 401(k) plans. Provides information on the requirement to provide participants with sufficient information to make informed decisions about the investment vehicles available under the plan.
Cross Reference: See Section (b)(2)(B)(1) of DOL ERISA Regulation 2550.404c-1.

Interpretive Bulletin

Agency: Pension and Welfare Benefits Administration, Labor.

Action: Interpretive bulletin.

Summary: This interpretive bulletin sets forth the views of the Department of Labor (the Department) concerning the circumstances under which the provision of investment-related information to participants and beneficiaries in participant-directed individual account pension plans will not constitute the rendering of "investment advice" under the Employee Retirement Income Security Act of 1974, as amended (ERISA). This guidance is intended to assist plan sponsors, service providers, participants and beneficiaries in determining when activities designed to educate and assist participants and beneficiaries in making informed investment decisions will not cause persons engaged in such activities to become fiduciaries with respect to a plan by virtue of providing "investment advice" to plan participants and beneficiaries for a fee or other compensation.

Effective Date: January 1, 1975.

Explanatory Preamble to PTE 86-128 (Excerpt)

Text of Interpretive Bulletin

For further information contact:

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Supplementary Information: In order to provide a concise and ready reference to its interpretations of ERISA, the Department publishes its interpretive bulletins in the Rules and Regulations section of the Federal Register. Published in this issue of the Federal Register is ERISA Interpretive Bulletin 96-1, which interprets section 3(21)(A)(ii), 29 USC 1002(21)(A)(ii), and the Department's regulation issued thereunder at 29 C.F.R. 2510.3-21(c). The Department is publishing this interpretive bulletin because it believes there is a need to clarify the circumstances under which the provision of investment-related information to participants and beneficiaries will not give rise to fiduciary status under ERISA section 3(21)(A)(ii). (Sec. 505, Pub. L. 93-406, 88 Stat. 894 (29 USC 1135).)

Background

With the growth of participant-directed individual account pension plans, more employees are directing the investment of their pension plan assets and, thereby, assuming more responsibility for ensuring the adequacy of their retirement income.* At the same time, there has been an increasing concern on the part of the Department, employers and others that many participants may not have a sufficient understanding of investment principles and strategies to make their own informed investment decisions. It has been represented to the Department that, while a number of employers sponsoring participant-directed individual account pension plans have instituted programs intended to educate their employees about investment principles, financial planning and retirement, many employers have not offered programs or offered only limited programs due to uncertainty regarding the extent to which the provision of investment-related information may be considered the rendering of "investment advice" under section 3(21)(A)(ii) of ERISA, resulting in fiduciary responsibility and potential liability in connection with participant-directed investments. Although section 404(c) of ERISA, 29 USC 1104(c), and the Department's regulations, at 29 C.F.R. 2550.404c-1, provide limited relief from liability for fiduciaries of pension plans that permit a participant or beneficiary to exercise control over the assets in his or her individual account, there remains a need for employers and others who provide investment information with respect to pension plan assets to know what standards apply in determining whether an

education activity may give rise to fiduciary status.

In view of the important role that investment education can play in assisting participants and beneficiaries in making informed investment and retirement-related decisions and the uncertainty relating to the fiduciary implications of providing investment-related information to participants and beneficiaries, the Department is clarifying, herein, the application of ERISA's definition of the term "fiduciary with respect to a plan" in section 3(21)(A)(ii) to the provision of investment-related information to participants and beneficiaries.

Interpretive Bulletin 96-1 identifies categories of information and materials regarding participant-directed individual account pension plans that do not, in the view of the Department, constitute "investment advice" under the definition of "fiduciary" in ERISA section 3(21)(A)(ii) and the corresponding regulation at 29 C.F.R. 2510.3-21(c)(1). The interpretive bulletin points out, in effect, a series of graduated safe harbors under ERISA for plan sponsors and service providers who provide participants and beneficiaries with four increasingly specific categories of investment information and materials -- plan information, general financial and investment information, asset allocation models and interactive investment materials -- as described in paragraph (d) of IB 96-1.

Comments on the Interpretive Bulletin

Interpretive Bulletin 96-1 was developed following extensive review of educational materials currently being provided by plan sponsors and service providers to participants. To further ensure that the guidance provided would be helpful, and would promote increased and improved participant education efforts, the Department also released an exposure draft of the interpretive bulletin for public comment. The response to the exposure draft was overwhelmingly positive. Both plan sponsor and service provider representatives unequivocally agreed that the guidance as drafted would strengthen participant investment education, and urged the Department to proceed as expeditiously as possible to adopt the interpretive bulletin. The commenters also suggested various technical and clarifying changes which, as discussed below, have been included in the interpretive bulletin.

Identifying Specific Investment Alternatives in Model Asset Allocations

The most frequent comment on the exposure draft concerned the safe harbor provision in paragraphs (d)(3) (asset allocation models) and (d)(4) (interactive investment materials) that if a model asset allocation identifies or matches any specific investment alternative available under the plan with a generic asset class, then all investment alternatives under the plan with similar risk and return characteristics must be similarly identified or matched. The commenters were concerned that in plans with investment alternatives offered by multiple service providers it would be difficult, and possibly inappropriate, for one service provider to identify and describe a competitor's products.

The requirement to identify other investment alternatives within an asset class was intended to address the concern that a service provider could effectively steer participants to a specific investment alternative by identifying only one particular fund in connection with an asset allocation model. Where it is possible to identify other investment alternatives within an asset class, the Department encourages service providers to do so. In response to the comments, however, safe harbors (d)(3) and (d)(4) have been revised to provide that, where an asset allocation model identifies any specific investment alternative available under the plan, an accompanying statement must indicate that other investment alternatives having similar risk and return characteristics may be available under the plan, and must identify where information on those investment alternatives may be obtained.

The Fiduciary Safe Harbors and Section 404(c)

Several commenters requested clarification of the statement in the exposure draft that issues relating to the circumstances under which information provided to participants and beneficiaries may affect their ability to exercise independent control for purposes of 404(c) are outside the scope of the IB. The commenters were concerned that activities which come within one of the safe harbors for participant education may nevertheless be viewed by the Department as compromising a participant's or beneficiary's ability to exercise independent control under section 404(c).

Whether a participant or beneficiary has exercised independent control over the assets in his or her individual account pursuant to section 404(c) is necessarily a factual inquiry. In general, however, the types of educational programs described in the safe harbors do not, in the view of the Department, raise issues under section 404(c). Accordingly, footnote 2 of IB 96-1 makes clear that the provision of investment-related information and materials to participants and beneficiaries in accordance with paragraph (d) of the IB will not, in and of itself, affect the availability of relief from the fiduciary responsibility provisions of ERISA that is

provided by section 404(c).

Applying Asset Allocations to Individual Participants and Beneficiaries

A number of commenters asked the Department to clarify the requirement to provide a statement that individual participants and beneficiaries should consider their other assets, income or investments (outside of the plan) when applying an asset allocation model or using interactive investment materials. The commenters pointed out that, in many instances, interactive models or materials already take into account an individual's other assets. Accordingly, they requested clarification that such models or materials come within the safe harbor in paragraph (d)(4). Commenters were also concerned that given the rationale for the safe harbor in paragraph (d)(4) -- i.e. that interactive investment models or materials enable participants and beneficiaries independently to design and assess multiple asset allocation models -- the Department may have intended to exclude from the safe harbors situations in which service providers assist individual participants or beneficiaries to develop possible asset allocation models based upon their personal financial information.

The provisions of the safe harbors are designed to ensure that participants and beneficiaries will have adequate information to enable them to make their own, informed asset allocation decisions. The Department has clarified that the safe harbor in paragraph (d)(4) for interactive investment materials would not be unavailable merely because the asset allocation models generated by the materials take into account a participant's or beneficiary's non-plan assets, income and investments. Nor does the Department consider that the safe harbor would be unavailable merely because participants and beneficiaries receive personal assistance in developing model asset allocations. In this regard, paragraph (d) of the IB states that providing the categories of information identified in paragraph (d) will not in and of itself constitute the rendering of "investment advice" irrespective of the form in which the materials are provided (e.g., whether on an individual or group basis, in writing or orally, or via video or computer software). The interpretive bulletin also makes clear that information and materials within each category may be furnished alone or combined with information and materials from other categories. For example, general financial and investment information on estimating future retirement income needs, determining investment time horizons and assessing risk tolerance, as described in paragraph (d)(2), may be combined with interactive investment materials described in paragraph (d)(4) in order to assist participants and beneficiaries to relate basic retirement planning concepts to their individual situations.

Generally Accepted Investment Theories

Several commenters requested clarification of the requirement that asset allocation models and interactive investment materials must be based on "generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time." The Department included this requirement to assure that, for purposes of the safe harbors, any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification.

Plan Sponsor or Fiduciary Endorsements of Service Providers

The commenters also requested clarification regarding the circumstances in which a plan sponsor or fiduciary may be viewed as having fiduciary responsibility by virtue of endorsing a third party who has been selected by a participant or beneficiary to provide participant education or investment advice. Commenters noted, for example, that a plan sponsor may wish merely to provide office space or make computer terminals available for use by a service provider that has been selected by a participant or beneficiary to provide investment education using interactive materials. Whether a plan sponsor or fiduciary has effectively endorsed or made an arrangement with a particular service provider is an inherently factual inquiry which depends upon all the relevant facts and circumstances. It is the Department's view, however, that a uniformly applied policy of providing office space or computer terminals for use by participants or beneficiaries who have independently selected a service provider to provide investment education would not, in and of itself, constitute an endorsement of or arrangement with the service provider for purposes of the IB.

Participation Rates, Contribution Levels and Pre-retirement Withdrawals

With the objective of distinguishing between investment education and investment advice, IB 96-1 focuses primarily on educational activities relating to investment decision-making. However, as suggested in a recent study by the Employee Benefits Research Institute (EBRI), which was commissioned by the Department of Labor, plan participants also need to be informed about the impact on retirement savings of pre-retirement withdrawals and other fundamental principles regarding plan participation and contribution levels. According to the EBRI study, the impact of pre-retirement withdrawals on retirement income is one of the least often

provided topics and could have serious consequences for the adequacy of employees' retirement income. The Department, therefore, encourages educational service providers to emphasize that participants should: (1) participate in available plans as soon as they are eligible; (2) make the maximum contribution possible to the plan; and(3) if they change employment, refrain from withdrawing their retirement savings, and opt instead to directly transfer or roll over their plan account into an IRA or other retirement vehicle. Such information relating to plan participation is specifically encompassed within the safe harbor in paragraph (d)(1) of IB 96-1.

Application of the Investment Advisers Act of 1940

Employer sponsors of participant-directed individual account pension plans that provide investment-related information to employees who are participants in those plans have also raised questions regarding their status under the Investment Advisers Act of 1940, 15 USC 80b-1 et seq., ("Advisers Act"). In this regard, the staff of the Division of Investment Management of the Securities and Exchange Commission (SEC) has advised the Department of Labor that, generally, employers who provide their employees with investment information including, but not limited to, the type described in paragraph (d) of IB 96-1 would not be subject to registration or regulation under the Advisers Act. This position applies only to employers who provide such information, and not to third-party service providers, whose status under the Adviser's Act must be determined independently. See Letters from Jack W. Murphy, Associate Director (Chief Counsel), Division of Investment Management, SEC, to Olena Berg, Assistant Secretary, Pension and Welfare Benefit Administration, U.S. Department of Labor, dated February 22, 1996, and December 5, 1995. Persons who have questions regarding this issue are directed to contact the Office of the Chief Counsel, Division of Investment Management, at (202) 942-0660. This is not a toll free number.

Interpretive Bulletin

For the reasons set forth above, Part 2509 of Title 29 of The Code of Federal Regulations is amended as follows:

a. *Scope*. This interpretive bulletin sets forth the Department of Labor's interpretation of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and 29 C.F.R. 2510.3-21(c) as applied to the provision of investment-related educational information to participants and beneficiaries in participant-directed individual account pension plans (i.e., pension plans that permit participants and beneficiaries to direct the investment of assets in their individual accounts, including plans that meet the requirements of the Department's regulations at 29 C.F.R. 2550.404c-1).
b. *General*. Fiduciaries of an employee benefit plan are charged with carrying out their duties prudently and solely in the interest of participants and beneficiaries of the plan, and are subject to personal liability to, among other things, make good any losses to the plan resulting from a breach of their fiduciary duties. ERISA sections 403, 404 and 409, 29 USC 1103, 1104, and 1109. Section 404(c) of ERISA provides a limited exception to these rules for a pension plan that permits a participant or beneficiary to exercise control over the assets in his or her individual account. The Department of Labor's regulation, at 29 C.F.R. 2550.404c-1, describes the kinds of plans to which section 404(c) applies, the circumstances under which a participant or beneficiary will be considered to have exercised independent control over the assets in his or her account, and the consequences of a participant's or beneficiary's exercise of such control.[1]

   With both an increase in the number of participant-directed individual account plans and the number of investment options available to participants and beneficiaries under such plans, there has been an increasing recognition of the importance of providing participants and beneficiaries, whose investment decisions will directly affect their income at retirement, with information designed to assist them in making investment and retirement-related decisions appropriate to their particular situations. Concerns have been raised, however, that the provision of such information may in some situations be viewed as rendering "investment advice for a fee or other compensation," within the meaning of ERISA section 3(21)(A)(ii), thereby giving rise to fiduciary status and potential liability under ERISA for investment decisions of plan participants and beneficiaries.

   In response to these concerns, the Department of Labor is clarifying herein the applicability of ERISA section 3(21)(A)(ii) and 29 C.F.R. 2510.3-21(c) to the provision of investment-related educational information to participants and beneficiaries in participant directed individual account plans.[2] In providing this clarification, the Department does not address the "fee or other compensation, direct or indirect," which is a necessary element of fiduciary status under ERISA section 3(21)(A)(ii).[3]

c. *Investment Advice*. Under ERISA section 3(21)(A)(ii), a person is considered a fiduciary with respect to an employee benefit plan to the extent that person "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority to do so * * *." The Department issued a regulation, at 29 C.F.R. 2510.3-21(c), describing the circumstances under which a person will be considered to be rendering "investment advice" within the meaning of section 3(21)(A)(ii). Because section 3(21)(A)(ii) applies to advice with respect to "any moneys or other property" of a plan and 29 C.F.R. 2510.3-21(c) is intended to clarify the application of that section, it is the view of the Department of Labor that the criteria set forth in the regulation apply to determine whether a person renders "investment advice" to a pension plan participant or beneficiary who is permitted to direct the investment of assets in his or her individual account.

   Applying 29 C.F.R. 2510.3-21(c) in the context of providing investment- related information to participants and beneficiaries of participant-directed individual account pension plans, a person will be considered to be rendering "investment advice," within the meaning of ERISA section 3(21)(A)(ii), to a participant or beneficiary only if: (i) the person renders advice to the participant or beneficiary as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property (2510.3-21(c)(1)(i); and (ii) the person, either directly or indirectly, (A) has discretionary authority or control with respect to purchasing or selling securities or other property for the participant or beneficiary (2510.3-21(c)(1)(ii)(A)), or (B) renders the advice on a regular basis to the participant or beneficiary, pursuant to a mutual agreement, arrangement or understanding (written or otherwise) with the participant or beneficiary that the advice will serve as a primary basis for the participant's or beneficiary's investment decisions with respect to plan assets and that such person will render individualized advice based on the particular needs of the participant or beneficiary (2510.3-21(c)(1)(ii)(B)).[4]

   Whether the provision of particular investment-related information or materials to a participant or beneficiary constitutes the rendering of "investment advice," within the meaning of 29 C.F.R. 2510.3-21(c)(1), generally can be determined only by reference to the facts and circumstances of the particular case with respect to the individual plan participant or beneficiary. To facilitate such determinations, however, the Department of Labor has identified, in paragraph (d), below, examples of investment-related information and materials which if provided to plan participants and beneficiaries would not, in the view of the Department, result in the rendering of "investment advice" under ERISA section 3(21)(A)(ii) and 29 C.F.R. 2510.3- 21(c).

d. *Investment Education*. For purposes of ERISA section 3(21)(A)(ii) and 29 C.F.R. 2510.3-21(c), the Department of Labor has determined that the furnishing of the following categories of information and materials to a participant or beneficiary in a participant-directed individual account pension plan will not constitute the rendering of "investment advice," irrespective of who provides the information (e.g., plan sponsor, fiduciary or service provider), the frequency with which the information is shared, the form in which the information and materials are provided (e.g., on an individual or group basis, in writing or orally, or via video or computer software), or whether an identified category of information and materials is furnished alone or in combination with other identified categories of information and materials.

   1. Plan Information.

      i. Information and materials that inform a participant or beneficiary about the benefits of plan participation, the benefits of increasing plan contributions, the impact of pre-retirement withdrawals on retirement income, the terms of the plan, or the operation of the plan; or
      ii. Information such as that described in 29 C.F.R. 2550.404c-1(b)(2)(i) on investment alternatives under the plan (e.g., descriptions of investment objectives and philosophies, risk and return characteristics, historical return information, or related prospectuses).[5]

         The information and materials described above relate to the plan and plan participation, without reference to the appropriateness of any individual investment option for a particular participant or beneficiary under the plan. The information, therefore, does not contain either "advice" or "recommendations" within the meaning of 29 C.F.R. 2510.3-21(c)(1)(i). Accordingly, the furnishing of such information would not constitute the rendering of "investment advice" for purposes of section 3(21)(A)(ii) of ERISA.

2. General Financial and Investment Information. Information and materials that inform a participant or beneficiary about: (i) General financial and investment concepts, such as risk and return, diversification, dollar cost averaging, compounded return, and tax deferred investment; (ii) historic differences in rates of return between different asset classes (e.g., equities, bonds, or cash) based on standard market indices; (iii) effects of inflation; (iv) estimating future retirement income needs; (v) determining investment time horizons; and (vi) assessing risk tolerance.

   The information and materials described above are general financial and investment information that have no direct relationship to investment alternatives available to participants and beneficiaries under a plan or to individual participants or beneficiaries. The furnishing of such information, therefore, would not constitute rendering "advice" or making "recommendations" to a participant or beneficiary within the meaning of 29 C.F.R. 2510.3-21(c)(1)(i). Accordingly, the furnishing of such information would not constitute the rendering of "investment advice" for purposes of section 3(21)(A)(ii) of ERISA.

3. Asset Allocation Models. Information and materials (e.g., pie charts, graphs, or case studies) that provide a participant or beneficiary with models, available to all plan participants and beneficiaries, of asset allocation portfolios of hypothetical individuals with different time horizons and risk profiles, where: (i) Such models are based on generally accepted investments theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over define periods of time; (ii) all material facts and assumptions on which such models are based (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and rates of return) accompany the models; (iii) to the extent that an asset allocation model identifies any specific investment alternative available under the plan, the model is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained; and (iv) the asset allocation models are accompanied by a statement indicating that, in applying particular asset allocation models to their individual situations, participants or beneficiaries should consider their other assets, income, and investments (e.g., equity in a home, IRA investments, savings accounts, and interests in other qualified and non-qualified plans) in addition to their interests in the plan.

   Because the information and materials described above would enable a participant or beneficiary to assess the relevance of an asset allocation model to his or her individual situation, the furnishing of such information would not constitute a "recommendation" within the meaning of 29 C.F.R. 2510.3-21(c)(1)(i) and, accordingly, would not constitute "investment advice" for purposes of section 3(21)(A)(ii) of ERISA. This result would not, in the view of the Department, be affected by the fact that a plan offers only one investment alternative in a particular asset class identified in an asset allocation model.

4. Interactive Investment Materials. Questionnaires, worksheets, software, and similar materials which provide a participant or beneficiary the means to estimate future retirement income needs and assess the impact of different asset allocations on retirement income, where: (i) Such materials are based on generally accepted investment theories that take into account the historic returns of different asset classes (e.g., equities, bonds, or cash) over defined periods of time; (ii) there is an objective correlation between the asset allocations generated by the materials and the information and data supplied by the participant or beneficiary; (iii) all material facts and assumptions (e.g., retirement ages, life expectancies, income levels, financial resources, replacement income ratios, inflation rates, and rates of return) which may affect a participant's or beneficiary's assessment of the different asset allocations accompany the materials or are specified by the participant or beneficiary; (iv) to the extent that an asset allocation generated by the materials identifies any specific investment alternative available under the plan, the asset allocation is accompanied by a statement indicating that other investment alternatives having similar risk and return characteristics may be available under the plan and identifying where information on those investment alternatives may be obtained; and (v) the materials either take into account or are accompanied by a statement indicating that, in applying particular asset allocations to their individual situations, participants or beneficiaries should consider their other assets, income, and investments (e.g., equity in a home, IRA investments, savings accounts, and interests in other qualified and non-qualified plans) in addition to their interests in the plan.

   The information provided through the use of the above-described materials enables participants and beneficiaries independently to

design and assess multiple asset allocation models, but otherwise these materials do not differ from asset allocation models based on hypothetical assumptions. Such information would not constitute a "recommendation" within the meaning of 29 C.F.R. 2510.3-21(c)(1)(i) and , accordingly, would not constitute "investment advice" for purposes of section 3(21)(A)(ii) of ERISA.

The Department notes that the information and materials described in subparagraphs (1)-(4) above merely represent examples of the type of information and materials which may be furnished to participants and beneficiaries without such information and materials constituting "investment advice." In this regard, the Department recognizes that there may be many other examples of information, materials, and educational services which, if furnished to participants and beneficiaries, would not constitute "investment advice." Accordingly, no inferences should be drawn from subparagraphs (1)-(4), above, with respect to whether the furnishing of any information, materials or educational services not described therein may constitute "investment advice." Determinations as to whether the provision of any information, materials or educational services not described herein constitutes the rendering of "investment advice" must be made by reference to the criteria set forth in 29 C.F.R. 2510.3-21(c)(1).

e. *Selection and Monitoring of Educators and Advisors.* As with any designation of a service provider to a plan, the designation of a person(s) to provide investment educational services or investment advice to plan participants and beneficiaries is an exercise of discretionary authority or control with respect to management of the plan; therefore, persons making the designation must act prudently and solely in the interest of the plan participants and beneficiaries, both in making the designation(s) and in continuing such designation(s). See ERISA sections 3(21)(A)(i) and 404(a), 29 USC 1002 (21)(A)(i) and 1104(a). In addition, the designation of an investment advisor to serve as a fiduciary may give rise to co-fiduciary liability if the person making and continuing such designation in doing so fails to act prudently and solely in the interest of plan participants and beneficiaries; or knowingly participates in, conceals or fails to make reasonable efforts to correct a known breach by the investment advisor. See ERISA section 405(a), 29 USC 1105(a). The Department notes, however, that, in the context of an ERISA section 404(c) plan, neither the designation of a person to provide education nor the designation of a fiduciary to provide investment advice to participants and beneficiaries would, in itself, give rise to fiduciary liability for loss, or with respect to any breach of part 4 of title I of ERISA, that is the direct and necessary result of a participant's or beneficiary's exercise of independent control. 29 C.F.R. 2550.404c-1(d). The Department also notes that a plan sponsor or fiduciary would have no fiduciary responsibility or liability with respect to the actions of a third party selected by a participant or beneficiary to provide education or investment advice where the plan sponsor or fiduciary neither selects nor endorses the educator or advisor, nor otherwise makes arrangements with the educator or advisor to provide such services.

Signed at Washington, DC, this 30th day of May, 1996.

Olena Berg,

Assistant Secretary

Pension and Welfare, Benefits Administration

U.S. Department of Labor.

- Footnotes -

* Under section 3(2) of ERISA, 29 USC 1002(2), the term "pension plan" encompasses any plan, fund or program established or maintained by an employer or employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances, it provides retirement income to employees or results in a deferral of income by employees for periods extending to the termination of covered employment or beyond. The Department notes that, for purposes of Title I of ERISA, an employer-sponsored individual retirement account (IRA) is

considered to be an individual account pension plan. See 29 C.F.R. 2510.3-2(d).

1. The section 404(c) regulation conditions relief from fiduciary liability on, among other things, the participant or beneficiary being provided or having the opportunity to obtain sufficient investment information regarding the investment alternatives available under the plan in order to make informed investment decisions. Compliance with this condition, however, does not require that participants and beneficiaries be offered or provided either investment advice or investment education, e.g. regarding general investment principles and strategies, to assist them in making investment decisions. 29 C.F.R. 2550.404c-1(c)(4).
2. Issues relating to the circumstances under which information provided to participants and beneficiaries may affect a participant's or beneficiary's ability to exercise independent control over the assets in his or her account for purposes of relief from fiduciary liability under ERISA section 404(c) are beyond the scope of this interpretive bulletin. Accordingly, no inferences should be drawn regarding such issues. See 29 C.F.R. 2550.404c-1(c)(2). It is the view of the Department, however, that the provision of investment-related information and material to participants and beneficiaries in accordance with paragraph (d) of this interpretive bulletin will not, in and of itself, affect the availability of relief under section 404(c).
3. The Department has expressed the view that, for purposes of section 3(21)(A)(ii), such fees or other compensation need not come from the plan and should be deemed to include all fees or other compensation incident to the transaction in which the investment advise has been or will be rendered. See A.O. 83-60A (Nov. 21, 1983); Reich v. McManus, 883 F. Supp. 1144 (N.D. Ill. 1995).
4. This IB does not address the application of 29 C.F.R. 2510.3-21(c) to communications with fiduciaries of participant-directed individual account pension plan plans.
5. Descriptions of investment alternatives under the plan may include information relating to the generic asset class (e,g,, equities, bonds, or cash) of the investment alternatives. 29 C.F.R. 2550.404c-1(b)(2)(i)(B)(1)(ii).

29 CFR 2509.95-1 - Interpretive bulletin relating to the fiduciary standard under ERISA when selecting an annuity provider.

(a) Scope. This Interpretive Bulletin provides guidance concerning
certain fiduciary standards under part 4 of title I of the Employee
Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1104-1114,
applicable to the selection of annuity providers for the purpose of
pension plan benefit distributions where the plan intends to transfer
liability for benefits to the annuity provider.
(b) In General. Generally, when a pension plan purchases an annuity
from an insurer as a distribution of benefits, it is intended that the
plan's liability for such benefits is transferred to the annuity
provider. The Department's regulation defining the term ``participant
covered under the plan'' for certain purposes under title I of ERISA
recognizes that such a transfer occurs when the annuity is issued by an
insurance company licensed to do business in a State. 29 CFR 2510.3-
3(d)(2)(ii). Although the regulation does not define the term
``participant'' or ``beneficiary'' for purposes of standing to bring an
action under ERISA Sec. 502(a), 29 U.S.C. 1132(a), it makes clear that
the purpose of a benefit distribution annuity is to transfer the plan's
liability with respect to the individual's benefits to the annuity
provider.
Pursuant to ERISA section 404(a)(1), 29 U.S.C. 1104(a)(1),
fiduciaries must discharge their duties with respect to the plan solely
in the interest of the participants and beneficiaries. Section
404(a)(1)(A), 29 U.S.C. 1104(a)(1)(A), states that the fiduciary must
act for the exclusive purpose of providing benefits to the participants
and beneficiaries and defraying reasonable plan administration expenses.
In addition, section 404(a)(1)(B), 29 U.S.C. 1104(a)(1)(B), requires a
fiduciary to act with the care, skill, prudence and diligence under the
prevailing circumstances that a prudent person acting in a like capacity
and familiar with such matters would use.
(c) Selection of Annuity Providers. The selection of an annuity
provider for purposes of a pension benefit distribution, whether upon
separation or retirement of a participant or upon the termination of a
plan, is a fiduciary decision governed by the provisions of part 4 of
title I of ERISA. In discharging their obligations under section
404(a)(1), 29 U.S.C. 1104(a)(1), to act solely in the interest of
participants and beneficiaries and for the exclusive purpose of
providing benefits to the participants and beneficiaries as well as
defraying reasonable expenses of administering the plan, fiduciaries
choosing an annuity provider for the purpose of making a benefit
distribution must take steps calculated to obtain the safest annuity
available, unless under the circumstances it would be in the interests
of participants and beneficiaries to do otherwise. In addition, the
fiduciary obligation of prudence, described at section 404(a)(1)(B), 29
U.S.C. 1104(a)(1)(B), requires, at a minimum, that plan fiduciaries

conduct an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities. In conducting such a search, a fiduciary must evaluate a number of factors relating to a potential annuity provider's claims paying ability and creditworthiness. Reliance solely on ratings provided by insurance rating services would not be sufficient to meet this requirement. In this regard, the types of factors a fiduciary should consider would include, among other things:

(1) The quality and diversification of the annuity provider's investment portfolio;

(2) The size of the insurer relative to the proposed contract;

(3) The level of the insurer's capital and surplus;

(4) The lines of business of the annuity provider and other indications of an insurer's exposure to liability;

(5) The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts;

(6) The availability of additional protection through state guaranty associations and the extent of their guarantees. Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert. A fiduciary may conclude, after conducting an appropriate search, that more than one annuity provider is able to offer the safest annuity available.

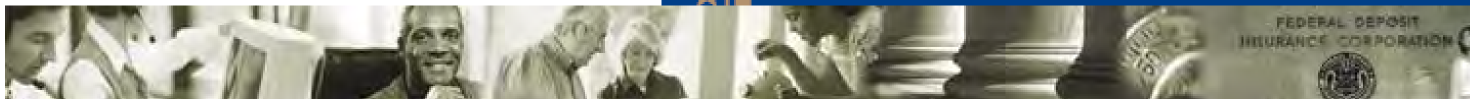
(d) Costs and Other Considerations. The Department recognizes that there are situations where it may be in the interest of the participants and beneficiaries to purchase other than the safest available annuity. Such situations may occur where the safest available annuity is only marginally safer, but disproportionately more expensive than competing annuities, and the participants and beneficiaries are likely to bear a significant portion of that increased cost. For example, where the participants in a terminating pension plan are likely to receive, in the form of increased benefits, a substantial share of the cost savings that would result from choosing a competing annuity, it may be in the interest of the participants to choose the competing annuity. It may also be in the interest of the participants and beneficiaries to choose a competing annuity of the annuity provider offering the safest available annuity is unable to demonstrate the ability to administer the payment of benefits to the participants and beneficiaries. The Department notes, however, that increased cost or other considerations could never justify putting the benefits of annuitized participants and beneficiaries at risk by purchasing an unsafe annuity.

In contrast to the above, a fiduciary's decision to purchase more risky, lower-priced annuities in order to ensure or maximize a reversion of excess assets that will be paid solely to the employer-sponsor in connection with the termination of an over-funded pension plan would violate the fiduciary's duties under ERISA to act solely in the interest of the plan participants and beneficiaries. In such circumstances, the interests of those participants and beneficiaries who will receive annuities lies in receiving the safest annuity available and other participants and beneficiaries have no countervailing interests. The fiduciary in such circumstances must make diligent efforts to assure that the safest available annuity is purchased.

Similarly, a fiduciary may not purchase a riskier annuity solely because there are insufficient assets in a defined benefit plan to purchase a safer annuity. The fiduciary may have to condition the purchase of annuities on additional employer contributions sufficient to purchase the safest available annuity.

(e) Conflicts of Interest. Special care should be taken in reversion situations where fiduciaries selecting the annuity provider have an interest in the sponsoring employer which might affect their judgment and therefore create the potential for a violation of ERISA Sec. 406(b)(1). As a practical matter, many fiduciaries have this conflict of interest and therefore will need to obtain and follow

independent expert advice calculated to identify those insurers with the highest claims-paying ability willing to write the business.
[60 FR 12329, Mar. 6, 1995]



Appendix E — Employee Benefit Law

Technical Bulletin 86-1

Soft Dollars and Directed Commission Arrangements

May 22, 1986

Summary

Establishes DOL positions on how (1) the "soft dollar" safe harbor of Section 28(e) of the Securities Exchange Act and (2) the directed commission arrangements on securities transactions apply to ERISA accounts and fiduciaries.

TechnicalBulletin

This statement reflects the views of the Pension and Welfare Benefits Administration (PWBA) with regard, to "soft dollar" and directed commission arrangements pursuant to its responsibility to administer and enforce the provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Investment managers, plan sponsors and other members of the pension community which provide services to employee plans have expressed a great deal of interest in the application of the fiduciary responsibility provisions of ERISA to these arrangements.

"Soft dollar" and directed commission arrangements typically involve situations in which an investment manager of an employee benefit plan or other plan fiduciary purchases goods or services with a portion of the brokerage commission paid by a plan to a broker for executing a securities transaction. Prior to the elimination of fixed commission rates on stock exchange transactions, investment managers often purchased additional services with commission dollars beyond simple execution, clearance and settlement of securities transactions. After the elimination of fixed commission rates in May 1975, Congress, as part of the Securities Acts Amendments of 1975, added Section 28(e) to the Securities Exchange Act of 1934 (the 1934 Act) to address the practice whereby brokers provided investment managers with brokerage and research services. The Securities and Exchange Commission (the Commission) administers the 1934 Act and has exclusive authority to interpret the scope of Section 28(e) and the terms used therein.

Section 28(e) of the 1934 Act provides generally that no person who exercises investment discretion with respect to securities transactions will be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of paying brokerage commissions for effecting a securities transaction in excess of the amount of commission another broker-dealer would have charged, if such person determined in good faith that the commission was reasonable in relation to the value of brokerage and research services provided by the broker-dealer. The limited safe harbor provided by Section 28(e) is available only for the provision of brokerage and research services to persons who exercise investment discretion with respect to an account as that term is defined in Section 3(a)(35) of the 1934 Act. The Commission has indicated that if a plan fiduciary does not exercise investment discretion with respect to the securities transaction or uses "soft dollars" to pay for non-research related services, the transaction falls outside the protection afforded by Section 28(e) of the 1934 Act and may be in violation of the securities laws and the fiduciary responsibility provisions of ERISA.

It has come to the attention of PWBA that ERISA fiduciaries may be involved in several types of "soft dollar" and directed commission arrangements which do not qualify for the "safe harbor" provided by Section 28(e) of the 1934 Act. In some instances, investment managers direct a portion of a plan's securities trades through specific broker-dealers, who then apply a percentage of the brokerage commissions to pay for travel, hotel

rooms and other goods and services for such investment managers which do not qualify as research within the meaning of Section 28(e).[1] In other instances, plan sponsors who do not exercise investment discretion with respect to a plan direct the plan's securities trades to one or more broker-dealers in return for research, performance evaluation, other administrative services or discounted commissions. The Commission has indicated that the safe harbor of Section 28(e) is not available for directed brokerage transactions.[2]

A fiduciary for an ERISA plan, such as a trustee or investment manager, must meet the fiduciary responsibility standards set forth in part 4 of Title I of ERISA. These standards are designed to help ensure that the fiduciary's decisions are made in the best interests of the plan and are not colored by self-interest.

Section 403(c)(1) provides, in part, that the assets of a plan shall be held for the exclusive purpose of providing benefits to the plan's participants and their beneficiaries and defraying reasonable expenses of administering the plan. Section 404(a)(1) sets forth a similar requirement on how a plan fiduciary must discharge his duties with respect to the plan, and provides further that such fiduciary must act prudently and solely in the interest of the participants and beneficiaries. Those basic provisions are supplemented by the *per se* prohibitions of certain classes of transactions set forth in section 406 of ERISA.

Section 406(a)(1)(D) of ERISA prohibits a fiduciary of an ERISA plan from causing that plan to engage in a transaction if he knows or should know that the transaction would constitute a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of that plan. Section 3(14) includes, within the definition of "party in interest" with respect to a plan, any fiduciary with respect to that plan. Thus, section 406(a)(1)(D) would not only prohibit a fiduciary from causing the plan to engage in a transaction which would benefit a third person who is a party in interest, but it also would prohibit the fiduciary from similarly benefiting himself. In addition, section 406(b)(1) specifically prohibits a fiduciary with respect to a plan from dealing with the assets of that plan in his own interest or for his own account. Section 406(b)(3) supplements these provisions by prohibiting a plan fiduciary from receiving any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

When investment management responsibility has been properly delegated to an investment manager, the manager is responsible for all aspects of the investment process.[3] The manager, in those cases, is required to act prudently with respect to a decision to buy or sell securities as well as with respect to the decision concerning who will execute the transaction. If such a delegation has occurred, the named fiduciary of the plan is not liable for the particular acts or omissions of the manager but has oversight responsibility to periodically review the investment manager's performance.

Where an investment manager has entered into a "soft dollar" arrangement, Section 28(e) of the 1934 Act does not relieve anyone other than the person who exercises investment discretion from the applicability of the fiduciary provisions of ERISA. Therefore, the fiduciary who appoints the investment manager is not relieved of his ongoing duty to monitor the investment manager to assure that the manager has secured best execution of the plan's brokerage transactions and to assure that the commissions paid on such transactions are reasonable in relation to the value of the brokerage and research services provided to the plan.[4]

It is PWBA's understanding that where a plan sponsor or other plan fiduciary directs the investment manager to execute securities trades for the plan through one or more specified broker-dealers, the direction generally requires the investment manager to execute a specified percentage of the plan's trades or a specified amount of the plan's commission business through the particular broker-dealers, consistent with the manager's duty to secure best execution for the transactions.

A plan sponsor's decision to direct brokerage transactions must be made prudently and solely in the interest of the participants and beneficiaries. In directing a plan's brokerage transactions, the sponsor has an initial responsibility to determine that the broker-dealer is capable of providing best execution for the plan's brokerage transactions. In addition, the sponsor has an ongoing responsibility to monitor the services provided by the broker-dealer so as to assure that the manager has secured best execution of the plan's brokerage transactions and that the commissions paid are reasonable in relation to the value of the brokerage and other services received by the plan.

In considering "soft dollar" and directed commission arrangements, ERISA's prohibited transaction provisions also must be taken into account. A fiduciary with respect to an ERISA plan is generally prohibited, by section 406(b)(1), from causing the plan to engage in a transaction if the fiduciary has an interest in the matter which may affect the fiduciary's best judgment as a fiduciary. For example, an employer which is the named fiduciary for its plan and which does not exercise investment discretion would, normally be prohibited from directing the plan's brokerage transactions through a designated broker-dealer who agrees to utilize a portion

of the brokerage commissions received from the plan to procure goods or services for the benefit of the employer. (As previously noted, Section 28(e) is unavailable for such brokerage transactions.) Each use of the broker-dealer that results in the receipt of goods and services by the employer following that designation would create an additional violation of sections 406(a)(1)(D) and 406(b)(1) of ERISA. In addition, where the relief provided by Section 28(e) is unavailable, the receipt by a fiduciary (i.e., the employer) of goods or services for its own personal account from a party (i.e., the broker-dealer) dealing with a plan in connection with a transaction involving the assets of the plan would, in the opinion of PWBA, constitute a violation of section 406(b)(3). Such an arrangement would also violate sections 403(c)(1) and 404(a)(1) to the extent that the employer is benefiting from its use of its position.

However, where an investment manager directs brokerage transactions through a designated broker-dealer to procure goods and services on behalf of the plan, and for which the plan would be otherwise obligated to pay, such use of brokerage commissions ordinarily would not violate the fiduciary provisions of ERISA, provided that the amount paid for the brokerage and other goods and services is reasonable, and the investment manager has fulfilled its fiduciary duty to obtain best execution for the plan's securities transactions. This result does not depend on the availability of the "safe harbor" under Section 28(e) for these transactions.

In applying the fiduciary responsibility provisions of ERISA to the various "soft dollar" and directed commission arrangements that fall outside of the protection of Section 28(e), it is apparent to PWBA that issues are raised under section 406 of ERISA whenever there is an inducement for the investment manager or other plan fiduciary to direct plan brokerage transactions through particular broker-dealers. The following examples illustrate the application of the fiduciary responsibility provisions of ERISA to "soft dollar" and directed commission arrangements:

1. Employer X instructs the master trustee of its plan to direct all plan brokerage transactions through Broker-Dealer B. Part of the commissions are rebated to the master trustee, to reduce its fees. The plan provides that administrative costs, including the fees of the master trustee, are to be paid by the plan. Under these circumstances, this transaction would not, in itself, constitute a violation of the prohibited transaction provisions of ERISA since the "soft dollars" are being used for the exclusive benefit of the plan which generated the commissions. However, in order to act prudently under section 404(a)(1) of ERISA, Employer X would be obligated to initially determine that Broker-Dealer D is capable of providing best execution of the plan's brokerage transactions. In addition, Employer X must also periodically monitor the execution of the plan's brokerage transactions and evaluate whether the brokerage commissions paid by the plan are reasonable in light of the total services received by the plan. Moreover, Employer X would be obligated to assure that the arrangement does not result in the payment of unreasonable compensation to the master trustee.
2. Money Manager A enters into an arrangement with Broker-Dealer B whereby Money Manager A would direct brokerage on behalf of its managed plan accounts which would generate fees of $500,000 per year to Broker-Dealer B. In return, Broker-Dealer P would provide bookkeeping services that do not constitute research under Section 28(e) for the general corporate purposes of Money Manager A. Money Manager A has engaged in an act prohibited by sections 406(a)(1)(D), 406(b)(1) and 406(b)(3) of ERISA since Money Manager A has exercised its fiduciary authority over plan assets to benefit itself. Such a transaction would also violate the exclusive purpose provisions of sections 403(c)(1) and 404(a)(1) of ERISA. In these circumstances, the relief provided by Section 28(e) would not be available because the "soft dollars" are paid for services other than research.
3. The named fiduciaries of Plan P retain Money Manager C to manage part of the assets of Plan P. Money Manager C directs the plan's brokerage transactions through Broker-Dealer D. In return, Broker-Dealer D will provide research on tax-exempt securities to Money Manager C. Although tax-exempt securities would not be a suitable investment for Plan P, Money Manager C has, determined that this research would be useful to his managed accounts as a whole. Money Manager C's arrangement with Broker-Dealer P is therefore encompassed by Section 28(e) of the 1934 Act. However, in retaining Money Manager C, the named fiduciaries of Plan P are required under section 404(a)(1) of ERISA to periodically review the execution secured by Money Manager C and ensure that the brokerage commissions paid by Plan P to Broker-Dealer D are reasonable.

The foregoing discussion is intended to provide general guidance as to the nature of the analysis applicable to these situations. The discussion should not be viewed as expressing an opinion with respect to any specific case.

- Footnotes -

1. See Securities Exchange Act Release No. 34-23170 (April 23, 1986).
2. See Section VI of Securities Exchange Act Release No. 34-23170 (April 23, 1986).
3. Section 405 of ERISA limits the liability of certain plan fiduciaries if management of plan assets has been properly delegated to an investment manager.
4. In PWBA's view, an investment manager's responsibility to seek best execution under the circumstances requires the manager to consider not only the cost of the commissions for the transaction but the quality and reliability of the execution.

Trust Examination Manual

Appendix E — Employee Benefit Law

Advisory Opinion 77-46

Diversification Applicability to Insured and Uninsured Deposits

June 7, 1977

Summary	
Indicates a plan may invest in own-bank:	
I	Insured deposits without violating ERISA diversification requirements.
I	Uninsured deposits without violating ERISA diversification requirements if the bank's assets are diversified.

U.S. Department of Labor

Pension and Welfare Benefits Programs

Washington, D.C. 20216

June 7, 1977 AO 77-46

Mr. Frederic S. Kramer

Assistant General Counsel

National Association of Mutual Savings Banks

200 Park Avenue

New York, N. Y. 10017

Dear Mr. Kramer:

Thank you for your letter requesting our advice as to whether the diversification rule of the Employee Retirement Income Security Act of 1974 (ERISA) permits savings bank trustees or custodians to invest contributions under self-employed retirement plans and individual retirement account plans (IRAs) in savings accounts and deposits with the trustee or custodian savings bank where the account balance exceeds the $40,000 amount covered by FDIC insurance. With respect to IRAs, we assume your question refers to an IRA which is established by an employer or union (or other employee association), since an IRA established by an individual for himself is not subject to Title I of ERISA. I regret the delay in responding to your letter.

You explain that the National Association of Mutual Savings Banks represents the 475 mutual savings banks in the United States which are authorized under the Internal Revenue Code of 1954 to act as trustees or custodians of self-employed retirement plan funds and IRAs. You advise that many jurisdictions in which savings banks do not enjoy trust powers have enacted legislation permitting savings banks to act as fiduciaries with respect to such plans and that New York law is typical of such legislation. You state that New York law provides that savings banks shall have the power to act as trustees of such plans provided that the provisions of these plans "require the funds of such trust to be invested exclusively in deposits in savings banks"

(section 237.7 and 237.8, New York Banking Law). Accordingly, typical provisions in self-employed retirement plans and IRAs in savings banks jurisdictions authorizing savings banks to act as trustees of these accounts provide that the funds of such trusts will be invested exclusively in savings accounts or deposits in the trustee (or custodian) savings bank.

You advise that mutual savings banks are state chartered institutions that derive their powers, including investment powers, from their respective states; as state chartered institutions, mutual savings bank investments are not regulated by federal law.

You have submitted a chart showing the types of legal investments for mutual savings banks, by state, which was most recently compiled as of September 30, 1975. The chart shows that mutual savings banks in Connecticut, Delaware, Maryland, Massachusetts, New Hampshire, Oregon, Pennsylvania, Rhode Island, and Washington are permitted to invest in the following: U.S. Government bonds; state, county, and municipal bonds; railroad bonds; equipment obligations; telephone bonds; electric utility bonds; Canadian bonds; real estate construction loans; conventional mortgage loans; 20 percent mortgage loans; FHA loans; VA loans; large-scale housing; equity securities; bank stock; collateral loans; unsecured notes; acceptances and bills of exchange. The chart also shows that mutual savings banks in Maine, New Jersey, New York, Ohio, and Vermont are permitted to invest in all but one of these types of investments and that Minnesota, Indiana, Alaska, and Wisconsin are somewhat more restrictive in the types of investments permitted for such banks. In all of the above-named states, except Indiana, Vermont, and Wisconsin, mutual savings banks are permitted to invest in equity securities, as well as in debt instruments.

You have also submitted a booklet containing a list of securities considered legal investments for savings banks under section 235 of the New York Banking Law as of July 1, 1975, and financial statements showing the actual investments of three mutual savings banks (a large bank, a small one, and a medium-sized one).

You explain that the investment authority of mutual savings banks differs from that of commercial banks in that while practically all mutual savings banks can invest in equity securities, commercial banks are prohibited, with limited exceptions, from investing in stocks of corporations. Also, while mutual savings banks' authority to invest in equity securities is generally far broader than that of commercial banks, commercial banks have the power to make short term commercial loans at rates which may be tied to the prime rate and further may make such loans to any one issuer or borrower in an amount up to ten percent of the bank's capital stock, paid-in and unimpaired, plus ten percent of its unimpaired surplus fund.

Section 404(a)(1)(C) of ERISA requires a fiduciary to discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. The Conference Report (H. Rep. No. 93-1280, 93rd Congress, 2nd Session) states, on page 305, that the conferees intend that, in general, whether the plan assets are sufficiently diversified is to be determined by examining the ultimate investment of the plan assets. For example, the conferees understand that for efficiency and economy plans may invest all their assets in a single bank or other pooled investment fund, but that the pooled fund itself could have diversified investments. It is intended that, in this case, the diversification rule is to be applied to the plan by examining the diversification of the investments in the pooled fund. The same is true with respect to investments in a mutual fund. Also, generally a plan may be invested wholly in insurance or annuity contracts without violating the diversification rules, since generally an insurance company's assets are to be invested in a diversified manner. The Conference Report also explains, on page 314, that it is expected that the prudent man, diversification, and other rules of section 404(a) of ERISA generally will not be violated if all plan assets in an individual account plan are invested in a federally-insured account, so long as the investments are fully insured. (If an individual's account balance is greater than the amount covered by federal insurance, this will not violate the prudence and diversification requirements if the individual participant or beneficiary has control over his account and determines, for himself, that the assets should be so invested.)

With respect to control, section 404(c) of ERISA states that in the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) -- (1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise and (2) no person who is otherwise a fiduciary shall be liable under Part I of ERISA for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control. However, the Conference Report states, on pages 305-306, that the conferees recognize that there may be difficulties in determining whether the participant in fact exercises independent control over his account. Consequently, whether participants and beneficiaries exercise independent control is to be determined pursuant to regulations prescribed by the Secretary of Labor. The conferees expect that the regulations generally will require that for there to be independent control by participants, a broad range of investments must be available

to the individual participants and beneficiaries.

You believe that although the term "control" is not defined by ERISA, the requisite control would exist even though substantial penalties for withdrawal from retirement plan accounts are imposed both by the FDIC and the Internal Revenue Code. A participant can withdraw his funds, which are fully vested at all times, at any time subject to these penalties. A participant's control over his IRA is such that he can, once every three years, withdraw the entire amount of the funds in his account and reinvest the proceeds in another IRA funded through insurance contracts or a mutual fund, or through the deposits of another financial institution.

Alternatively, in the event it is determined that the individual participant or beneficiary does not have control over the account as that term might be defined in regulations, you suggest that recognition of the diversification of insurance company investments, discussed on page 305 of the Conference Report, should apply equally to those of a mutual savings bank. You believe that the investment alternatives of a savings bank are, in much the same way as the investment alternatives of an insurance company, strictly regulated to insure the sound and prudent investment of these kinds of funds.

As noted above, no regulations have yet been issued under section 404(c). In the absence of such regulations, we are unable to respond to the question of control.

[*FDIC Note:* DOL Regulation 2550.404c-1 *was not adopted until 10-13-92*.]

With respect to your second question as to whether section 404(a)(1)(C) of ERISA permits investment of all the assets of an individual account plan in savings accounts of mutual savings banks where the account balance exceeds the amount covered by Federal insurance, **it is the view of the Department of Labor that such an investment would not, in and of itself, contravene the diversification requirements of section 404(a)(1)(C), assuming that the bank invested its assets in a diversified manner. As noted by the Conference Report at p. 314, to the extent that the investment in the account balance is not in excess of the amount covered by Federal insurance, the diversification standard will not be violated, as there cannot be large losses.** However, the individual account plan may invest all its assets in a savings bank even if such amount exceeds the amount covered by Federal insurance, without violating the diversification rules, if the bank's assets are invested in a diversified manner. **The fiduciary making such investment would, of course, have to determine whether the bank's assets were diversified so as to minimize the risk of large losses.**

We are expressing no opinion as to whether in practice the investments of self-employed retirement plans or IRAs in any specific mutual savings bank or any specific group of mutual savings banks are actually sufficiently diversified to meet the requirements of section 404(a)(1)(C).

Sincerely,

Fred W. Stuckwisch

Director

Office of Regulatory Standards and Exceptions

Advisory Opinion to Bank Plan (79-49)

Payment of Fiduciary Fee to Bank Sponsor of Plan

May 14, 1979

Summary
Indicates a bank plan may provide fiduciary services to its own plan only on a no-fee basis.

U.S. Department of Labor

Labor-Management Services Administration

Washington, D.C. 20216

Washington Service Bureau Reference

May 14, 1979 79-49

Mr. Alfred T. Spada

Hogan and Hartson

815 Connecticut Avenue, N.W.

Washington, D.C. 20006

Re: Riggs National Bank Amended Pension Plan

Dear Mr. Spada:

This is in response to your letter of September 8, 1977, in which you seek our opinion as to whether the appointment and service of the Riggs National Bank (the Bank) as trustee of the Riggs National Bank Amended Pension Plan (the Plan) would constitute a prohibited transaction under section 406 of the Employee Retirement Income Security Act of 1974 (ERISA) or would otherwise be prohibited under ERISA.

In your letter, you represent that the Board of Directors of the Bank adopted the Plan in September 1976 and the related amended trust agreement in May 1977. These documents include an amendment substituting Riggs as trustee of the Plan in place of various individuals currently serving as trustees. You further represent that the Bank will not receive any fee or other compensation from the Plan for its services as trustee.

A number of provisions in Part 4 of Subtitle B of Title I of ERISA seem to imply that an employer of a plan's participants may serve as trustee of the plan.

Section 402(c)(1) states that any employee benefit plan may provide that any person or group of persons may serve in more than one fiduciary capacity with respect to the plan (including service both as trustee and administrator).

Section 408(c)(3) provides that the restrictions of section 406 shall not prohibit a fiduciary from serving as a fiduciary in addition to being an officer, employee, agent, or other representative of a party in interest. Under section 3(14)(C), an employer any of whose employees are covered by a plan is a party in interest with respect to the plan.

Section 408(b)(4)(A) permits the investment of Plan assets in deposits which bear a reasonable interest rate in a bank or similar financial institution supervised by the United States or a State, if such bank or other institution is a fiduciary of the plan and if the plan covers only employees of the bank or other institution and employees of affiliates of such bank or other institution.

Part 4 of Subtitle B of Title I of ERISA contains no provision that prohibits an organization from being both an employer of a plan's participants and a trustee of the plan. We note, however, that the conduct of any organization in its capacity as trustee would be subject to the fiduciary responsibility requirements of Part 4, including section 404 (relating to fiduciary duties) and section 406 (relating to prohibited transactions).

Section 406(a)(1)(C) of ERISA provides generally that a plan fiduciary shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest.

Section 408(b)(2), however, exempts from the prohibitions of section 406 contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of a plan, if no more than reasonable compensation is paid therefore.

Regulation 2550.408b-2 explains that the 408(b)(2) exemption applies only to transactions described in section 406(a) of ERISA. If the furnishing of a service involves an act described in section 406(b) (relating to conflicts of interest by fiduciaries), such act constitutes a separate transaction which in not exempt under section 408(b)(2). The prohibitions of section 406(b) are intended to deter fiduciaries from exercising the authority, control, or responsibility which makes them fiduciaries when they have interests which may conflict with the interests of the plans for which they act. Thus, section 406(b) would prohibit a fiduciary from using the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service.

Section 2550.408b-2(c)(3) **of the regulation states, however, that if a fiduciary provides services to a plan**

without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services), the provision of such services does not, in and of itself, constitute an act described in section 406(b) of ERISA.

We regret the delay in responding to your request, and hope you find this general information helpful.

Sincerely,

Alan D. Lebowitz

Assistant Administrator

Office of Fiduciary Standards

Advisory Opinion to OCC (80-OCC)

Investment in Fiduciary Bank/Holding Company Securities

July 25, 1980

Summary	
(1)	The discretionary purchase, retention, or sale of a fiduciary bank's own stock, or that of its own holding company, would involve a violation of ERISA's prudence requirement in § 404(a)(1)(B). If the fiduciary had a direct or indirect interest in the transaction, a violation of ERISA § 406(b) would occur.
(2)	The non-discretionary purchase, retention, or sale of a fiduciary bank's own stock, or that of its own holding company, would not involve a violation of ERISA.

U.S. Department of Labor

Labor-Management Services Administration

Washington, D.C. 20216

Reply to the Attention of:

Ivan Strasfeld

(202) 523-8971

July 25, 1980

Mr. Dean E. Miller

Deputy Comptroller for Specialized Examinations

Comptroller of the Currency

Administrator of National Banks

Washington, D.C. 20219

Dear Mr. Miller:

By letter dated May 27, 1980, you presented certain issues arising under the prohibited transactions provisions contained in Part 4 of Title I of ERISA that are often discerned by your trust examiners during the course of their inspections.

Accordingly, you have requested guidance with regard to the following questions:

1. Where a bank has sole investment responsibility with respect to the assets of an employee benefit plan, will the purchase for the plan of the bank's stock or its holding company's stock constitute a prohibited transaction under ERISA? If so, which provisions of section 406 would it violate? (You have asked us to

assume that the stock will not be purchased from a party in interest).

2. Where the bank as trustee is directed by a named fiduciary authorized to direct the investments of a plan, will the directed purchase for the plan of the bank's stock or its holding company's stock constitute a prohibited transaction under ERISA? (Again, you ask us to assume that the stock will not be purchased from a party in interest).
3. Where an investment manager has been named, will the purchase of the bank trustee's stock or its holding company's stock at the direction of the investment manager constitute a prohibited transaction under ERISA?
4. Does the retention by a plan of the bank trustee's stock or its holding company's stock constitute a prohibited transaction under ERISA?

The prohibited transactions provisions of ERISA restrict the acquisition and holding by an employee benefit plan of securities issued by an employer-sponsoring company. See section 407 of ERISA. No such explicit proscription or limitation applies to stock of a bank trustee or holding company thereof.

However, section 406(a)(1)(D) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if he knows or should know that such transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. The ERISA Conference Report (H.R. Rep. No. 93-1280; 93d Cong., 2d Session 308 (1974)) clarifies this prohibition by stating, among other things, "... securities purchases or sales by a plan to manipulate the price of the security to the advantage of a party in interest constitutes a use by or for the benefit of a party in interest of any assets of the plan."

Sections 406(b)(1) and (2) further prohibit a fiduciary from dealing with the assets of a plan in his own interest or for his own account or acting in any transaction involving the plan on behalf of a party or representing a party whose interests are adverse to the interests of its participants or beneficiaries. The prohibitions of section 406(b) of ERISA impose upon fiduciaries a duty of undivided loyalty to the plans for which they act. Moreover, the codification of the "prudent man rule" contained in section 404(a)(1) of ERISA provides in relevant part:

> ... a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and ...
>
> (B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like characters and with like aims.

Although a determination of whether a violation of sections 406(b)(1) or (2) and 404(a) has occurred will generally depend on the particular facts and circumstances of each case, *it burdens our imagination to envision a situation in which a trustee with investment discretion could make an objective decision, solely on the basis of the prudence standard, regarding the purchase or sale of its own stock* [emphasis added]. For example, a trustee may exercise his or her discretion based on inside information regarding the bank's financial condition. Although, in a particular case, it may be in the plan's best interest to sell the bank stock, the sale of such stock might cause a further decline in its market value. In such case, the bank trustee would have an interest in the transaction which would conflict with the interest of the plan for which he acts so as to be in violation of section 406(b)(2) of ERISA.

A bank trustee may avoid engaging in an act described in section 406(b)(1) or (2) of ERISA by not using the authority, control or responsibility which makes it a fiduciary to cause a plan to purchase or sell bank stock. Thus, the purchase or sale of bank stock by a trustee pursuant to the instructions of a named fiduciary or investment manager not affiliated with such trustee will not result in violations of such 406(b) of ERISA.

It should be noted that the inquiry concerning whether a fiduciary has violated section 406(b)(1) and (2) of ERISA is not limited to a decision whether to buy or sell bank stock. At all times that a trustee acts in a fiduciary capacity, he may make no decision on behalf of a plan which would have the effect of benefiting a person in which such fiduciary has an interest. A decision to retain bank stock in the plan portfolio, as well as decisions to buy or sell such stock, may involve acts described in section 406(b) of ERISA. However, to the extent a trustee has no discretion regarding retention of bank stock, (e.g., the decision to retain bank stock is, in fact, made by an independent investment manager), no violation of section 406(b)(1) or (2) will occur.

We hope this information provides adequate guidance to you in the implementation of examination policy. Of course, we would welcome any further inquiries raised under the fiduciary responsibility provisions of ERISA.

Sincerely,

Alan D. Lebowitz

Assistant Administrator for Fiduciary Standards

Pension and Welfare Benefit Programs

Advisory Opinion/Individual Exemption 85-36A

Loans Intended to Benefit Union Members/Employers

October 23, 1985

Summary
[Construction Loan by Construction Union Plan to Provide Employment for Union Members] (1) The loan would probably be a prohibited transaction in violation of ERISA § 406(a)(1)(D) as it would benefit employers contributing to plan, and (2) might violate ERISA § 404 (as imprudent and/or undiversified) and ERISA § 403 (as plan assets benefiting contributing employers).

U.S. Department of Labor

Office of Pension and Welfare Benefit Programs

Washington, D.C. 20210

Ralph P. Katz

Delson & Gordon

230 Park Avenue

New York, NY 10169

RE: Annuity Fund of the Electrical Industry of Long Island

Identification Number: F-2521

Dear Mr. Katz:

This is in response to your letter of September 23, 1982, in which you requested clarification regarding the application of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to a proposed investment by the Annuity Fund of the Electrical Industry of Long Island (the Fund). Specifically, you inquired whether a prohibited transaction would occur if the trustees of the Fund made an investment which was part of an overall agreement obligating an insurance company to invest a specified amount of insurance company assets in construction mortgages within the geographic jurisdiction of the union whose members are participants in the Fund. The agreement would further require the insurance company to make such investments in construction projects employing only labor represented by unions affiliated with the AFL-CIO. You state that the trustees will make the investment after determining that the investment rate of return is equal to or greater than similar investments bearing similar risks.

Section 406(a)(1)(D) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction which the fiduciary knows or should know constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) and (2) of ERISA further prohibit a fiduciary with respect to a plan from dealing with the assets of a plan in his or her own interest or for his or her own account, or acting in any transaction on behalf of a party or representing a party whose interests are adverse to the interest of the plan or its participants.

Section 3(14) of ERISA defines the term party in interest to include a fiduciary, an employer any of whose employees are covered by the plan, and any employees of such employer.

We wish to point out, as we have done in prior correspondence regarding this matter, that ERISA's general standards of fiduciary conduct apply to your proposed investment course of action. Sections 403(c) and 404(a)

(1) of ERISA require, among other things, that a fiduciary of a plan act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries. As you know the Department, on a number of occasions, has expressed its views as to the meaning of these requirements in the context of investment decision-making.

We have stated that, to act prudently, a plan fiduciary must consider, among other factors, the availability, riskiness, and potential return of alternative investments for his plan. Because the investment you propose causes the plan to forego other alternative investment opportunities, such an investment would not be prudent if it provided a plan with less return, in comparison to risk, than comparable investments available to the plan, or if it involved a greater risk to the security of plan assets than other investments offering a similar return.

We have construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their requirement income to unrelated objectives. Thus, in deciding whether and to what extent to invest in a particular investment, a fiduciary must ordinarily consider only factors relating to the interests of plan participants and beneficiaries in their retirement income. A decision to make an investment may not be influenced by desire to stimulate the construction industry and generate employment, unless the investment, judged solely on the basis of its economic value to the plan, would be equal or superior to alternative investments available to the plan.

Thus, it would not be inconsistent with the requirements of sections 403(c) or 404 of ERISA for plan fiduciaries to select an investment course of action that reflects non-economic factors, so long as application of such factors follows primary consideration of a broad range of investment opportunities that are, economically advantageous.

Based on the representations made in your letter, it does not appear that the arrangement you describe would involve a prohibited transaction of the kind described in sections 406(a)(1)(A), (B) or (C) of ERISA (relating to sales, leases or other exchanges of property, loans or other extensions of credit and the furnishing of goods, services or facilities). In addition, it does not appear that the arrangement involves a direct transfer of plan assets to, or use of plan assets by or for the benefit of, a party of interest of the kind described in section 406(a)(1)(D) of the Act.

Nonetheless, it is reasonable to infer that the arrangement will result in some benefit to parties in interest with respect to the plan, i.e. contributing employers and their employees. Thus, it is necessary to determine whether the arrangement would involve an indirect use of plan assets for the benefit of a party in interest.

In the circumstances you describe, where the arrangement would be prohibited, if at all, solely as an indirect use of plan assets for the benefit of a party in interest,* the Department believes that it is appropriate to examine the facts and circumstances surrounding the plan's investment to determine whether it is made for the purposes of providing a prohibited benefit. Since this is an inherently factual determination, the Department is not prepared to issue an advisory opinion regarding the specific arrangement described in your letter.

In our view, however, a plan investment which is made subject to a condition which can reasonably be expected to result in a benefit to one or more parties in interest would violate section 406(a)(1)(D) (as well as sections 403 and 404 of the Act) if it involves greater a greater risk or a lesser return to the plan than a comparable transaction that is not subject to such a condition.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Elliot I. Daniel

Assistant Administrator for Regulations and Interpretations

* This kind of arrangement should be distinguished from a plan investment made subject to a condition which in effect makes the transaction an indirect sale or loan.

ERISA Section 403(c)(1)

"Except as provided in paragraph (2) or (3) of subsection (d), or under section 4042 and 4044 (relating to termination of insured plans), the assets of a plan shall never insure to the benefit of an employer and shall be

held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan."

> Editor Note: - Paras (2) and (3) [of 403(c)] relate to the tax-qualification and tax-deductibility of contributions, and so are not germane to this situation.
>
> - Subsection (d) [of 403] and sections 4042 and 4044 deal with returning excess plan assets to plan sponsors upon termination of plans, and so are not germane to this situation.

Advisory Opinion/Individual Exemption 86-FRB

Sweep Arrangements and Related Sweep Transaction Fees

August 1, 1986

Summary
Covers sweeps from ERISA accounts into own/affiliated-bank deposits and other internal short-term investment vehicles, together with fees that may be charged for such transactions.
Also released is an OCC Trust Interpretive Letter #40 dated August 1, 1986.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

Mr. Robert S. Plotkin

Assistant Director

Division of Banking Supervision and Regulation

Board of Governors of the Federal Reserve System

Washington, D.C. 20551

Dear Mr. Plotkin:

This is in response to your letter requesting our views regarding the application of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to certain "sweep services" provided to employee benefit plans by banks acting as trustees and/or investment managers. Under such arrangements, banks transfer ("sweep") idle cash balances of customer accounts, including plan accounts, into short term interest bearing investment vehicles such as money market funds or bank-affiliated short-term collective investment funds. You have specifically asked whether such "sweep services" would qualify for the statutory exemptions provided by sections 408(b)(2), 408(b)(6) and/or 408(b)(8) of ERISA.

You indicate that the bank regulatory agencies for many years have been advising the institutions subject to their supervision of their duty to institute cash management procedures and to productively invest trust funds that are temporarily in their custody. Recent technological advances have permitted increased investment returns to trust accounts by the sweeping of once idle cash balances into interest-bearing investment vehicles. You further state that typically, as compensation for its sweep services, a bank retains as its fee a portion of the daily interest generated by the sweep fund, which fee is calculated as a percentage of the daily invested cash balance. In the case of an employee benefit plan, you believe that this compensation retained by a bank may violate the prohibited transaction provisions of ERISA in the absence of an applicable statutory exemption.[1]

Section 406(a) of ERISA provides, in pertinent part, that a fiduciary of an ERISA plan shall not cause the plan to engage in a transaction which the fiduciary knows or should know constitutes a direct or indirect: (1) sale or exchange, or leasing of any property between the plan and a party in interest; (2) furnishing of goods, services, or facilities between the plan and a party in interest; or (3) transfer to, or use by or for the benefit of a party in interest, of any asset of the plan. Section 3(14) defines the term "party in interest" to include a fiduciary

and a person providing services to the plan. In addition, section 406(b) provides that a fiduciary with respect to a plan shall not: (1) deal with the assets of the plan in its own interest or for its own account; (2) act on behalf of or represent a part whose interests are adverse to those of the plan; or (3) receive consideration from a third party in connection with a transaction involving plan assets.

ERISA section 408(b)(2) exempts from the prohibitions of section 406(a) the payment by a plan to a party in interest, including a fiduciary, for a service (or a combination of services if: (1) the service is necessary for the establishment or operation of the plan; (2) the service is furnished under a contract or arrangement which is reasonable; and (3) no more than reasonable compensation is paid for the service. Accordingly, the mere provision of cash sweep services by a bank or similar institution would be exempt from the prohibitions of ERISA section 406(a) if the conditions of the exemption described in section 408(b)(2) were met.[2]

With respect to the prohibitions in section 406(b), regulation 29 C.F.R. 2550.408b-2(a) indicates that ERISA section 408(b)(2) does not contain an exemption for an act described in ERISA section 406(b) (relating to conflicts of interest on the part of fiduciaries) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2). As explained in regulation 29 C.F.R. 2550.408b-2(e)(1), if a fiduciary uses the authority, control, or responsibility which makes it a fiduciary to cause the plan to enter into a transaction involving the provision of services when such fiduciary has an interest in the transaction which may affect the exercise of its best judgment as a fiduciary, a transaction described in section 406(b) would occur, and that transaction would be deemed to be a separate transaction from the transaction involving the provision of services and would not be exempted by section 408(b)(2).

As a general matter, a bank engages in violations of section 406(b)(1) whenever it uses its fiduciary authority or control with respect to plan funds to increase the amount of its compensation by determining the timing and/or the amount of plan funds to be transferred into the sweep fund.[3] Conversely, section 29 C.F.R. 2550.408b-2(e)(3) indicates that if a bank provides sweep services without the receipt of additional compensation or other consideration (other than reimbursement of direct expenses Properly and actually incurred in the performance of such services within the meaning of 29 C.F.R. 2550.408c-2(b)(3)), then the provision of sweep services by the bank would not, in itself, constitute a violation of section 406(b) of ERISA. Moreover, the provision by a bank of investment management services, including sweep services, under a single arrangement which is calculated as a investment management services, including sweep services, of the market value of the total assets under management would not, in itself, constitute an act described in section 406(b)(1) of ERISA because the bank would not be exercising its fiduciary authority or control to cause a plan to pay an additional fee.

The following examples illustrate the application of the of section 408(b)(2) of ERISA to sweep service arrangement. The examples assume that the underlying investment transactions otherwise comply with applicable statutory exemptions.

> (1) A plan enters into a standing arrangement with its bank investment manager which authorizes the bank to exercise its discretion to sweep idle cash balances into the bank's money market fund. For this service, the bank will charge the plan a fee calculated as a percentage of the daily invested cash balance in the money market fund. In effect, the bank would be using its fiduciary authority to cause the plan to pay an additional fee for a service performed by the bank in violation of section 406(b)(1) of ERISA. Although there would be initial approval of the arrangement by the plan, thereafter the bank would have total discretion to transfer plan funds into the money market fund and to determine how long the plan funds remain in such fund, thereby increasing its compensation. In this respect, we note that a bank which exercises its fiduciary authority in a manner which contravenes section 406(b)(1) cannot avoid liability simply by obtaining the consent of an independent plan fiduciary after disclosure to that fiduciary. See 29 C.F.R. 2550.408b-2(f), Example (2).
>
> (2) Bank A proposes to provide investment management services, including sweep services, to plans under a single fee arrangement which is calculated as a percentage of the market value of the plan funds under management. There will be no separate charges for the provision of sweep services. Under these circumstances, the provision by Bank A of investment management services, including sweep services, would not, in itself, constitute a violation of section 406(b)(1) because the bank would not be using its fiduciary authority or control to cause a plan to pay additional fees for a service furnished by the Bank. We are assuming for purposes of this example that the total fees to be paid by a plan are reasonable in light of the investment management services received by that plan.
>
> (3) Trustee Bank B proposes to enter into an arrangement with a plan for the provision of sweep services under the following circumstances. The Bank would have a standing authorization whereby, at the close of each business day, the Bank would be required to sweep all uninvested cash in excess of

$100 into the Bank's money market fund. For this service, the Bank will charge the plan a fee calculated as a percentage of the daily invested cash balance in the money market fund. Investment Manager C, who is unrelated to the Bank, is the plan's investment manager as described in section 3(38) with the power to acquire or dispose of the plan's assets. C has sole discretion as to when money will be withdrawn from the fund. The plan's arrangement with the Bank is subject to immediate termination without penalty and requires that the Bank notify the plan no less than 30 days prior to any change in the fees to be charged for its provisions of sweep services. This arrangement does not violate section 406(b)(1) because the Bank would not be exercising any of its fiduciary authority or control to cause the plan to pay an additional fee.

You further indicate that some banks have been relying on the exemption provided by section 408(b)(6) of ERISA. Section 408(b)(6) exempts from the prohibitions of section 406 the provision of certain ancillary services by a bank or similar financial institution supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions of 29 C.F.R. 2550.408b-6(b) are met. Such ancillary services include services which do not meet the requirements of ERISA section 408(b)(2) because the provision of such services involves an act described in section 406(b)(1) or (b)(2) of ERISA, section 2550.408b-6(b) requires that such services must be provided at not more than reasonable compensation; under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and only to the extent such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of section 2550.408b-6(c). To date, no regulations have been issued clarifying that section. However, the Department has stated that the condition contained in section 408(b)(6)(B) requiring "specific guidelines" is satisfied (in the absence of such regulations) if the ancillary services are provided in accordance with specific guidelines issued by the bank or similar financial institution, and if adherence to the guidelines would reasonably preclude such bank or institution from providing the services in an excessive or unreasonable manner and in a manner that would be inconsistent with the best interests of the participants and beneficiaries. (See 47 FR 14806, April 6, 1982.)

A bank which is a fiduciary to a plan may receive additional fees for additional services rendered only if such services are "ancillary services." In the Department's view, the question of whether short-term cash management services constitute "ancillary services" within the meaning of section 408(b)(6) depends on the expectations of the parties as evidenced by the terms of the governing instrument and applicable Federal banking law. Thus, for example, the Department believes that where a plan appoints a bank trustee or investment manager with complete discretion to manage the assets placed in its control, and no provision for short-term cash management is made under the terms of the governing instrument, the plan does so with the expectation that such person will minimize uninvested cash balances and maximize the plan's rate of return in accordance with evolving technology for short-term cash management. However, where, for example, a plan appoints an independent investment manager to manage plan assets, the provision by a custodial trustee bank of sweep services for any idle cash balances may constitute an "ancillary service" within the meaning of section 408(b)(6). At the present time, the Department is not prepared to conclude that section 408(b)(6) is available in all cases For the arrangements described in your letter.

You further indicate that some banks appear to be relying on the exemption provided by ERISA section 408(b)(8) to invest plan funds in collective trust funds maintained by such banks.

Section 408(b)(8) of ERISA provides an exemption for any transaction between a plan and a common or collective trust fund maintained by a bank or trust company supervised by a State or Federal agency, if (a) the transaction is a sale or purchase of an interest in the fund, (b) the bank or trust company receives not more than reasonable compensation, and (c) the transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company, or an affiliate thereof) who has authority to manage and control the assets of the plan. The Department has been unwilling to indicate the extent to which section 408(b)(8) provides relief from the prohibitions of section 406(b) of ERISA (See 44 FR 44291 n. 3, July 27, 1979). However, if the bank does not exercise its fiduciary authority to cause a plan to pay an additional fee or other compensation in connection with the acquisition by a plan of an interest in a collective trust fund or for the provisions of services under such fund, the investment would not, in itself, involve acts described in section 406(b)(1) of ERISA.

We hope these comments have been helpful. However, if you should have any further questions or if we can provide any further assistance, please feel free to contact Ivan Strasfeld at (202) 523-8671.

Alan D. Lebowitz

Deputy Administrator for Program Operations

cc: Dean Miller

- Footnotes -

1. Your request appears to be limited to the situation where the bank fiduciary sweeps idle cash balances into its in-house short-term investment vehicles. Accordingly, our response focuses on that situation and does not address the sweep of cash balances into short-term vehicles maintained by parties unrelated to the bank.
2. The Department notes that, although section 408(b)(2) of ERISA provides relief for the furnishing of goods in the course of, and incidental to, the furnishing of services to a plan, the statutory exemption for services does not extend to underlying investment transactions, such as sales or extensions of credit otherwise described in section 406 of ERISA. Rather, section 408(b)(2) provides relief from the restrictions of section 406(a) only for those service transactions which satisfy the conditions of section 408(b)(2) and the regulations thereunder. For example, if a bank fiduciary sells repurchase agreements to a plan under a sweep service arrangement, section 408(b)(2) may provide relief for the provision of such sweep service, but does not provide relief for the acquisition of the repurchase agreements from the bank.
3. In this regard, the Department expresses no opinion as to whether the underlying investment transaction itself is the subject of statutory or administrative relief. See, for example, sections 408(b)(4) and 408(b)(8) of ERISA

Advisory Opinion/Individual Exemption 88-02A

Sweep Arrangements and Related Sweep Transaction Fees

February 2, 1988

Summary
Covers sweeps from *non-discretionary* ERISA accounts into *non-affiliated* mutual funds, together with fees that may be charged for such transactions.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

February 2, 1988 88-02A

Sec. 406(b)(1) & (3), 408(b)(2)

Ms. Charlotte 0. Roederer

Vice President and

Associate General Counsel

Manufacturers and Traders Trust Company

One M&T Plaza

Buffalo, NY 14240

Re: Identification Number: F-3634A

Dear Ms. Roederer;

This is in response to your request for an advisory opinion regarding the application of the Employee Retirement Income Security Act of 1974 (ERISA) to certain "sweep services" provided by Manufacturers and Traders Trust Company (the Bank) to employee benefit plans for which the Bank acts as custodian or directed trustee. You specifically ask whether the transactions would qualify for the statutory exemptions provided by sections 408(b)(2) and/or 408(b)(6) of ERISA.

You represent that the bank offers a daily cash "sweep service" to employee benefit plans for which the Bank

acts as custodian or directed trustee. For those plans which elect to utilize the sweep service, some or all of the plans' uninvested cash is swept into one of several money market funds, all of which are sponsored by independent third parties. For each plan to which the Bank offers this service, an independent third party (or the employer, other than the Bank) functions as the sole investment advisor. The investment advisor determines whether and how much uninvested cash will be swept, and chooses which of several money market funds will be utilized. The specified amount of uninvested cash is swept into the selected investment vehicle at the close of each business day.

Each month the plans participating in the sweep service receive a dividend from the money market funds based on the prior month's daily invested cash balance in the funds. The bank periodically calculates a "cash sweep" fee which is a percentage of the dividends received by each plan from the funds. The bank receives no fees or other compensation from the money market funds. Thus, you represent that no part of the dividends received are allocated to the Bank for its own account as compensation for sweep services. The cash sweep fee is recorded separately in the periodic accounting and billing which the Bank sends to the employer. For most plans, the fee is calculated and billed on a quarterly basis, but small plan accounts are billed annually. The cash sweep arrangement is subject to immediate termination without penalty and requires that the Bank notify the plan no less than 30 days prior to any change in the fees to be charged for the service.

The provisions of section 406(a)(1)(C) and (D) of ERISA prohibit a fiduciary with respect to a plan from causing the plan to engage in a transaction if he or she knows or should know that the transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest, or transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA further prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(2) of ERISA provides that a fiduciary shall not in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Section 406(b)(3) of ERISA prohibits a fiduciary from receiving a fee or other consideration for his or her own personal account from a party dealing with a plan in connection with a transaction involving the assets of the plan.

Subject to the limitations of section 408(d), section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) contracting (or making reasonable arrangements) for services (or a combination of services) with a party in interest if: the service is necessary for the establishment or operation of the plan; (2) the service is furnished under a contract which is reasonable; and no more than reasonable compensation is paid for the service. Regulations issued by the Department clarify the terms "necessary service" (29 C.F.R. 2550.408b-2(b)), "reasonable contract or arrangement" (29 C.F.R. 2550.408b-2(c)), and "reasonable compensation" (29 C.F.R. 2550.408c-2).

Accordingly, the provision of sweep services would be exempt from the prohibitions of section 406(a) of ERISA if the conditions of section 408(b)(2) are met.[1] We note, however, that the questions of what constitutes a necessary service, a reasonable contract or arrangement, and reasonable compensation are inherently factual in nature. Section 5.01 of Advisory Opinion Procedure 76-1 (ERISA Proc. 76-1, 41 FR 36281, August 27, 1976) states that the Department generally will not issue opinions on such questions.

With respect to the prohibitions in section 406(b), regulation 29 C.F.R. 2550.408b-2(a) states that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b). As explained in 29 C.F.R. 2550.408b-2(e)(1), if a fiduciary uses the authority, control or responsibility that makes him or her a fiduciary to cause the plan to enter into a transaction involving the provision of services when such a fiduciary has an interest in the transaction that may affect the exercise of his or her best judgment as a fiduciary, a transaction described in section 406(b) of ERISA would occur, and the transaction would be deemed to be a separate transaction from the one involving the provision of services and would not be exempted by ERISA section 408(b)(2).

Your letter of March 31, 1987 states that the bank does not have investment discretion with respect to the plans to which the Bank offers the sweep service, and that the decision to utilize the sweep services and compensate the Bank therefore is made by independent investment advisors. Your submission also explains that the Bank will not receive a fee or other benefit from any of the unrelated money market funds into which uninvested cash is swept and that the Bank will notify a plan no less than 30 days prior to any change in the fees to be charged for the service. Your letter also states that each month, the plan receives from the fund into which the plan's assets are swept a dividend based on the prior month's activity and that the bank's "cash sweep" fee is a percentage of these dividends either paid by the plan sponsor or deducted by the Bank (at the instruction of the sponsor) from the assets of the plan.[2]

In the circumstances you describe, it appears that the Bank would not be exercising any of the authority, control, or responsibility that makes it a fiduciary to cause a plan to pay an additional fee in connection with the "sweep services". Thus, the provision of sweep services would not, in and of itself, involve acts described in section 406(b)(1) of ERISA. The Bank also would not appear to violate section 406(b)(2) because it would not, solely by reason of the circumstances you describe, be acting on behalf of a party whose interests are adverse to those of the plan.[3]

With respect to section 406(b)(3), the Department notes that, under the described circumstances, the receipt of fees by the Bank from the assets of a plan for the provision of sweep services would not, in itself, constitute a violation of section 406(b)(3) of ERISA.

You also ask whether the provision of sweep services by the Bank would qualify for the statutory exemption provided by section 408(b)(6) of ERISA. However, to the extent that the arrangement you describe is covered by section 408(b)(2), the Department does not find it necessary to address whether an additional statutory exemption is available.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. We note that pursuant to section 5 of ERISA Procedure 76-1, this advisory opinion relates solely to the arrangement described involving the Bank.

Sincerely,

Robert J. Doyle

Acting Associate Director for Regulations and Interpretations

- Footnotes -

1. The Department expresses no opinion herein regarding the underlying investment of plan assets in the money market funds. In this regard, the Department notes that the statutory exemption for services does not extend to underlying investment transactions such as sales between a plan and a party in interest described in section 406 of ERISA.
2. We assume that, where the bank's fee is deducted from the assets of a plan, the obligation to pay such fee is, under the governing plan documents, an obligation of the plan and not of the plan sponsor.
3. In expressing this opinion, the Department assumes that no arrangement exists between either the Bank and any of the above described mutual funds or the directing plan fiduciary and any of the funds such as described in 29 C.F.R. § 2509.75-2(c).

Advisory Opinion/Individual Exemption 88-09A

Investment in Fiduciary Bank/BHC Treasury Stock

April 15, 1988

Summary	
(1)	Permits self-directed IRAs to purchase stock of the fiduciary bank's parent holding company if: (1) the fiduciary bank is directed in writing to do so by the participant, who is authorized to direct investments, (2) the seller is not a "disqualified person" (the fiduciary bank or a bank insider), and (3) the participant is not a director or officer of the fiduciary bank.
(2)	Such purchases may be made from the holding company's treasury stock if the participant gives specific instructions to do so and the fiduciary bank has no decision authority in deciding the seller.

U.S. Department of Labor

Pension and Welfare Benefits Administration

Washington, D.C. 20210

April 15, 1988 A/Opinion 88-09A

Lloyd V. Crawford

Rushton, Stakely, Johnston & Garrette

184 Commerce Street

Montgomery, AL 36104

Re: Bank of Prattville

Identification Number: F-3677A

Dear Mr. Crawford:

This is in response to your letters of May 29 and June 18, 1987 requesting an advisory opinion regarding the application of the prohibited transaction provisions of section 4975 of the Internal Revenue Code of 1986 (the Code). In particular, your letter concerns purchases of stock of the parent (the Parent) of the Bank of Prattville (the Bank) by various self-directed individual retirement accounts (IRAs) sponsored by the Bank.

You represent that the Bank is a banking corporation organized under the laws of the state of Alabama and is wholly owned by the Parent. The Bank qualifies under section 408(a)(2) and 408(n) of the Code as a trustee of IRAs.

The Bank is considering amending the existing master and prototype IRA for which it serves as custodian to include a self-directed feature which permits the participants to direct the investments of their accounts in securities selected by the participants, including stock of the Parent. Pursuant to these amendments, the participants will have complete and sole discretion over the investments, with the Bank acting only as a nondiscretionary trustee or custodian. The Bank will not make any investments or dispose of any investments for the IRAs except upon the written direction of the participants. Neither the Bank nor the Parent will provide any form of investment advice or make investment recommendations. Purchases and sales of securities will be conducted through brokerage accounts which the IRA participants will establish with the Bank.

Parent stock is not traded on any exchange or on the national over-the-counter market system. In cases where an IRA participant directs that funds in his or her account be invested in Parent stock, the stock would be purchased either from the Parent's treasury or from unrelated third parties.

You ask for an opinion with respect to the following questions:

(1) Will purchases of Parent stock by the Bank as custodian of its IRAs on behalf of and at the sole direction of participants who are neither executive officers nor directors of the Bank constitute prohibited transactions within the meaning of Code section 4975(c)(1), when the purchase is made directly from the Parent's treasury?

(2) Will purchases of Parent stock by the Bank as custodian of its IRAs on behalf of and at the sole direction of participants who are executive officers or directors of the Bank constitute prohibited transactions within the meaning of Code section 4975(c)(1), when the purchase is made directly from the Parent's treasury?

(3) Will purchases of Parent stock by the Bank as custodian of its IRAs on behalf of and at the sole direction of participants who are neither executive officers nor directors of the Bank constitute prohibited transactions within the meaning of Code section 4975(c)(1), when the purchase is made directly from a third party who is neither an executive officer or director of the Bank?

(4) Will purchases of Parent stock by the Bank as custodian of its IRAs on behalf of and at the sole direction of participants who are executive officers or directors of the Bank constitute prohibited transactions within the meaning of Code section 4975(c)(1), when the purchase is made directly from a third party who is neither an executive officer or director of the Bank?

(5) Will purchases of Parent stock by IRA custodians other than the Bank on behalf of and at the sole direction of participants who are executive officers or directors of the Bank constitute prohibited transactions within the meaning of Code section 4975(c)(1), whether the purchase is made directly from a third party or from the Parent's treasury?

Pursuant to section 2510.3-2(d) of the Department's regulations, the Department does not have jurisdiction

under Title I of the Employee Retirement Income Security Act (ERISA) over those individual retirement accounts described in section 408(2) of the Code which comply with the provisions of that section of the regulation.[1] Such IRAs are within the purview of Title II of ERISA, section 4975 of the Code. Under Presidential Reorganization No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority. To the extent there is Title I jurisdiction regarding any IRA for which the Bank serves as custodian or trustee, references to specific sections of the Code in this letter shall also refer to the corresponding sections of ERISA.

Section 4975(c)(1) of the Code prohibits, in relevant part, the sale or exchange of property between a plan and a disqualified person (4975(c)(1)(A)), the furnishing of goods or services between a plan and a disqualified person (4975(c)(1)(C)), the use by or for the benefit of a disqualified person of the income or assets of a plan (4975(c)(1)(D)), and an act by a disqualified person who is a fiduciary whereby he or she deals with the income or assets of a plan in his or her own interest or for his or her own account (4975(c)(1)(E)).

Section 4975(e)(2) of the Code defines the term "disqualified person" to include a plan fiduciary and a person providing services to a plan.

Thus, the Bank is a disqualified person with respect to the IRAs. The Parent, however, is not a disqualified person with respect to the IRAs solely by reason of its ownership of the Bank.[2] The question of whether the Parent is a disqualified person with respect to the IRAs under any other provision of section 4975(e)(2) of the Code is inherently factual in nature. Section 5.01 of Advisory Opinion Procedure 76-1 (ERISA Proc. 76-1, 41 FR 36281, August 27, 1976) states that the Department generally will not issue opinions on such questions.

Therefore, with respect to questions 1 and 2, to the extent that the Parent is not a disqualified person with respect to the IRAs, purchases of stock from the Parent by the Bank on behalf of and at the direction of the IRA participants would not involve transactions described in section 4975(c)(1)(A) of the Code.

With respect to questions 3 and 4, it is the Department's opinion that if the seller of the Parent stock is not otherwise a disqualified person with respect to an IRA, the purchase by the Bank of Parent stock from unrelated third parties on behalf of the IRA does not constitute a transaction described in section 4975(c)(1)(A) of the Code.

With respect to question 5, regarding purchases of Parent stock by IRA custodians other than the Bank on behalf of and at the sole direction of participants who are officers or directors of the Bank from the Parent or an unrelated third party, it is our view that the purchases of Parent stock do not constitute transactions described in section 4975(c)(i)(A) of the Code to the extent that the seller of Parent stock is not a disqualified person with respect to the IRA.[3]

However, while the Parent may not be a disqualified person with respect to the IRAs sponsored by the Bank, purchases and holding of Parent stock by the self-directed IRAs of officers and directors of the Bank raise questions under section 4975(c)(1)(D) and (E) of the Code, depending on the degree (if any) of the participant's interest in the transaction. The IRA participants, as officers and directors of the Bank, may have interests in the proposed transactions which may affect their best judgment as fiduciaries of their IRAs. In such circumstances, the transactions may violate section 4975(c)(1)(D) and (E) of the Code.

In addition, although the Bank may have no discretion in selecting the investments to be made by the IRAs, it appears that the Bank may have discretion in determining the seller from which the IRAs will purchase Parent stock. To the extent that it does have such discretion, the Bank would be a plan fiduciary with respect to its exercise of such discretion.

Thus, if the IRA participants do not instruct the Bank with respect to such matters but, rather, rely on it as a fiduciary to select appropriate sellers for the transactions, a selection by the Bank of the Parent as seller would raise questions under section 4975(c)(1)(D) and (E) of the Code. This is because the Bank, as a wholly-owned subsidiary of the Parent, has an interest in the fortunes of the Parent. Therefore, the Bank may be in a position to indirectly use the assets of a plan for its own benefit or to deal with the assets of a plan in its own interest.[4]

We note that you have not requested and consequently the Department is not offering an opinion regarding the provision of brokerage services by the Bank to the IRAs.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Section 10 of the procedure describes the effect of advisory opinions.

Sincerely,

Robert J. Doyle

Acting Associate Director for

Regulations and Interpretations

1. Under the regulation, Title I is inapplicable only if: (1) no contributions to the plan are made by the employer or employee association; (2) participation is completely voluntary for employees or members; (3) the sole involvement of the employer or employee organization is to permit the sponsor to publicize the program and to collect contributions on behalf of the sponsor through payroll deductions or dues checkoffs; and (4) the employer or employee organization receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions or dues checkoffs.
2. However, the Department notes that the Parent may be a party in interest with respect to any IRAs sponsored by the Bank which are within the jurisdiction of Title I of ERISA. In this regard, contrast section 3(14)(H) of ERISA with section 4975(e)(2)(H) of the Code.
3. We are assuming for the purposes of this letter that the Bank is not acting as an employer, as defined in section 4975(e)(2)(D) of the Code and section 3(14)(C) of ERISA, with respect to the IRAs of officers and directors of the Bank. See Advisory Opinion 85-26, April 10, 1985.
4. We assume, for purposes of this ruling, that the Bank does not have any authority or responsibility to vote or otherwise deal with Parent stock held by its self-directed IRAs.

Advisory Opinion/Individual Exemption 88-18A

Self-Directed IRA Loans to Company Where IRA Grantor/Beneficiary is Insider

December 23, 1988

Summary
Covers self-directed IRA account loans to company owned by the IRA's grantor/beneficiary.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

December 23, 1988

Mr. Joseph E. Hurst, Jr.

Friday, Eldredge & Clark

2000 First Commercial Building

Little Rock, AR 72201

Re: Thomas E. Darragh

Identification Number: F-3819A

Dear Mr. Hurst:

Your letter dated January 22, 1988, to the Internal Revenue Service (the Service) has been forwarded to this office for our consideration and response. Your letter concerns whether a loan from an Individual Retirement Account (IRA) to a corporation would violate section 4975(c)(1)(B) of the Internal Revenue Code of 1986 (the Code).

You represent that Thomas F. Darragh established an IRA described in section 408 of the Code. Mr. Darragh is the only participant in the IRA and has reserved the right to direct the IRA's investments. You further represent that Mr. Darragh is currently an employee, shareholder and member of the Board of Directors of Darragh Company (the Corporation). Your subsequent letter of April 28, 1988, indicates that the Corporation has no involvement whatsoever with the establishment or maintenance of the IRA. The Corporation has two

classes of stock, Class A voting and Class B nonvoting. Mr. Darragh owns directly and indirectly (pursuant to section 4975(e)(4) and (6) of the Code) 46.04 percent of the total voting power of the Corporation and 48.14 percent of the total issued and outstanding shares of stock.

Mr. Darragh proposes to direct the IRA Custodian, One National Bank, to lend the Corporation approximately $500,000 pursuant to a promissory note entered into by the Corporation. The Corporation will pay the IRA interest on the note based on the then current prevailing market rate of interest which lenders are currently charging to the Corporation.

You have requested an advisory opinion that the proposed loan will not constitute a prohibited transaction under section 4975(c)(1)(B) of the Code.

Pursuant to section 2510.3-2(d) of the Department of Labor's (the Department) regulations, the Department does not have jurisdiction under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) over those IRAs described in section 408(a) of the Code which comply with the provisions of that section of regulation.* Under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by such interpretations of the Secretary of Labor pursuant to such authority.

Section 4975(c)(1)(B) of the Code prohibits any direct or indirect sale, lending of money or other extension of credit between a plan and a disqualified person. Section 4975(e)(1) of the Code, in relevant part, defines the term plan to include an IRA described in section 408(a) of the Code. Section 4975(e)(2) of the Code defines "disqualified person" to include a fiduciary, an employer any of whose employees are covered by the plan, and a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of the corporation, (ii) the capital interest or profits interest of such partnership, or (iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by a fiduciary. Section 4975(e)(3) of the Code defines the term fiduciary, in part, to include any person who exercises any discretionary authority or discretionary control respecting management of the plan, or exercised any authority or control respecting the management or the disposition of its assets.

Mr. Darragh is a fiduciary and, thus, a disqualified person with respect to the IRA because of the authority under the IRA to direct investments. You have stated that Mr. Darragh is employed by the Corporation. Although section 4975 does not define the term "employer", section 3(5) of ERISA provides, in part, that an "employer" is any person acting as an employer in relation to an employee benefit plan. You have stated that the Corporation has no involvement with the establishment or maintenance of the IRA. Therefore, it is the opinion of the Department that the Corporation is not a disqualified person with respect to the IRA under section 4975(e)(2)(C) of the Code. In addition, the Corporation is not a disqualified person with respect to the IRA under section 4975(e)(2)(G) of the Code by reason of Mr. Darragh's stock ownership in the Corporation.

Therefore, to the extent that the Corporation is not a disqualified person with respect to the IRA under any other provision of section 4975(e)(2) of the Code, the loan by the IRA to the Corporation would not violate section 4975(c)(1)(B) of the Code.

We note, however, that this conclusion does not preclude the existence of other prohibited transactions under section 4975 of the Code. Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 4975(c)(1)(E) of the Code prohibits a fiduciary from dealing with the income or assets of a plan in his own interest or for his own account. Section 54.4975-6(a)(5) of the Pension Excise Tax Regulations characterizes transactions described in section 4975(c)(1)(E) as involving the use of authority by fiduciaries to cause plans to enter into transactions when those fiduciaries have interests which may affect the exercise of their best judgment as fiduciaries. Mr. Darragh is a fiduciary with respect to the IRA. In addition, he has a substantial interest in the Corporation. Therefore, the Corporation is a party in whom Mr. Darragh has an interest which might affect his best judgment as a fiduciary. ***Accordingly, a prohibited use of plan assets for the benefit of a disqualified person under*** section 4975(c)(1)(D) ***or an act of self-dealing under*** section 4975(c)(1)(E) ***is likely to result if Mr. Darragh directs the IRA to loan funds to the Corporation***. [Emphasis added]

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedures, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle

Acting Associate Director for Regulations and Interpretations

- Footnote -

> * Under the regulations, Title I is inapplicable only if the following conditions are met: (1) no contributions to the plan are made by the employer or employee association; (2) participation is completely voluntary for employees or members; (3) the sole involvement of the employer or employee association is to permit the sponsor to publicize the program and to collect contributions on behalf of the sponsor through payroll deductions or dues checkoffs; and (4) the employer or employee association receives no consideration in the form of cash or otherwise other than reasonable compensation for services actually rendered in connection with such payroll deductions or dues checkoffs.

Advisory Opinion/Individual Exemption 88-28

Investment in Fiduciary Bank/BHC Stock in Initial Public Offering

January 26, 1988 (Exemption Application D-7187)

Summary
Self-directed IRA and Keogh accounts may invest in a new issue ("initial public offering") of own-bank stock or own holding company stock if: (1) the fiduciary bank is directed in writing to do so by the participant, who is authorized to direct investments, (2) other investment vehicles are available to the account, (3) not more than 25% of any account's assets will be invested in the stock issue, (4) no fees or commissions are paid, (5) no more than fair market value is paid, and (6) fair market value is determined by an independent appraiser.

U.S. Department of Labor

Office of Pension and Welfare Benefit Programs

Washington, D.C. 20210

People's Bank (People's) Located In

Bridgeport, Connecticut

(Application No. D-7187)

Proposed Exemption

The Department is considering granting an exemption under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 21 1975). If the exemption is granted the restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) thru (D) of the Code shall not apply to the sale by People's of its subsidiary's stock to the Keogh Plans (the Keoghs) for which People's services [sic] as custodian, as part of an initial issue of such stock, and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the sale by People's of its subsidiary's stock to the individual retirement accounts (the IRAs) for which People's serves as custodian, as part of an initial issue of such stock, provided the Keoghs and IRAs pay no more than the fair market value of the stock on the date of the sale.[1]

Summary of Facts and Representations

1. People's is a mutual savings bank organized under the laws of the State of Connecticut. People's is in the process of reorganizing (the Reorganization) pursuant to Connecticut Public Act 85-330 (the Reorganization Act) from its current form as a mutual savings bank to a mutual holding company with a capital stock subsidiary bank (the Bank) which will assume substantially all of the operations of People's. The majority of the bank's stock will be held by People's in its reorganized form as a mutual holding company.

2. In connection with, and as part of the Reorganization, the Bank proposes to offer between 20% and 30% of its stock to the public. The Reorganization Act permits the Bank from selling or offering to sell its common stock or securities convertible into common stock unless it first gives to each "eligible account holder" subscription rights to acquire Bank stock pursuant to a subscription offering. Regulations issued by the Department of Banking of the State of Connecticut clearly establish that the IRAs and the Keoghs, held in time deposits by People's as custodian, are eligible accounts requiring that the holders of those accounts receive subscription rights to purchase Bank stock. Accordingly, People's intends to offer its IRA and Keogh depositors subscription rights to Bank stock in connection with the Reorganization. After the Reorganization, the Bank stock will be traded publicly on the Over-the-Counter market.
3. People's currently acts as custodian for approximately 64,000 IRA customers and 2,000 participants in custodial Keoghs with assets, in the aggregate, of approximately $500 million. These assets represents approximately 12% of total deposits held by People's. People's as custodian has no discretionary authority with respect to the investment of IRA or Keogh assets. All investments are made at the direction of the account holder within the range of investment choices permitted by the plan documents. The applicants represent that no single IRA or Keogh account will be permitted to invest more than 25% of the assets of such account in stock of the Bank in connection with this initial offering.
4. In accordance with the provisions of the Reorganization Act, People's must submit to the Connecticut Banking Commissioner (the Commissioner) a plan outlining the terms of the subscription offering. Within 15 days from the date of that submission, People's will be required to mail to each holder, including holders of IRAs and Keoghs, a notice that the Board of Trustees has approved the sale of a certain number of shares of common stock or securities convertible into common stock, a description of the rights of such depositors to subscribe to such stock and various other information concerning rights of stockholders. Subscription rights must be exercised within a period ending no sooner than 60 days from the date the subscription plan is submitted to the Commissioner, or they will expire. Pursuant to the terms of the proposed transaction, the IRA and Keogh customers would notify People's within that subscription period of their intention to invest the assets of their IRA and Keogh accounts in Bank stock. Since the purchase of stock will be made in connection with an initial issue, no broker will be involved and purchases will be made by the IRA or Keogh directly from the Bank. Since no broker is involved in the transaction, no commissions will be paid with respect to the purchase.
5. As part of the subscription plan submitted to the Commissioner, People's will include an appraisal prepared by an independent firm of the estimated market value of the Bank and the Bank stock to be issued. The valuation will be based on financial information relating People's and the economic environment in which it operates, a comparison of People's with selected publicly held thrift institutions and with other thrift institutions located in Connecticut, and any other factor as the independent appraiser may deem to be appropriate. The valuation will be stated in terms of a subscription price range, the maximum of which will be no more than 25% above the average of the minimum and maximum of such price range, and the minimum of which will be no more than 25% below such average. After the subscription plan is approved by the Commissioner, the independent appraiser will review, prior to the subscription offering, all developments consequent to its initial valuation in order to confirm or amend its determination of the initial subscription price range. The subscription price will be no less than the minimum of the price range, nor any greater than the maximum of the price range.
6. Concurrently with the subscription offering, People's may offer the opportunity to purchase all shares not subscribed for in the subscription offering to (a) Certain other customers of People's who may not have qualified as eligible account holders; (b) trustees, officers, or employees of People's or its affiliates, and (c) residents of Fairfield, New Haven, Tolland, Hartford and Litchfield Counties, Connecticut (the Community Offering). If all shares of Bank stock are sold through the exercise of subscription rights and through the Community Offering, the independent appraiser will re-examine its estimate of the market value of the Bank and of the shares of Bank stock as of the last day of the subscription offering and the Community Offering. If at that time the independent appraiser's estimate of the value of Bank stock is less than the subscription price (but not less than the minimum of the originally estimated price range), then that estimated value will become the final purchase price for Bank stock and the Bank will refund to all purchasers the difference between the subscription price and the independent appraiser's final estimate of the value of Bank stock. If, however, the independent appraiser's final estimate of the value of Bank stock exceeds the subscription price (or is less than the minimum of the originally estimated price range), then with the approval of the Commissioner, People's will either terminate the subscription plan, establish a new subscription price range, or adjust the total number of shares of the Bank so that the market value per share will be within the subscription price range.
7. If all the shares of Bank stock to be sold are not sold through the exercise of subscription rights or through the Community Offering, the remaining shares will be sold to the public after approval of a public offering circular by the Commissioner. The independent appraiser will again update its prior appraisal of the estimated market value of Bank stock. If there is any change in that appraisal, the

number of shares of the Bank may be adjusted to reflect the increase or decrease of the appraised value of the Bank stock. That number of shares will then be sold to or through the underwriters of the public offering pursuant to terms of an underwriting agreement. In the event the sale price of Bank stock pursuant to the public offering is less than the price paid for exercise of subscription rights or pursuant to the Community Offering the difference will be refunded to those who paid the higher price.

8. The applicants represent that the entire process is designed to ensure that the price paid for Bank stock is fair market value. In any event, the determination as to the price to be paid for Bank stock will be subject to approval by the Commissioner.
9. In summary, the applicants represent that the proposed transaction meets the criteria of section 408(a) of the Act and section 4975(c)(2) of the Code because: (1) The decision to purchase the Bank stock will be made by IRA and Keogh customers out of a range of investment choices, and People's has no discretion over such decision; (2) no fees or commissions will be paid with respect to the transaction; (3) no more than 25% of the assets of any IRA or Keogh account will be invested in Bank stock in connection with the initial offering; and (4) the purchase price or the stock will be determined by independent appraisal and must be approved by the Commissioner.

For further information contact: Gary H. Lefkowitz of the Department, telephone (202) 523-8881. (This is not a toll-free number.)

People's Bank (People's) Located

Bridgeport, Connecticut

[Prohibited Transaction Exemption 88-28.

Exemption Application No. D-7187]

Exemption

The restrictions of section 406(a) of the Act and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(2)(A) through (D) of the Code, shall not apply to the sale by People's of its subsidiary's stock to the Keogh plans (the Keoghs) for which People's serves as custodian, as part of an initial issue of such stock, and the sanctions resulting from the application of section 4975 of the Code, by reason of section 4975(c)(1)(A) through (D) of the Code shall not apply to the sale by People's of its subsidiary's stock to the individual retirement accounts (the IRAs) for which People's serves as custodian, as part of an initial issue of such stock, provided the Keoghs and the IRAs pay no more than the fair market value of the stock on the date of the sale.[1]

For a more complete statement of the facts and representations supporting the Department's decision to grant this exemption refer to the notice of proposed exemption published on January 26, 1988 at 53 FR 2106.

For Further Information Contact: Gary Lefkowitz of the Department, telephone (202) 523-8881. (This is not a toll-free number.)

1. Because the IRAs do not meet the conditions described in 29 C.F.R. 2510.3-2(d), there is no jurisdiction with respect to the IRAs under Title I of the Act. However, there is jurisdiction under Title II of the Act pursuant to section 4975 of the Code.

Advisory Opinion/Individual Exemption 89-03

Self-Directed IRA Purchases of Employer Stock from Employer

March 23, 1989

Summary
Covers self-directed IRA account purchases of stock from the employer of the IRA's grantor/beneficiary.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

March 23, 1989

Ms. Maria Stefanis

Arthur Young

3000 K Street, N.W.

Washington, D.C. 20007

Re: Individual Retirement Accounts of Edward E. and Frances E. Bowns

Identification Number F-3879A

Dear Ms. Stefanis:

Your letter dated May 19, 1988, to the Internal Revenue Service has been forwarded to this office for our consideration and response. Your letter concerns whether a purchase of stock by an Individual Retirement Account (IRA) from a corporation would violate section 4975(c)(1)(A) of the Internal Revenue Code of 1986 (the Code).

You represent that Edward E. Bowns and his wife, Frances, established IRAs described in section 408 of the Code. Mr. and Mr. Bowns are the only participants in their respective IRAs and have reserved the right to direct their IRA's investments. Mr. Bowns is Executive Vice President and General Manager of the Partition Division of the Rock-Tenn Company. Mr. Bowns owns directly 1,122 shares. Mr. Bowns holds incentive stock options, expiring 1993 through 1998, to acquire an additional 27,020 shares. Assuming all options are exercised and including the 400 shares proposed to be purchased by the IRAs, the Bowns family would own a total of 29,327 shares. There are now approximately 2,500,000 shares of Rock-Tenn common stock outstanding. You further attest that Rock-Tenn has not sponsored, maintained or made any contribution to the IRAs.

Mr. and Mrs. Bowns propose to direct their IRA trustee to purchase Rock-Tenn common stock from Rock-Tenn on behalf of each of their IRAs. The trustee will pay no more than adequate compensation for the Rock-Tenn stock.

You have requested an advisory opinion that the proposed purchase will not constitute a prohibited transaction under section 4975(c)(1)(A) of the Code.

Pursuant to section 2510.3-2(d) of the Department of Labor's (the Department) regulations, the Department does not have jurisdiction under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) over those IRAs described in section 408 of the Code which comply with the provisions of that section of regulation.[1] Such IRAs are, however, subject to section 4975 of the Code. Pursuant to Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code, subject to certain exceptions not here relevant, has been transferred to the Secretary of Labor and the Secretary of the Treasury is bound by such interpretations.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale, exchange or leasing of any property between a plan and a disqualified person. Section 4975(e)(1) of the Code, in relevant part, defines the term plan to include an IRA described in section 408(a) of the Code. Section 4975(e)(2) of the Code defines the term disqualified person to include a fiduciary, an employer any of whose employees are covered by the plan, and a corporation of which 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of the corporation, is owned directly or indirectly, or held by a fiduciary. Section 4975(e)(4) of the Code provides that, for purposes of section 4975(e)(2)(G), there shall be taken into account indirect stock holdings which would be taken into account under section 267(c) of the Code. Section 4975(e)(3) of the Code defines the term fiduciary, in part, to include any person who exercises any discretionary authority or discretionary control respecting management of the plan, or exercised any authority or control respecting the management or the disposition of its assets.

Mr. and Mrs. Bowns are fiduciaries and, thus, disqualified persons with respect to their IRAs because of their authority under the IRAs to direct investments. Although section 4975 does not define the term employer, section 3(5) of ERISA provides, in part, that an employer is any person acting as an employer in relation to an employee benefit plan. You have stated that Rock-Tenn has no involvement with the establishment or maintenance of the IRAs. Therefore, it is the opinion of the Department that Rock-Tenn is not a disqualified

person with respect to the IRAs under section 4975(e)(2)(C) of the Code. In addition, Rock-Tenn is not a disqualified person under section 4975(e)(2)(G) of the code by reason of the Bowns' stock ownership in Rock-Tenn.

Therefore, to the extent that Rock-Tenn is not a disqualified person under any other provisions of section 4975(e)(2) of the Code, the purchase of Rock-Tenn would not violate section 4975(c)(1)(A) of the Code.

We note, however, that this conclusion does not preclude the existence of other prohibited transactions under section 4975 of the Code. Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 4975(c)(1)(E) of the Code prohibits a fiduciary from dealing with the income or assets of a plan in his own interest or for his own account. The Department will generally not issue advisory opinions with respect to inherently factual matters.[2] We note, however, that Mr. and Mrs. Bowns are fiduciaries with respect to their IRAs. In addition, Mr. Bowns is an officer of Rock-Tenn and the Bowns have stock ownership interests in Rock-Tenn. Accordingly, you may wish to consider whether the purchases of stock involve violations of section 4975(c)(1)(D) or (E) of the Code.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedures, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle

Director of Regulations and Interpretations

- Footnotes -

1. Under the regulations, Title I is inapplicable only if the following conditions are met: (1) no contributions to the plan are made by the employer or employee association; (2) participation is completely voluntary for employees or members; (3) the sole involvement of the employer or employee association is to permit the sponsor to publicize the program and to collect contributions on behalf of the sponsor through payroll deductions or dues checkoffs; and (4) the employer or employee association receives no consideration in the form of cash or otherwise other than reasonable compensation for services actually rendered in connection with such payroll deductions or dues checkoffs.
2. See ERISA Proc. 76-1, section 5.01.

Advisory Opinion/Individual Exemption 92-23A

Investment in Fiduciary Bank/BHC Stock

October 27, 1992

Summary
Permits ERISA plans to purchase stock of the fiduciary bank (or its parent holding company) if: (1) Fiduciary bank is directed in writing to do so by an outside party authorized to direct investments, (2) Transaction takes place on open market where bank does not know identity of seller, (3) Plan does not prohibit such investments, and (4) Fiduciary bank cannot vote the stock.

U.S. Department of Labor

Pension and Welfare Benefits Administration

Washington, D.C. 20210

92-23A

October 27, 1992 ERISA SEC.

403(a)(1),

Mr. John S. Brescher, Jr., Esq. 406(b)(1)

McCarter & English

Four Gateway Center

100 Mulberry Street

P. 0. Box 652

Newark, NJ 07101-0652

Dear Mr. Brescher:

This is in response to your request for an advisory opinion regarding the application of the prohibited transaction provisions of section 406 of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4975 of the Internal Revenue Code (the Code). Your letter concerns purchases of securities issued by the parent company of Citizens First National Bank of New Jersey (the Bank) at the direction of fiduciaries of employee benefit plans for which the Bank serves an trustee.

According to your representations, the Bank is a wholly owned subsidiary of Citizens First Bancorp., Inc. (Bancorp), a bank holding company organized and existing under the laws of the State of New Jersey. Bancorp is a publicly held company; its stock is regularly traded on the American Stock Exchange.

You represent that the Bank, as part of its regular banking services, maintains a Prototype Defined Contribution Plan and Trustee/Custodial Account (the Prototype Plan) for adoption by those of its customers who wish to adopt a qualified retirement program. You state that the Bank may be appointed to serve either as custodian or trustee of an employee benefit plan that adopts the Prototype Plan. You indicate that, in either of these cases, the Bank must invest funds held thereunder in accordance with the requirements of ERISA.

You state that, where the Bank serves as trustee, the Prototype Plan permits investments "in any form of property," expressly including "securities issued by the Trustee and/or affiliates of the Trustee." An adopting employer has the option to direct investments by the trustee, to appoint an investment manager (registered as an investment advisor under the Investment Advisors Act of 1940) to direct investments by the trustee, or to give the trustee sole investment management responsibility. The employer must choose an option in its adoption agreement and the Bank must agree to it. You represent that if the Bank as trustee is subject to the investment direction of the employer or of an investment manager, any investment direction to the Bank must be made in writing by the authorized person.

According to your representations, the Bank, as directed trustee, anticipates receiving directions to purchase Bancorp stock on behalf of a plan. Such stock purchases would be made on the open market on the American Stock Exchange through an unaffiliated national brokerage firm selected by the Bank. No more than fair market value would be paid for the stock and the Bank would receive no commission as a result of any such purchase. The identity of the sellers of any stock so purchased would not be known to the Bank and would, you state, be difficult, if not impossible, to ascertain. You represent that the Bank does not act as market-maker for such stock.

You request an opinion as to whether the Bank would engage in a prohibited transaction within the meaning of section 406 of ERISA or section 4975 of the Code if, in its capacity as directed trustee of an employee benefit plan which adopts the Prototype Plan, it purchased Bancorp stock on the American Stock Exchange on behalf of any such plan, at the proper direction of a named fiduciary having the authority to direct investments by the Bank, or of an investment manager appointed by a named fiduciary.[1]

Section 403(a) of ERISA provides, in part, that a plan trustee shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that: (1) the plan expressly provides that the trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustee shall be subject to the proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to ERISA; or (2) the authority to manage, acquire, or dispose of the assets of the

plan is delegated to one or more investment managers pursuant to section 402(c)(3) of ERISA.

Section 406(a)(1)(A) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if he or she knows or should know that the transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between the plan and a party in interest. Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary with respect to a plan and a person providing services to a plan, as well as a 10 percent or more shareholder, directly or indirectly, of such a person.[2]

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account.

With respect to purchases and sales of Bancorp stock on the open market in the manner described above, we note that the Conference Report accompanying ERISA states that:

> In general, it is expected that a transaction will not be a prohibited transaction (under either the labor or tax provisions) if the transaction is an ordinary "blind" transaction purchase or sale of securities through an exchange where neither buyer or seller (nor the agent of either) known the identity of the other party involved. In this case, there is no reason to impose a sanction on a fiduciary (or party-in-interest) merely because, by chance, the other party turns out to be a party-in-interest (or plan). H.R. Rep. 93-1280, 93rd Cong., 2d Sess., 307 (1974).

Based on your representations, it is the opinion of the Department that purchases and sales of Bancorp stock in blind transactions executed by unaffiliated brokers at the proper direction of named fiduciaries of plans of its customers would not constitute transactions described in section 406(a)(1)(A) of ERISA. Moreover, under such circumstances, the Bank would not exercise the authority, control or responsibility to cause the plans for which it serves as directed trustee to engage in purchases and sales of Bancorp stock. Accordingly, it is the Department's view that the Bank, as directed trustee, would not engage in prohibited self-dealing under section 406(b)(1) solely as a result of following the directions of an unaffiliated named fiduciary, made in accordance with section 403(a), to purchase Bancorp stock.[3]

It should be pointed out, however, that under section 403(a)(1) of ERISA, a trustee that is subject to proper directions from the plan's named fiduciary remains responsible for determining whether following a given direction would result in a violation of ERISA. The directed trustee also has responsibility to exercise discretion where the directed trustee has reason to believe that the named fiduciary's directions are not made in accordance with the terms of the plan or are contrary to ERISA. Furthermore, as with other fiduciary duties, the trustee must ascertain whether existing or potential conflicts of interest may interfere with the proper exercise of this responsibility. Whether, in light of all the facts and circumstances, a trustee is subject to a conflict of interest or has reason to believe that a particular direction is contrary to ERISA are inherently factual questions as to which the Department generally will not opine. See section 5.01 of ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976).

If the named fiduciary has designated an investment manager pursuant to ERISA section 402(c)(3), then pursuant to ERISA section 405(d)(1) the trustee is not liable for the acts and omissions of the investment manager and is under no obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager. Under ERISA section 405(d)(2), however, the trustee would remain liable for any acts of the trustee including knowing participation or knowing concealment of a breach by another fiduciary under ERISA section 405(a)(1).

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Section 10 of the procedure describes the affect of advisory opinions.

Sincerely,

Robert J. Doyle

Director of Regulations and Interpretations

- Footnotes -

1. Under Reorganization Plan No. 4 of 1978, 43 Fed. Reg 47713 (Oct. 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code, with certain exceptions not here relevant has been transferred to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to corresponding sections of the Code.
2. We note that while Bancorp is thus a party in interest for purposes of Title I of ERISA, it is not a

"disqualified person" under the parallel provisions of the Code. In this regard, contrast section 3(14)(H) of ERISA with section 4975(e)(2)(H) of the Code.
3. We assume, for purposes of this ruling, that the Bank does not have any additional authority to vote or otherwise deal with Bancorp stock held by plans for which it serves as directed trustee.

Advisory Opinion/Individual Exemption 93-13A

Investment in Affiliated Mutual Funds

April 27, 1993

Summary
Provides guidance on the application of PTE 77-4 to the purchase of affiliated mutual funds. Also indicates in footnote 4 that 12b-1 fees may not be paid by a mutual fund on transactions generated by ERISA accounts.

U.S. Department of Labor

Pension and Welfare Benefits Administration

Washington, D.C. 20210

April 27, 1993 AO 93-13A

Fred R. Green, Esq.

Schulte Roth & Zabel

900 Third Avenue

New York, NY 10022

Re: Frank Russell Company

Identification No.: C-9103

Dear Mr. Green:

This is in response to your request for an advisory opinion on behalf of Frank Russell Trust Company and its affiliates regarding the application of Prohibited Transaction Exemption 77-4 (42 FR 18732, April 8, 1977) (PTE 77-4).

You represent that Frank Russell Company (FRC), Frank Russell Trust Company (FRTC), Frank Russell Investment Company (FRIC) and Frank Russell Investment Management Company (FRIMCO) are part of a group of affiliated companies referred to as the Frank Russell Group (hereinafter referred to collectively as FRG).

You further indicate that FRTC serves as trustee, or as investment manager with respect to employee benefit plans (Plans). In addition, FRIMCO serves as investment adviser[1] for a family of mutual funds (the Funds) sponsored by FRIC, each of which is an open-end, registered investment company under the Investment Company Act of 1940. FRIMCO develops the investment programs for each of the Funds, selects money managers/investment advisers (Sub-Advisers) within each of the Funds, allocates assets among the Sub-Advisers within each Fund and monitors the Sub-Advisers' investment programs and results.

FRTC proposes to invest plan assets in the Funds. The Plans will continue to pay an investment advisory fee to FRTC with respect to all plan assets for which FRTC is a trustee with investment discretion or investment manager, including plan assets invested in the Funds. The Plans and the Funds will not pay an investment advisory or similar fee to FRIMCO, or any affiliate, with respect to the plan assets invested in the shares of the Funds. However, shareholders of the Funds, other than the Plans, will pay an investment management fee directly to FRIMCO. In turn, FRIMCO is responsible for the payment of investment advisory fees to the Sub-Advisers of the Funds from fees it receives.

In addition, FRC and FRIMCO provide other services (Secondary Services) to the Funds including (i) transfer agent services; (ii) portfolio activity reports; (iii) analysis of international management reports; and (iv) tax record maintenance. FRIMCO and FRC propose to collect all fees for Secondary services provided to the Funds without waiver of, or credit for, the Plans' pro rata share of such fees.

You state that a fiduciary of a Plan who is independent of and unrelated to FRTC or any affiliate will receive a current prospectus provided by FRTC and written disclosure of the investment advisory and other fees, and any change in such fees, to be paid to FRG by the Funds.[2] After reviewing the written fee disclosures and the prospectus, the independent fiduciary will provide written approval of a program of investment of Plan assets in the shares of the Funds. The form of the written approval may include, but is not limited to, the execution of modified trust and investment management agreements by the independent fiduciary and FRTC.

You ask whether FRIMCO's waiver of the investment advisory fee, otherwise payable by the Plans to FRG in connection with the investment of plan assets in the Funds, complies with the requirements of paragraph (c) of section II of PTE 77-4.[3] Further, you ask whether paragraphs (d), (e) and (f) of section II of PTE 77-4 require written disclosure and approval of fees paid to parties unrelated to FRIMCO, or any affiliate, with respect to the investment of plan assets in the Funds. Finally, you ask whether PTE 77-4 provides relief for the purchase or sale of shares of the Funds subsequent to the approval by a Plan fiduciary, independent of and unrelated to FRTC, of a program for the purchase or sale of shares in the Funds, without prior approval of each such purchase or sale by the independent Plan fiduciary.

PTE 77-4 provides, in part, that:

> The restrictions of section 406 of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975(c)(1) of the Code, shall not apply to the purchase or sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to a plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan (hereinafter referred to as "fiduciary/investment adviser"), provided that the following conditions are met . . . .

Paragraph (c) of section II of PTE 77-4 states that:

> [t]he Plan does not pay an investment advisory or similar fee with respect to the plan assets invested in such shares for the entire period of such investment. This condition does not preclude the payment of investment advisory fees by the investment company under the terms of its investment advisory agreement adopted in accordance with suction 15 of the Investment Company Act of 1940. This condition also does not preclude payment of an investment advisory fee by the plan based on total plan assets from which a credit has been subtracted representing the plan's pro rata share of investment advisory fees paid by the investment company.

The preamble to the proposed class exemption (41 FR 50516, November 16, 1976) explains that:

> the proposed exemption would not permit the payment of a "double" investment advisory or investment management fee by the plan with respect to those assets invested in the mutual fund shares (i.e., both the direct fee paid by the plan to its fiduciary with respect to the invested assets and the investment advisory fee paid by the mutual fund to such fiduciary as investment advisor for the fund).

In addition, paragraph (d) of section II of PTE 77-4 provides that:

> A second fiduciary with respect to the plan, who is independent of and unrelated to the fiduciary/investment adviser or any affiliate thereof, receives a current prospectus issued by the investment company, and full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan and the investment company, including the nature and extent of any differential between the rates of such fees, the reasons why the fiduciary/investment adviser may consider such purchases to be appropriate for the plan, and whether there are any limitations on the fiduciary/investment adviser with respect to which plan assets may be invested in shares of the investment company and, if so, the nature of such limitations.

Further, paragraph (e) of section II of PTE 77-4 states that:

> On the basis of the prospectus and disclosure referred to in paragraph (d), the second fiduciary

> approves such purchases consistent with the responsibilities, obligations, and duties imposed on fiduciaries by Part 4 of Title I of the Act. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan and need not relate to any other aspects of such investment. In addition, such approval must be either (1) set forth in the plan documents or in the investment management agreement between the plan and the fiduciary/investment adviser, (2) indicated in writing prior to each purchase or sale, or (3) indicated in writing prior to the commencement of a specified purchase or sale program in the shares of such investment company.

In addition, paragraph (f) of section II of PTE 77-4 provides that:

> The second fiduciary referred to in paragraph (d), or any successor thereto is notified of any change in the rates of the fees referred to in paragraph (d) and approves in writing the continuation of such purchases or sales and the continued holding of any investment company shares acquired by the plan prior to such change and still held by the plan. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan and need not relate to any other aspects of such investment.

It is the opinion of the Department that the arrangement described in your submissions for the payment of investment management fees by the Plans to FRTC and the waiver of investment advisory fees otherwise payable by the Plans to FRIMCO, or any affiliate, with respect to plan assets invested in the Funds will satisfy the conditions of paragraph (c) of section II of PTE 77-4.[4] With respect to your second request, the Department is of the view that the conditions of paragraphs (d), (e) and (f) of section II of PTE 77-4 do not apply to fees paid to parties unrelated to FRIMCO, or any affiliate, under the above described arrangement.[5] With respect to your last issue, the Department believes that PTE 77-4 provides relief for transactions in which FRTC causes a Plan to purchase or sell shares of the Funds subsequent to written approval by a Plan fiduciary, independent of and unrelated to FRTC, of a program for the purchase or sale of shares in the Funds, without the prior approval of each such purchase or sale by an independent fiduciary, provided all of the other conditions of the exemption are met.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. We note that pursuant to section 5 of ERISA Procedure 76-1 this advisory opinion relates solely to the arrangement described involving FRG.

Sincerely,

Ivan L. Strasfeld

Director

Office of Exemption Determinations

- Footnotes -

1. The applicant represents that FRIMCO is an investment adviser registered under section 203 of the Investment Advisers Act of 1940. Further, the applicant represents that FRIMCO is an investment adviser with respect to the Funds as defined in section 2(a)(20) of the Investment Company Act of 1940.
2. We assume, for purposes of this letter, that the fee disclosure includes disclosure of the investment management fees paid directly to FRIMCO by shareholders other than the Plans.
3. Although you have not requested an opinion regarding the retention of fees for Secondary Services, it is the Department's view that whether a particular service constitutes the provision of investment advisory services or is in fact an additional service depends on the facts and circumstances of each case. Accordingly, the Department is expressing no opinion regarding your characterization of the services for which you propose to collect fees as services other than investment advisory services.
4. The Department notes that PTE 77-4 would not be available for the purchase or sale of investment company shares if any of the secondary services for which FRIMCO and/or FRC receive compensation involved any function which would be considered to constitute the provision of investment advisory services.

   The Department further notes that at the time PTE 77-4 was granted, the use of a portion of the assets of a registered investment company to pay distribution expenses was not generally permitted by the

Securities and Exchange Commission. Accordingly, the payment of fees pursuant to a distribution plan adopted in accordance with Rule 12b-1 under the Investment Company Act ("12b-1 fees"), was not specifically considered by the Department as part of its determination to grant PTE 77-4. In any event, the Department does not believe that the payment of a 12b-1 fee by a fund to a plan fiduciary or its affiliate can be functionally distinguished in many instances from the payment of a commission by the plan in connection with the acquisition or sale of shares in a mutual fund. Therefore, the Department is unable to conclude that PTE 77-4 would be available for plan purchases and sales of mutual fund shares if a 12b-1 fee is paid to the fiduciary or its affiliate with regard to that portion of the fund's assets attributable to the plan's investment.

5. The fact that a transaction is the subject of an administrative exemption does not relieve a fiduciary from the general fiduciary responsibility provisions of section 404 of ERISA. In this regard, the Department emphasizes that it expects the plan fiduciary with investment management responsibility to consider the totality of fees to be paid by the plan directly, and/or indirectly through the mutual fund, prior to entering into the arrangement.

   Also, the Department is expressing no opinion herein on whether disclosure is required under PTE 77-4 where the fees paid to the sub-advisers are paid out of the investment advisory fees paid to the investment adviser with respect to plan assets invested in the fund.

Advisory Opinion 93-24A

Float Management

September 13, 1993

Summary
Provides guidance on float associated with demand deposits. Also covers certain factors regarding retail repurchase agreements.
Also see interpretive letter to American Bankers Association, immediately following this Advisory Opinion.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

September 13, 1993 AO 93-24A

ERISA SECTION:

406(b)(1)

406(b)(3)

Roger W. Thomas

Staff Attorney

Department of Financial Institutions

Fourth Floor, The John Sevier Building

500 Charlotte Avenue

Nashville, TN 37243-0705

Dear Mr. Thomas:

This is in response to your inquiry whether certain transactions engaged in by a Tennessee bank are consistent with the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you call attention to an asserted "common industry practice" whereby banks acting as agents or trustees for employee benefit plans earn interest for their own accounts from the "float" when a benefit check is written to a participant until

the check is presented for payment.

You indicate that a company (Trust Company), which is chartered under Tennessee law as a non-depository bank limited to trust powers, acts as an agent or trustee for various employee benefit plans. It also offers various collective investment funds in which plans invest. A national bank (National Bank) located in Tennessee serves as custodian for some of these plans.

In connection with the administration of the plans, Trust Company maintains accounts at National Bank, including a "General Account" and a "Disbursement Account." When Trust Company is directed to liquidate pooled fund assets to pay benefits, unless it is specifically directed to wire the funds to the participant, it transfers the funds to the General Account and simultaneously issues a check payable to the participant from the Disbursement Account. When checks are presented for payment, funds are wired from the General to the Disbursement Account. In the interim, Trust Company earns income on such funds

for its own account, pursuant to a retail repurchase agreement with National Bank.

You question whether the payment of this income to Trust Company is a prohibited receipt by a fiduciary of consideration from a party dealing with the plan in connection with a transaction involving the assets of the plan under section 406(b)(3) of ERISA. You also express concern that the Trust Company may be violating ERISA by dealing with National Bank, given National Bank's relationship to the plans.

Trust Company, through its attorney, contends that once a check is written to a participant, corresponding amounts in the General Account cease to be plan assets. In support of this argument Trust Company relies upon the first example of the participant contribution regulation in 29 C.F.R. 2510.3-102, which addresses when amounts that an employer withholds from a participant's pay for contribution to a plan can reasonably be segregated from the employer's general assets, and thus become assets of the plan for certain purposes. These special rules concerning segregation of participant contributions from an employer's general assets, however, have no application to the question of whether a plan has an interest in an administrative account when plan assets are transferred to the account in support of an outstanding benefit check.[1]

Turning to an analysis of the issues presented, section 406(b)(1) of ERISA states that a fiduciary with respect to a plan shall not deal with the assets of the plan in his or her own interest or for his or her own account. Section 3(21)(A) of ERISA defines a fiduciary, in part, as one who exercises any discretionary authority with respect to the assets of a plan. As explained in 29 C .F.R. 2509.75-8, persons serving as plan trustees (and certain other plan officials) will be fiduciaries due to the very nature of their positions. Other persons will be fiduciaries to the extent that they perform any of the functions described in section 3(21)(A) of ERISA.

Accordingly, it is the view of the Department that, based on the facts described above, where a fiduciary (e.g. Trust Company) exercises discretion with regard to plan assets, its receipt of income from the "float" on benefit checks under a repurchase agreement with a national bank in connection with the investment of such plan assets would result in a transaction described in ERISA section 406(b)(1).[2]

Moreover, even if all income earned under the repurchase agreements were allocated to the plans, the repurchase agreements themselves may be prohibited where the national bank is a party in interest with respect to the plans. Section 406(a)(1)(A) and (B) of ERISA, in part, prohibit sales or extensions of credit between plans and parties in interest. The term "party in interest" is defined in section 3(14) of ERISA to include a person providing services to a plan. From the information provided, it appears that National Bank, as the custodian of plan assets for some of the plans, is a service provider to such plans.

As we understand it, repurchase agreements essentially involve debt transactions structured as sales of securities. Therefore, absent exemptive relief, it appears that the repurchase agreements in question would involve prohibited extensions of credit, as well as prohibited sales between National Bank and plans that it serves. The Department has issued an administrative exemption, Prohibited Transaction Exemption 81-8 (copy enclosed), which provides conditional relief for investments in repurchase agreements, by or on behalf of an employee benefit plan. Whether this class exemption would grant relief to the parties involved in the subject retail repurchase agreement cannot be determined from the information provided.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle

Director of Regulations and Interpretations

- Footnotes -

1. It is commonly understood that a check does not of itself operate as an assignment of any funds in the hands of the drawee bank available for its payment and the bank is not liable on the instrument until it accepts it. U.C.C. § 3-409(1). A bank which properly pays checks drawn on it extinguishes its liability to the depositor to the extent of the amount so paid, so that it may charge the depositor's account with the amount of such payment. 9 C.J.S. Banks and Banking § 353 (1938).
2. Although you asked if this arrangement would be prohibited under section 406(b)(3), due to the limited information provided we are unable to conclude that the arrangement described herein gives rise to a violation of this section. Specifically, we are unable to conclude that the bank knew, or should have known, the circumstances under which plan assets were invested pursuant to the repurchase agreements. Thus, we are restricting our analysis to the potential violation of section 406(b)(1).

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

AUG 11 1994

Ms. Judith A. McCormick

Federal Counsel

American Bankers Association

1120 Connecticut Avenue, N.W.

Washington, D.C. 20036

Dear Ms. McCormick:

Thank you for the invitation to respond to an editorial entitled "Special Analysis, Perspectives on the 'Float' Issue," which appeared in the American Bankers Association January 1994 edition of the Trust Letter. We appreciate this opportunity to clear up an apparent misunderstanding in the editorial regarding prohibited self-dealing by banks that serve as fiduciaries to employee benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).

The focus of the editorial is an ERISA advisory opinion, AO 93-24A (Sept. 13, 1993), which concluded that a bank trustee's exercise of discretion to earn income for its own account from the "float" attributable to outstanding benefit checks constitutes prohibited fiduciary self-dealing under ERISA. The editorial questions whether the analysis in AO 93-24A is limited to its facts -- which involved the use of accounts and repurchase agreements with a third-party national bank to earn income for the bank trustee during the period of the float -- or whether the opinion has broader implications for the procedures banks commonly utilize in issuing benefit checks. Although advisory opinions apply only to the specific factual situations that they describe, (ERISA Procedure 76-1, § 10, 41 Fed. Reg. 36281, 36283 (Aug. 27, 1976)), the essential analysis of AO 93-24A is not unique to its facts.

The editorial notes that, in contrast to the facts presented In AO 93-24A, banks commonly issue benefit checks drawn on a disbursement account within the same institution. The editorial points out that, as a technical matter depending upon the type of account used, the actual amounts in such disbursement accounts may no longer be considered plan assets. From this, the editorial concludes, in our view erroneously, that "[i]f these balances are no longer plan assets once transferred to such an account, then no prohibited transaction occurs." This conclusion misses the fundamental principle of AO 93-24A that, without regard to the status of the funds after they are placed in a disbursement or other account, a bank fiduciary's decision to handle plan assets in such a way as to benefit itself constitutes prohibited self-dealing.

We also take issue with the suggestion in the editorial that section 408(b)(6) of ERISA exempts such fiduciary self-dealing. That section affords conditional relief from the prohibitions on self-dealing for the providing of "ancillary" services by a bank to a plan for which it is a fiduciary if, among other requirements, the services are provided for no more than reasonable compensation. The legislative history of this section indicates that "in determining whether a plan pays more than reasonable compensation for its checking account services, the

interest available on an alternate use of the funds is to be considered." H.R. Conf. Rept. No. 93-1280, 93d Cong., 2d Sess. (1974) at 315. Given the widespread technological advances in cash management during the twenty years since ERISA was enacted, it is by now generally recognized that banks have the capability of investing daily all but small amounts of cash in trust-quality investment vehicles at competitive market rates. (See Board of Governors of the Federal Reserve System letter to Stephen R. Steinbrink, Deputy Comptroller, Office of Comptroller of the currency, dated May 17, 1991). Accordingly, Section 408(b)(6) does not provide relief for a bank trustee who maintains cash balanced in a zero-interest disbursing account within the same institution to the extent that it is reasonably possible to earn net returns for the plan on those monies. Nor would such an exercise of discretion that is intended to benefit the bank at the expense of the plan's interests comport with the requirements of section 404(a)(1)(A) of ERISA that fiduciaries act prudently and solely in the interest of participants and beneficiaries.

Of course, if a bank fiduciary has openly negotiated with an independent plan fiduciary to retain earnings on the float attributable to outstanding benefit checks as part of its overall compensation, then the bank's use of the float would not be self-dealing because the bank would not be exercising its fiduciary authority or control for its own benefit. Therefore, to avoid, problems, banks should, as part of their fee negotiations, provide full and fair disclosure regarding the use of float an outstanding benefit checks.

Again, thank you for opening a dialogue on this important matter. We hope that this exchange will help to clarify any misunderstanding concerning the "float" issue.

Sincerely,

Robert J. Doyle

Director of Regulations and Interpretations

Advisory Opinion/Individual Exemption 93-26A

Investment in Affiliated Mutual Funds by IRA and Keogh Accounts

September 9, 1993

Summary
Provides guidance on the application of PTE 77-4 to the purchase of affiliated mutual funds by IRA and Keogh (HR-10) accounts.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

September 9, 1993

Donald S. Kohla, Esq. AO 93-26A

King & Spalding

191 Peachtree Street

Atlanta, Georgia 30303-1763

Re: SunTrust Banks, Inc. (SunTrust)

Exemption Application No. D-9423

Dear Mr. Kohla:

This is in response to the above referenced application requesting an exemption from the prohibitions of section 406 of the Employee Retirement Income Security Act of 1974 (ERISA or the Act) and from the sanctions resulting from the application of Section 4975 of the Internal Revenue Code of 1986 (the Code).

Your application sets forth the following facts and representations. SunTrust proposes to offer shares of the

STI Classic Funds (the Funds), a series of open-end investment companies registered under the Investment Company Act of 1940, to individual retirement accounts (IRAs) for which SunTrust acts as a trustee with investment management responsibility. Sun Bank Capital Management and Trustco Capital Management, affiliates of SunTrust, serve as investment advisers for the Funds and receive fees for their services from the Funds. You represent that SunTrust will not charge the IRAs any investment management fees for assets that are invested in the Funds.

At the conference regarding your exemption request on August 19, 1993, you stated that, as an alternative to obtaining an individual exemption for the proposed transactions, SunTrust would be willing to structure the arrangement to comply with Prohibited Transaction Exemption (PTE) 77-4 (42 FR 18732, April 8, 1977) if that exemption is available for IRAs.

Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) the authority to issue rulings under section 4975 of the Code has been transferred, with certain exceptions, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to corresponding sections of the Code.

PTE 77-4 provides that the restrictions of section 406 of the Act, and the taxes imposed by section 4975(a) and (b) of the Code, shall not apply to the purchase and sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to the plan (or an affiliate of such fiduciary), and is not an employer of employees covered by the plan, provided certain conditions are met.

Although PTE 77-4 does not define the term "employee benefit plan", the Department of Labor (the Department) is of the view that the exemption is applicable not only to transactions involving employee benefit plans covered under Title I of ERISA, but also to transactions involving IRAs and HR-10 plans which are not covered by Title I of ERISA but which are subject to the provisions of section 4975 of the Code. We have conferred with representatives of the Internal Revenue Service and they concur in the view that plans described in code section 4975(e)(1) are included within the scope of PTE 77-4.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. This opinion relates only to the specific issue addressed herein. For example, the Department is not providing an opinion as to whether the particular arrangement described in your exemption application would satisfy the conditions imposed by PTE 77-4. Nor is the Department providing an opinion as to the definition of the term "employee benefit plan" in any exemption other than PTE 77-4.

if you have any further questions, please contact Mr. E. F. Williams, Department of Labor, (202) 219-8883.

Sincerely,

Ivan L. Strasfeld

Director

Office of Exemption Determinations

Advisory Opinion to OCC (94-41A)

Escheating

December 7, 1994

U.S. Department of Labor

Pension and Welfare Benefits Administration

Washington, DC 20210

December 7, 1994

Mr. Thomas R. Giltner 94-4IA

Cox & Smith Incorporated ERISA SECTION

112 East Pecan Street, Suite 2000 514(a)

San Antonio, Texas 78205

Dear Mr. Giltner:

This is in reply to your request for an advisory opinion regarding the applicability of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you ask whether section 514(a) of Title I of ERISA preempts the application of the Texas Unclaimed Property Statutes (Tex. Prop. Code Ann. Title 6 (West 1985)), with the result that the State of Texas may not assume custody over unclaimed benefits of those participants in the Luby's Cafeterias, Inc. Employees Profit Sharing and Retirement Trust (the Plan) who cannot be located.

You advise that Luby's Cafeterias, Inc. (the Company) sponsors the Plan for its ible employees. You further adv ise that, in the normal operation of the Plane plan administrator has occasionally been unable to locate a parti cipor beneficiary entitled to a distribution of retirement benefits. You interpretion 7.10 of the plan document, which provides a procedure in the event a part ant or beneficiary fails to claim a distribution, to permit or requir e your curpractice in such circumstances, which you describe as follows. If a distribute ils to claim a distributi on under the plan, the amount of the unclaimedsbeansferred to an account styled "Terminated Employees' A ccount,"ch is an account segregated from the Plan's other bank accounts, but n account of the Plan . (l) The Plan maintains records to indicate the amoueach "lost" participant's or beneficiary's interest in the account. If a lost participant or beneficiary is later located, his or her benefits are paid from the Plan's main account, which is then reimbursed from the Terminated Employees' Account. If a lost participant or beneficiary is not located within four years, you represent that his or her share in the Terminated Employees' Account is then transferred to the Plan's main account. If the lost participant or beneficiary is located at any time after this transfer occurs, you represent that his or her benefits are reinstated and paid by the Plan.

(1) You represent that, when a distribution is for benefits valued at less than $3,500, the plan trustee mails a check to the last known address of the unlocated participant. If the check is not cashed after a reasonable period of time (presumably no more than a few months), the trustee cancels the check and transfers the same amount to the Terminated Employees' Account.

In your request, you further assert that Section 7.10 of the Plan, as interpreted above, fully complies with Treasury Regulation section 1.411(a)-4(b)(6), which provides:

(b) Special rules. For purposes of paragraph (a) of this section, a right is- not treated as forfeitable-

6) Lost beneficiary: escheat. In the case of a benefit which is payable, merely because the benefit is forfeitable on account of the inability to find the participant or beneficiary to whom payment is due, provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is lost by reason of escheat under applicable state law is not treated as a forfeiture.

You further advise that 72.101 of the Texas Unclaimed Property Statutes provides:

72.101. Personal Property Subject to Escheat

Personal property, other than traveler's checks, is presumed abandoned and subject to escheat if, for, longer than seven years:

(1) the existence and location of the owner of the property is unknown to the holder of the property;

(2) according to the knowledge and records of the holder of the property, a claim to the property has not been asserted or an act of ownership of the property has not been exercised; and

(3) a will of the owner of the property has not been recorded or probated in the county in which the property is located.

Section 514(a) of Title I of ERISA provides:

(a) Supersedure; effective date. Except as provided in subsection (b) of this section, the provisions of this title and title IV shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan described in section 4(a) and not exempt under section 4(b).

Section 514(a) does conflict with Title I of ERISA, not merely preempt state laws that

ERISA, but broadly preempts all state laws related to employee benefit plans. The reasons for the broad preemption of state laws under ERISA were succinctly stated by Senator Javits, a major sponsor and floor manager of the bill that became ERISA, during its final consideration:

> Both House and Senate bills provided for preemption of State law but -- with one major exception appearing in the House Bill -- defined the perimeters of preemption in relation to the areas regulated by the bill. Such a formulation raised the possibility of endless litigation over the validity of State action that might impinge on Federal regulation, as well as opening the door to multiple and potentially conflicting State laws hastily contrived to deal with some particular aspect of private welfare or pension plans not clearly connected to the Federal scheme.
>
> Although the desirability of further regulation at either the State or Federal level -- undoubtedly warrants further attention, on balance, the emergence of a comprehensive and pervasive Federal

interest and the interests of uniformity with respect to interstate plans required -- but for certain exceptions -- the displacement of State action in the field of private employee benefit programs. (120 Cong. Rec. S15751 (daily ed. Aug 22, 1974)).

It is the view of the Department of Labor (the Department) that, if the above-quoted section of the Texas Unclaimed Property Statutes were applied to require the Plan to pay to the State amounts held in the Terminated Employees' Account, or in other accounts of the Plan, pursuant to the procedures described above, then such application of the section would be preempted under section 514(a) of ERISA. (2) Such an application of the State escheat law would directly affect the core functions of the Plan by reducing, through the escheat, the amount of plan assets held in trust for the benefit of all participants and beneficiaries of the Plan. (3) Moreover, because the statute at issue is not a law regulating insurance, banking or securities, it is not saved from preemption under section 514(b) (2). (4)

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,

Robert J. Doyle

Director of Regulations and Interpretations

> (2) In Opinion 78-32A (December 22, 1978), the Department concluded that a provision of the Illinois Uniform Disposition of Property Act was preempted as applied to employee benefit plans. In Opinion 79-30A (May 14, 1979) the Department reached the same conclusion with respect to a provision of California's Unclaimed Property Law that expressly referred to employee benefit trust dispositions. In Opinion 83-39A (July 29, 1983), the Department found that a section of the New York Abandoned Property Law, which addressed the escheat of "[u]nclaimed insurance proceeds other than life insurance," was saved from preemption under ERISA 514(b)(a)(A) as a law regulating insurance.
>
> (3) In our view, the decision of the United States Court of Appeals for the Second Circuit in Aetna Life Ins. v. gorges, 869 F.2d 142 (2d Cir. 1989), is clearly distinguishable. In that case, the court considered the application of a state escheat law to amounts held in reserve by an insurance company to cover benefit checks issued pursuant to an insurance contract with an employer to provide welfare benefits, which checks were never presented by the participant or beneficiary for payment. The court found that the application of the escheat law in those circumstances would have only an indirect economic and~ administrative impact on the plan that was too remote and tangential to trigger preemption.
>
> (4) We note that Treasury Regulation 1.411(a)-4(b)(6) provides that a benefit "lost by reason of escheat under applicable state law" will not be treated as an impermissible forfeiture under Internal Revenue Code 411(a). This regulation, however, provides no guidance as to whether a particular application of state escheat law is preempted under ERISA Section 514.

Advisory Opinion to OCC (94-OCC)

Collective Investment Fund Conversions to Mutual Funds

(Makes reference to PTE 77-4)

February 14, 1994

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, DC 20210

February 14, 1994

Mr. William Granovsky

National Bank Examiner

Compliance Management

Comptroller of the Currency

Administrator of National Banks

Washington, D.C. 20219

Re: Applicability of Prohibited Transaction Exemption (PTE) 77-4 to the Conversion of Bank Collective Investment Funds.

Dear Mr. Granovsky:

As a follow-up to our meeting on February 1, 1994, I thought it would be helpful if the Department formally provided its views regarding the applicability of Prohibited Transaction Exemption PTE 77-4 to the conversion of bank collective investment funds.

As you know, PTE 77-4 provides conditional relief from ERISA's prohibited transaction provisions for the purchase or sale by a plan of shares of an open-end investment company, the investment adviser for which is also a fiduciary with respect to the plan. Although PTE 77-4 does not specifically address in-kind exchanges, the Department is of the view that the transactions exempted by PTE 77-4 do not include the acquisition or sale of investment company shares for anything other than cash. We believe that if such transactions had been contemplated at the time that the exemption was granted, the exemption would contain additional safeguards designed to address the valuation and other' issues associated with in-kind exchanges. Therefore, the Department is unable to conclude that PTE 77-4 would be available for conversions of bank collective investment funds involving the exchange of securities held by the fund on behalf of plan investors for shares of the bank's affiliated investment company.

If you have any further questions please contact Eric Berger at (202) 219-8971.

Sincerely,

Ivan L. Strasfeld

Director

Office of Exemption Determinations

Pension and Welfare Benefits Administration

Advisory Opinion to OCC (96-OCC)

Investments in Derivatives

March 21, 1996

U.S. Department of Labor

Assistant Secretary for

Pension and Welfare Benefits

Washington, D.C. 20210

March 21, 1996

Honorable Eugene A. Ludwig

Comptroller of the Currency

250 E Street, S.W.

Washington, D.C. 20219

Dear Mr. Ludwig,

At our last meeting we discussed the Department of Labor's views with respect to the utilization of derivatives in the management of a portfolio of assets of a pension plan which is subject to the Employee Retirement Income Security Act of 1974 (ERISA). This letter is to provide you with an update of our views in a format which may be of use to you and your staff.

ERISA governs private-sector sponsored employee welfare and pension benefit plans and provides a general framework within which plan fiduciaries are expected to conduct their investment activities. Under ERISA, a fiduciary includes anyone who exercises discretion in the administration of an employee benefit plan; has authority or control over the plan's assets; or renders investment advice for a fee with respect to any plan assets.[2] Thus, any entity, including an institution such as a bank, that meets this functional test with respect to an employee benefit plan sponsored by a private-sector employer, employee organization, or both, would be considered a fiduciary under ERISA.

ERISA establishes comprehensive standards to govern fiduciary conduct. Among other things, fiduciaries with respect to an employee benefit plan must discharge their duties with respect to a plan solely in the interest of the plan's participants and beneficiaries, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[3]

Investments in derivatives are subject to the fiduciary responsibility rules in the same manner as are any other plan investments. Thus, plan fiduciaries must determine that an investment in derivatives is, among other things, prudent and made solely in the interest of the plan's participants and beneficiaries. In determining whether to invest in a particular derivative, plan fiduciaries are required to engage in the same general procedures and undertake the same type of analysis that they would in making any other investment decision. This would include, but not be limited to, a consideration of how the investment fits within the plan's investment policy, what role the particular derivative plays in the plan's portfolio, and the plan's potential exposure to losses.

While derivatives may be a useful tool for managing a variety of risks and for broadening investment alternatives in a plan's portfolio, investments in certain derivatives, such as structured notes and collateralized mortgage obligations, may require a higher degree of sophistication and understanding on the part of plan fiduciaries than other investments. Characteristics of such derivatives may include extreme price volatility, a high degree of leverage, limited testing by markets, and difficulty in determining the market value of the derivative due to illiquid market conditions.

As with any investment made by a plan, plan fiduciaries with the authority for investing in derivatives are responsible for securing sufficient information to understand the investment prior to making the investment. For example, plan fiduciaries should secure from dealers and other sellers of derivatives, among other things, sufficient information to allow an independent analysis of the credit risk and market risk being undertaken by the plan in making the investment in the particular derivative. The market risks presented by the derivatives purchased by the plan should be understood and evaluated in terms of the effects that they will have on the relevant segments of the plan's portfolio as well as the portfolio's overall risk.

Plan fiduciaries have a duty to determine the appropriate methodology used to uate market risk and the inf ormation which must be collected to do so. Amher things, this would include, where appropriate, stress simulation modelsng the projected performance of the derivatives and of the plan's portfolio un various market conditions. Stress simulations are particularly important becausumptions which may be valid for normal ma rkets may not be valid in abnormal mas, resulting in significant losses. To the extent that there may be littl e pricinformation available with respect to some derivatives, reliable price arisons may be necessary. A fter entering into an investment, a plan fiduciary should be able to obtain timely information from the derivatives dealer regarding the plan's credit exposure and the current market value of its derivative positions, and, where

appropriate, should obtain such information from third parties to determine the current market value of the plan's derivative positions, with a frequency that is appropriate to the nature and extent of these positions.

If the plan is investing in a pooled fund which is managed by a party other than the plan fiduciary who has chosen the fund, then that plan fiduciary should obtain, among other things, sufficient information to determine the pooled fund's strategy with respect to use of derivatives in its portfolio, the extent of investment by the fund in derivatives, and such other information as would be appropriate under the circumstances.

As part of its evaluation of the investment, a fiduciary must analyze the operational risks being undertaken in making the investment. Among other things, the fiduciary should determine whether it possesses the requisite expertise, knowledge, and information to understand and analyze the nature of the risks and potential returns involved in a particular derivative investment. In particular, the fiduciary must determine whether the plan has adequate information and risk management systems in place given the nature, size and complexity of the plan's derivatives activity, and whether the plan fiduciary has personnel who are competent to manage these systems. If the investments are made by outside investment managers hired by the plan fiduciary, that fiduciary should consider whether the investment managers have such personnel and controls and whether the plan fiduciary has personnel who are competent to monitor the derivatives activities of the investment managers.

Plan fiduciaries have a duty to evaluate the legal risk related to the investment. This would include assuring proper documentation of the derivative transaction and, where the transaction is pursuant to a contract, assuring written documentation of the contract before entering into the contract.

Also, as with any other investment, plan fiduciaries have a duty to properly monitor their investments in derivatives to determine whether they are still appropriately fulfilling their role in the portfolio. The frequency and degree of the monitoring will, of course, depend on the nature of such investments and their role in the plan's portfolio.

We hope these comments have been helpful. However, if you should have any further questions or if we can provide any further assistance, please feel free to contact Morton Klevan at (202) 219-9044 or Louis Campagna at (202) 219-8883.

Sincerely,

Olana Berg

- Footnotes -

1. We refer to derivatives in this letter as financial instruments whose performance is derived in whole or in part from the performance of an underlying asset (such as a security or index of securities). Some examples of these financial instruments include futures, options, options on futures, forward contracts, swaps, structured notes and collateralized mortgage obligations.
2. See ERISA section 3(21).
3. See ERISA section 404(a).

Advisory Opinion 97-15A to Frost National Bank

Acceptance of Mutual Fund 12b-1 Fees; Letter to Frost National Bank; Discretionary and Non-Discretionary Accounts

May 22, 1997

Summary
Guidance on the purchase of mutual funds which pay 12b-1 fees to fiduciaries.

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, DC 20210

May 22 1997

Mark S. Miller 97-15A

Fulbright & Jaworski, LLP

1301 McKinney, Suite 5100

Houston, Texas 77010-3095

Dear Mr. Miller:

This is in response to your request for an advisory opinion regarding the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you ask whether the payment of certain fees by a mutual fund in which an employee pension benefit plan has invested to a bank serving as the plan's trustee would violate sections 406(b)(1) and 406(b)(3) of ERISA.

You represent that Frost National Bank (Frost) serves as trustee to various employee pension benefit plans (the Plans). As trustee of the Plans, Frost's duties may include one or more of the following functions, pursuant to instructions from the Plan sponsor or participants: opening and maintaining individual participant accounts; receiving contributions from the Plan sponsor and crediting them to individual participant accounts; investing contributions in shares of a mutual fund and reinvesting dividends and other distributions; redeeming, transferring, or exchanging mutual fund shares; providing or maintaining various administrative forms in making distributions from the Plan to participants or beneficiaries; keeping custody of the Plan's assets; withholding amounts on Plan distributions; making sure all Plan loan payments are collected and properly credited; conducting Plan enrollment meetings; and preparing newsletters and videos relating to the administration of the Plan.

In connection with its Plan-related business, Frost has entered into arrangements with one or more distributors of, or investment advisors to, mutual fund families pursuant to which Frost will make the mutual fund families available for investment by the Plans. Frost will periodically review each such mutual fund family to determine whether to continue the arrangement, and will reserve the right to add or remove mutual fund families that it makes available to the Plans.

As part of Frost's arrangements with the mutual fund families, Frost may provide shareholder services to, and receive fees from, some of the Individual mutual funds in which Plan assets are invested. The shareholder services may include, e.g., providing mutual fund recordkeeping and accounting services in connection with the Plans' purchase or sale of shares, processing mutual fund sales and redemption transactions involving the Plans, and providing mutual fund enrollment material (including prospectuses) to Plan participants. The fees paid by the mutual funds to Frost will generally be based on a percentage of Plan assets invested in each mutual fund, and will be paid pursuant to either a distribution plan described in Securities and Exchange Commission (SEC) Rule 12b-1, 17 C.F.R. 270.12b-I (a 12b-1 plan), or a "subtransfer agency arrangement."[1]

You further represent that, with respect to some of the Plans, Frost will recommend to the Plan fiduciary the advisability of investing in particular mutual funds offered pursuant to Frost's arrangements with the mutual fund families. In addition, Frost will monitor the performance of the individual mutual funds selected by the Plan fiduciary and, as it deems appropriate, will make further recommendations regarding additional or substitute mutual funds for the investment of Plan assets.

With respect to other Plans, Frost will not make any recommendations concerning the selection of, or continued investment in, particular mutual funds. Rather, the responsible Plan fiduciary will independently select, from the mutual fund families made available by Frost, particular mutual funds for the investment of Plan assets, or for designation as investment alternatives offered to participants under the Plan.

In both instances, whether or not Frost makes specific investment recommendations, you represent that, before a Plan enters into the arrangement, the terms of Frost's fee arrangements with the mutual fund families will be fully disclosed to the Plans. In addition, Frost's trustee agreement with a Plan will be structured so that any 12b-1 or subtransfer agent fees received by Frost that are attributable to the Plan's investment in a mutual fund will be used to benefit the Plan. Pursuant to the particular agreement with each Plan, Frost will offset such fees, on a dollar-for-dollar basis, against the trustee fee that the Plan is obligated to pay Frost or against the recordkeeping fee that the Plan is obligated to pay to a third-party recordkeeper; or Frost will credit the Plan directly with the fees it receives based on the investment of Plan assets in the mutual fund.[2] The trustee agreement will provide that, to the extent that Frost receives fees from mutual funds in connection with the Plan's investments that are in excess of the fee that the Plan owes to Frost, the Plan will be entitled to the excess amount.

You request an opinion that Frost's receipt of fees from the mutual funds under the circumstances described would not constitute a violation of ERISA section 406(b)(1) or (b)(3).[3]

You have asked us to assume for the purpose of your request that the arrangements between Frost and the Plans satisfy the conditions of ERISA section 408(b)(2).[4]

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(3) prohibits a fiduciary with respect to a plan from receiving any consideration for his or her personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.[5]

Under section 3(21)(A) of ERISA, a person is a "fiduciary" with respect to a plan to the extent that the person (i) exercises any discretionary authority or control respecting management of the plan or any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in the administration of the plan.

Frost, as trustee, is a fiduciary with respect to the Plans under section 3(21)(A) of ERISA. See 29 C.F.R. 2509.75-8, D-3 (the position of trustee of a plan, by its very nature, requires the person who holds it to perform one or more of the functions described in ERISA section 3(21)(A))[6]

When the Trustee Advises

You have indicated that, with respect to some of the Plans, Frost will advise the Plan fiduciary regarding particular mutual funds in which to invest Plan assets.[7] It also appears from your submission that, under Frost's arrangements with various mutual fund families, Frost may receive fees from some of the mutual funds as a result of a Plan's investment in the mutual funds recommended by Frost. In the view of the Department, advising that plan assets be invested in mutual funds that pay additional fees to the advising fiduciary generally would violate the prohibitions of ERISA section 406(b)(1).

You represent, however, that before entering into an arrangement with a Plan, or recommending any particular mutual fund investments, Frost will disclose to the Plan fiduciary the extent to which it may receive fees from the mutual fund(s). Furthermore, you represent that the trustee agreement between Frost and the Plan will expressly provide that any fees received by Frost as a result of the Plan's investment in such a mutual fund will be used to pay all or a portion of the compensation that the Plan is obligated to pay to Frost, and that the Plan will be entitled to any such fees that exceed the Plan's liability to Frost.[8] To the extent the Plan's legal obligation to Frost is extinguished by the amount of the offset, it is the opinion of the Department that Frost would not be dealing with the assets of the Plan in its own interest or for its own account in violation of section 406(b)(1).

With respect to the prohibition of section 406(b)(3), Frost's contract with a Plan, as described above, will provide that Frost's receipt of fees from one or more mutual funds in connection with the Plan's investment in such funds will be used to reduce the Plan's obligation to Frost, will in no circumstances increase Frost's compensation, and thus will benefit the Plan rather than Frost. Accordingly, it is the opinion of the Department that in these circumstances Frost would not be deemed to receive such payments for its own personal account in violation of section 406(b)(3).

When the Trustee is Directed

With respect to Plans for which Frost does not provide any investment advice, it appears that the Plan fiduciary, and in some instances the Plan participants, will select the mutual funds in which to invest Plan assets from among those made available by Frost. Generally speaking, if a trustee acts pursuant to a direction in accordance with section 403(a)(1) or 404(c) of ERISA and does not exercise any authority or control to cause a plan to invest in a mutual fund that pays a fee to the trustee in connection with the plan's investment, the trustee would not be dealing with the assets of the plan for its own interest or for its own account in violation of section 406(b)(1).

Similarly, it is generally the view of the Department that if a trustee acts pursuant to a direction in accordance with section 403(a)(1) or 404(c) of ERISA and does not exercise any authority or control to cause a plan to invest in a mutual fund, the mere receipt by the trustee of a fee or other compensation from the mutual fund in connection with such investment would not in and of itself violate section 406(b)(3). Your submission indicates,

however, that Frost reserves the right to add or remove mutual fund families that it makes available to Plans. Under these circumstances, we are unable to conclude that Frost would not exercise any discretionary authority or control to cause the Plans to invest in mutual funds that pay a fee or other compensation to Frost.[9]

However, because Frost's trustee agreements with the Plans are structured so that any 12b-1 or subtransfer agent fees attributable to the Plans' investments in mutual funds are used to benefit the Plans, either as a dollar-for-dollar offset against the fees the Plans would be obligated to pay to Frost for its services or as amounts credited directly to the Plans, it is the view of the Department that Frost would not be dealing with the assets of the Plans in its own interest or for its own account, or receiving payments for its own personal account in violation of section 406(b)(1) or (b)(3).

Finally, it should be noted that ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, the above-described arrangement and trustee agreement with Frost, and in determining which investment options to utilize or make available to Plan participants or beneficiaries. In this regard, the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to Frost is reasonable, taking into account the trustee services provided to the Plan as well as any other fees or compensation received by Frost in connection with the investment of Plan assets. In this connection, it is the view of the Department that the responsible Plan fiduciaries must obtain sufficient information regarding any fees or other compensation that Frost receives with respect to the Plan's investments in each mutual fund to make an informed decision whether Frost's compensation for services is no more than reasonable. The Plan fiduciaries also must periodically monitor the actions taken by Frost in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof regarding the effect of advisory opinions.

Sincerely,

Bette J. Briggs

Chief, Division of Fiduciary Interpretations .

Office of Regulations and Interpretations

- Footnotes -

1. A "subtransfer agency fee" is typically a fee paid for recordkeeping services provided to the mutual fund transfer agent with respect to bank customers.
2. We assume for purposes of this opinion that each Plan's governing documents provide that the Plan will pay costs and expenses for trustee services necessary to the operation and administration of the Plan.
3. For a discussion of related issues involving receipt of fees by a record-keeper offering a program of investment options and services to plans, see also Advisory Opinion 97-16A, May 22, 1997.
4. We offer no opinion herein as to whether such conditions have been satisfied; nor does this opinion address the application of any other provisions of ERISA.
5. Under Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Internal Revenue Code of 1986 (the Code) has been transferred, with certain exceptions not here relevant, to the Secretary of Labor, and the Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.
6. Section 403(a) of ERISA establishes that, in general, a trustee of a plan must have exclusive authority and discretion to manage and control the plan's assets. Under section 403(a)(1), when the plan expressly so provides, the trustee may be subject to the proper directions of a named fiduciary which are made in accordance with the terms of the plan and not contrary to ERISA. Nevertheless, a directed trustee has residual fiduciary responsibility for determining whether a given direction is proper and whether following the direction would result in a violation of ERISA. Accordingly, it is the view of the Department that a directed trustee necessarily will perform fiduciary functions.
7. We assume for the purposes of your request that Frost will provide investment advice within the meaning of ERISA section 3(21)(A)(ii) and 29 C.F.R. 2510.3-21(c)(1)(i) and (ii)(B) with respect to these Plans.

8. We express no opinion herein as to the propriety of such a pass-through of fees under Federal securities laws. Questions concerning the application of the Federal securities laws are within the jurisdiction of the SEC.
9. See, in this regard, the Department's position as expressed in the preamble to the final regulation regarding participant-directed individual account plans (ERISA section 404(c) plans), 57 Fed. Reg. 46906, 46924 n. 27 (Oct. 13, 1992):

   In this regard [a fiduciary is relieved of responsibility only for the direct and necessary consequences of a participant's exercise of control], the Department points out that the act of limiting or designating investment options which are intended to constitute all or part of the investment universe of an ERISA 404(c) plan is a fiduciary function which, whether achieved through fiduciary designation or express plan language, is not a direct or necessary result of any participant direction of such plan.

Advisory Opinion 97-16A to Aetna Life Insurance and Annuity Company

Acceptance of Mutual Fund 12b-1 Fees; Letter to Aetna Life Insurance and Annuity Company; Non-Discretionary Accounts

May 22, 1997

Summary
Guidance on the purchase of mutual funds which pay 12b-1 fees to Non-Discretionary Administrative and Record Keeping Service Providers

U.S. Department of Labor Pension and Welfare Benefits Administration

Washington, D.C. 20210

May 22 1997

Stephen M. Saxon 97-16A

Groom & Nordberg

1701 Pennsylvania Avenue, N.W.

Suite 1200

Washington, DC 20006

Dear Mr. Saxon:

This is in response to your request for an advisory opinion concerning the application of section 406(b)(3) of the Employee Retirement Income Security Act (ERISA) to the receipt of certain fees by the Aetna Life Insurance and Annuity Company (ALIAC), an indirect subsidiary of Aetna Insurance Company, Inc. (Aetna). In particular, you request an opinion that ALIAC's receipt of fees from mutual funds that are unrelated to Aetna for recordkeeping and other services in connection with investments by employee benefit plans in the unrelated funds does not violate section 406(b)(3) under the circumstances described in your request.

ALIAC is a life insurance company domiciled in Connecticut, as well as a registered broker-dealer and a registered investment adviser. You represent that ALIAC sponsors and manages the Aetna Mutual Funds 401(k) Program (the 401(k) Program), which offers sponsors (other than Aetna) of participant-directed defined contribution plans (Plans): a) a volume submitter plan document; b) recordkeeping and related administrative services through Aetna 401 Retirement Plan Services (ARPS), ALIAC's business unit; c) investment options selected by ALIAC consisting of no-load or low load mutual funds from various fund families that are unrelated to Aetna (Unrelated Funds), Aetna Series Funds (a series of mutual funds within a diversified open-ended investment company registered under the Investment Company Act of 1940 (ICA)), and group annuity contracts (GACS) issued by Aetna Life Insurance Company (ALIC), an affiliate of ALIAC;[1] and d) directed trustee or custodial services provided by a bank that is unrelated to Aetna (the Bank). You represent that

Unrelated Funds from three different mutual fund families are currently available and that additional families may be added in the future. You further represent that, in the future, Unrelated Funds may also pay fees to ALIAC for "marketing services."[2]

Plan fiduciaries who are independent of and unrelated to ALIAC, ALIC, and their affiliates are responsible for selecting the investment options to be offered to Plan participants from among the Unrelated Funds, Aetna Series Funds, and several options under the GACS. You further represent that neither ALIAC, ALIC, nor any other affiliate of Aetna (or any of its employees) provides investment advice or recommendations, within the meaning of ERISA section 3(21)(A)(ii), to Plan fiduciaries or participants regarding the advisability of either selecting any of the investment options for the Plans, or investing in any of the investment options that are available under the Plans.

ARPS, ALIAC's business unit, will, pursuant to a plan services agreement, provide some **or** all of the following services to Plans:

1) one-time installation services, which may include assistance in preparation of Plan documents, participant communication materials, and government filings, and installation of Plan and participant level records into the ARPS recordkeeping systems;

2) basic non-discretionary administrative and recordkeeping services, e.g. (a) enrolling participants, (b) maintaining participant and Plan-level account records, (c) balancing and allocating contributions, loan repayments, and forfeitures among accounts, (d) processing distributions and withdrawals, (e) reconciling Plan and participant activity on a daily basis, (f) preparing periodic account activity statements for participants and Plan fiduciaries, (g) providing participant communication materials, (h) providing toll-free telephone access permitting participants to obtain current balance and investment information, change investment elections, and initiate loans, withdrawals and terminations, (i) performing certain tax qualification testing on a semi-annual basis, and (j) preparation of certain tax reporting forms;

3) recordkeeping and administrative support services for an employer stock fund, or for existing non-convertible GICs held by a Plan pending maturity (which are not associated with the GACS); and

4) optional services, e.g., (a) processing of participant loans, rollovers, lump sum and installment distributions, and qualified domestic relations orders, (b) additional tax qualification testing, (c) assistance in preparation of Plan-level government filings, and (d) recordkeeping and administrative support services for an employer stock fund and/or non-convertible GICS.

You represent that ARPS is not a "plan administrator" as defined in ERISA section 3(16)(A).

You indicate that the 401(k) Program service charges are fully disclosed in the marketing materials describing the 401(k) Program that are provided to Plan fiduciaries. Plans entering into the 401(k) Program pay ARPS a one-time charge for installation services, and annual charges for standard administrative and recordkeeping services, based on the number of participants.

Additional services are available on a fee-for-service basis, at the election of the Plan fiduciary. Either party may terminate the arrangement without penalty on 60 days written notice. ALIC receives fees for administration and management of the GACS, including the separate accounts maintained in connection with the GACS. ALIAC receives advisory and administrative fees for investment management and related services provided to the Aetna Series Funds, pursuant to agreements between the Aetna Series Funds and ALIAC, which you represent are standard in the mutual fund industry.[3]

ALIAC has entered into various contracts with the Unrelated Funds (or r advisers or distributors) pursuant to which shares issued by the Unrde Funds are purchased on behalf of Plans from the distributors of the Unrelat dnds or directly from the Unrelated Funds. Pursuant to these agreements, C receives from the Unrelated F unds (or their advisers or distributors) pa ts in consideration of (1) ARPS's provision of shareholder service cluding participant-level recordkeeping) and other administrative services onnection with Plan invest ments in the Unrelated Funds, and (2) reductions in Unrelated Funds' shareholder servicing and other administrative expenseg., transfer agency fees) made possible by ARPS's provision of suchvices. Thes e payments are based on a percentage of Plan assets invested in ea nrelated Fund through the 401(k) Prog ram, and are paid either as administrati xpenses by an Unrelated Fund (or by a servicing agent, advise r, or distributo om which the Unrelated Fund obtains its administrative services), or pursuant tritten plan described in Securities and Exchange Commission (SEC) Rule 12b-1 CFR 270.12b-1 (a 12b-1 Plan). The t otal administrative expenses paid by Unrelated Funds, including fees paid pursuant to 12b-1 Plans, are

described to shareholders in prospectus materials. ALIAC discloses its receipt of fees from the Unrelated Funds (or their investment managers or other affiliates) in marketing and other disclosure materials provided to Plan fiduciaries. In particular, ALIAC will provide existing and prospective Plan customers a statement disclosing that ALIAC receives, or may receive, fees from many, but not all, of the Unrelated Funds, their managers or other affiliates (described as a percentage of assets under management with the Unrelated Funds). The statement will enumerate the services that ALIAC provides to the mutual funds and the rate of fees paid. The statement will also provide a toll-free telephone number to request more detailed information concerning which funds pay fees and an estimate of how much ALIAC may receive or has received during a particular time period. ALIAC will update the disclosure whenever there is any material change.

ALIAC reserves the right to modify the agreement with the Plan, including the list of Unrelated Funds available for investment, by giving 60 days written notice to the Plan's named fiduciary. If ALIAC decides to delete or replace an Unrelated Fund, ALIAC will notify the fiduciary of each Plan affected by the change. This notice would generally be sent by first class mail or fax. The notice would: (1) explain the proposed modification to the Unrelated Funds menu; (2) fully disclose any resulting chances in the fees paid to ALIAC by the Plan, or by any other entity with respect to Plan assets invested in the affected Funds; (3) identify the effective date of the change; (4) explain the Plan fiduciary's right to reject the change or terminate the agreement; and (5) reiterate that, pursuant to the contract provisions agreed to by the Plan fiduciary, failure to object will be treated as consent to the proposed change.

In addition, ALIAC may, depending on the facts and circumstances, send the notice by certified mail, include additional information and notice of the proposed deletion or substitution in other mailings to the Plan fiduciary (e.g., in periodic newsletters, in materials provided to assist the Plan fiduciary in notifying participants of the change, or in an invoice), or follow up its notice of a Fund deletion or substitution by telephone or other contact with the Plan fiduciary. Any or all of these procedures might be taken with respect to a particular Plan or implemented for all Plans affected by a deletion or substitution of a Fund.

You represent that if a Plan fiduciary rejects the proposed deletion or substitution, ALIAC would not be authorized to make the proposed deletion or substitution effective with respect to that particular Plan. In such circumstances, upon written notice of termination, the Plan fiduciary is afforded an additional 60 days to convert the Plan to another service provider. You represent, however, that in most cases ALIAC would seek to avoid terminating the agreement and losing a customer by negotiating to address the concerns of a Plan fiduciary that has rejected a proposed modification to the Unrelated Funds menu.

You also represent that ALIAC may determine, based on the particular facts and circumstances, to provide more than the minimum 60 days notice of the proposed change, waive some or all of the agreement's 60-day period for notice of termination by a Plan, and/or, if administratively feasible, agree to continue to provide services to a particular Plan beyond the 60-day termination period without deleting or substituting any Unrelated Funds pending the Plan's conversion to a new service provider if additional time is required to complete a conversion. Any of these or other measures might be taken with respect to particular Plans, or implemented for all Plans affected by a deletion or substitution of an Unrelated Fund. You thus represent that a Plan fiduciary will have a reasonable period of time within which to convert to a new service provider.

You have requested an opinion that the receipt of fees by ALIAC from the Unrelated Funds would not violate ERISA section 406(b)(3). Section 406(b)(3) provides that:

A fiduciary with respect to a plan shall not receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

The Department has taken the position that if a fiduciary does not exercise any authority or control to cause a plan to invest in a mutual fund, the mere receipt by the fiduciary of a fee or other compensation from the mutual fund in connection with the plan's investment would not in and of itself violate section ERISA 406(b)(3) (See, Advisory Opinion 97-15A, May 22, 1997).

Whether the receipt of such fees by ALIAC involves violations of section 406(b)(3) turns first on whether ALIAC is a fiduciary with respect to the investing Plans. ALIAC receives fees from an Unrelated Fund for its own account that are based on a percentage of the Plan assets invested in the Unrelated Fund. Such fees are paid to ALIAC by the Unrelated Fund or a related party in connection with a transaction (the purchase and sale of securities issued by the Unrelated Fund) involving the assets of the Plans.

The circumstances under which ALIAC provides recordkeeping and administrative services to Plans, you believe, would not cause ALIAC to be considered a fiduciary. You seek assurance, however, that ALIAC will not be deemed to be a fiduciary with respect to a Plan merely because ALIC, an affiliate under common control with ALIAC, may be considered a fiduciary of the Plan by virtue of providing investment management

services for Plan assets invested in an ALIC separate account.

ERISA section 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent that he/she (i) exercises any discretionary authority or control respecting management of the plan or exercises any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in the administration of the plan. Section 3(21)(B) provides that neither an investment company registered under the ICA, nor its investment adviser or principal underwriter shall be deemed to be fiduciaries or parties in interest with respect to a plan solely by reason of the plan's investment in securities issued by the investment company, unless the plan covers employees of the investment company, investment adviser or principal underwriter.

Interpretive Bulletin 75-8 (IB 75-8, 29 C.F.R. 2509-75-8) provides additional guidance concerning what types of functions will make a person a fiduciary with respect to a plan. In particular, question-and-answer D-2 states that a person who performs purely ministerial functions, such as preparation of employee communications material, preparation of government reports, and preparation of reports concerning participants' benefits, among others, within a framework of policies, interpretations, rules, practices and procedures made by other persons is not a fiduciary because such person does not have or exercise any discretionary authority or control regarding the management of the plan or its assets.

Pursuant to these provisions, a determination of whether a person is a fiduciary with respect to a plan requires an analysis of the types of functions performed and actions taken by the person on behalf of the plan to determine whether particular functions or actions are fiduciary in nature and therefore subject to ERISA's fiduciary responsibility provisions. As a result, the question of whether ALIAC is a "fiduciary" within the meaning of section 3(21)(A) of ERISA is inherently factual and will depend on the particular actions or functions ALIAC performs on behalf of the Plans.

You represent that ALIAC is not a trustee or administrator of the Plans, and provides only non-discretionary administrative and recordkeeping services pursuant to detailed administrative guidelines described in the Plan services agreement. Based on this representation, it would appear that, in most respects, ALIAC would not be a fiduciary with respect to Plans that are a party to such service agreements. ALIAC, however, retains some authority over the investment options selected by the Plans under the 401(k) Program in that it may, in its discretion, delete or substitute Unrelated Funds. In such instances, you represent that, before implementing a change in Funds with respect to any given Plan, ALIAC will provide advance notice to the appropriate Plan fiduciary regarding the change, including any changes in the fees to be received by ALIAC. If the Plan is permitted to maintain its investments in a deleted or replaced Fund, the advance notice will disclose any increased charges attributable to the retention by the Plan of the deleted or replaced Fund. In connection with this notice, you represent that Plan fiduciaries are afforded up to120 days, or more, to reject the change and terminate ALIAC's services without penalty.

It is the view of the Department that a person would not be exercising discretionary authority or control over the management of a plan or its assets solely as a result of deleting or substituting a fund from a program of investment options and services offered to plans, provided that the appropriate plan fiduciary in fact makes the decision to accept or reject the change. In this regard, the fiduciary must be provided advance notice of the change, including any changes in the fees received, and afforded a reasonable period of time within which to decide whether to accept or reject the change and, in the event of a rejection, secure a new service provider. On the basis of your representations that ALIAC provides the appropriate Plan fiduciary advance notice of the deletion or substitution of Funds and a reasonable period of time following receipt of the notice (here, at least 120 days) within which to reject the change in Funds and secure a new service provider,[5] as described in your letter, it is the view of the Department that ALIAC would not become a fiduciary solely as a result of deleting or substituting an Unrelated Fund under such circumstances, provided that the actual decision to accept or reject the change in Funds is made by the Plan fiduciary.

You have assumed that ALIC, an affiliate under common control with ALIAC, is a fiduciary with respect to the Plans by virtue of exercising authority or control over Plan assets invested in separate accounts maintained by ALIC. There is nothing, however, in your submission to indicate that ALIAC is in a position to (or in fact does) exercise any authority or control over those assets. Accordingly it does not appear that ALIAC would be considered a fiduciary merely as a result of its affiliation with ALIC.

Finally, it should be noted that ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Under section 404(a)(1) of ERISA, the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries both in deciding whether to enter into, or continue, the above-described arrangement with ALIAC, and in determining which investment options to utilize

or make available to Plan participants and beneficiaries. In this regard, the responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to ALIAC is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by ALIAC in connection with the investment of Plan assets. The responsible Plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that ALIAC receives with respect to the Plan's investments in each Unrelated Fund to make an informed decision whether ALIAC's compensation for services is no more than reasonable.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section to relating to the effect of advisory opinions.

Sincerely,

Bette J. Briggs

Chief, Division of Fiduciary Interpretations

Office of Regulations and Interpretations

- Footnotes -

1. You represent that ALIC utilizes several separate accounts in connection with the GACS, and have assumed for purposes of the advisory opinion request that the assets of these separate accounts would be deemed to be plan assets pursuant to the Department's regulation at 29 CFR 2510.3-101.
2. The Department does not express any opinion concerning the effect, if any, of the receipt by ALIAC of fees for marketing services that may be added in the future.
3. In this letter the Department expresses no opinion regarding the fees paid by the Aetna Series Funds to ALIAC.
4. Under Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Internal Revenue Code of 1986 (the Code) has been transferred, with certain exceptions not here relevant, to the Secretary of Labor, and the Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.
5. What constitutes a "reasonable period" within which to terminate an arrangement and change service providers will depend on the particular facts and circumstances of each case. There may be situations in which a time period shorter than 120 days may constitute a "reasonable period."

Advisory Opinion (98-06A)

Investment of In-House Employee Benefit Plans into Proprietary Mutual Funds

July 30, 1998

Summary
Clarification of Applicability of PTE 97-4 and PTE 77-3 to Investment of In-House Bank Employee Benefit Plans into Proprietary Mutual Funds

U.S. Department of Labor

Washington, D.C. 20216

July 30, 1998

Mr. Donald J. Myers

Reed Smith Shaw & McClay LLP

1301 K Street, N.W.

Suite 1100 - East Tower

Washington, D.C. 20005-3317

Re: Federated Investors

Identification Number C-9171

Dear Mr. Myers:

This is in response to your request on behalf of Federated Investors ("Federated") for guidance concerning whether Prohibited Transaction Class Exemption 77-3, 42 Fed. Reg. 18734 (April 8, 1977) (PTE 77-3) provides relief for the investment by a bank's in-house plan in a mutual fund advised by the bank through an in-kind exchange of assets for mutual fund shares, assuming the conditions of the exemption have been satisfied.

You represent that Federated advises, administers and distributes its own mutual funds, and also administers, distributes and provides related services to funds that are advised by other financial institutions, including many banks. Federated has assisted its client banks in establishing "proprietary" mutual funds, *i.e.,* open-end investment companies registered under the Investment Company Act of 1940 as to which the bank serves as investment adviser. These funds often come to serve as the investment vehicles for in-house bank plans through the conversion or partial conversion of the collective investment funds (the "CIFs") maintained by the bank. Federated assists these banks in the conversion process, and may serve as administrator and distributor, as well as in other capacities (such as transfer agent and portfolio recordkeeper) with respect to the proprietary mutual funds.

You state that on the date of a CIF conversion, assets representing the interests of investing plans in the converting CIFs are transferred to the mutual funds, in exchange for which the plans receive shares of the mutual funds of equal value to the assets transferred. These assets are valued for purposes of the transfer in a consistent and objective manner as of the close of business on the day of the transfer in accordance with the valuation conditions of Rule 17a-7 under the Investment Company Act of 1940 at 17 C.F.R. section 270.17a-7. Rule 17a-7 was adopted by the Securities and Exchange Commission as an exemption to permit, among other things, direct portfolio transactions between funds using the same investment adviser subject to specific conditions. That rule, at subsection 270.17a-7(b), requires that each security be valued at its "independent current market price" and stipulates the methods for determining price based on independent sources, as follows:

> (1) If the security is a `reported security' as that term is defined in rule 11Aa3-1 under the Securities Exchange Act of 1934, the last sale price with respect to such security reported in the consolidated transaction reporting system ('consolidated system') or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to rule 11Ac1-1 under the Securities Exchange Act of 1934) if there are no reported transactions in the consolidated system that day; or
>
> (2) If the security is not a reported security, and the principal market for such security is an exchange, then the last sale on such exchange or the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day; or
>
> (3) If the security is not a reported security and is quoted in the NASDAQ system, then the average of the highest current independent bid and lowest current independent offer reported on Level 1 of NASDAQ; or
>
> (4) For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.

You also represent that all plans involved in these transactions, both the in-house plans of the bank and the outside client plans of the bank, are treated in the same manner in these transactions and on a basis no less favorable than such dealings would be with other shareholders of the mutual funds. No brokerage commissions or other transaction costs are charged to the CIFs, the investing plans or the mutual funds in the exchange transaction.

PTE 77-3 provides that the restrictions of sections 406 and 407(a) of the Employee Retirement Income Security Act of 1974 ("ERISA") and the taxes imposed by section 4975 (a) and (b) of the Internal Revenue

Code (the "Code"), by reason of section 4975(c)(1) of the Code, shall not apply to the acquisition or sale of shares of an open-end investment company registered under the Investment Company Act of 1940 by an employee benefit plan covering only employees of such investment company, employees of the investment adviser or principal underwriter for such investment company, or employees of any affiliated person of such investment adviser or principal underwriter; provided that the conditions of the class exemption are met. The term "acquisition" is not defined in PTE 77-3.

In support of your argument that PTE 77-3 extends to the in-kind exchange of assets for mutual fund shares, you note that the regulation at 29 C.F.R. 2550.407a-2(b) defines the term "acquisition" for purposes of section 407(a) of ERISA to include both an acquisition "by purchase" and "by the exchange of plan assets." You assert that by distinguishing a "purchase" from an "exchange," the regulation makes clear that, compared to a "purchase," an "acquisition" is a broader term that includes both cash "purchases" and in-kind "exchanges." In this regard, you argue that the meaning of the term "acquisition" in both the regulation and PTE 77-3 should be interpreted in a similar manner. However, the Department notes that the definition of the term "acquisition" in 29 CFR 2550.407a-2(b) does not control the meaning of that term in PTE 77-3, since the application of that definition is expressly limited to the implementation of section 407(a) of ERISA.

Nevertheless, it is the view of the Department of Labor (the "Department") that relief under PTE 77-3 is available not only for cash purchases of investment company shares, but also for transactions involving the exchange of securities held on behalf of a plan for shares of the investment company. In this regard, the Department notes that section (d) of PTE 77-3 requires that all other dealings between the plan and the investment company, the investment adviser or principal underwriter for the investment company, or any affiliated person of such investment adviser or principal underwriter, are on a basis no less favorable to the plan than such dealings are with other shareholders of the investment company. The Department further notes that Prohibited Transaction Exemption 97-41 (62 FR 42830, August 8, 1997) permits a plan to purchase shares of an open-end mutual fund, the investment adviser for which is a bank that also serves as a fiduciary of a non-affiliated client plan, in exchange for plan assets transferred in-kind to the fund from a collective investment fund maintained by the bank. To the extent that the transactions described in your request involve both the conversion of CIF assets owned by outside client plans, which is within the scope of PTE 97-41, and the conversion of CIF assets owned by in-house plans, which is not, the Department interprets section (d) of PTE 77-3 to require that the methodology used to value the assets of the in-house plan transferred to the mutual fund and to determine the number of shares of the mutual fund received by the in-house plan, be the same as is applicable to the conversion of outside client plan assets under PTE 97-41.

Moreover, section 406(b)(1) of ERISA prohibits a fiduciary from dealing with the plan's assets in his or her own interest or for his or her own account. In addition, section 406(b)(2) of ERISA prohibits a plan fiduciary from acting on behalf of a party whose interests are adverse to the interests of the plan or the plan's participants or beneficiaries. Accordingly, a plan fiduciary considering the in-kind acquisition of shares of a mutual fund advised by the bank in exchange for assets of the bank's in-house plan must ensure that the fiduciary's or the bank's interest in attracting and retaining investors in the mutual fund does not conflict with the interests of the plan or its participants and beneficiaries in the selection of appropriate investment vehicles.

In addition, it is the Department's view that the class exemption prescribed in PTE 77-3 would not provide relief for any prohibited transaction that may arise in connection with terminating a CIF, permitting certain plans to withdraw from a CIF that is not terminating, or transferring any plan assets held by a CIF. PTE 77-3 only provides relief for the acquisition of a proprietary mutual fund's shares by an in-house plan in exchange for assets that were transferred from a CIF.

The Department cautions that ERISA's general standards of fiduciary conduct would apply to the plan's acquisition of mutual fund shares in exchange for plan assets transferred in-kind to the mutual fund from a CIF maintained by the plan's sponsor. Section 404(a)(1)(B) of ERISA requires that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Accordingly, the plan fiduciary must act "prudently" and "solely in the interest" of the plan's participants and beneficiaries with respect to the decision regarding the in-kind acquisition of mutual fund shares by the plan.

The Department further emphasizes that it expects a plan fiduciary, prior to entering into the transaction, to fully understand the mechanics of the transaction and to evaluate the risks associated with this type of investment, following disclosure of all relevant information pertaining to the transaction, including the valuation methodology applicable to the transferred securities and the mutual fund shares received in exchange. If the decision by the plan fiduciary to enter into the transaction is not "solely in the interest" of the plan's participants and beneficiaries, *e.g.*, if the decision is motivated by the intent to generate seed money that facilitates the

marketing of the mutual fund, then the plan fiduciary would be liable for any loss resulting from such breach of fiduciary responsibility, even if the acquisition of mutual fund shares was exempt by reason of PTE 77-3.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is issued subject to the provisions of the procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Ivan Strasfeld

Director

Office of Exemption Determinations

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

January 25, 1999

Michael A. Lawson
Skadden, Arps, Slate, Meagher, & Flom, LLP
300 South Grand Avenue
Los Angeles, California 90071-3144
1999-03A
ERISA Sec. 406(b)

Dear Mr. Lawson:

This is in response to your request for an advisory opinion concerning the application of section 406(b) of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4975(c)(1)(D), (E), and (F) of the Internal Revenue Code of 1986 (the Code).(1) In particular, you request guidance with respect to a plan fiduciary's decision to purchase on the secondary market, with plan assets, non-subordinated mortgage-backed pass-through certificates (Certificates) representing interests in a trust fund for which an affiliate of the fiduciary serves as a sub-servicer.(2)

You represent that BlackRock Financial Management, Inc. (BlackRock), is an investment advisor that is registered under the Investment Advisors Act of 1940 and is a wholly-owned second-tier subsidiary of PNC Bank, a national banking association (PNC). BlackRock has over $45 billion in assets under management, including assets of a number of employee benefit plans (Plans) subject to Title I of ERISA and/or section 4975 of the Internal Revenue Code of 1986 (the Code).

The Certificates represent interests in trust funds (Trusts), each of which consists of a segregated pool primarily of conventional, fixed-rate, multifamily or commercial mortgage loans (Mortgage Loans). A portion of the Mortgage Loans in each pool have been originated by PNC (PNC Loans). PNC also acts, pursuant to the pooling and servicing agreement that establishes each Trust, as a sub-servicer for the PNC Loans held in each Trust. The services provided by PNC typically include, among other things, notifying borrowers of amounts due on receivables, maintaining records of payments received, and instituting foreclosure or similar proceedings in the event of default with respect to the PNC Loans. Such services do not include any investment management or investment advisory services. As the subservicer of PNC Loans in a Trust, PNC receives a monthly fee in an amount equal to a fixed percentage of the outstanding principal balance of each Loan. This amount is collected from interest actually paid with respect to each Loan. In addition, under certain Trusts, PNC is entitled to retain certain ancillary fees that may be collected with respect to the Loan, including assumption fees, modification fees, insufficient funds fees and similar charges. You represent that PNC has no discretion with respect to the assets or management of the Trust. You further represent that neither PNC nor BlackRock is affiliated with any other entity that is a party to any of the Trusts, including the underwriter, master servicer, trustee, insurer, or obligor to or of the Trusts.

The sponsor of a Trust, through one or more underwriters or placement agents, makes an initial public or private offering of Certificates to investors. After the initial offering, Certificates are traded on the secondary market. The price of Certificates, both in the initial offering and in the secondary market, is affected by market forces, including investor demand, the pass-through interest rate on the Certificates in relation to the rate payable on investments of similar types and quality, expectations as to the effect on yield resulting from the prepayment of underlying mortgages, and expectations as to the likelihood of timely payment.(3)

The pass-through rate for holders of Certificates is equal to the interest rate on mortgages included in the Trust minus a specified servicing fee. You represent that all fees and other consideration payable by the Trust to PNC and other service providers to the Trust are determined and fixed as of the closing of the initial offering of the Certificates.

You state that BlackRock will cause Plans to purchase Certificates only on the secondary market.(4) You assert that any fees payable to PNC in accordance with the applicable pooling and servicing agreement between PNC and the Trust will be unaffected by BlackRock's causing Plans to purchase Certificates on the secondary market. Neither PNC nor BlackRock, you state, would have any interest in, or receive any additional consideration from, any source by reason of, or in connection with, such secondary market transactions.

You are seeking guidance that BlackRock would not violate ERISA section 406(b) by causing Plans over which it has fiduciary authority to purchase, on the secondary market, Certificates of Trusts containing PNC Loans merely because its affiliate, PNC, acts as sub- servicer for such Loans and receives compensation, pursuant to its subservicing agreements, from the Trusts for the provision of such services.

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his own interest or for his own account. Section 406(b)(2) prohibits a fiduciary, in his individual or any other capacity, from acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Section 406(b)(3) prohibits a fiduciary from receiving any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

You have represented that PNC's compensation from the Trusts is determined and fixed as of the close of the initial offering of Certificates in each Trust and is not affected by whether or not BlackRock invests plan assets in the Certificates in the secondary market. Regulation section 29 C.F.R. 2550.408b-2(e)(2) states that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility that makes such person a fiduciary to cause a plan to pay additional fees for a service provided by such fiduciary or by a person in whom such fiduciary has an interest that may affect the exercise of such fiduciary's best judgment as a fiduciary. Similarly, it is the view of the Department that a fiduciary does not engage in an act described in section 406(b)(3) of ERISA if the fiduciary does not use any of its authority, control, or responsibility to cause a third party to pay to the fiduciary any compensation in connection with a transaction involving the assets of the plan.(5) Accordingly, it is the opinion of the Department that BlackRock would not violate section 406(b)(1) or (b)(3) of ERISA by causing Plans over which it has fiduciary authority to purchase Certificates of the Trusts on the secondary market merely because its affiliate, PNC, acts as a sub-servicer of the Trusts, as long as the compensation that BlackRock and PNC receives is not affected by such investment. Moreover, because PNC's relationship to the Trusts remains wholly unaffected by BlackRock's investment of Plan assets in the Certificates, such investment would not be considered to involve BlackRock's acting on behalf of PNC in violation of section 406(b)(2) of ERISA merely because of PNC's role as sub-servicer of the Trusts.(6)

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Susan G. Lahne
Acting Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

1. --

   Footnotes

   Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA refer also to the corresponding sections of the Code.
2. You represent that, although BlackRock Financial Management, Inc., a plan fiduciary that is an affiliate of a sub-servicer of the issuing trust, is the entity that would cause a plan to purchase the Certificates, the purchase of such Certificates would otherwise conform to the conditions set forth in a series of individual prohibited transaction exemptions (PTEs) issued by the Department of Labor for plan investments in securities issued by trusts that hold multifamily and commercial mortgages (generally referred to as the Underwriter Exemptions). See, e.g., PTEs 97-5 (SouthTrust Securities, Inc. (62 FR 1926, January 14, 1997), 96-94 (First Chicago, NBD, 61 FR 68787, December 30, 1996), and 96-92 (BA Securities, Inc., 61 FR 66333, December 17, 1996). See also, class PTE 97-34 (62 FR 39021, July

21, 1997), which amended the individual PTEs involving such trusts, primarily to permit pre-funding of the tru sts, and making related changes.

3. In this connection, we note that the Underwriter Exemptions referred to in fn. 2, above, require that, at the time of acquisition by a plan, certificates must have received one of the three highest ratings available from one of four specified rating services.
4. Under the facts detailed in the Underwriter Exemptions, the underwriter of certificates normally attempts to make a market for securities (including certificates) for which it is the lead or co-managing underwriter. At times, an underwriter will facilitate sales by investors who purchase certificates if the underwriter has acted as agent or principal in the original private placement of the certificates and if such investors request the underwriter's assistance.
5. See, in this regard, Advisory Opinion 97-15A (May 22, 1997).
6. This opinion does not address, however, the question of whether, in actual operation, BlackRock's decisions to invest plan assets are designed to benefit PNC. For example, this opinion would not apply if BlackRock conditioned investment in any Certificate of a Trust on whether the Trust includes mortgages that are serviced by PNC.

February 22, 1999

Laraine S. Rothenberg, Esq.
Fried, Frank, Harris, Shriver & Jacobson
One New York Plaza
New York, New York 10004
1999-05A
ERISA Sec. 401(b)

Dear Ms. Rothenberg:

This is in response to your request on behalf of the Federal Agricultural Mortgage Corporation ("Farmer Mac") for an advisory opinion regarding the application of the "plan assets" regulation issued by the Department of Labor (the Department) under the Employee Retirement Income Security Act of 1974 ("ERISA") to certain mortgage pool certificates offered by Farmer Mac. Specifically, you request an advisory opinion that guaranteed mortgage-backed certificates issued by Farmer Mac are "guaranteed governmental mortgage pool certificates" within the meaning of 29 C.F.R. 2510.3-101(i)(2). You also request an advisory opinion as to whether certain parties performing various services with respect to the assets underlying the mortgage-backed certificates would be parties in interest under section 3(14) of ERISA or disqualified persons under section 4975(e)(2) of the Internal Revenue Code of 1986 (the Code) with respect to investing employee benefit plans. (1) In addition, you ask for an advisory opinion that the certificates would be deemed to meet a particular condition of a group of prohibited transaction exemptions ("the Underwriter Exemptions"),(2) granted to provide relief for the origination and operation of certain asset pool investment trusts, including guaranteed governmental mortgage pool certificate investment trusts, and for the acquisition, holding and disposition of asset backed pass-through certificates representing undivided interests in those trusts.

You represent that Farmer Mac is a federally chartered corporate instrumentality of the United States established in 1987 for the purpose of promoting a secondary market for agricultural mortgage loans, similar to the secondary markets in residential mortgage loans established by the Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac").(3) The Board of Directors of Farmer Mac consists of fifteen members, five of whom are elected by holders of common stock of Farmer Mac that are banks, insurance companies, or other financial institutions or entities; five of whom are elected by holders of common stock of Farmer Mac that are Farm Credit System institutions; and five of whom, including the Chairman of the Board, are appointed by the President of the United States and confirmed by the Senate.

Farmer Mac is authorized under the Farm Credit Act to purchase several different types of agricultural and real estate mortgages, mortgage pass-through certificates and other mortgage- backed securities evidencing interests in or secured by agricultural real estate mortgages, and to resell them, primarily in the form of mortgage-backed certificates ("Certificates") representing undivided interests in pools of mortgages purchased by Farmer Mac.(4) You state that while Farmer Mac Certificates are not guaranteed directly by the United States, Farmer Mac guarantees the timely payment of principal and interest on such investments to all Certificate holders. Farmer Mac Certificates provide for periodic (monthly, quarterly, semi-annual or annual) payment of interest and the pass-through of principal based on collections with respect to the underlying mortgages.

You state further that Farmer Mac Certificates are offered from time to time in one or more series. Each series of Certificates represents, in the aggregate, the entire beneficial ownership interest in a segregated pool of mortgages held in a trust fund managed by Farmer Mac Securities Corporation ("Depositor"), a wholly-owned subsidiary of Farmer Mac. The Certificates are purchased from the Depositor by an underwriter or placement agent that offers the Certificates from time to time in public offerings registered under the Securities Act of

1933, and in private placements. The Certificates may be sold in negotiated transactions, at varying prices determined at the time of sale.

The trustee of the trust funds managed by the Depositor is currently U.S. Bank Trust National Association.(5) The assets of the trust funds consist of segregated pools of fixed rate or adjustable rate agricultural real estate mortgage loans (“Qualified Loans”); portions of loans that are guaranteed by the United States Secretary of Agriculture (“Guaranteed Portions”); mortgage pass-through certificates or other mortgage-backed securities evidencing interests in or secured by Qualified Loans or Guaranteed Portions; or any combination thereof (collectively, “Qualified Assets”).(6) Qualified Loans are secured by parcels of land, which may be improved by buildings or other structures permanently affixed to the parcels, that are used for the production of one or more agricultural commodities and consist of a minimum of five acres or are used in producing minimum annual receipts of at least $5,000; or by a mortgage on a principal residence that is a single-family moderately priced residential dwelling located in a rural area.(7)

You represent further that the sellers of Qualified Assets (“Sellers”) are banks and other financial institutions, including member institutions of the Farm Credit System and insurance companies. The Sellers may be the financial institutions that originally made the Qualified Loans (“Originators”) or they may be purchasers of the Qualified Loans from one or more Originators. Farmer Mac selects the Qualified Assets that it wishes to purchase from a Seller, after determining that the Qualified Assets meet Farmer Mac’s underwriting standards. The Depositor then purchases the Qualified Assets from the Seller, assigns the Qualified Assets transferred to it by the Seller to a segregated pool in a trust fund,(8) causes the trust fund to issue one or more series of Certificates, and receives the proceeds of the sale of the Certificates. Farmer Mac guarantees the timely payment of principal and interest on the Certificates upon their issuance by the Depositor. To assure its ability to fulfill its guarantee obligations, Farmer Mac is required to establish reserves upon issuance of a guarantee. Farmer Mac’s charter provides that, in the event that Farmer Mac’s own reserves and capital are insufficient to enable it to meet its guarantee obligations, the Treasury will purchase up to $1.5 billion of Farmer Mac’s obligations.(9)

You state that Farmer Mac acts as Master Servicer of the Qualified Loans in each loan pool and is ultimately responsible for the servicing of the Qualified Loans, though it has contracted with banks and other financial institutions (collectively, “Central Servicers”) to perform the servicing functions on its behalf, including the distribution of principal and interest payments on the Qualified Loans in each pool and the distribution of any yield maintenance charge (the amount payable by a borrower under a loan in connection with a principal prepayment or acceleration by the lender) to the Trust Fund, on behalf of the holders of Certificates.(10) Pursuant to the contracts, Central Servicers establish and maintain separate accounts on behalf of the Trust Fund for the collection of payments on Qualified Assets and foreclose upon or comparably convert the ownership of properties of any Qualified Loans that continue in default.(11) The Central Servicers are compensated for their services out of the interest payments received on each Qualified Loan and also retain certain late fees, servicing charges assessed against borrowers, and other fees. Central Servicers may subcontract their servicing functions with respect to the Qualified Loans to qualified agricultural mortgage servicers (“Field Servicers”), some of whom may be Sellers or Originators.

The Farm Credit Administration (FCA), acting through the Office of Secondary Market Oversight (OSMO), has general regulatory and enforcement authority over Farmer Mac, including the authority to promulgate rules and regulations governing the activities of Farmer Mac and to apply its general enforcement power to Farmer Mac and its activities. In accordance with its statutory mandate, Farmer Mac’s loan standards were submitted to Congress for approval before they were adopted in 1990. The Director of OMSO, who is selected by and reports to the FCA Board, is responsible for the examination of Farmer Mac and the general supervision of the safe and sound performance by Farmer Mac of the powers and duties vested in it by Title VIII of the Farm Credit Act of 1971, as amended.(12)

The Farm Credit Act requires the FCA to examine and audit Farmer Mac’s books and financial transactions and to perform an evaluation of the safety and soundness of Farmer Mac’s operations at least annually. Farmer Mac is required to file quarterly reports of condition with the FCA, as well as copies of all documents filed with the Securities Exchange Commission under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934. While the FCA is not required to approve the payment of dividends on Farmer Mac common stock, the Farm Credit Act provides that no dividend may be declared or paid unless the Farmer Mac Board determines that adequate provision has been made for the corporation’s reserve against guarantee losses and that no obligation issued by Farmer Mac to the Secretary of the Treasury remains outstanding.(13) Under its general regulatory and supervisory authority, the FCA regularly reviews new programs and activities of Farmer Mac involving the purchase, sale, servicing of, lending on the security of, or otherwise dealing in conventional agricultural mortgages. In addition, the Farm Credit Act requires the

Comptroller General of the United States to perform an annual review of the actuarial soundness and reasonableness of the guarantee fees established by Farmer Mac.

It is expected by the Board of Directors and management of Farmer Mac that the Depositor will not have any relationships to investing employee benefit plans, other than through their transactions with respect to the Certificates. However, you state that obligors with respect to Qualified Assets Collateralizing the Certificates ("Borrowers") may be related to sponsors of investing employee benefit plans. For example, a Borrower may also be the plan sponsor of an investing employee benefit plan. You state that it is also possible that a Central Servicer, Field Servicer, Seller, or trustee of a trust fund managed by the Depositor may be related to investing employee benefit plans and may therefore be a party in interest or fiduciary with respect to such plans.

The Department's plan asset regulation at 29 C.F.R. 2510.3-101 describes the circumstances under which the assets of an entity in which a plan invests will be considered to include assets of the plan for purposes of ERISA's reporting and disclosure and fiduciary responsibility provisions and the related prohibited transaction provisions of the Internal Revenue Code. Section 2510.3-101(i)(2) defines a "guaranteed governmental mortgage pool certificate" as "a certificate backed by, or evidencing an interest in, specified mortgages or participation interests therein and with respect to which interest and principal payable pursuant to the certificate are guaranteed by the United States or an agency or instrumentality thereof." The regulation specifically refers to mortgage pool certificates guaranteed by Ginnie Mae, Freddie Mac, or Fannie Mae,(14) but makes clear that the exception may also apply to similar governmental mortgage pool investments. As explained in the preamble to the final regulation, the regulation provides in section 2510.3-101(i)(l) that, when a plan invests in a guaranteed governmental mortgage pool, its assets include its investment, but do not, solely by reason of such investment, include any of the underlying mortgages. Thus, the sponsor or manager of a governmental mortgage pool would not be a fiduciary of a plan solely by reason of the plan's investment in the pool. The regulation specifically states that interests in Freddie Mac, Ginnie Mae and Fannie Mae are among the investments to which the regulation's general rule applies.(15) Accordingly, the term "guaranteed governmental mortgage pool certificate" in section 2510.3-101(i)(2) is not limited to securities of the three entities specifically listed, but encompasses any certificates backed by, or evidencing an interest in, specified mortgages or participation interests therein and with respect to which interest and principal payable pursuant to the certificate are guaranteed by the United States or an agency or instrumentality thereof.

It appears to the Department from your representations that, for purposes of the definition of plan assets, Farmer Mac was established and is operated in a manner substantially similar to that of Fannie Mae and Freddie Mac. Like those entities, Farmer Mac is a Federally chartered instrumentality of the United States that issues guarantees on pools of mortgage loans in order to increase the availability of mortgage credit. Although Farmer Mac Certificates are not guaranteed by the United States, in light of the significant Federal involvement in the management of the Farmer Mac, it is our view that investments in Certificates issued by Farmer Mac should be treated in the same way as investments in certificates issued by Fannie Mae and Freddie Mac. Based on your representations and in view of the foregoing, it is the view of the Department that the mortgage pool Certificates guaranteed and issued by Farmer Mac meet the definition of a "guaranteed governmental mortgage pool certificate," as defined in 29 C.F.R. 2510.3-101(i)(2).

The Department notes that ERISA's general standards of fiduciary liability apply to any investment by a plan covered by Title I, including an investment in a guaranteed governmental mortgage certificate as defined in 29 C.F.R. 2510.3-101(i)(2). Section 404(a)(1)(B) of ERISA requires that a fiduciary discharge his duties to a plan solely in the interests of the plan participants and beneficiaries, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man would use in the conduct of an enterprise of like character and with like aims. Accordingly, the fiduciaries of an investing plan must act "prudently" and "solely in the interest" of the plan's participants and beneficiaries when deciding whether or not to invest in a Certificate.

You also requested an opinion as to whether trustees of a trust fund managed by the Depositor, Central Servicers, Field Servicers or Borrowers would be parties in interest under section 3(14) of ERISA or disqualified persons under section 4975(e)(2) of the Code. In this regard, we note that the mere investment of plan assets in the Certificates issued by Farmer Mac would not, by itself, make those entities parties in interest or disqualified persons, since it is our view that it is only the Certificates, and not the assets underlying the Certificates, that are plan assets. However, to the extent any of these entities have other relationships to the investing plans that are described in ERISA section 3(14) or Code section 4975(e)(2), such entities may be parties in interest or disqualified persons with respect to such plans.

Further, because it is our view that the Certificates are "guaranteed governmental mortgage certificates" within the meaning of that term as defined at 29 C.F.R. 2510.3-101(i)(2), transactions between these parties and a

Farmer Mac trust fund that relate only to the assets underlying the Certificates, and that do not involve the Certificates themselves, would not constitute prohibited transactions under sections 406 or 407 of ERISA or section 4975(c)(1) of the Code.

We are unable to provide you guidance on your final question regarding the Underwriter Exemptions. Specifically, you asked for an opinion that the Certificates are deemed to meet the condition that "the certificates acquired by the plan have received a rating at the time of such acquisition that is in one of the three highest generic rating categories from either Standard & Poor's Structured Rating Group, Moodys Investors Service, Inc., Duff & Phelps Credit Rating Co. or Fitch Investors Service, L.P." We do not have authority to deem that a transaction satisfies a condition set forth in an individual exemption. To the extent that the prohibited transactions provisions of ERISA or the Code are implicated by transactions involving the Certificates, we suggest that you discuss this matter with the Office of Exemption Determinations of this agency.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Section 10 of the Procedure describes the effect of advisory opinions.

Sincerely,
Susan G. Lahne
Acting Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

1. --

   Footnotes

   Under Presidential Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been, with certain exceptions not here relevant, transferred to the Secretary of Labor, and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority.
2. Such exemptions include, for example, Banc One Capital Corporation, 60 Fed. Reg. 49011 (Sept. 21, 1995); ContiFinancial Services Corporation, 61 Fed. Reg. 3490 (Jan 31, 1996); and SouthTrust Securities, 62 Fed. Reg. 1926 (Jan. 14, 1997).
3. Farmer Mac was created by the Agricultural Credit Act of 1987 (12 U.S.C. §§ 2279aa et seq.), which amended the Farm Credit Act of 1971. The Farm Credit System Reform Act of 1996 (Pub. L. 104-105 (1996)) (the 1996 Act) amended the Farm Credit Act and expanded Farmer Mac's secondary market authority. Among other things, the 1996 Act authorized Farmer Mac to purchase and pool eligible loans to serve as collateral for securities guaranteed by Farmer Mac; eliminated a requirement to create a subordinated interest or reserve of at least 10% of the initial principal balance of pooled loans; and included requirements that Federal Reserve banks act as depositories for and fiscal agents of Farmer Mac and that Farmer Mac have access to the Federal Reserve System's book-entry system, thereby permitting Farmer Mac securities to be traded in the same manner as those issued by Fannie Mae, Freddie Mac and the Government National Mortgage Association ("Ginnie Mae"). The latter three entities are also sometimes referred to as FNMA, FHLMC, and GNMA, respectively.
4. Public offerings of Farmer Mac guaranteed mortgage-backed Certificates are required to be registered under the Securities Act of 1933.
5. Under the Farm Credit Act, Farmer Mac may select itself, or banks or other financial institutions not affiliated with Farmer Mac, to serve as trustee of a trust fund. While U.S. Bank Trust Corporation is currently the trustee of all the trust funds managed by the Depositor, it is possible that at some point different trusts might have different trustees.
6. The Trust Fund may also include a de minimus amount of real estate owned by the Trust Fund following a foreclosure and proceeds received by the Trust Fund with respect to Qualified Loans prior to such proceeds being distributed.
7. You represent that Farmer Mac does not currently secure Qualified Loans solely by mortgages on primary residences located in rural areas, but, under the Farm Credit Act, is permitted to do so.
8. The segregated pool may also contain Qualified Assets transferred to the Depositor by other Sellers.
9. The Farm Credit Act also permits Farmer Mac and its affiliates to issue debt obligations for the purpose of obtaining amounts for the re-purchase of any securities previously issued and guaranteed by Farmer Mac that represent interests in, or obligations backed by, pools of Qualified Loans; for the purchase of Qualified Loans; and for obtaining reasonable amounts for business operations, including adequate liquidity, subject to minimum capital requirements imposed by Farmer Mac's charter.
10. As Master Servicer, Farmer Mac has the right to purchase from the Trust Fund delinquent Qualified

Loans and property acquired by the Trust Fund upon foreclosure or comparable conversion of a Qualified Loan.

11. Central Servicers are selected by Farmer Mac based on their experience, general reputation and financial strength. Current Central Servicers are Lend Lease Business, Inc.; AgFirst Farm Credit Bank; and GMAC Commercial Mortgage Corporation.
12. 12 U.S.C. §§ 2279aa et seq.
13. “Guarantee losses” refer to payments by Farmer Mac of principal and interest on guaranteed securities in excess of the liquidation proceeds of the collateral securing the Qualified Loans in the pool that backs such securities.
14. Farmer Mac was created subsequent to the promulgation of both the Department’s 1982 final regulation on government mortgage pools (the 1982 Regulation), 47 Fed. Reg. 21241 (May 18, 1982), and the Department’s 1986 final regulation on the definition of plan assets. (See 29 CFR 2510.3-101, 51 Fed. Reg. 41262, 41278 (Nov. 13, 1986)). The 1986 final regulation on the definition of plan assets incorporated the guaranteed governmental mortgage pool exception established in the 1982 Regulation and redesignated it to appear at 29 C.F.R. 2510.3-101(i).
15. Preamble to the Final Regulation on Trust Requirement and Definition of Plan Assets--Governmental Mortgage Pools, 47 Fed. Reg. 21241 (May 18, 1982), at 21243-44.

September 29, 1999

Brian G. Belisle
Oppenheimer Wolff & Donnelly LLP
Plaza VII
45 South Seventh Street, Suite 3400
Minneapolis, Minnesota 55402-1609
1999-13A
ERISA Sec. 206(d)(3)

Dear Mr. Belisle:

This is in response to your request on behalf of the UAL Corporation (UAL) and United Air Lines, Inc. (United) for an advisory opinion. Specifically, you ask how a plan administrator should treat domestic relations orders the plan administrator has reason to believe are “sham” or “questionable” in nature.(1)

UAL is a holding company. Its major wholly-owned subsidiary is United. You represent that employees of United participate in three pension plans — an employee stock ownership plan (the ESOP); a 401(k) plan that is a profit sharing plan qualified under section 401(a) of the Code (the 401(k) Plan); and a defined benefit pension plan. The ESOP is a combination leveraged ESOP and non-leveraged stock bonus plan that is qualified under section 401(a) of the Code. Substantially all of the assets in the ESOP are invested in UAL stock.

You represent that the named plan administrator of the ESOP is UAL. UAL has assigned many of its administrative duties under the ESOP, including the duty to establish procedures for determining whether a domestic relations order constitutes a “qualified domestic relations order” (QDRO), to an ESOP Committee consisting of employees of United. The ESOP Committee has delegated to United’s Pension Programs Department (Pension Programs) the responsibility of reviewing and determining whether a domestic relations order received by the ESOP Committee is a QDRO within the meaning of section 206(d)(3) of ERISA. Appeals of QDRO determinations are made to the ESOP Committee.

You further represent that the ESOP permits an alternate payee to request the immediate lump sum distribution of any benefits under the plan that are assigned pursuant to the terms of any domestic relations order that the ESOP Committee determines is a QDRO. The ESOP otherwise permits lump sum distributions only following a participant’s termination of employment (including by way of the participant’s death).

The named plan administrator of the 401(k) Plan is United. United has delegated the authority to control and manage the administration of the 401(k) Plan, including the duty to establish procedures for determining whether a domestic relations order constitutes a QDRO, to a Pension and Welfare Plans Administration Committee (PAWPAC) consisting of employees of United. PAWPAC in turn has delegated to Pension Programs the responsibility for reviewing and determining whether a domestic relations order applying to the 401(k) Plan is a QDRO. Appeals of a QDRO determination are made to PAWPAC. As with the ESOP, the 401(k) Plan permits the immediate distribution of benefits under the plan that are assigned pursuant to the terms of a QDRO. Although an alternate payee may thus receive an immediate lump sum distribution from the 401(k) Plan, participants or beneficiaries are entitled to distributions from the 401(k) plan only following termination of employment (including by way of the participant’s death) or upon financial hardship.

You represent that Pension Programs currently has under review 16 domestic relations orders concerning benefits under the ESOP and the 401(k) Plan that Pension Programs believes may be “questionable” or “sham” in nature.(2)

You detail the grounds for Pension Programs' suspicions as to the nature of these domestic relations orders as follows. Pension Programs received within a very short period of time five domestic relations orders from the same lawyer (two of the orders were mailed in the same envelope). Each order related to participants working in United's maintenance facility located in Indianapolis, Indiana. Each of the five orders identically provided for an assignment of 100 percent of the participant's benefit in the ESOP and the 401(k) Plan to an alternate payee. Each order made no provision for any assignment of these participants' benefits in United's defined benefit pension plan. In each of the orders, the alternate payee and participant were shown as having the same address. Despite its suspicions, Pension Programs determined that each of the five orders was qualified because they satisfied the requirements of section 206(d)(3) of ERISA. In Pension Programs' view, these orders differed from other domestic relations orders processed by Pension Programs in that they dealt only with the ESOP and the 401(k) Plan; they provided for assignment of 100 percent of the participant's benefit; and they showed the participant and alternate payee as having the same address.

After its determination that these five domestic relations orders were QDROs, Pension Programs received and reviewed 16 other orders that had unusual characteristics similar to those of the original five orders. These 16 orders similarly provided for a 100 percent assignment of benefits payable under the ESOP and/or the 401(k) Plan, made no mention of the defined benefit pension plan, and specified in most cases that the alternate payee and participant shared the same address. You represent that Pension Programs performed additional investigation in its review of these 16 domestic relations orders to determine whether they were qualified.(3) While these orders were pending review with Pension Programs, two participants from the Indiana facility called at different times to determine the status of the review of their orders. You indicate that, during those conversations, each participant asserted that his order was not one of the "fraudulent QDROs." You represent that these statements led Pension Programs to heighten its scrutiny of the 16 orders assigning 100 percent of the participant's right to the ESOP and 401(k) benefits.

You further represent that, after beginning its investigation of the 16 domestic relations orders in question, Pension Programs learned of a pamphlet entitled "Retirement Liberation Handbook" that was being distributed by at least one United employee in the Indianapolis, Indiana area.(4) The pamphlet advocated, as a method of acquiring a distribution of pension plan benefits before reaching retirement age, that participants and their spouses obtain a divorce for the sole purpose of securing a court order assigning pension plan benefits and then remarry. Such a sham divorce, according to the Liberation Handbook, would enable the participant to obtain direct control over the investment of the participant's pension benefit. The Liberation Handbook also suggested that single employees could go through a sham marriage and subsequent divorce, by paying an individual a percentage of the anticipated pension distribution as compensation for acting as spouse, or could instead quit employment in order to obtain a similar early distribution and later get rehired. The Handbook described in some detail how distributions from pension plans are handled for tax purposes and discussed various options for distributions and investments of the distributions.

After reviewing the Liberation Handbook, Pension Programs determined that all of the 16 orders in question, as well as the original five orders it had previously deemed qualified, had significant similarities to the specific format promoted by the Liberation Handbook. For example, two of the initial five orders requested that distribution be made to an inappropriate account named in the Liberation Handbook.

In addition, all of the orders identified by Pension Programs as questionable relate to the ESOP and 401(k) benefits of employees who, at the time of the order, resided in the Indianapolis area and were in related work groups, and all had a number of common characteristics not typically seen in Pension Programs' review of domestic relations orders. Included in these were rapid remarriage and continued use by the putative alternate payee of United's no-cost travel for spouses.

You represent that Pension Programs engaged local counsel in Indiana to determine whether and to what extent the questionable domestic relations orders might be valid under Indiana law. Indiana counsel opined that, if the orders had been obtained as promoted by the Liberation Handbook, (i) the participant and alternate payee would have committed perjury; (ii) the parties would be in contempt of court; (iii) the order would have been fraudulently obtained; and (iv) if the foregoing could be established to the satisfaction of a judge, the order likely would be vacated by the court.

You have asked for an advisory opinion as to whether, and if so when, a plan administrator may investigate or question a domestic relations order submitted for review to determine whether it is a valid "domestic relations order" under State law for purposes of section 206(d)(3)(B) of ERISA.

Section 206(d)(1) of ERISA generally requires pension plans covered by Title I of ERISA to provide that plan benefits may not be assigned or alienated. Section 206(d)(3)(A) of ERISA states that section 206(d)(1) applies

to an assignment or alienation of benefits pursuant to a “domestic relations order” unless the order is determined to be a “qualified domestic relations order” (QDRO). Section 206(d)(3)(A) further provides that pension plans must provide for payment of benefits in accordance with the applicable requirements of any QDRO.

Section 206(d)(3)(B) of ERISA defines the terms “qualified domestic relations order” and “domestic relations order” for purposes of section 206(d)(3) as follows:

(B) For purposes of [section 206(d)(3)] —

(i) the term “qualified domestic relations order” means a domestic relations order —

(I) which creates or recognizes the existence of an alternate payee’s right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan, and

(II) with respect to which the requirements of subparagraphs (C) and (D) are met, and

(ii) the term “domestic relations order” means any judgment, decree, or order (including approval of a property settlement agreement) which —

(I) relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and

1. (II) is made pursuant to a State domestic relations law (including a community property law).

   Section 206(d)(3)(C) requires that in order for a domestic relations order to be qualified such order must clearly specify (i) the name and the last known mailing address (if any) of the participant and the name and mailing address of each alternate payee covered by the order; (ii) the amount or percentage of the participant’s benefits to be paid by the plan to each such alternate payee, or the manner in which such amount or percentage is to be determined; (iii) the number of payments or period to which such order applies; and (iv) each plan to which the order applies.

   Section 206(d)(3)(D) specifies that a domestic relations order is qualified only if such order does not require (i) the plan to provide any type of benefit, or any option, not otherwise provided by the plan; (ii) the plan to provide increased benefits (determined on the basis of actuarial value); and (iii) the payment of benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a qualified domestic relations order.

   Section 206(d)(3)(G) of ERISA requires the plan administrator to determine the qualified status of domestic relations orders received by the plan and to administer distributions under such qualified orders, pursuant to reasonable procedures established by the plan. In administering QDROs, plan administrators must follow the plan’s reasonable procedures, as required under section 206(d)(3)(G), and must assure that the plan pays only reasonable expenses of administering the plan, as required by sections 403(c)(1) and 404(a)(1)(A) of ERISA. In this regard, plan fiduciaries must take appropriate steps to ensure that plan procedures are designed to be cost effective and to minimize expenses associated with the administration of domestic relations orders. See Advisory Opinion 94-32A (Aug. 4, 1994).

   When a pension plan receives an order requiring that all or a part of the benefits payable with respect to a participant be paid to an alternate payee, the plan administrator must determine that the judgment, decree or order is a “domestic relations order” within the meaning of section 206(d)(3)(B)(ii) of ERISA — i.e., that it relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child or other dependent of the participant and that it is made pursuant to State domestic relations law by a State authority with jurisdiction over such matters. Additionally, the plan administrator must determine that the order is qualified under the requirements of section 206(d)(3) of ERISA. It is the view of the Department that the plan administrator is not required by section 206(d)(3) or any other provision of Title I to review the correctness of a determination by a competent State authority pursuant to State domestic relations law that the parties are entitled to a judgment of divorce. See Advisory Opinion 92-17A (Aug. 21, 1992). Nevertheless, a plan administrator who has received a document purporting to be a domestic relations order must carry out his or her responsibilities under section 206(d)(3) in a manner consistent with the general fiduciary duties in part 4 of title I of ERISA.

   For example, if the plan administrator has received evidence calling into question the validity of an

order relating to marital property rights under State domestic relations law, the plan administrator is not free to ignore that information. Information indicating that an order was fraudulently obtained calls into question whether the order was issued pursuant to State domestic relations law, and therefore whether the order is a "domestic relations order" under section 206(d)(3)(C). When made aware of such evidence, the administrator must take reasonable steps to determine its credibility. If the administrator determines that the evidence is credible, the administrator must decide how best to resolve the question of the validity of the order without inappropriately spending plan assets or inappropriately involving the plan in the State domestic relations proceeding. The appropriate course of action will depend on the actual facts and circumstances of the particular case and may vary depending on the fiduciary's exercise of discretion. However, in these circumstances, we note that appropriate action could include relaying the evidence of invalidity to the State court or agency that issued the order and informing the court or agency that its resolution of the matter may affect the administrator's determination of whether the order is a QDRO under ERISA.(5) The plan administrator's ultimate treatment of the order could then be guided by the State court or agency's response as to the validity of the order under State law. If, however, the administrator is unable to obtain a response from the court or agency within a reasonable time, the administrator may not independently determine that the order is not valid under State law and therefore is not a "domestic relations order" under section 206(d)(3)(C), but should rather proceed with the determination of whether the order is a QDRO.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Susan G. Lahne
Acting Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

You do not ask and we do not opine as to whether any of the individual domestic relations orders at issue is "qualified" pursuant to section 206(d)(3) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and section 414(p) of the Internal Revenue Code (Code).

2. Pension Programs processes between approximately 200 and 300 domestic relations orders per year for all of its qualified retirement plans.
3. You represent that United pays all expenses related to the administration of domestic relations orders and QDROs, including all of the investigative efforts relating to any questionable QDROs and all legal expenses. You state that no plan assets of either the ESOP or the 401(k) Plan have been used directly or indirectly to pay for the expenses of investigating the QDROs at issue here.
4. The Liberation Handbook apparently first appeared in the classified section of a local advertising exchange.
5. Appropriate action could take other forms, depending on the circumstances and the fiduciary's assessment of the relative costs and benefits, including actual intervention in or initiation of legal proceedings in State court.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

July 27, 2000

Hugh Janow
Janow & Meyer, LLC
One Blue Hill Plaza
P.O. Box 1606 Suite 1006
Pearl River, New York 10965-8606
2000-10A
ERISA Sec. 4975(c)(1)

Dear Mr. Janow:

This is in response to your request for an advisory opinion under section 4975 of the Internal Revenue Code (Code). Specifically, you ask whether allowing the owner of an IRA to direct the IRA to invest in a limited partnership, in which relatives and the IRA owner in his individual capacity are partners, will violate section 4975 of the Code.(1)

You represent that the Fetner Family Partnership is a New York general partnership that is an investment club (the Partnership), in which Mr. Adler, through a general partnership known as Esponda Associates (Esponda), and various relatives of Mr. Adler invest. Through his investment in Esponda, which is a pass-through partnership, Mr. Adler owns a 12.11 percent interest in the Partnership. Mr. Adler presently owns a 30.38 percent interest in Esponda. The only other partner in Esponda is David Geiger, who is unrelated to Mr. Adler. Esponda currently owns a 39.85 percent interest in the Partnership.

The other current partners of the Partnership are as follows: Steven Adler (Mr. Adler's son) — 5.25%; Jack Fetner (Mr. Adler's father-in-law) — 13.44%; Adam Nadel (Mr. Adler's son's brother-in-law); Fay Nadel (Mr. Adler's mother-in-law) — 25.55%; Andrea Raskin (Mr. Adler's daughter) — 5.33%; Lois Zoldon (Mr. Adler's sister-in-law) — 7.57%.

The Partnership's assets are managed by Bernard L. Madoff Investment Securities (Madoff), which is unrelated to Mr. Adler. Madoff requires entities to maintain a minimum capital account. You represent that the Partnership currently has an account with Madoff and has not received any notice that its does not meet minimum capital requirements for investment management by Madoff. The IRA's assets are not necessary for the Partnership to continue its account with Madoff.

You represent that Leonard Adler intends to open a self-directed individual retirement account (IRA) in the amount of approximately five hundred thousand ($500,000.00) dollars through Retirement Accounts, Inc. of Denver, Colorado. At the time Mr. Adler directs the IRA investment, the Partnership will become a limited Partnership. Mr. Adler will be the only general partner in the Partnership and will own 6.52%. Mr. Adler will not have any investment management functions with respect to the assets of the Partnership.

The limited partners and their percentage ownership interests will be as follows: Andrea Raskin — 1.35%; Steven Adler — 3.07%; Jack Fetner — 3.94%; Fay Nadel — 18.1%; Adam Nadel — 1.77%; Lois Zoldon — 5.55%; David Geiger — 20.31%; IRA of Leonard Adler — 39.38%. Messrs. Adler and Geiger will invest directly in the Partnership in the same percentages as they would have invested through Esponda, instead of investing through Esponda. Esponda will no longer invest in the Partnership.

You further represent that Mr. Adler believes that Madoff would effectively manage assets for the IRA, but that Mr. Adler's IRA does not meet the minimum capital requirements (currently $1 million) for investment management by Madoff. You represent, however, that Madoff will manage the IRA's assets if it invests with Madoff through the Partnership, even though the IRA by itself otherwise would not meet the minimum capital

requirements. You further represent that all of the assets of the Partnership are liquid marketable securities. You also represent that none of the funds contributed by the IRA is required to be used, or will be used, to liquidate or redeem any other partner's interest in the Partnership.

Finally, you represent that Mr. Adler does not and will not receive any compensation from the Partnership. He likewise will not receive any compensation as a result of the acquisition by the IRA of its limited partnership interest.

You ask whether the investment by the IRA in the Partnership will give rise to a prohibited transaction under section 4975 of the Code. Section 4975(e)(1) of the Code, in relevant part, defines the term "plan" to include an IRA, described in section 408(a) of the Code. Section 4975(e)(2) of the Code defines "disqualified person," in relevant part, to include a fiduciary, a relative, and a partnership, of which (or in which) 50 percent or more of the capital interest or profits interest of such partnership is owned directly or indirectly, or held by a fiduciary. Section 4975(e)(3) of the Code defines the term "fiduciary," in part, to include any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control regarding management or disposition of its assets. In order for a prohibited transaction to occur under section 4975 of the Code, there must be a transaction involving a disqualified person with respect to a plan. Where none of the relationships described in section 4975(e)(2) of the Code are found to exist, an entity would not be a disqualified person with respect to a plan.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale or exchange or leasing, of any property between a plan and a disqualified person. Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. Section 4975(c)(1)(E) of the Code prohibits a fiduciary from dealing with the income or assets of a plan in his or her own interest or for his or her own account. Section 54.4975-6(a)(5) of the Pension Excise Tax Regulations characterizes transactions described in section 4975(c)(1)(E) as involving the use of authority by fiduciaries to cause plans to enter into transactions when those fiduciaries have interests which may affect the exercise of their best judgment as fiduciaries.

As a trustee with investment discretion over the assets of his IRA, Mr. Adler is a fiduciary, and therefore, a disqualified person under section 4975(e)(2) of the Code. Mr. Adler is also a disqualified person in his capacity as the general partner of the Partnership to the extent he exercises discretionary authority over the administration or management of the IRA assets invested in the Partnership. In addition, although Mr. Adler, his son and his daughter are disqualified persons, you represent that the investment transaction is between the Partnership itself and the IRA, and not with Mr. Adler and his family, except as fellow investors in the Partnership. Mr. Adler owns only 6.5 percent of the Partnership, and therefore the Partnership itself is not a disqualified person under section 4975(e)(2)(G) of the Code which defines a disqualified person to include a corporation, partnership or trust or estate of which 50 percent or more of the capital interest is owned directly or indirectly, or held by persons described as fiduciaries.

Based solely on the facts and representations contained in your submissions, it is the opinion of the Department that the IRA's purchase of an interest in the Partnership would not constitute a transaction described in section 4975(c)(1)(A) of the Code (prohibiting any direct or indirect sale or exchange or leasing of any property between a plan and a disqualified person).

Whether the proposed transaction would violate sections 4975(c)(1)(D) and (E) of the Code raises questions of a factual nature upon which the Department will not issue an opinion. A violation of section 4975(c)(1)(D) and (E) would occur if the transaction was part of an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit such fiduciary (or any person which such fiduciary had an interest which would affect the exercise of his best judgment as a fiduciary).

In this regard, the Department notes Mr. Adler does not and will not receive any compensation from the Partnership and will not receive any compensation by virtue of the IRA's investment in the Partnership. However, the Department further notes that if an IRA fiduciary causes the IRA to enter into a transaction where, by the terms or nature of that transaction, a conflict of interest between the IRA and the fiduciary (or persons in which the fiduciary has an interest) exists or will arise in the future, that transaction would violate either 4975(c)(1)(D) or (E) of the Code. Moreover, the fiduciary must not rely upon and cannot be otherwise dependent upon the participation of the IRA in order for the fiduciary (or persons in which the fiduciary has an interest) to undertake or to continue his or her share of the investment. Furthermore, even if at its inception the transaction did not involve a violation, if a divergence of interests develops between the IRA and the fiduciary (or persons in which the fiduciary has an interest), the fiduciary must take steps to eliminate the conflict of interest in order to avoid engaging in a prohibited transaction. Nonetheless, a violation of section 4975(c)(1)(D)

or (E) will not occur merely because the fiduciary derives some incidental benefit from a transaction involving IRA assets.

Moreover, the Department notes that by virtue of the contemplated investment by the IRA in the Partnership, there will be significant investment in the Partnership by benefit plan investors. See 29 CFR § 2510.3-101(f). Accordingly, the Partnership will hold "plan assets" within the meaning of that term in the Department's regulations at 29 CFR § 2510.3-101. As a result, any person who exercises discretionary authority or control with respect to assets of the Partnership will be fiduciary of the IRA and subject to the restrictions of section 4975(c)(1) of the Code, except to the extent a statutory or administrative exemption applies.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

1. --

   Footnotes

   Under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority.

January 18, 2001

Mr. Carl J. Stoney, Jr.
Crosby, Heafey, Roach & May
Two Embarcadero Center, Suite 2000
San Francisco, California 94111-4106
2001-01A
ERISA Sec. 403 - 404

Dear Mr. Stoney:

This is in response to your recent correspondence in which you request confirmation of the continued viability of the Department of Labor's views expressed in Advisory Opinion 97-03A (January 23, 1997), discussing the application of the Employee Retirement Income Security Act (ERISA) to the payment of certain plan termination expenses by tax-qualified plans administered by the Insurance Commissioner of the State of California in its capacity as liquidator of the companies which sponsored the plans. Further, you request any other guidance that the department may be able to provide on the issue of permissible plan expenses. In this regard, you indicate that you represent the Conservation and Liquidation Office of the State of California Department of Insurance in connection with the termination of, and attendant distribution of assets from, tax-qualified retirement plans sponsored by now-insolvent insurance companies.

Since the issuance of Advisory Opinion 97-03A, questions have been raised concerning the extent to which an employee benefit plan may pay the costs attendant to maintaining tax- qualified status, without regard to the fact that tax qualification confers a benefit on the plan sponsor. The following is intended to clarify the views of the Department of Labor on this issue.

As discussed in Advisory Opinion 97-03A, a determination as to whether to pay a particular expense out of plan assets is a fiduciary act governed by ERISA's fiduciary responsibility provisions. ERISA provides that, subject to certain exceptions, the assets of an employee benefit plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan. In discharging their duties under ERISA, fiduciaries must act prudently and solely in the interest of the plan participants and beneficiaries, and in accordance with the documents and instruments governing the plan insofar as they are consistent with the provisions of ERISA. See ERISA sections 403(c)(1), 404(a)(1)(A), (B), and (D).

With regard to sections 403 and 404 of ERISA, we noted that, as a general rule, reasonable expenses of administering a plan include direct expenses properly and actually incurred in the performance of a fiduciary's duties to the plan. We also noted, however, that the department has long taken the position that there is a class of discretionary activities which relate to the formation, rather than the management, of plans, explaining that these so-called settlor functions include decisions relating to the establishment, design and termination of plans and, except in the context of multi-employer plans, generally are not fiduciary activities governed by ERISA. Expenses incurred in connection with the performance of settlor functions would not be reasonable expenses of a plan as they would be incurred for the benefit of the employer and would involve services for which an employer could reasonably be expected to bear the cost in the normal course of its business operations. However, reasonable expenses incurred in connection with the implementation of a settlor decision would generally be payable by the plan.

In Advisory Opinion 97-03A, the department expressed the view that the tax-qualified status of a plan confers benefits upon both the plan sponsor and the plan and, therefore, in the case of a plan that is intended to be tax-qualified and that otherwise permits expenses to be paid from plan assets, a portion of the expenses attendant to tax-qualification activities may be reasonable plan expenses. This view has been construed to

require an apportionment of all tax qualification- related expenses between the plan and plan sponsor. The department does not agree with this reading of the opinion. The opinion recognizes that, in the context of tax-qualification activities, fiduciaries must consider, consistent with the principles articulated in earlier letters,(1) whether the activities are settlor in nature for purposes of determining whether the expenses attendant thereto may be reasonable expenses of the plan. However, in making this determination, the department does not believe that a fiduciary must take into account the benefit a plan's tax-qualified status confers on the employer. Any such benefit, in the opinion of the department, should be viewed as an integral component of the incidental benefits that flow to plan sponsors generally by virtue of offering a plan.(2)

In the context of tax-qualification activities, it is the view of the department that the formation of a plan as a tax-qualified plan is a settlor activity for which a plan may not pay. Where a plan is intended to be a tax-qualified plan, however, implementation of this settlor decision may require plan fiduciaries to undertake activities relating to maintaining the plan's tax-qualified status for which a plan may pay reasonable expenses (i.e., reasonable in light of the services rendered). Implementation activities might include drafting plan amendments required by changes in the tax law, nondiscrimination testing, and requesting IRS determination letters. If, on the other hand, maintaining the plan's tax-qualified status involves analysis of options for amending the plan from which the plan sponsor makes a choice, the expenses incurred in analyzing the options would be settlor expenses.

The foregoing views are intended to clarify, rather than supersede, the views of the department set forth in Advisory Opinion 97-03A. We hope the information provided is of assistance to you.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976).

Sincerely,
Robert J. Doyle
Director of Regulations and Interpretations

1. --

   Footnotes

   See letter to John N. Ernlenborn from Dennis M. Kass (March 13, 1986); letter to Kirk F. Maldonado from Elliot I. Daniel (March 2, 1987).
2. The Supreme Court has recognized that plan sponsors receive a number of incidental benefits by virtue of offering an employee benefit plan, such as attracting and retaining employees, providing increased compensation without increasing wages, and reducing the likelihood of lawsuits by encouraging employees who would otherwise be laid off to depart voluntarily. It is the view of the department that the mere receipt of such benefits by plan sponsors does not convert a settlor activity into a fiduciary activity or convert an otherwise permissible plan expense into a settlor expense. See Lockheed Corp. v. Spink, 517 U.S. 882 (1996); Hughes Aircraft Company v. Jacobson, 525 U.S. 432 (1999).

Contact EBSA
- Comuniquese con EBSA

About EBSA
- Mission Statement
- Organization Chart
- EBSA Offices
- ERISA Advisory Council
- CHIP Working Group

FAQs

Consumer Information
- Health Plans
- Retirement Plans
- Retirement Savings

Laws & Regulations
- Final Rules
- Notices
- Proposed Rules
- Public Comments

Technical Guidance
- Advisory Opinions
- Exemptions
- Field Bulletins
- Information Letters
- Interpretive Bulletins
- Technical Releases
- EO 12866 Guidance

Compliance Assistance
- Abandoned Plans
- Apprenticeship Plans
- Correction Programs
- Fiduciary Education
- For Health Plans
- For Retirement Plans
- For Small Employers
- Reporting and Filing
- 403(b) Plans
- Webcasts

Guidance on Settlor v. Plan Expenses

In conjunction with investigations involving reviews of plan expenses, a number of questions have been raised concerning the extent to which plans may pay certain expenses that might be viewed as conferring a benefit on the plan sponsor. In this regard, the department has issued a number of letters which have attempted to lay out the fiduciary provisions, principles and considerations relevant to an analysis of this question.(1)

On This Page

- Hypothetical Fact Pattern One
- Hypothetical Fact Pattern Two
- Hypothetical Fact Pattern Three
- Hypothetical Fact Pattern Four
- Hypothetical Fact Pattern Five
- Hypothetical Fact Pattern Six

Nonetheless, it has been determined that further clarification and guidance will facilitate both compliance and enforcement efforts in this area.

In an effort to specifically address the most frequently raised questions, the Pension and Welfare Benefits Administration has developed a set of six hypothetical fact patterns in which various plan expense issues are both presented and addressed.(2)

Questions concerning this guidance may be addressed to:

U.S. Department of Labor
Pension and Welfare Benefits Administration
Office of Regulations and Interpretations
200 Constitution Avenue, NW, Suite N-5669
Washington, DC 20210
Attention: Settlor Expense Guidance
Tel 202.693.8510

Back To Top

Fact Pattern Number One

During 1997, ACD Inc. agreed to sell a business segment to EFG Inc., a friendly competitor. The closing date for the sale was January 1, 1998. As a result of this sale, 1,600 participants and $180 million (the amount of accrued benefits attributable to the transferring employees) were to be transferred from the ACD defined benefit plan to the EFG defined benefit plan on the sale closing date. In December 1997, the companies were forced, through no fault of the parties, to postpone the sale closing date until May 1, 1998. The following expenses were paid by the ACD plan as a result of the business segment sale:

- $80,000 for a plan design study
- $30,000 to amend the ACD Plan to provide for the spin-off
- $75,000 to compute the amount necessary to implement the transfer of plan assets from the ACD Plan to the EFG Plan and an additional $75,000 to re-compute the amount of the asset transfer due to the changed closing date
- $25,000 for negotiations with various unions related to the transfer of assets and participants

Which of the above expenses, if otherwise reasonable, may be paid by the ACD Plan?

Answer

The department has taken the position that there is a class of activities which relates to the formation, rather than the management, of plans. These activities, generally referred to as settlor functions, include decisions relating to the formation, design and termination of plans and, except in the context of multi-employer plans, generally are not activities subject to Title I of ERISA. Expenses incurred in connection with settlor functions would not be reasonable expenses of a plan. The department also has taken the position that, while expenses attendant to settlor activities do not constitute reasonable plan expenses, expenses incurred in connection with the implementation of settlor decisions may constitute reasonable expenses of the plan. See Letters to Carl J. Stoney, Jr. (2001, Advisory Opinion 01-01A); Samuel Israel (1997, Advisory Opinion 97-03A); Kirk

Maldonado (1987); and John Erlenborn (1986).

Applying the foregoing principles, the $80,000 for a plan design study clearly constitutes an expense for a settlor activity and, therefore, cannot be paid by the ACD Plan. The $30,000 to amend the ACD Plan to provide for the spin off should, in the view of the department, be treated as a settlor/plan design expense inasmuch as the plan fiduciary would have no implementation responsibilities under the plan until such time as the plan is actually amended.

The $75,000 expense incurred to determine the amount of plan assets to be transferred to the EFG Plan would be a permissible plan expense if the expense is attendant to implementing ACD's decision to spin off certain participants, rather than for assisting ACD in formulating the spin-off. The second $75,000 expense incurred to re-compute the amount of the asset transfer due to the changed closing date also may be a reasonable plan expense, where, for example, the delay in the closing date was through no fault of the sponsor and the plan was duly amended to accomplish the merger at the new closing date.

The $25,000 expense related to negotiations with various unions would be a settlor expense. The described union negotiations typically take place in advance of plan changes. Activities (such as union negotiations, benefit studies, actuarial analyses) that take place in advance of, or in preparation for, a plan change will almost always constitute settlor activities, the expenses for which would not constitute reasonable plan expenses.

Fact Pattern Number Two

MNOP Corp., a Georgia gold mining company with pharmaceutical operations in the Miami area, decided to reduce its staff after several years of poor mining results, falling gold prices, and failed marketing projects in the Miami area. After exploring several other staff reduction options, MNOP decided to initiate an early retirement window (window) in their defined benefit plan (plan) to induce older workers to retire. The plan paid the following expenses related to the window:

- $150,000 for a plan design study to determine the components of the window
- $80,000 for cost projections and to determine the impact of the window on MNOP's financial statements in accordance with FASB Statement No. 87 (Employer's Accounting for Pension)
- Following adoption of the early retirement window, $90,000 to compute potential benefits for those participants that would be eligible for the window
- $30,000 to communicate selected components of the window and the plan benefits under the window to encourage eligible participants to take advantage of the early retirement benefit offer
- $50,000 for benefit calculations for those opting to retire under the window
- $20,000 to communicate plan benefits to the participants that opted to retire under the window
- $10,000 for FASB Statement No. 88 (Employer's Accounting for Settlements and Curtailments of Defined Benefit Pension plans and for Termination of Benefits') calculations, as the window resulted in a plan curtailment

Which of the above expenses, if otherwise reasonable, may be paid by the plan?

Answer

The expenses incurred in hypothetical question 2 fall into three basic categories - plan design, benefit computation and communication expenses.

Plan design expenses clearly constitute settlor expenses and, therefore, are not payable by the plan. Typically, plan design expenses are incurred in advance of the adoption of the plan or a plan amendment. In the case at hand, the $150,000 for plan design study and the $80,000 for cost projections to determine financial impact of the plan change on the sponsor are settlor expenses and may not be paid by the plan. Similarly, the $10,000 for FASB Statement No. 88 expense relate to the plan sponsor's financial statements and are not payable by the plan.

Calculating the actual benefits to which a participant is entitled under the plan is an administrative function of the plan and, accordingly, reasonable expenses attendant to such calculations may be paid by the plan. Thus, the $50,000 expense for calculating the benefits of those opting for the retirement window may be a reasonable expense of the plan. In addition, the $90,000 paid to compute the potential benefits for all eligible employees may be a reasonable expense of the plan, if the fiduciary determines that such an expenditure is a prudent use of plan assets. Even though providing such information to all eligible employees might be viewed as furthering the objectives of the company, this benefit to the employer would not prevent the plan from incurring the expense.[3]

As suggested above, communicating plan information to participants and beneficiaries is an important plan activity and, therefore, expenses attendant to such communications will usually constitute permissible plan expenses, if the expenses are otherwise reasonable. In this regard, administrators and plan fiduciaries generally should be afforded substantial latitude in the method, form and style of their plan communications. Applying the foregoing, the $30,000 to communicate selected components of the window to all eligible participants and the $20,000 to communicate plan benefits to participants that opted for early retirement under the window may constitute reasonable expenses of the plan, even though, like the above benefit calculations, the communication to all eligible participants might be viewed as furthering the objective of the company to induce employees to opt for early retirement.

Back To Top

Fact Pattern Number Three

HIJ, Inc. is a major retailer in Boston, Chicago and San Francisco. During the last two years, it was determined that HIJ's defined benefit plan (plan) was amended to offer a participant loan program and an early retirement window for management employees. The plan is intended to be maintained as a tax-qualified plan. HIJ normally maximizes its tax-deductible contribution to the plan. Upon review of the Plan's financial records, it was determined that the following expenses were paid by the plan:

- $100,000 to amend the plan to establish an early retirement window for management employees and to obtain an IRS determination letter
- $50,000 to amend the plan to comply with tax law changes
- $25,000 to amend the plan to establish a participant loan program
- $20,000 for routine nondiscrimination testing to ensure compliance with the tax qualification requirements

Which of the above expenses, if otherwise reasonable, may be paid by the plan?

Answer

In Advisory Opinion 97-03A, the department expressed the view that the tax-qualified status of a plan confers benefits upon both the plan sponsor and the plan and, therefore, in the case of a plan that is intended to be tax-qualified and that otherwise permits expenses to be paid from plan assets, a portion of the expenses attendant to tax qualification activities may be reasonable plan expenses. The department further clarified its views on tax-qualification expenses in Advisory Opinion No. 01-01. In that opinion, the department expressed the view that a plan fiduciary is not required to take into account the benefits a plan's tax-qualified status confers on an employer in determining whether the expenses attendant to maintaining a plan's tax-qualified status constitute reasonable expenses of the plan. The department further noted that any such benefit should be viewed as an integral component of the incidental benefits that flow to plan sponsors generally by virtue of offering a plan.[(4)]

In the context of tax qualification activities, it is the view of the department that the design of a plan as a tax-qualified plan clearly involves settlor activities for which a plan may not pay. On the other hand, implementation of the settlor decision to maintain a tax-qualified plan would require plan fiduciaries to undertake activities relating to maintaining the plan's tax-qualified status for which a plan may pay reasonable expenses (i.e., reasonable in light of the services rendered). Implementation activities might include drafting plan amendments required to maintain tax-qualified status, nondiscrimination testing, requesting IRS determination letters.

Applying the above principles, the $50,000 to amend the plan to comply with tax law changes and the $20,000 for routine nondiscrimination testing may constitute reasonable expenses of the plan. The $25,000 to amend the plan to establish a participant loan program would be a plan design/settlor expense inasmuch as the plan fiduciaries have no implementation obligations under the plan until such time as the plan is amended. Subsequent to the plan amendment, however, expenses attendant to operating the established loan program would be implementation expenses with respect to which the plan may pay reasonable expenses.

The single charge of $100,000 includes expenses for plan design/settlor activities (i.e., amending the plan to establish an early retirement window) and implementation activities (i.e., obtaining an IRS determination letter). Inasmuch as fiduciaries may pay only reasonable expenses of administering the plan, the fiduciaries of the plan would be required to obtain from the service provider a determination of the specific expense(s) attributable to the fiduciaries' implementation responsibilities (i.e., obtaining an IRS determination letter) prior to payment by the plan.

Back To Top

Fact Pattern Number Four

The QRS Corp. is a world-wide shoe manufacturer with plants in the Cincinnati and Detroit areas. A review of the financial records of the QRS Corp. defined benefit plan (the plan) reflected the following expenses:

- $60,000 for consulting fees to analyze the company's options for compliance with Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) and Small Business Jobs Protection Act of 1996 (SBJPA)
- $5,000 to amend the plan to comply with USERRA and SBJPA and $5,000 to obtain an IRS determination letter
- $50,000 in actuary fees to perform nondiscrimination testing due to a plan amendment increasing benefits as a result of union negotiations
- $5,000 to amend the plan to comply with the requirements of Title I of ERISA

Which of the above expenses, if any, may be paid by the plan?

Answer

The expenses presented in this hypothetical raise some of the same issues as those raised in hypothetical question 3 - the extent

to which expenses relating to maintenance of tax-qualification may constitute reasonable plan expenses. Applying the principles set forth in the answers to hypothetical question 3, the $5,000 expense to amend the plan, the $5,000 expense for a determination letter and the $50,000 for nondiscrimination testing may be necessary to maintain the plan's tax-qualified status and, therefore, may constitute reasonable plan expenses. The fact that the $50,000 discrimination testing was necessary because of a union-negotiated plan amendment does not affect the expense being treated as a permissible plan expense. On the other hand, if the $50,000 was incurred as part of the plan sponsor's negotiating with the union - in advance of adoption of the plan amendment giving rise to the testing - the expense, as discussed in the Answer to hypothetical question 1, would be viewed as a settlor, rather than plan, expense. The $60,000 for consulting fees to analyze the Company's options for compliance with USERRA and SBJPA would constitute plan design/settlor expenses that may not be paid by the plan.

Similar to a fiduciary's implementation responsibility with regard to maintaining the tax-qualified status of a plan, fiduciaries have an obligation to ensure that administration of their plan comports with the requirements of ERISA, as well as other applicable Federal laws. Accordingly, the $5,000 expense to amend the plan to comply with the requirements of Title I of ERISA would be a permissible plan expense, assuming that the amount is reasonable in light of the services rendered.

Fact Pattern Number Five

The public relations firm, TUV (the Firm), has offices in Philadelphia, Dallas, Los Angeles and New York. The Firm operates a defined benefit plan (plan). From 1993 to 1996, the plan, in addition to distributing a Summary Annual Report (SAR), distributed an individual benefit statement to each participant. The total preparation and distribution costs for the benefit statements were approximately $50,000 annually.

In 1996, the Firm decided it would be a good idea to make sure its employees were aware of all of the benefits provided by the Firm. Accordingly, for 1996 and subsequent years, the individual benefit information was incorporated in a twelve page booklet that included summary information about all the Firm's benefit plans (health, dental, vision), as well as one full page devoted to other Firm benefits (e.g., the physical fitness center, limousine services) and activities (e.g., annual picnic, Holiday party, etc). The booklets are prepared by the plan's actuarial consultant. The booklet costs approximately $125,000 to prepare and distribute annually.

What, if any, of these expenses may be paid by the plan?

Answer

The issues presented by this hypothetical involve the extent to which a plan can pay expenses related to the disclosure of plan information. Clearly, plans may pay those expenses attendant to compliance with ERISA's disclosure requirements (e.g., furnishing and distributing summary plan descriptions, summary annual reports and individual benefit statements provided in response to individual requests). As indicated in the Answer to hypothetical question 2, communicating plan information to participants and beneficiaries is an important plan activity. The department notes that there is nothing in Title I of ERISA that precludes a plan fiduciary from providing more information than that specifically required by statute. Whether or not a particular communication related expense should be incurred by a plan is a fiduciary decision governed by the fiduciary responsibility provisions of Title I of ERISA.

Accordingly, the $50,000 to produce and distribute individual benefit statements would be a permissible plan expense to the extent that the actual costs of preparation and distribution are reasonable. Similarly, a portion of the $125,000 for preparation and distribution of the benefit booklets may also be a permissible plan expense. Clearly, the plan sponsor should pay that portion (1/12) of the costs of the booklet that relates to non-plan matters (i.e., physical fitness center, limousine services, picnic, etc.). In addition, a plan may pay only those reasonable expenses relating to that plan, and therefore, each of the plans should pay their proportionate share of the expenses of the booklet. While plan administrators and fiduciaries should be given considerable deference with regard to their disclosure decisions, plan administrators should be able to explain their disclosure decisions and justify the costs attendant thereto.

Fact Pattern Number Six

The QT, P. C. (QT) is a law firm with satellite offices in most major U. S. cities. QT operates a defined benefit plan (plan). Until 1997, the plan was administered by a ten lawyer benefits committee. In 1997, the plan fiduciaries decided to out-source the administration. Following an in-depth search, the plan's fiduciaries selected Firm, Inc. and agreed to pay $1 million in start-up fees. The start-up fees were paid from the plan and were used to set up data bases and transfer data to Firm that was necessary to administer the plan. The new system operated by Firm provides plan participants with a significantly enhanced level of service than was previously provided by the staff of ten lawyers. Once the plan's administration was transferred to Firm, the plan paid all of Firm's administration fees.

To what extent may the expenses associated with outsourcing the plan's administration be paid by the plan?

Answer

Section 404(a)(1)(A) specifically contemplates the payment of reasonable expenses by an employee benefit plan. Where a plan sponsor has assumed responsibility for the payment of plan expenses and later prospectively shifts that responsibility to the

plan, the plan may pay those expenses to the extent reasonable and not otherwise precluded by the terms of the plan.[5]

To the extent that the services provided by Firm are necessary for the administration of the plan, the $1 million start-up fee and ongoing administrative fees may constitute reasonable expenses of the plan if they are reasonable with respect to the services provided, and not otherwise precluded by the plan.

Footnotes

1. See Letters to Carl J. Stoney, Jr. from Robert J. Doyle (Advisory Opinion 01-01A, January 18, 2001); Samuel Israel from Robert J. Doyle (Advisory Opinion 97-03A, January 23, 1997); Kirk Maldonado from Elliot I. Daniel (March 2, 1987); John Erlenborn from Dennis M. Kass (March 13, 1986).

2. The expense information set forth in the following hypotheticals are for illustrative purposes only and are not intended to reflect a determination by the department on the reasonableness of an expense.

3. The Supreme Court has recognized that plan sponsors receive a number of incidental benefits by virtue of offering an employee benefit plan, such as attracting and retaining employees, providing increased compensation without increasing wages, and reducing the likelihood of lawsuits by encouraging employees who would otherwise be laid off to depart voluntarily. The mere receipt of such benefits by plan sponsors does not convert a settlor activity into a fiduciary activity or convert an otherwise permissible plan expense into a settlor expense. See Lockheed Corp. v. Spink, 517 U.S. 882 (1996), Hughes Aircraft Company v. Jacobson, 525 U.S. 432 (1999).

4. See footnote 3.

5. The department has taken the position that where a plan document is silent as to the payment of reasonable administrative expenses, the plan may pay reasonable administrative expenses. Where a plan document provides that the employer will pay any such expenses, and if the employer has reserved the right to amend the plan document, ERISA would not prevent the employer from amending the plan to require, prospectively, that the relevant expenses be paid by the plan. The department believes that the prohibition against self- dealing in section 406(b)(1) precludes an employer from exercising fiduciary authority to use plan assets to pay for an amendment that would (retroactively) relieve the employer of an obligation to pay plan expenses. See Advisory Opinion 97-03A.

Trust Examination Manual

December 14, 2001

Mr. James M. Winn
Smith & Downey
1110 Vermont Ave., NW, Suite 400
Washington, DC 20005
2001-10A
ERISA Sec. 408(b)(2) & 408(b)(6)

Dear Mr. Winn:

This is in response to your letter requesting an advisory opinion under the Employee Retirement Income Security Act of 1974, as amended (ERISA). In particular, you request an opinion that the provision of trustee services by Laurel Trust Company (Laurel) to two defined benefit pension plans sponsored by Laurel (the Plans), and the payment by the Plans of Laurel's standard trustee fees would be exempt from ERISA's prohibited transaction provisions by reason of section 408(b)(6) of ERISA.(1)

Your letter contains the following representations. Laurel provided trustee services to the Plans and charged its customary trustee fees for such services. Laurel assumed that the provision of such services and the receipt of the fees was exempted from the prohibited transactions provisions of section 406 of ERISA by reason of section 408(b)(6). You represent that in 1996, the Department of Labor (the Department) determined that this arrangement constituted a violation of section 406 of ERISA and imposed on Laurel (then known as BT Management Trust Company) a civil penalty under section 502(l) of ERISA. Laurel petitioned the Department for a waiver or reduction of the civil penalty, which was denied. Laurel paid the civil penalty and ceased charging its customary fees to the Plans. Citing a 1993 IRS Field Service Advice Memorandum, which you believe takes a view contrary to that of the Department, you have requested that the Department reconsider its position with respect to section 408(b)(6) of ERISA.

Laurel contends that section 406 of ERISA does not prohibit the Plans from paying Laurel its customary trustee fees, which are the same fees paid by plans sponsored by parties unrelated to Laurel. You represent that such fees represent reasonable compensation for services, which plans are permitted to pay, even if those fees include a profit component. You recognize that ERISA section 406 would otherwise prohibit the payment of such fees, but claim that the statutory exemption provided by section 408(b)(6) permits the payment of the fees by the Plans to Laurel.

Section 406(a)(1)(C) and (D) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if the fiduciary knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest or a transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA provides that a fiduciary with respect to a plan shall not deal with plan assets in his own interest or for his own account. Section 406(b)(2) of ERISA prohibits a fiduciary with respect to a plan from acting in any transaction involving the plan on behalf of a party, or represent a party, whose interests are adverse to the interests of the plan or of its participants and beneficiaries.

Section 408(b)(6) of ERISA provides that the prohibitions of section 406 shall not apply to the provision of any ancillary service by a bank or similar financial institution supervised by the United States or a State, if such bank or financial institution is a fiduciary of such plan, provided that certain conditions are satisfied.

You represent that Laurel, as a Pennsylvania state-chartered trust company, is a "bank or similar financial institution" that is supervised by a State. You further represent that the provision of services to and payment of fees by the Plans satisfies the other conditions of ERISA section 408(b)(6).

You claim that the Department has previously concluded that a plan's payment of fees that include a profit component is not "reasonable compensation," as that term is used in both section 408(b)(2) and 408(b)(6) of ERISA. You further claim that the Internal Revenue Service (IRS) has taken a contrary position with respect to section 4975(d)(6) of the Internal Revenue Code of 1986 (the Code), a parallel provision to ERISA section 408(b)(6), in a 1993 Field Service Advice Memorandum (Memorandum), a copy of which you included with your letter. Pursuant to section 102 of Reorganization Plan No. 4 of 1978 (see, footnote 1, above), all authority to issue regulations, rulings, interpretations, and exemptions under section 4975(d) of the Code, with exceptions not here relevant, was transferred to the Department. The Department, therefore, has sole authority and responsibility to interpret section 4975(d)(6) of the Code.

Section 408(b)(6) of ERISA (and by reference, section 4975(d)(6) of the Code, see, footnote 1, above) exempts from the prohibited transaction provisions of ERISA the provision of "ancillary" services to a plan by a fiduciary that is a bank or similar financial institution supervised by the United States or a State and the payment of no more than "reasonable compensation" by the plan. It is the opinion of the Department that trustee services are not ancillary services.

Trustee services are necessary and essential to the establishment, maintenance, and operation of a pension plan that is subject to ERISA. Section 403(a) of ERISA requires that, subject to several exceptions not relevant here, all assets of an employee benefit plan shall be held in trust by one or more trustees. The trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan, except to the extent that the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to ERISA, or to the extent that authority to manage, acquire, or dispose of assets of the plan is delegated to one or more investment managers. In the Department's view a service is "ancillary" if it aids or is auxiliary to a primary or principal service. For instance, the Department has stated that the provision of "sweep services" by a trustee who is subject to direction from an independent investment manager for the investment of plan assets, may constitute an "ancillary service" within the meaning of section 408(b)(6).(2) Given the central role that the establishment of a trust and the naming of a trustee plays in the establishment, maintenance, and operation of an employee benefit plan, the Department concludes that trustee services cannot be "ancillary services" within the meaning of ERISA section 408(b)(6).

Section 408(b)(2) of ERISA exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefore. Regulations issued by the Department clarify the terms "necessary service" (29 CFR §2550.408b-2(b)), "reasonable contract or arrangement" (29 CFR §2550.408b-2(c)) and "reasonable compensation" (29 CFR §2550.408b-2(d) and 2550.408c-2) as used in section 408(b)(2). As a general matter, whether the requirements of that section are met in each case involves questions which are inherently factual in nature. Pursuant to section 5.01 of ERISA Procedure 76-1, the Department ordinarily does not issue opinions on such matters. The Department has not concluded, however, that fees including a profit component necessarily exceed reasonable compensation.

With respect to the prohibitions in section 406(b), the regulation under section 408(b)(2) of ERISA (29 CFR §2550.408b-2(a)) states that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) even if such act occurs in connection with a provision of services that is exempt under section 408(b)(2).

As explained in regulation 29 CFR §2550.408b-2(e)(1), the prohibitions of section 406(b) are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility that makes them fiduciaries when they have interests that may conflict with the interests of the plans for which they act. Thus, a fiduciary may not use the authority, control, or responsibility that makes him a fiduciary to cause a plan to pay an additional fee to such fiduciary, or to a person in which he has an interest that may affect the exercise of his best judgment as a fiduciary, to provide a service. However, regulation 29 CFR §2550.408b-2(e)(2) provides that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility that makes him a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest that may affect the exercise of his judgment as a fiduciary. Furthermore, regulation section 2550.408b-2(e)(3) explains that if a fiduciary provides services to a plan without the receipt of compensation or other consideration other than the

reimbursement of direct expenses properly and actually incurred in the performance of such services, the provision of such services does not, in and of itself, constitute an act described in section 406(b) of ERISA. Regulation section 2550.408c-2(b)(3) provides that an expense is not a direct expense to the extent that it would have been sustained had the service not been provided or if it represents an allocable portion of overhead.

Accordingly, it is the opinion of the Department that if Laurel provides trustee services to the Plans and charges the Plans a fee that exceeds the direct expenses that Laurel incurs in the provision of trustee services to the Plans, it would engage in violations of ERISA section 406(b)(1) and (2), which would not be exempted by ERISA section 408(b)(2) or (6).

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

1. --

   Footnotes

   Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), 5 U.S.C. App.1, 92 Stat. 3790, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.
2. See, letter from Alan D. Lebowitz to Robert S. Plotkin, Assistant Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, August 1, 1986.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Advisory Opinion

June 7, 2002

Wallace M. Starke, Esq.
Troutman, Sanders, Mays & Valentine, L.L.P.
P.O. Box 1122
Richmond, VA 23218-1122
2002-04A
ERISA Sec. 408(e)

Dear Mr. Starke:

This is in response to your request for an advisory opinion regarding the application of section 408(e) of the Employee Retirement Income Security Act of 1974, as amended (ERISA) to certain transactions between a plan and various personal trusts and estates sharing a common trustee with the plan.

You represent that National Bankshares, Inc. (NBI) is a bank holding company which owns all the issued and outstanding stock of the National Bank of Blacksburg (the Bank). The Bank is a national banking association subject to the supervision of the Office of the Comptroller of the Currency (OCC).

You further represent that NBI acts as plan sponsor of the National Bankshares, Inc. Employee Stock Ownership Plan (the ESOP) and the Bank is a participating employer with respect to the ESOP. You state that the Bank serves as trustee of the ESOP and also serves as trustee of various inter vivos and executorial trusts and estates (referred to hereafter as personal trusts). You state that to the best of your knowledge, none of the personal trusts are ERISA plans, parties in interest with respect to the ESOP as defined in section 3(14) of ERISA, or disqualified persons within the meaning of section 4975(e) of the Internal Revenue Code (the Code).

You state that the ESOP is an employee stock ownership plan within the meaning of 4975(e)(7) of the Code and section 407(d)(6) of ERISA. It is intended to be qualified under section 401(a) of the Code and last received a favorable determination letter from the Internal Revenue Service to that effect on June 1, 1995. The ESOP, by its terms, is designed to invest primarily in the stock of NBI. NBI's outstanding stock consists of one class of common stock which is readily traded on the NASDAQ small cap market.

You request an advisory opinion regarding several transactions involving the purchase by the ESOP of NBI stock from several personal trusts for which the Bank also serves as trustee. No broker was used for the sales. You represent that the Bank as trustee for the ESOP initiated such purchases of NBI stock for the ESOP. You state that the Bank has an established procedure to obtain, prior to executing any acquisition of NBI stock by the ESOP from a personal trust, written consent from the primary beneficiary or any co-fiduciary of the personal trust to sell NBI stock owned by the personal trust to the ESOP.

You state that no commission was charged to the ESOP or the personal trusts in connection with the NBI stock purchases in question. The consideration paid by the ESOP for the NBI stock was cash equal to the bid price for such shares as quoted by the online service MSN Money Central, a price which was not more than the fair market value of such shares at the time of their purchase. The trustee did not receive any consideration for its personal account in connection with any of the NBI stock purchases in question.

You state that MSN Money Central is an online pricing service that obtains its stock quotes from Standard and Poor's ComStock, Inc., the same service used by a number of other pricing services. You state that there is a 15-minute delay when a stock quote is obtained from MSN Money Central, and that in each of the purchases

at issue the transaction was executed within 15 minutes of the time that a price quote was obtained. You state that effecting the trade at the bid price, rather than the asked price, benefitted the plan in that the bid price in most, if not all, cases is lower than the asked price.

A total of ten such transactions occurred between June of 2000 and April of 2001 representing a total of 7,646 shares of NBI stock and a total sale price of $163,301. During an examination by the OCC of the operations of the trust department of the Bank, the OCC examiner questioned whether these transactions were prohibited by ERISA and the Code.

You request the Department's view as to whether the described transactions are exempt from the prohibited transaction restrictions of ERISA and the Code by virtue of sections 408(e) of ERISA and 4975(d)(13) of the Code.

Section 406(a)(1)(A) and (D) of ERISA prohibit a fiduciary with respect to a plan from causing a plan to engage in a transaction if s/he knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing of any property between a plan and a party in interest; or a transfer to, or use for the benefit of, a party in interest, of any assets of the plan. Section 3(14)(A) and (C) of ERISA define a party in interest with respect to a plan to include a fiduciary of the plan and an employer any of whose employees are covered by such plan.

Section 406(a)(1)(E) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if s/he knows or should know that such transaction constitutes a direct or indirect acquisition, on behalf of the plan, of any employer security in violation of section 407(a). In addition section 406(a)(2) prohibits certain fiduciaries from permitting a plan to hold any employer security if s/he knows or should know that holding such security violates section 407(a).

Section 407(a) of ERISA provides, in part, that a plan may not acquire or hold any employer security which is not a qualifying employer security.

Section 406(b)(1) and (2) of ERISA prohibit a fiduciary with respect to a plan from dealing with the assets of a plan in his or her own interest or for his own account, or from acting in his or her individual or in any other capacity in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Section 406(b)(3) prohibits a fiduciary with respect to a plan from receiving any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of a plan.

However, section 408(e) of ERISA provides, in part, that sections 406(a) and 406(b)(1) and (2) shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5)) if the following conditions are met: (1) the acquisition or sale is for adequate consideration; (2) no commission is charged with respect to the acquisition or sale; and (3) the plan is an eligible individual account plan (as defined in section 407(d)(3))… 2.

Section 407(d)(1) of ERISA defines the term employer security in part to mean a security issued by an employer of employees covered by the plan or by an affiliate of such employer. With respect to eligible individual account plans, section 407(d)(5) of ERISA defines the term qualifying employer security to include an employer security which is a stock.

Section 3(18) of ERISA defines the term adequate consideration to include, in the case of a security for which there is a generally recognized market and if the security is not traded on a national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any party in interest.

The term eligible individual account plan is defined under section 407(d)(3) as including employee stock ownership plans which explicitly provide for the acquisition and holding of qualifying employer securities.

Based on the representations described in your request, it is the opinion of the Department that the ESOP constitutes an eligible individual account plan inasmuch as the plan is an employee stock ownership plan within the meaning of 4975(e)(7) of the Code and 407(d)(6) of ERISA and is designed, by its terms, to invest primarily in the common stock of NBI.

You have represented that the transactions involve the purchase of NBI common stock by the ESOP. You

state that the ESOP is maintained for the benefit of the employees of NBI, the Bank, and any other NBI affiliate which adopts the ESOP as a participating employer. The Bank, as a wholly owned subsidiary of NBI, constitutes an affiliate of NBI on the basis of the facts you describe. Based on your representations, it is the Department's view that common stock of NBI will constitute qualifying employer securities with respect to the ESOP.

You represent that none of these trusts are parties in interest as defined under section 3(14). As a result, a violation of section 406(a) would not have occurred with respect to the transactions. You have also represented that the transactions involve the purchase of NBI common stock by the ESOP from several personal trusts for which the Bank also serves as the trustee. Such transactions would involve violations of section 406(b)(2).

Further, the Department has stated that to the extent that an investment manager exercises discretion over both sides of a transaction in a cross-trade transaction, there is potential for the investment manager to use its discretion to favor one account over another, for example, in the pricing or timing of the trade or in the decision to buy or sell securities for an ERISA account. Such acts could result in one or more violations of the fiduciary provisions of Title I of ERISA in addition to those described in section 406(b)(2).

Regulations issued by the Department clarify that section 408(e), by its terms, exempts certain transactions from the prohibitions of section 406(a) and 406(b)(1) and (2). Accordingly, it is the view of the Department that the acquisitions of NBI stock by the ESOP under the circumstances described would be exempt from the prohibitions of 406(a), and 406(b)(1) and (2) by virtue of section 408(e) provided that the transactions are for adequate consideration and that no commission is charged with respect to the transactions.

Whether the terms of section 408(e) have been met with respect to a transaction is an inherently factual question which may only be answered by the appropriate plan fiduciaries based on all of the relevant facts and circumstances. The Department generally will not opine as to whether a particular transaction is for adequate consideration. Rather, the Department believes that such determinations should be made by appropriate plan fiduciaries on the basis of all relevant facts and circumstances.

We would note, however, that the fact that a transaction is exempt under section 408(e) is not determinative of whether a fiduciary has met its fiduciary obligations under ERISA. Section 404(a)(1)(A) of ERISA requires plan fiduciaries to discharge their duties with respect to a plan solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan. Section 404(a)(1)(B) requires plan fiduciaries to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims. Section 403(c)(1) provides that the assets of a plan shall never inure to the benefit of an employer and shall be held for the exclusive purposes of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

The general standards of fiduciary conduct contained in sections 404(a)(1) and 403(c) apply to the described purchases of NBI stock by the ESOP. Accordingly, fiduciaries of the ESOP must act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying reasonable plan administrative costs when deciding whether to acquire NBI stock for the ESOP. Therefore, if plan fiduciaries failed to act in compliance with these general fiduciary standards in the acquisition of the NBI stock for the ESOP, they would be liable for losses resulting from such breaches of fiduciary responsibility regardless of whether the acquisition may be exempt from certain prohibited transaction restrictions by virtue of section 408(e).

If, under the facts and circumstances of any transaction, the Bank uses the authority which makes it a fiduciary with respect to the transaction to benefit personal trust clients at the expense of the ESOP, or otherwise fails to act solely in the interest of plan participants and beneficiaries in deciding to purchase NBI stock for the ESOP, violations of sections 404(a)(1) and 403(c) could occur.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations

Office of Regulations and Interpretations

Last Updated 04/02/2008

supervision@fdic.gov

Advisory Opinion

June 7, 2002

Melanie Franco Nussdorf, Esq.
Steptoe & Johnson LLP
1330 Connecticut Avenue, NW
Washington, DC 20036-1795
2002-05A
PTE 77-4

Dear Ms. Nussdorf:

This is in response to your request for an advisory opinion concerning Prohibited Transaction Exemption 77-4 (42 FR 18732, April 8, 1977) (PTE 77-4). Specifically, you request an opinion as to whether the prohibition on sales commission payments in PTE 77-4 would apply to commissions paid by a plan to an independent broker who executes the plan's purchase or sale of shares of open-end investment companies registered under the Investment Company Act of 1940 through a securities exchange.

As you know, PTE 77-4 provides an exemption from the restrictions of section 406 of the Employee Retirement Income Security Act (the Act), as amended, and the taxes imposed by section 4975(a) and (b) of the Internal Revenue Code of 1986, as amended (the Code), by reason of section 4975(c)(1) of the Code, for the purchase or sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, where the investment adviser for the investment company is also a fiduciary with respect to the plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan, provided certain conditions are met.

Section II(a) of PTE 77-4 provides that the plan must not pay a sales commission in connection with such purchase or sale.

You represent that your inquiry concerns an investment vehicle known as an Exchange Traded Fund or ETF which is similar to a mutual fund. You have explained that an ETF is legally classified as a registered open-end investment company. Like other open-end investment companies, an ETF issues shares representing an undivided interest in a managed portfolio of securities. Additionally, ETF shares are offered continuously and may be purchased and redeemed directly through the ETF on a daily basis, at the net asset value (NAV) per share, with or without a fixed transaction fee.

You represent that direct purchases and redemptions occur, however, only in large blocks (generally called creation units) and generally are effected through an in-kind tender of a specified basket of securities, and not cash. You note that this tends to reduce portfolio turnover and attendant transactional expenses by minimizing the liquidations and acquisitions of portfolio securities required with respect to purchases and redemptions in ETF shares.

You state that individual ETF shares trade on the exchanges at market prices, which may differ from NAV. Trades of ETF shares in the secondary market incur brokerage commissions, like common stocks.

You have requested an advisory opinion confirming that the sales commissions precluded under section II(a) of PTE 77-4 do not include commissions paid to brokers provided that: (1) the sale of shares of open-end investment companies registered under the Investment Company Act of 1940 are executed through a securities exchange; and (2) the brokers are unrelated to the investment company's principal underwriter or investment adviser (or their affiliates). You note that where the broker is not affiliated with the investment

adviser for the fund and the fund's principal underwriter, neither the adviser, the principal underwriter, nor any of their affiliates, derives any additional benefit from initiating a transaction which causes the broker to receive a commission.

ETFs did not exist in 1977 at the time PTE 77-4 was granted by the Department of Labor (the Department). At that time open-end investment company shares were purchased from the fund itself (or through a broker affiliated with the fund). The prohibition in PTE 77-4 on the payment of sales commissions by a plan was intended to avoid potential abuses that could arise if a mutual fund, its investment adviser or an affiliate thereof were to receive a commission or load in connection with the transaction. The Department explained in the preamble to the proposed class exemption relating to PTE 77-4 that the requirement that the plan not pay commissions would apply ...whether the transaction is between the plan and the mutual fund directly or is executed by the mutual fund's principal underwriter or transfer agent as an intermediary. (See 41 FR 50516, November 16, 1976). Each of these types of transactions would involve payment of a commission to someone associated with the mutual fund.

The Department's views regarding fees paid to parties with respect to transactions described in PTE 77-4 were also discussed in Advisory Opinion 93-13A, in which a company, serving as investment manager or trustee to employee benefit plans, proposed to invest the plans' assets in affiliated mutual funds. The Department stated that conditions (d), (e) and (f) of PTE 77-4, relating to required disclosures and approval by an independent fiduciary, would not apply to fees paid to parties unrelated to the mutual funds' adviser, or any affiliate, under the arrangement described in the advisory opinion.

As noted above, ETFs are a more recent development in the securities market and their trading procedures differ from those of traditional open-end investment companies. In this regard, creation units are traded directly with the fund in like-kind exchanges while individual shares are traded between investors on securities exchanges and result in brokerage commissions being paid to brokers who may or may not be related to the fund, investment adviser or any affiliates thereof.

Based on the above facts and representations, the Department is of the view that the term sales commission as used in section II(a) of PTE 77-4 does not include brokerage commissions paid to a broker in connection with purchases or sales of shares of registered open-end investment companies on an exchange if the broker is unaffiliated with the fund, its principal underwriter, investment adviser or any affiliate thereof.(1)

The Department cautions, however, that where a plan fiduciary, who is an investment adviser to a fund, causes the plan to pay commissions to a broker-dealer who is an affiliate of such adviser or of the fund, such commission payments would be separate prohibited transactions under section 406(b) of the Act for which no relief is available under PTE 77-4. Section 406(b) prohibits a plan fiduciary from dealing with the assets of the plan in his own interest or for his own account, acting in his individual or in any other capacity in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants and beneficiaries, or receiving any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. This opinion relates only to the specific issue addressed herein.

Sincerely,
Ivan L. Strasfeld
Director, Office of Exemption Determinations

Footnotes

The Department notes PTE 77-4 would not apply to the in-kind purchase or sale of ETF creation units by employee benefit plans.

supervision@fdic.gov

Trust Examination Manual

Advisory Opinion

August 20, 2002

Michael A. Crabtree, Esq.
Central Pension Fund of the International Union of
Operating Engineers and Participating Employers
4115 Chesapeake Street, NW
Washington, DC 20016-4665
2002-08A
ERISA Sec. 404(a) & 408(b)(2)

Dear Mr. Crabtree:

This is in response to your request for an advisory opinion on behalf of the Central Pension Fund of the International Union of Operating Engineers and Participating Employers (the “Fund”) concerning the application of the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Specifically, you have requested the views of the Department as to whether inclusion of certain indemnification and hold-harmless provisions in a plan’s service provider contract would violate the fiduciary provisions of ERISA.

You represent that an actuarial firm, in connection with discussions relating to the renewal of its contract to provide actuarial services to the Fund, advised that it was requiring all new engagement letters to contain, among other things, “limitation of liability” and “indemnification” provisions. These provisions, in effect, would require the Fund to agree not to recover from the actuarial firm an amount in excess of the greater of $250,000 or one year’s fee for any damage caused to the Fund “regardless of the cause of action,” and to indemnify and hold the actuarial firm harmless for any amount exceeding the same limits “from any third party claim or liability” arising from, or in connection with, the firm’s services to the Fund. The Fund’s insurer has informed the Fund that its fiduciary liability policy would not cover the Fund’s losses if the Fund suffered losses in excess of $250,000 as a result of the actuarial firm’s actions that were not recovered because of the proposed limitation of liability and indemnification provisions. The insurer explained that the policy is not designed to cover professional liability exposures normally associated with Actuarial Errors and Omissions coverage.

Although the Fund has decided not to retain the actuarial firm, opting instead for a firm that required no specific limitation of liability or indemnification provision, limitation of liability and indemnification provisions may be becoming increasingly popular with actuarial firms according to press and other reports. Given the current and future issues presented to fiduciaries with respect to the engagement of service providers with contractual limitations of liability or indemnification provisions, you have requested guidance from the Department concerning the permissibility of such provisions under ERISA.

Section 404(a)(1) of ERISA requires, among other things, that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character with like aims. The prohibited transaction provisions state, in section 406(a)(1)(C) and (D) of ERISA, that a fiduciary with respect to an employee benefit plan shall not cause the plan to engage in a transaction if he or she knows or should know that such transaction constitutes a direct or indirect furnishing of services between the plan and a party in interest with respect to the plan, or transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 408(b)(2) of ERISA provides a statutory exemption from the prohibitions of section 406(a) for contracting or making reasonable arrangements with a party in interest, including a fiduciary, for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if

no more than reasonable compensation is paid for such services.

With regard to the selection of service providers under ERISA, the Department has previously indicated that the responsible plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. In addition, such process should be designed to avoid self-dealing, conflicts of interest or other improper influence. What constitutes an appropriate method of selecting a service provider, however, will depend upon the particular facts and circumstances. Soliciting bids among service providers is a means by which a fiduciary can obtain the necessary information relevant to the decision-making process, including information about contractual provisions such as those identified in your letter relating to limitations of liability and indemnification.

The Department does not believe that, in and of themselves, most limitation of liability and indemnification provisions in a service provider contract are either per se imprudent under ERISA section 404(a)(1)(B) or per se unreasonable under ERISA section 408(b)(2). The Department believes, however, that provisions that purport to apply to fraud or willful misconduct by the service provider are void as against public policy and that it would not be prudent or reasonable to agree to such provisions. Other limitations of liability and indemnification provisions, applying to negligence and unintentional malpractice, may be consistent with sections 404(a)(1) and 408(b)(2) of ERISA when considered in connection with the reasonableness of the arrangement as a whole and the potential risks to participants and beneficiaries. At a minimum, compliance with these standards would require that a fiduciary assess the plan's ability to obtain comparable services at comparable costs either from service providers without having to agree to such provisions, or from service providers who have provisions that provide greater protection to the plan.

In the Department's view, compliance with ERISA's fiduciary provisions, including section 408(b)(2), also would require that a fiduciary assess the potential risk of loss and costs to the plan that might result from a service provider's act or omission subject to a proposed limitation of liability or indemnification provision. In making such an assessment, a fiduciary should consider the potential for, and outside limits of, such a loss, as well as any additional actions that may be available to the plan to minimize such a loss.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Advisory Opinion

December 18, 2002

Leonard A. Davis, Chief Counsel – Benefits
Sharon W. Vaino, Assistant Tax Counsel
Tax Department
Metropolitan Life Insurance Company
One MetLife Plaza
Long Island City, NY 11101-4015
2002-14A
29 CFR 2509.95-1

Dear Mr. Davis and Ms. Vaino:

This is in response to your request for guidance concerning the selection of annuity providers, pursuant to Interpretive Bulletin 95-1 (29 C.F.R. § 2509.95-1), in connection with distributions from defined contribution plans. Specifically, you have requested the Department to address the application of specific requirements of Interpretive Bulletin 95-1 to defined contribution plans.

Interpretive Bulletin 95-1 (the IB) provides guidance concerning the fiduciary standards under Part 4 of Title I of the Employee Retirement Income Security Act (ERISA) applicable to the selection of annuity providers for purposes of pension plan benefit distributions. In general, the IB makes clear that the selection of an annuity provider in connection with benefit distributions is a fiduciary act governed by the fiduciary standards of section 404(a)(1), including the duty to act prudently and solely in the interest of the plan's participants and beneficiaries. In this regard, the IB provides that plan fiduciaries must take steps calculated to obtain the safest annuity available, unless under the circumstances it would be in the interest of the participants and beneficiaries to do otherwise. The IB also provides that fiduciaries must conduct an objective, thorough and analytical search for purposes of identifying providers from which to purchase annuities and sets forth six factors that should be considered by fiduciaries in evaluating a provider's claims paying ability and creditworthiness. (§ 2509.95-1(c)). Further, the IB recognizes that there may be situations where it may be in the interest of participants and beneficiaries to purchase other than the safest available annuity, such as when an annuity is only marginally safer, but disproportionately more expensive than a competing annuity. However, the IB notes that increased costs or other considerations could never justify putting the benefits of participants and beneficiaries at risk by purchasing an unsafe annuity. (§ 2509.95-1(d)).

The following information is provided in response to the specific issues raised by your request.

The general fiduciary principles set forth in the IB with regard to the selection of annuity providers are equally applicable to defined benefit and defined contribution plans. Accordingly, the selection of annuity provider by the fiduciary of a defined contribution plan would be governed by section 404(a)(1) and, therefore, such fiduciary, in evaluating claims paying ability and creditworthiness of an annuity provider, should take into account the six factors set forth in § 2509.95-1(c).

With regard to factor six (§ 2509.95-1(c)(6)) relating to state guarantees, you requested a clarification as to the scope of a fiduciary's consideration. Factor six indicates that fiduciaries should consider "the availability of additional protection through state guaranty associations and the extent of their guarantees." For purposes of factor six, fiduciaries should determine whether the provider and annuity product are covered by state guarantees and the extent of those guarantees, in terms of amounts (e.g., percentage limits on guarantees) and individuals covered (e.g., residents, as opposed to non-residents, of a state). Such information should be available to the public and easily accessible through state guaranty associations and state insurance

departments. Of course, if there were facts known to the fiduciary calling into question the ability of a state association offering guarantees to meet its obligations under the guarantee, it would be incumbent on the fiduciary to weigh that information when selecting an annuity provider.

In evaluating the six factors, the IB indicates that, “[u]nless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a qualified, independent expert.” With regard to this provision, you express concern that fiduciaries should be able to make evaluations of annuity providers without becoming or hiring an expert in annuity matters. The standard set forth in the IB follows from the prudence standard of section 404(a)(1)(B). That section provides that a fiduciary shall discharge its duties “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” (Emphasis supplied). Accordingly, in those instances where the fiduciary responsible for the selection of an annuity provider has, at the time of the selection, a sufficient level of expertise or knowledge to meaningfully evaluate the claims paying ability and creditworthiness of an annuity provider, including the factors set forth in the IB, the fiduciary would not be required to engage a qualified, independent expert to evaluate such factors. For purposes of the IB, “independent” means independent of the annuity provider.

With regard to paragraph (d) of § 2509.95-1, relating to costs and other considerations, you request confirmation that, in evaluating competing products, cost is an appropriate consideration for the fiduciary of a defined contribution plan when the participant receives an increased benefit as a result of reduced costs. It is the view of the Department that it is appropriate for the fiduciary of a defined contribution plan in selecting an annuity provider to take into account the costs and benefits to the participant or beneficiary of competing annuity products. Consistent with the IB, however, a lower cost cannot justify the purchase of an unsafe annuity even when the annuity would pay a higher benefit amount to the participant or beneficiary.

Lastly, you raise a question concerning the applicability of paragraph (e) of § 2509.95-1 to defined contribution plans. Paragraph (e) requires that special care be taken in reversion situations where fiduciaries selecting annuity providers have an interest in the sponsoring employer that may affect their judgment. In such situations, the IB advises that the fiduciary will need to obtain and follow independent expert advice calculated to identify those insurers with the highest claims-paying ability willing to write the business. In the absence of any possibility of funds reverting to a plan sponsor in connection with the termination of a defined contribution plan, it is the view of the Department that paragraph (e) would not apply to such plan.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

1.

Trust Examination Manual

Advisory Opinion 2003-02A

February 10, 2003

Lisa J. Bleier
Senior Counsel
Regulatory and Trust Affairs
American Bankers Association
1120 Connecticut Avenue, NW
Washington, DC 20036
2003-02A
ERISA Sec. 408(b)(2) and 408(b)(6)

Dear Ms. Bleier:

This is in response to your request, on behalf of the American Bankers Association, regarding the fiduciary responsibility provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Specifically, you have requested an opinion clarifying the application of sections 408(b)(2) and 408(b)(6) of ERISA to the provision of overdraft protection services, including any inherent extension of credit incident to such services, by banks, whether or not the bank or other financial institution or affiliate exercises investment discretion over plan assets.(1)

You represent that banks provide custodial or trust services to institutional clients, including employee benefit plans. A bank or its affiliate may also serve as investment manager for plans and other clients or as trustee and investment manager of collective funds in which plans invest. An essential part of bank custodial and trust services provided to clients, including employee benefit plans, is the orderly processing of the client's securities and other financial market transactions, generally based on the anticipated receipt of funds to cover such transactions. In this regard, you indicate that banks have established settlement policies and procedures to maximize the efficiency of the securities trading in institutional accounts.

You note that plan investment performance would suffer significantly if a bank held up settlements to ensure that every sale scheduled to settle (thus generating funds necessary to effectuate subsequent transactions) had in fact settled or that anticipated funds had indeed been received. You represent that, although most transactions settle on time, settlement problems may arise due to errors, unexpected delays by a counterparty or its agent, settlement failures by a counterparty or its custodian, broker failures or inefficient markets. In the event of such a failure, banks will generally settle plan transactions without contemporaneous assurance that the necessary funds have been credited, in the correct currency, to the plan's account. You represent that this overdraft protection is provided as part of a bank's and its sub-custodians' "standard operating systems and practices maintained routinely for all institutional customers." Overdraft protection is necessary to the custody service and is expected and demanded by plan and non-plan clients.

You explain that unlike a conventional loan between a plan and a bank, overdraft protection involves no agreement to lend a stated sum for a specified period of time. Events giving rise to an overdraft are generally inadvertent or outside the control of the bank or affiliate. A bank or an affiliate makes no specific discretionary decision to extend overdraft protection at the time of the settlement of a transaction and neither the plan nor its investment fiduciary makes a specific discretionary decision at that time to accept it. In fact, although the client is aware that overdraft protection is available, when needed, neither the client nor the bank is likely to be aware of the existence of any particular overdraft or its amount at the time that overdraft protection is actually provided. Banks recognize the extent to which overdrafts occur only in

retrospect upon reconciliation of client accounts. Further, you represent that banks have procedures in place to discourage overdrafts and prevent clients, including plans, from using the overdraft protection as an intentional line of credit.

Your letter contains the following general information about overdraft protection procedures. Overdraft protection procedures are designed to ensure that overdraft protection is consistent with sound banking practice under published positions of both the Office of the Comptroller of the Currency and the Federal Reserve Board.(2) According to your letter, bank procedures, as well as agreements with plan clients, ensure that the terms of overdraft protection are at least as favorable to plans as the terms generally available in arm's length transactions between unrelated parties. After an overdraft is determined, a bank promptly notifies the appropriate investment manager or other plan fiduciary to determine the course of action that the fiduciary will take to correct the overdraft. Notice may be provided by telephone, facsimile, e-mail, through a bank's secure Web site or by some alternative method directed by the plan. Banks generally impose an overdraft charge and intend that such charge function as a disincentive for the investment fiduciary to intentionally prolong an overdraft. The overdraft charge is based on an objective measure that varies depending upon factors such as the custody location or currency involved. The overdraft charge may be defined by reference to an identified published rate. The overdraft charge, according to your letter, does not exceed "reasonable compensation."

You represent that banks disclose and obtain the consent of plan clients to the provision of overdraft protection. Bank disclosures describe the overdraft protection service and identify the objective basis for the overdraft charge. Consent may be affirmative if the plan client signs a trust, custody, or other agreement describing the services. Alternatively, consent may be deemed given following disclosure of the services.

As a trustee or custodian, a bank is a party in interest with respect to each plan. ERISA section 3(14) defines “party in interest” to include, among others, a fiduciary or person who provides services to a plan. Absent an exemption, a bank’s provision of overdraft protection, as described herein, to plans would violate sections 406(a)(1)(C) and (D) of ERISA, which prohibit the provision of services by a party in interest to a plan and the transfer of assets from a plan to a party in interest. In addition, absent an exemption, any extension of credit between the bank and plan that may occur in connection with the overdraft protection would violate section 406(a)(1)(B) of ERISA. Moreover, if a bank uses any of the authority, control, or responsibility that makes the bank a fiduciary to cause a plan to pay to the bank an overdraft charge, the bank may violate sections 406(b)(1) and (2) of ERISA.

As discussed below, it is the view of the Department that the provision of overdraft protection services, including any inherent extensions of credit incident to such services, described in your letter would not constitute a prohibited transaction under section 406 to the extent that the bank providing such services complies with the requirements for relief under section 408(b)(2) or section 408(b)(6) of ERISA, as appropriate, and such provision of services is not otherwise part of an arrangement to secure credit unrelated to the settlement of securities or other financial market transactions.

Section 408(b)(2) provides a statutory exemption from the prohibitions of section 406(a) for contracting or making reasonable arrangements with a party in interest, including a fiduciary, for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor. Regulations issued by the Department clarify the terms "necessary service" (29 C.F.R. §2550.408b-2(b)), "reasonable contract or arrangement" (29 C.F.R. §2550.408b-2(c)), and "reasonable compensation” (29 C.F.R. §§2550.408b-2(d) and 2550.408c-2) as used in section 408(b)(2). Thus, overdraft protection services, in the context described in your letter, appear to be necessary to ensure the orderly processing of plan securities and other financial market transactions and, therefore, would appear to be a “necessary service” for purposes of section 408(b)(2) and §2550.408b-2(b). Accordingly, such services would be covered by section 408(b)(2) to the extent such services are furnished under contracts or arrangements that are reasonable and no more than reasonable compensation is paid for such services within the meaning of §2550.408b-2. As explained in §2550.408b-2(a), section 408(b)(2) does not contain an exemption for an act described in ERISA section 406(b) (relating to conflicts of interest on the part of fiduciaries) even if such act occurs in connection with the provision of services that are exempt under section 408(b)(2).

Section 408(b)(6) of ERISA provides a statutory exemption from the prohibitions of section 406 for any ancillary services provided to a plan by a bank or similar financial institution supervised by the United States or a State, if such bank or financial institution is a fiduciary of such plan and certain conditions are satisfied. Section 2550.408b-6 further clarifies the application of section 408(b)(6). Such ancillary services

include services that do not meet the requirements of ERISA section 408(b)(2) because the provision of such services involves an act described in section 406(b)(1) or (b)(2) of ERISA.

The Department has indicated that a service is “ancillary” if it aids or is auxiliary to a primary or principal service. The Department has concluded that the provision of “sweep services” by a trustee who is subject to direction from an independent investment manager for the investment of plan assets may constitute an “ancillary service” within the meaning of section 408(b)(6).(3) The Department also has indicated that the question of what constitutes an “ancillary service” within the meaning of section 408(b)(6) depends on the expectations of the parties as evidenced by the terms of the underlying service agreement and applicable Federal banking law.(4)

With regard to the expectations of the parties, you represent that plan fiduciaries are fully informed about, and approve, the terms governing the provision of overdraft protection services in settling securities and other financial market transactions for the plan, including associated charges.(5) Additionally, you represent that disclosure documents make clear that charges attendant to overdrafts are in addition to and separate from fees charged for other services, such as trustee or investment management services, provided by the bank or an affiliate. Given the foregoing and the fact that overdraft protection services appear to be necessary to ensure the orderly processing of plan securities transactions and other financial market transactions, as well as a banking practice recognized and permitted by Federal banking authorities, it is the view of the Department that the overdraft protection services described in your letter would constitute an “ancillary service” and, therefore, may be exempt from the prohibitions of section 406 if the conditions of section 408(b)(6) are satisfied. Whether any given bank satisfies the conditions of section 408(b)(6) is an inherently factual determination on which the Department generally will not rule.

Section 2550.408b-6(b) requires that ancillary services described in section 408(b)(6) must be provided at not more than reasonable compensation; under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and only to the extent such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of §2550.408b-6(c). To date, no regulations have been issued to set specific requirements for such guidelines. However, the Department has stated that the condition contained in section 408(b)(6)(B) requiring "specific guidelines" is satisfied (in the absence of such regulations) if the ancillary services are provided in accordance with the specific guidelines issued by the bank or similar financial institution, and adherence to the guidelines would reasonably preclude such bank or institution from providing the services in an excessive or unreasonable manner and in a manner that would be inconsistent with the best interests of the participants and beneficiaries (See 47 FR 14806, April 6, 1982).

In order to reasonably preclude providing services in an excessive or unreasonable manner or in a manner that would be inconsistent with the best interests of the participants and beneficiaries, it is the view of the Department that guidelines relating to overdraft protection services, at a minimum, would be required to include measures designed to ensure timely notice to the appropriate plan fiduciary of any overdraft and the imposition of charges with respect thereto, to monitor and limit the duration and usage of overdraft services, and to limit the ability of a fiduciary to utilize overdraft protection services as a routine means by which securities and other financial market transactions are settled. For example, a pattern or practice of routine use of overdraft protection for settlement of securities or other financial market transactions would evidence the providing of ancillary services in an excessive and unreasonable manner and in a manner inconsistent with the interests of participants and beneficiaries in violation of section 408(b)(6).

ERISA’s general standards of fiduciary conduct also apply to the overdraft protection services. Section 404 requires, among other things, a fiduciary to discharge his duties respecting a plan solely in the interest of the plan’s participants and beneficiaries and in a prudent fashion and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Further, except as provided in section 408, fiduciaries also have an obligation under section 406 not to engage in self-dealing or to cause the plan to engage in certain transactions, including a direct or indirect furnishing of goods, services or facilities between the plan and a party in interest. In this regard, banks or institutions which act as investment managers to plans and provide through their affiliates or otherwise overdraft services would need to assure adherence with the conditions and guidelines specified in section 408(b)(6) of ERISA in the performance of those services.

As with the selection of any service provider, a plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of the

services offered, and the reasonableness of the fees charged in light of the services provided, including overdraft protection services. As with any compensation arrangement, plan fiduciaries should consider the circumstances under which services will be rendered and the charges for such services, the basis for such charges and the ability of the fiduciary to limit such charges.

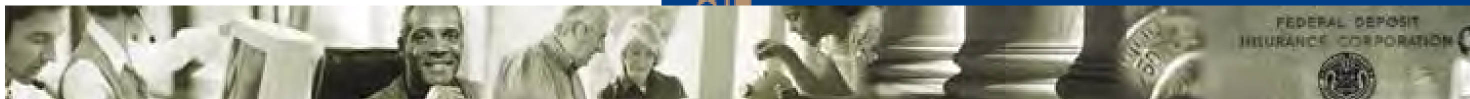
This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is subject to the provisions of the procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978, 43 FR 47713 (Oct. 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Internal Revenue Code (Code) has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA also refer to the corresponding sections of the Code.

2. You represent that the Office of the Comptroller of the Currency recognizes that overdrafts in fiduciary accounts are permissible if they are temporary in nature, made only for proper purposes and appropriately accounted for in the records of the bank. The Federal Reserve Board takes a similar position, permitting overdrafts that are temporary, corrected as soon as possible, kept to a minimum and adequately secured. Both agencies permit the imposition of a fee with respect to the overdraft if the policy is permitted under local law. See e.g., Fed. Res. Interp. Ltr. No. 5-942.22, (March 16, 1993), available at 1993 WL 764576 (F.R.B.).
3. See Advisory Opinion No. 2001-10A, December 14, 2001.
4. See DOL information letter to Robert Plotkin, August 1, 1986.
5. What constitutes an approval by an appropriate plan fiduciary will depend on the facts and circumstances of each case. See Advisory Opinions Nos. 97-16A, May 22, 1997 and 2001-01A, January 18, 2001.



Trust Examination Manual

Advisory Opinion 2003-09A

June 25, 2003
2003-09A
ERISA Sec. 406(b)(1), 406(b)(3)

Gary W. Howell
Gardner, Carton & Douglas
191 North Wacker Drive, Suite 3700
Chicago, IL 60606

Dear Mr. Howell:

This is in response to your request for guidance under the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you ask whether a trust company's receipt of 12b-1 and subtransfer fees from mutual funds, the investment advisers of which are affiliates of the trust company, for services in connection with investment by employee benefit plans in the mutual funds, would violate section 406(b)(1) and 406(b)(3) of ERISA when the decision to invest in such funds is made by an employee benefit plan fiduciary or participant who is independent of the trust company and its affiliates.

You write on behalf of ABN AMRO Trust Services Company (AATSC), a state-chartered trust company. You represent that AATSC is a wholly owned subsidiary of Alleghany Asset Management Company (Alleghany), which is a wholly owned subsidiary of ABN-AMRO North America Holding Company, a bank holding company (ABN-AMRO).(1)

Alleghany is also the parent organization of several institutional investment advisers (Advisers), including some that have entered into investment advisory contracts with mutual funds registered under the Investment Company Act of 1940. You refer to those mutual funds with which such Advisers have investment advisory contracts as 'Proprietary Funds.' All other mutual funds are referred to as 'Non-Proprietary Funds.'

You represent that AATSC provides directed trustee and 'non-fiduciary' services to participant-directed and other defined contribution pension plans (Client Plans) through 'bundled service' arrangements. You represent that these services (Plan Services) provided by AATSC through bundled service arrangements include, but are not limited to, custodial trustee services, participant level recordkeeping, participant communications and educational materials and programs, voice response system access to accounts for participants, plan documentation, including prototype plans, summary plan descriptions and annual reports, tax compliance assistance, administrative assistance in processing plan distributions and loans, and a facility for plan investment options.

In connection with the Client Plan-related business, AATSC has entered into shareholder service arrangements with distributors of, or investment advisers to, mutual fund families pursuant to which AATSC will make mutual fund families available for investment by Client Plans. Among the investment advisers with which AATSC enters into such arrangements are those Advisers with investment advisory contracts with Proprietary Funds.

You represent that neither AATSC, nor any other bundled service provider of which AATSC is aware, engages in arrangements where just Plan Services are provided. You represent that, because the true cost of Plan Services would exceed any amount that could be charged in the competitive bundled service market with regard to a Client Plan's engagement of AATSC as a bundled service provider, all bundled service arrangements between AATSC and a Client Plan are predicated on a Client Plan's offering of one

or more Proprietary Funds as an investment option.

You represent that disclosures with regard to Proprietary Funds will enable the fiduciaries of potential Client Plans to make an informed decision regarding whether to engage AATSC in a bundled service arrangement. Included in every proposal made by AATSC to a potential Client Plan are the following disclosures regarding each Proprietary Fund offered:

the total number of actively-managed mutual funds in the same category as the Proprietary Fund (based on fund classifications by Lipper, Morningstar, or some other generally recognized mutual fund analytical service);

the investment advisory fee, 12b-1 fee (if any) and other fees paid by the Proprietary Fund, as well as the aggregate fees paid by such Proprietary Fund; and

1. the same fee information described in (b) with respect to the highest-fee, lowest-fee, median-fee, and average-fee fund in the same category as the Proprietary Fund.

   You represent that participant-directed and other defined contribution pension plans become Client Plans through a process of presentation and negotiation. Typically, a plan sponsor, on behalf of a potential Client Plan, either directly, or through a third-party consultant, will ask AATSC to respond to a 'request for proposal' to provide a bundle of services for the plan, such as recordkeeping, directed trusteeship, participant investment education, participant loan and distribution processing and investment vehicles. You represent that a potential Client Plan will typically ask other bundled service providers also to respond to a request for proposal.

   Client Plan fiduciaries select the funds in which the Client Plans will invest. AATSC does not restrict the mutual funds that a Client Plan may utilize, beyond requiring, as a condition of engagement, that a Client Plan select at least one Proprietary Fund to offer as an investment option. AATSC will, if requested, provide a list of investment funds for the Client Plan to consider. The Client Plan fiduciaries are free to select funds other than those listed by AATSC. Your representations indicate that AATSC, under the terms of a bundled service arrangement, will not be able to assert any influence with respect to selection of other investment options in which Client Plans will invest or the particular Proprietary Fund in which the Client Plan elects to invest.

   Potential Client Plan fiduciaries are free to accept, reject or further negotiate a bundled service arrangement from AATSC. Based upon such flexibility on the part of a potential Client Plan with respect to negotiation of the terms surrounding engagement of AATSC to provide Plan Services, you represent that engagement of AATSC results from arm's length negotiations between a potential Client Plan and AATSC.

   You represent that a Client Plan's choice of investment vehicles affects the cost of engaging AATSC to provide Plan Services. AATSC estimates the amounts that a potential Client Plan would likely invest in Proprietary Funds based on the amount of the Client Plan's assets and the number of Proprietary Funds selected. This estimate affects the price at which AATSC offers to perform Plan Services. For example, if Client Plan fiduciaries may direct investment into three Proprietary Funds, Plan Services would cost less than if Client Plan fiduciaries may direct investment into two Proprietary Funds. Similarly, Client Plan fiduciaries that may direct investment into only one Proprietary Fund would be quoted a higher price for bundled services, because AATSC would expect to cover less of the cost of providing Plan Services from asset management revenue.

   As a directed trustee, AATSC takes direction from Client Plans regarding their selection of investment options. You assert that, because AATSC does not restrict the mutual funds that a potential Client Plan may utilize, the preparation and furnishing of a list offering an array of mutual fund choices does not constitute discretion to add or delete mutual fund families in which Client Plans may invest.

   You represent that if a Client Plan decides to remove a Proprietary Fund as an investment option, AATSC's total anticipated revenue from the Client Plan and Proprietary Fund would be affected, leaving less asset management revenue with which to provide Plan Services. In such a situation, you represent that AATSC would invite the Client Plan fiduciaries to consider one or more other Proprietary Funds to replace non-Proprietary Fund investment options. If the plan fiduciaries do not choose to offer another Proprietary Fund as an investment option, AATSC would continue to

provide Plan Services pursuant to the bundled services arrangement, but would evaluate such arrangement, as follows.

If AATSC determines that a bundled service arrangement is no longer profitable, AATSC can withdraw or make an offer to the Client Plan fiduciaries to renegotiate the fees for AATSC's provision of Plan Services. You represent that AATSC's bundled service arrangements generally include a provision whereby AATSC may propose a fee adjustment upon sixty days' written notice. In addition, either party can terminate a bundled service arrangement without cause, upon at least thirty days' advance written notice. Upon termination of a bundled service arrangement, funds are transferred on the effective date of appointment of a successor trustee.

You represent that AATSC has the systems and administrative capability to provide investment facilities to a Client Plan for any mutual fund that accepts investments from pension plans. You represent that the majority of mutual funds are traded by AATSC on the National Securities Clearing Corporation (NSCC) 'platform' for processing transactions in mutual funds. Mutual fund transactions processed through NSCC's 'Fund/SERV' service are made on its standard, highly automated platform that links approximately 2,000 key providers in the mutual fund industry, including AATSC. For those few funds utilized by Client Plans that do not participate in NSCC, generally because of their small size or low volume of trades, you represent that AATSC processes trades manually, in a manner consistent with industry practice.

You ask whether AATSC's receipt of 12b-1 and subtransfer agency fees from mutual funds, including those Proprietary Funds the investment advisers of which are affiliates of AATSC, for services in connection with investment by employee benefit plans in the mutual funds, would violate section 406(b)(1) and 406(b)(3) of ERISA when the decision to invest in such funds is made by an employee benefit plan fiduciary who is independent of AATSC and its affiliates.(2)

Section 3(14)(A) and (B) of ERISA provides that a party in interest means, as to an employee benefit plan, any fiduciary, including a trustee, of an employee benefit plan or a person providing services to a plan. ERISA section 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent that it (i) exercises any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) has any discretionary authority or responsibility in the administration of the plan. Accordingly, as directed trustee of Client Plans, AATSC will be a party in interest and a fiduciary.

Section 406(a)(1)(C) of ERISA proscribes the provision of services to a plan by a party in interest, including a fiduciary, and section 406(a)(1)(D) prohibits the use by or for the benefit of, a party in interest, of the assets of a plan. However, section 408(b)(2) of ERISA provides an exemption from the prohibitions of section 406(a) of ERISA for contracting or making reasonable arrangements with a party in interest, including a fiduciary, for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid.

29 CFR 2550.408b-2 provides, with respect to a reasonable contract or arrangement, that no contract or arrangement is reasonable within the meaning of section 408(b)(2) and 29 CFR 2550.408b-2(a)(2) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. Your representations indicate that, pursuant to the Client Plan's arrangement with AATSC and consistent with 29 CFR 2550.408b-2(c), the Client Plan may terminate a bundled service arrangement without cause and without penalty, upon at least thirty days' advance written notice.(3)

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in its own interest or for its own account. Section 406(b)(3) of ERISA prohibits a fiduciary with respect to a plan from receiving any consideration for its own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

With respect to the prohibitions in section 406(b), regulation 29 CFR 2550.408b-2(a) indicates that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) of ERISA (relating to conflicts of interest on the part of fiduciaries) even if such act occurs in connection with a provision of services which is exempt under section 408(b)(2). As explained in

regulation 29 CFR 2550.408b-2(e)(1), if a fiduciary uses the authority, control, or responsibility which makes it a fiduciary to cause the plan to enter into a transaction involving the provision of services when such fiduciary has an interest in the transaction which may affect the exercise of its best judgment as a fiduciary, a transaction described in section 406(b)(1) would occur, and that transaction would be deemed to be a separate transaction from the transaction involving the provision of services and would not be exempted by section 408(b)(2). Conversely, the regulation explains that a fiduciary does not engage in an act described in section 406(b)(1) if the fiduciary does not use any of the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary.

You assert that principles previously expressed by the Department in Advisory Opinion 97-15A(4) would apply here. In Advisory Opinion 97-15A, the Department opined that if a trustee acts pursuant to a proper direction in accordance with sections 403(a)(1) or 404(c) of ERISA and does not exercise any authority or control to cause a plan to invest in a mutual fund that pays a fee to the trustee in connection with the plan's investment, then the trustee would not be dealing with assets of the plan for its own interest or for its own account in violation of section 406(b)(1) of ERISA and the trustee would not be receiving consideration for itself from a third party in connection with a transaction involving plan assets in violation of section 406(b)(3).

The arrangement about which you request the Department's guidance differs from the facts of Advisory Opinion 97-15A. In that letter, the trustee had reserved the right to add or remove mutual fund families that it made available to its client plans. The trustee also agreed to apply any fees it received from the mutual funds to the benefit of the plans. You represent that, once a Client Plan enters into a bundled service arrangement with AATSC, the Client Plan fiduciary possesses authority to make decisions regarding investment fund choices and any modifications to the menu of investment fund choices available for investment of plan assets.

In Advisory Opinion 97-16A,(5) the Department expressed the view that a person would not be exercising discretionary authority or control over the management of a plan or its assets solely as a result of deleting or substituting a fund from a program of investment options and services offered to plans, provided that the appropriate plan fiduciary in fact makes the decision to accept or reject the change. In this regard, the Department went on to opine that the plan fiduciary must be provided advance notice of the change, including disclosure of record-keeper fee information and must be afforded a reasonable amount of time in which to accept or reject the change. Such advance notice ensured that the fiduciary would maintain independence with respect to selection of investment options offered. Similar to the arrangement described in Advisory Opinion 97-16A, here a Client Plan sponsor or other fiduciary shall, independent of AATSC, maintain complete control with respect to the selection of funds in which the Client Plan will invest. AATSC itself has no role with respect to selection of investment options beyond requiring, as a condition of initial engagement of AATSC as a bundled service provider, that at least one Proprietary Fund is offered by a Client Plan for investment.

You represent that when a Client Plan engages AATSC to provide bundled services, a Client Plan fiduciary, independent of AATSC or its affiliates, will select the Client Plan's investment options. We note, however, that if, with respect to a particular Client Plan, AATSC provides 'investment advice' within the meaning of regulation 29 CFR 2510.3-21(c), AATSC would engage in a violation of section 406(b)(1) of ERISA in causing the Client Plan to invest in a Proprietary Fund (or any mutual fund that pays a fee to AATSC or its affiliates).

It is the view of the Department that AATSC's receipt of 12b-1 or subtransfer fees from mutual funds, including those Proprietary Funds the investment advisers of which are affiliates of AATSC, for services in connection with investment by employee benefit plans in the mutual funds, under the circumstances described above, would not violate section 406(b)(1) or 406(b)(3) of ERISA when the decision to invest in such funds is made by a fiduciary who is independent of AATSC and its affiliates, or by participants of such employee benefit plans.

Finally, it should be noted that ERISA's general standards of fiduciary conduct also would apply to the proposed arrangement. Section 403(c)(1) of ERISA provides that the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the

plan. Under section 404(a)(1) of ERISA, the responsible plan fiduciaries must act prudently and solely in the interest of the plan participants and beneficiaries both in deciding whether to enter into, or continue, arrangements with AATSC and in determining the investment options in which to invest or make available to plan participants and beneficiaries in self-directed plans.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

In your initial submission, you wrote on behalf of The Chicago Trust Company (TCTC). Since the date of submission, TCTC has been renamed AATSC, effective January 1, 2002. This change is in name only and was effected without any legal change in the individual corporate status of TCTC. AATSC continues as a state-chartered trust company under the original charter and corporate status granted by the state to the former TCTC, and remains in the same legal relationship, by way of ownership, to Alleghany and ABN-AMRO.

2. Consistent with Prohibited Transaction Exemption 96-74, granted to TCTC, TCTC will never receive any 12b-1 or subtransfer agency fees from its Proprietary Funds in connection with the conversion of certain collective investment fund units into shares of Proprietary Funds. Furthermore, you represent that AATSC relies upon Prohibited Transaction Class Exemption 77-4 to cover situations where AATSC may serve as a fiduciary to a Client Plan with authority to select investments, including Proprietary Funds. In Advisory Opinions 93-12A and 93-13A, the Department expressed the view that it was unable to conclude that PTE 77-4 would be available for plan purchases and sales of mutual fund shares if a 12b-1 fee is paid to the fiduciary or its affiliate with regard to that portion of the mutual fund's assets attributable to the plan's investment.
3. The Department expresses no view as to whether the conditions contained in section 408(b)(2) of ERISA would be satisfied with respect to any arrangement between AATSC and a Client Plan.

Issued on May 22, 1997.

Issued on May 22, 1997.

1.

Trust Examination Manual

Advisory Opinion 2003-11A

September 8, 2003
2003-11A
ERISA Sec. 404(c)

Stephen M. Saxon
Groom Law Group, Chartered
1701 Pennsylvania Ave., NW
Washington, DC 20006-5893

Dear Mr. Saxon:

This is in response to your request for guidance under the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you ask whether a participant-directed individual account plan's delivery of a mutual fund Profile, as described below, to participants and beneficiaries immediately before or immediately after their investment in the mutual fund would satisfy regulations issued by the Department of Labor (Department) pursuant to section 404(c) of ERISA.

You represent that the Principal Financial Group (Principal) provides investment products and administrative services to tax-qualified defined contribution plans established pursuant to section 401(a) of the Internal Revenue Code of 1986 (the Code), including plans that permit employee elective deferrals under section 401(k) of the Code (401(k) plans). Many of these 401(k) plans permit participants to direct the investments of the amounts in their individual accounts. These 401(k) plans are typically designed and administered by Principal to comply with regulations issued by the Department pursuant to section 404(c) of ERISA (404(c) regulations).(1)

Section 404(c) of ERISA provides that, in the case of an individual account plan that permits participants or beneficiaries to exercise control over assets in their accounts, no person who is otherwise a fiduciary shall be liable under part 4 of Title I of ERISA for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control. The 404(c) regulations require, among other things, that a participant or beneficiary shall be provided or have the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan.(2) In the case of an investment alternative subject to the registration requirements of the Securities Act of 1933 (Securities Act) such as a mutual fund, the 404(c) regulations provide that a participant or beneficiary shall be provided by the identified plan fiduciary (or a person or persons designated by the plan fiduciary to act on his behalf), a copy of the most recent prospectus that was provided to the plan, either immediately before the participant's or beneficiary's initial investment in such investment alternative, or immediately following the participant's or beneficiary's initial investment.(3) The 404(c) regulations also provide that a participant or beneficiary shall be provided, either directly or upon request, the following information, which shall be based on the latest information available to the plan: copies of any prospectuses, financial statements and reports, and of any other materials relating to the investment alternatives available under the plan, to the extent such information is provided to the plan.(4)

Section 2(a)(10) of the Securities Act generally defines the term "prospectus" to include any notice, circular, advertisement, letter, or communication that offers any security for sale or confirms the sale of any security.(5) Section 10(a) of the Securities Act generally provides that a prospectus relating to a security (10(a) prospectus) shall contain much of the same information that is contained in the registration statement of the security.(6) Section 10(a) of the Securities Act specifies the information that a prospectus must contain and the information that a prospectus may omit.(7) Section 10(b) of the Securities Act

provides that the Securities and Exchange Commission (SEC) shall, by rules or regulations deemed necessary or appropriate in the public interest or for the protection of investors, permit the use of a summary document (10(b) prospectus) which omits in part or summarizes information provided in a 10(a) prospectus.

Under section 5(b)(1) of the Securities Act, a 10(b) prospectus may be provided to an investor in connection with an offer to sell a registered security.(8) Under section 5(b)(2) of the Securities Act, however, a 10(a) prospectus must be provided to an investor at or before any sale of a registered security.(9) Thus, under the federal securities laws, while a summary document under section 10(b) of the Securities Act may be delivered for purposes of an offer, a 10(a) prospectus would, in any event, also be required to be delivered in order to sell a registered security.

On March 13, 1998, the SEC adopted Rule 498 under the Securities Act (Securities Act Rule 498). Under Securities Act Rule 498, a summary prospectus, or a Profile, designed to comply with section 10(b) of the Securities Act, may be delivered to investors in connection with an offer to purchase or sell mutual fund shares.(10) Paragraph (b) of Securities Act Rule 498 provides that a Profile is intended to be a standardized summary of key information contained in a 10(a) prospectus. Securities Act Rule 498 requires a Profile to provide clear and concise information in a format designed to communicate information effectively, while avoiding excessive detail, technical or legal terms, and long sentences and paragraphs.(11) A Profile is specifically required to include, among other things: identifying information; an explanation that the Profile summarizes key information included in the prospectus; information regarding how investors can obtain the prospectus; investment objectives, strategies, and risks; fees and expenses; identities of investment advisers and managers; information regarding purchase and sale of shares; investment requirements; distributions and tax information; and other services available.

In adopting Securities Act Rule 498, the SEC stated its belief that investors in participant-directed defined contribution plans may find a Profile helpful in evaluating and comparing funds offered as investment alternatives in a plan.(12) Paragraph (d)(1) of Securities Act Rule 498 provides that, in a Profile intended for use with respect to a 401(k) plan, a mutual fund may modify or omit certain information which may not be relevant to participants and beneficiaries of a plan, such as information about requirements for purchasing and selling shares, fund distributions, tax consequences with regard to distributions, and other fund services that are not applicable to plan participants and beneficiaries. The SEC did not, however, authorize the use of the Profile for purposes of a sale under section 5(b)(2) of the Securities Act.

You represent that, because Principal's 401(k) plan clients typically design and administer their plans to comply with the 404(c) regulations, administrative services provided by Principal include assistance in meeting the disclosure and other requirements of the 404(c) regulations. With regard to mutual funds, Principal proposes to deliver Profiles of mutual funds, including its proprietary funds, to participants of 401(k) plans designed to comply with the 404(c) regulations. You represent that Principal believes that delivery of a mutual fund Profile to a participant of a 401(k) plan designed to comply with the 404(c) regulations will satisfy the requirement under the 404(c) regulations that a prospectus be delivered to each participant either immediately before or immediately after the participant's initial investment in the mutual fund.(13) You assert that automatic delivery of a Profile would permit plans to avoid the additional expense of automatically providing a lengthy 10(a) prospectus. In addition, you represent that, with regard to delivery of a 10(a) prospectus, Principal will send a 10(a) prospectus to any requesting participant or beneficiary within three days of receipt of such request.(14)

You assert that, consistent with the Department's reasoning in the preamble to the 404(c) regulations with regard to delivery of a prospectus, the delivery of a Profile, as a concise summary of a mutual fund's investment objectives, risk and return characteristics, and type and diversification of assets, will provide participants and beneficiaries with the information necessary for them to make informed investment decisions with respect to investment in mutual funds. You assert that the required delivery of a prospectus under section 404(c) is intended to ensure that participants and beneficiaries are provided with sufficient information in order to be able to make informed decisions with respect to investment alternatives under the plan. In this regard, you represent that a Profile conveys all the information about a mutual fund that the 404(c) regulations require to be delivered automatically to participants in connection with each designated investment option (i.e., the description of investment objectives, risk and return characteristics, type and diversification of assets, and identification of investment manager, required by 29 CFR section 2550.404c-1(b)(2)(i)(B)(1)(ii) and (iii)).

You specifically ask whether delivery of a Profile would satisfy a participant-directed individual account plan's obligation under the 404(c) regulations to deliver a copy of the most recent prospectus to plan

participants and beneficiaries immediately before or immediately after such individuals initially invest in mutual funds.

The Department has not defined the term “prospectus” in the 404(c) regulations, or elsewhere. In the preamble to the 404(c) regulations, the Department states that the prospectus delivery requirement is intended to ensure that, immediately before or immediately after a participant’s or beneficiary’s initial investment in an investment alternative, such as a mutual fund, that is required to deliver a prospectus to investors under the federal securities laws, participants and beneficiaries must be afforded the opportunity to review the prospectus in connection with an initial investment in such investment alternative.(15)

The Department takes no position with respect to the application of the federal securities laws to your question. However, it is the view of the Department that, under the 404(c) regulations, the term “prospectus” includes a Profile. The Department believes that the delivery of a Profile by an identified plan fiduciary or designee to plan participants or beneficiaries satisfies the requirements of the 404(c) regulations because it provides a clear summary of key information about a mutual fund that is useful to such participants and/or beneficiaries.

A Profile, designed to comply with section 10(b) of the Securities Act, provides participants with information of the sort that the Department intended a participant in a section 404(c) plan to receive both automatically and upon request with respect to a relevant investment. Moreover, if a participant wishes to obtain additional information, the cover page of the Profile shows how to obtain a 10(a) prospectus from the offeror.

Where the most recent prospectus in the plan’s possession is a Profile, then delivering the Profile to plan participants and beneficiaries, immediately before or immediately after such individuals’ initial investment in a mutual fund, would satisfy a participant-directed individual account plan’s prospectus delivery obligation under 29 CFR section 2550.404c-1(b)(2)(i)(B)(1)(viii). Where the most recent prospectus is a 10(a) prospectus, 29 CFR section 2550.404c-1(b)(2)(i)(B)(1)(viii) would require the delivery of a 10(a) prospectus.

Separately, under 29 CFR section 2550.404c-1(b)(2)(i)(B)(2), the identified plan fiduciary or designee must provide, either directly or upon request, copies of prospectuses (among other things) based on the latest information available to the plan. Where a participant requests a prospectus, and the most recent prospectus is a Profile, then providing the Profile will comply with this requirement. If, however, the participant specifically requests a 10(a) prospectus, the most recent 10(a) prospectus must be provided.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

1. 29 CFR 2550.404c-1.
2. 29 CFR 2550.404c-1(b)(2)(i)(B).
3. 29 CFR 2550.404c-1(b)(2)(i)(B)(1)(viii).
4. 29 CFR 2550.404c-1(b)(2)(i)(B)(2)(ii).
5. See 15 USC 77b(a)(10).
6. On March 13, 1998, the SEC adopted amendments to Form N-1A, the registration form used by mutual funds. Pursuant to the amendments, a mutual fund prospectus must provide investors with essential information about the mutual fund, including: risk/return summaries; investment strategies; mutual fund performance; management, organization, and capital structure; shareholder information; and distribution arrangements. A mutual fund prospectus should avoid: lengthy legal and technical discussions; a restatement of legal or regulatory requirements to which mutual funds generally are subject; and disproportionate emphasis on possible investments or activities of the mutual fund that are not a significant part of the mutual fund’s investment operations. In addition, a mutual fund prospectus may modify or omit certain items when mutual funds are investment options for 401(k) plans, including:

procedures for purchasing and redeeming mutual fund shares if such procedures are inapplicable; dividend and distribution policies if such policies are inapplicable; and tax consequences to shareholders with respect to buying, holding, exchanging, and selling mutual fund shares if such consequences are inapplicable. See Registration Form Used by Open-End Management Investment Companies, Securities Act Release No. 7512 (March 13, 1998).

7. See 15 USC 77j(a).
8. See 15 USC 77j(b).
9. See 15 USC 77e(b)
10. See New Disclosure Option for Open-End Management Investment Companies, Securities Act Release No. 7513 (March 13, 1998) (Securities Act Rule 498 Adopting Release). In adopting Securities Act Rule 498 which permits the use of a Profile, the SEC stated that the "profile of a fund will be a summary prospectus under section 10(b) of the Securities Act, but the fund's section 10(a) prospectus will remain the primary disclosure document under the federal securities laws." Securities Act Rule 498 Adopting Release. Accordingly, paragraph (c)(1)(v) of Securities Act Rule 498 requires that a Profile shall provide a toll-free (or collect) telephone number that investors can use to obtain the prospectus and a mutual fund may indicate, as applicable, that the prospectus and other information is available on the mutual fund's internet site or by e-mail request, or that the prospectus is available through a financial intermediary.
11. See 17 CFR 230.498.
12. Securities Act Rule 498 Adopting Release, text accompanying note 124.
13. See 29 CFR 2550.404c-1(b)(2)(i)(B)(1)(viii).
14. We note that the Instruction to Paragraph (c)(1)(v) of Securities Act Rule 498 provides that when a mutual fund (or financial intermediary through which shares of the mutual fund may be purchased or sold) receives a request for a 10(a) prospectus, the mutual fund (or financial intermediary) must send the 10(a) prospectus within three business days.
15. See 57 Fed. Reg. 46906, 46911 (October 13, 1992).

1.

Trust Examination Manual

[Advisory Opinion 2003-15A]

November 17, 2003
2003-15A
ERISA Sec. 3(14)(G) and 406(a)

William A. Schmidt
Kirkpatrick & Lockhart LLP
1800 Massachusetts Avenue, NW
Second Floor
Washington, DC 20036-1800

Jacob I. Friedman
Proskauer Rose LLP
1585 Broadway
New York, NY 10036-8299

Dear Messrs. Schmidt and Friedman:

This is in response to your request for an advisory opinion on behalf of Verizon Investment Management Corp. as to whether certain transactions between employee benefit plans sponsored by Verizon Communications, Inc. (Verizon) and a limited partnership in which those plans invest would constitute prohibited transactions under the Employee Retirement Income Security Act of 1974 (ERISA).

You represent that Verizon sponsors welfare benefit plans that qualify as voluntary employees' beneficiary associations (VEBAs) and defined benefit plans (DB Plans), collectively the Verizon Plans.(1) The Bell Atlantic Master Trust (Master Trust) holds the assets of the Verizon DB Plans. Mellon Bank, N.A. (Mellon) serves as the directed trustee of the Master Trust. Each VEBA is held in trust by Mellon.

Verizon Investment Management Corp. (VIMCO), a wholly-owned subsidiary of Verizon, serves as investment manager of the Verizon Plans. You represent that VIMCO is an in-house asset manager (INHAM) within the meaning of Part IV(a) of Prohibited Transaction Exemption 96-23 with respect to the Verizon Plans.

You represent that Verizon intends to create an investment vehicle for the Verizon Plans, employee benefit plans maintained and sponsored by third parties unrelated to Verizon or Mellon (Third Party Plans), and other institutional investors. To accomplish this, VIMCO, in concert with Mellon, would establish and operate a limited partnership, which is a collective investment vehicle (CIV) organized under the laws of Delaware.(2) The CIV will be managed by a joint venture between VIMCO and Mellon (Joint Venture).

You represent that Delaware law requires that, among other things, the CIV have one or more general partners and one or more limited partners. You represent that, pursuant to Delaware law, the general partner is not required to make contributions to the CIV nor acquire a partnership interest in the CIV. You further represent that the general partner will not make a contribution to, nor acquire a partnership interest in, the CIV unless required to do so pursuant to the law of jurisdictions, other than Delaware, in which the CIV may be doing business.(3) A wholly-owned subsidiary of VIMCO will be the general partner of the CIV. You represent that the Verizon Plans will contribute assets to the CIV and become limited partners of the CIV at the time the CIV is organized. You represent that Mellon will have no responsibility or authority with respect to the Verizon Plans' decisions to invest in the CIV. The Third Party Plans and other third party institutional investors will become limited partners at future dates upon contribution to the CIV.

Mellon or a third party will be the trustee for the Third Party Plans. The Third Party Plans will not have any relationship with VIMCO prior to making a contribution to the CIV. You represent that, assuming that state law requirements are fulfilled, the liability of each limited partner for the CIV's debts or obligations will be limited to the extent of the capital that the limited partner has contributed or has agreed to contribute to the CIV, undistributed profits and, under certain circumstances, the return of certain distributions from the CIV. You represent that the CIV will not be designated as a named fiduciary of, nor perform fiduciary functions for, the Verizon Plans or the Third Party Plans.

With respect to a Third Party Plan's participation in the CIV, an independent fiduciary (i.e., independent of VIMCO and Mellon) will make a determination whether to make initial or subsequent contributions into the CIV based upon detailed information provided by VIMCO concerning the available investment pools and other relevant information. The independent fiduciary must approve each Third Party Plan's program of purchases and redemptions of interests in the CIV.

Mellon will be the custodian of the assets of the CIV. You represent that Mellon, as trustee of the Master Trust, will hold at least fifty percent of the interests of the CIV, on behalf of the Verizon DB Plans, for the foreseeable future.

The CIV will be composed of multiple investment pools with varying investment risks. The Joint Venture will be the investment manager of the CIV, and as such, will direct the allocation of each limited partner's interests in the CIV among the various investment pools. The Joint Venture will enter into a contract with VIMCO under which VIMCO will discharge substantially all of the Joint Venture's investment management responsibilities with respect to the CIV. You further represent that each limited partner will have an undivided interest in the assets of each underlying investment pool in which it invests. The various investment pools will be either (i) invested in common investment funds or mutual funds, or (ii) managed by the Joint Venture or other investment advisers designated by the Joint Venture (Third Party Investment Advisers), which will act as investment managers and which are registered under the Investment Advisers Act of 1940 or which are banks or insurance companies.

You represent that the Joint Venture and the Third Party Investment Advisers will receive reasonable fees from the Third Party Plans and other institutional investors for their services. In addition, while the Third Party Investment Advisers will receive reasonable fees from the Verizon Plans for their services, the Joint Venture, VIMCO and Mellon will not receive any fees or other compensation (directly or indirectly) for investment management services to the Verizon Plans, but will be reimbursed for expenses directly and properly incurred for performing services for the Verizon Plans.

You have asked for an advisory opinion to the effect that, where fifty percent or more of the interests in the CIV are legally held by Mellon, as fiduciary for the benefit of the Verizon Plans, the CIV is not itself a party in interest with respect to the Verizon Plans invested in the CIV, and therefore, contributions to and distributions from the CIV would not constitute prohibited transactions under ERISA. You are specifically concerned that the CIV may be deemed a party in interest with respect to the Verizon Plans under section 3(14)(G) of ERISA because Mellon would hold more than fifty percent of the interests in the CIV on behalf of the Verizon Plans as trustee of those Plans.

Section 406(a)(1)(A) and (D) prohibits, in relevant part, the exchange of any property between a plan and party in interest and the transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 3(14)(G) of ERISA defines a party in interest to include a corporation, partnership or trust or estate of which (or in which) fifty percent or more of (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation, (ii) the capital interest or profits interest of such partnership, or (iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by, among others, a fiduciary of a plan. (Emphasis added.)

Mellon, as trustee of the Verizon Plans, is a fiduciary with respect to the Verizon Plans under section 3(21) of ERISA. The Verizon Plans' contributions to the CIV would be directed by VIMCO. The ownership interests in the CIV would be held by Mellon on behalf of the Verizon Plans. Similarly, distributions from the CIV to the Verizon Plans would be made to Mellon and held on behalf of the Verizon Plans.

Consistent with section 3(14) of ERISA, a plan's ownership of fifty percent or more of a partnership entity will not cause that partnership to become a party in interest with respect to that investing plan.(4) In our view, the application of section 3(14)(G) should not change that result merely because a plan's interests in a partnership are held by a fiduciary on behalf of the plan. Although Mellon would hold more than fifty percent of the value of the CIV interests, it would hold such interests on behalf of the Verizon Plans, not on

behalf of itself or a third party. As a result, it is the view of the Department that the CIV will not be a party in interest with respect to the Verizon Plans.(5) Therefore, transactions between the Verizon Plans and the CIV, including initial and subsequent contributions to the CIV by the Verizon Plans and distributions from the CIV to the Verizon Plans, would not be prohibited under section 406(a) of ERISA.

Section 406(b)(1) of ERISA prohibits a fiduciary from dealing with plan assets in his or her own interests or for his or her own account. ERISA section 406(b)(2) specifically prohibits fiduciaries in their individual or in any other capacity from acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Accordingly, VIMCO and Mellon must ensure that they can act on behalf of the CIV without compromising their positions as fiduciaries of the Verizon Plans. Further, while the Department recognizes that determining whether violations of the prohibited transaction provisions of section 406(b) of ERISA would occur are inherently factual questions, it is the view of the Department that if, in operation, VIMCO's provision of investment management services to the Verizon Plans or Mellon's provision of trustee services to the Verizon Plans results in a divergence of interests between VIMCO and the Verizon Plans or Mellon and the Verizon Plans, violations of sections 406(b) of ERISA could occur.

The Department cautions that ERISA's general standards of fiduciary conduct would apply to the Verizon Plans' investment in the CIV. Section 404(a)(1) of ERISA requires, among other things, that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. Accordingly, the appropriate plan fiduciaries must act "prudently" and "solely in the interests" of the plan participants and beneficiaries with respect to the decision to acquire or dispose of the Verizon Plans' interests in the CIV.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Internal Revenue Code (the Code) has been transferred to the Secretary of Labor, with certain exceptions not here relevant. The Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.

2. You represent that the CIV will be treated as a partnership for tax purposes pursuant to Treasury Regulation 26 CFR 301.7701-3(b).
3. You represent that if the general partner must make a contribution to, or acquire a partnership interest in, the CIV pursuant to state law requirements, the general partner's interest in the CIV will be limited to the extent necessary to comply with such requirements.
4. Under the plan assets regulation, 29 CFR 2510.3-101, the extent of a plan's equity ownership interest in an entity may cause that entity to be deemed to hold plan assets.
5. See Advisory Opinion 80-67A (Nov. 30, 1980).

Advisory Opinion 2004-02A
ERISA Sec. 206(d)(3)

Whether a domestic relations order that changes a prior assignment of benefits to an alternate payee to reduce the amount assigned to the alternate payee may be a qualified domestic relations order within the meaning of section 206(d)(3) of ERISA.

Terry-Lynne Lastovich
Dorsey & Whitney LLP
50 South Sixth Street, Suite 1500
Minneapolis, MN 55402-1498

Dear Ms. Lastovich:

This is in response to your request on behalf of Northwest Airlines, Inc. Retirement Plan for Pilot Employees (the Plan) for an advisory opinion under section 206(d) of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you ask whether a domestic relations order that changes a prior assignment of benefits to an alternate payee to reduce the amount assigned to the alternate payee may be a "qualified domestic relations order" (QDRO) within the meaning of section 206(d)(3) of ERISA.

You represent that this question arises out of a divorce and property settlement involving a now-retired employee of Northwest Airlines, Inc. (the participant) and his former spouse (the alternate payee). The participant has earned a vested pension benefit under the Plan, which is a defined benefit pension plan. Northwest Airlines, Inc. (Northwest) sponsors and is the administrator of the Plan.

In 1997, while the participant was still actively employed, the Plan received a domestic relations order, dated April 3, 1997, that assigned to the alternate payee a percentage of the participant's pension benefits (the 1997 Order). The 1997 Order was issued by the District Court of the First Judicial District, Family Court Division, County of Dakota, State of Minnesota. In accordance with its procedures, the Plan reviewed the order, determined it to be a QDRO, and so informed both the participant and the alternate payee on August 27, 1997.

In November 2000, while the participant was still actively employed, the participant notified the Plan that both he and the alternate payee desired to modify the assignment reflected in the QDRO to reduce the portion of the participant's benefits that would be paid in the future to the alternate payee. The participant sought the Plan's advice on how to make such a change. The Plan advised the alternate payee and the participant that it would not consider an order that purported to reduce the assignment already made under a previously recognized QDRO to be permissible.

Nonetheless, on June 6, 2002, the participant submitted to the Plan a second domestic relations order, dated June 4, 2002 (the 2002 Order). The 2002 Order was also issued by the District Court of the First Judicial District, Family Division, County of Dakota, State of Minnesota. This order stated that the parties to the divorce were "in agreement" that the QDRO provisions of the 1997 Order should be altered and therefore ordered that those 1997 QDRO provisions were "deleted." The 2002 Order set forth new provisions for a different (and smaller) assignment to the alternate payee.

During the course of its review of the 2002 Order, the Plan expressed its doubts as to whether such a reduction in the amount assigned could be effected by a QDRO and requested both participant and alternate payee to provide "a written explanation of why this amended order should or should not be reviewed as a qualified domestic relations order." These parties declined to offer argument on this issue and continued to assert that the 2002 Order expressed their consensus on how the participant's benefits should be divided

between them.

In September 2002, before the Plan had issued a determination on the qualified status of the 2002 Order, the participant retired, and Northwest began paying benefits to both the participant and the alternate payee under the terms of the 1997 Order.

On November 15, 2002, the Plan sent a letter to the participant, setting forth its "decision" that the 2002 Order was not qualified, based upon its view that a subsequent order cannot reduce the benefits awarded to an alternate payee under a previous domestic relations order recognized by the Plan as a QDRO. This letter set forth the following additional determinations: (1) the 2002 Order is "provisionally" determined not to be a QDRO; (2) the 1997 Order continues in full force and effect; (3) the Plan has requested an advisory opinion from the Department of Labor (the Department) on whether an order that "takes away" benefits previously assigned to an alternate payee can be a QDRO; and (4) pending issuance of the advisory opinion, the Plan will continue to pay out benefits in accordance with the 1997 Order. The letter further advised the participant that, if the Department opined that the 2002 Order cannot be a QDRO, the Plan's determination would become "final." The letter further stated that if the Department opined that the 2002 Order could be a QDRO "even though it 'takes away' a benefit previously awarded" to the alternate payee, it would then seek reimbursement of any "overpayments" made to the alternate payee based on the 1997 Order. If the alternate payee did not return the "overpayments" the Plan would withhold future payments to the alternate payee until the "overpayments" were recovered.

This request for an advisory opinion ensued. In the context of these facts, you seek guidance on whether the 2002 Order, which purported to reduce the amount of the participant's benefits that are assigned to the alternate payee, could qualify as a QDRO within the meaning of section 206(d)(3) of ERISA.

Under section 206(d)(3) of ERISA, the plan administrator is the party to whom an initial determination of the qualified status of an order is entrusted. The Department generally does not provide advisory opinions addressing this question because making such a determination necessarily requires an interpretation of the specific provisions of a plan and application of those provisions to specific facts, including the nature and amount of a participant's pension benefits. Nonetheless, the Department believes it is appropriate to provide guidance under section 206(d)(3) on the narrow issue you have presented of whether a subsequent domestic relations order that alters or modifies a qualified domestic relations order involving the same participant and alternate payee may itself be qualified and therefore supercede the previous order. In providing this guidance, however, the Department takes no position on whether any particular order described in this letter is or is not a "qualified domestic relations order" within the meaning of section 206(d)(3) of ERISA.

Section 206(d)(1) of ERISA generally requires pension plans covered by Title I of ERISA to provide that plan benefits may not be assigned or alienated. Section 206(d)(3)(A) of ERISA states that section 206(d)(1) applies to any assignment or alienation of benefits made pursuant to a "domestic relations order," unless the order is determined to be a “qualified domestic relations order.” Section 206(d)(3)(A) further provides that pension plans must provide for the payment of benefits in accordance with the applicable requirements of any order that is determined to be a “qualified domestic relations order.” The grounds on which the plan administrator must judge the status of an order that purports to assign benefits are set forth in the specific subparagraphs of section 206(d)(3).

Subparagraph (B) of section 206(d)(3) of ERISA defines the terms "qualified domestic relations order" and "domestic relations order" for purposes of section 206(d)(3) as follows:

(B) For purposes of [section 206(d)(3)] —

(i) the term "qualified domestic relations order" means a domestic relations order —

(I) which creates or recognizes the existence of an alternate payee’s right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan, and

(II) with respect to which the requirements of subparagraphs (C) and (D) are met, and

(ii) the term "domestic relations order" means any judgment, decree, or order (including approval of a property settlement agreement) which —

(I) relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and

(II) is made pursuant to a State domestic relations law (including a community property law).

Subparagraphs (C) and (D) of section 206(d)(3) of ERISA contain both positive and negative requirements for qualification of a domestic relations order. Subparagraph (C) specifies that, in order for a domestic relations order to be qualified, such order must clearly specify (i) the name and the last known mailing address (if any) of the participant and the name and mailing address of each alternate payee covered by the order; (ii) the amount or percentage of the participant's benefits to be paid by the plan to each such alternate payee, or the manner in which such amount or percentage is to be determined; (iii) the number of payments or period to which such order applies; and (iv) each plan to which the order applies.

Subparagraph (D) provides that an order cannot be qualified if it either (i) requires the plan to provide any type of benefit, or any option, not otherwise provided by the plan; (ii) requires the plan to provide increased benefits (determined on the basis of actuarial value); or (iii) requires the plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a qualified domestic relations order.

A plan administrator may determine that an order is not qualified only on the basis of the requirements set forth in section 206(d)(3) of ERISA. In our view, nothing in section 206(d)(3) suggests that a State court (or other appropriate State agency or instrumentality) may not alter or modify a previous domestic relations order involving the same participant and alternate payee, as long as the new domestic relations order itself meets the statutory requirements. Indeed, the purpose of section 206(d)(3) is to permit the division of marital property on divorce in accordance with the directions of the State authority with jurisdiction to achieve the appropriate disposition of property upon the dissolution of a marriage. Where a State authority reasserts jurisdiction over a marital dissolution and issues an order changing a previously established property allocation, it would appear contrary to this purpose to create additional requirements, beyond what is specified in section 206(d)(3) of ERISA, that would thwart the exercise of that authority. Accordingly, provided that a domestic relations order otherwise meets the requirements of section 206(d)(3) of ERISA, a plan administrator may not fail to qualify the domestic relations order merely because the order changes a prior assignment to the same alternate payee.(1) Thus, it is the Department's view that a plan administrator may determine, consistent with the requirements of section 206(d)(3), that a domestic relations order is qualified even if it would supersede or amend a pre-existing QDRO assigning the same participant's benefits to the same alternate payee.

The plan administrator in this case has made apparent its intention to seek repayments from, or to withhold future payments to, the alternate payee of amounts paid out in accordance with the 1997 Order. We do not believe that, under these facts, the plan administrator would have the authority to do so. As a general matter, a plan administrator making QDRO determinations has fiduciary duties applicable to the determination process. The administrator has a duty under section 206(d)(3)(G) of ERISA to determine whether a domestic relations order is a QDRO within a reasonable time after receipt and to promptly notify the participant and each alternate payee of the determination. The administrator has a duty under section 404(a)(1) of ERISA to act prudently and solely in the interests of the plan's participants and beneficiaries, and to follow the plan's QDRO procedures unless they conflict with the provisions of ERISA.

Because, in this case, the plan administrator had previously determined the 1997 Order to be a QDRO, the plan was required to make benefit payments in accordance with the 1997 Order. The plan administrator took no steps to preserve the amounts that would be affected by the 2002 Order during its consideration of that order's qualified status, but continued to make the payments required by the 1997 Order. Subparagraph (I) of section 206(d)(3) of ERISA provides that, if a plan fiduciary, acting in accordance with its fiduciary duties, treats a domestic relations order as being qualified, and pays out benefits in accordance with its determination and the 18-month segregation rules of subparagraph (H), the plan's obligations to the participant and any alternate payee are discharged with respect to such payments.(2) Accordingly, under these circumstances it is appropriate to treat the 2002 Order as prospective only. There does not appear to be grounds on which the plan could seek repayment from the alternate payee of the benefits paid out in accordance with the 1997 Order.(3)

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations

Office of Regulations and Interpretations

Footnotes

1. Section 206(d)(3)(D)(iii), which provides that a domestic relations order may be qualified only if it does not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under a pre-existing QDRO, does not apply here, where there is only one alternate payee.
2. Although § 206(d)(3)(H) requires an administrator to segregate amounts that would be payable to an alternate payee under an order for 18 months pending determination of the order's qualified status, that section does not require segregation of amounts that would be transferred from the alternate payee (per a previously recognized QDRO) to the participant. Nonetheless, the administrator may have been able, under these facts, to arrange a voluntary escrow of the amounts in question, since both the participant and the alternate payee apparently sought the change in assignment.
3. Nothing in this letter is intended to alter or have any effect on the federal tax consequences under the Internal Revenue Code (the Code) to the participant and alternative payee of distributions under either the 1997 Order or the 2002 Order.

1.

Trust Examination Manual

Advisory Opinion 2004-05A

May 24, 2004
2004-05A
ERISA Sec. 406(a)(1)(A),(D)
406(b)(1),(2)

Mr. William R. Charyk
Arent Fox Kintner Plotkin & Kahn, PLLC
1050 Connecticut Avenue, NW
Washington, DC 20036-5339

Dear Mr. Charyk:

This is in response to your request for guidance under section 406 of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4975 of the Internal Revenue Code of 1986, as amended (the Code).(1) In particular, you ask whether the execution of a securities transaction between a plan and a party in interest with respect to such plan as defined in ERISA through an alternative trading system (ATS) maintained by Liquidnet, Inc. (Liquidnet) constitutes a prohibited transaction under section 406(a)(1)(A) and (D) of ERISA. In addition, you inquire whether the execution of a securities transaction through the Liquidnet ATS (the Liquidnet System) between a plan and a counterparty that is an affiliate of the fiduciary directing such trade on behalf of the plan also violates section 406(b) of ERISA.

You write on behalf of Liquidnet, a registered broker/dealer that maintains the Liquidnet System. The Liquidnet System is an "alternative trading system," as defined in Rule 300(a) of Regulation ATS under the Securities Exchange Act of 1934, as amended. You also represent that all of Liquidnet's approximately 200 subscribers are large institutional investors that individually manage, on average, approximately $31 billion of equity assets. You note that these subscribers, none of which are affiliated with Liquidnet, often act as named fiduciaries, investment managers, or provide other services to employee benefit plans.

You state that Liquidnet was created to facilitate the trading of "blocks" of equity securities. In this regard, since its inception in 2001, more than three billion shares of equity securities have been traded over the Liquidnet System pursuant to trade sizes that have averaged approximately 44,000 shares. You state that the total value of the shares traded through the Liquidnet System approximated $61 billion as of August 29, 2003.

You state that subscribers to Liquidnet may trade U.S., U.K., French, German, Netherlands, and Swiss equity securities through the Liquidnet System. In this regard, you state that the Liquidnet System: (1) interfaces with the order management systems of Liquidnet's subscribers; and (2) identifies, with respect to a particular security, each Liquidnet subscriber that has an interest in buying the security and each Liquidnet subscriber that contemporaneously has an interest in selling the security. You state that each Liquidnet subscriber indicates to the Liquidnet System its interest in buying or selling various securities. If one subscriber indicates to the Liquidnet System an interest in buying a certain security that a different subscriber has independently indicated to the Liquidnet System an interest in selling, the Liquidnet System notifies both subscribers that a transaction opportunity exists.(2) You note that the Liquidnet System does not disclose the identity of either subscriber to the other. The two subscribers may then negotiate; through their respective computer systems; both the price and the quantity of the security. Accordingly, you state that the Liquidnet System enables subscribers to engage in an anonymous, no obligation, one-on-one, real-time negotiation (a subscriber must terminate its current negotiation with another subscriber before engaging in a new negotiation with a different subscriber).

You state that multiple Liquidnet subscribers may have an interest in buying (or selling) a security that a different Liquidnet subscriber has an interest in selling (or buying). Where, for example, the Liquidnet System identifies that multiple subscribers have an interest in buying a security that a different subscriber has an interest in selling, the Liquidnet System provides the selling subscriber with an electronic listing of the anonymous subscribers interested in buying. You note that once a subscriber is provided with such a listing, the subscriber may thereafter negotiate with any or all of the subscribers on the list. You state that the Liquidnet System currently determines the order of a multiple subscriber listing by comparing the quantities they have posted to the quantity posted by the single contra-side subscriber. The subscriber posting a quantity that is nearest to the quantity posted by the single contra-side subscriber is placed first on the list. The remaining order is determined in the same fashion.(3) You state that the Liquidnet System's trading rules, which are distributed to all subscribers, contains a disclosure that describes how multiple potential negotiating subscribers will be ordered.

You represent that trades entered into pursuant to the Liquidnet System are executed on a “blind” basis. In this regard, you state that, during the entire execution and settlement processes, subscribers interact with each other pursuant to policies and rules designed to ensure anonymity. You represent that the Liquidnet System, never discloses the identity of a subscriber to any other. In addition, all physical transfers of equity securities and cash are made between an independent clearing firm, Bear, Stearns Securities Corp. and the buyer’s and seller’s respective custodians. Therefore, the identities of the parties to a trade will not be revealed to the parties during the clearing process.

You state that: given the number and type of Liquidnet subscribers; the large number of trades executed on Liquidnet on a daily basis; and the fact that such trades are executed and settled pursuant to rules, procedures and software designed to ensure anonymity; it is expected that the parties to a transaction engaged in through the Liquidnet System will not know, at any time, the identity of each other.(4) Accordingly, it is possible for a subscriber, in its capacity as a fiduciary with respect to a plan, to unknowingly buy/sell a security on behalf of the plan through the Liquidnet System from/to a Liquidnet subscriber that is a party in interest to the plan.

Further, you note that although a subscriber cannot execute a securities transaction with itself through the Liquidnet System (i.e., as both the buyer and seller), it is possible for a plan fiduciary to direct a trade through the Liquidnet System whereby the Liquidnet subscriber that is the counterparty to the plan is an affiliate of such fiduciary. You state that two affiliates may request that Liquidnet "block" negotiations between the two entities. However, you note that a Liquidnet subscriber may not be aware that an affiliate thereof is also a Liquidnet subscriber.

Section 3(14)(A) and (B) of ERISA defines the term “party in interest” as meaning, as to an employee benefit plan, any fiduciary (including, among others, a trustee) of an employee benefit plan; and a person providing services to such plan. ERISA section 3(21)(A) provides that a person is a fiduciary with respect to a plan to the extent that (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or responsibility in the administration of such plan.

Section 406(a)(1)(A) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if he or she knows or should know that the transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between the plan and a party in interest. Section 406(a)(1)(D) of ERISA provides that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA provides that a fiduciary with respect to a plan shall not deal with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(2) provides that a fiduciary with respect to a plan shall not in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.

With respect to purchases and sales of equity securities, we note that the Conference Report accompanying ERISA states that:

In general, it is expected that a transaction will not be a prohibited transaction (under either the labor or tax provisions) if the transaction is an ordinary “blind” purchase or sale of securities through an exchange

where neither buyer nor seller (nor the agent of either) knows the identity of the other party involved. In this case, there is no reason to impose a sanction on a fiduciary (or party-in-interest) merely because, by chance, the other party turns out to be a party-in-interest (or plan). H.R. Rep. 93-1280, 93rd Cong., 2d Sess., 307 (1974).

As you noted, Liquidnet matches purchase and sell orders from its clients and gives purchasers and sellers the opportunity to negotiate a trade based on price and volume. The number of subscribers and the trading procedures assure a party's anonymity, unless the party wishes to identify itself to the counter-party. In our view, transactions executed through Liquidnet's trading procedures for the execution of transactions, that are designed to permit anonymous negotiations without identifying the parties, function in a manner similar to the operation of an exchange. Accordingly, based on your representations, it is our further view that "blind" transactions executed pursuant to such procedures would not, in themselves, constitute prohibited transactions under section 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) or 406(b)(2) of ERISA.

The Department notes, however, that a transaction effectuated through the Liquidnet System will not be considered "blind" if, prior to the execution of such transaction, the plan fiduciary responsible for the plan's engagement in the transaction knew, or had reason to know, the identity of the counterparty to such transaction. Given the ability of parties to a transaction to disclose their identities to each other, persons trading on behalf of employee benefit plans should be particularly careful to make sure the transaction is truly blind. Moreover, these determinations assume that such purchase and sale transactions did not arise in connection with any arrangement, agreement, or understanding designed to benefit the fiduciary (including an affiliate thereof) or any other party in interest to the plan.

In addition, with respect to the arrangement and transactions described above, ERISA's general standards of fiduciary conduct apply to: (i) the determination to buy or sell a particular equity security (and, in addition, the determination as to the appropriate purchase or sale price for such security); and (ii) the determination as to which trading system should be used to assist with the purchase or sale of equity securities.(5) In this regard, as noted above, section 404 of ERISA requires a fiduciary to discharge his duties respecting a plan solely in the interest of the plan's participants and beneficiaries. This section also requires that a plan fiduciary act prudently and for the exclusive purpose of: providing benefits to plan participants and their beneficiaries; and defraying reasonable expenses of administering the plan. Accordingly, plan fiduciaries that subscribe to Liquidnet must consider the costs associated with the use of alternative trading systems as well as the potential revenue returns, discounts, and other benefits that result from the continuing use of particular alternative trading systems over other similar services.

Further, prior to a plan fiduciary's decision to execute a securities transaction through Liquidnet, the plan fiduciary (as a subscriber or an affiliate of a subscriber) should determine whether any existing or potential conflicts of interest or prohibited transactions under ERISA would interfere with the proper exercise of any of the fiduciary's responsibilities under section 404 of ERISA, including the duty to act solely on behalf of the plan.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions. The opinion only relates to the specific issues raised by your request. For example, you have not asked and the Department is expressing no opinion with respect to the fees and other compensation received by persons engaging in transactions on the Liquidnet System on behalf of plans.

Sincerely,
Louis Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978, 43 FR 47713 (5 U.S.C. App. 1 [1996]), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. The Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to

specific sections of ERISA should be read to refer also to the corresponding sections of the Code.

2. Accordingly, you state that Liquidnet does not "solicit" subscriber interest with respect to the buying or selling of securities (i.e., once a subscriber notifies Liquidnet that it has an interest in buying or selling a security, the Liquidnet System does not thereafter broadcast that interest to all of the other Liquidnet subscribers).
3. You state that in the future, the percentage of successful negotiations attributable to each respective subscriber may also affect the ordering of a multiple subscriber list.
4. You note, however, that subscribers using the system to negotiate a securities transaction may "chat" with each other. In this regard, you state that although the Liquidnet System does not disclose the identities of negotiating subscribers to each other, two such subscribers may electronically correspond to each other, without restriction as to content, through the Liquidnet System as part of the negotiation. You note that this type of correspondence is reviewed and retained by Liquidnet.
5. Whether, in light of all the facts and circumstances, a purchase or sale of securities or the use of a particular service provider satisfies the fiduciary responsibility provisions of ERISA is an inherently factual question as to which the Department generally will not opine. See section 5.01 of ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976).

1.

Trust Examination Manual

Advisory Opinion 2004-07A

July 1, 2004
2004-07A
ERISA Sec. 412

William A. Mrozowski
President and Chief Executive Officer
First Commonwealth Trust Company
614 Philadelphia Street
Indiana, PA 15701-0400

Dear Mr. Mrozowski:

This is in response to your request for an advisory opinion regarding the application of section 412 of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Specifically, you ask whether the First Commonwealth Trust Company (FCTC) is exempt from ERISA's fidelity bonding requirement pursuant to the statutory exemption in section 412(a)(2) of ERISA with respect to plans for which FCTC acts in a fiduciary capacity. You also ask whether FCTC would be covered by the regulatory exemption in 29 C.F.R. §§ 2580.412-27 and 412-28 applicable to certain banking institutions and trust companies subject to federal regulation.

The correspondence and materials you forwarded contain the following facts and representations. FCTC is a corporation that has operated as a trust company in the State of Pennsylvania since 1991, and it is authorized to exercise trust powers under a non-deposit trust bank charter from Pennsylvania. Although FCTC is not itself a member of the Federal Reserve System, it is a wholly owned subsidiary of First Commonwealth Financial Corporation ("First Commonwealth"), a bank holding company. Further, an affiliate of FCTC, another wholly owned subsidiary of First Commonwealth, is a state-chartered member bank of the Federal Reserve System. First Commonwealth is subject to supervision and examination by the Federal Reserve System pursuant to the Bank Holding Company Act. You represent that FCTC is subject to examination and supervision by Pennsylvania banking regulators under state law and by the Federal Reserve System pursuant to section 5 of the Bank Holding Company Act, 12 U.S.C. § 1844, which provides the Federal Reserve System with the authority to supervise and examine subsidiaries of bank holding companies.(1) You represent that the Federal Reserve Bank of Cleveland in fact periodically examines FCTC. You further represent that FCTC has over $1 million in capital and surplus, and has fidelity bonding coverage that would satisfy the bonding coverage required for First Commonwealth under federal banking law.

Section 412 of ERISA, subject to certain exceptions, requires that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan shall be covered by a fidelity bond that meets the requirements of section 412 of ERISA and the Department of Labor's implementing regulations. Section 412(a)(2) provides, in relevant part, that no bond shall be required of a fiduciary (or of any director, officer, or employee of such fiduciary) if such fiduciary – (A) is a corporation organized and doing business under the laws of the United States or of any State; (B) is authorized under such laws to exercise trust powers or to conduct an insurance business; (C) is subject to supervision or examination by Federal or State authority; and (D) has at all times a combined capital and surplus in excess of such a minimum amount as may be established by regulations issued by the Secretary, which amount shall be at least $1,000,000.(2)

Section 412(a)(2) of ERISA further provides that the exemption for such fiduciaries shall apply to a bank or

other financial institution which is authorized to exercise trust powers and the deposits of which are not insured by the Federal Deposit Insurance Corporation (FDIC), "only if such bank or institution meets bonding or similar requirements under State law which the Secretary [of Labor] determines are at least equivalent to those imposed on banks by Federal law." The Secretary has not made any determinations as to whether any state bonding or similar requirements are at least equivalent to those imposed on banks by federal law. The statutory exemption in section 412(a)(2) thus is not available to any bank or other financial institution authorized to exercise trust powers that has deposits that are not insured by the FDIC. It is the view of the Department, however, that banks and other financial institutions that have no deposits, such as FCTC, are not subject to this additional condition. Accordingly, based on your representations that FCTC satisfies all of the other conditions in section 412(a)(2), FCTC would satisfy the conditions for the exemption in section 412(a)(2) of ERISA with respect to the ERISA-covered plans for which FCTC acts in a fiduciary capacity.

The Department has also promulgated regulations under section 412 of ERISA. The regulation at 29 C.F.R. § 2550.412-1 provides, in relevant part, that any plan official, as defined in section 412(a), shall be deemed to be in compliance with the bonding requirements of ERISA if he or she is exempt from such bonding requirements under an exemption in Part 2580 of Title 29 of the Code of Federal Regulations.(3) The regulations at 29 C.F.R. §§ 2580.412-27 and 412-28 provide "banking institutions and trust companies subject to regulation and examination by the Comptroller of the Currency or the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation" with an "exemption from the bonding requirements" in sections 412(a) and (b) of ERISA.(4)

In the view of the Department, the authority of the Federal Reserve System over FCTC as a subsidiary of a bank holding company pursuant to the Bank Holding Company Act constitutes regulation and examination by the Board of Governors of the Federal Reserve System within the meaning of 29 C.F.R. §§ 2580.412-27 and 412-28.(5) Accordingly, based on the facts and representations you supplied, it is the opinion of the Department that FCTC would also be exempt under 29 C.F.R. §§ 2580.412-27 and 412-28 from being bonded under Title I in connection with its handling of plan funds or other property of ERISA-covered welfare and pension plans.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976), and, accordingly, is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
John J. Canary
Chief, Division of Coverage, Reporting and Disclosure
Office of Regulations and Interpretations

Footnotes

12 U.S.C. § 1844(c) provides in relevant part: "(1) Reports (A) In general – The Board, from time to time, may require a bank holding company and any subsidiary of such company to submit reports under oath to keep the Board informed as to – (i) its financial condition, systems for monitoring and controlling financial and operating risks, and transactions with depository institution subsidiaries of the bank holding company; and (ii) compliance by the company or subsidiary with applicable provisions of this chapter or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary. . . . (2) Examinations (A) Examination authority for bank holding companies and subsidiaries – Subject to subparagraph (B), the Board may make examinations of each bank holding company and each subsidiary of such holding company in order – (i) to inform the Board of the nature of the operations and financial condition of the holding company and such subsidiaries; (ii) to inform the Board of – (I) the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of any depository institution subsidiary of such holding company; and (II) the systems for monitoring and controlling such risks; and (iii) to monitor compliance with the provisions of this chapter or any other Federal law that the Board has specific jurisdiction to enforce against such company or subsidiary and those governing transactions and relationships between any depository institution subsidiary and its affiliates."

2. In the absence of regulations setting higher capital and surplus requirements under section 412(a)(2) of ERISA, the requisite amount to be eligible for the exemption is the $1,000,000 minimum provided in the statute.

3. 29 C.F.R. §2550.412-1, pending issuance of permanent bonding regulations implementing section 412 of ERISA, incorporates by reference most of the bonding regulations issued under the predecessor statute, the Welfare and Pension Plans Disclosure Act (the WPPDA) and makes them applicable to plan officials under ERISA.
4. Sections 2580.412-27 and 412-28 provide an exemption from the "bonding requirements" in section 412(a) and (b) of ERISA, but not from the section 412(b) prohibition on any plan official, or any other person having the authority to direct the receipt, handling, disbursement, or other exercise of custody or control of any of the funds or other property of any employee benefit plan, from directing that such functions be performed by any plan official with respect to whom the requirements of subsection 412(a) have not been met.
5. You represent that FCTC is neither a registered investment advisor nor a broker-dealer that would be a "functionally regulated subsidiary" of a bank holding company within the meaning of the Bank Holding Company Act. We express no opinion in this letter regarding the applicability of the bonding exemption in 29 C.F.R. §§ 2580.412-27 and 412-28 to entities that are "functionally regulated subsidiaries" within the meaning of the Bank Holding Company Act.

1.

Trust Examination Manual

Advisory Opinion 2004-09A

December 22, 2004
2004-09A
Code Sec. 4975(c)

Thomas G. Schendt, Esq.
Alston & Bird LLP
601 Pennsylvania Avenue, N.W.
North Building, 10th Floor
Washington, DC 20004-2601

Dear Mr. Schendt:

This is in response to your request for an advisory opinion from the U.S. Department of Labor (the Department) concerning the application of the prohibited transaction provisions under section 4975(c) of the Internal Revenue Code of 1986, as amended (the Code), to certain contributions to health savings accounts (HSAs), as described below.(1)

You represent that your client, an insurer (the Company) and its affiliates, offers various health benefit plans in the individual market, including high deductible health plans (HDHPs), as that term is defined in section 223(c)(2) of the Code. In addition, the Company either offers HSAs, as defined in section 223(d) of the Code, to individuals covered by HDHPs issued by the Company, or enters into a contractual arrangement with a specified bank that will offer HSAs to such individuals, as described below.

Your letter contains the following facts and representations.

Factual Scenario I

Under Factual Scenario I, only persons insured under HDHPs issued by the Company in the individual market are able to establish HSAs with the Company. However, a person does not have to establish an HSA with the Company to participate in an individual HDHP with the Company. If a person establishes an HSA with the Company, the Company will serve as both the trustee or custodian and the record-keeper of the HSA. The Company does not provide HSA custodial services in the employer group market.

To encourage participation in the Company's HSA program, the Company will offer an incentive to a person who establishes an HSA with the Company when he or she first enters into an individual HDHP with the Company. This incentive will be in the form of a $100 cash credit by the Company, as trustee or custodian, directly to the individual's HSA. This credit to the HSA will be automatic. The account holder will not be required to make any contribution to his or her HSA to receive the credit to his or her HSA. The credit is dependent on the establishment of an HSA with the Company. The account holder will not be able to divert the money to himself or herself before it is credited to the HSA.

If the person does not establish an HSA with the Company, he or she will not receive any incentive from the Company under this incentive program. Thus, for example, the individual will not receive any incentive from the Company in the form of a credit to an HSA not provided by the Company or in the form of money paid to him or her outside of the HSA. The credit to the account holder's HSA with the Company will be subject to the statutory requirements for HSAs set forth in section 223 of the Code, and the tax treatment of any distributions from the HSA attributable to this credit will be governed by the provisions of section 223(f) of the Code.

With respect to each HSA established with the Company pursuant to this incentive program, the Company represents that any arrangement for services by the Company to the HSA (e.g., as trustee or custodian and/or record-keeper of the HSA) will meet the requirements of section 4975(d)(2) of the Code and the Treasury's regulations at 26 CFR §54.4975-6.

The Company represents that the premiums payable under the HDHP will not vary based on the individual's choice of HSA custodian or trustee. Thus, the individual's insurance premiums will not be higher or lower as a result of his or her decision to establish an HSA either with the Company or with some other custodian or trustee. The Company also represents that any administrative fees the Company may charge the account holder with respect to his or her HSA will not change (i.e., will not increase or decrease) as a result of the credit to his or her HSA.

The Company states that although the duration of this incentive program has not been determined, it envisions that the incentive program could be used at various times for specified periods of time. The Company also anticipates that the amount of the incentive could change from time to time. However, for purposes of this request, the Company represents that the amount of the incentive will not exceed $100 per person.

Factual Scenario II

Under Factual Scenario II, the Company and its affiliates offer various health benefit plans in the group market, including HDHPs as defined under the Code.

The Company enters into a contractual relationship with a specified bank (the Bank) to provide HSAs for individuals covered by HDHPs issued by the Company. However, an individual does not have to establish an HSA with the Bank to participate in a group HDHP issued by the Company. The Bank serves as the trustee or custodian and the record-keeper of those HSAs and receives remuneration from the Company for its services in that regard. The Company also enters into a contractual relationship with a specified entity (the Vendor) to provide various services in relation to these HSAs, for which the Company compensates the Vendor. Neither the Bank nor the Vendor is a member of the Company's controlled group under sections 414(b), (c) and (m) of the Code.

To encourage the establishment of HSAs with the Bank in connection with group HDHPs issued by the Company, the Bank will offer an incentive to a person who establishes an HSA with the Bank when the Company first covers such person under a group HDHP. This incentive will be in the form of a $100 cash credit from the Bank directly to the individual's HSA. This credit to the HSA will be automatic. The account holder will not be required to make any contribution to his or her HSA to receive the credit to his or her HSA. The credit will be dependent on the establishment of an HSA with the Bank. The account holder will not be able to divert the money to himself or herself before it is credited to the HSA.

If the person does not establish an HSA with the Bank, he or she will not receive any incentive from the Bank under this incentive program. For example, the individual will not receive any incentive from the Company or the Bank in the form of a credit to an HSA not provided by the Bank or in the form of money paid to him or her outside of his or her HSA. The credit to the account holder's HSA with the Bank will be subject to the statutory requirements for HSAs set forth in section 223 of the Code, and the tax treatment of any distributions from the HSA attributable to this credit will be governed by the provisions of section 223(f) of the Code.

With respect to the HSAs established with the Bank pursuant to this incentive program, the Company, the Bank and the Vendor intend that any arrangements for services by the Bank or the Vendor to the HSA (e.g., as the trustee or custodian and/or record-keeper of the HSA) will meet the requirements of section 4975(d)(2) of the Code and the Treasury's regulations at 26 CFR §54.4975-6.(2)

The Company represents that the premiums charged for the individual's coverage under the group HDHP will not vary based on the individual's choice of HSA custodian or trustee. Thus, the premiums charged by the Company for the individual's coverage under the group HDHP will not be higher or lower as a result of his or her decision to establish an HSA either with the Bank or with some other custodian or trustee. In addition, any administrative fees the Bank or the Vendor may charge the account holder with respect to his or her HSA will not change (i.e., will not increase or decrease) as a result of this credit to his or her HSA.

The Company states that although the duration of this incentive program has not been determined, it

envisions that the incentive program could be used at various times for specified periods of time. The Company also anticipates that the amount of the incentive could change from time to time. However, for purposes of this request, the Company represents that the amount of the incentive will not exceed $100 per person.

Advisory Opinions Requested

With respect to Factual Scenario I, you have requested an advisory opinion that the credit to an account holder's HSA will not constitute a prohibited transaction under section 4975(c) of the Code for either the account holder or the Company.

In addition, with respect to Factual Scenario II, you have requested an advisory opinion that the credit to an account holder's HSA will not constitute a prohibited transaction under section 4975(c) of the Code or section 406 of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Prohibited Transactions under the Internal Revenue Code

Section 4975(e)(1)(E) of the Code defines the term "plan" to include "…a health savings account described in section 223(d)" of the Code.

A "prohibited transaction" under section 4975(c)(1) of the Code includes, among other things, any direct or indirect:

(A) sale or exchange, or leasing, of any property between a plan and a disqualified person;

(C) furnishing of goods, services, or facilities between a plan and a disqualified person;

(D) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;

(E) act by a disqualified person who is a fiduciary whereby he deals with the income or assets of a plan in his own interest or for his own account; or

(F) receipt of any consideration for his own personal account by any disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

A "disqualified person" is defined under section 4975(e)(2) of the Code, in pertinent part, to include a person who is a fiduciary or a person providing services to the plan.

Analysis of Factual Scenarios I and II

Under Factual Scenario I, the Company will be a trustee or custodian of the HSA. As such, the Company would be a disqualified person with respect to the HSA.

Under Factual Scenario II, the Bank will be a trustee or custodian of the HSA. As such, the Bank is a disqualified person with respect to the HSA. However, as we understand the facts, the Company would not be a disqualified person with respect to the HSA. In both scenarios, the account holder is a fiduciary and disqualified person with respect to the HSA.

Under both Factual Scenarios, the $100 credit proposed by either the Company or the Bank, respectively, would be a cash contribution to the account holder's HSA. The Department notes that in accordance with IRS Notice 2004-50, Q&A 28, wherein it states that "any person . . . may make contributions to an HSA on behalf of an eligible individual," Code section 223 does not prohibit the Company or the Bank from making such contributions to its customers' HSAs. A cash contribution to a plan is not generally a sale or exchange of property prohibited by section 4975(c)(1)(A) of the Code. Additionally, the cash contribution would not be a transfer of an asset of a plan for the benefit of a disqualified person or an act of self-dealing by either the Company or the Bank under section 4975(c)(1)(D) or (E) of the Code involving the assets of a plan. Therefore, neither the Company's nor the Bank's contribution of a cash credit to the account holder's HSA, as described herein, would be a prohibited transaction under section 4975(c)(1) of the Code.(3)

Similarly, the HSA's receipt of the Company's or the Bank's contribution of a cash credit, under the facts

described above, would not be an act of self-dealing on the part of the account holder nor a receipt by the account holder in his or her individual capacity of any consideration from a party dealing with the HSA in connection with a transaction involving assets of the HSA. Even though the Company or the Bank, respectively, would make the contribution as an incentive to encourage the account holder's participation in the Company's or the Bank's HSA program, the contribution goes to the HSA and not to the account holder.(4) Therefore, the receipt by the HSA of such cash contributions would not be a prohibited transaction under section 4975(c)(1) of the Code.(5)

Since the Company is not a disqualified person with respect the HSA under Factual Scenario II, the Bank's contribution of the credit to the account holder's HSA would not be a prohibited transaction under section 4975(c) of the Code with respect to the Company.

Finally, with respect to the contribution of any cash credits by the Bank to an account holder's HSA under the facts described above, the same analysis and conclusions would apply, for purposes of the prohibited transaction provisions contained in section 406(a) and (b) of ERISA, to an HSA that would be an "employee benefit plan" covered under Title I of ERISA(6) under the principles discussed in the Department's Field Assistance Bulletin (FAB) 2004-01 (April 7, 2004). Further, in such instances, the fiduciary responsibility provisions of Title I would apply to the selection of service providers to the HSA.

In discussing whether, and under what circumstances, HSAs established in connection with employment-based group health plans would be subject to the provisions of Title I of ERISA, FAB 2004-01 states that generally such HSAs would not constitute an "employee welfare benefit plan" as defined under section 3(1) of ERISA, if employer involvement with the HSA is limited. Specifically, HSAs meeting the conditions of the safe harbor for group or group-type insurance programs at 29 CFR §2510.3-1(j)(1)-(4) are not considered employee welfare benefit plans within the meaning of section 3(1) of ERISA. However, a finding that an HSA established by an employee is not covered by ERISA does not affect whether an HDHP sponsored by the employer is itself a group health plan subject to Title I. In fact, FAB 2004-01 states that unless otherwise exempt from Title I (e.g., governmental plans, church plans), employer-sponsored HDHPs will be "employee welfare benefit plans" within the meaning of section 3(1) of ERISA and, thus, subject to the fiduciary responsibility provisions of Title I.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (Aug. 27, 1976). The letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978, 43 Fed. Reg. 47713 (Oct. 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. See 5 USC App. at 214 (2000 ed.).

2. The Company is not requesting, and the Department is not providing, an opinion as to whether any arrangement for services by the Company, the Bank or the Vendor to an HSA will satisfy the requirements necessary for relief under section 4975(d)(2) of the Code and the regulations relating thereto. In this regard, the Department ordinarily does not issue advisory opinions on questions that are inherently factual in nature.
3. With respect to contributions or transfers of property to a plan that are considered to be an "exchange," see Adv. Op. 81-69A (July 28, 1981) and the Department's Interpretative Bulletin at 29 CFR 2509.94-3, relating to in-kind contributions to employee benefit plans.
4. This distinguishes the arrangement from others that have been found to involve prohibited transactions. See Adv. Op. 89-12A (July 14, 1989)(personal receipt of "free checking" account services by a customer from a bank in connection with the investment of assets of the customer's individual retirement account (IRA) in the bank's financial products would constitute a violation of section 4975(c)(1) of the Code.) See also PTE 93-33, 58 Fed. Reg. 31053 (May 28, 1993) (exempting certain arrangements benefiting an IRA account holder).
5. This advisory opinion does not address payments to the individual account of any person who is a

disqualified person for reasons other than as the account holder of an HSA.

6. Section 3(3) of ERISA defines the term “employee benefit plan” or “plan” as an employee welfare benefit plan (see section 3(1) of ERISA) or an employee pension benefit plan (see section 3(2) of ERISA) or a plan which is both an employee welfare benefit plan and an employee pension benefit plan.

1.

Trust Examination Manual

Advisory Opinion 2005-04A

March 25, 2005
2005-04A
ERISA Sec. 406(b)

Ms. Norma M. Sharara
Buchanan Ingersoll, PC
1776 K Street, NW, Suite 800
Washington, DC 20006-2365

Dear Ms. Sharara:

This is in response to your request for guidance under the Employee Retirement Income Security Act of 1974 (ERISA). In particular, you request an advisory opinion that the proposed investment of assets of an employee retirement plan (the Plan) in a mutual fund (the Fund) will not constitute a per se prohibited transaction under section 406 of ERISA.(1) The Plan is sponsored by a foundation (the Foundation) and the Fund is a registered open-ended investment company that is advised and distributed by an investment advisor (the Advisor).

You represent that the Foundation is a tax-exempt organization described in Code section 501(c)(3). The Foundation was organized under Ohio law as a non-profit corporation, and its principal place of business is currently located in New York City. The Foundation has functioned as a private foundation whose principal purpose is to support other operating charitable organizations. It is exempt from federal income taxation and has been classified by the Internal Revenue Service (IRS) as a private foundation under Code section 509. As of December 31, 2002, the Foundation had approximately $305,000,000 in assets. The Foundation, in keeping with the wishes of its founder is time-limited, and expects to disburse substantially all of its assets by 2010.

Because the Foundation expects to bring its operations to a close by 2010, the level of grant-making will accelerate significantly in the coming years. Prior to 2002, the Foundation did not have any paid staff. The Foundation hired nine individuals in 2002 essentially to prepare for and carry out the increased grant-making activities that the Foundation expects to occur between 2002 and 2010 as the Foundation winds down its activities and operations. The Plan was established in 2002 on behalf of these nine employees.

The Foundation is governed by a three-person board of trustees (the Board), none of whom are currently employees of the Foundation or participants in the Plan. One trustee also serves as the chief executive officer of the Foundation, and will soon become an employee of the Foundation. Another trustee serves as a vice-president of the Foundation.

The Plan is a defined contribution plan covering nine participants and is intended to qualify under Code section 401(a). As of December 31, 2002, the Plan had net assets of $163,652. Investment decisions for the plan are made by the Foundation. The Foundation is also the plan administrator and named fiduciary of the Plan. The Board, as the decision-maker for the Foundation, carries out the Foundation's fiduciary responsibilities on behalf of the Plan. The Board also serves as the Plan's trustee, in which capacity it is subject to direction by the Foundation. The Board has determined to allocate the Plan's investments equally between equity and interest-bearing securities.

The Fund invests primarily in common stocks and is managed using a "value" strategy. The Fund has consistently outperformed its benchmark, the S&P 500 Index, over the last 10 years. A trustee and

member of the Board is the President and Chief Executive Officer of the Advisor. He also holds a 22.9% ownership interest in the Advisor. Neither the Foundation nor any of the other trustees holds any ownership interest in, or has any other relationship with, the Advisor. The Board proposes to invest up to 25% of the Plan's assets in the Fund. The remaining allocation to equity securities will be invested in other mutual funds that are unrelated to the Advisor. The Board has determined that this allocation would be consistent with the Plan's investment policy.

This trustee is also one of three Advisor portfolio managers charged with day-to-day management of the Fund's assets. The Fund pays the Advisor an annual investment advisory fee of 1% of the Fund's net asset value, reduced by certain expenses that the Advisor reimburses to the Fund. The Fund's independent Board of Directors is responsible for approving the investment advisory agreement between the Fund and the Advisor. The Fund imposes no sales charges, exchange fees, or redemption fees.

You represent that the trustee's compensation for his services on behalf of the Advisor is not affected by the total amount of assets under management by the Fund. As of December 31, 2002, the Fund held net assets of approximately $3.9 billion.

You request an opinion that the Plan's investment of up to 25% of its assets in the Fund will not result in a prohibited transaction under section 406 of ERISA.

Section 3(21) of ERISA provides that a person is a fiduciary with respect to a plan to the extent he exercises any discretionary authority or control respecting the management of the plan or the management or disposition of the assets of the plan. A plan's administrator and named fiduciary by virtue of having those positions, must have or exercise discretionary authority or control respecting the management of the plan or the management or disposition of its assets.(2) The Foundation is the Plan's administrator and named fiduciary. The Board exercises the Foundation's fiduciary responsibilities on behalf of the plan. Accordingly, all trustees and members of the Board are fiduciaries with respect to the Plan.

Section 406(b)(1) of ERISA prohibits a fiduciary from dealing with the assets of the plan in his own interest or for his own account. Section 406(b)(2) of ERISA prohibits a fiduciary with respect to a plan from acting in any transaction involving the plan on behalf of a party, or represent a party, whose interests are adverse to the interests of the plan or of its participants and beneficiaries.

The Department has explained in regulation 29 CFR §2550.408b-2(e) that the prohibitions of section 406(b) are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility that makes them fiduciaries when they have interests that may conflict with the interests of the plans for which they act. Thus, a fiduciary may not use the authority, control, or responsibility that makes him a fiduciary to cause a plan to pay an additional fee to such fiduciary, or to a person in which he has an interest that may affect the exercise of his best judgment as a fiduciary, to provide a service. However, regulation 29 CFR §2550.408b-2(e)(2) provides that a fiduciary does not engage in an act described in section 406(b)(1) of ERISA if the fiduciary does not use any of the authority, control, or responsibility that makes him a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which the fiduciary has an interest that may affect the exercise of his judgment as a fiduciary.

One member of the Board and trustee of the Plan is a significant owner and the President and Chief Executive Officer of the Advisor, the investment advisor for the Fund. In addition, he is one of the portfolio managers of the Fund, involved in the day-to-day operation of the Fund. It is the opinion of the Department that based on these factors, taken together, this trustee has an interest in the Fund that may affect his best judgment as a fiduciary of the Plan regarding the decision whether to invest Plan assets in the Fund. Accordingly, if that trustee uses any of the authority, control, or responsibility that makes him a fiduciary to cause the Plan to invest in the Fund, the trustee will engage in a violation of section 406(b)(1) and 406(b)(2).

The Department has stated in other situations involving a fiduciary who has this type of conflict of interest that the fiduciary can avoid engaging in a transaction described in section 406(b)(1) and 406(b)(2) of ERISA by removing himself from all consideration of the transaction in question, and not exercising any of the authority, control, or discretion that makes him a fiduciary to cause the plan to enter into the transaction, as long as there is no arrangement, agreement, or understanding regarding the proposed transaction.(3) We note, however, that if a fiduciary has or obtains material information, including information regarding plan investments, that would be necessary in order for other plan fiduciaries to make

an appropriate and prudent decision with respect to the purchase, holding, or disposition of a particular investment, we believe the fiduciary's duties under section 404 of ERISA would require informing the deciding fiduciaries of that information.(4)

ERISA's general standards of fiduciary conduct also would apply to the proposed investment. Under section 404(a)(1), the responsible Plan fiduciaries must act prudently and solely in the interest of the Plan participants and beneficiaries in deciding whether to make an investment of Plan assets in the Fund.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 (41 Fed. Reg. 36281, August 27, 1976). Accordingly, this letter is issued subject to the provisions of the procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Internal Revenue Code (the Code) has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this letter to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.

2. See, Interpretive Bulletin 75-8, D-3 (29 CFR 2509.75-8, D-3)
3. See, Advisory Opinion 99-09A (May 21, 1999) and Advisory Opinion 79-72A (October 10, 1979)
4. We offer no opinion on the impact that insider-trading rules under the Federal securities laws may have on the dissemination of such information to other fiduciaries. Such rules are under the jurisdiction of the Securities and Exchange Commission.

Trust Examination Manual

Advisory Opinion 2005-09A

May 11, 2005
2005-09A
ERISA Sec. 408(b)(8)

Donald J. Myers, Esq.
Reed Smith LLP
1301 K Street, NW, Suite 1100 East Tower
Washington, DC 20005-3373

Dear Mr. Myers:

This is in response to your request for an advisory opinion on behalf of Vanguard Fiduciary Trust Company (Vanguard) concerning the application of section 408(b)(8) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the parallel provisions under section 4975(d)(8) of the Internal Revenue Code of 1986, as amended (the Code),(1) to an in-kind investment in a bank collective investment fund, as made under the circumstances described herein.

Background

You represent that Vanguard is a trust company, based in Valley Forge, Pennsylvania, that is organized under the laws applicable to such entities under the Pennsylvania Banking Code. Vanguard is supervised by the Pennsylvania Department of Banking. Vanguard is a wholly-owned subsidiary of The Vanguard Group, Inc. (Vanguard Group).

The Vanguard Group manages assets through registered open-end investment companies, pursuant to the Investment Company Act of 1940 (i.e., mutual funds). Vanguard manages assets held in collective trust funds for employee benefit plans covered by ERISA. You state that many Vanguard Group mutual funds and Vanguard trust funds serve as investment options for participant-directed individual account plans, organized to comply with section 401(k) of the Code ("401(k) plans"), and as investments for other qualified retirement plans.

Vanguard structures stable value investment options, designed to allow investors to receive current interest income and preserve principal amounts, for many 401(k) plans either using a commingled trust, or as a separately managed account for a particular plan. You state that over 900 plans use the commingled trust structure, and approximately 40 are using the stable value separate account structure (referred to collectively herein as "stable value portfolios").

The commingled trust structure uses a collective investment vehicle, the VRST Master Trust. Plans do not hold interests directly in the VRST Master Trust, but instead invest in one of seven "feeder" trusts – the Retirement Savings Trusts – that invest all of their assets in the VRST Master Trust. Investment management fees are imposed at the "feeder" trust level.

The commingled trusts used by Vanguard take the form of collective investment funds intended to qualify as group trusts, pursuant to Revenue Ruling 81-100, 1981-1 C.B. 326, and Revenue Ruling 2004-67, 2004-28 I.R.B., that are tax exempt under section 401 and 501(a) of the Code. Vanguard serves as trustee for such commingled trusts.

Plans pay fees to Vanguard only at the level of the stable value investment portfolio in which the plan directly invests. This is the level of the separately managed account or, with respect to the VRST Master

Trust, the "feeder" trust level.

Vanguard's stable value portfolios (i.e., the commingled trusts or the separately managed accounts) currently invest in, among other things, a series of fixed-income commingled trusts, the Vanguard Targeted Return Trusts (the TRTs). The TRTs were established quarterly on a rolling basis, each with a 5-year term, and managed to a constantly decreasing duration to provide liquidity at the end of the 5-year term. At any one time, there would be 20 TRTs in existence with durations ranging from one quarter of a year to 5 years. Each quarter, one TRT would expire and a new one would be created. The stable value portfolios managed by Vanguard, including the VRST Master Trust, have invested in the various TRTs based on their available cash, other investments and liquidity needs. The VRST Master Trust holds the majority of the assets of each TRT.

You state that Vanguard created the TRTs as stable value portfolios with high-quality fixed income securities with fixed maturity dates. These securities were then backed by "wrap" contracts with insurance companies or banks to provide for certain disbursements to be made at the "book" value of the assets, rather than the market value. This structure is commonly referred to as a "synthetic" guaranteed investment contract arrangement.

You represent that for various reasons related to investment management strategies and cost efficiencies, Vanguard has begun to phase out the TRT program. As the existing TRTs mature, they are being replaced by investments in two commingled trusts of comparable aggregate duration – the Vanguard Intermediate-Term Bond Trust (ITBT), and the Vanguard Short-Term Bond Trust (STBT). These trusts (collectively, the Bond Trusts), like the TRTs, invest principally in high-quality fixed-income securities.

As a means of transitioning to the new investment management structure, and more quickly realizing the efficiencies and other benefits of managing assets through the Bond Trusts rather than the existing TRTs, Vanguard would like to transfer the assets of the TRTs in-kind to the Bond Trusts as soon as possible, and then terminate the TRTs.

Specifically, TRT securities would be allocated to the Bond Trusts based on the TRTs' average durations. Each TRT would receive in return interests in the applicable Bond Trust – i.e., the STBT or ITBT – that are equal in value to the value of the securities it transferred to the respective Bond Trust. The same business day, the TRT would distribute those Bond Trust interests to each stable value portfolio that holds interests in the TRT, in proportion to the portfolio's TRT interests, and then terminate. At the end of the business day, each stable value portfolio would hold Bond Trust interests equal in value to its former TRT interests.

The principal advantage of liquidating the TRTs through in-kind exchanges of securities for interests in the Bond Trusts, as opposed to liquidations for cash on the open market, would be to avoid transaction costs. The total transaction cost estimates are in the range of $5.4 million as existing TRTs have securities with an estimated market value of approximately $3.4 billion. In addition, Vanguard seeks to avoid the possibility of the Bond Trusts not acquiring the same securities on the open market that are sold by the TRTs.

You represent that the trust documents for the TRTs and the Bond Trusts provide the necessary authority for Vanguard to cause the TRTs to make an in-kind investment in the Bond Trusts. You state that the TRTs, by their terms, permit investment in a collective investment fund maintained by the trustee of the TRTs (i.e., Vanguard), where the fund invests principally in securities of the type in which the TRT is permitted to invest. Specifically, Article 6.1(a) of each TRT gives the trustee the authority, in its sole discretion, "to invest and reinvest the Trust in such investments and other property, without restrictions to investments authorized for fiduciaries, as the Trustee determines in accordance with the Trust's investment objective as set forth in Article 1.2 …, including, without limitation, (i) any other collective investment trust maintained by the Trustee…"

Your represent further that the trust documents for the Bond Trusts permit investment by any common, collective or commingled trust fund or group trust that consists solely of the assets of pension, profit-sharing and other qualified plans, and/or other types of retirement plans or vehicles holding retirement plan assets. Under Article 1.02 of the STBT and Article 2.2 of the ITBT, an investment in units of the respective Trust may be made in the form of cash, or in the form of other property acceptable to the trustee.

For purposes of the in-kind investments by the TRTs in the Bond Trusts, you state that the assets being transferred would be valued in a consistent manner by both the investing and receiving trusts, using independent pricing sources.

Specifically, for valuing fixed-income securities, Vanguard uses the same pricing services for both the TRTs and the Bond Trusts. Where none of the pricing services used makes a value available for a particular security, or where there has been a significant change in value of the security from the previous price used (i.e., greater than 1%), Vanguard will obtain quotations from three (3) different independent brokers, and will use the lowest of the three available quotes. You state that pricing services and broker quotations are not used for short-term instruments maturing within 60 days. Thus, pursuant to the trust document's valuation provisions, these instruments would be valued at cost (plus or minus any amortized discount or premium). All valuations would be made as of 3:00 p.m. Eastern Time on the valuation date.

Vanguard serves as trustee of both the TRTs and the Bond Trusts – all of which, as bank collective investment funds, are deemed to hold "plan assets" subject to ERISA pursuant to the Department's regulations (see 29 CFR §2510.3-101(h)(1)(ii)). For this reason, you state that Vanguard would find itself acting in a discretionary role on both sides of any transaction between the TRTs and the Bond Trusts. Thus, the in-kind investment by the TRTs in the Bond Trusts could be viewed as a sale by the TRTs of their securities to the Bond Trusts, with Vanguard, in its capacity as trustee, acting in the role of both the buyer and the seller.

Advisory Opinion Requested

You request an opinion as to whether a purchase of interests in a collective investment fund through an in-kind investment of securities would be exempt from the prohibited transaction provisions of section 406 of ERISA by reason of the statutory exemption contained in section 408(b)(8) of ERISA.

Relevant Provisions of ERISA and Analysis

Section 406(a)(1) of ERISA provides, in part, that a fiduciary with respect to a plan shall not cause the plan to engage in certain direct or indirect transactions with a party in interest, including sales or exchanges of property between the plan and a party in interest (section 406(a)(1)(A)), and transfers to or use by or for the benefit of a party in interest of any assets of the plan (section 406(a)(1)(D)).

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(2) of ERISA provides that a fiduciary shall not in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.

Section 3(21) of ERISA defines a "fiduciary" of a plan to include a person who exercises any discretionary authority or control respecting management or disposition of its assets; or who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so.

Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary and a person providing services to a plan.

The Department's regulation at 29 CFR §2510.3-101 defines what are considered to be "plan assets" when a plan invests in another entity. The regulation provides, at 29 CFR §2510.3-101(h)(1)(ii), that when a plan acquires an interest in a common or collective trust fund of a bank, its assets include its investment as well as an undivided interest in each of the fund's underlying assets.

As you have acknowledged, Vanguard is a fiduciary under section 3(21) of ERISA with respect to ERISA-covered plans for which it serves as trustee. Pursuant to the Department's regulations defining "plan assets" (as noted above), Vanguard is also a fiduciary for ERISA-covered plans that invest in the TRTs, either through separately managed accounts or commingled trusts, by reason of its discretionary authority and control over such assets. You indicate that Vanguard receives investment management fees from plans that invest in such accounts or trusts invested in the TRTs, at either the separate account or "feeder" trust level, as applicable.

Therefore, unless an exemption applies, you are concerned that Vanguard would violate sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1), and 406(b)(2) of ERISA if, as a fiduciary of ERISA-covered plans, it caused "plan assets" invested in the TRTs to be invested in the Bond Trusts.

Section 408(b)(8) of ERISA exempts, in pertinent part, any transaction between a plan and a common or collective trust fund maintained by a party in interest which is a bank or trust company supervised by a state or federal agency, if the following conditions are met:

the transaction is a sale or purchase of an interest in the fund,

the bank or trust company receives not more than reasonable compensation, and

1. such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company or an affiliate) who has authority to manage and control the assets of the plan.

   You represent that the TRTs and Bond Trusts are collective trust funds maintained by Vanguard, a trust company supervised by the Pennsylvania Department of Banking. The transactions at issue would be purchases of interests in the Bond Trusts, and would be authorized by the applicable trust documents relating to each TRT and Bond Trust. Vanguard would not be paid any separate fees by the Bond Trusts for the assets invested therein by the TRTs. You state that Vanguard's existing fee arrangements with plans would remain unaffected by the proposed transactions and it would not receive more than reasonable compensation as a result of the transactions.

   With respect to the conditions of ERISA section 408(b)(8), although the statutory provisions do not define the term "reasonable compensation" for purposes of the exemption, the ERISA Conference Committee Report (as issued by Congress in 1974) provides that:

   "[t]o be allowed, no more than reasonable compensation may be paid by the plan in the purchase (or sale) and no more than reasonable compensation may be paid by the plan for investment management by the pooled fund."

   [See H.R. Rep. No. 93-1280, 93rd Cong., 2nd Sess., at 316 (1974)]

   Thus, Congress anticipated that the term "reasonable compensation" would apply to the purchase or sale of an interest in a collective investment fund by a plan and to amounts to be paid by the plan for investment management of such assets.

   In addition, with respect to covered transactions, the ERISA Conference Committee Report does not appear to distinguish cash from in-kind assets, nor does it specify a particular form of investment, with regard to any purchase or sale of interests or units in a common or collective investment trust fund, or pooled investment fund, maintained by a party in interest which is a bank or trust company. Furthermore, at the end of the relevant section discussing the provisions of ERISA section 408(b)(8), Congress expressed the view that, under the general fiduciary rules of ERISA, a bank "…cannot use pooled funds as a place to dump unwanted investments which were initially made on its own (or another's behalf)." Id.

   In this regard, by noting the possibility of a bank placing investments it previously had made into a collective investment fund, Congress appears to have anticipated in-kind investments being made into such a fund as a "purchase" covered by the statutory exemption.

   Accordingly, it is the opinion of the Department that the statutory exemption provided under section 408(b)(8) of ERISA would permit an in-kind exchange of securities owned by a plan or fund holding "plan assets" for units or interests in a collective investment fund maintained by a bank or trust company, provided that the conditions necessary for relief as stated therein are met.(2) However, please note that the issue of whether all of the conditions of section 408(b)(8) will be met is a factual determination upon which the Department cannot opine. Therefore, the appropriate plan fiduciaries, including Vanguard, must determine, based on the particular facts and circumstances, whether the conditions of section 408(b)(8) will be met for the proposed in-kind exchanges.

   In particular, the Department notes that the exemption provided in section 408(b)(8) is available for the proposed in-kind exchanges only if the valuation method used by Vanguard in connection with each transaction results in a plan paying no more than reasonable compensation for its investment. In our view, a plan would pay more than reasonable compensation in any in-kind exchange in which the value of assets transferred to a fund would be more than the value of the fund units or interests the plan received.

Therefore, the Department cautions Vanguard to ensure that appropriate procedures and safeguards are in place to guarantee uniform pricing of both the relevant "plan assets" in each TRT to be transferred to each Bond Trust and the Bond Trust's units to be received by each plan's stable value portfolio investment. As described herein, such investments would include the Retirement Savings Trusts that are "feeder" trusts for the VRST Master Trust, as managed by Vanguard on the date of the transactions.

Finally, the Department is providing no opinion herein as to Vanguard's current or future stable value investment strategies, or courses of action to implement to such strategies (including methods for saving transaction costs or avoiding market impact).

Section 404(a)(1) of ERISA provides, in pertinent part, that fiduciaries shall discharge their duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Among other things, a fiduciary must give appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.(3)

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

Under Reorganization Plan No. 4 of 1978, effective December 31, 1978 [5 USC App. at 214 (2000 ed.)], the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.

2. See Adv. Op. 96-15A (Aug. 7, 1996), wherein the Department took the position that section 408(b)(8) of ERISA provides relief from sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2) for the purchase or sale by a bank or trust company, as fiduciary of ERISA-covered plans, of interests in a collective fund so long as the conditions of the statutory exemption are met, including that the transaction be expressly permitted by the plan or an authorized independent fiduciary.
3. The Department notes that regulation §2550.404a-1 defines appropriate considerations for an investment course of action by fiduciaries in such matters.

Advisory Opinion 2006-01A
ERISA Sec. 29 CFR 2509.75-2

Whether a lease by a company (LLC) 49% owned by an IRA to a company (S) which is a disqualified person with respect to that IRA is a prohibited transaction where the manager of the LLC is an officer of S. Whether 29 CFR 2509.75-2 makes the transaction an indirect prohibited transaction and whether it makes the transaction a violation of the Internal Revenue Code's exclusive benefit rule.

January 6, 2006
Debra C. Buchanan, Esq.
Guidant Legal Group, PLLC
225 Commerce Street, Suite 450
Tacoma, WA 98402

Dear Ms. Buchanan,

This is in response to your request for an advisory opinion as to whether the following proposed transaction would be prohibited under section 4975 of the Internal Revenue Code (the "Code"), 26 U.S.C. § 4975.(1)

You represent that Salon Services and Supplies, Inc. is a Washington state "S" Corporation ("S Company") which is 68% owned by Miles and Sydney Berry, a marital community (M). The other 32% is owned by a third-party, George Learned ("G"). Miles Berry (Berry) proposes to create a limited liability corporation ("LLC") that will purchase land, build a warehouse and lease the property to S Company. The investors in the LLC would be Berry's individual retirement account ("IRA") (49%), Robert Payne's ("R") IRA (31%) and G (20%). R is the comptroller of S Company. R and G will manage the LLC. You represent that S Company is a disqualified person with respect to Berry's IRA under section 4975(e)(2) of the Code. You represent that R and G are independent of Berry. You also represent that the LLC does not contain plan assets because it is a "real estate operating company" (REOC) as defined by 29 C.F.R. § 2510.3-101(e).

You state that an independent qualified commercial real estate appraiser has appraised the rental value of the lease and has found that the terms of the lease are not less favorable to the LLC and its IRA investors than those obtainable in an arm's length transaction between unrelated parties. Finally, the custodian for Berry's and R's IRAs has reviewed the LLC operating agreement and has approved the investment for those two self-directed IRAs.

Section 4975(c)(1)(A) of the Code prohibits any direct or indirect sale, exchange or leasing of any property between a plan and a "disqualified person." Section 4975(c)(1)(D) of the Code prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan. A "disqualified person" is defined under section 4975(e)(2)(A) of the Code to include a person who is a fiduciary. Code section 4975(e)(3) defines the term "fiduciary" to include, in pertinent part, any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets. Section 4975(c)(1)(E) prohibits a fiduciary from dealing with the income or assets of a plan in the fiduciary's own interest or for his or her own account. Section 4975(e)(1)(B) of the Code defines the term "plan" to include an individual retirement account described in Code section 408(a).

We first address the proposed lease as it relates to Berry's IRA. Berry is a fiduciary to his own IRA because he exercises authority or control over its assets and management. 26 U.S.C. § 4975(e)(3). As a fiduciary, Berry is a disqualified person under section 4975(e)(2)(A) of the Code. You represent that S Company is a disqualified

person under section 4975(e)(2) of the Code. R, the comptroller of S Company, is a disqualified person with respect to Berry's IRA under section 4975(e)(2)(H) as an officer of S Company. R, as an employee of S Company, a company 68% owned by M, cannot be considered independent of Berry.

Based upon your representations, it is the opinion of the Department that a lease of property between the LLC and S Company would be a prohibited transaction under Code section 4975, at least as to Berry's IRA. The lease constitutes a prohibited transaction regardless of whether the LLC qualifies as a REOC under the Department's plan assets regulation. 29 C.F.R. § 2510.3-101.

The Department's regulation at 29 C.F.R. § 2509.75-2(a) (Interpretative Bulletin 75-2), explains that a transaction between a party in interest under ERISA(2) (or disqualified person under the Code, in this case S Company) and a corporation in which a plan has invested (i.e., the LLC) does not generally give rise to a prohibited transaction. However, in some cases it can give rise to a prohibited transaction. Regulation section 2509.75-2(c) and Department opinions interpreting it have made clear that a prohibited transaction occurs when a plan invests in a corporation as part of an arrangement or understanding under which it is expected that the corporation will engage in a transaction with a party in interest (or disqualified person).(3)

According to your representations, it appears that Berry's IRA will invest in the LLC under an arrangement or understanding that anticipates that the LLC will engage in a lease with S Company, a disqualified person. Therefore, the lease would amount to a transaction between Berry's IRA and S Company that Code section 4975(c)(1)(A) and (D) prohibits. Additionally, the proposed lease, if consummated, may also constitute a violation by Berry, a fiduciary, of Code section 4975(c)(1)(D) and (E).

Finally, we note the express emphasis in 29 C.F.R. § 2509.75-2(c) that the Department considers "a fiduciary who makes or retains an investment in a corporation or partnership for the purpose of avoiding the application of the fiduciary responsibility provisions of the Act to be in contravention of the provisions of section 404(a) of the Act."

Thus, the proposed lease, which would violate section 4975(c)(1) of the Code, would also have to be referred to the Internal Revenue Service for a determination as to whether it would consider the transaction a violation of the exclusive benefit rule of section 401(a)(2) of the Code, which is the Code's analogue to the fiduciary responsibility provisions of section 404(a) of ERISA.

Because we have concluded that the proposed lease would constitute a prohibited transaction with respect to Berry's IRA, the issue of whether the Code prohibits the lease as it relates to R's IRA is moot, and does not need to be addressed.

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

1. Under Reorganization Plan No. 4 of 1978, effective December 31, 1978 [5 U.S.C. App. at 214 (2000 ed.)], the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code was transferred, with certain exceptions not here relevant, to the Secretary of Labor. As a result, citations to section 406 of the Employee Retirement Income Security Act (ERISA), 29 U.S.C. § 1001 et seq. and applicable regulations also refer to the parallel citations of section 4975 of the Code.
2. Section 3(14) of ERISA defines the term "party in interest" for purposes of Title I of ERISA, including the prohibited transaction provisions of ERISA section 406.
3. See 29 C.F.R. § 2509.75-2(c); Opinion No. 75-103 (Oct. 22, 1975); 1978 WL 170764 (June 13, 1978). Further, prior to the promulgation of the Department's plan assets regulation, 29 C.F.R. § 2510.3-101, the Department had issued Interpretive Bulletin 75-2 which discusses certain prohibited transactions under section 406 of ERISA or section 4975 or the Code. As indicated in the preamble to the plan assets regulation, part of Interpretive Bulletin 75-2 was revised to coordinate it with the final regulation (51 Fed. Reg. 41278). The remainder of the Interpretive Bulletin 75-2, published at 29 C.F.R. § 2509.75-2(c), remains in force and was not affected by the plan assets regulation. Regulation section 2509.75-2(c) sets forth that a transaction between a party in interest and a corporation in which a plan has invested may constitute a prohibited transaction under certain circumstances. Such transactions

are prohibited regardless of whether or not they meet the plan assets regulation.

Advisory Opinion 2006-06A
PTE 77-3

Whether the prohibition on the payment of sales commissions in PTE 77-3 applies to the payment of 12b-1 Fees by a proprietary mutual fund to an unrelated broker.

July 26, 2006
Mr. F. Jefferson Bragdon
Williams Coulson
15th Floor
Two Chatham Center
Pittsburgh, PA 15219

Re: Company A 401(k) and Profit Sharing Plan (the Plan)

Identification Number C-09259

Dear Mr. Bragdon:

This is in response to your request for an advisory opinion concerning Prohibited Transaction Exemption (PTE) 77-3 (42 FR 18734, April 8, 1977).(1) Specifically, you request an opinion on whether the prohibition on the payment of sales commissions in PTE 77-3 applies to the payment of distribution-related expenses (12b-1 Fees) by a proprietary mutual fund (the Mutual Fund) to an unrelated broker. In particular, the distributor of the Mutual Fund would pay the unrelated broker from Mutual Fund assets received by the distributor under a Rule 12b-1 plan of distribution (the 12b-1 Plan).(2) The distributor would retain no portion of the 12b-1 Fees. Due to your uncertainty about the application of PTE 77-3, you requested that we not identify the relevant parties.

You describe the facts as follows. Company A is the sponsor of the Plan. Company A is an investment adviser to the Z Family of Mutual Funds (the Funds), and one of four employers of employees covered by the Plan. The other employers are Company B, the distributor and principal underwriter of the Funds; Company C, another investment adviser of the Funds; and Company D, which provides other services to the Funds.

The Plan is a defined contribution plan with a section 401(k) cash or deferred feature permitting employee pre-tax deferrals, which allows participants to direct the investment of their accounts among the Funds. The Plan was established by Company A, effective January 1, 1994. The Plan covers only employees of Companies A, B, C, and D (the Companies). The Plan is intended to comply with section 404(c) of the Employee Retirement Income Security Act of 1974 (the Act or ERISA). As of June 30, 2005, the Plan had total assets of approximately $7 million. As of September 9, 2005, the Plan had 260 participants. The trustee of the Plan is Individual G, a senior executive officer of the Companies.

From the inception of the Plan to September 2005, you explain that participants have directed the investment of their accounts among the Funds. Beginning in 1999, you indicate that some of the Funds, in which participants invested their accounts, adopted 12b-1 Plans in accordance with Rule 12b-1 under the Investment Company Act of 1940 (the ’40 Act), 17 CFR §240.12b-1. You further explain that the 12b-1 Plans permit 0.25 percent of the Funds’ assets to be used by Company B to pay 12b-1 Fees to promote the sale of shares of the Funds. No 12b-1 Fees have been paid by Company B in connection with the acquisition or sale of shares of the Funds by the Plan.

You state that Company A has entered into an agreement (the Agreement) with Company E, an unrelated party to the Funds and the Companies, to provide administration services for the Plan. In connection therewith, Company A will (a) adopt the approved prototype plan of Company E, (b) appoint Bank F as successor

trustee, and (c) transfer the assets of the Plan to Bank F in cash. After the transfer of the Plan assets, you explain that participants will direct the investment of their account balances among investment alternatives consisting of mutual funds that are offered by parties unrelated to the Funds and the Companies, whose net asset values are listed daily in financial and other news publications.

To accommodate a number of participants that want to continue to direct the investment of their account balances in the Funds after the transfer, you state that the Agreement with Company E provides for a self-directed brokerage account (the Self-Directed Brokerage Account) established with Company H, that will permit participants to direct the investment of their account balances in the Funds. The Self-Directed Brokerage Accounts will be available to all participants on an equal basis. A Plan participant that uses the Self-Directed Brokerage Account option will pay a $75 annual fee to the Plan recordkeeper.

You represent that Company B will pay a 12b-1 Fee to Company H, the broker, with respect to amounts invested in the Funds by Plan participants and that Company B will not retain any portion of such fee. You explain that Company H provides brokerage services to the Plan participants and that it is unrelated to the Funds, the Companies, Individual G, and Bank F. You also state that Company H is not a fiduciary, as defined in section 3(21) of the Act, with respect to the Plan, because it does not exercise any discretionary authority or control with respect to management of the Plan or exercise any authority or control with respect to management or disposition of assets of the Plan, and does not render investment advice with respect to any property of the Plan. You further represent that no fiduciary of the Plan, or affiliate of any fiduciary, will benefit from any part of the 12b-1 Fee.

You represent that the Plan's investment in the Funds has met and will continue to meet the conditions stated in PTE 77-3. Therefore, you explain that the only issue with respect to the continued availability of PTE 77-3 is the possibility that the payment of 12b-1 Fees to Company H may not be permissible under PTE 77-3.

PTE 77-3 provides relief from the restrictions of sections 406 and 407(a) of the Act and the taxes imposed by section 4975 (a) and (b) of the Internal Revenue Code (the Code), by reason of section 4975(c)(1) of the Code, with respect to the acquisition or sale of shares of an open-end investment company registered under the '40 Act by an employee benefit plan covering only employees of such investment company, employees of the investment adviser or principal underwriter for such investment company, or employees of any affiliated person of such investment adviser or principal underwriter; provided that the conditions of the class exemption are met. Among its requirements, section (c) of PTE 77-3 provides that the plan must not pay a sales commission in connection with such acquisition or sale.

As you have noted, the Department's concern with respect to 12b-1 Fees was expressed in ERISA Advisory Opinion 93-12A (April 27, 1993) in the context of a transaction otherwise covered by PTE 77-4 (42 FR 18732, April 8, 1977). PTE 77-4 permits the purchase or sale by a plan of shares of a registered open-end investment company where an investment adviser to the mutual fund is also a fiduciary with respect to the plan. In ERISA Advisory Opinion 93-12A, a company serving as investment manager or trustee to employee benefit plans invested plan assets in affiliated mutual funds. The company credited the plan for investment advisory fees that the company received from the mutual fund, but did not credit the plan for fees that it received for secondary services provided to that fund. The Department stated that PTE 77-4 would be available if the secondary services were not investment advisory services and the conditions of this class exemption were otherwise met.

The Department also noted in ERISA Advisory Opinion 93-12A that at the time PTE 77-4 was granted, the use of a portion of the assets of a registered investment company to pay distribution-related expenses was not generally permitted by the Securities and Exchange Commission. Accordingly, the Department stated that the payment of 12b-1 Fees was not specifically considered as part of its determination to grant PTE 77-4. In any event, the Department was of the view that the payment of a 12b-1 Fee by a mutual fund to a plan fiduciary or its affiliate could not be "functionally distinguished" in many instances from the payment of a commission by the plan in connection with the acquisition or sale of shares in a mutual fund. Therefore, the Department was unable to conclude that PTE 77-4 would be available for plan purchases and sales of mutual fund shares if a 12b-1 Fee was paid to the fiduciary or its affiliate with regard to that portion of the fund's assets attributable to the plan's investment.

In ERISA Advisory Opinion 2002-05A (June 7, 2002) involving "exchange-traded funds," the Department expressed the view that the term "sales commission," as used in section II(a) of PTE 77-4, would not include brokerage commissions paid to a broker in connection with purchases or sales of shares of registered open-end investment companies listed on an exchange if the broker is unaffiliated with the fund, its principal underwriter, investment adviser or any affiliate thereof.

Similarly in the case under consideration, the broker (Company H) is unaffiliated with the Mutual Fund, its principal underwriter/distributor (Company B), any investment advisers (Companies A and C) or any affiliate thereof (Company D), and any other fiduciary of the Plan (Bank F and Company E). In addition, neither the Companies nor their affiliates would receive any part of the 12b-1 Fees, nor would any fiduciary with respect to the Plan or affiliate of such fiduciary receive such fees. Finally, no commissions would be paid from the Plan participants' accounts other than 12b-1 Fees out of Fund assets. Accordingly, it is the Department's view that the term "sales commission," as used in section (c) of PTE 77-3, would not include 12b-1 Fees that are paid to Company H, by Company B, from Mutual Fund assets, where Company H is an unrelated party and Company B keeps no part of the 12b-1 Fees.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. This opinion relates only to the specific issue addressed herein and is consistent with ERISA Advisory Opinion 2002-05A.

Sincerely,
Ivan L. Strasfeld
Director, Office of Exemption Determinations

Footnotes

1. The Department received your submission as a request for an administrative exemption. However, due to the nature of the issue involved, the Department has decided, with your concurrence, to process this submission as an advisory opinion request.
2. Although you have also requested information concerning excise taxes and the correction of inadvertent prohibited transactions related to the 12b-1 Fees, this opinion letter does not address these issues. The Department believes that the appropriate forum to resolve these matters is the Internal Revenue Service.

Trust Examination Manual

Advisory Opinion 2006-08A
ERISA Sec. 404(a)

Whether a fiduciary of a defined benefit plan may, consistent with the requirements of section 404 of ERISA, consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan.

October 3, 2006
Donald J. Myers, Esq.
Reed Smith LLP
1301 K Street, N.W.
Suite 1100-East Tower
Washington, D.C. 20005-3373

Dear Mr. Myers:

This is in response to your request for an advisory opinion on behalf of JPMorgan Chase Bank, N.A. (JPMorgan) regarding the application of the fiduciary responsibility provisions of Title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA). Specifically you have inquired whether a fiduciary of a defined benefit plan may, consistent with the requirements of section 404 of ERISA, consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan.

You represent that JPMorgan, as a plan fiduciary, proposes to “risk manage” the assets of defined benefit plans by better matching the risks of a plan’s investment portfolio assets with the risks associated with its benefit liabilities, with a goal toward reducing the likelihood that liabilities will rise at a time when the assets decline. Defined benefit plan liabilities are determined by a number of factors, most significantly the demography of the participant population (participants’ number of years of service and/or expected length of time for payment of retirement benefits) and the interest rates used to calculate the present value of the plan’s obligations for funding and accounting purposes.

According to your letter, these liabilities most closely correlate with fixed-income assets, so that one approach for risk managing assets would be to invest directly in a portfolio of fixed-income securities with a duration of the plan’s benefit obligations. However, you note that there may be aspects of a plan’s obligations that correlate more closely with other types of investments, and it may not be possible to match liabilities precisely with fixed-income securities due to limitations in the fixed-income market. As a result, you indicate that a variety of approaches may be used in practice, depending on the facts and circumstances of the particular plan.

In developing an asset allocation that better matches the risk and duration characteristics of a plan’s benefit liabilities, you explain that the focus of JPMorgan’s services would be on reducing the risk of underfunding to the plan and its participants and beneficiaries by reducing volatility in funding levels. In this regard, you note that there may be incidental benefits to the plan sponsor from maintaining more consistent funding levels, such as reduced volatility on the sponsor’s financial statements and reduced minimum contribution obligations. However, you also note that the principal benefit of decreased volatility would be the reduced need for the plan to rely on the plan sponsor to meet its funding obligations, protecting the plan participants and beneficiaries in the event of the sponsor’s insolvency.

Taking into account the foregoing, you have requested the views of the Department on whether a fiduciary of a defined benefit plan may, consistent with the requirements of section 404 of ERISA, consider the liability obligations of the plan and the risks associated with such liability obligations in determining a prudent investment strategy for the plan.

Sections 403(c) and 404(a)(1)(A) of ERISA require plan fiduciaries to discharge their duties with respect to a plan solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan. Section 404(a)(1)(B) of ERISA requires plan fiduciaries to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims. These fiduciary standards apply to the selection and monitoring of plan investments, including plan investments made pursuant to a particular investment strategy. The frequency and degree of monitoring, will, of course, depend on the nature of such investments and their role in the plan's portfolio.

The general standards of fiduciary conduct contained in sections 404(a)(1) apply to any investment by a plan covered by Title I, including investments made pursuant to the described risk management investment strategy. Accordingly, fiduciaries of the plan must act prudently, solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits and defraying reasonable plan administrative costs when deciding whether to invest in a particular investment or use a particular investment strategy.

With regard to investing plan assets, the Department has issued a regulation, at 29 CFR 2550.404a-1, interpreting the prudence requirements of ERISA as they apply to the investment duties of fiduciaries of employee benefit plans. The regulation provides that the prudence requirements of section 404(a)(1)(B) are satisfied if (1) the fiduciary making an investment or engaging in an investment course of action has given appropriate consideration to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant, and (2) the fiduciary acts accordingly. This includes giving appropriate consideration to the role that the investment or investment course of action plays with respect to that portion of the plan's investment portfolio within the scope of the fiduciary's responsibility.

The regulation further specifies the facts and circumstances that must be given appropriate consideration to include, but not be limited to, (A) a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio (or, where applicable, that portion of the plan portfolio with respect to which the fiduciary has investment duties) to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action and (B) consideration of the following factors as they relate to such portion of the portfolio: (i) the composition of the portfolio with regard to diversification; (ii) the liquidity and current return of the portfolio relative to the anticipated cash flow requirement of the plan; and (iii) the projected return of the portfolio relative to the funding objectives of the plan.

Within the framework of ERISA's prudence, exclusive purpose and diversification requirements, the Department believes that plan fiduciaries have broad discretion in defining investment strategies appropriate to their plans. In this regard, the Department does not believe that there is anything in the statute or the regulations that would limit a plan fiduciary's ability to take into account the risks associated with benefit liabilities or how those risks relate to the portfolio management in designing an investment strategy.

For these reasons, a fiduciary would not, in the view of the Department, violate their duties under sections 403 and 404 solely because the fiduciary implements an investment strategy for a plan that takes into account the liability obligations of the plan and the risks associated with such liabilities and results in reduced volatility in the plan's funding requirements. Whether any particular investment strategy is prudent with respect to a particular plan will depend on all the facts and circumstances involved.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is issued subject to the provisions of that procedure, including section 10 thereof relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

supervision@fdic.gov

Trust Examination Manual

Advisory Opinion 2006-09A
IRC Section 4975 (c)(1)(A) & (B)

This advisory opinion concludes that a self-directed IRA's investment in notes of a corporation, a majority of whose stock is owned by the son-in-law of the IRA owner, would be a prohibited transaction under the Internal Revenue Code.

December 19, 2006
Edward A. Appelt
24 Winslow Drive
Pittsburg, PA 15229

Dear Mr. Appelt:

This is in response to your request for an advisory opinion under section 4975 of the Internal Revenue Code (Code). Specifically, you ask whether allowing the owner of an individual retirement account (IRA) to direct the IRA to invest in notes being offered by a corporation, in which a relative of the IRA owner is the majority owner and stockholder, would give rise to a prohibited transaction under Code section 4975.(1)

You represent that as the owner of an IRA for which you have retained investment discretion, you would like to direct the investment of these IRA funds into notes (Notes) that are being offered by STARR Life Sciences Corporation (STARR). STARR is currently owned by the founders of the Company who are: Eric (your son-in-law) - 87.5%; Erika (an unrelated party) - 7.5%; and Dr. Strolh (an unrelated party) - 5.0%.

You represent that these Notes are being offered and sold exclusively to persons who qualify as "accredited investors" under rule 501(a) of Regulation D promulgated under the Securities Act of 1933. You represent that you qualify as an accredited investor.

You ask whether the IRA's investment in the Notes would give rise to a prohibited transaction under section 4975 of the Code. Section 4975(c)(1)(A) and (B) of the Code defines a prohibited transaction to include any direct or indirect sale or exchange of property and lending of money or other extension of credit between a plan and a disqualified person.

Section 4975(e)(1) of the Code defines, in relevant part, the term "plan" to include an IRA described in Code section 408(a). Section 4975(e)(3) of the Code defines the term "fiduciary," in relevant part, to include any person who exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets. Because you retain investment discretion over the IRA, you are a fiduciary. Section 4975(e)(2) of the Code defines "disqualified person," in relevant part, to include a fiduciary and certain members of the family of a fiduciary. Consequently, you are also classified as a disqualified person under Code section 4975(e)(2)(A). Sections 4975(e)(2)(F) and 4975(e)(6) of the Code state, in relevant part, that the family of a fiduciary shall include his spouse, ancestor, lineal descendant, and any spouse of a lineal descendant. Consequently, your son-in-law is also classified as a disqualified person because he is a member of the family of a fiduciary.

The IRA's purchase of the Notes would be a transaction between STARR and the IRA. Code section 4975(e)(2)(G)(i) defines "disqualified person," in relevant part, to include a corporation of which (or in which) 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation is owned indirectly by a fiduciary.

In determining indirect stockholdings, Code section 4975(e)(4) requires that for purposes of Code section 4975(e)(2)(G)(i), indirect stockholdings include those which would be taken into account under Code section 267(c), except that members of a family of a fiduciary are members within the meaning of Code section 4975(e)(6). The application of this rule attributes to you the majority stockholdings of your son-in-law.

Consequently, STARR is also classified as a disqualified person.

The IRA is a plan and STARR is a disqualified person. Based on the facts and representations in your submissions, it is the opinion of the Department of Labor that the IRA's purchase of the Notes from STARR at your direction would be a transaction described in section 4975(c)(1)(A) and (B) of the Code which prohibit a direct or indirect sale or exchange of property and lending of money or other extension of credit between a plan and a disqualified person.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of such procedure, including section 10 relating to the effect of advisory opinions.

Sincerely,
Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

Footnotes

1. Under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Advisory Opinion 2007-01A
PTE 84-14

Whether transactions between a broker-dealer and a separate account managed by a QPAM under a 401(k) plan fail to satisfy section I(a) of PTE 84-14 where plan participants investing in such account receive investment allocation advice from a subsidiary of the broker-dealer.

January 22, 2007
Melanie Franco Nussdorf, Esq.
Steptoe & Johnson LLP
1330 Connecticut Ave NW
Washington DC 20036

Dear Ms. Nussdorf:

This is in response to your request for guidance concerning the application of section I(a) of Prohibited Transaction Exemption (PTE) 84-14 (49 FR 9494, March 13, 1984, as corrected at 50 FR 41430, October 10, 1985, as amended at 70 FR 49305, August 23, 2005).(1) PTE 84-14 permits certain transactions between a party in interest with respect to an employee benefit plan and an investment fund (as defined in section V(b) of PTE 84-14) in which the plan has an interest and which is managed by a qualified professional asset manager (QPAM), if the conditions of the exemption are satisfied.

You write on behalf of an investment banking, securities and investment management firm (Firm A). You represent that Firm A is a broker-dealer which is a frequent counterparty to plans and vehicles that hold plan assets. A subsidiary of Firm A (Subsidiary B) provides investment advice for a fee to participants in self-directed individual account plans.

You request our views on a scenario under which a participant-directed individual account plan offers a separate account that is managed by a QPAM as one of its investment options. The QPAM is not related to either Firm A or Subsidiary B. You represent that Subsidiary B's services to the plan are limited to advising participants with respect to allocation of their investments in the plan. Subsidiary B does not have authority or control over any participant accounts and does not participate in the selection or oversight by the plan sponsor of investment options available under the plan. The plan sponsor (or a named fiduciary unrelated to Firm A and Subsidiary B) would possess and exercise the authority to appoint and terminate the QPAM for the plan. Neither Firm A nor Subsidiary B would participate in the negotiation of the terms of the management agreement with the QPAM. You note that, under certain circumstances, a fiduciary who provides investment advice to a plan for a fee may exert so much influence over the plan sponsor (or named fiduciary) so as to have effectively "exercised" authority or control over the operation of the plan or its assets. You ask, however, that the Department assume, for purposes of this opinion, the absence of such influence, control or authority over the plan sponsor (or named fiduciary).

You have requested guidance as to whether transactions between Firm A and the investment fund managed by the QPAM as an option under the plan would fail to satisfy the condition in section I(a) of the exemption if plan participants investing in such fund receive investment allocation recommendations from Subsidiary B. You state that, since the plan sponsor (or named fiduciary) of each plan, as opposed to Firm A or Subsidiary B, is the party that possesses and exercises the power to select the investment vehicles that may be managed by a QPAM, and since plan participants, as opposed to Firm A or Subsidiary B, have the power to select investment options under the plan in which to invest, such transactions should fall within the relief provided by PTE 84-14.

Section I(a) of PTE 84-14 provides that, at the time of the transaction, the party in interest, or its affiliate (as

defined in section V(c)), does not have the authority to appoint or terminate the QPAM as a manager of the plan assets involved in the transaction, or negotiate on behalf of the plan the terms of the management agreement with the QPAM (including renewals or modifications thereof) with respect to the plan assets involved in the transaction.

Section V(c) of the exemption defines an affiliate of a person as:

[a]ny person directly or indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the person,

[a]ny corporation, partnership, trust or unincorporated enterprise of which such person is an officer, director, 10 percent or more partner ... or highly compensated employee as defined in section 4975(e)(2)(H) of the Code (but only if the employer of such employee is the plan sponsor), and

[a]ny director of the person or any employee of the person who is a highly compensated employee, as defined in section 4975(e)(2)(H) of the Code, or who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets involved in the transaction. A named fiduciary (within the meaning of section 402(a)(2) of ERISA) of a plan with respect to the plan assets involved in the transaction and an employer any of whose employees are covered by the plan will also be considered affiliates with respect to each other for purposes of section I(a) if such an employer or an affiliate of such employer has the authority, alone or shared with others, to appoint or terminate the named fiduciary or otherwise negotiate the terms of the named fiduciary's employment agreement.

It is the Department's view that, based upon the circumstances you have described, neither Firm A nor Subsidiary B has the authority to appoint or terminate the QPAM as a manager of plan assets involved in the transaction, or to negotiate the terms of the QPAM's management agreement. The fact that Subsidiary B provides investment advice for a fee to participants in a plan who invest in a separate account under the plan managed by such QPAM would not cause a transaction between the separate account and Firm A to fail section I(a) of the QPAM class exemption solely by reason of the provision of such participant advice.

The Department notes that Part I of PTE 84-14 provides no relief for transactions described in section 406(b) of ERISA. If Subsidiary B is a fiduciary by virtue of rendering investment advice within the meaning of 29 CFR 2510.3-21(c), the provision of such investment advice involving self-dealing will subject the fiduciary adviser to liability under section 406(b) of ERISA. Thus, for example, a violation of section 406(b) would occur if Subsidiary B advised plan participants to invest in a QPAM-managed fund pursuant to an arrangement or understanding with the QPAM which would result in a benefit being conferred upon Firm A or Subsidiary B as a result of such investment.

This letter constitutes an advisory opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of advisory opinions. This opinion relates only to the specific issue addressed herein.

Sincerely,
Ivan L. Strasfeld
Director , Office of Exemption Determinations

Footnotes

1. See also Proposed Amendment to Prohibited Transaction Exemption (PTE) 84-14 for Plan Asset Transactions Determined by Independent Qualified Professional Asset Managers, 70 FR 49312 (August 23, 2005).

U.S. Department of Labor **Employee Benefits Security Administration**
Washington, D.C. 20210

2007-02A
PTE 84-14

February 26, 2007

Melanie Franco Nussdorf, Esq.
Steptoe & Johnson
1330 Connecticut Avenue, NW
Washington, DC 20036

Dear Ms. Nussdorf:

This is in response to your request for guidance concerning Prohibited Transaction Exemption (PTE) 84-14 (49 FR 9494, March 13, 1984, as corrected, 50 FR 41430, October 10, 1985, and as amended, 70 FR 49305, August 23, 2005). Your request concerns the proper application of section I(a) of PTE 84-14 to certain pooled investment funds that are deemed to hold plan assets within the meaning of 29 CFR 2510.3-101(f)(the Plan Asset Regulation).

You write on behalf of The Goldman Sachs Group, Inc. (Goldman Sachs), a provider of global investment banking, asset management and other financial services. Goldman Sachs seeks the Department's opinion concerning the application of section I(a) of PTE 84-14 in instances where a pooled investment fund (the First Fund) that is deemed to hold plan assets under the Plan Asset Regulation invests in another pooled investment fund (the Second Fund) that also is deemed under the Plan Asset Regulation to hold plan assets. Specifically, you request guidance as to whether, under section I(a), the Second Fund is required to look through to (and thus count separately) the assets of any plan invested in the First Fund.

PTE 84-14 generally provides relief from the prohibited transaction restrictions of section 406(a)(1)(A)-(D) for transactions between a plan and a party in interest provided that the plan is invested in an investment fund managed by a qualified professional asset manager (QPAM). Section I(a) of PTE 84-14 requires that, at the time of the transaction, the party in interest or its affiliate does not have the authority to either appoint or terminate the QPAM as manager of the plan assets involved in the transaction, or negotiate on behalf of the plan the terms of the QPAM's management agreement with respect to the plan assets involved in the transaction. Section I(a) contains an exception to this requirement in the case of two or more unrelated plans invested in an investment fund in instances where the assets of a plan, when combined with assets of other plans established or maintained by the same employer or employee organization, and managed in the same investment fund represent less than 10% of the assets of the investment fund.

As noted above, you have asked for clarification of this requirement in the situation in which the First Fund invests in the Second Fund. You provide the following example:

> Assume that Plan X is a 50% investor in the First Fund and also a 4% investor in the Second Fund. The First Fund purchases a 30% interest in the Second Fund. The underlying assets of both Funds contain plans assets.

You have offered your view that, consistent with the language of section I(a), the manager of the Second Fund need not inquire concerning the presence of plan investors in the First Fund, nor aggregate a plan's interest in the First Fund with its direct investment in the Second Fund for the purpose of determining if the plan holds 10% or more of the assets of the Second Fund. In the example you have provided, the manager would only count Plan X's direct 4% investment in the Second Fund and not the indirect interest held by Plan X as a result of its investment in the First Fund.

You have asked the Department to assume, for purposes of your request, that the two investment funds are not managed by the same manager or an affiliate. Under these circumstances, it is the Department's view that the 10 percent exception contained in section 1(a) of PTE 84-14 does not require the consideration by a QPAM of the ownership interests of any plan investors in an investment fund which is investing in a second fund managed by such QPAM.

The Department cautions, however, that, Part I of PTE 84-14, does not provide any relief from the prohibitions of section 406(b). In addition, section I(c) of the exemption provides, in part, that the transaction not be part of an agreement, arrangement, or understanding designed to benefit a party in interest. Thus, for example, if the investment manager of the First Fund invested in the Second Fund pursuant to an agreement or understanding that the manager of the Second Fund would engage in transactions that benefit the manager of the First Fund or its affiliate, the QPAM exemption would not be available for those transactions. In addition, the investment of plan assets by the First Fund in the Second Fund would violate 406(b) of ERISA.

This letter constitutes an Advisory Opinion under ERISA Procedure 76-1 and is issued subject to the provisions of that procedure, including section 10, relating to the effect of Advisory Opinions. This opinion relates only to the specific issue addressed herein.

Sincerely,

Ivan L. Strasfeld
Director
Office of Exemption Determinations

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration
Field Assistance Bulletin 2002-1

September 26, 2002

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: ESOP Refinancing Transactions

Issue

What are the obligations of a fiduciary under sections 404(a) and 408(b)(3) of ERISA in connection with the refinancing of an exempt ESOP loan?

Background

An ESOP is a defined contribution pension plan designed to invest primarily in stock of the sponsoring employer or an affiliate. A leveraged ESOP is an ESOP that finances its purchase of such stock through securities acquisition debt obtained from, or guaranteed by, the sponsoring employer. A leveraged ESOP, operated in accordance with applicable regulations, holds the shares purchased with the proceeds of such a loan in a "suspense account," and releases them from the suspense account as the loan is repaid according to a set formula that is expressed in terms of number of shares.(1) This release formula requires that in a given year, the number of shares released from the suspense account will be determined by multiplying the number of shares in the suspense account by a fraction. The numerator of that fraction is the amount of principal and interest paid for the year, and the denominator is the sum of the numerator plus the amount of principal and interest to be paid for all future years on the loan.(2) After the shares of stock are released from the suspense account, they are allocated to participants' accounts.

Loan repayment schedules typically are designed to provide for the release of stock from the ESOP suspense account consistent with a specific projected level of benefits or participant contributions. Loan repayment schedules, therefore, are often formulated based on projections as to the future value of shares, the number of participants and, if relevant, levels of participant contributions over the term of the loan. Accordingly, where there are significant deviations from the projections – such as significant increases in the value of the stock held in the ESOP suspense account or significant decreases in the number of participating employees – the release of stock in accordance with original loan terms will result in a level of benefits greater than originally intended by the plan sponsor. Refinancing of the underlying loans is a means by which some plan sponsors have sought to bring future allocations closer to the amounts they originally intended. In general, an ESOP refinancing involves entering into a new loan that extends the repayment schedule and, therefore, the period over which stock will be allocated from the suspense account to individual participants. Typically, the ESOP uses the loan proceeds to retire the original loan and release suspense account shares to the accounts of the participants only as the new, extended, loan is repaid. While all of the shares acquired in the original stock purchase are ultimately released under the extended terms of the new loan, fewer shares are released from the suspense account during the period of the original underlying loan and fewer shares are allocated to participants' accounts during that same period.

Analysis

Section 404(a)(1)(A) of ERISA requires, among other things, that a fiduciary of a plan discharge its duties with respect to the plan solely in the interest of the plan's participants and beneficiaries and for the

exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. Section 404(a)(1)(B) requires that a fiduciary of a plan discharge its duties with respect to the plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Section 403(c)(1) requires, in part, and subject to certain exceptions, that the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan.

Section 406(a)(1)(B) provides, in pertinent part, that a fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect "lending of money or other extension of credit between the plan and a party in interest." ERISA section 3(14) defines a "party in interest" to include an employer. Section 408(b)(3) provides that a loan to an ESOP is exempt from section 406 (except section 406(b)(3)(3)) if such loan is "primarily for the benefit of participants and beneficiaries of the plan, and . . . such loan is at an interest rate which is not in excess of a reasonable rate." It is the view of the Department that the requirements of section 408(b)(3) apply to the refinancing of an ESOP loan, as well as to the original loan. Accordingly, an ESOP fiduciary, in order to avoid engaging in a prohibited transaction, must take steps to ensure that a refinancing transaction comports with the requirements of section 408(b)(3) and 29 C.F.R. § 2550.408b-3.

§ 2550.408b-3(c) addresses the application of the "primary benefit" requirement of section 408(b)(3). In applying the "primary benefit" requirement, paragraph (c)(1) of § 2550.408b-3 provides, among other things, that a fiduciary must consider "[a]ll the surrounding circumstances, including those described in paragraphs (c)(2) and (3) of this section."(4) Paragraph (c)(2) of that section provides that "[a]t the time that a loan is made, the interest rate for the loan and the price of securities to be acquired with the loan proceeds should not be such that plan assets might be drained off." Paragraph (c)(3) of that section provides that "[t]he terms of a loan, whether or not between independent parties, must, at the time the loan is made, be at least as favorable to the ESOP as the terms of a comparable loan resulting from arm's-length negotiations between independent parties." The preamble to the final regulation explains that the tests encompassed in paragraphs (c)(2) and (3) of § 2550.408b-3 were added to the regulation to illustrate how a determination can be made with respect to whether a transaction meets the primary benefit requirement.(5) The regulation additionally states that the Department will give "special scrutiny" to ESOP loans and that fiduciaries have an obligation to ensure that such loans are "truly arranged primarily in the interest of participants and beneficiaries." 29 C.F.R. § 2550.408b-3(b)(2).

Whether a fiduciary acts in accordance with its responsibilities under sections 404(a)(1)(A) and (B) and 403(c) of ERISA, and whether a particular loan satisfies the requirements of section 408(b)(3) of ERISA, are inherently factual determinations that must be made by the appropriate plan fiduciary based on all relevant facts and circumstances. In determining whether a refinancing is consistent with the fiduciary provisions of Title I of ERISA, the burden is on the fiduciary to establish compliance. However, we note that certain procedures and factors considered by a fiduciary may be appropriate in determining whether to cause an ESOP to engage in a refinancing.

Conclusion

At a minimum, in determining whether to cause an ESOP to engage in a refinancing, a fiduciary must make a careful assessment of the costs and benefits conferred upon the ESOP and the likely consequences of a failure to refinance, and ensure that the transaction is "arranged primarily in the interest of participants and beneficiaries." 29 C.F.R. § 2550.408b-3(b)(2). It is the view of the Department that, consistent with the obligation to consider "all the surrounding circumstances" pursuant to § 2550.408b-3(c)(1), an ESOP fiduciary must, in considering any refinancing of an ESOP loan that results in an extension of the period over which stock will be allocated to participant accounts, assess the extent to which the refinancing is consistent with the documents and instruments governing the plan, including loan and related agreements.(6) An ESOP fiduciary, in our view, also should assess the extent to which such an extension is consistent with the reasonable expectations of the plan's participants and beneficiaries, as might be determined by reference to the plan's summary plan description or other disclosures describing the funding and benefits of the plan.

Although a refinancing may also benefit the employer (for example, by reducing the employer's cost of providing future pension benefits), the fiduciary must act with undivided loyalty to the participants and beneficiaries of the plan if it is to satisfy the requirements of sections 404(a)(1)(A) and 408(b)(3) of ERISA. The "primary benefit" test set forth in section 408(b)(3) of ERISA and the regulations thereunder require

the fiduciary to focus on the benefits of the refinancing transaction to the plan's participants and beneficiaries. Accordingly, a refinancing would satisfy the primary benefit test if the fiduciary reasonably concludes that the transaction is advantageous to the plan's participants and beneficiaries after a careful assessment of the costs and benefits of the transaction, and if the terms related to the refinancing are at least as favorable as the terms that would have resulted from an arm's-length negotiation between independent parties.

Often, employers offer a number of inducements for the plan to engage in the refinancing which could support a fiduciary's conclusion that the transaction is primarily for the benefit of participants and beneficiaries, such as a commitment that shares held in the suspense account will not be applied to repayment of the outstanding portion of the refinanced loan if the ESOP is terminated (often referred to as "event protection"); additional diversification rights for participants; an increase in the amount of the employer's matching contribution; the payment of a "dividend make-whole" to compensate participants and beneficiaries for the increased use of dividends for loan repayment; and other such inducements. Whether some or all of such inducements are sufficient to satisfy the primary benefit test is highly dependent on the particular facts and circumstances surrounding the transaction.

One circumstance of particular importance is whether the sponsoring employer has made an enforceable commitment to make all of the contributions necessary to retire the loan. In such a case, the ESOP may have an unqualified right to receive contributions and to release stock in accordance with the original amortization schedule. As a result, the negative consequences to the ESOP of rejecting a proposed refinancing could be minimal, and the economic value transferred to a sponsoring employer may be substantial, unless the ESOP receives substantial additional consideration for entering into the transaction.

Further, we note that the fiduciary has a duty of impartiality to all of the plan's participants, and may appropriately balance the interests of different classes of participants in evaluating a proposed refinancing, including the potentially varying interests of present and future participants. See Varity Corp. v. Howe, 516 U.S. 489, 514 (1996); Restatement (Second) of Trusts § 183. In our view, however, the fiduciary cannot satisfy the duty of impartiality solely by considering the asserted benefits of the refinancing to future participants (e.g., more generous benefits in later years than the employer would otherwise provide), but must also consider the interests of current participants and beneficiaries. Although a refinancing does not remove shares from the ESOP, those current participants who terminate employment before the full repayment of a refinanced loan may receive fewer shares of stock than they would have received absent the refinancing, and current participants who remain employed by the sponsor must work more years to receive the same number of shares that they would have received absent the refinancing. Accordingly, a fiduciary cannot reasonably assess the costs and benefits conferred upon an ESOP without giving due consideration to the interests of current participants.

With respect to the obligations of an ESOP fiduciary under section 404(a)(1), it is the view of the Department that satisfaction of the "primary benefit" requirement of section 408(b)(3) and the regulation with respect to the refinancing of an ESOP loan also typically would serve to satisfy a fiduciary's obligations to act prudently and solely in the interest of plan participants and beneficiaries under section 404(a)(1). Conversely, a failure to satisfy the "primary benefit" requirement of section 408(b)(3) would also result in a violation of section 404(a)(1).

Any questions concerning this matter may be directed to Louis Campagna or Fred Wong, Division of Fiduciary Interpretations at 202.693.8510.

Footnotes

1. 29 C.F.R. § 2550.408b-3(h); 26 C.F.R. § 54.4975-11(c).
2. 29 C.F.R. § 2550.408b-3(h)(1). Also note that § 2550.408b-3(h)(2) permits a release formula that is determined solely with reference to principal payments.
3. In adopting § 2550.408b-3, the Department expressed its view that the only prohibited transactions to which the exemption under section 408(b)(3) does not apply are those arising under section 406(b)(3), relating to the receipt by a fiduciary of any consideration for his own personal account from a party dealing with the plan. 42 Fed. Reg. 44384 (September 2, 1977).
4. Paragraph (c) of § 2550.408b-3 also provides that no loan will satisfy the primary benefit requirement unless it also satisfies the requirements of paragraphs (d) [relating to use of loan proceeds], (e) [relating to liability and collateral for an ESOP loan] and (f) [relating to defaults].
5. 42 Fed. Reg. 44384 (September 2, 1977).
6. For purposes of this discussion, it is assumed that there are no provisions in documents or

instruments governing the plan, including loan and related agreements, that specifically preclude the refinancing of an ESOP loan.

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2002-2

November 4, 2002

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Plan Amendments Made by Multiemployer Plan Trustees

Issue

Were the trustees of two related multiemployer plans subject to ERISA's fiduciary standards when they amended the plans' trust agreement?

Background

Employer Association X and Labor Union Y established a defined benefit plan (DB plan) in 1955 and, in 1987, a defined contribution plan (DC Plan). Employer contributions to Fund Z fund both plans. Although some DC Plan participants also participate in the DB plan, most do not. In 1989, the DB plan was frozen. No new employees became participants of the DB plan and the existing participants accrued no further benefits. At that time, the trustees believed that the DB plan needed no further contributions. All future contributions were allocated to the DC Plan.

By 1999, the DB plan's funding situation had apparently changed. That year, Employer Association X and Labor Union Y amended the trust agreement to allocate employer contributions to the DB plan in an amount equivalent to the forfeitures in the DC Plan. The collective bargaining agreement under which the plans are maintained only sets a formula for employer contributions to Fund Z; the trust agreement specifies the allocation of contributions among the plans. The trust agreement provides that either Employer Association X and Labor Union Y, or Fund Z's board of trustees may make amendments.

The 1999 reallocation did not prove sufficient to make the DB Plan solvent. In 2002, the trustees voted to amend the trust agreement, this time diverting an additional 20% of the employer contributions to the DB plan. The amendment resolution states that the trustees were acting "in their Settlor capacity."

Analysis

Section 3(21) of ERISA defines a fiduciary as one who has or exercises discretionary authority or control in the administration or management of an employee benefit plan or its assets. Part 4 of Title I of ERISA establishes the standards pursuant to which any fiduciary is to act, including the duty to act solely in the interests of the participants and beneficiaries of the plan, to be prudent in carrying out her responsibilities, and to avoid engaging in prohibited transactions. Section 3(16) of ERISA, in relevant part, defines the term "plan sponsor" of a plan established or maintained jointly by one or more employers and one or more employee organizations, as the joint board trustees who establish or maintain the plan.

In analyzing the extent to which assets of an employee benefit plan may properly be applied toward the payment of certain expenses, the Department has distinguished between activities that are "settlor" in nature (i.e., activities that relate to the establishment, design, and termination of plans) and activities that are fiduciary in nature (i.e., activities involving management of the plan). As indicated in various pronouncements, expenses

incurred in connection with the performance of settlor functions would not be reasonable plan expenses as they would be incurred for the benefit of the employer and would involve services for which an employer could reasonably be expected to bear the cost in the normal course of its business or operations.(1) In applying these distinctions, the Department has generally recognized that certain activities that would be settlor activities in the context of a single employer plan might be fiduciary activities in the context of a multiemployer plan.(2) This view was consistent with earlier case law, such as NLRB v. Amax Coal Co., 453 U.S. 322 (1981) which held that employer appointed trustees of a multiemployer plan do not represent the interests of the contributing employers, but act as fiduciaries of the plan. 453 U.S. at 331-334. More recent Supreme Court pronouncements on settlor functions, however, have led several courts to conclude that multiemployer plan trustees may act in a settlor capacity without regard to ERISA's fiduciary standards.(3)

For example, the Third Circuit Court of Appeals, in Walling v. Brady(4) and the Sixth Circuit Court of Appeals, in Gard v. Blankenburg,(5) have taken the position that boards of trustees may act as settlors when they amend plans, and that such amendments are not subject to ERISA's fiduciary responsibility provisions. As the Third Circuit noted in the Walling case, the Supreme Court, in both Lockheed Corp. v. Spink and Wright Corp. v. Schoonejongen,(6) recognized that the use of the term "plan sponsor" is significant. Under ERISA section 3(16), the sponsor of a multiemployer plan is the joint board of trustees that is directed, pursuant to a collective bargaining agreement, to establish one or more employee benefit plans. While the Walling court noted that, notwithstanding Lockheed, there may be situations in which single employer and multiemployer plans should be treated differently, they opined that under the facts of that case, involving the amendment of a multiemployer plan, ERISA's fiduciary rules did not apply.

The facts in Walling are very similar to those in the present case. In Walling, the board of trustees of a multiemployer defined benefit pension plan and group health plan amended the health plan (pursuant to authority granted under the collective bargaining agreement and the plan document) to require that participants pay $100 per month in order to receive benefits and amended the pension plan (also pursuant to authority granted under the collective bargaining agreement and the plan document) to provide an additional $100 benefit to those participants who were also participants in the health plan. The court in Walling, in concluding that the trustees' amendment of the pension plan fell outside of the scope of ERISA's fiduciary responsibility provisions, noted that imposing fiduciary duties on a sponsor's decision to amend a plan, whether the employer in the case of a single-employer plan, or the trustees in the case of a multiemployer plan, would divide the sponsor's loyalties and make amendment of a plan impossible.

In Advisory Opinion 80-8A,(7) we considered the issue of whether trustees who allocate employer contributions to related multiemployer plans established and maintained under the same collective bargaining agreements engage in a fiduciary act in making such allocations. In that opinion, we concluded that where allocations are made pursuant to a fixed formula established in the collective bargaining agreement, which formula is binding on the trustees, the trustees are not, solely by reason of such allocation, engaged in an act described in section 406(b)(2). However, the opinion noted that if the trustees exercise discretion in determining how to allocate employer contributions among the related plans, the trustees were engaging in a transaction involving the plans to which contributions were allocated, or withheld, and that such transactions could violate section 406(b)(2) since the plans may have competing interests as to the fixed pool of money. We note, however, that the opinion expressly reserved the question of whether the trustees would be engaged in a fiduciary violation where the collective bargaining agreement gives the trustees the authority to make prospective changes in the formula under which contributions are allocated among related plans.

In the case at hand, the collective bargaining agreements vested broad authority in the trustees to act establish the Fund, as well as the DB Plan and the DC Plan. The trustees also had the authority to amend the Fund and the plans. Pursuant to this authority, the trustees have amended the trust agreement and the plans to provide for the allocation of a portion of the employer contributions to the DB Plan, based on a fixed formula contained in the trust agreement. Once the amendment was properly adopted, the formula became binding on the trustees.

Conclusion

In our view, where relevant documents (e.g., collective bargaining agreements, trust documents, and plan documents) contemplate that the board of trustees of a multi-employer plan will act as fiduciaries in carrying out activities which would otherwise be settlor in nature, such activities would be governed by the fiduciary provisions of ERISA. In our view, such designation by the plan would result in the board of trustees exercising discretion as fiduciaries in the management or administration of a plan or its assets when undertaking the activities. However, where, as here, the relevant plan documents are silent, then the activities of the board of trustees which are settlor in nature generally will be viewed as carried out by the board of trustees in a settlor capacity, and such activities would not be fiduciary activities subject to Title I of ERISA. Accordingly, it is the

view of this Office that the Trustees of the Fund did not violate their fiduciary duties under ERISA in amending the Fund, the DB Plan, and the DC Plan to provide for an allocation of employer contributions to the DB Plan.

It is also the view of this Office that, consistent with the plan expense guidance discussed above, it would not be appropriate for a multiemployer plan to pay for expenses attendant to activities that a multiemployer plan trustee carries out in a settlor capacity.

Any questions concerning this matter may be directed to Louis Campagna or David Lurie, Division of Fiduciary Interpretations at 202.693.8510.

Footnotes

1. See, Advisory Opinion Nos. 97-03A and 2001-01A. Also see letter to Kirk F. Maldonado from Elliot I. Daniel (March 2, 1987).
2. Advisory Opinions 97-03A and 2001-01A both indicate “these so-called ‘settlor’ functions include decisions relating to the establishment, design, and termination of plans, and except in the context of multiemployer plans, generally are not fiduciary activities.” (Emphasis added)
3. E.g., Walling v. Brady, 125 F.3d 114 (3rd Cir. 1997); Gard v. Blackenburg, No. 00-1234 (6th Cir. 2002) Hartline v. Sheetmetal Workers' National Pension Fund, 134 F. Supp. 2d 1 (D.D.C. 2000), citing Lockheed Corp. v. Spink, 517 U.S. 882 (1996); Wright Corp. v. Schoonejongen, 514 U.S. 73 (1995). See also Pope v. Central States, Southeast and Southwest Areas Health and Welfare Fund, 27 F.3d 211 (6th Cir. 1994).
4. 125 F.3d 114 (3d Cir., 1997)
5. No. 00-1234 (6th Cir., 2002)
6. 517 U.S. 882 (1996); 514 U.S. 73 (1995)

February 1, 1980

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2002-3

November 5, 2002

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Disclosure and other Obligations Relating to "Float"

Issue

What does a fiduciary need to consider in evaluating the reasonableness of an agreement under which the service provider will be retaining "float" and what information is a service provider required to disclose to plan fiduciaries with respect to such arrangements in order to avoid engaging in a prohibited transaction?

Background

A number of financial services providers, such as banks and trust companies, acting as non-discretionary directed trustees or custodians maintain general or "omnibus" accounts to facilitate the transactions of employee benefit plans. The service provider may retain earnings ("float") resulting from the anticipated short-term investment of funds held in such accounts. Typically, these accounts hold contributions and other assets pending investment directions from plan fiduciaries. In addition, fiduciaries transfer funds to a general account of the financial institution in connection with issuance of a check to make a plan distribution or other disbursement. Funds are then held in the account earning interest until checks are presented for payment.

In Advisory Opinion 93-24A, the Department expressed the view that a trustee's exercise of discretion to earn income for its own account from the float attributable to outstanding benefit checks constitutes prohibited fiduciary self-dealing under section 406(b)(1) of ERISA. Advisory Opinion 93-24A dealt with a situation where there was no disclosure of the float to employee benefit plan customers. In a subsequent information letter to the American Bankers Association (August 11, 1994), the Department indicated that " . . . if a bank fiduciary has openly negotiated with an independent plan fiduciary to retain float attributable to outstanding benefit checks as part of its overall compensation, then the bank's use of the float would not be self-dealing because the bank would not be exercising its fiduciary authority or control for its own benefit. Therefore, to avoid problems, banks should, as part of their fee negotiations, provide full and fair disclosure regarding the use of float on outstanding benefit checks." (Emphasis supplied).

In general, the concepts of open negotiation and full and fair disclosure, as used in the 1994 letter, are intended to ensure that service providers provide sufficient information concerning such arrangements so that plan fiduciaries can make informed assessments concerning the prudence of the arrangements. Further, those concepts are intended to ensure that the amount of the service provider's compensation is determined and approved by a fiduciary independent of the service provider so that prohibited self-dealing is avoided.(1) Since the issuance of the letter, Field offices have found, as part of their investigations, a variety of methods by which plan fiduciaries are informed of, and or approve, the practice of plan service providers retaining float as part of their overall compensation. Typically, a service agreement will provide that, in addition to other specifically identified or scheduled fees, the service provider may also receive compensation in the form of earnings on funds awaiting investment or reinvestment or funds pending distribution. According to the investigations, however, there is little or no disclosure of specific information regarding compensation earned in the form of float.

Further guidance, therefore, has been requested concerning the obligations of plan fiduciaries and service providers regarding float arrangements and disclosures.

Analysis

Obligations of Plan Fiduciary - In selecting a service provider, plan fiduciaries must, consistent with the requirements of section 404(a), act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Except as provided in section 408, plan fiduciaries also have an obligation under section 406(a) not to cause the plan to engage in certain transactions, including a direct or indirect furnishing of goods, services or facilities between the plan and a party in interest. Section 408(b)(2) exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.(2) In carrying out these responsibilities, the Department has indicated that a plan fiduciary must engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. In addition, such process should be designed to avoid self-dealing, conflicts of interest or other improper influence.

In circumstances where a service provider may receive compensation in the form of float, we believe the selection and monitoring process engaged in by the responsible fiduciary should include:

A review of comparable providers and service arrangements (e.g., quality and costs) to determine whether such providers may credit float to the provider's own account, rather than the plan.

A review of the circumstances under which float may be earned by the service provider. For example, in the case of float on cash awaiting investment, fiduciaries should ensure that their service agreements include time limits within which the provider will implement investment instructions following receipt of cash from the plan. Fiduciaries also should understand that delays in the plan providing investment instruction or delays in implementing investment direction by the service provider would result in increased compensation in the form of float. In the case of float on funds awaiting disbursement, fiduciaries should ensure that their service agreements specify the time at which assets are transferred from the plan to the general account (e.g., the date the check is requested, the date the check is written, or the date the check is mailed). Inasmuch as timing of mailing or distribution of a check may also affect the amount of float, service agreements should provide, if relevant, an indication as to when checks are mailed following a direction to distribute funds. Fiduciaries also should understand that float will be earned on such disbursements until checks are presented for payment by the payee, the timing of which is beyond the control of the plan and service provider. In this regard, fiduciaries should review periodic statements or reports of distribution checks to determine the extent to which checks tend to remain outstanding for unusually long periods of time (e.g., 90 or more days).

A review of sufficient information to enable the plan fiduciary to evaluate the float as part of the total compensation to be paid for the services to be rendered under the agreement. In this regard, fiduciaries should request and review the rates the provider generally expects to earn. For example, the provider might indicate that earnings on uncashed checks are generally at money market interest rates. Given the uncertainties with respect to both actual interest rates and the length of the periods during which any given funds may be pending investment or pending disbursement, it is anticipated that any projections by the fiduciary will result in only a rough approximation of the potential float. However, the information on which the approximation is based (e.g., basis for earnings rates and agreement terms relating to maximum periods within which funds will be invested following investment direction, timing of transfers of cash from the plan to the provider's general account following direction to distribute funds, period for mailing checks, extent to which experience shows that distribution checks remain outstanding for unusually long periods of time, etc.) and the approximation itself, will enable a fiduciary both to compare service provider float practices and assess the extent to which float is a significant component of the overall compensation arrangement.

Additionally, a plan fiduciary must periodically monitor compliance by the service provider with the terms of the agreement and the reasonableness of compensation under the agreement in order to ensure continuation of the agreement meets the requirements of sections 404(a)(1), 406 and 408(b)(2).

Obligations of Service Providers - The primary issue for service providers with float arrangements is whether the provider has disclosed to its employee benefit plan customers sufficient information concerning the administration of its accounts holding float so that the customer can reasonably approve the arrangement based on an understanding of the service provider's compensation. Moreover, the arrangement must not permit the service provider to affect the amount of its compensation in violation of section 406(b)(1) (e.g., by

giving the service provider broad discretion over the duration of the float). For example, even where a service provider discloses in its service agreement that additional compensation may be paid to the service provider as a result of float, a prohibited transaction may nonetheless result to the extent that the service provider exercises discretionary authority or control sufficient to cause a plan to pay additional fees to the provider. As noted in Advisory Opinion 93-24A, a fiduciary's decision to handle plan assets in such a way as to benefit itself constitutes prohibited self-dealing, without regard to the status of the funds after they are placed in a disbursement or other account.

It is the view of this Office that, in connection with a service agreement pursuant to which the service provider may be retaining float as part of its compensation, the service provider can avoid self-dealing with respect to such earnings by taking the following steps:

Disclose the specific circumstances under which float will be earned and retained.

In the case of float on contributions pending investment direction, establish, disclose and adhere to specific time frames within which cash pending investment direction will be invested following direction from the plan fiduciary, as well as any exceptions that might apply.

In the case of float on distributions, disclose when the float period commences (e.g., the date check is requested, the date the check is written, the date the check is mailed) and ends (the date on which the check is presented for payment). Also disclose, and adhere to, time frames for mailing and any other administrative practices that might affect the duration of the float period.

Disclose the rate of the float or the specific manner in which such rate will be determined. For example, earnings on cash pending investment and earnings on uncashed checks are generally at a money market interest rate.

We note that the disclosure of and adherence to the foregoing by service providers will not only reduce the likelihood of prohibited self-dealing, but also will assist plan fiduciaries in discharging their obligations under sections 404(a)(1), 406 and 408(b)(2).

Conclusion

Float should be regarded by plan fiduciaries and service providers as part of the service provider's compensation for services to the plan. As such, the plan fiduciary must have an adequate understanding of how the service provider will earn float, and how it contributes to the service provider's compensation. The service provider must make disclosures sufficient to permit the fiduciary to make an informed decision regarding the proposed float arrangement. In addition, to avoid having the arrangement give rise to self-dealing violations of section 406(b), both parties must avoid giving the service provider discretion to affect the amount of compensation it receives from float.

Questions concerning this matter may be directed to Louis Campagna or Fred Wong, Division of Fiduciary Interpretations at 202.693.8510.

Footnotes

1. What constitutes an approval by an appropriate plan fiduciary will depend on the facts and circumstances of each case. See Advisory Opinion Nos. 97-16A and 2001-02A.
2. As interpreted by the Department, section 408(b)(2) exempts from the prohibitions of section 406(a) payment by a plan to a party in interest, including a fiduciary, for any service (or combination of services) if (1) such service is necessary for the establishment or operation of the plan; (2) such service is furnished under a contract or arrangement which is reasonable; (3) no more than reasonable compensation is paid for such service. However, section 408(b)(2) does not provide an exemption for an act described in section 406(b) of ERISA, even if such act occurs in connection with a provision of services that is exempt under section 408(b)(2). See 29 C.F.R. § 2550.408b-2.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2003-1

April 15, 2003

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Participant Loans to Corporate Directors and Officers

Issue

May a plan administrator deny participant loans to directors and executive officers of the sponsoring employer of the plan on the basis that such loans may violate Section 13(k) of the Securities Exchange Act of 1934 without contravening the requirement of section 408(b)(1) of ERISA that loans be made available to all participants on a reasonably equivalent basis?

Law And Analysis

Section 402 of the Sarbanes-Oxley Act of 2002 added a new subsection (k) to Section 13 of the Securities Exchange Act of 1934 (the “1934 Act”). Section 13(k) makes it unlawful for any issuer (as defined in Section 2(a)(7) of the Sarbanes-Oxley Act of 2002)(1), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to modify or renew an extension of credit maintained by the issuer on the date of enactment,(2) in the form of a personal loan to or for any director or executive officer (or equivalent thereof). The Department of Labor does not have interpretative authority with respect to the 1934 Act.

Section 404 of ERISA requires, among other things, that fiduciaries of employee benefit plans discharge their duties prudently and solely in the interest of the plan’s participants and beneficiaries. Section 404(a)(1)(D) requires that fiduciaries discharge their duties in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of title I of ERISA. Section 406(a)(1)(B) prohibits a fiduciary from causing an employee benefit plan to engage in a loan between the plan and a party in interest. Parties in interest include employees, officers and directors of an employer sponsoring the plan.

Section 408(b)(1) exempts from the prohibited transactions provisions of section 406 the making of a loan by an employee benefit plan to a party in interest who is a participant or beneficiary of the plan, provided that certain conditions are satisfied. Among other things, section 408(b)(1)(A) and the Department’s regulations issued thereunder, at 29 CFR § 2550.408b-1, provide that such loans must be made available to all participants and beneficiaries of the plan on a reasonably equivalent basis.

Section 514(d) of ERISA provides that nothing in Title I of ERISA shall be construed to alter, amend, modify, invalidate, impair, or supersede any other Federal law.

We understand that ERISA practitioners have raised the question of whether section 13(k) of the 1934 Act prohibits directors and executive officers of an employer from taking loans from employee pension benefit plans. It has long been the view of the Department that fiduciaries are responsible for administering their plans to assure compliance with both ERISA and other applicable Federal laws, in recognition of the fact that such other Federal laws are not preempted by ERISA.

In our view, a decision to disallow a participant loan based on a reasonable question concerning the legality of the loan would not be a failure to provide loans to all participants on a reasonably equivalent basis and would not affect the plan's compliance with section 408(b)(1) or 29 C.F.R. § 2550.408b-1.

Conclusion

It is the view of this Office that, in view of the uncertainty concerning the scope of section 13(k) of the 1934 Act, plan fiduciaries of public companies may deny participant loans to officers and directors (or the equivalent thereof) without violating the requirements of section 404(a)(1) or the requirement of section 408(b)(1)(A) and the regulation issued thereunder that loans be available to all participants and beneficiaries on a reasonably equivalent basis. In stating this view, the Department takes no position on the application of section 13(k) of the 1934 Act to participant loans.

Any questions concerning this matter may be directed to Louis Campagna or David Lurie, Division of Fiduciary Interpretations, 202.693.8510.

Footnotes

1. Section 2(a)(7) of the Sarbanes-Oxley Act of 2002 defines “issuer” as “an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of the Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.”

July 30, 2002.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2003-2

May 7, 2003

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Application of Participant Contribution Requirements to Multiemployer Defined Contribution Pension Plans

Issue

In the context of a multiemployer defined contribution pension plan, to what extent may collective bargaining, employer participation and similar agreements be taken into account in determining when participant contributions can reasonably be segregated from the general assets of participating employers?

Background

In 1996, the Department adopted final rules defining when amounts that a participant pays to, or has withheld by, an employer for contribution to an employee benefit plan are "plan assets" for purposes of Title I of ERISA. These rules are set forth at 29 CFR § 2510.3-102 ("Definition of plan assets – participant contributions"). In general, the rules provide that the assets of a plan include amounts that a participant or beneficiary pays to, or amounts that a participant has withheld from his wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets. (1) With respect to pension plans, the rules also provide that in no event shall such date be later than the 15th business day of the month following the month in which the amounts were received by the employer (in the case of amounts paid to the employers) or in which the amounts would otherwise have been payable to the participant (in the case of amounts withheld by the employer from a participant's wages).(2)

On the basis of information obtained by, and furnished to, the Department, many multiemployer defined contribution pension plans establish through collective bargaining, employer participation and similar agreements, the form, manner and timing of amounts for contributions to employee benefit plans, including participant contributions to defined contribution pension plans. Frequently, such agreements provide for contributions to be remitted to the plan at specific times, without regard to when any given participating employer might be able to mechanically segregate monies from its general assets. Such practices, therefore, have raised questions concerning the extent to which multiemployer defined contribution pension plan trustees and participating employers must disregard the terms of collective bargaining and employer participation agreements in order to ensure compliance with the terms of the plan assets - participant contribution regulation. Determining when participant contributions to a multiemployer, defined contribution plan become plan assets is critical to understanding the fiduciary obligations of plan trustees and participating employers in handling participant contributions.(3)

Analysis

In adopting changes to the plan assets – participant contribution rules in 1996, the Department recognized that plan sponsors and fiduciaries must weigh the costs and benefits, as well as risks presented to participants, of processes established for the transmittal and receipt of participant contributions.(4) In this regard, many commenters on the proposed rules, while acknowledging that participant contributions could be segregated

quickly and frequently into a trust established to temporarily hold such contributions until they could be reconciled, represented that the costs of establishing and administering such a trust would be considerable, outweighing any additional benefits to participants.(5) Taking such comments into consideration, the Department indicated that, while the final rule significantly reduces the maximum period during which participant contributions may be treated as other than plan assets, the final rule "accommodates employers who are unable reasonably to segregate participant contributions from their general assets more frequently than in what appears to be a fairly standard monthly processing cycle for participant contributions to pension plans."(6)

With regard to multiemployer plans specifically, several commenters on the proposed rules argued that, given the unique nature of such plans, multiemployer plans with participant contributions should either be exempt from the plan asset – participant contribution rules altogether or exempt from the maximum period within which contributions must be made. While the Department did not adopt either of these suggestions, the Department did determine that "the maximum time period for pension plans in the final rule was sufficient to accommodate multiemployer plans." The Department also recognized that transmission of participant contributions may be controlled by pre-existing collective bargaining agreements and, therefore, postponed the application of the final rule's new maximum period (within which participant contributions must be transmitted to a plan) for collectively bargained pension plans.(7)

It is the view of this Office that the provisions of the participant contribution regulation apply in the same way to multiemployer plans that the provisions apply to single employer plans. That is, participant contributions deducted by or paid to an employer become plan assets as soon as they can reasonably be segregated from the employer's general assets. As is the case with single employer plans, if a multiemployer plan maintains a reasonable process for the expeditious and cost-effective receipt of contributions, this process may be taken into account in determining when participant contributions can reasonably be segregated from the employer's general assets. To the extent that a collective bargaining agreement, for example, describes such a process, then the collective bargaining agreement should be considered in determining when participant contributions become plan assets.

To be reasonable, a plan's process for receiving participant contributions should take into account how quickly the participating employers can reasonably segregate and forward contributions. The plan fiduciaries should also consider how costly to the plan a more expeditious process would be. These costs should be balanced against any additional income and security the plan and plan participants would realize from a faster system.

No matter how reasonable a pension plan's process, however, participants contributions become plan assets no later than the 15th business day of the month following the month in which the amounts were received by the employer (in the case of amounts paid to the employers) or in which the amounts would otherwise have been payable to the participant (in the case of amounts withheld by the employer from a participant's wages). Thus neither a collective bargaining agreement, nor any other agreement between the plan and an employer, can justify a failure to comply with the maximum periods in the regulation.

Conclusion

In determining when participant contributions can reasonably be segregated from the general assets of any given contributing employer to a multiemployer defined contribution plan, it is the view of this Office that the time frames established in collective bargaining, employer participation and similar agreements must be taken into account to the extent such agreements represent the considered judgment of the plan's trustees that such time frames reflect the appropriate balancing of the costs of transmitting, receiving and processing such contributions relative to the protections provided to participants and beneficiaries, provided that any such time frames do not extend beyond the maximum period prescribed in § 2510.3-102(b). As with other fiduciary duties, plan trustees must make such determinations prudently and solely in the interest of plans' participants and beneficiaries.(8)

Questions concerning the information contained in this Bulletin may be directed to Louis Campagna or David Lurie, at 202.693.8510.

Footnotes

1. See paragraph (a) of § 2510.3-102.
2. See paragraph (b) of § 2510.3-102. Also note that paragraph (d) of § 2510.3-102 describes the circumstances under which the maximum time period may be extended.
3. The obligation of a fiduciary to collect participant contributions from an employer is similar to the obligations of a fiduciary to collect contributions payable by an employer on its own behalf. In this respect, the Department has indicated that if a multiple employer trustee does not establish and

implement collection procedures which are reasonable, diligent and systematic, it may be found to be engaging in prohibited transactions for failing to collect delinquent contributions. See section 406(a)(1)(B). Cf. Central States Pension Fund v. Central Transport, Inc., 472 U.S. 559, 574 (1985) where the Court interpreted 406(a)(1)(B) as creating a requirement that the plan trustee assure full and prompt collection of all contributions owed to the plan.

4. See 61 Fed. Reg. at 41226.
5. See 61 Fed. Reg. at 41222.
6. See 61 Fed. Reg. at 41223.
7. See 61 Fed. Reg. at 41228.
8. The mere fact that plan settlors via collective bargaining establish specific dates for the transmittal of participant contributions does not relieve plan trustees from their fiduciary responsibility to determine that the established time frames reflect the appropriate balancing of costs and protections. If the trustees determine that time frames established in collective bargaining agreements fail to reflect the appropriate balance and, therefore, would result in an unreasonable delay in transmittal of participant contributions, the trustees must take steps to collect participant contributions from employers consistent with their fiduciary obligations.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2003-3

May 19, 2003

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Allocation of Expenses in a Defined Contribution Plan

Issue

What rules apply to how expenses are allocated among plan participants in a defined contribution pension plan?

Background

A number of questions have been raised in the course of investigations and otherwise concerning the propriety of certain expense allocation practices in defined contribution plans. This memorandum is intended to respond to the various requests for guidance from the National and Regional Offices on these issues.(1)

The two principal issues raised with respect to the allocation of plan expenses in defined contribution plans involve the extent to which plan expenses are required to be allocated on a pro rata, rather than per capita, basis and the extent to which plan expenses may properly be charged to an individual participant, rather than plan participants as a whole. For purposes of discussing these issues, we assume first that the expenses at issue are proper plan expenses(2) and second that, with respect to the plan as a whole, the amount of the expenses at issue are reasonable with respect to the services to which they relate.

Analysis

ERISA contains no provisions specifically addressing how plan expenses may be allocated among participants and beneficiaries. The Act and implementing regulations, however, do address certain instances in which a plan may impose charges on particular participants and beneficiaries. For example, section 104(b)(4) provides that the plan administrator may impose a reasonable charge to cover the cost of furnishing copies of plan documents and instruments upon request of a participant or beneficiary.(3) Also, section 602 permits group health plans, subject to certain conditions, to require the payment of 102% of the applicable premium for any period of continuation coverage elected by an eligible participant or beneficiary. Further, the Department's regulations under sections 404(c) and 408(b)(1) provide that reasonable expenses associated with a participant's exercise of an option under the plan to direct investments or to take a participant loan may be separately charged to the account of the individual participant.(4) By contrast, regulations may limit the ability of a plan to charge a particular participant or beneficiary by requiring that information be furnished free of charge upon request of a participant or beneficiary.(5)

Section 404(a)(1) generally provides, in relevant part, that fiduciaries shall discharge their duties with respect to a plan "solely in the interest of the participants and beneficiaries," prudently (404(a)(1)(B)), and "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [Title I] . . . " (404(a)(1)(D)). Plan fiduciaries, therefore, would be required to implement allocation of expense provisions set forth in the plan, unless such provisions otherwise violate Title I.

Accordingly, plan sponsors and fiduciaries have considerable discretion in determining, as a matter of plan design or a matter of plan administration, how plan expenses will be allocated among participants and beneficiaries.

Allocating Expenses Among All Participants - Pro rata v. Per capita

In analyzing formulas for allocating expenses among all plan participants, the starting point is a review of the instruments governing the plan. Inasmuch as ERISA does not specifically address the allocation of expenses in defined contribution plans, a plan sponsor, as noted above, has considerable discretion in determining the method of expense allocation. Where the method of allocating expenses is determined by the plan sponsor (i.e., set forth in the plan documents), fiduciaries, consistent with section 404(a)(1)(D), will be required to follow the prescribed method of allocation. The fiduciary's obligation in this regard does not change merely because the allocation method favors a class (or classes) of participants. When set forth in plan documents, the method of allocating expenses, in effect, becomes part of defining the benefit entitlements under the plan.(6)

When the plan documents are silent or ambiguous on this issue, fiduciaries must select the method or methods for allocating plan expenses. A plan fiduciary must be prudent in the selection of the method of allocation. Prudence in such instances would, at a minimum, require a process by which the fiduciary weighs the competing interests of various classes of the plan's participants and the effects of various allocation methods on those interests. In addition to a deliberative process, a fiduciary's decision must satisfy the "solely in the interest of participants" standard. In this regard, a method of allocating expenses would not fail to be "solely in the interest of participants" merely because the selected method disfavors one class of participants, provided that a rational basis exists for the selected method.(7) On the other hand, if a method of allocation has no reasonable relationship to the services furnished or available to an individual account, a case might be made that the fiduciary breached his fiduciary duties to act prudently and "solely in the interest of participants" in selecting the allocation method. Further, in the case where the fiduciary is also a plan participant, the selection of the method of allocation may raise issues under the prohibited transaction provisions of section 406 of ERISA where the benefit to the fiduciary is more than merely incidental.(8) For example, if in anticipation of the plan fiduciary's own divorce, the fiduciary who is also a plan participant decides to change the allocation of expenses related to a determination of whether a domestic relations order constitutes a "qualified" order from the account incurring the expense to the plan as a whole, such change in allocation by the fiduciary could constitute an act of self-dealing under section 406 of ERISA.

While a pro rata method of allocating expenses among individual accounts (i.e., allocations made on the basis of assets in the individual account) would appear in most cases to be an equitable method of allocation of expenses among participants, it is not the only permissible method. A per capita method of allocating expenses among individual accounts (i.e., expenses charged equally to each account, without regard to assets in the individual account) may also provide a reasonable method of allocating certain fixed administrative expenses of the plan, such as recordkeeping, legal, auditing, annual reporting, claims processing and similar administrative expenses. On the other hand, where fees or charges to the plan are determined on the basis of account balances, such as investment management fees, a per capita method of allocating such expenses among all participants would appear arbitrary. With regard to services which provide investment advice to individual participants, a fiduciary may be able to justify the allocation of such expenses on either a pro rata or per capita basis and without regard to actual utilization of the services by particular individual accounts. Investment advice services might also be charged on a utilization basis, as discussed below, whereby the expense will be allocated to an individual account solely on the basis of a participant's utilization of the service.

Allocating Expenses to an Individual v. General Plan Expense

In contrast to the preceding discussion, which focused on methods of allocating plan expenses among all participants, the following discussion focuses on the extent to which an expense may be allocated (or charged) solely to a particular participant's individual account, rather than allocated among the accounts of all participants (e.g., on a pro rata or per capita basis). The Department provided some guidance on this issue in Advisory Opinion No. 94-32A. In analyzing the extent to which a plan may charge a participant (or alternate payee) for a determination as to whether a domestic relations order constitutes a "qualified" order, the Department concluded in AO 94-32A that imposing the costs of a QDRO determination solely on the participant (or alternate payee) seeking the QDRO, rather than the plan as a whole, would violate ERISA.

Since the issuance of AO 94-32A, the Department has had an opportunity to review the Act and the opinion in the context of a broader array of plan expense allocation issues raised in the course of investigations. On the basis of this review, the Department has determined that neither the analyses or conclusions set forth in that opinion are legally compelled by the language of the statute. Except for the few instances in which ERISA

specifically addresses the imposition of expenses on individual participants, the statute places few constraints on how expenses are allocated among plan participants. In this regard, the same principles applicable to determining the method of allocating expenses among all participants, as discussed above, apply to determining the permissibility of allocating specific expenses to the account of an individual participant, rather than the plan as a whole (i.e., among all participants).(9)

Examples of Specific Plan Expenses

Hardship Withdrawals. Some plans may provide for the allocation of administrative expenses attendant to hardship withdrawal distributions to the participant who seeks the withdrawal. ERISA does not specifically preclude the allocation of reasonable expenses attendant to hardship withdrawals to the account of the participant or beneficiary seeking the withdrawal.

Calculation of Benefits Payable under Different Plan Distribution Options. Some defined contribution plans may charge participants for a calculation of the benefits payable under the different distribution options available under the plan (e.g., joint and survivor annuity, lump sum, single life annuity, etc.). ERISA does not specifically preclude the allocation of reasonable expenses attendant to the calculation of benefits payable under different distribution options available under the plan to the account of the participant or beneficiary seeking the information.

Benefit Distributions. Some plans provide for the imposition of benefit distribution charges on the participant to whom the distribution is being made. These charges may be assessed for benefit distributions paid on a periodic basis (e.g., monthly check writing expenses). ERISA does not specifically preclude the allocation of reasonable expenses attendant to the distribution of benefits to the account of the participant or beneficiary seeking the distribution.

Accounts of Separated Vested Participants. Some plans, with respect to which the plan sponsor generally pays the administrative expenses of the plan, provide for the assessment of administrative expenses against participants who have separated from employment. In general, it is permissible to charge the reasonable expenses of administering a plan to the individual accounts of the plan’s participants and beneficiaries. Nothing in Title I of ERISA limits the ability of a plan sponsor to pay only certain plan expenses or only expenses on behalf of certain plan participants. In the latter case, such payments by a plan sponsor on behalf of certain plan participants are equivalent to the plan sponsor providing an increased benefit to those employees on whose behalf the expenses are paid. Therefore, plans may charge vested separated participant accounts the account’s share (e.g., pro rata or per capita) of reasonable plan expenses, without regard to whether the accounts of active participants are charged such expenses and without regard to whether the vested separated participant was afforded the option of withdrawing the funds from his or her account or the option to roll the funds over to another plan or individual retirement account.

Qualified Domestic Relations Orders (QDROs) and Qualified Medical Child Support Order (QMCSOs) Determinations. ERISA does not, in our view, preclude the allocation of reasonable expenses attendant to QDRO or QMCSO determinations to the account of the participant or beneficiary seeking the determination. (10)

It should be noted that, pursuant to 29 CFR § 2520.102-3(l), plans are required to include in the Summary Plan Description a summary of any provisions that may result in the imposition of a fee or charge on a participant or beneficiary, or the individual account thereof, the payment of which is a condition to the receipt of benefits under the plan. In addition, § 2520.102-3(l) provides that Summary Plan Descriptions must include a statement identifying the circumstances that may result in the “ . . . offset, [or] reduction . . . of any benefits that a participant or beneficiary might otherwise reasonably expect the plan to provide on the basis of the description of benefits . . .” These requirements are intended to ensure that participants and beneficiaries are apprised of fees and charges that may affect their benefit entitlements.

Questions concerning the information contained in this Bulletin may be directed to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, 202.693.8510.

Footnotes

1. The views set forth herein relate solely to the application of Title I of ERISA. We express no view as to whether any particular allocation of expenses might violate the Internal Revenue Code or any other Federal statute.
2. See Advisory Opinion No. 2001-01A and related hypotheticals for discussion of the principles applicable to distinguishing settlor from plan expenses.
3. See § 29 CFR 2520.104b-30. See also § 2520.104-4(b)(2)(ii).

4. See § 2550.404c-1(b)(2)(ii)(A) and 54 FR 30520, 30522 (July 20, 1989)(preamble to 29 CFR § 2550.408b-1).
5. See §§ 2520.104-46(b)(1)(i)(C), 2520.104b-1(c)(1)(iii) and (iv), 2520.104b-30.
6. If a plan is intended to be a tax qualified plan, the fiduciary would have a duty to assure that the allocation method does not negatively affect the tax qualified status of the plan.
7. In reviewing the propriety of such fiduciary actions, the judicial standard is whether the fiduciary acted in an arbitrary or capricious manner. In meeting this standard, the fiduciary has a duty of impartiality to all the plan's participants and may appropriately balance the interests of different classes of participants in evaluating a proposed method of expense allocation. See Varity Corp. v. Howe, 516 U.S. 489, 514 (1996); Restatement (Second) of Trusts §183.
8. See Advisory Opinion No. 2000-10A.
9. The views expressed herein supersede the views expressed in AO 94-32A.
10. See footnote 9.

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2004-1

April 7, 2004

Memorandum for: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Health Saving Accounts

Issue

Whether Health Savings Accounts established in connection with employment-based group health plans constitute "employee welfare benefit plans" for purposes of Title I of ERISA?

Background

Section 3(1) of the Employee Retirement Income Security Act of 1974 (ERISA) defines the term "employee welfare benefit plan" in relevant part to mean "any plan, fund, or program . . . established or maintained by an employer . . . to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness . . . ."

Section 1201 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, Pub. L. No. 108-173 (the Medicare Modernization Act), added section 223 to the Internal Revenue Code (Code) to permit eligible individuals to establish Health Savings Accounts (HSAs).(1) In general, HSAs are established to receive tax-favored contributions by or on behalf of eligible individuals, and amounts in an HSA may be accumulated over the years or distributed on a tax-free basis to pay or reimburse "qualified medical expenses." In order to establish an HSA, an eligible individual, among other conditions, must be covered under a High Deductible Health Plan (HDHP).(2) Contributions to an HSA established by an eligible individual who is an employee may be made by the employee, the employee's employer or both in a given year.(3) Amounts in an HSA may be rolled over to another HSA.(4) If an employer makes contributions to HSAs, the employer must make available a comparable contribution on behalf of all eligible employees with comparable coverage during the same period.(5) However, employers that make contributions to an employee's HSA are not responsible for determining whether HSAs are used for qualified medical expenses or for investing or managing amounts contributed to an employee's HSA.(6)

It is our understanding that a number of employers that currently sponsor ERISA-covered group health plans may wish to add an HDHP option and offer programs designed to enable employees to establish HSAs to pay for medical expenses not covered by the HDHP. Questions have been raised about whether, and under what circumstances, HSAs established in connection with employment-based programs would constitute "employee welfare benefit plans" within the meaning of section 3(1) of ERISA.

Analysis

Congress, in enacting the Medicare Modernization Act, recognized that HSAs would be established in conjunction with employment-based health plans and specifically provided for employer contributions. However, neither the Medicare Modernization Act nor section 223 of the Code specifically address the application of Title I of ERISA to HSAs. Based on our review of Title I, and taking into account the provisions of

the Code as amended by the Medicare Modernization Act, we believe that HSAs generally will not constitute employee welfare benefit plans established or maintained by an employer where employer involvement with the HSA is limited, whether or not the employee's HDHP is sponsored by an employer or obtained as individual coverage.

Specifically, HSAs meeting the conditions of the safe harbor for group or group-type insurance programs at 29 C.F.R. § 2510.3-1(j)(1)-(4) would not be employee welfare benefit plans within the meaning of section 3(1) of ERISA.(7) Moreover, although contributions or payment of group insurance premiums by an employer would be a significant consideration in determining whether a group or group-type insurance arrangement is an employee welfare benefit plan under section 3(1), such contributions or payments are not necessarily significant in analyzing the status of HSAs under ERISA. As noted above, HSAs are personal health care savings vehicles rather than a form of group health insurance. For example, funds deposited in an HSA generally may not be used to pay health insurance premiums,(8) and the beneficiaries of the account have sole control and are exclusively responsible for expending the funds in compliance with the requirements of the Code. Because of these differences, we regard court precedent on the significance of employer contributions to group or group-type insurance arrangements as inapposite to HSAs. In the group health insurance context, the employer, whether by choosing an insurance policy or creating a self-funded program, typically establishes the type of benefits provided, the conditions for their receipt, and the manner in which claims will be adjudicated. In the context of HSAs, however, the employer may be doing little more than contributing funds to an account controlled solely by the employee.

Accordingly, we would not find that employer contributions to HSAs give rise to an ERISA-covered plan where the establishment of the HSAs is completely voluntary on the part of the employees and the employer does not: (i) limit the ability of eligible individuals to move their funds to another HSA beyond restrictions imposed by the Code; (ii) impose conditions on utilization of HSA funds beyond those permitted under the Code; (iii) make or influence the investment decisions with respect to funds contributed to an HSA; (iv) represent that the HSAs are an employee welfare benefit plan established or maintained by the employer; or (v) receive any payment or compensation in connection with an HSA.

The mere fact that an employer imposes terms and conditions on contributions that would be required to satisfy tax requirements under the Code or limits the forwarding of contributions through its payroll system to a single HSA provider (or permits only a limited number of HSA providers to advertise or market their HSA products in the workplace) would not affect the above conclusions regarding HSAs funded with employer or employee contributions, unless the employer or the HSA provider restricts the ability of the employee to move funds to another HSA beyond those restrictions imposed by the Code.

Conclusion

HSAs generally will not constitute "employee welfare benefit plans" for purposes of the provisions of Title I of ERISA. Employer contributions to the HSA of an eligible individual will not result in Title I coverage where, as discussed above, employer involvement with the HSA is limited. Finding that an HSA established by an employee is not covered by ERISA does not, however, affect whether an HDHP sponsored by the employer is itself a group health plan subject to Title I. In fact, unless otherwise exempt from Title I (e.g., governmental plans, church plans) employer-sponsored HDHPs will be employee welfare benefit plans within the meaning of ERISA section 3(1) subject to Title I.

Questions concerning this matter may be directed to Suzanne Adelman, Division of Coverage, Reporting and Disclosure at 202.693.8523.

Footnotes

1. The U.S. Department of the Treasury and the Internal Revenue Service (IRS), which have interpretive and regulatory authority over HSAs under section 223 of the Code, issued general guidance concerning HSAs on December 22, 2003, in I.R.S. Notice 2004-2, and issued additional guidance on March 30, 2004, in I.R.S. Notice 2004-23, I.R.S. Notice 2004-25, Revenue Ruling 2004-38, and Revenue Procedure 2004-22. The Treasury/IRS guidance is available on the Internet at www.treas.gov/offices/public-affairs/hsa.
2. See I.R.S. Notice 2004-2, Q&A Nos. 1 and 2.
3. Id. Q&A No. 11.
4. Id. Q&A No. 23.
5. Id. Q&A No. 32.
6. Id. Q&A No. 30.
7. Regulation section 2510.3-1(j) excludes from Title I coverage certain group or group-type insurance

programs. In general, such programs are excluded from coverage where there are no employer contributions, employee participation is voluntary, the employer does not endorse the program, and the employer receives no consideration in connection with the program, other than reasonable compensation for administrative services actually rendered in connection with payroll deductions. See also 29 C.F.R. § 2509.99-1 relating to payroll deduction IRAs.

8. Although the Medicare Modernization Act excludes health insurance from the qualified medical expenses that may be paid from an HSA, there are exceptions for the payment of COBRA premiums, certain insurance for individuals over 65, long-term care insurance premiums and health insurance during periods of unemployment. Code section 223(d)(2).

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2004-02

September 30, 2004

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Fiduciary Duties and Missing Participants in Terminated Defined Contribution Plans

Issue

What does a plan fiduciary need to do in order to fulfill its fiduciary obligations under ERISA with respect to: (1) locating a missing participant of a terminated defined contribution plan; and (2) distributing an account balance when efforts to communicate with a missing participant fail to secure a distribution election?

Background

All plan assets must be distributed as soon as administratively feasible after the date of a plan termination in order to effectively complete a plan termination under Internal Revenue Code requirements.(1) Prior to any distribution, the Code requires a plan administrator to contact all participants for affirmative directions regarding distribution of their account balances.(2) This notice requirement extends to all participants, regardless of their length of service or the size of their account balances, because all participants vest in their account balances upon termination of the plan.(3)

In the context of terminated defined contribution plans, some participants may be unresponsive to written notices from plan administrators asking for direction regarding the distribution of their account balances: these participants are commonly referred to as missing participants.(4) As a result of participants' unresponsiveness, plan administrators often are unable to effectively wind–up the plans' financial affairs and are confronted with an array of issues related to their duties under the fiduciary responsibility provisions of ERISA to search for missing participants and distribute their benefits.

The Department has previously issued guidance to fiduciaries of terminated defined contribution plans on the handling of certain missing participant issues. However, Field Offices have, in the course of their investigations, found that plan fiduciaries use a variety of methods in searching for missing participants and distributing account balances when a search proves unsuccessful. Additional guidance, therefore, has been requested concerning the obligations of plan fiduciaries that are confronted with missing participant issues in terminated defined contribution plans.(5)

Analysis

Consistent with the requirements of section 404(a) of ERISA, a fiduciary must act prudently and solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Also, under section 404(a)(1)(D) of ERISA, fiduciaries are required to act in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of Title I and IV. Section 402(b)(4) of ERISA provides that every employee benefit plan shall specify the basis on which payments are made to and from the plan. Section 403(a) of ERISA generally requires that the assets of a plan be held in trust by a trustee. In the case of plan terminations, fiduciaries must also ensure that the allocation of any previously

unallocated funds is made in accordance with the provisions of section 403(d) of ERISA.

Under Title I of ERISA, the decision to terminate a plan is generally viewed as a “settlor” decision rather than a fiduciary decision relating to the administration of the plan. However, the steps taken to implement this decision, including steps to locate missing participants, are governed by the fiduciary responsibility provisions of ERISA.(6) Further, in our view, while the distribution of the entire benefit to which a participant is entitled ends his or her status as a plan participant and the distributed assets cease to be plan assets under ERISA, a plan fiduciary’s choice of a distribution option is a fiduciary decision subject to the general fiduciary responsibility provisions of ERISA.(7)

It is our view that a plan fiduciary must take certain steps in an effort to locate a missing participant or beneficiary before the plan fiduciary determines that the participant cannot be found and distributes his or her benefits in accordance with this Bulletin. These steps are identified below under the heading “Search Methods.” It also is our view that, in determining any additional steps that may be appropriate with regard to a particular participant, a plan fiduciary must consider the size of the participant’s account balance and the expenses involved in attempting to locate the missing participant. Accordingly, the specific steps that a plan fiduciary takes to locate a missing participant may vary depending on the facts and circumstances. This consideration of additional steps is discussed below under the heading “Other Search Options.” Reasonable expenses attendant to locating a missing participant may be charged to a participant’s account, provided that the amount of the expenses allocated to the participant’s account is reasonable and the method of allocation is consistent with the terms of the plan and the plan fiduciary’s duties under ERISA.(8) Whatever decisions are made in connection with locating of missing participants or the distribution of assets on their behalf, plan fiduciaries must be able to demonstrate compliance with ERISA’s fiduciary standards.

Search Methods

In the context of a defined contribution plan termination, one of the most important functions of the plan’s fiduciaries is to notify participants of the termination and of the plan’s intention to distribute benefits. In most instances, routine methods of delivering notice to participants, such as first class mail or electronic notification, will be adequate. In the event that such methods fail to obtain from the participant the information necessary for the distribution, or the plan fiduciary has reason to believe that a participant has failed to inform the plan of a change in address, plan fiduciaries need to take other steps to locate the participant or a beneficiary. In our view, some search methods involve such nominal expense and such potential for effectiveness that a plan fiduciary must always use them, regardless of the size of the participant’s account balance. A plan fiduciary cannot distribute a missing participant’s benefits in accordance with the distribution options discussed below unless each of these methods proves ineffective in locating the missing participant. However, a plan fiduciary is not obligated to take each of these steps if one or more of them are successful in locating the missing participant. These methods are:

Use Certified Mail. Certified mail can be used to easily ascertain, at little cost, whether the participant can be located in order to distribute benefits.

Check Related Plan Records. While the records of the terminated plan may not have current address information, it is possible that the employer or another plan of the employer, such as a group health plan, may have more up-to-date information with respect to a given participant or beneficiary. For this reason, plan fiduciaries of the terminated plan must ask both the employer and administrator(s) of related plans to search their records for a more current address for the missing participant. If there are privacy concerns, the plan fiduciary that is engaged in the search can request the employer or other plan fiduciary to contact or forward a letter on behalf of the terminated plan to the participant or beneficiary, requesting the participant or beneficiary to contact the plan fiduciary.

Check With Designated Plan Beneficiary. In connection with a search of the terminated plan’s records or the records of related plans, plan fiduciaries must attempt to identify and contact any individual that the missing participant has designated as a beneficiary (e.g., spouse, children, etc.) for updated information concerning the location of the missing participant. Again, if there are privacy concerns, the plan fiduciary can request the designated beneficiary to contact or forward a letter on behalf of the terminated plan to the participant, requesting the participant or beneficiary to contact the plan fiduciary.

Use A Letter-Forwarding Service. Both the Internal Revenue Service (IRS) and the Social Security Administration (SSA) offer letter-forwarding services. Plan fiduciaries must choose one service and use it in attempting to locate a missing participant or beneficiary. The IRS has published guidelines under which it will forward letters for third parties for certain “humane purposes,” including a qualified plan administrator’s attempt to locate and pay a benefit to a plan participant.(9) The SSA’s letter forwarding service may be used for similar

purposes, and is described on the SSA's Web site.(10) It is our understanding that to use either the IRS or SSA program, the plan fiduciary/requestor must submit a written request for letter forwarding to the agency, and must provide the missing participant's social security number or certain other identifying information. Both the IRS and SSA will search their records for the most recent address of the missing participant and will forward a letter from the plan fiduciary/requestor to the missing participant if appropriate. In using these letter-forwarding services to notify a missing participant that he or she is entitled to a benefit, the plan fiduciary's letter should provide contact information for claiming the benefit. This notice may also suggest a date by which the participant must respond, as neither the IRS nor the SSA will notify the plan fiduciary as to whether the participant was located.

Other Search Options

In addition to using the search methods discussed above, a plan fiduciary should consider the use of Internet search tools, commercial locator services, and credit reporting agencies to locate a missing participant. Depending on the facts and circumstances concerning a particular missing participant, it may be prudent for the plan fiduciary to use one or more of these other search options. If the cost of using these services will be charged to the missing participant's account, plan fiduciaries will need to consider the size of the participant's account balance in relation to the cost of the services when deciding whether the use of such services is appropriate.

Distribution Options

There will be circumstances when, despite their use of the search methods described above, plan fiduciaries will be unable to locate participants or otherwise obtain directions concerning the distribution of their benefits from terminated defined contribution plans. In these circumstances, plan fiduciaries will nonetheless have to consider distribution options in order to effectuate the termination of the plan.(11) We have set forth below the fiduciary considerations that are relevant to the various options available to plan fiduciaries in the context of missing participants of terminated defined contribution plans.

Individual Retirement Plan Rollovers - In our view, plan fiduciaries must always consider distributing missing participant benefits into individual retirement plans (i.e., an individual retirement account or annuity).(12) Establishing an individual retirement plan is the preferred distribution option because it is more likely to preserve assets for retirement purposes than any of the other identified options.

Distribution to an individual retirement plan preserves retirement assets because it results in a deferral of income tax consequences for missing participants. A distribution that qualifies as an eligible rollover distribution(13) from a qualified plan, which is handled by a trustee to trustee transfer into an individual retirement plan, will not be subject to immediate income taxation, the 20 percent mandatory income tax withholding requirement, or the 10 percent additional tax for premature distributions that may be required based on the participant's age and related facts.(14)

As we have noted in other contexts, the choice of an individual retirement plan also raises fiduciary issues as to the particular choice of an individual retirement plan trustee, custodian or issuer as well as the selection of an initial individual retirement plan investment to receive the distribution.(15) By regulation, the Department established a safe harbor for plan fiduciaries to satisfy their fiduciary responsibility under section 404(a) of ERISA when selecting individual retirement plan providers and initial investments in connection with the rollover of certain mandatory distributions to individual retirement plans.(16) In general, this regulation applies to distributions of $5,000 or less for separating participants who leave an employer's workforce without making an election to either receive a taxable cash distribution or directly roll over assets into an individual retirement plan or another qualified plan.

In our view, the circumstances giving rise to relief under this safe harbor regulation are similar to those confronting fiduciaries of terminated defined contribution plans. Therefore, in the context of making distributions from terminated defined contribution plans on behalf of participants who are determined to be missing or otherwise fail to elect a method of distribution in connection with the termination, fiduciaries who choose investment products that are designed to preserve principal should, as an enforcement matter, be treated as satisfying their fiduciary duties in connection with such distributions, when the fiduciary complies with the relevant requirements of the automatic rollover safe harbor regulation, without regard to the amount involved in the rollover distribution.(17)

Alternative Arrangements - If a plan fiduciary is unable to locate an individual retirement plan provider that is willing to accept a rollover distribution on behalf of a missing participant, plan fiduciaries may consider either establishing an interest-bearing federally insured bank account in the name of a missing participant or transferring missing participants' account balances to state unclaimed property funds. In this regard, fiduciaries

should be aware that transferring a participant's benefits to either a bank account or state unclaimed property fund will subject the deposited amounts to income taxation, mandatory income tax withholding and a possible additional tax for premature distributions. Moreover, interest accrued would also be subject to income taxation. Plan fiduciaries should not use 100% income tax withholding as a means to distribute plan benefits to missing participants.

Federally Insured Bank Accounts - Plan fiduciaries may consider establishing an interest bearing federally insured bank account in the name of a missing participant, provided the participant would have an unconditional right to withdraw funds from the account. In selecting a bank and accepting an initial interest rate, with or without a guarantee period, a plan fiduciary must give appropriate consideration to all available information relevant to such selection and interest rate, including associated bank charges.

Escheat To State Unclaimed Property Funds - As an alternative, plan fiduciaries may also consider transferring missing participants' account balances to state unclaimed property funds in the state of each participant's last known residence or work location. We understand that some states accept such distributions on behalf of missing participants. We also understand that states often provide searchable Internet databases that list the names of property owners and, in some instances, award minimal interest on unclaimed property funds.

In prior guidance, the Department concluded that, if a state unclaimed property statute were applied to require an ongoing plan to pay to the state amounts held by the plan on behalf of terminated employees, the application of that statute would be preempted by section 514(a) of ERISA.(18) However, we do not believe that the principles set forth in Advisory Opinion 94-41A, which dealt with a plan fiduciary's duty to preserve plan assets held in trust for an ongoing plan, prevent a plan fiduciary from voluntarily deciding to escheat missing participants' account balances under a state's unclaimed property statute in order to complete the plan termination process.

Additionally, we believe that a plan fiduciary's transfer of a missing participant's account balance from a terminated defined contribution plan to a state's unclaimed property fund would constitute a plan distribution, which ends both the property owner's status as a plan participant and the property's status as plan assets under ERISA.(19)

In deciding between distribution into a state unclaimed property fund and distribution into a federally insured bank account, we believe that a plan fiduciary should evaluate any interest accrual and fees associated with a bank account against the availability of the state unclaimed property fund's searchable database that may facilitate the potential for recovery. In any event, transfer to state unclaimed property funds must comply with state law requirements.

100% Income Tax Withholding - We are aware that some plan fiduciaries believe that imposing 100% income tax withholding on missing participant benefits, in effect transferring the benefits to the IRS, is an acceptable means by which to deal with the benefits of missing participants. After reviewing this option with the staff of the Internal Revenue Service, we have concluded that the use of this option would not be in the interest of participants and beneficiaries and, therefore, would violate ERISA's fiduciary requirements. Based on discussions with the IRS staff and our understanding of the IRS's current data processing, the 100% withholding distribution option would not necessarily result in the withheld amounts being matched or applied to the missing participants'/taxpayers' income tax liabilities resulting in a refund of the amount in excess of such tax liabilities.(20) This option, therefore, should not be used by plan fiduciaries as a means to distribute benefits to plan participants and beneficiaries.

Miscellaneous Issues

Fiduciaries have expressed concerns about legal impediments that might hinder the establishment of individual retirement plans or bank accounts on behalf of missing participants. These impediments include perceived conflicts with the customer identification and verification provisions of the USA PATRIOT Act (Act).(21) With regard to this problem, we note that Treasury staff, along with the staff of the other Federal functional regulators,(22) has issued helpful guidance for fiduciaries that are establishing an individual retirement plan or federally insured bank account in the name of a missing participant. This guidance was published in a set of questions and answers on the customer identification and verification provision (CIP) of the Act, "FAQs: Final CIP Rule," on the regulators' Web sites.(23)

The Federal functional regulators advised the Department that they interpret the CIP requirements of section 326 of the Act and implementing regulations to require that banks and other financial institutions implement their CIP compliance program with respect to an account (including an individual retirement plan or federally

insured bank account) established by an employee benefit plan in the name of a former participant (or beneficiary) of such plan, only at the time the former participant or beneficiary first contacts such institution to assert ownership or exercise control over the account. CIP compliance will not be required at the time an employee benefit plan establishes an account and transfers the funds to a bank or other financial institution for purposes of a distribution of benefits from the plan to a separated employee.

With regard to the application of state laws, including those governing signature requirements and escheat, we note that such issues are beyond the Department's jurisdiction.

Conclusion

Actions taken to implement the decision to terminate a plan, including the search for missing participants, and if search efforts fail, the selection of a distribution option for the benefits of missing participants, are governed by the fiduciary responsibility provisions of ERISA. In fulfilling their duties of prudence and loyalty to missing participants, we believe there are certain search methods which involve such nominal expense and potential for effectiveness that fiduciaries must always use them, regardless of the size of the account balance, as discussed in detail above.

We also believe that these duties require that fiduciaries consider establishing individual retirement plans as the preferred method of distribution for the benefits of missing participants. In this regard, the selection of an individual retirement plan provider and the initial investment for an individual retirement plan also constitute fiduciary decisions. If plan fiduciaries are unable to locate an individual retirement plan provider that is willing to accept a rollover distribution, fiduciaries may consider distributing a missing participant's benefits into a federally insured bank account or transferring a missing participant's benefit to a state unclaimed property fund; the factors to be considered in choosing between these options are discussed more fully above.

Questions concerning the information contained in this Bulletin may be directed to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, 202.693.8510.

Footnotes

1. See Rev. Rul. 89-87, 1989-2 C.B. 81.
2. Under Internal Revenue Code (Code) §402(f), a plan administrator is required, prior to making an eligible rollover distribution, to provide the participant with a written explanation of the Code provisions under which the participant may elect to have the distribution transferred directly to an IRA or another qualified plan, the provision requiring tax withholding if the distribution is not directly transferred and the provisions under which the distribution will not be taxed if the participant transfers the distribution to an IRA or another qualified plan within 60 days of receipt.
3. Under Code §411(d)(3), a plan must provide that, upon its termination or complete discontinuance of contributions, benefits accrued to the date of termination or discontinuance of contributions become vested to the extent funded on such date.
4. The Department notes that this guidance applies only in the context of terminated defined contribution plans. For rules governing the Pension Benefit Guaranty Corporation's missing participants program, which applies to terminated defined benefit plans covered by Title IV of ERISA, see ERISA § 4050 and 29 CFR § 4050.
5. This guidance assumes that the terminated plan does not provide an annuity option and that no other appropriate defined contribution plans are maintained within the sponsoring employer's corporate group to which account balances from the terminated plan could be transferred..
6. See Advisory Opinion 2001-01A (Jan. 18, 2001); see also Letter to John N. Erlenborn from Dennis M. Kass (Mar. 13, 1986).
7. See Rev. Rul. 2000-36 where the Department stated that the selection of an IRA trustee, custodian or issuer and of an IRA investment for purposes of a default rollover pursuant to a plan provision would constitute a fiduciary act under ERISA.
8. See generally Field Assistance Bulletin 2003-3 (May 19, 2003) for the Department's views with respect to expense allocations in defined contribution plans. See also Rev. Rul. 2004-10, 2004-7 I.R.B. (Jan. 29, 2004).
9. See Rev. Proc. 94-22, 1994-1 C.B. 608; IRS Policy Statement P-1-187.
10. The Social Security Administration's Web site is found at www.ssa.gov.
11. See supra footnote 1.
12. Code §7701(a)(37) defines an "individual retirement plan" to mean an individual retirement account described in Code §408(a) and an individual retirement annuity described in Code §408(b).
13. An "eligible rollover distribution" is, subject to certain limited exceptions, any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust. See Code §402(c)

and (f)(2)(A).

14. Code §402(a), §3405(c), and §72(t).
15. See supra footnote 6.
16. See 29 C.F.R. §2550.404a-2.
17. It should be noted that Class Exemption (PTE No. 2004-16) generally provides relief from ERISA's prohibited transaction provisions for a plan fiduciary's selection of itself as the provider of an individual retirement plan and/or issuer of an investment in connection with rollovers of missing participant accounts for amounts up to $5,000.
18. Advisory Opinion 94-41A (Dec. 7, 1994).
19. Prior Departmental Advisory Opinions addressed distributions from ongoing plans. See, e.g., Advisory Opinion 94-41A (Dec. 7, 1994); Advisory Opinion 79-30A (May 14, 1979); Advisory Opinion 78-32A (Dec. 22, 1978). We note, however, that this memorandum addresses only distributions that complete the termination of defined contribution plans.
20. See, e.g., Code section 6511 (regarding the time limitations for taxpayer refunds).
21. Pub. L. No. 107-56, Oct. 26, 2001, 115 Stat. 272.
22. The term "other Federal functional regulators" refers to the other agencies responsible for administration and regulations under the Act.
23. See "FAQs: Final CIP Rule" at:
    www.occ.treas.gov/10.pdf
    www.fincen.gov/finalciprule.pdf
    www.fdic.gov/news/news/financial/2004/FIL0404a.html

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin 2004-03

December 17, 2004

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Fiduciary Responsibilities Of Directed Trustees

Issue

In the context of publicly traded securities, what are the fiduciary responsibilities of a directed trustee?

Background

Many employee pension plans use directed trustees to carry out transactions according to instructions from a named fiduciary of the plan. During investigations of such transactions by the Department, difficult questions may arise regarding the scope of the directed trustee's fiduciary duties. Recent court decisions, addressing this issue in the context of purchases and holdings of publicly traded employer securities in particular, have focused attention on the nature and scope of a directed trustee's fiduciary duties. This bulletin provides general guidance to EBSA regional offices regarding the Department's views on the responsibilities of directed trustees under ERISA, particularly with respect to directions involving employer securities.

Fiduciary Status Of Directed Trustee

Section 403(a) provides that a plan trustee "shall have exclusive authority and discretion to manage and control the assets of the plan." Section 3(21)(A) provides that a person is a fiduciary with respect to a plan "to the extent . . . he . . . exercises any authority or control respecting management or disposition of its assets." A plan trustee, therefore, will, by definition, always be a "fiduciary" under ERISA as result of its authority or control over plan assets. Not all trustees, however, have the same authority or discretion to manage or control the assets of a plan. In this regard, section 403(a) specifically recognizes that a trustee or trustees will have limited authority or discretion when:

(1) the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee, in which case the trustees shall be subject to proper directions of such fiduciary which are made in accordance with the terms of the plan and which are not contrary to this Act.

While section 403(a)(1) does not remove a directed trustee from section 3(21)'s purview, it significantly limits such a trustee's responsibilities as a plan fiduciary. As the district court in In re Enron Corp. Securities, Derivative & ERISA Litig., 284 F. Supp. 2d 511, 601 (S.D. Tex. 2003), recognized:

At least some fiduciary status and duties of a directed trustee are preserved, even though the scope of its exclusive authority and discretion to manage and control the assets of the plan' has been substantially constricted by the directing named fiduciary's correspondingly broadened role . . . .

The court in In re WorldCom, Inc. ERISA Litig., 263 F. Supp. 2d 745, 762 (S.D.N.Y. 2003) also noted that, while the directed trustee provision serves as a limiting principle, "section 403(a) does not . . . eliminate the fiduciary status or duties that normally adhere to a trustee with responsibility over ERISA assets." See also

FirsTier Bank, N.A. v. Zeller, 16 F.3d 907, 9110 (8th Cir.), cert. denied sub nom, Vercoe v. FirsTier Bank, N.A., 513 U.S. 871 (1994); Herman v. NationsBank Trust Co., 126 F.3d 1354, 1361-62, 1370 (11th Cir. 1997).

The duties of a directed trustee under section 403(a)(1) are therefore significantly narrower than the duties generally ascribed to a discretionary trustee under common law trust principles.(1)

Determining Whether A Direction Is "Proper"

Under section 403(a)(1), a directed trustee is subject to proper directions of a named fiduciary. For purposes of section 403(a)(1), a direction is proper only if the direction is "made in accordance with the terms of the plan" and "not contrary to the Act [ERISA]." Accordingly, when a directed trustee knows or should know that a direction from a named fiduciary is not made in accordance with the terms of the plan or is contrary to ERISA, the directed trustee may not, consistent with its fiduciary responsibilities, follow the direction.

In accordance with plan terms

Under section 403(a)(1), a directed trustee may not follow a direction that the trustee knows or should know is inconsistent with the terms of the plan. In order to make such determinations, directed trustees necessarily have a duty to request and review all the documents and instruments governing the plan that are relevant to its duties as directed trustee. Accordingly, if a directed trustee either fails to request such documents or fails to review the documents furnished in response to its request and, as a result of such failure, follows a direction contrary to the terms of the plan, the directed trustee may be liable for following such direction because the directed trustee had a duty to request and review pertinent plan documents and, therefore, should have known that the direction was not in accordance with the terms of the plan. If a directed trustee follows an improper direction, as would be the case where the purchase of a particular stock at the direction of the plan's named fiduciary is contrary to the plan's investment policy, the directed trustee may be liable for a breach of its fiduciary duty to follow only proper directions.

It is the view of the Department that a direction is consistent with the terms of a plan if the documents pursuant to which the plan is established and operated do not prohibit the direction. It is also the view of the Department that if, in the course of reviewing the propriety of a particular direction, a directed trustee determines that the terms of the relevant documents are ambiguous with respect to the permissibility of the direction, the directed trustee should obtain a clarification of the plan terms from the fiduciary responsible for interpreting such terms in order to ensure that the direction is proper. In this regard, the directed trustee may rely on the interpretation of such fiduciary.

Not contrary to ERISA

Even when a direction is consistent with the terms of the plan, the direction may nonetheless fail to be a proper direction because it is contrary to ERISA. Under section 403(a)(1), a directed trustee may not follow a direction that the trustee knows or should know is contrary to ERISA. For example, the directed trustee cannot follow a direction that the directed trustee knows or should know would require the trustee to engage in a transaction prohibited under section 406 or violate the prudence requirement of section 404(a)(1). The following discussion further clarifies the duties of a directed trustee in this area.

Prohibited transaction determinations

A directed trustee must follow processes that are designed to avoid prohibited transactions. A directed trustee could satisfy its obligation by obtaining appropriate written representations from the directing fiduciary that the plan maintains and follows procedures for identifying prohibited transactions and, if prohibited, identifying the individual or class exemption applicable to the transaction. A directed trustee may rely on the representations of the directing fiduciary unless the directed trustee knows that the representations are false.

Prudence determinations

The named fiduciary has primary responsibility for determining the prudence of a particular transaction, whether the transaction involves buying, selling or holding particular assets. Accordingly, as the courts and the Department have long recognized, the scope of a directed trustee's responsibility is significantly limited. A directed trustee does not, in the view of the Department, have an independent obligation to determine the prudence of every transaction. The directed trustee does not have an obligation to duplicate or second-guess the work of the plan fiduciaries that have discretionary authority over the management of plan assets and does not have a direct obligation to determine the prudence of a transaction. See In re WorldCom ERISA Litig., 263 F. Supp. 2d at 761; Herman v. NationsBank Trust Co., 126 F.3d at 1361-62, 1371 (directed trustee does not have a direct obligation of prudence under ERISA section 404; its obligation is simply "to make sure" the

"directions were proper, in accordance with the terms of the plan, and not contrary to ERISA").

Duty to act on non-public information

The directed trustee's obligation to question market transactions involving publicly traded stock on prudence grounds is quite limited. The primary circumstance in which such an obligation could arise is when the directed trustee possesses material non-public information regarding a security. If a directed trustee has material non-public information that is necessary for a prudent decision, the directed trustee, prior to following a direction that would be affected by such information, has a duty to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. For example, if a directed trustee has non-public information indicating that a company's public financial statements contain material misrepresentations that significantly inflate the company's earnings, the trustee could not simply follow a direction to purchase that company's stock at an artificially inflated price.

Generally, the possession of non-public information by one part of an organization will not be imputed to the organization as a whole (including personnel providing directed trustee services) where the organization maintains procedures designed to prevent the illegal disclosure of such information under securities, banking or other laws.(2) If, despite such procedures, the individuals responsible for the directed trustee services have actual knowledge of material non-public information, the directed trustee, prior to following a direction that would be affected by such information, has a duty, as indicated above, to inquire about the named fiduciary's knowledge and consideration of the information with respect to the direction. Similarly, if the directed trustee performs an internal analysis in which it concludes that the company's current financial statements are materially inaccurate, the directed trustee would have an obligation to disclose this analysis to the named fiduciary before making a determination whether to follow a direction to purchase the company's security. The directed trustee would not have an obligation to disclose reports and analyses that are available to the public.

Duty to act on public information

Absent material non-public information, a directed trustee, given its limited fiduciary duties as determined by statute, will rarely have an obligation under ERISA to question the prudence of a direction to purchase publicly traded securities at the market price solely on the basis of publicly available information. Three considerations counsel in favor of this view: (1) markets generally are assumed to be efficient so that stock prices reflect publicly available information and known risks; (2) in the case of employer securities, the securities laws impose substantial obligations on the company, its officers, and its accountants to state their financial records accurately; and (3) ERISA section 404 requires the instructing fiduciary to adhere to a stringent standard of care.(3) Furthermore, because stock prices fluctuate as a matter of course, even a steep drop in a stock's price would not, in and of itself, indicate that a named fiduciary's direction to purchase or hold such stock is imprudent and, therefore, not a proper direction.

In limited, extraordinary circumstances, where there are clear and compelling public indicators, as evidenced by an 8-K filing with the Securities and Exchange Commission (SEC), a bankruptcy filing or similar public indicator, that call into serious question a company's viability as a going concern,(4) the directed trustee may have a duty not to follow the named fiduciary's instruction without further inquiry.(5) For example, if a company filed for bankruptcy under circumstances which make it unlikely that there would be any distribution to equity-holders, or otherwise publicly stated that it was unlikely to survive the bankruptcy proceedings in a manner that would leave current equity-holders with any value, the directed trustee would have an obligation to question whether the named fiduciary has considered the prudence of the direction.(6) It also is the view of the Department that, in situations where a fiduciary who is a corporate employee gives an instruction to buy or hold stock of his or her company subsequent to the company, its officers or directors, being formally charged by state or Federal regulators with financial irregularities, the directed trustee, taking such facts into account, may need to decline to follow the direction or may need to conduct an independent assessment of the transaction in order to assure itself that the instruction is consistent with ERISA.(7) If, however, an independent fiduciary was appointed to manage the plan's investment in company stock, a directed trustee could follow the proper directions of the independent fiduciary without having to conduct its own independent assessment of the transaction.

Effect Of Questioning Directions On Fiduciary Status

It is the view of the Department that the nature and scope of a directed trustee's fiduciary responsibility, as discussed herein, does not change merely because the directed trustee, in carrying out its duties, raises questions concerning whether a direction is "proper" or declines to follow a direction that the directed trustee does not believe is a proper direction within the meaning of section 403(a)(1). For example, information provided to a named fiduciary concerning the prudence of a direction is not investment advice for purposes of

ERISA §3(21)(A)(ii). Similarly, if a named fiduciary changes a direction in response to a directed trustee's inquiries or information, the directed trustee's fiduciary responsibility with respect to the changed direction remains governed by section 403(a)(1). The directed trustee does not become primarily responsible for the prudence of the direction.

Co-Fiduciary Duties

Under ERISA section 405(a)(1), a fiduciary is liable for the breach of another fiduciary if the fiduciary "participates knowingly" in the breach of the other fiduciary. Accordingly, if a directed trustee has knowledge of a fiduciary breach, the directed trustee may be liable as a co-fiduciary unless the directed trustee takes reasonable steps to remedy the breach. Thus, if the directed trustee knew that the named fiduciary was failing to discharge its obligations in accordance with ERISA's requirements, it could not simply follow directions from the breaching fiduciary. Efforts to remedy a breach (or to prevent an imminent breach) may include reporting the breach to other fiduciaries of the plan or the Department of Labor.

Conclusion

Although its responsibilities are significantly limited under the statute, a directed trustee is a fiduciary under ERISA and must exercise its duties prudently and solely in the interest of the plan participants and beneficiaries. Particularly in the context of purchasing, selling or holding publicly traded securities on a generally recognized market, the trustee may follow the named fiduciary's directions absent extraordinary circumstance as discussed above.

Footnotes

1. It is assumed for purposes of this guidance that discretionary authority or control over plan assets, beyond that discussed herein as applicable to a person serving as a directed trustee under section 403(a)(1), has not been conferred upon a directed trustee under the terms of the plan, including trust and service provider agreements.
2. The Department expresses no view as to whether, or under what circumstances, other procedures established by an organization to limit the disclosure of information will serve to avoid the imputation of information to a directed trustee.
3. It should be noted that, in the case of an individual account plan, the diversification requirements of section 404(a)(1)(C) do not apply to the acquisition or holding of qualifying employer securities within the meaning of section 407(d)(5).
4. We note that section 409 of the Sarbanes-Oxley Act of 2002, 15 U.S.C. 78(m)(l), requires public companies to disclose "on a rapid and current basis" material information regarding changes in the company's financial condition or operations as the SEC by rule determines to be necessary or useful for the protection of investors or in the public interest. The SEC has recently updated its disclosure requirements related to Form 8-K, expanding the number of reportable events and shortening the filing deadline for most items to four business days after the occurrence of the event triggering the disclosure requirements of the form. 69 FR. 15594 (Mar. 25, 2004). Not all 8-K filings regarding a company would trigger a duty on the part of a directed trustee to question a direction to purchase or hold securities of that company. Only those relatively few 8-Ks that call into serious question a company's ongoing viability may trigger a duty on the part of the directed trustee to take some action.
5. A directed trustee's actual knowledge of media or other public reports or analyses that merely speculate on the continued viability of a company does not, in and of itself, constitute knowledge of clear and compelling evidence concerning the company sufficient to give rise to a directed trustee's duty to act.
6. Even under such circumstances, it might not be imprudent to purchase or hold stock in a distressed company in bankruptcy. There may be situations in which the plan's fiduciaries could reasonably conclude that the stock investment makes sense, even for a long-term investor, in light of the proposed restructuring of the company's debts or other factors.
7. Nothing in the text should be read to suggest that a directed trustee would have a heightened duty whenever a regulatory body opens an investigation of a company whose securities are the subject of a direction, merely based on the bare fact of the investigation.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin No. 2006-01

Date: April 19, 2006

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: The Distribution To Plans Of Settlement Proceeds Relating To Late Trading And Market-Timing

Issue

What are the duties and responsibilities under ERISA of independent distribution consultants (IDCs), plan service-providers and fiduciaries with respect to the allocation and distribution of mutual fund settlement proceeds to plans and plan participants?

Background

Pursuant to Orders entered by the Securities and Exchange Commission (SEC) in several SEC enforcement matters alleging late trading and market timing activities, SEC distribution funds have been created for the purpose of making distributions to investors who suffered losses as a result of the conduct alleged in the matters. For each relevant mutual fund or series of funds, an independent distribution consultant (IDC) has been or will be appointed pursuant to SEC Orders to establish a plan to distribute the monies from the settlement fund to appropriate fund shareholders, subject to the SEC's approval.

A number of ERISA-covered plans will be entitled to settlement proceeds by virtue of their mutual fund investments. In some cases, plans will be the shareholder of record and receive their settlement distribution directly from the settlement fund. In other cases, an intermediary, e.g., a broker-dealer, underwriter, and/or record-keeper, will be the shareholder of record and plans, as well as non-plan investors, will receive their settlement distribution based on their interest in an "omnibus account" operated by the intermediary. When an intermediary is involved, we understand that distribution plans may provide an intermediary with the option of either receiving the settlement proceeds in a lump sum and making the requisite distribution of proceeds to the individual investors in its omnibus account or providing the IDC the necessary client and transaction records, based on which the IDC will make distributions to the individual investors. In other instances, we understand that distribution plans will provide that the IDC will allocate and distribute settlement proceeds directly to all beneficial shareholders, including plans.

Under certain settlement agreements, mutual fund companies or settling parties may agree to pay the costs associated with allocations and distributions made by the IDCs with respect to omnibus account clients of intermediaries. However, in most instances it is anticipated that settlements will not provide for the costs associated with allocations among plans or, at the plan level, among plan participants and beneficiaries.

A number of issues have been raised by IDCs, intermediaries, plan sponsors, plan-level fiduciaries, and others regarding the application of ERISA's fiduciary responsibility rules to the distribution and allocation of these settlement proceeds. Among the issues raised are questions about whether and/or when settlement proceeds will become "plan assets" under ERISA and when an intermediary or other plan service-provider may become a "fiduciary" by virtue of its receipt and investment of such proceeds. Other issues concern the duties of a plan fiduciary with respect to the allocation of such proceeds among plans and participants and beneficiaries.

This bulletin provides general guidance to EBSA regional offices regarding the Department's views on the application of ERISA's fiduciary rules to parties involved in the distribution and allocation of mutual fund settlement proceeds to employee benefit plans and among the participants and beneficiaries of such plans.

Analysis

Independent Distribution Consultants (IDCs) – Allocation among shareholders

In light of the fact that some ERISA-covered employee benefit plans, as investors in the relevant mutual funds, will be entitled to a portion of the mutual fund settlement proceeds, questions have been raised as to whether an IDC, in developing and implementing a distribution plan, is subject to ERISA's fiduciary rules. It is the view of the Department that the development and implementation of settlement fund distribution plans will not, in and of itself, cause an IDC to become a fiduciary under ERISA.

Section 3(21) of ERISA defines a fiduciary as one who has or exercises discretionary authority or control in the administration or management of an employee benefit plan or exercises any authority or control respecting management or disposition of its assets. In determining whether particular funds constitute plan assets, the Department has issued regulations describing what constitutes plan assets with respect to a plan's investment in other entities and with respect to participant contributions. See 29 C.F.R. § § 2510.3-101 and 2510.3-102. The Department also has indicated that the assets of an employee benefit plan generally are to be identified in other situations on the basis of "ordinary notions of property rights."(1)

As discussed above, IDCs are appointed pursuant to SEC Orders to establish a plan to distribute the monies from the settlement fund to affected shareholders, and prior to implementation, distribution plans must be approved by the SEC. The IDC, in this capacity, has not been engaged to act on behalf of an employee benefit plan or plans and is not an agent of the plans. Moreover, we have been informed by the SEC that no mutual fund investor, including employee benefit plan investors, has an interest in or claims against settlement fund proceeds prior to their distribution to the affected shareholders.(2) For these reasons, in our view, under the regulations and applying ordinary notions of property rights, settlement fund proceeds, in whole or in part, would not constitute plan assets prior to their distribution by an IDC to affected plan shareholders or intermediaries acting on their behalf. Accordingly, an IDC, in developing and implementing a distribution plan, would not be exercising any authority or control in the administration or management of an employee benefit plan or its assets. Therefore, the development and implementation of settlement fund distribution plans will not, in and of itself, cause an IDC to become a fiduciary under ERISA.

This conclusion would not be affected by the fact that the IDC, as part of its distribution plan, applied a de minimis threshold for determining which shareholders, including plans, received distributions, or imposed conditions on the receipt of a distribution, such as conditioning receipt on the use of a particular allocation methodology at the participant-level(3) or furnishing a report to the IDC on how the distributed funds were allocated among participants.

Intermediaries – Allocation among omnibus account clients

Unlike IDCs acting under the auspices of the SEC, intermediaries, in receiving settlement fund proceeds, will be acting on behalf of their omnibus account clients, including employee benefit plan clients.(4) The omnibus account clients, therefore, will have a beneficial interest in the settlement fund proceeds received by the intermediary, without regard to whether determinations have been made as to the specific entitlement of each omnibus account client. Accordingly, applying ordinary notions of property rights, settlement fund proceeds received by intermediaries on behalf of employee benefit plan clients will constitute plan assets and, as such, will be required to be held in trust and managed in accordance with the fiduciary responsibility provisions of Part 4 of Title I of ERISA.(5)

Without regard to whether an intermediary was a fiduciary with respect to an employee benefit plan prior to receiving a distribution of settlement proceeds, an intermediary receiving proceeds on behalf of an employee benefit plan would, in the view of the Department, be assuming fiduciary responsibilities upon receipt of such proceeds as a result of having discretionary authority or control respecting administration or management of an ERISA plan or exercising any authority or control respecting management or disposition of plan assets. The Department notes that the decision by an intermediary, who is not otherwise a fiduciary, to decline to receive a settlement fund distribution on behalf of its omnibus account clients would not, in and of itself, be viewed as a fiduciary decision. The intermediary's decision or related actions, however, may nonetheless give rise to fiduciary liability if such actions adversely affect the plan's right to receive proceeds in accordance with the IDC's plan of distribution.(6)

As noted above, an intermediary in receipt of settlement fund proceeds will be required to hold the proceeds in

trust and manage those proceeds in accordance with the fiduciary responsibility provisions of Part 4 of Title I. Among other things, an intermediary in discharging its responsibilities to act prudently and solely in the interest of plan participants and beneficiaries, in accordance with section 404(a) of ERISA, may have to invest the proceeds pending the development and/or implementation of a plan for distributing the proceeds to individual omnibus account clients. In such instances, the intermediary may also be responsible for developing and/or implementing a plan for allocating settlement proceeds among individual omnibus account clients.

If an IDC, as part of its distribution plan approved by the SEC, makes available to an intermediary or requires, as a condition to the distribution, that the intermediary utilize a particular methodology for allocating settlement fund proceeds among individual omnibus account clients, the Department will, as an enforcement matter, view the application of such methodology to the allocation of settlement fund proceeds among individual omnibus account clients as satisfying the requirements of section 404(a) with respect to the methodology for allocating assets to employee benefit plans. We note that while the use of a particular allocation methodology may be considered prudent, fiduciaries also need to ensure that implementation of the methodology (e.g., making allocations and distributions in accordance with such methodology) is carried out in a prudent manner.

In some instances, the intermediary will be responsible both for developing and implementing the plan for allocating proceeds among its omnibus account clients. As fiduciaries, intermediaries must be prudent in the selection of the method of allocating the proceeds among its clients in an omnibus account, including plans. Prudence in such instances would, at a minimum, require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected clients in relation to the impact the late trading and market timing activities may have had on the particular plan. However, prudence would also require a process by which the fiduciary weighs the costs and ultimate benefit to the clients associated with achieving that goal. For example, there may be instances where the cost of allocating an amount to a particular plan may exceed the projected amount of the proceeds with respect to which the plan might be entitled under a prudent methodology. In such instances (i.e., where the cost to the plan is projected to exceed the benefit to the plan), an allocation plan would not be considered imprudent merely because it included an objective formula pursuant to which amounts otherwise allocable to a plan are forfeited and reallocated among other omnibus account clients, provided that any such formula applies to all omnibus account clients, not just employee benefit plans, and does not permit the exercise of discretion by the intermediary.

Further, it is our view that an allocation plan would not fail to be “solely in the interest of participants,” for purposes of section 404(a)(1), merely because the allocation methodology does not result in an exact reflection of transactional activity of the clients, provided such method is reasonable, fair and objective. For example, if a fiduciary determines that it would be more cost-effective to do so, it may allocate the proceeds among clients in an omnibus account according to the average share or dollar balance of the clients’ investment in the mutual fund during the relevant period.

In some instances, the services rendered by intermediaries in connection with the receipt, allocation and/or distribution of settlement fund proceeds may involve services or compensation not contemplated in the service provider agreement between the employee benefit plan(s) and the intermediary. While an intermediary may charge plans for any direct expenses incurred in connection with receipt, allocation and/or distribution of settlement fund proceeds, an intermediary, as a plan fiduciary, cannot compensate itself from plan assets beyond direct expenses without violating the prohibited transaction rule of section 406 of ERISA.(7)

If the receipt, allocation and/or distribution services of the intermediary, and compensation for such services, are carried out in accordance with the directions and approval of appropriate plan fiduciaries, the intermediary may be able to avoid fiduciary status and issues relating to self-dealing under ERISA. However, determinations as to whether approval by a plan fiduciary has occurred would be factual in nature and would involve considerations such as language in relevant service contracts or whether the intermediary has disclosed to its employee benefit plan clients sufficient information concerning its proposed administration of the settlement proceeds so that the plan client reasonably can approve the arrangement based upon its understanding of the arrangement and related expenses.(8)

In some instances, an intermediary may receive settlement proceeds with respect to plans that have, since the event leading to the settlement, hired a new record keeper or intermediary for investments made by the plan. In such instances, the intermediary in receipt of the proceeds would still be considered a fiduciary with respect to plan assets in its possession and would be expected to transfer the assets to the plan’s new record keeper or to an appropriate fiduciary of the plan.

An intermediary may also receive proceeds on behalf of plans that have terminated. In such instances, an intermediary should make reasonable efforts to deliver such assets to a responsible plan fiduciary (most likely,

the plan sponsor) for distribution to plan participants or other appropriate disposition. If the intermediary is unable to locate a responsible plan fiduciary after a reasonable and diligent search, the intermediary may reallocate such proceeds among its other clients. Under no circumstances may an intermediary retain such assets for its own use.

Plan Fiduciary – Allocation among participants and beneficiaries

The following discussion focuses on the obligations of the plan fiduciary in allocating settlement fund proceeds among the plan's participants and beneficiaries. For purposes of this discussion, the fiduciary might be the plan sponsor, intermediary or other person charged with allocating the proceeds among participants and beneficiaries.

Similar to the allocation of settlement fund proceeds among plans, if an IDC, as part of its distribution plan approved by the SEC, requires, as a condition to the distribution, that the fiduciary utilize a particular methodology for allocating settlement fund proceeds among plan participants and beneficiaries, the Department will, as an enforcement matter, view the application of such methodology to the allocation of proceeds among participants and beneficiaries as satisfying the requirements of section 404(a) with respect to the methodology for allocating assets to participants and beneficiaries.

If an IDC's distribution plan provides, but does not require the use of, a methodology for allocating proceeds among plan participants and beneficiaries, the Department also will, as an enforcement matter, view the use of such methodology as satisfying the requirements of section 404(a)(1)(A) and (B) of ERISA with respect to a methodology for allocating assets to participants and beneficiaries. As noted above, while the use of a particular allocation methodology may be treated as prudent, fiduciaries also need to ensure that implementation of the IDC allocation methodology (e.g., making allocations to participants and beneficiaries in accordance with the methodology) is carried out in a prudent manner.

In the absence of guidance in the IDC's distribution plan with respect to allocations to a plan's participants and beneficiaries, fiduciaries must select a method or methods for allocating proceeds. In this regard, a plan fiduciary must be prudent in the selection of a method of allocating settlement proceeds among plan participants. Prudence in such instances, at a minimum, would require a process by which the fiduciary chooses a methodology where the proceeds of the settlement would be allocated, where possible, to the affected participants in relation to the impact the market timing and late trading activities may have had on the particular account. However, prudence would also require a process by which the fiduciary weighs the costs to the plan or the participant accounts and ultimate benefit to the plan or the participants associated with achieving that goal.

In addition, a fiduciary's decision must satisfy the "solely in the interest of participants" standard of section 404(a)(1) of ERISA. In this regard, a method of allocation would not fail to be "solely in the interest of participants" merely because the selected method may be seen as disadvantaging some affected participants or groups of participants. In deciding on an allocation method, the plan fiduciary may properly weigh the competing interests of various participants or classes of plan participants (e.g., affected versus current participants) and the effects of the allocation method on those participants provided a rational basis exists for the selected method and such method is reasonable, fair and objective. For example, if a fiduciary determines that plan records are insufficient to reasonably determine the extent to which participants invested in mutual funds during the relevant period should be compensated, the fiduciary may properly decide to allocate the proceeds to current participants invested in the mutual fund based upon a reasonable, fair and objective allocation method. Similarly, if a plan fiduciary determines that the cost to allocate the proceeds among participants whose accounts were invested in the mutual fund during the entirety of the relevant period approximates the amount of the proceeds, the fiduciary may properly decide to allocate the proceeds to current participants invested in the mutual fund based upon a reasonable, fair and objective allocation method.

As plan assets, the proceeds of the settlement may not be used to benefit employers, fiduciaries or other parties in interest with respect to the plan. Sections 403(c) and 406 of ERISA. Such proceeds should not be used to offset an employer's future contributions to the plan, unless such use is permissible under the terms of the plan and would not violate applicable provisions of the Internal Revenue Code (e.g., such as when amounts involved would be considered "forfeitures" under the terms of the plan). However, we believe that a plan fiduciary, consistent with its obligations under sections 404 and 406,(9) may reasonably conclude that certain participant-level allocations that are not "cost-effective" (e.g., allocations to participant accounts of de minimis amounts) may instead be used for other permissible plan purposes, such as the payment of reasonable expenses of administering the plan.

It is the view of the Department that compliance with ERISA's fiduciary rules generally will require that a

fiduciary accept a distribution of settlement proceeds. The Department recognizes, however, that in rare instances the cost attendant to the receipt and distribution of such proceeds may exceed the value of such proceeds to the plan's participants. In such instances, and provided that there is no other permissible use for such proceeds by the plan (e.g., payment of plan administrative expenses), it might be appropriate for a plan fiduciary to not accept the settlement distribution.

Conclusion

SEC settlement fund proceeds resulting from market timing and late trading activities will not be considered "plan assets" until distributed from the settlement fund. A party will be a fiduciary to the extent it exercises any authority or control over such plan assets following distribution by an IDC.

Settlement fund proceeds will upon distribution to a plan or an intermediary constitute plan assets and, therefore, will be required to be held in trust and managed in accordance with ERISA's fiduciary responsibility rules. In general, as an enforcement matter, plan fiduciaries and intermediaries will be considered to satisfy their fiduciary duty to prudently select a method for allocating settlement proceeds if they utilize an allocation methodology provided or required by an IDC in a distribution plan approved by the SEC.

While plan fiduciaries generally have flexibility in designing a methodology for allocating settlement fund proceeds among the plan's participants and beneficiaries, plan fiduciaries must ensure that the selected methodology does not otherwise violate the prudence and "solely in the interest" requirements of section 404(a).

Finally, plan fiduciaries should document appropriately the plan's receipt and use of such settlement proceeds and work closely with their record-keepers and other service-providers in completing the process.

Questions concerning the information contained in this Bulletin may be directed to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, 202.693.8510.

Footnotes

1. See Advisory Opinion 2005-08A (May 11, 2005) and Advisory Opinion 92-24A (November 11, 1992).
2. See generally 17 C.F.R. § 201.1100, et. seq. (SEC Rules on Fair Fund and Disgorgement Plans).
3. Among other things, an allocation methodology might include the use of a particular algorithm or a restriction on the depositing of proceeds in the forfeiture account of a plan.
4. Some IDC plans may include ERISA plans within the definition of "intermediaries." This discussion of intermediaries is intended to include only those intermediaries that are not ERISA plans. Where ERISA plans are themselves shareholders of record, the fiduciaries of such plans are generally acting in a fiduciary capacity with respect to the settlements.
5. For example, any deposit of proceeds in funds managed by an intermediary or affiliate would be a transaction prohibited by section 406 of ERISA unless a relevant statutory or administrative exemption applies.
6. For example, if an intermediary elects not to receive settlement fund proceeds on behalf of its employee benefit plan clients and also refuses to provide client records and other information necessary for an IDC to make the required distributions, the intermediary would be considered to be effectively exercising discretion or control over plan assets and, thereby, subject to ERISA's fiduciary standards because its actions will have prevented the plan from receiving a share of the settlement.
7. Advisory Opinion Nos. 2001-10A (December 14, 2001), 93-06A (March 11, 1993).
8. See Field Assistance Bulletin 2002-3 (November 5, 2002). See also Advisory Opinion 2001-02A (February 15, 2001). In this advisory opinion involving demutualization proceeds distribution, Prudential provided the policyholder advance notice of the allocation options and a reasonable period of time (here at least 60 days) to select an option. As long as the plan fiduciary actually chose the default allocation, its failure affirmatively to communicate that decision to Prudential did not cause Prudential to become a fiduciary by implementing that option.
9. A violation of section 406 would arise, for example, if the plan document provides that the employer would pay plan expenses.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin No. 2006-02

Date: October 27, 2006

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Health Savings Accounts - ERISA Q&As

Background

In general, a Health Savings Account (HSA) is an account established pursuant to section 223 of the Internal Revenue Code (Code) to pay or reimburse the qualified medical expenses of eligible individuals. Although the requirements for tax qualified HSAs are found in the Code, questions regarding the application of the Employee Retirement Income Security Act of 1974 (ERISA) to HSAs arise because employers may establish and contribute to an employee's HSA. On April 7, 2004, the Department of Labor's Employee Benefits Security Administration issued Field Assistance Bulletin (FAB) 2004-01 addressing the status of HSAs under ERISA. That guidance explained that HSAs generally will not constitute "employee welfare benefit plans" covered by Title I of ERISA where employer involvement with the HSA is limited.

In FAB 2004-01, the Department specifically indicated that employer contributions to HSAs would not give rise to an ERISA-covered plan where the establishment of the HSA is completely voluntary on the part of the employees and the employer does not: limit the ability of eligible individuals to move their funds to another HSA or impose conditions on utilization of HSA funds beyond those permitted under the Code; make or influence the investment decisions with respect to funds contributed to an HSA; represent that the HSA is an employee welfare benefit plan established or maintained by the employer; or receive any payment or compensation in connection with an HSA.

Since the issuance of FAB 2004-01, the Department has received a number of recurring questions about the guidance and the evolving practices regarding the offering of HSAs. The following provides further guidance on many of the frequently asked questions raised with the Department.

Questions And Answers

In the absence of an employee's affirmative consent, may an employer open an HSA for an employee and deposit employer funds into the HSA without violating the condition in the FAB that requires that the establishment of an HSA by an employee be "completely voluntary"?
Yes. The intended purpose of the "completely voluntary" condition in FAB 2004-01 is to ensure that any contributions an employee makes to an HSA, including salary reduction amounts, will be voluntary. HSA accountholders have sole control and are exclusively responsible for expending HSA funds and generally may move the funds to another HSA or otherwise withdraw the funds. The fact that an employer unilaterally opens an HSA for an employee and deposits employer funds into the HSA does not divest the HSA accountholder of this control and responsibility and, therefore, would not give rise to an ERISA-covered plan so long as the conditions described in FAB 2004-01 are met.

If an employer maintains a high deductible health plan (HDHP) for its employees, can the employer limit the HSA providers that it allows to market their HSA products in the workplace or select a single HSA provider to which it will forward contributions without making the HSA part of the employer's ERISA-covered group health plan?
Yes. As stated in FAB 2004-01, an employer may offer an HSA to its employees without establishing an ERISA-covered plan in one of two ways. The employer may rely on the group-type insurance safe harbor in 29 C.F.R. § 2510.3-1(j), in which case the employer cannot make contributions to the HSA, or it may rely on the separate conditions outlined in FAB 2004-01, in which case the employer may or may not elect to make employer contributions to the HSA.

If the employer relies on the group-type insurance safe harbor in 29 C.F.R. § 2510.3-1(j), it cannot "endorse" the HSA provider. In the Department's view, an employer would not be considered to "endorse" an HSA within the meaning of the regulation merely by limiting the HSA providers that it allows to market their HSA products in the workplace or selecting a single HSA provider to which it will forward contributions. Employers may also provide employees general information on the advisability of using an HSA in conjunction with the HDHP without "endorsing" the program. See generally Interpretive Bulletin 99-1, 29 C.F.R. § 2509.99-1.

The separate conditions in FAB 2004-01, though including completely voluntary employee participation and employer neutrality in not representing that the HSA is an employee welfare benefit plan established or maintained by the employer, do not include the group-type insurance safe harbor's prohibition on employer "endorsement." As explained in FAB 2004-01, an employer could limit the HSA providers that it allows to market their HSA products in the workplace or select a single HSA provider to which it will forward contributions and still satisfy the conditions outlined in the FAB without converting the HSA into an ERISA-covered plan.

Would an employer be viewed as "making or influencing" the HSA investment decisions of employees, within the meaning of the FAB, merely because the employer selects an HSA provider that offers some or all of the investment options made available to the employees in their 401(k) plan?
No. The mere fact that an employer selects an HSA provider to which it will forward contributions that offers a limited selection of investment options or investment options that replicate the investment options available to employees under their 401(k) plan would not, in the view of the Department, constitute the making or influencing of an employee's investment decisions giving rise to an ERISA-covered plan, so long as employees are afforded a reasonable choice of investment options and employees are not limited in moving their funds to another HSA. The selection of a single HSA provider that offers a single investment option would not, in the view the Department, afford employees a reasonable choice of investment options.

If contributions to an HSA are made through a cafeteria plan, would the savings that benefit the employer from non-payment of FICA and FUTA taxes on those contributions be considered "payment or compensation received in connection with an HSA" that would subject the HSA to Title I coverage?
No. The Department does not view an employer's non-payment of FICA and FUTA taxes on amounts contributed to an HSA as "payment or compensation" for purposes of the guidance issued in FAB 2004-01.

Can an employer pay the fees associated with the HSA that the employee would normally be expected or required to pay without causing the HSA to become an ERISA-covered plan?
Yes. As stated in the FAB, the mere fact that an employer contributes to an HSA does not result in the HSA being an ERISA-covered plan. Therefore, the Department does not believe that an employer paying fees associated with an HSA that the employee would otherwise be required to pay would make that HSA an ERISA-covered plan.

May an HSA vendor offer an HSA product it offers to the public to its own employees without the HSAs being considered employee benefit plans covered by ERISA?
Yes. Offering HSA products that the employer offers to the public in the regular course of business would not

mean the HSA provider established or is maintaining the HSA as an employer to provide benefits to its employees.

If the employer limits the number of HSA vendors to which it will forward contributions, may the employer receive a discount on another product from one of the selected HSA vendors?
No. In the Department's view, receiving a discount on another product from an HSA vendor selected by the employer would constitute the employer receiving a "payment" or "compensation" in connection with an HSA. In the Department's view, the arrangement would also give rise to fiduciary and prohibited transaction issues.

Are HSAs subject to the prohibited transaction provisions of section 4975 of the Internal Revenue Code?
Yes. Although the Department believes that HSAs meeting the conditions of FAB 2004-01 generally will not be ERISA-covered plans, the Medicare Modernization Act specifically provided that HSAs will be subject to the prohibited transaction provisions in section 4975 of the Code. In that regard, the Department's plan asset regulation at 29 C.F.R. § 2510.3-102 states, in relevant part, that "[f]or purposes of [certain specified provisions of ERISA] and section 4975 of the Internal Revenue Code only . . . the assets of the plan include amounts . . . that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets." (Emphasis added). As a result, employers who fail to transmit promptly participants' HSA contributions may violate the prohibited transaction provisions of section 4975 of the Code. See Code § 4975(c)(1)(D) (prohibited transactions include the "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan").

Do the class prohibited transaction exemptions for owners of individual retirement accounts (IRAs) apply to accountholders of HSAs?
No. The class exemptions issued by the Department for products and services offered owners of IRAs, PTE 97-11, PTE 93-33, PTE 93-1, do not apply to HSA accountholders.

Is it a prohibited transaction for an HSA provider to offer a cash incentive for establishing an HSA with that provider?
No, if the provider deposits the incentive into the HSA. The Department stated in Advisory Opinion 2004-09A that, in certain situations, an HSA provider would not violate the prohibited transaction provisions under Code section 4975(c) or ERISA section 406 where the HSA provider offers an incentive to individuals for establishing an HSA with that provider by depositing cash directly into the individual's HSA. A cash contribution to an HSA generally would not be considered a "sale or exchange of property" or "a transfer of plan assets" for purposes of the prohibited transaction provisions of the Code. Because the cash contribution goes to the HSA and not the HSA account holder, the HSA's receipt of the cash contribution also would not be considered an act of self dealing on the part of the HSA account holder nor a receipt by the HSA account holder in his or her individual capacity of any consideration from a party dealing with the HSA.

May an HSA vendor provide a line of credit for HSA expenses to an HSA accountholder choosing its HSA?
The Internal Revenue Service has issued guidance permitting eligible individuals to use debit, credit, or stored-value cards to receive distributions from an HSA for qualified medical expenses. See IRS Notice 2004-2, Q&A 37. Subsequent guidance by the Service explains that, under section 223(e)(2) of the Code, account beneficiaries, HSA trustees, and HSA custodians may not enter into certain "prohibited transactions" with an HSA. See IRS Notice 2004-50, Q&A 67, 68. For example, an account beneficiary may not borrow or pledge the assets of the HSA or receive a benefit in his or her own individual capacity as a result of opening or maintaining an HSA because such a transaction would constitute a prohibited transfer to or use of the HSA assets by or for the benefit of the account beneficiary. See Advisory Opinion 89-12A. Whether a credit card arrangement between a vendor and owner of an HSA results in a prohibited transaction would depend on

specific facts and circumstances. A prohibited transaction would not result merely from an HSA accountholder directing the payment of HSA funds to the credit line vendor to reimburse the vendor for HSA expenses paid with a credit card.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin No. 2006-03

Date: December 20, 2006

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Periodic Pension Benefit Statements - Pension Protection Act of 2006

Background

Section 105 of the Employee Retirement Income Security Act (ERISA) sets forth the requirements applicable to the furnishing of pension benefit statements to plan participants and beneficiaries. Section 508(a) of the Pension Protection Act of 2006 (PPA)(1) amended section 105, making a number of significant changes to the pension benefit statement requirements for both individual account plans and defined benefit plans. Among other things, the amendments to section 105 establish an affirmative obligation to automatically furnish pension benefit statements – at least once each quarter, in the case of individual account plans that permit participants to direct their investments; at least once each year, in the case of individual account plans that do not permit participants to direct their investments; and at least once every three years in the case of defined benefit plans. The amendments also increase the amount of information required to be contained in pension benefit statements for both individual account and defined benefit plans.

The amendments to section 105 are generally applicable to plan years beginning after December 31, 2006, with special rules for plans maintained pursuant to collective bargaining agreements.(2) Section 508(b) of the PPA requires the Department to develop one or more model pension benefit statements within one year of the date of enactment of the PPA (i.e., by August 18, 2007).

Since the enactment of the PPA, representatives of plan sponsors, service providers and others in the employee benefits community have raised a number of interpretive and compliance issues concerning the new pension benefit statement provisions. In particular, concerns have been expressed about the imminent effective date, the absence of guidance, and the cost and burdens attendant to pension benefit statement compliance efforts prior to the adoption of pension benefit statement regulations and the issuance of model pension benefit statements by the Department.

In recognition of the foregoing concerns, including the fact that major changes in what, how, and when pension benefit statement information is furnished to participants and beneficiaries may, in the absence of regulatory guidance from the Department, result in plan sponsors, plans, or participants and beneficiaries (in the case of individual account plans) incurring excessive or unnecessary compliance costs, the Department is providing general guidance in this Bulletin for EBSA's national and regional offices, as well as plan sponsors and administrators, concerning good faith compliance with the pension benefit statement provisions pending the issuance of regulations.

Good Faith Compliance

The Department has not yet issued regulations or other guidance concerning compliance with the pension benefit statement provisions of section 105 of ERISA, as amended by section 508(a) of the PPA. Until such regulations or guidance is issued, the Department will, as an enforcement matter, treat a plan administrator as satisfying the requirements of section 105 if the administrator has acted in good faith with a reasonable

interpretation of those requirements. This Bulletin provides the Department's views as to what constitutes good faith compliance with certain requirements of section 105.

Issues

1. Form of furnishing statements. In the case of individual account plans that provide for participant direction of investments, to what extent can the benefit statement requirements be satisfied by using multiple documents or sources for the required information?

It appears that, in the case of individual account plans that provide for participant direction, the information required to be included in pension benefit statements will, in many instances, involve multiple service providers, each of whom is a source for some, but not all, of the required information. For example, the plan administrator may be the source for information on vesting, whereas the plan's recordkeeper or brokerage firm may be the source for investment-related account information. We understand that, in the short term, compiling all the required information for disclosure in a single document may be impractical for plans.

Pending the issuance of further guidance, it is the view of the Department that good faith compliance with the pension benefit statement provisions does not preclude the use of multiple documents or sources for benefit statement information, provided that participants and beneficiaries have been furnished notification that explains how and when the information required by section 105 will be furnished or made available to participants and beneficiaries. Such notification should be written in a manner calculated to be understood by the average plan participant, furnished in any manner that a pension benefit statement could be furnished under this Bulletin (see issue two, below), and furnished in advance of the date on which a plan is required to furnish the first pension benefit statement pursuant to section 105(a)(1)(A)(i) of ERISA.

2. Manner of furnishing statements. To what extent can the pension benefit statement requirements be satisfied using electronic media?

Section 105(a)(2)(A)(iv) provides that a pension benefit statement may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the participant or beneficiary. In the Technical Explanation of the PPA, prepared by the staff of the Joint Committee on Taxation, the Committee explains, by way of example, that regulations relating to the furnishing of pension benefit statements, "could permit current benefit statements to be provided on a continuous basis through a secure plan web site for a participant or beneficiary who has access to the web site."(3)

With regard to the use of electronic media generally, the Department has issued a regulation, at 29 C.F.R. § 2520.104b-1(c), setting forth conditions under which a plan administrator will be deemed to satisfy the requirement, in section 2520.104b-1(b), that certain disclosures be furnished using "measures reasonably calculated to ensure actual receipt of the material." While the furnishing of the required pension benefit statement information in accordance with the safe harbor prescribed in paragraph (c) of section 2520.104b-1 would constitute good faith compliance with section 105, the Department notes that such manner of furnishing is not the exclusive means by which plan administrators could, in the absence of guidance to the contrary, satisfy their obligation to furnish pension benefit statement information. In this regard, we note that the Department of the Treasury and Internal Revenue Service recently issued guidance, at 26 C.F.R. § 1.401(a)-21,(4) relating to the use of electronic media to provide certain notices and documents required to be furnished to participants by retirement plans under the Internal Revenue Code. For purposes of section 105 of ERISA, the Department, pending further guidance and a review of the provisions of section 2520.104b-1(c), will view the furnishing of pension benefit statements in accordance with the provisions of section 1.401(a)-21, as good faith compliance with the requirement to furnish pension benefit statements to participants and beneficiaries.

With regard to pension plans that provide participants continuous access to benefit statement information through one or more secure web sites, the Department will view the availability of pension benefit statement information through such media as good faith compliance with the requirement to furnish benefit statement information, provided that participants and beneficiaries have been furnished notification that explains the availability of the required pension benefit statement information and how such information can be accessed by the participants and beneficiaries In addition, the notification must apprise participants and beneficiaries of their right to request and obtain, free of charge, a paper version of the pension benefit statement information required under section 105. Such notification should be written in a manner calculated to be understood by the average plan participant, furnished in any manner that a pension benefit statement could be furnished under this Bulletin, and furnished both in advance of the date on which a plan is required to furnish the first pension benefit statement pursuant to section 105(a)(1)(A)(i) and (ii) of ERISA and annually thereafter.

3. Dates for furnishing statements. Because the new pension benefit statement provisions are applicable as of

the first plan year beginning after December 31, 2006, what is the earliest date on which non-collectively bargained pension plans will be required to automatically furnish benefit statements that comply with the new provisions?

With regard to individual account plans that permit participants and beneficiaries to direct the investment of assets in their account, section 105(a)(1)(A)(i) requires that a pension benefit statement be furnished at least once each calendar quarter. For calendar year plans subject to this provision, the first pension benefit statement would be required for the quarter ending March 31, 2007. If a plan operated on a fiscal year basis, with the first plan year (after December 31, 2006) beginning on July 1, 2007, the first pension benefit statement required to comply with the new requirements would be required to be furnished for the quarter ending September 30, 2007.

Plans that do not provide participants or beneficiaries a right to direct their investments are required, pursuant to section 105(a)(1)(A)(ii), to furnish pension benefit statements at least once each calendar year. Whether on a calendar year or fiscal year basis, the first pension benefit statement for such plans that is required to comply with the new requirements would be required to be furnished for the calendar year ending December 31, 2007.

Pending the issuance of further guidance, it is the view of the Department that the furnishing of pension benefit statement information not later than 45 days following the end of the period (calendar quarter or calendar year) will constitute good faith compliance with the requirement to furnish a pension benefit statements in accordance with section 105(a)(1)(A)(i) and (ii).

Defined benefit plans generally are required, pursuant to section 105(a)(1)(B)(i), to furnish participants a pension benefit statement at least once every three years. The first pension benefit statement complying with the new requirements, therefore, would be due for the 2009 plan year, provided that the plan does not elect to comply with the alternative notice requirement in section 105(a)(3)(A). The alternative notice requirement for defined benefit plans provides that the requirements of section 105(a)(1)(B)(i) shall be treated as met with respect to a participant if at least once each year the administrator provides the participant notice of the availability of the pension benefit statement and the ways in which the participant may obtain such statement. If a plan elects to take advantage of the alternative notice provision in section 105(a)(3)(A), the required notification must be furnished not later than December 31, 2007.

It is the view of the Department that, in the absence of guidance to the contrary, similar principles would apply in determining good faith compliance by plans maintained pursuant to one or more collective bargaining agreements, with respect to which PPA section 508(c)(2) provides special rules for determining the date on which the provisions of section 105 are effective.

4. Right to direct investments. Will an individual account plan that does not otherwise provide participants the right to direct the investment of assets in their accounts be subject to the requirement to furnish statements quarterly (section 105(a)(1)(A)(i)) merely because the plan permits participants to take participant loans from the plan?

Pending issuance of further guidance, a reasonable interpretation of section 105(a)(1)(A)(i) would be that a participant loan feature does not, standing alone, cause a plan to be a plan that provides participants the right to direct the investment of assets in their accounts.

5. Limitations or restrictions on right to direct investments. Section 105(a)(2)(B)(ii)(I) requires that the pension benefit statement of an individual account plan that permits participant investment direction include “an explanation of any limitations or restrictions on any right of the participant or beneficiary under the plan to direct an investment.” What types of limitations and restrictions, if any, need not be included in benefit statements?

In the absence of guidance to the contrary, a reasonable interpretation of section 105(a)(2)(B)(ii)(I) would be that benefits statements must include limitations and restrictions on participants' or beneficiaries' rights imposed "under the plan," but need not include limitations and restrictions imposed by investment funds, other investment vehicles, or by state or federal securities laws.

6. Investment principles. Section 105(a)(2)(B)(ii)(II) requires that the pension benefit statement of an individual account plan that permits participant investment direction include “an explanation . . . of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified[.]” In the absence of a model benefit statement, is there language that a plan might use to satisfy this requirement?

It is the view of the Department that, in the absence of guidance to the contrary, the use of the following language will constitute good faith compliance with the requirements of section 105(a)(2)(B)(ii)(II):

To help achieve long-term retirement security, you should give careful consideration to the benefits of a well-balanced and diversified investment portfolio. Spreading your assets among different types of investments can help you achieve a favorable rate of return, while minimizing your overall risk of losing money. This is because market or other economic conditions that cause one category of assets, or one particular security, to perform very well often cause another asset category, or another particular security, to perform poorly. If you invest more than 20% of your retirement savings in any one company or industry, your savings may not be properly diversified. Although diversification is not a guarantee against loss, it is an effective strategy to help you manage investment risk.

In deciding how to invest your retirement savings, you should take into account all of your assets, including any retirement savings outside of the Plan. No single approach is right for everyone because, among other factors, individuals have different financial goals, different time horizons for meeting their goals, and different tolerances for risk.

It is also important to periodically review your investment portfolio, your investment objectives, and the investment options under the Plan to help ensure that your retirement savings will meet your retirement goals.

7. Notification of diversification rights. May an individual account plan that, prior to January 1, 2007, provides participants and beneficiaries diversification rights at least equal to the new rights conferred under section 204(j), satisfy the notice obligations under section 101(m) of ERISA by providing information concerning the importance of a diversified portfolio in connection with the furnishing of the first quarterly pension benefit statement information required by section 105(a)(1)(A)(i)?

Yes. The Department believes that the information required to be disclosed to participants and beneficiaries pursuant to section 101(m) is most significant for those participants and beneficiaries acquiring new diversification rights under section 204(j). For this reason the Department continues to believe that participants and beneficiaries in plans conferring new diversification rights as of January 1, 2007, should be furnished information concerning such rights and the importance of maintaining a diversified portfolio as soon as possible following January 1, 2007.(5)

With regard to individual account plans that, prior to January 1, 2007, provide participants and beneficiaries diversification rights at least equal to those conferred under section 204(j), the Department is persuaded that the furnishing of the 101(m) notice as a stand-alone disclosure may result both in confusion to participants and beneficiaries and distribution costs that, in many instances, will be passed on to the plan's participants and beneficiaries. In view of the fact that the periodic pension benefit statement required to be furnished pursuant to section 105(a)(1)(A)(i) is required, pursuant to section 105(a)(2)(B)(ii)(II), to contain information similar to that required by section 101(m)(2) concerning the importance of maintaining a diversified portfolio, and the fact that the pension benefit statement required to be furnished pursuant to section 105(a)(1)(A)(i) is required to be furnished within a few months of the furnishing of the 101(m) notice, the Department will treat a plan administrator's compliance with the periodic benefit statement requirements of section 105(a)(1)(A)(i) as satisfying the notice requirements of section 101(m) if, prior to January 1, 2007, the individual account plan provided participants and beneficiaries diversification rights at least equal to those conferred under section 204(j).

8. Department of Labor Web site. Section 105(a)(2)(B)(ii)(III) requires that the pension benefit statement of an individual account plan that permits participant direction of investment include a notice directing participants and beneficiaries to the Internet web site of the Department of Labor for sources of information on individual investing and diversification. What Internet address should plan administrators use for this requirement?

For purposes of section 105(a)(2)(B)(ii)(III), plan administrators may use the following Internet address for pension benefit statements: www.dol.gov/ebsa/investing.html.

Questions concerning this matter may be directed to Jeff Turner or Suzanne Adelman, at 202.693.8523.

Footnotes

1. Pub. L. No. 109-280, 120 Stat. 780 (2006).
2. See § 508(c) of the Pension Protection Act of 2006.
3. See Joint Committee on Taxation, Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006

(JCX-38-06), August 3, 2006.
4. 71 FR 61877 (Oct. 20, 2006).
5. I.R.S. Notice 2006-107.

Trust Examination Manual

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin No. 2007-01

Date: February 2, 2007

Memorandum For: Virginia C. Smith
Director of Enforcement, Regional Directors

From: Robert J. Doyle
Director of Regulations and Interpretations

Subject: Statutory Exemption For Investment Advice

Background

Section 3(21)(A)(ii) includes within the definition of "fiduciary" a person that renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of a plan, or has any authority or responsibility to do so.(1) The prohibited transaction provisions of ERISA and the Internal Revenue Code (Code) prohibit an investment advice fiduciary from using the authority, control or responsibility which makes it a fiduciary to cause itself, or a party in which it has an interest that may affect its best judgment as a fiduciary, to receive additional fees. As a result, in the absence of a statutory or administrative exemption, fiduciaries are prohibited from rendering investment advice to plan participants regarding investments that result in the payment of additional advisory and other fees to the fiduciaries or their affiliates.

The growth of participant directed individual account plans has increased recognition of the importance of investment advice to participants in such plans. Accordingly, employers and other fiduciaries have raised questions concerning their responsibilities in connection with offering investment advice programs. In response to these questions, the Department has issued various forms of guidance concerning when a person would be a fiduciary by reason of rendering investment advice and when the provision of investment advice may result in prohibited transactions.(2)

The Pension Protection Act of 2006 (PPA)(3) amended both ERISA and the Code to add a statutory exemption relating to the provision of investment advice. Specifically, section 601 of the PPA added a statutory exemption under section 408(b)(14) of ERISA (and section 4975(d)(17) of the Code(4)). Section 408(b)(14) applies to the provision of investment advice under an "eligible investment advice arrangement, " as defined in paragraph (2) of section 408(g) (also added by the PPA), to participants and beneficiaries of a defined contribution plan that permits them to direct the investment of their accounts in the plan. If the conditions of section 408(g) are met, section 408(b)(14) exempts from the prohibited transaction rules the provision of investment advice, the investment transaction entered into pursuant to the advice, and the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate in connection with the provision of advice or the transaction pursuant to the advice. An "eligible investment advice arrangement" is an arrangement that either provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the investment of plan assets do not vary depending on the basis of any investment option selected, or uses a computer model under an investment advice program that meets the requirements set forth in section 408(g)(3).

Paragraph (10) of section 408(g) addresses the responsibility and liability of plan sponsors and other fiduciaries in the context of investment advice provided pursuant to the statutory exemption. Subject to certain requirements, section 408(g)(10) provides that a plan sponsor or other person who is a plan fiduciary, other than a fiduciary adviser, is not treated as failing to meet the fiduciary requirements of ERISA solely by reason of the provision of investment advice as permitted by the statutory exemption. This provision does not exempt a plan sponsor or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and

periodic review of the selected fiduciary adviser. The provision does make clear, however, that plan sponsors and other persons who are fiduciaries do not have a duty under ERISA to monitor the specific investment advice given by a fiduciary adviser to any particular recipient of the advice.

Since the enactment of section 408(b)(14) and 408(g) of ERISA, the Department has received a number of inquiries concerning the status of its prior guidance on investment advice and the scope of the statutory exemption for investment advice. This Bulletin provides guidance to EBSA's national and regional offices on the following specific issues.

Issues

1. Did enactment of the investment advice provisions of the Pension Protection Act of 2006 invalidate or otherwise affect prior guidance issued by the Department concerning investment advice?

No. It is the view of the Department that enactment of section 408(b)(14) and 408(g) allows the provision of investment advice to plan participants under circumstances that would, in the absence of an exemption, have constituted a prohibited transaction prior to the enactment of the PPA. Except for providing that persons who develop or market computer models described in section 408(g)(3) or who market investment advice programs using such models are fiduciaries, and requiring advisers to expressly acknowledge their fiduciary status,(5) sections 408(b)(14) and 408(g) do not alter ERISA's framework for determining fiduciary status or recast otherwise permissible forms of investment advice as prohibited for purposes of section 406. For this reason, it is the view of the Department that the new provisions do not invalidate or otherwise affect prior guidance of the Department relating to investment advice and that such guidance continues to represent the views of the Department.(6)

Guidance of particular note in this regard includes: Interpretive Bulletin 96-1 (29 CFR § 2509.96-1), in which the Department identified categories of investment-related information and materials that do not constitute investment advice; Advisory Opinion Nos. 97-15A and 2005-10A, in which the Department explained that a fiduciary investment adviser could provide investment advice with respect to investment funds that pay it or an affiliate additional fees without engaging in a prohibited transaction if those fees are offset against fees that the plan otherwise is obligated to pay to the fiduciary; and Advisory Opinion 2001-09A in which the Department concluded that the provision of fiduciary investment advice, under circumstances where the advice provided by the fiduciary with respect to investment funds that pay additional fees to the fiduciary is the result of the application of methodologies developed, maintained and overseen by a party independent of the fiduciary, would not result in prohibited transactions.

2. To what extent are the standards for selecting and monitoring a fiduciary adviser described in section 408(g)(10) different from the standards applicable to plan fiduciaries who offer an investment advice program with respect to which relief under the statutory exemption for investment advice (section 408(b)(14)) is not required?

It is the view of the Department that, with the exception of certain requirements in subparagraph (A)(i) – (iii) of section 408(g)(10) regarding compliance with the conditions of the statutory exemption, the same fiduciary duties and responsibilities apply to the selection and monitoring of an investment adviser for participants and beneficiaries in a participant directed individual account plan, regardless of whether the program of investment advice services is one to which the statutory exemption applies.

Subparagraph (A) of section 408(g)(10) provides that a plan fiduciary shall not be treated as failing to meet the requirements of Part 4 of title I of ERISA solely by reason of the provision of investment advice within the meaning of section 3(21)(A)(ii) or solely by reason of contracting or arranging for the provision of investment advice pursuant to an "eligible investment advice arrangement" but subject to subparagraph (B), which addresses a fiduciary's duty to select and review the investment advice provider prudently. This principle is consistent with the Department's guidance provided in Interpretive Bulletin 96-1 regarding the provision of investment advice generally. See 29 CFR § 2509.96-1(e). Accordingly, it is the view of the Department that a plan sponsor or other fiduciary will not fail to meet the requirements of Part 4 of title I of ERISA solely by reason of offering a program of investment advice services to participants or beneficiaries that is not an "eligible investment advice arrangement."

Subparagraph (B) of section 408(g)(10), however, makes clear that, without regard to subparagraph (A), plan fiduciaries have a duty to prudently select and periodically monitor the advisory program. Subparagraph (B) of section 408(g)(10) further clarifies that fiduciaries have no duty to monitor the specific investment advice given by the fiduciary adviser to any particular recipient of advice. As with subparagraph (A), it is the view of the Department that the principles described in subparagraph (B) of section 408(g)(10) are consistent with those

set forth in § 2509.96-1(e) and, therefore, equally applicable to plan fiduciaries who select a program of investment advice services with respect to which relief under the investment advice statutory exemption is not required.

Thus, it is the view of the Department that a plan sponsor or other fiduciary that prudently selects and monitors an investment advice provider will not be liable for the advice furnished by such provider to the plan's participants and beneficiaries, whether or not that advice is provided pursuant to the statutory exemption under section 408(b)(14).(7)

Although the Interpretive Bulletin does not address the monitoring of specific investment advice provided to a particular plan participant or beneficiary, the Department believes that fiduciaries selecting advisory programs are subject to the same fiduciary duty to prudently select and monitor investment advisers regardless of whether the advice arrangement was established under the section 408(b)(14) exemption. Accordingly, it is the view of the Department that, like fiduciaries offering exempted advice arrangements, fiduciaries offering programs of investment advice services with respect to which exemptive relief is not required have no duty to monitor the specific investment advice given by the investment advice provider to any particular recipient of the advice.

With regard to the prudent selection of service providers generally, the Department has indicated that a fiduciary should engage in an objective process that is designed to elicit information necessary to assess the provider's qualifications, quality of services offered and reasonableness of fees charged for the service. The process also must avoid self dealing, conflicts of interest or other improper influence. In applying these standards to the selection of investment advisers for plan participants, we anticipate that the process utilized by the responsible fiduciary will take into account the experience and qualifications of the investment adviser, including the adviser's registration in accordance with applicable federal and/or state securities law, the willingness of the adviser to assume fiduciary status and responsibility under ERISA with respect to the advice provided to participants, and the extent to which advice to be furnished to participants and beneficiaries will be based upon generally accepted investment theories.

In monitoring investment advisers, we anticipate that fiduciaries will periodically review, among other things, the extent to which there have been any changes in the information that served as the basis for the initial selection of the investment adviser, including whether the adviser continues to meet applicable federal and state securities law requirements, and whether the advice being furnished to participants and beneficiaries was based upon generally accepted investment theories. Fiduciaries also should take into account whether the investment advice provider is complying with the contractual provisions of the engagement; utilization of the investment advice services by the participants in relation to the cost of the services to the plan; and participant comments and complaints about the quality of the furnished advice. With regard to comments and complaints, we note that to the extent that a complaint or complaints raise questions concerning the quality of advice being provided to participants, a fiduciary may have to review the specific advice at issue with the investment adviser.

Subparagraph (C) of section 408(g)(10) makes clear that plan assets can be used to pay reasonable expenses in providing investment advice to participants and beneficiaries. Again, this provision is consistent with the long held view of the Department, as set forth in § 2509.96-1(e), provided that the service provider rendering investment advice is selected and monitored prudently. Consistent with this guidance, fiduciaries selecting programs of investment advice services with respect to which exemptive relief is not required may use plan assets to pay reasonable expenses in providing investment advice (and/or investment education) to plan participants and beneficiaries.

3. For purposes of an "eligible investment advice arrangement" within the meaning of section 408(g)(2)(A)(i), is an affiliate of a fiduciary adviser subject to the level fee requirement?

The investment advice exemption provided by section 408(b)(14) applies only to investment advice provided by a "fiduciary adviser" under an "eligible investment advice arrangement." Section 408(g)(2)(A)(i) includes within the meaning of "eligible investment advice arrangement" an arrangement that, among other things, provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected.

The term "fiduciary adviser" is defined in section 408(g)(11)(A) to mean a person who is a fiduciary of the plan by reason of providing investment advice and who is a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker dealer; an affiliate(8) of such registered investment adviser, bank, insurance company, or broker dealer; or an employee, agent or registered

representative of any such entity.

It is clear from section 408(g)(2)(A)(i) that only the fees or other compensation of the fiduciary adviser may not vary. In this regard we note that, in contrast to other provisions of section 408(b)(14) and section 408(g), section 408(g)(2)(A)(i) references only the fiduciary adviser, not the fiduciary adviser or an affiliate. Inasmuch as a person, pursuant to section 408(g)(11)(A), can be a fiduciary adviser only if that person is a fiduciary of the plan by virtue of providing investment advice, an affiliate of a registered investment adviser, a bank or similar financial institution, an insurance company, or a registered broker dealer will be subject to the varying fee limitation only if that affiliate is providing investment advice to plan participants and beneficiaries.

Also, consistent with past Departmental guidance (see discussion of issue 1), if the fees and compensation received by an affiliate of a fiduciary that provides investment advice do not vary or are offset against those received by the fiduciary for the provision of investment advice, no prohibited transaction would result solely by reason of providing investment advice and thus there would be no need for a prohibited transaction exemption.(9) It is the view of the Department, therefore, that, for purposes of section 408(g)(2)(A)(i), Congress did not intend for the requirement that fees not vary depending on the basis of any investment options selected to extend to affiliates of the fiduciary adviser, unless, of course, the affiliate is also a provider of investment advice to a plan.

We further note that although section 408(g)(11)(A) generally limits "fiduciary advisers" to certain types of entities, it also permits employees, agents, or registered representatives of those entities to also qualify as fiduciary advisers if they satisfy the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice. See section 408(g)(11)(A)(vi). As with affiliates, such an individual must, for purposes of section 408(g)(11)(A), not only be an employee, agent, or registered representative of one of those entities, but also must provide investment advice in his or her capacity as employee, agent, or registered representative. It is the view of the Department that when an individual acts as an employee, agent or registered representative on behalf of an entity engaged to provide investment advice to a plan, that individual, as well as the entity, must be treated as the fiduciary adviser for purposes of section 408(g)(11)(A).(10) In such instances, therefore, both the individual and the entity would be treated as fiduciary advisers and subject to the limitations of section 408(g)(2)(A)(i).(11)

In general, a party seeking to avail itself of a statutory or administrative exemption from the prohibited transaction provisions bears the burden of establishing compliance with the conditions of the exemption. With regard to the exemptive relief accorded an "eligible investment advice arrangement" within the meaning of section 408(g)(2)(A)(i), it is the expectation of the Department that parties offering investment advisory services will maintain, and be able to demonstrate compliance with, policies and procedures designed to ensure that fees and compensation paid to fiduciary advisers, at both the entity and individual level, do not vary on the basis of any investment option selected. Moreover, it is anticipated that compliance with such policies and procedures will be reviewed as part of the annual audit required by section 408(g)(5)(A) and addressed in the report referred to in section 408(g)(5)(B).

Questions concerning the information contained in this Bulletin may be directed to the Division of Fiduciary Interpretations, Office of Regulations and Interpretations, 202.693.8510.

Footnotes

1. See also 29 CFR § 2510.3-21(c).
2. See Interpretative Bulletin relating to participant investment education, 29 CFR § 2509.96-1 (Interpretive Bulletin 96-1), AO 97-15A (May 22, 1997), AO 2001-09A (December 14, 2001), and AO 2005-10A (May 11, 2005).
3. Pub. L. 109-280, 120 Stat. 780 (Aug. 17, 2006).
4. Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), 5 U.S.C. App.1, 92 Stat. 3790, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor. Therefore, the references in this Bulletin to specific sections of ERISA should be taken as referring also to the corresponding sections of the Code.
5. ERISA section 408(g)(11)(A)(flush language), 408(g)(10)(A), 408(g)(6)(A)(vii).
6. See also August 3, 2006 Floor Statement of Senate Health, Education, Labor and Pensions Committee Chairman Enzi (who chaired the Conference Committee drafting legislation forming the basis of H.R. 4), regarding investment advice to participants in which he states, "It was the goal and objective of the Members of the Conference to keep this advisory opinion [AO 2001-09A, SunAmerica Advisory Opinion] intact as well as other pre-existing advisory opinions granted by the Department. This legislation does not alter the current or future status of the plans and their many participants operating

under these advisory opinions. Rather, the legislation builds upon these advisory opinions and provides alternative means for providing investment advice which is protective of the interests of plan participants and IRA owners." 152 Cong. Rec. S8, 752 (daily ed. Aug. 3, 2006) (statement of Sen. Enzi).

7. We note, however, that a fiduciary may have co-fiduciary liability under ERISA section 405(a) if, for example, it knowingly participates in a breach committed by another fiduciary.
8. Under section 408(g)(11)(B) the term affiliate of another entity means an affiliated person of the entity (as defined in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3))).
9. See AO 97-15A and AO 2005-10A.
10. No inferences should be drawn regarding the extent to which such an entity is responsible as principal for the acts of the individual fiduciary adviser providing the investment advice.
11. For purposes of section 408(g)(2)(A)(i), the Department interprets the requirement that fees received by a fiduciary adviser not vary on the basis of any investment option selected as meaning that the fees or other compensation (including salary, bonuses, awards, promotions or any other thing of value) received, directly or indirectly from an employer, affiliate or other party, by a fiduciary adviser (or used for the adviser's benefit) may not be based, in whole or part, on the investment options selected by participants or beneficiaries.

Department of Labor - Employee Benefits Security Administration

Field Assistance Bulletin No. 2007-02

Date: July 24, 2007

Memorandum For:
Virginia C. Smith, Director of Enforcement
Regional Directors

From:
Robert J. Doyle
Director of Regulations and Interpretations

Subject:
ERISA Coverage Of IRC § 403(b) Tax-Sheltered Annuity Programs

Issue: How do the Department of the Treasury/Internal Revenue Service regulations governing Internal Revenue Code § 403(b) tax-sheltered annuity programs affect the status of such programs under the Department of Labor's safe harbor regulation at 29 C.F.R. § 2510.3-2(f)?

Background

A tax-sheltered annuity (TSA) program under section 403(b) of the Internal Revenue Code (Code), also known as a "403(b) plan," is a retirement plan for employees of public schools, employees of certain tax-exempt organizations, and certain ministers. Under a 403(b) plan, employers may purchase for their eligible employees annuity contracts or establish custodial accounts invested only in mutual funds for the purpose of providing retirement income. Annuity contracts must be purchased from a state licensed insurance company, and the custodial accounts must be held by a custodian bank or IRS approved non-bank trustee/custodian. The annuity contracts and custodial accounts may be funded by employee salary deferrals, employer contributions, or both. Although not subject to the qualification requirements of section 401 of the Code, some of the requirements that apply to qualified plans also apply, with modifications, to 403(b) plans.

These TSA programs, if established or maintained by an employer engaged in commerce or in any industry or activity affecting commerce, generally are "pension plans" within the meaning of section 3(2) of ERISA and covered by Title I pursuant to section 4(a) of ERISA.(1) The terms "establish" or "maintain" are not defined in ERISA, and uncertainty as to the application of ERISA to TSA programs funded entirely with employee contributions prompted the Department of Labor in 1979 to issue a "safe harbor" regulation at 29 C.F.R. § 2510.3-2(f).

The safe harbor at § 2510.3-2(f) states that a program for the purchase of annuity contracts or custodial accounts in accordance with provisions set forth in section 403(b) of the Code and funded solely through salary reduction agreements or agreements to forego an increase in salary, are not "established or maintained" by an employer under section 3(2) of the Act, and, therefore, are not employee pension benefit plans subject to Title I, provided that certain factors are present. These factors are: (1) that participation of employees is completely voluntary, (2) that all rights under the annuity contract or custodial account are enforceable solely by the employee or beneficiary of such employee, or by an authorized representative of such employee or beneficiary, (3) that the involvement of the employer is limited to certain optional specified activities, and (4) that the employer receive no direct or indirect consideration or compensation in cash or otherwise other than reasonable reimbursement to cover expenses properly and actually incurred in performing the employer's duties pursuant to the salary reduction agreements. In this latter regard, if an employer, or a person acting in the interest of an employer, receives, for example, other consideration from an

annuity contractor, the employer could be deemed to have “established or maintained” a plan.

The safe harbor allows the employer to engage in a range of activities to facilitate the operation of the program. The employer may permit annuity contractors—including agents or brokers who offer annuity contracts or make available custodial accounts—to publicize their products, may request information concerning proposed funding media, products, or annuity contractors, and may compile such information to facilitate review and analysis by the employees. The employer may enter into salary reduction agreements and collect annuity or custodial account considerations required by the agreements, remit them to annuity contractors, and maintain records of such collections. The employer may hold one or more group annuity contracts in the employer’s name covering its employees and exercise rights as representative of its employees under the contract, at least with respect to amendments of the contract. The employer may also limit funding media or products available to employees, or annuity contractors who may approach the employees, to a number and selection designed to afford employees a reasonable choice in light of all relevant circumstances.(2)

The Department of the Treasury/Internal Revenue Service has issued final regulations at 26 C.F.R. 1.403(b)-0 et seq. (July 2007) reflecting legislative changes made to § 403(b) since the existing regulations were adopted in 1964. The § 403(b) regulations also incorporate interpretive positions that the Department of the Treasury/Internal Revenue Service have taken in other guidance on § 403(b). This Bulletin is intended to provide guidance to EBSA’s national and regional offices concerning the extent to which compliance with the updated regulations would cause employers to exceed the limitations on employer involvement permitted under the Department of Labor’s safe harbor for tax-sheltered annuity programs at 29 C.F.R. § 2510.3-2(f).

Analysis

The new § 403(b) regulations have not led the Department of Labor to change its view on the principles that apply in determining whether any given TSA program is covered by Title I of ERISA. Even though the differences between the tax rules for TSA programs and those governing other ERISA-covered pension plans may have diminished, the Department's safe harbor regulation at 29 C.F.R. § 2510.3-2(f) remains operative. The new § 403(b) regulations allow significant flexibility regarding the employer's functions in the structure and operation of the arrangement. Thus, compliance with the new § 403(b) regulations will not necessarily cause a TSA program to become covered by Title I of ERISA.

The Department has acknowledged that employers have an interest separate from acting as their employees’ authorized representatives in ensuring that the annuity contracts and custodial accounts in TSA programs are tax compliant. The Code’s qualification requirements impose obligations directly on employers in connection with the employees’ annuity contracts and custodial accounts. If individual contracts or accounts fail to satisfy the tax qualification requirements, even if due to actions or errors of an employee or annuity contractor, the employer can be liable to the IRS for potentially substantial penalty taxes, correction fees, and employment taxes on employee salary deferrals. Accordingly, in the Department’s view, the safe harbor at section 2510.3-2(f) subsumes certain employer activities designed to ensure that a TSA program continues to be tax compliant under section 403(b) of the Code.

The Department of Labor has issued advisory opinions and other guidance on whether specific employer functions are compatible with the safe harbor. The Department believes that the safe harbor allows an employer to conduct administrative reviews of the program structure and operation for tax compliance defects. Such reviews may include discrimination testing and compliance with maximum contribution limitations under the Treasury regulations. As noted in previous guidance issued by the Department, the employer may also fashion and propose corrections; develop improvements to the plan's administrative processes that will obviate the recurrence of tax defects; obtain the cooperation of independent entities involved in the program needed to correct tax defects; and keep records of its activities.(3)

A program could fit within the section 2510.3-2(f) safe harbor and include terms that require employers to certify to an annuity provider a state of facts within the employer's knowledge as employer, such as employee addresses, attendance records or compensation levels. The employer may also transmit to the annuity provider another party's certification as to other facts, such as a doctor's certification of the employee's physical condition. The employer could not, however, consistent with the safe harbor, have responsibility for, or make, discretionary determinations in administering the program. Examples of such discretionary determinations are authorizing plan-to-plan transfers, processing distributions, satisfying applicable qualified joint and survivor annuity requirements, and making determinations regarding hardship distributions, qualified domestic relations orders (QDROs), and eligibility for or enforcement of loans.(4)

An important requirement in the Treasury regulations is that a TSA program must be maintained pursuant to a

"written defined contribution plan" that satisfies the Code's regulatory requirements and contains all the material terms and conditions for benefits under the plan. An employer, by adopting such a written plan, does not automatically establish a Title I plan. Compiling the benefit terms of the contracts and the responsibilities of the employer, annuity providers and participants is a function similar to the information collection and compilation activities expressly permitted under the Department's TSA safe harbor. Indeed, the preamble to the final Treasury regulations makes clear that the "plan" required to satisfy the Code does not have to be a single document, but may incorporate by reference other documents, including insurance policies and custodial account agreements and other documents governing the contracts and accounts prepared by the annuity providers. 26 C.F.R. § 1.403(b)-3(b)(3).

The Department of Labor expects that the written plan for a TSA program that complies with the safe harbor would consist largely of the separate contracts and related documents supplied by the annuity providers and account trustees or custodians. An employer's development and adoption of a single document to coordinate administration among different issuers, and to address tax matters that apply, such as the universal availability requirement in Code section 403(b)(12)(A)(ii), without reference to a particular contract or account, would not put the TSA program out of compliance with the safe harbor.

Because the Treasury regulations allow a plan to allocate responsibility for performing administrative functions to persons other than the employer, the relevant documents should identify the parties that are responsible for administrative functions, including those related to tax compliance. The documents should correctly describe the employer's limited role and allocate discretionary determinations to the annuity provider or participant or other third party selected by the provider or participant.

In addition, an employer seeking to take advantage of the safe harbor may periodically review the documents making up the plan for conflicting provisions and for compliance with the Code and the Treasury regulations. Negotiating with annuity providers or account custodians to change the terms of their products for other purposes, such as setting conditions for hardship withdrawals, would be a form of employer involvement outside the safe harbor.

A tax-sheltered annuity program will not, in the Department's view, become covered by Title I of ERISA merely because the written plan conforms to the new § 403(b) regulations by limiting employees to exchanges of contract funds only among providers who have adopted the written plan, or transfers from the program of a former employer to that of the current employer. Under the safe harbor, the employer may limit funding media or products available to employees, or annuity providers who may approach the employee, to a number designed to afford employees a reasonable choice in light of all relevant circumstances. The Code-mandated restrictions on transfers of funds may, however, require the employer to allow providers to offer a wider variety of products in order to afford employees a reasonable choice in light of all relevant circumstances for purposes of the safe harbor. Alternately, an employer may limit the number of providers to which it will forward salary reduction contributions as long as employees may transfer all or a part of their funds to any provider whose annuity contract or custodial account complies with the Code requirements and who agrees to the plan's division of tax compliance responsibilities among the employer, provider and participant.

Finally, in the event an employer decides that it does not want to continue to perform the ministerial and administrative functions required under the § 403(b) regulations, the Department does not believe that the employer's determination to terminate a TSA program in compliance with the Treasury regulations will cause a program not otherwise covered by Title I of ERISA to become covered.

Conclusion

The Department is of the view that tax-exempt employers will be able to comply with the requirements in the new § 403(b) regulations and remain within the Department's safe harbor for TSA programs funded solely by salary deferrals. We note, however, that the new § 403(b) regulations offer employers considerable flexibility in shaping the extent and nature of their involvement under a tax-sheltered annuity program. The question of whether any particular employer, in complying with the § 403(b) regulations, has established or maintained a plan covered under Title I of ERISA must be analyzed on a case-by-case basis applying the criteria set forth in 29 C.F.R. § 2510.3-2(f) and section 3(2) of ERISA.

Questions concerning the information contained in this Bulletin may be directed to the Division of Coverage, Reporting and Disclosure, Office of Regulations and Interpretations, 202.693.8523.

Footnotes

1. Under ERISA § 4(b) (1) and (2), "governmental plans" and "church plans" generally are excluded from coverage under Title I of ERISA. Therefore, § 403(b) contracts and custodial accounts purchased or

provided under a program that is either a “governmental plan” under § 3(32) of ERISA or a non-electing “church plan” under § 3(33) of ERISA are not subject to Title I.

2. The regulation at 29 C.F.R. § 2510.3-2(f) provides a “safe harbor” for TSA programs that conform to its provisions. The safe harbor does not preclude the possibility that programs that do not fully conform with the regulation may nevertheless not be “established or maintained” by an employer for purposes of Title I of ERISA.
3. See DOL Information Letter to Siegel Benefit Consultants (Feb. 27, 1996).
4. See Advisory Opinion Nos. 94-30A, 83-23A, and 80-11A.

Trust Examination Manual

Field Assistance Bulletin No. 2007-03

Date: October 12, 2007

Memorandum For:
Virginia C. Smith, Director of Enforcement
Regional Directors

From:
Robert J. Doyle
Director of Regulations and Interpretations

Subject:
Periodic Pension Benefit Statements for Non-Participant Directed Individual Account Plans

On December 20, 2006, the Department of Labor issued Field Assistance Bulletin (FAB) 2006-03 providing guidance for the Employee Benefits Security Administration's national and regional offices concerning good faith compliance with the pension benefit statement provisions of section 105 of ERISA, as amended by the Pension Protection Act of 2006. In FAB 2006-03, the Department indicated, among other things, that, pending the issuance of further guidance, the furnishing of pension benefit statement information not later than 45 days following the end of the relevant period (calendar quarter or calendar year) will constitute good faith compliance with the requirement to automatically furnish pension benefit statements by individual account plans.

Since the issuance of FAB 2006-03, it has come to the attention of the Department that many individual account plans that do not permit participants and beneficiaries to direct the investment of assets in their individual accounts may not be able to comply within the 45-day period set forth in the FAB. It is represented that many of these plans are profit sharing plans and the sponsors of those plans do not determine or contribute profit sharing contributions until after the sponsor's business tax return is completed. Similarly, non-participant directed individual account plans sponsored by partnerships cannot make contribution determinations until completion of the partnership tax return. It also is represented that many such plans are dependent on securing third-party valuations for those assets that do not have a readily ascertainable value. Compliance with the 45-day good faith period, therefore, would appear to be impossible or very expensive for many of these plans unless the benefit statements were based on data from the end of the prior plan year. It is further represented that much of the required information is compiled in connection with the preparation of the plan's Form 5500 Annual Return/Report and, accordingly, the time frame for furnishing benefit statements should correspond to the required filing of the plan's Form 5500.

In view of the foregoing, and pending the issuance of further guidance, the Department is providing the following additional guidance. Plan administrators of individual account plans that do not provide for participant direction of investments will be treated as acting in good faith compliance with a reasonable interpretation of section 105(a)(1)(A)(ii) of ERISA when statements are furnished to participants and beneficiaries on or before the date on which the Form 5500 Annual Return/Report is filed by the plan (but in no event later than the date, including extensions, on which the Annual Return/Report is required to be filed by the plan) for the plan year to which the statement relates.

This guidance supersedes the guidance provided in FAB 2006-03 as it relates to the dates for furnishing pension benefit statements to participants and beneficiaries of individual account plans that do not permit participants and beneficiaries to direct the investment of assets in their individual accounts.

Questions concerning this matter may be directed to Jeff Turner or Suzanne Adelman, at 202.693.8523.

Last Updated 04/02/2008 supervision@fdic.gov

Trust Examination Manual

[Field Assistance Bulletin No. 2007-04]

December 7, 2007

Memorandum For:
Virginia C. Smith, Director of Enforcement
Regional Directors

From:
Daniel J. Maguire
Director of Health Plan Standards and Compliance Assistance

Subject:
Supplemental health insurance coverage as excepted benefits under HIPAA and related legislation

Issue

What are the circumstances under which supplemental health insurance coverage satisfies the requirements for excepted benefits under sections 732(c)(3) and 733(c)(4) of ERISA?

Background

HIPAA Health Reform and Related Legislation

Titles I and IV of the Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, 110 Stat. 1936 (HIPAA) amended the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code (Code), and the Public Health Service Act (PHS Act) to improve portability, access, and continuity with respect to group health plan coverage provided in connection with employment. These laws include limitations on preexisting condition exclusions, require issuance of certificates of creditable coverage, provide special enrollment rights, and prohibit discrimination on the basis of any health factor. Later amendments to these laws provide protections relating to mental health parity, hospital lengths of stay following childbirth, and post-mastectomy coverage. Regulations issued by the Departments of Labor, the Treasury, and Health and Human Services (the Departments) on these group market provisions are contained in 29 CFR Part 2590, 26 CFR Part 54, and 45 CFR Parts 144 and 146. Additional reforms were provided in the PHS Act for health coverage in the individual market and are contained in 45 CFR Parts 144 and 148.

In general, these health reform provisions apply to group health plans (generally plans established or maintained by employers or employee organizations, or both) and health insurance issuers in the group or individual market. However, these provisions do not apply to certain excepted benefits. In general, if all benefits under a plan or coverage are excepted benefits, then the plan and any health insurance coverage under the plan does not have to comply with the health reform requirements, and the coverage may not qualify as creditable coverage.

Supplemental Health Insurance Coverage

One category of excepted benefits is supplemental excepted benefits. Benefits are supplemental excepted benefits only if they are provided under a separate policy, certificate, or contract of insurance and are either Medicare supplemental health insurance, TRICARE supplemental programs, or similar supplemental coverage provided to coverage under a group health plan. The phrase “similar supplemental coverage provided to coverage under a group health plan” is not defined in the statute or regulations. However, the regulations clarify that one requirement to be similar supplemental coverage is that the coverage must be specifically designed to fill gaps in primary coverage, such as coinsurance or deductibles (but similar supplemental coverage does not include coverage that becomes secondary or supplemental only under a coordination-of-

benefits provision). 29 CFR 2590.732 (c)(5)(i)(C), 26 CFR 54.9831-1(c)(5)(i)(C), and 45 CFR 146.145(c)(5)(i)(C).

Coordination of Administration

Various situations have come to the attention of the Departments that raise concerns about whether all of the coverage that is being marketed as similar supplemental coverage actually qualifies as such.

Section 104 of HIPAA requires the Secretaries of Labor, the Treasury, and Health and Human Services to ensure that guidance under HIPAA issued by the Departments that relates to the same matter be administered so as to have the same effect at all times. In accordance with section 104 of HIPAA, each of the Departments is issuing guidance concerning the requirements for “similar supplemental coverage” that qualifies as benefits excepted from the requirements of HIPAA. The guidance being issued has been developed on a coordinated basis by the Departments. HHS is also issuing guidance on similar supplemental coverage for the individual market.

Discussion

In order to prevent issuers from avoiding compliance with ERISA’s health reform provisions by issuing multiple insurance contracts in connection with a plan, this bulletin establishes an enforcement safe harbor under which supplemental health insurance will be considered excepted benefits for purposes of Part 7 of ERISA. Similar supplemental coverage that does not meet the standards for this safe harbor may be subject to enforcement actions by the Department.

To fall within the safe harbor, a policy, certificate, or contract of insurance must be issued by an entity that does not provide the primary coverage under the plan and must be specifically designed to fill gaps in primary coverage.

In addition, the Department believes that the value of the supplemental coverage must be significantly less than the value of the primary coverage that it supplements. To fall within the enforcement safe harbor, the cost of supplemental coverage may not exceed 15 percent of the cost of the plan’s primary coverage. The Department will determine cost in the same manner as the “applicable premium” is calculated under a COBRA continuation provision.(1) Some plans subject to HIPAA titles I or IV are not subject to the COBRA continuation coverage requirements, such as plans maintained by an employer with 20 or fewer employees. For these plans, the Department will compute cost as if they were subject to COBRA. (For insured coverage – all supplemental coverage and primary coverage to the extent insured – the COBRA cost is, for purposes of this bulletin, the cost of the insurance coverage.)

Issuers of Medicare supplemental health insurance (commonly referred to as “Medigap”) generally are subject to prohibitions against discrimination based on enrollees’ or potential enrollees’ health status. Accordingly, to fall within the enforcement safe harbor, the coverage may not differentiate among individuals in eligibility, benefits, or premiums based upon any health factor of the individual.

Conclusion

For purposes of enforcing ERISA’s health reform provisions, the Department will treat coverage as “similar supplemental coverage provided to coverage under a group health plan” under 29 CFR 2590.732(c)(5)(i)(C), within the enforcement safe harbor, if it is a separate policy, certificate, or contract of insurance and if it satisfies all of the following requirements:

Independent of Primary Coverage. The supplemental policy, certificate, or contract of insurance must be issued by an entity that does not provide the primary coverage under the plan. For this purpose, entities that are part of the same controlled group of corporations or part of the same group of trades or businesses under common control, within the meaning of section 52(a) or (b) of the Code, are considered a single entity.

Supplemental for Gaps in Primary Coverage. The supplemental policy, certificate, or contract of insurance must be specifically designed to fill gaps in primary coverage, such as coinsurance or deductibles, but does not include a policy, certificate, or contract of insurance that becomes secondary or supplemental only under a coordination-of-benefits provision.

Supplemental in Value of Coverage. The cost of coverage under the supplemental policy, certificate, or contract of insurance must not exceed 15 percent of the cost of primary coverage. Cost is determined in the same manner as the applicable premium is calculated under a COBRA continuation provision.

Similar to Medicare Supplemental Coverage. The supplemental policy, certificate, or contract of insurance that is group health insurance coverage must not differentiate among individuals in eligibility, benefits, or premiums based on any health factor of an individual (or any dependent of the individual).

Questions concerning the information contained in this Bulletin may be directed to the Office of Health Plan Standards and Compliance Assistance at 202.693.8335.

Footnotes

Under the COBRA rules, plans are generally permitted to charge up to 102 percent of the applicable premium. Thus, COBRA cost for purposes of this bulletin is 100 percent of the applicable premium, not 102 percent of the applicable premium that the plan is generally permitted to charge under the COBRA rules.

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

Trust Examination Manual

Field Assistance Bulletin No. 2008-01

February 1, 2008

Memorandum For:
Virginia C. Smith, Director of Enforcement
Regional Directors

From:
Robert J. Doyle
Director of Regulations and Interpretations

Subject:
Fiduciary Responsibility for Collection of Delinquent Contributions

Issue

What are the responsibilities of named fiduciaries and trustees of ERISA-covered plans for the collection of delinquent employer and employee contributions?

Background

A number of pension plan investigations have revealed agreements that purport to relieve the financial institutions serving as plan trustees of any responsibility to monitor and collect delinquent contributions. The investigations have revealed circumstances where no other trust agreement or plan document assigns those obligations to another trustee or imposes the obligations on a named fiduciary with the authority to direct a trustee. In other cases, the plan documents and trust agreements are silent or ambiguous on the matter. Questions have been raised as to whether, and if so, to what extent, trust agreements and other instruments may define the scope of trustee undertakings and exclude responsibilities for monitoring the plan's receipt of contributions, determining when they are delinquent and taking appropriate steps for collection.

Employer contributions are delinquent when they are due and owing to the plan under the documents and instruments governing the plan but have not been transmitted to the plan in a timely manner.(1) The Department has taken the position that employer contributions become an asset of the plan only when the contribution has been made.(2) However, when an employer fails to make a required contribution to a plan in accordance with the plan documents, the plan has a claim against the employer for the contribution, and that claim is an asset of the plan. Participant contributions that are withheld from wages or paid to the employer are delinquent if they become plan assets while still in the hands of the employer. Under the Department's regulations, participant contributions become plan assets in the hands of the employer on the earliest date that the amount withheld from the participant's pay or paid to the employer reasonably can be segregated from the employer's general assets. With respect to an employee pension benefit plan, this date can be no later than the 15th business day of the month following the month in which participant contribution amounts were withheld from the employee's paychecks or paid to the employer.(3)

Analysis

The duty to enforce valid claims held by a trust has long been considered a trustee responsibility under common law. IIA Austin W. Scott & William E. Fratcher, The Law of Trusts § 177 (4th ed. 1989); Restatement (Third) of Trusts, § 76 (2007). See also George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 583 at p.355 (2d rev. ed. 1980) (where the settlor retains possession of trust assets, "the trustee must hold the settlor to [his] obligation"); Scott 175, at 1415 ("trustee is under a duty to take such steps as are reasonable to secure control of the trust property and to keep control of it"). The Supreme Court affirmed that the collection of contributions is a trustee responsibility under ERISA in Central States, Southeast and

Southwest Areas Pension Fund v. Central Transport, 472 U.S. 559, 571 (1985). The Court noted that:

One of the fundamental common-law duties of a trustee is to preserve and maintain trust assets, and this encompasses "determin[ing] exactly what property forms the subject-matter of the trust [and] who are the beneficiaries." The trustee is thus expected to "use reasonable diligence to discover the location of the trust property and to take control of it without unnecessary delay." A trustee is similarly expected to "investigate the identity of the beneficiary when the trust documents do not clearly fix such party" and to "notify the beneficiaries under the trust of the gifts made to them" (citations omitted).

Section 404(a) of ERISA requires that a fiduciary discharge his duties prudently and solely in the interests of the participants and beneficiaries of the plan. The steps necessary to discharge a duty to collect contributions will depend on the facts of each case. In determining what collection actions to take, a fiduciary should weigh the value of the plan assets involved, the likelihood of a successful recovery, and the expenses expected to be incurred. Among other factors, the fiduciary may take into account the employer's solvency in deciding whether to expend plan assets to pursue a claim. Diduck v. Kaszycki & Sons Contractors, 874 F. 2d 912 (2nd Cir. 1989). The Department of Labor has also long held the view that if the plan is not making systematic, reasonable and diligent efforts to collect delinquent employer contributions, or the failure to collect delinquent contributions is the result of an arrangement, agreement or understanding, express or implied, between the plan and a delinquent employer, such failure to collect delinquent contributions may be deemed to be a prohibited transactions under section 406 of ERISA.(4)

Section 402(a)(1) provides that every employee benefit plan shall be established and maintained pursuant to a written instrument, and that the instrument "shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan."(5) Section 403(a) of ERISA provides, with certain exceptions, that all assets of an employee benefit plan must be held in trust by one or more trustees, who are to be named in the plan or trust instrument or appointed by a person who is a named fiduciary. Section 403(a) further provides that "upon acceptance of being named or appointed, the trustee or trustees shall have exclusive authority and discretion to manage and control the assets of the plan . . . ." A plan trustee, therefore, will, by definition, always be a "fiduciary" under ERISA as a result of its authority or control over plan assets and, accordingly, is required to discharge its trustee responsibilities prudently and solely in the interest of the plan's participants and beneficiaries. Although trust documents cannot excuse trustees from their duties under ERISA, ERISA clearly gives named fiduciaries the authority to appoint multiple trustees and to allocate trustee responsibilities among those trustees (including directed trustees).

Section 403(a) recognizes two exceptions to the general rule that exclusive authority and discretion to manage and control the assets of a plan must be vested in one or more plan trustees. The first exception, at section 403(a)(1), applies when "the plan expressly provides that the trustee or trustees are subject to the direction of a named fiduciary who is not a trustee." In such instances, the trustee, commonly referred to as a "directed trustee," is subject to the proper directions of the named fiduciary. As the Department noted in Field Assistance Bulletin No. 2004-03 (Dec. 17, 2004), directed trustees are fiduciaries, and as such, are subject to ERISA's fiduciary rules, but the scope of their duties is "significantly narrower than the duties generally ascribed to a discretionary trustee under common law trust principles." The second exception to the "exclusive authority" provision in section 403(a)(1) applies when the authority to manage, acquire or dispose of plan assets is delegated to one or more investment managers pursuant to section 402(c)(3).

Additionally, section 405(b)(1)(B) provides, in relevant part, that, except as set forth in section 403(a)(1), if the assets of a plan are held by two or more trustees they shall jointly manage and control the assets of a plan except that nothing shall preclude any agreement, authorized by the trust instrument, allocating specific responsibilities, obligations, or duties among trustees, in which event a trustee to whom certain responsibilities, obligations, or duties have not been allocated shall not be liable either individually or as a trustee for any loss resulting to the plan arising from the acts or omissions on the part of another trustee to whom such responsibilities, obligations or duties have been assigned. Similarly, in those cases where the assets of a plan are held in more than one trust, a trustee is responsible only for those acts or omissions of the trustees of the trust for which it is trustee.(6)

Thus, in accordance with the statutory framework described above, authority over a plan's assets subject to the trust requirement of section 403(a) of ERISA, including a plan's legal claim for delinquent contributions, must be assigned to i) a plan trustee with discretionary authority over the assets, ii) a directed trustee subject to the proper and lawful directions of a named fiduciary, or iii) an investment manager.

Accordingly, it is the view of the Department that a named or functional fiduciary who has authority to appoint the plan's trustee(s) must ensure that the obligation to collect contributions is appropriately assigned to a

trustee, unless the plan expressly provides that the trustee will be a directed trustee with respect to contributions pursuant to section 403(a)(1) or the authority to collect contributions is delegated to an investment manager pursuant to section 403(a)(2).

Thus, although a fiduciary may enter into a trust agreement under which a particular trustee is not responsible for monitoring and collecting contributions, if no trustee or investment manager has this responsibility, the fiduciary with authority to hire the trustees may be liable for plan losses due to a failure to collect contributions because the fiduciary failed to specifically allocate this responsibility.(7)

These situations should be evaluated on the basis of all the facts and circumstances. Where the provisions in trust instruments and plan documents are ambiguous, they should generally be interpreted in a manner that corresponds to the statutory scheme, rather than in a manner that relieves all of the trustees and investment managers from responsibility.(8) Reliance on plan, trust and other governing documents to define the responsibilities of plan fiduciaries, however, may not be completely determinative if the provisions in the documents are inconsistent with the actions of the parties. For example, if a nominally directed trustee routinely assumes discretionary responsibility, the trustee cannot seek to limit its liability with respect to the exercise of that discretion on the basis that it is a directed trustee. Similarly, a trustee cannot alter its status as fiduciary through a contractual provision that defines its trustee duties as non-fiduciary in nature.

If a particular trustee is not responsible for monitoring and collecting contributions under the terms of the trust instrument, that trustee (including a directed trustee) nonetheless would have an obligation under sections 404 and 405(a) to take appropriate steps to remedy a situation where the trustee knows that no party has assumed responsibility for the collection and monitoring of contributions and that delinquent contributions are going uncollected. As explained in Field Assistance Bulletin No. 2004-03, a fiduciary, pursuant to section 405(a)(1), is liable for the breach of another fiduciary if the fiduciary "participates knowingly" in the breach of the other fiduciary. In addition, under section 405(a)(2), a fiduciary is liable for a breach of another fiduciary if the fiduciary's failure to comply with section 404(a)(1) in the administration of his specific fiduciary responsibilities enables the other fiduciary to commit a breach. Under section 405(a)(3), a fiduciary is liable for a breach of another fiduciary if the fiduciary has knowledge of the breach of the other fiduciary, unless the fiduciary takes reasonable efforts under the circumstances to remedy the breach. Efforts to remedy may, depending on the circumstances, include advising the named fiduciary or the Department of Labor of the breach, reporting the breach to other fiduciaries of the plan, directly taking actions to enforce the contribution obligation on behalf of the plan, seeking an amendment of the relevant plan and trust documents, or seeking a court order mandating a proper allocation of fiduciary responsibility over contributions. The documents and instruments governing a plan cannot serve to absolve a co-fiduciary from liability for failing to take steps to remedy a known breach of another fiduciary.(9) Whether and to what extent information concerning the failure of an employer to forward contributions to a plan constitutes knowledge of a breach that would give rise to co-fiduciary liability will depend upon the facts and circumstances of each case.

Conclusion

The responsibility for collecting contributions is a trustee responsibility. If a plan has two or more trustees, the duty may be allocated to a single trustee. A plan may also provide that a named fiduciary may direct a trustee as to this responsibility or may appoint an investment manager to take on this duty. To the extent the nature and scope of the trustee's responsibilities are specifically limited in the plan documents or trust agreement, it is generally the responsibility of the named fiduciary with the authority to hire and monitor trustees to assure that all trustee responsibilities with respect to the management and control of the plan's assets (including collecting delinquent contributions) have been properly assigned to a trustee or investment manager.

Footnotes

1. In the event that those instruments are ambiguous, promised employer contributions are delinquent if not transmitted to the plan within a reasonable time after the legally enforceable obligation to make the contribution arises.
2. See Advisory Opinion 93-14; Preamble to Prohibited Transaction Exemption 76-1, 41 FR 12740 at 12741 (Mar. 26, 1976).
3. See 29 CFR 2510.3-102. An employer continuing to hold participant contribution commingled with its general assets after the participant contributions reasonably could have been segregated will have engaged in a prohibited transaction in violation of ERISA section 406. This memorandum is not intended to address any civil or criminal liability that may attach to an employer as a result of such a prohibited transaction.
4. See the preamble to Prohibited Transaction Exemption 76-1, 41 FR 12740, 12741 (Mar. 26, 1976).
5. Section 402(a)(2) of ERISA defines the term "named fiduciary" to mean "a fiduciary who is named in the

plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly."

6. See discussion below on co-fiduciary liability under section 405(a).
7. Under ERISA section 403(b), employee benefit plans are not subject to section 403(a)'s trust requirement if the plan's assets consist entirely of insurance contracts or policies issued by an insurance company qualified to do business in a State, or individual retirement accounts, such as SIMPLE-IRA plans and SEPS, with assets held in custodial accounts under Code section 408(h), or contracts established and maintained under Code section 403(b) with assets held in custodial accounts under Code section 403(b)(7). In such cases, the duty to use reasonable diligence to discover the location of the plan's property (such as delinquent contributions) and to take control of it without unnecessary delay is, in the view of the Department, part of the named fiduciary's duties under ERISA section 402(a)(1) to control and manage the operation and administration of the plan. In the case of SIMPLE-IRAs and SEPS, the plan sponsor generally will be a named fiduciary because the documents establishing the plan typically provide the employer with authority with respect to management and administration of the plan notwithstanding that the plan documents may fail to state expressly that the plan sponsor is a "named fiduciary."
8. See Best v. Cyrus, 310 F.3d 932, 935 (6th Cir. 2002)
9. See ERISA section 410 (which provides, subject to certain exceptions, that "any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy."). See also 29 CFR § 2509.75-4.

Trust Examination Manual

Appendix E — Employee Benefit Law

U.S. Department of Labor

Pension and Welfare Benefits Administration

Washington, D.C. 20210

August 20, 1997

Judith A. McCormick

Senior Trust Counsel

American Bankers Association

1120 Connecticut Avenue, N.W.

Washington, D.C. 20036

Dear Ms. McCormick:

This is in response to your request for an information letter on behalf of the American Bankers Association (ABA), confirming that the principles enunciated in Advisory Opinions 97-15A and 97-16A (May 22, 1997) would apply in the case of a bank that acts as a directed trustee of an employee benefit plan. A.O. 97-15A concerned a bank that served both as a directed trustee and as a trustee with investment discretion. A.O. 97-16A involved a plan recordkeeper. Both opinions addressed the receipt of fees by the trustee or recordkeeper from mutual funds (or their distributors or investment advisors) in connection with the investment of plan assets in the mutual funds as part of a combined program of investment options and services offered to plans, commonly referred to as a "bundled services" product.

In general, you have described a typical "bundled services" product as a comprehensive program of administrative, custodial, and investment services offered by affiliated and non-affiliated entities to pension plans, most typically participant-directed defined contribution plans. Such a program may be offered by a single financial institution or through an arrangement in which multiple vendors contract with each other to offer a bundle of plan services. The plan services typically include, but are not limited to, custodial trustee services, participant level record-keeping, participant communications and educational materials and programs, voice response system access to accounts for participants, plan documentation, including prototype plans, summary plan descriptions and annual reports, tax compliance assistance, administrative assistance in processing plan distributions and loans, and a menu of investment options, typically consisting of mutual funds from one or more mutual fund families.

You described typical situations in which a financial institution (the bank) may offer to plans a bundled services product in which it acts as a directed trustee and which includes as investment options mutual funds from one or more mutual fund families. Pursuant to the bank’s contracts with the mutual funds (or their distributors or investment advisors), the bank may provide subtransfer agent, administrative and/or shareholder services to or on behalf of the mutual funds in connection with the purchase of mutual fund shares by the plans. In return for these services, the mutual fund (or its distributor or investment advisor) pays a fee to the bank (frequently pursuant to a plan adopted under Securities and Exchange Commission Rule 12b-1) based on percentage of the mutual fund’s assets attributable to plan investments in the fund. Generally, the bank reserves the right to add, delete, or substitute individual mutual funds or mutual fund families to or from the investment menu, but otherwise has and exercises no investment discretion.

In A.O. 97-15A, the Department explained that, although a directed trustee is necessarily a fiduciary, if the

trustee acts pursuant to a direction in accordance with section 403(a)(1) or 404(c) of ERISA, and does not exercise any authority or control to cause a plan to invest in a mutual fund, the mere receipt by the trustee of a fee or other compensation from the mutual fund in connection with such investment would not in and of itself violate sections 406(b)(1) or (b)(3). The Department indicated, however, that because the trustee in that case had reserved the right to add or remove mutual fund families that it made available to the plans, the Department could not conclude that the trustee would not exercise any discretionary authority or control to cause the plans to invest in mutual funds that pay a fee or other compensation to the trustee. The Department further noted that the trustee in that case fully disclosed to the plans its fee arrangements with the mutual fund families, and agreed to apply any fees it received from the mutual funds to the benefit of the plans, either as a dollar-for-dollar offset against the fees the plans were obligated to pay for trustee or recordkeeping services, or as amounts credited directly to the plans. Under these circumstances, the Department concluded that the trustee would not violate sections 406(b)(1) or (b)(3) because it would not be dealing with plan assets in its own interest or for its own account, or receiving the payments from the mutual funds for it s own personal account.

In A.O. 97-16A, the Department opined that a recordkeeper that offered plans a bundled services product would not exercise discretionary authority or control over the management of a plan or its assets solely as a result of deleting or substituting a mutual fund from its program of investment options and services it offered to the plans, provided that the appropriate plan fiduciary in fact makes the decision to accept or reject the change. The Department emphasized that, in order to be able to make that decision, the plan fiduciary must be provided advance notice of the change, including any changes in the fees received by the recordkeeper, and afforded a reasonable period of time within which to decide whether to accept or reject the change and, in the event of a rejection, secure a new service provider. In that case, the recordkeeper provided at least 120 days following notice of a proposed change in funds within which to reject the change and secure a new service provider. The Department noted, however, that what constitutes a reasonable period of time within which to terminate a bundled services arrangement and change service providers is inherently a factual question which must be determined by the appropriate plan fiduciary in light of the particular facts and circumstances in each case.

The opinions expressed in A.O. 97-15A and A.O. 97-16A are limited to the facts presented and may be relied upon only by the parties to whom they were issued. See Advisory Opinion Procedure 76-1, Section 10, 41 Fed. Reg. 36281 (Aug. 27, 1976). Nevertheless, it is the view of the Department that the foregoing legal principles, as expressed in A.O. 97-15A and A.O. 97-16A, would apply in the case of a bank that serves as a directed trustee for employee benefit plans in the context of a bundled services product as described above.

We hope that this information is helpful to you.

Sincerely,

Bette J. Briggs

Chief, Division of Fiduciary Interpretations

Office of Regulations and Interpretations

Appendix E — Employee Benefit Law

Department of Labor

Advisory Opinion Procedure

ERISA Procedure 76-1

August 27, 1976

41 FR 36281

It is the practice of the Department of Labor (the Department) to answer inquiries of individuals or organizations affected, directly or indirectly, by the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406, hereinafter "the Act") as to their status under the Act and as to the effect of certain acts and transactions. The answers to such inquiries are categorized as "information letters" and "advisory opinions." This "ERISA Procedure" (ERISA Proc. 76-1) describes the general procedures of the Department in issuing Information letters and advisory opinions under the Act, and is designed to promote efficient handling of inquiries and to facilitate prompt responses.

Section 7 of this Procedure (instructions to individuals and organizations requesting advisory opinions relating to prohibited transactions and common definitions) is reserved. This section will set forth the procedures to be followed to obtain an advisory opinion relating to prohibited transactions and common definitions, such as whether a person is a party in interest and a disqualified person. In general, this section will incorporate a revenue Procedure to be published by the Internal Revenue Service.

This advisory opinion procedure consists of rules of agency procedure and practice, and is therefore excepted under 5 USC 552(b)(3)(A) of the Administrative Procedure Act from the ordinary notice and comment provisions for agency rulemaking. Accordingly, the Procedure is effective August 27, 1976.

Sec. 1. *Purpose*. The purpose of this ERISA Procedure is to describe the general Procedures of the Department of Labor (the Department) in issuing information letters and advisory opinions to individuals and organizations under the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406), hereinafter referred to as "the Act." This ERISA Procedure also informs individuals and organizations, and their authorized representatives, where they may direct requests for information letters and advisory opinions, and outline procedures to be followed in order to promote efficient handling of their inquiries.

Sec. 2. *General practice*. It is the practice of the Department to answer inquiries of individuals and organizations, whenever appropriate, and in the interest of sound administration of the Act, as to their status under the Act and as to the effects of their acts or transactions. One of the functions of the Department is to issue information letters and advisory opinions in such matters.

Sec. 3. *Definitions*.

.01 An "information letter" is a written statement issued either by the Pension and Welfare Benefit Programs (Office of Employee Benefits Security), U.S. Department of Labor, Washington, D.C. or a Regional Office or an Area Office of the Labor-Management Services Administration, U.S. Department of Labor, that does no more than call attention to a well established interpretation or principle of the Act without applying it to a specific factual situation. An information letter may be issued to any individual or organization when the nature of the request from the individual or the organization suggests that it is seeking general information or where the request does not meet all the requirements of section 6 or 7 of this procedure, and it is believed that such general information will aid the individual or organization.

.02 An "advisory opinion" is a written statement issued to an individual or organization, or to the authorized representative of such individual or organization, by the Administrator of Pension and Welfare Benefit Programs or his delegate, that interprets and applies the Act to a specific factual situation. Advisory opinions are issued only by the Administrator of Pension and Welfare Benefit programs or his delegate.

.03 Individuals and organizations are those persons described in section 4 of this procedure.

Sec. 4. *Individuals and organizations who may request advisory opinions or information letters*.

.01 Any individual or organization affected directly or indirectly by the Act may request an information or an advisory opinion from the Department.

.02 A request by or for an individual or organization must be signed by the individual or organization, or by the authorized representative of such individual or organization. See section 7.03 of this procedure.

Sec. 5. *Discretionary Authority to Render Advisory Opinions*.

.01 The Department will issue advisory opinions involving the interpretation of the application of one or more sections of the Act, regulations promulgated under the Act, interpretive bulletins or exemptions issued by the Department to a specific factual situation. Generally, advisory opinions will be issued by the Department only with respect to prospective transactions (i.e., a transaction which will be entered into). Moreover, there are certain areas where, because of the inherently factual nature of the problem involved, or because the subject of the request for opinion is under investigation for a violation of the Act, the Department will ordinarily not issue advisory opinions. Generally, an advisory opinion will not be issued on alternative courses of proposed transactions, or on hypothetical situations or where all parties involved are not sufficiently identified and described, or where material facts or details of the transaction are omitted.

.02 The Department ordinarily will not issue advisory opinions relating to the following sections of the Act:

.02(a) Section 3(18), relating to whether certain consideration constitutes adequate consideration;

.02(b) Section 3(26), relating to whether the valuation of any asset is at current value;

.02(c) Section 3(27), relating to whether the valuation of any asset is at present value;

.02(d) Section 102(a)(1), relating to whether a summary plan description is written in a manner calculated to be understood by the average participant;

.02(e) Section 103(a)(3)(A), relating to whether the financial statements and schedules required to be included in the Annual Report are presented fairly in conformity with generally accepted accounting principles applied on a consistent basis;

.02(f) Section 103(b)(1), relating to whether a matter must be included in a financial statement in order to fully and fairly present the financial statement of the plan;

.02(g) Section 202 (other than section 202(a)(3) and (b)(1)), relating to minimum participation standards;

.02(h) Section 203 (other than sections 202(a)(3)(B), (b)(1) (flush language), (b)(2), (b)(3)(A);

.02(i) Section 204 of the Act (other than sections 204(b)(1)(B), (b)(1)(A), (C), (D), (E)), relating to benefit accrual requirements;

.02(j) Section 205(e), relating to the period during which a participant may elect in writing not to receive a joint and survivor annuity;

.02(k) Section 208, relating to mergers and consolidation of plans or transfer of plan assets;

.02(l) Section 209(a)(1), relating to whether the report required by section 209(a)(1) is sufficient to inform the employee of his accrued benefits under the plan, etc.;

.02(m) Sections 302 through 305, relating to minimum funding standards;

.02(n) Section 403(c)(1), relating to the purposes for which plan assets must be held;

.02(o) Section 404(a), relating to fiduciary duties as applied to particular conduct; and

.02(p) Section 407(a)(2) and (3) and (c)(1), relating to fair market value, as applied to whether the value of any particular security or real property constitutes fair market value.

This list is not all inclusive and the department may decline to issue advisory opinions relating to other sections of the Act whenever warranted by the facts and circumstances of a particular case. The Department may, when it is deemed appropriate and in the best interest of sound administration of the Act, issue information letters calling attention to established principles under the Act, even though the request that was submitted was for an advisory opinion.

.03 Pending the adoption of regulations (either temporary or final) involving the interpretation of the application of a provision of the Act, consideration will be given to the issuance of advisory opinions relating to such provisions of the Act only under the following conditions:

.03(a) If an inquiry presents an issue on which the answer seems to be clear from the application of the provisions of the Act to the facts described, the advisory opinion will be issued in accordance with the procedures contained herein.

.03(b) If an inquiry presents an issue on which the answer seems reasonably certain but not entirely free from doubt, an advisory opinion will be issued only it is established to the satisfaction of the Department that a business emergency requires an advisory opinion or that unusual hardship to the plan or its participants and beneficiaries will result from failure to obtain an advisory opinion. In any case in which the individual or organization believes that a business emergency exists or that an unusual hardship to the plan or its participants and beneficiaries will result from the failure to obtain an advisory opinion, the individual or organization should submit with the request a separate letter setting forth the facts necessary for the Department to make a determination in this regard. In this connection, the Department will not deem a "business emergency" to result from circumstances within the control of the individual or organization such as, for example, scheduling within an inordinately short time the closing date of a transaction or a meeting of the Board of Directors or the shareholders of a corporation.

.03(c) If an inquiry presents an issue that cannot be reasonably resolved prior to the issuance of a regulation, an advisory opinion will not be issued.

.04 The Department ordinarily will not issue advisory opinions on the form or effect in operation of a Plan, fund, or program (or a particular provision or provisions thereof) subject to Title I of the Act. For example, the Department will not issue an advisory opinion on whether a plan satisfies the requirements of Parts 2 and 3 of Title I of the Act.

Sec. 6. *Instructions to individuals and organizations requesting advisory opinions from the Department.*

.01 If an advisory opinion is desired, a request should be submitted to: Advisory Opinion, Office of Regulatory Standards and Exceptions, Pension and Welfare Benefit Programs, U.S. Department of Labor, Washington, D.C. 20216.

.02 A request for an advisory opinion must contain the following information:

.02(a) The name and type of plan or plans (e.g., pension, profit-sharing, or welfare plan); the Employer Identification Number (EIN); the Plan Number (PN) used by the plan in reporting to the Department of Labor on Form EBS-1; or a copy of the first two pages of the most recent Form EBS-1 filed with the Department.

.02(b) A detailed description of the act or acts or transaction or transactions with respect to which an advisory opinion is requested. Where the request pertains to only one step of a larger integrated act or transaction, the facts, circumstances, etc. must be submitted with respect to the entire transaction. In addition, a copy of all documents submitted must be included in the individual's or organization's statement and not merely incorporated by reference, and must be accompanied by an analysis of their bearing on the issue or issues, specifying the pertinent Provisions.

.02(c) A discussion of the issue or issues presented by the act or acts or transaction or

transactions which should be addressed in the advisory opinion.

.02(d) If the individual or organization is requesting a particular advisory opinion, the requesting party must furnish an explanation of the grounds for the request, together with a statement of relevant supporting authority. Even though the individual or organization is urging no particular determination with regard to a proposed or prospective act or acts or transaction or transactions, the party requesting the ruling must state such party's views as to the results of the proposed act or acts or transaction or transactions and furnish a statement of relevant authority to support such views.

.03 A request for an advisory opinion by or for an individual or organization must be signed by the individual or organization or by the individual's or organization's authorized representative. If the request is signed by a representative of an individual or organization, or the representative may appear before the Department in connection with the request, the request must include a statement that the representative is authorized to represent the individual or organization.

.04 A request for an advisory opinion that does not comply with all the provisions of this procedure will be acknowledged, and the requirements that have not been met will be noted. Alternatively, at the discretion of the Department, the Department will issue an information letter to the individual or organization.

.05 If the individual or organization, or the authorized representative, desires a conference in the event the Department contemplates issuing an adverse advisory opinion, such desire should be stated in writing when filing the request or soon thereafter in order that the Department may evaluate whether in the sole discretion of the Department, a conference should be arranged and at what stage of the consideration a conference would be most helpful.

.06 It is the practice of the Department to process requests for information letters and advisory opinions in regular order and as expeditiously as possible. Compliance with a request for consideration of a matter ahead of its regular order, or by a specified time, tends to delay the disposition of other matters. Requests for processing ahead of the regular order, made in writing (submitted with the request or subsequent thereto) and showing clear need for such treatment will be given consideration as the particular circumstances warrant. However, no assurance can be that any letter will be processed by the time requested. The Department will not consider a need for expedited handling to arise if the request shows such need has resulted from circumstances within the control of the person making the request.

.07 An individual or organization, or the authorized representative desiring to obtain information relating to the status of his or her request for an advisory opinion may do so by contacting the Office of Regulatory Standards and Exemptions, Pension and Welfare Benefit Programs, U.S. Department of Labor, Washington, D.C.

Sec. 7. *Instructions to individuals and organizations requesting advisory opinions relating to prohibited transactions and common definitions.* .01 [Reserved] .02 [Reserved] .03 [Reserved]

Sec. 8. *Conferences at the Department of Labor*. If a conference has been requested, and the Department determines that a conference is necessary or appropriate, the individual or organization or the authorized representative will be notified of the time and place of the conference. A conference will normally be scheduled only when the Department in its sole discretion deems it will be necessary or appropriate in deciding the case. If conferences are being arranged with respect to more than one request for an opinion letter involving the same individual or organization, they will be so scheduled as to cause the least inconvenience to the individual or organization.

Sec. 9. *Withdrawal of requests*. The individual or organization's request for an advisory opinion may be withdrawn at any time prior to receipt of notice that the Department intends to issue an adverse opinion. Even though a request is withdrawn, all correspondence and exhibits will be retained by the Department and will not be returned to the individual or organization.

Sec. 10. *Effect of Advisory Opinion*. An advisory opinion is an opinion of the Department as to the application of one or more sections of the Act, regulations promulgated under the Act, interpretive bulletins, or exemptions. The opinion assumes that all material facts and representations set forth in the request are accurate, and applies only to the situation described therein. Only the parties described in the request for opinion may rely on the opinion, and they may rely on the opinion only to the extent that the request fully and accurately contains all the material facts and representations necessary to issuance of the opinion and the

situation conforms to the situation described in the request for opinion.

Sec. 11. *Effect of Information Letters*. An information letter issued by the Department is informational only and is not binding on the Department with respect to any particular factual situation.

Sec. 12. *Public inspection*.

.01 Advisory opinions shall be open to public inspection at the Public Disclosure Room, U.S. Department of labor, 200 Constitution Avenue, N.W., Washington, D.C. 20216.

.02 Background files (including the request for an advisory opinion, correspondence between the Department and the individual or organization requesting the advisory opinion) shall be available upon written request. Background files may be destroyed after three years from the date of issuance.

.03 Advisory opinions will be modified to delete references to proprietary information prior to disclosure. Any information considered to be proprietary should be so specified in a separate letter at the time of request. Other than proprietary information, all materials contained in the public files shall be available for inspection pursuant to section 12.02.

.04 The cost of search, copying and deletion of any references to proprietary information will be borne by the person requesting the advisory opinion or the background file.

Sec. 13. *Effective date*. This procedure is effective August 27, 1976, the date of its publication in the Federal Register.

Signed at Washington, D.C. this 24 day of August 1976.

James D. Hutchinson

Administrator of Pension and Welfare Benefit Programs,

U.S. Department of Labor.

Voluntary Correction Programs

Employee Benefit Plan Voluntary Correction Programs

The Internal Revenue Service, US Department of Labor, and Pension Benefit Guaranty Corporation have adopted voluntary correction programs which permit employee benefit plan sponsors and other plan officials to correct certain categories of errors and misfilings with either no, or reduced, penalties, while preserving the plan's tax qualification.

1. Internal Revenue Service

The IRS retirement plan correction program (Employee Plans Compliance Resolution System, covered under Revenue Procedure 2003-44), helps employer sponsors protect participant benefits and keep their plans within the requirements of the Internal Revenue Code. This revenue procedure combined and revised a series of previous IRS remedial programs for correcting plan qualification defects. The program covers qualified retirement plans, Section 403(b) arrangements, SEPs, and SIMPLE IRAs, for a variety of plan qualification failures and violations, including: operational failures, for failure to comply with terms of plan documents; plan document failures, in which retirement plan provisions violate IRS qualification requirements; demographic failures, in which IRS nondiscrimination requirements are not met in the plan document; and the diversion or misuse of plan assets.

Self Correction Program

Under the Self Correction Program certain plan errors can be corrected without IRS involvement. No notification of IRS is required, no fees or penalties are assessed, and the plan and its participants retain tax benefits.

Voluntary Correction Program

The Voluntary Correction Program may be used for plan errors which not eligible for

self correction. Errors are corrected and the tax benefits of the plan are preserved for plan participants with IRS assistance.

IRS Plan Audits

Errors corrected under either the Self Correction or Voluntary Correction programs are not treated as errors when the IRS audits these plans. For other errors found during IRS examinations, the Audit Closing Agreement Program permits their correction and tax benefit preservation at fees which are lower than would be incurred if the plan had not a participated in the Voluntary Correction Programs.

2. U.S. Department of Labor

The Employee Benefits Security Administration has two voluntary self-correction programs for plan administrators who need help in meeting ERISA requirements: t he Delinquent Filer Voluntary Compliance Program promotes, through the assessment of reduced civil penalties, plan administrator compliance with annual reporting obligations under Title I of the Employee Retirement Income Security Act of 1974; the Voluntary Fiduciary Compliance Program allows plan participants and beneficiaries and certain other persons engaging prohibited transactions under the Employee Retirement Income Security Act of 1974 to self correct the violations, and avoid potential civil actions by the DOL.

§ Delinquent Filer Voluntary Compliance Program

The Delinquent Filer Voluntary Compliance Program assists plan administrators who have filed Form 5500 late, or not filed it at all, to comply with the filing requirements and pay reduced civil penalties. The IRS has agreed to provide penalty relief under the Code for delinquent Form 5500 Annual Returns/Reports filed for Title I plans where the conditions of this program have been satisfied.

§ Voluntary Fiduciary Correction Program

The Voluntary Fiduciary Correction Program (PTE 2002-51) affords plan sponsors and officials the opportunity to self-correct 15 specific transactions, involving delinquent participant contributions and other violations, prohibited under ERISA. The DOL also relieves these individuals from the payment of excise taxes associated with the transactions covered under the class exemption. It has released a VFC Program FAQ bulletin outlining specific issues and qualifications for participating in the program.

3. Pension Benefit Guaranty Corporation

PBGC provides incentives to self-correct late filings, or other errors involving missed premium deadlines and underpaid premiums.

§ Underpaid Premium Correction Program

Voluntarily self-corrected underpayments made before PBGC sends a notice of premium delinquency or a premium audit, reduces the monthly penalty rate by 80 percent (from 5 percent to 1 percent of the unpaid premium). Premium penalties may be waived for reasonable cause or in other appropriate circumstances.

§ Participant Notice Voluntary Correction Program

Missed or improperly prepared reports or notices are assessed lower penalties where the failure is quickly corrected or involves a small plan. Information penalties are waived for reasonable cause or in other appropriate circumstances. Self correction is considered a mitigating factor for plans participating in this program.

Voluntary Fiduciary Correction Program (VFCP)

March 28, 2002 (67 FR 15062)

Summary

Allows voluntary correction of some breaches to allow plan officials to avoid potential civil actions initiated by the DOL and civil penalties under ERISA.

Agency: Pension and Welfare Benefits Administration, Labor Department.

Action: Permanent adoption of the VFCP.

Frequently Asked Questions about the Voluntary Fiduciary Correction Program

What is the Voluntary Fiduciary Correction Program (VFCP)?

The VFCP is a voluntary enforcement program that encourages the correction of possible violations of Title I of ERISA. The program allows plan officials to identify and fully correct certain transactions such as prohibited purchases, sales and exchanges, improper loans, delinquent participant contributions, and improper plan expenses. The program includes 15 specific transactions and their acceptable means of correction, eligibility requirements, and application procedures. If an eligible party documents the acceptable correction of a specified transaction, the U.S. Department of Labor Employee Benefits Security Administration (EBSA) will issue a no-action letter.

Why did the U.S. Department of Labor create the VFCP?

In part, the U.S. Department of Labor developed the VFCP in response to requests from the employee benefits community for a formal program that would reduce the risk of enforcement action and the imposition of the Section 502(l) penalty. Most of EBSA's investigations are resolved by fiduciaries taking corrective action after EBSA identifies violations. The U.S. Department of Labor recognized that as the private benefit system evolves, there is a need for innovation in voluntary compliance. Publication of the VFCP provides an opportunity to inform plan fiduciaries of their obligations so that complete and fully acceptable corrections may be made without discussion or negotiation with the U.S. Department of Labor.

Who is eligible to participate in the program?

The U.S. Department of Labor will consider an application if neither the plan nor the applicant is under investigation and if the application contains no evidence of potential criminal violations as determined by EBSA.

How long will the U.S. Department of Labor operate the program?

The U.S. Department of Labor expects to operate the program indefinitely.

What if the U.S. Department of Labor receives an application from a plan sponsor that has not adequately corrected a violation?

The U.S. Department of Labor may need to negotiate with the sponsor for full correction. In that case, the Section 502(l) penalty may apply to amounts restored pursuant to the negotiation. Depending on the facts, EBSA may also need to conduct a civil or criminal investigation or take other action, such as seeking removal of persons from positions of authority with respect to a plan.

Are there any civil penalties involved in the program?

If the applicant complies with the conditions of the program, no Section 502(l) penalty would apply to correction amounts paid to the plan or to participants. However, the U.S. Department of Labor is not precluded from referring information regarding the transaction to the IRS as required by Section 3003(c) of ERISA, or from imposing civil penalties under Section 502(c)(2) of ERISA based on the failure or refusal to file a timely, complete and accurate annual report Form 5500.

Will the new program provide any certainty to the applicant if he or she complies with the conditions?

Yes. The U.S. Department of Labor acknowledged the need for plan sponsors and their service providers to know that the U.S. Department of Labor would take no further action if the applicant satisfied the terms of the program. Under those circumstances, the U.S. Department of Labor will issue a no-action letter to the applicant. The no-action letter states that the U.S. Department of Labor will not initiate a civil investigation under Title I of ERISA regarding the applicant's responsibility for any transaction described in the no-action letter, nor assess a Section 502(l) penalty. However, the issuance of a no-action letter does not affect the ability of any other government agency, or any other person, to enforce their rights.

How do I apply for relief?

The program includes application procedures. Briefly, one must submit a written narrative and supporting documents describing the transaction and its correction, proof of restoration of losses, and an executed penalty of perjury statement.

Where do I apply?

Applications should be mailed to the appropriate EBSA regional office.

How can I find out more about the program?

Interested parties may contact the appropriate EBSA regional office. Regional coordinator's assigned to the program will assist you with your questions. Information about the VFCP can also be obtained by calling EBSA's Toll-Free number at 1.866.444.EBSA (3272)

How can I comment on the program?

Comments may be addressed in writing to:

U.S. Department of Labor
Employee Benefits Security Administration
Office of Enforcement - VFCP
200 Constitution Avenue, NW, Suite N-5702
Washington, DC 20210

How do I determine when participant contributions to pension plans are late?

The Department's regulation relating to the definition of Plan Assets - Participant Contributions (29 CFR 2510.3-102) describes a general rule and a maximum time period for pension benefit plans. The general rule provides that the assets of a plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets.

The maximum time period for pension benefit plans for transmitting participant contributions shall in no event be later than the 15th business day of the month following the month in which the participant contribution amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

The date when participant contributions reasonably can be segregated from the employer's general assets usually will be earlier than the maximum time period for pension plans in the regulation. Thus, when contributions reasonably can be segregated from the employer's general assets in a shorter time period, delay in forwarding the contributions, even a delay that does not exceed the maximum time period under the regulation, may cause a breach of fiduciary duty under Title I of ERISA that may be corrected under the Voluntary Fiduciary Correction Program (VFCP). Moreover, where the contributions have been delinquent longer than the maximum time period and the contributions could have been segregated earlier than the maximum time period, the loss date (as defined in the program), for purposes of calculating lost earnings (as defined in the program), is the date on which the contributions reasonably could have been segregated and not the maximum time period.

How do I show the earliest date contributions can be segregated for purposes of preparing a VFCP application?

Program applicants are reminded that the program requires that the applicant document, under its particular circumstances, the earliest date on which the contributions reasonably could have been segregated from the employer's general assets. This documentation may consist of the plan sponsor's past withholding and remittance history, the sponsor's withholding and remittance process, and the minimum period between withholding and remittance.

Participant contributions to the plan were delinquent, but the dollar amount to correct is very small. Do I have to participate in the VFCP?

If participant contributions are delinquent, plan officials must take appropriate action to correct the violation. Although plan officials are not required to file an application with the Department under the VFCP to correct a violation, the VFCP is available to correct a loss of any amount resulting from a transaction covered by the program. Participation in the VFCP is voluntary. However, if you do not file an application with the Department, you cannot obtain the relief available under the program. Moreover, if the Department discovers the violation on audit, and the correction was not complete for purposes of the program, a civil penalty may be assessed on any additional amount required by the Department to fully correct the violation following the Department's audit of the plan.

Can I use the VFCP to correct a failure to forward participant loan repayments to a plan in a timely fashion?

Yes. In Advisory Opinion 2002-02A, the Department concluded that, while not subject to the participant contribution regulation (29 C.F.R. § 2510.3-102), participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets. Given the similar treatment of participant contributions and loan repayments, the Department has determined that it is appropriate to permit delinquent participant loan repayments to be corrected under the VFCP in the same manner as delinquent participant contributions.

I have determined that participant contributions to the pension plan were delinquent and I want to correct under the program. How do I determine what rate of return to use for calculating earnings on the delinquent contributions?

In order to correct under the program, you will need to calculate the lost earnings on the delinquent contributions. For purposes of correction under the program, the rate of return to use is the highest of:

- The rate of return of the plan for non-participant directed plans or of individual participant accounts
- Restoration of profits (as defined under the program)
- The Internal Revenue Code §6621 rate. How to calculate each of those amounts is demonstrated in the questions and answers below

The plan investments are selected by the plan fiduciaries. How do I calculate the overall rate of return for the plan?

Where there are no distributions or expense disbursements during the period of delinquency, the overall rate of return for the plan is calculated by subtracting the amount of plan assets on the date contributions were due under the Department's regulation from the amount of plan assets on the date the delinquent contributions are repaid to the plan, but not including the addition of the delinquent contributions, divided by the amount of assets on the date the contributions were due.

Where there have been distributions or expense disbursements during the period of delinquency, applicants may demonstrate the actual average rate of return of all the investments of the plan where they have evidence to show such rate of return. In the alternative, applicants may, for administrative convenience, calculate the overall rate of return by using a fraction where the numerator is the amount of plan assets on the date the contributions are repaid minus the amount of plan assets on the date contributions were due, but not including the addition of the delinquent contributions, plus any distributions and expense disbursements made between the date the contributions were repaid and the date the contributions were due, and the denominator is the amount of assets on the date the contributions were due.

The plan investments are participant directed. How do I calculate the rate of return for purposes of determining lost earnings on delinquent contributions?

When calculating the rate of return for participant-directed plans, it is necessary to calculate the rate of return for each individual participant account. The same method used for calculating the overall plan rate of return for a plan where the investments are selected by the plan fiduciaries is used for each participant account. For administrative convenience, the applicant may use the highest rate of return of any plan investment option as the rate of return for each individual participant account.

If the plan investments are participant directed and certain participants have not designated any investment options, what rate of return do I use for those participants for purposes of determining earnings on delinquent contributions?

For those participants in a participant-directed plan who have not designated any investment options, the applicant may use the plan's overall rate of return for those participants during the period of the delinquency.

How do I determine what is the restoration of profits amount for purposes of determining earnings on delinquent contributions?

The restoration of profits amount is the amount earned by the fiduciary or party in interest on the use of the monies that should have been forwarded to the plan for the duration of the delinquency. If the purpose for which the monies were used and the earnings thereon are ascertainable, then those actual earnings are the amount of the restoration of profits.

What is the IRC §6621 rate and how do I find out what the rate was for the applicable time period?

Section 6621 of the Internal Revenue Code establishes the rates for interest on tax overpayments and underpayments. The VFCP uses the underpayment rate as the rate of return that must be examined for determining lost earnings where it is not possible to ascertain the restoration of profits amount. The Internal Revenue Service publishes the §6621(a)(2) rate quarterly. The rate announcements can be found on the internet.

Pension Benefit Guaranty Corporation

Participant Notice Voluntary Correction Program

May 3, 2004 (FR 04-10406)

Recap
Permits plan administrators to correct Participant Notice compliance failures for 2002 and 2003 without penalty.

Voluntary Correction Program

RIN 1212-AB00

Agency: Pension Benefit Guaranty Corporation

Action: Notice

Effective Date: May 3, 20024

Summary: The Pension Benefit Guaranty Corporation (''PBGC'') is announcing a Participant Notice Voluntary Correction Program (''VCP''). This program, which generally covers Participant Notices for the 2002 or 2003 plan year that were not issued as required, is designed to encourage plan administrators to correct recent compliance failures without penalty and to facilitate plan administrators' future compliance. The PBGC will not pursue any failure to provide a pre-2002 Participant Notice unless there is a 2002 or 2003 participant Notice failure that is covered by the VCP but that does not meet the requirements for penalty relief under the VCP. Elsewhere in today's Federal Register, the PBGC is proposing a new Participant Notice penalty policy.

Dates: To meet the requirements for penalty relief under the Participant Notice Voluntary Correction Program with respect to a Participant Notice failure for the 2002 or 2003 plan year, the plan administrator must: (1) Issue a VCP corrective notice by the 2004 Participant Notice due date (for calendar year plans, generally October 4, 2004, November 15, 2004, or December 15, 2004); and (2) notify the PBGC within 30 days after the 2004 Participant Notice due date.

For further information contact: Harold J. Ashner, Assistant General Counsel, or Catherine B. Klion, Attorney, Office of the General Counsel, Pension Benefit Guaranty Corporation, 1200 K Street, NW., Washington, DC 20005-4026; 202-326-4024 (TTY/TDD users may call the Federal relay service toll-free at 1-800-877-8339 and

ask to be connected to 202-326-4024.)

Supplementary information: Overview of Participant Notice Requirements Section 4011 of the Employee Retirement Income Security Act of 1974 ("ERISA") requires certain underfunded plans to issue a notice to participants of the plan's funding status and the limits on the PBGC's guarantee ("Participant Notice"). The Participant Notice helps to ensure that participants better understand the financial status of their plans and the consequences that plan underfunding may have on their promised benefits. The PBGC's implementing regulations are at 29 CFR part 4011. In general, a plan administrator must issue a Participant Notice for a plan year if a variable rate premium (which is tied to plan underfunding) is payable for that plan year, unless the plan meets the "DRC Exception Test" for that plan year or for the prior plan year. However, the Job Creation and Worker Assistance Act of 2002 (JCWAA) made a temporary change to the premium interest rate that did not apply for purposes of determining whether a Participant Notice was required. Therefore, a plan administrator may be required to provide a Participant Notice for the 2002 or 2003 plan year even if a variable rate premium is not payable for that plan year. The Pension Funding Equity Act of 2004 (PFEA), which was signed into law by the President on April 10, 2004, changes the rules for determining the required interest rate for premium payment years beginning in 2004 or 2005. Under PFEA, plan administrators may use the premium interest rate for purposes of determining whether a Participant Notice is required. Thus, a plan administrator may be required to issue a Participant Notice for the 2004 or 2005 plan year only if a variable rate premium is payable for that plan year. A Participant Notice for a plan year is due in that plan year-"two months after the due date (with extensions) for the plan's Form 5500 for the prior plan year. (The due date for a plan's Participant Notice for a plan year is keyed to the due date for the plan's Summary Annual Report for the prior plan year so that the two documents may be issued together.) For calendar year plans, common due dates for the 2004 Participant Notice are therefore October 4, 2004, November 15, 2004, and December 15, 2004. There are a variety of rules governing who is entitled to receive the Participant Notice and the form, content, and manner of issuance of the Participant Notice. Plan administrators are required to certify on the annual PBGC premium filing (Form 1 or Form 1-EZ) that, for the prior plan year: (1) A Participant Notice was not required to be issued; (2) a Participant Notice was issued as required; or (3) an explanation is attached (*e.g.*, because a required Participant Notice was issued late). *See* appendix A for a detailed explanation of the requirements governing Participant Notices.

Compliance and Enforcement Background The Participant Notice requirement went into effect in the 1995 plan year for large plans (generally plans with more than 100 participants) and in the 1996 plan year for small plans (generally plans with 100 or fewer participants). In the first few years after the requirement went into effect, plan administrators of only a relatively small number of defined benefit plans had to provide a Participant Notice, reflecting the fact that plans were better funded at that time. The PBGC conducted compliance surveys and found that both large plan and small plan compliance was high for those plan years. In the last several years, however, because of low interest rates and poor investment returns, more plans have become underfunded and, therefore, many plan administrators have been required to issue a Participant Notice for the first time. Recent PBGC audits have found higher rates of noncompliance with the Participant Notice requirement than in prior years. Much of the noncompliance appears to have resulted from a lack of awareness or understanding of the applicable requirements rather than from an attempt to avoid disclosure. Nonetheless, plan participants deserve to know if their plans are underfunded. As a result, the PBGC is expanding its Participant Notice enforcement program with a view toward more actively auditing compliance and assessing penalties for noncompliance.

Overview of Voluntary Correction Program As a transition to this expanded enforcement program, the PBGC is launching a Participant Notice Voluntary Correction Program ("VCP") designed to encourage plan administrators to correct past compliance failures and to facilitate their future compliance with Participant Notice requirements. The VCP generally covers Participant Notice failures for the 2002 and 2003 plan years. Under this program, the PBGC will not assess penalties for failure to provide a 2002 or 2003 Participant Notice as required if the failure is corrected in accordance with the guidelines in this notice. (The VCP focuses on the 2002 and 2003 plan years in part because the PBGC is concerned that some plan administrators may have misunderstood the effect of JCWAA on their Participant Notice obligations for those plan years.) The PBGC will not pursue failures to provide a pre-2002 Participant Notice unless there is a 2002 or 2003 by the VCP but that does not meet the requirements for penalty relief under the VCP. Focusing the PBGC's enforcement resources primarily on 2002 and later Participant Notice failures will concentrate those resources effectively and limit disclosures to plan years that are most relevant to participants. The PBGC anticipates that many plan administrators will want to participate in the VCP as a precaution, even in the absence of a known Participant Notice failure. Participation in the VCP will not affect the likelihood that a plan will be selected for audit of compliance with the requirement to issue a post-VCP Participant Notice (see "Participant Notices Covered by VCP"), with the PBGC premium requirement, or with any other PBGC requirement.

Participant Notices Covered by VCP The VCP covers any Participant Notice for a plan's 2002 or 2003 plan

year: (1) That is due before May 7, 2004; and (2) that is not, as of May 7, 2004, the subject of a PBGC audit proceeding. For purposes of determining whether the VCP covers a plan's Participant Notice, the date the Participant Notice is due is determined without regard to any deadline extension resulting from a disaster relief notice. For example, if a calendar year plan's 2003 Participant Notice was originally due on December 15, 2003, but as a result of a disaster relief notice the due date was extended to May 14, 2004, the VCP would cover the plan's 2003 Participant Notice because the extension to May 14, 2004, would be disregarded.

Requirements for VCP Penalty Relief For any Participant Notice that is covered by the VCP, the PBGC will not assess a penalty if the plan administrator, in accordance with the guidelines in this notice: (1) Issues a VCP corrective notice; and (2) notifies the PBGC that it is participating in the VCP. (If the only failure was a late issuance corrected before May 7, 2004, *see* ''Special rule for late 2002/2003 notices already corrected.'') *VCPCorrective Notice* The PBGC believes that many of the plans that will participate in the VCP to correct a Participant Notice failure for 2002 or 2003 will also be required to issue a Participant Notice for 2004. Accordingly, the PBGC has structured the VCP corrective notice requirements to enable such plans to issue a single notice that meets the requirements for a VCP corrective notice *and* for the 2004 Participant Notice. This approach will minimize the confusion for participants that could result from the issuance of multiple notices at or about the same time. The VCP corrective notice must meet all of the requirements that apply to the 2004 Participant Notice (or, if the plan is not required to issue a 2004 Participant Notice, all of the requirements that would apply if it were required), except as otherwise provided in the guidelines in this notice. Normally the 2004 Participant Notice would have to include the ''funded current liability percentage'' for the 2003 plan year or for the 2004 plan year. Under the VCP, whether the plan administrator is correcting only a 2002 failure, only a 2003 failure, or both a 2002 and a 2003 failure, the VCP corrective notice: (1) Must include the funded current liability percentage for the 2002 plan year and for the 2003 plan year, and (2) may include as well the funded current liability percentage for the 2004 plan year. In all other respects, the VCP corrective notice must contain the information required in a 2004 Participant Notice (*e.g.*, current information on funding waivers, missedcontributions, and limitations on the PBGC's guarantee). Although the plan administrator is not required to inform participants that it had a Participant Notice failure for the 2002 or 2003 plan year (or for both), or that it is participating in a ''voluntary correction program,'' a plan administrator may choose to include that information in the VCP corrective notice. Appendix B contains a model VCP corrective notice that plan administrators may use to meet VCP requirements. The PBGC will treat a VCP corrective notice that is issued in accordance with the guidelines in this notice as meeting the requirements for the 2004 Participant Notice. Plan administrators should take special note that because the VCP corrective notice is tied to the requirements for the 2004 Participant Notice rather than to the requirements for the 2002 or 2003 Participant Notice that was not issued as required, the VCP corrective notice is required to be issued only to those persons entitled to receive the plan's 2004 Participant Notice (or that would be entitled to receive the plan's 2004 Participant Notice if it were required). Thus, there is no need to issue the VCP corrective notice to those persons who were entitled to receive the 2002 or 2003 Participant Notice that was not issued as required but who are not entitled to receive the 2004 Participant Notice (*e.g.*, a participant whose entire benefit has been annuitized or paid out in a lump sum). *Notice to PBGC* The plan administrator must notify the PBGC that it is participating in the VCP no later than the 30th day after the due date for issuing the VCP corrective notice. The notification must include a copy of the VCP corrective notice and the name and telephone number of a person for the PBGC to contact with any questions. Plan administrators may notify the PBGC electronically through the PBGC's Web site at *http:// www.pbgc.gov/participantnotice,* by fax at 202-336-4197, or by mail, commercial delivery service, or hand at Contracts and Control Review Department, Pension Benefit Guaranty Corporation, 1200 K Street, NW., Suite 580, Washington, DC 20005-4026. The PBGC will promptly issue a written acknowledgment of the notification. Plan administrators should keep the acknowledgment as proof of meeting the VCP requirement of notifying the PBGC.

Special Rule for Late 2002/2003 Notices Already Corrected If a plan administrator's only failure with respect to a 2002 or 2003 Participant Notice was late issuance and the failure has been corrected before May 7, 2004, the PBGC will treat the plan administrator as having participated in the VCP and will assess no penalty for that 2002 or 2003 failure (and will not pursue any pre-2002 Participant Notice failure) without requiring that the plan administrator issue a VCP corrective notice or notify the PBGC of the plan's participation in the VCP.

Effect of VCP on Certification Requirements Ordinarily, a plan administrator that filed an erroneous certification on the annual PBGC premium filing as to whether a Participant Notice was required for the prior plan year and, if so, whether it was issued as required would have to file an amended certification. However, if the plan administrator notifies the PBGC of the plan's participation in the VCP, the PBGC will treat the notification as effectively amending any erroneous certification filed on or before May 7, 2004, with respect to a 2002 or 2003 Participant Notice. The PBGC will take no enforcement action based on the erroneous prior certification if the plan administrator of a plan that meets the requirements for penalty relief under the VCP amends (or effectively amends) the erroneous prior certification. meet the requirements for VCP penalty relief will be

required to check a box on the 2005 PBGC premium filing notifying the PBGC of the plan's participation in the VCP. This requirement is in addition to the Notice to PBGC requirement described above that must be met to qualify for VCP penalty relief, except under "Special rule for late 2002/2003 notices already corrected."

Compliance Assistance The PBGC has developed written guidance on the requirements of the VCP, including a Fact Sheet and Frequently Asked Questions. All information related to the VCP and to Participant Notice requirements generally is available on the PBGC's Web site at *http://www.pbgc.gov/ participantnotice.* In addition, plan administrators seeking guidance on Participant Notice compliance questions, including questions about the VCP, may submit questions electronically through that Web site or call the toll-free telephone number at the PBGC's Practitioner Customer Service Center (1-800-736-2444). Plan administrators may also contact the PBGC to request appropriate modifications to the VCP requirements on a case-by-case basis. For example, in the case of a 2002 or 2003 "partial" failure such as a failure to provide the notice to some of the participants or a failure to include in the notice some required information, the PBGC will work with the plan administrator to determine what type of correction, if any, would be needed to address the partial failure in order to qualify for penalty relief under the VCP.

Future Participant Notice Penalties Elsewhere in today's Federal Register, the PBGC is proposing a new Participant Notice penalty policy. The PBGC intends to publish its final Participant Notice penalty policy as soon as practicable after considering public comments.

Compliance With Rulemaking Guidelines The PBGC has determined, in consultation with the Office of Management and Budget, that this Notice is a "significant regulatory action" under Executive Order. The Office of Management and Budget has therefore reviewed this notice under Executive Order 12866. The collection of information requirements under the VCP have been approved by the Office of Management and Budget under control numbers 1212-0009 (expires December 31, 2006) and 1212-0050 (expires November 30, 2004). An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Because this action deals only with a general statement of PBGC enforcement policy, it is not subject to the notice and comment rulemaking requirements or delayed effective date requirements under section 553 of the Administrative Procedure Act. Because no general notice of proposed rulemaking is required, the Regulatory Flexibility Act does not apply. *See* 5 U.S.C. 601(2), 603, 604. Issued in Washington, DC, this 3rd day of May, 2004.

Bradley D. Belt,

Executive Director, Pension Benefit Guaranty Corporation.

Appendix A

Summary of Participant Notice Requirements *Statutory and Regulatory Framework* Section 4011 of ERISA and 29 CFR part 4011 require certain underfunded plans to issue an annual notice to participants (a "Participant Notice") that discloses the plan's funding status and the limits of the PBGC's guarantee.

When Requirement Applies In general, a plan administrator is required to provide a Participant Notice for a plan year if a variable rate premium (which is tied to plan underfunding) is payable for that plan year, unless the plan meets a funding-related test tied to the "deficit reduction contribution" rules-the "Deficit Reduction Contribution ("DRC") Exception Test"-for that plan year or for the prior plan year. *See* § 4011.3. However, as discussed below under Effect of JCWAA on Requirements, a plan administrator may be required to provide a Participant Notice for the 2002 or 2003 plan year even if a variable rate premium is not payable for that plan year. In general, the DRC Exception Test requires a plan to be at least 90 percent funded, although a plan that is at least 80 percent funded meets the test if it was at least 90 percent funded for two consecutive plan years out of the last three. There are special rules under the DRC Exception Test that allow small plans to avoid doing additional calculations by using numbers they already reported on the Schedule B to their Form 5500. *See* § 4011.4. Most new and newly covered plans are exempt from the Participant Noticerequirement. *See* § 4011.5. *Due Dates* A participant notice for a plan year is due in that plan year. The due date for issuing a Participant Notice for a plan year is two months after the plan's due date, with extensions, if any, for filing the Form 5500 for the prior plan year. (The due date for a plan's Participant Notice for a plan year is keyed to the due date for the plan's Summary Annual Report for the prior plan year so that the two documents may be issued together.) The plan administrator may change the date of issuance from one plan year to the next, provided that the effect of any change is not to avoid disclosing a minimum funding waiver or a missed contribution. *See* § 4011.8.

Persons Entitled To Receive Notice A plan administrator must provide a Participant Notice to participants, beneficiaries of deceased participants, alternate payees, and unions. To determine who is a person entitled to receive a Participant Notice, the plan administrator may select any date during the period beginning with the

last day of the prior plan year and ending with the date on which the Participant Notice is due, provided that a change in the date from one plan year to another does not exclude a substantial number of participants and beneficiaries. *See* § 4011.7.

Manner of Issuance The plan administrator must issue a Participant Notice using measures reasonably calculated to ensure actual receipt by the persons entitled to receive it. A Participant Notice may be issued together with another document, such as the Summary Annual Report (which is due at the same time as the Participant Notice), as long as it is in a separate document. *See* § 4011.9, as amended by the PBGC's final rule published October 28, 2003 (68 FR 61344, 61353).

Form of Notice A Participant Notice must contain the plan's "Notice Funding Percentage"-the plan's "funded current liability percentage" as defined in section 302(d)(9)(C) of ERISA- for the current plan year or the prior plan year, along with the date as of which that percentage is determined. The Participant Notice also must contain information on minimum funding waivers and missed contributions, a summary of plan benefits guaranteed by the PBGC with an explanation of the limitations on the guarantee, and other information specified in the regulation. *See* § 4011.10(b) and (c). Additional information must be in a separate document. *See* § 4011.10(d). A Participant Notice must be readable and written in a manner calculated to be understood by the average plan participant and not to mislead recipients. *See* § 4011.10(a). Plan administrators of plans with specified numbers or percentages of participants literate only in the same non-English language must provide either an English-language Participant Notice with aprominent legend in the common non-English language offering assistance in that language or a Participant Notice in the common non-English language. *See* § 4011.10(e). The Participant Notice regulation contains a Model Participant Notice as an example of a Participant Notice that meets the requirements of § 4011.10. Each year the PBGC issues a Technical Update that provides specific information relating to that year's Participant Notice and updates the Model Notice. *Effect of JCWAA on Requirements* Section 405 of the Job Creation and Worker Assistance Act of 2002 ("JCWAA") increased the required interest rate for calculating vested benefits for the PBGC variable rate premium under section 4006(a)(3)(E)(iii) of ERISA from 85 percent to 100 percent of the yield on 30-year Treasury securities. The statutory change applies only to plan years beginning in 2002 or 2003. However, JCWAA does *not* allow use of 100 percent of the Treasury yield to determine whether a PBGC variable rate premium is payable for purposes of determining whether a Participant Notice is required. Thus, plan administrators must continue to use 85 percent of the Treasury yield for this purpose. Section 405 of JCWAA also increased, for plan years beginning in 2002 or 2003, the maximum interest rate (from 105 percent to 120 percent of the four-year weighted average of the yield on 30-year Treasury securities) that may be used to calculate current liability for purposes of the DRC funding requirement. The change in the maximum interest rate used to calculate current liability for DRC funding purposes can affect, for the 2002, 2003, and certain future plan years: (1) Whether a plan administrator is required to issue a Participant Notice; and (2) the plan funding information required to be disclosed in a Participant Notice. The effect of JWCAA on Participant Notice requirements is fully discussed in PBGC Technical Updates 02-2 and 03-17, both available on the PBGC's Web site, *http:// www.pbgc.gov/participantnotice*.

*Certification*The plan administrator is required to certify on the annual PBGC premium filing (Form 1 or Form 1-EZ) that, for the prior plan year: (1) A Participant Notice was not required to be issued; (2) a Participant Notice was issued as required; or (3) an explanation is attached (*e.g.*, because a required Participant Notice was issued late).

Penalties If a Participant Notice is not issued as required, the PBGC may assess penalties under section 4071 of ERISA and 29 CFR part 4071. For more information on Participant Notice penalties, *see* the PBGC's proposal on such penalties published elsewhere in today's Federal Register

Appendix B *Model VCP Corrective Notice* The following is an example of a corrective notice that satisfies the requirements of the Participant Notice Voluntary Correction Program when the required information is filled in (subject to § 4011.10(d)-(e), as applicable). It also satisfies the requirements of § 4011.10 for the 2004 Participant Notice.

Notice to Participants of [Plan Name] The law requires that you receive information on the funding level of your defined benefit pension plan and the benefits guaranteed by the Pension Benefit Guaranty Corporation (PBGC), a federal insurance agency. [You may include a statement to the effect that the plan had a prarticipant notice failure for the 2002 plan year or for the 2003 plan year (or for both). You may also include a statement to the effect that the plan is participating the PBGC'S Participants Notice Voluntary Correction Program.] Your Plan's Funding As of [Applicable date], your plan had [Insert plan's funded current liability percentage (as defined in section 302(d)(9)(C) of ERISA) for the 2002 plan year] percent of the money needed to pay benefits promised to employees and retirees. As of [Applicable date], your plan had [Insert plan's funded current liability percentage (as defined in section 302(d)(9)(C) of ERISA) for the 2003 plan year]

percent of the money needed to pay benefits promised to employees and retirees. [You may also include the following statement: As of [Applicable date], your plan had [Insert plan's funded current liability percentage (as defined in section 302(d)(9)(C) of ERISA) for the 2004 plan year] percent of the money needed to pay benefits promised to employees and retirees.] [SEE § 4011.10(c)(2) For special rules small plans may use to determine the plan's funded current liability percentage.] To pay pension benefits, your employer is required to contribute money to the pension plan over a period of years. A plan's funding percentage does not take into consideration the financial strength of the employer. Your employer, by law, must pay for all pension benefits, but your benefits may be at risk if your employer faces a severe financial crisis or is in bankruptcy. [include the following paragraph only if, for any of the previous five plan years, the paln has been granted and has not fully repaid a funding waiver.] Your plan received a funding waiver for [List any of the five previous plan years for which a funding waiver was granted and has not been fully repaid]. If a company is experiencing temporary financial hardship, the Internal Revenue Service may grant a funding waiver that permits the company to delay contributions that fund the pension plan. [Include the following with respect to any unpaid or late payment that must be disclosed under section 4011.10(b)(6):] Your plan was required to receive a payment from the employer on [List applicable due date(s)]. That payment [has not been made] [was made on [List applicable payment date(s)]]. PBGC Guarantees When a pension plan terminates without enough money to pay all benefits, the PBGC steps in to pay pension benefits. The PBGC pays most people all pension benefits, but some people may lose certain benefits that are not guaranteed. The PBGC pays pension benefits up to certain maximum limits. The maximum guaranteed benefit is $3,698.86 per month or $44,386.32 per year for a 65-year-old person in a plan that terminates in 2004. [If you issue this notice after the maximum guaranteed benefit information for plans that terminate in 2005 is announced, you may add or substitute that information in order to provide participants with more current information. The PBGC expects to make that information available on its website at *www.PBGC.gov* in early November 2004.] The maximum benefit may be reduced for an individual who is younger than age 65. For example, it is $1,664.49 per month or $19,973.88 per year for an individual who starts receiving benefits at age 55. [In Lieu of age 55, you may add or substitute any age(s) relevant under the plan. For example, you may add or substitute the maximum benefit for ages 62 or 60. The maximum benefit is $2,922.10 per month or $35,065.20 per year at age 62; It is $2,404.26 per month or $28,851.12 per year at age 60. If the plan provides for normal retirement before AGE 65, you must include the normal retirement age.] [If you issue this notice after the maximum guaranteed benefit information for plans that terminate in 2005 is announced, you may add or substitute that information in order to provide participants with more current inforamtion. The PBGC expects to make that information available on its web site at www.PBGC.gov in early November 2004.] [If the plan does not provide for commencement of benefits before age 65, you may omit this paragraph.] The maximum benefit will also be reduced when a benefit is provided for a survivor. The PBGC does not guarantee certain types of benefits. [Include the following guarantee limits that apply to the benefits available under your plan.]

The PBGC does not guarantee benefits for which you do not have a vested right when a plan terminates, usually because you have not worked enough years for the company. The PBGC does not guarantee benefits for which you have not met all age, service, or other requirements at the time the plan terminates. Benefit increases and new benefits that have been in place for less than a year are not guaranteed. Those that have been in place for less than 5 years are only partly guaranteed. Early retirement payments that are greater than payments at normal retirement age may not be guaranteed. For example, a supplemental benefit that stops when you become eligible for Social Security may not be guaranteed. Benefits other than pension benefits, such as health insurance, life insurance, death benefits, vacation pay, or severance pay, are not guaranteed. The PBGC generally does not pay lump sums exceeding $5,000. Where To Get More Information Your plan, [EIN-PN], is sponsored by [Contributing sponsor(s)]. If you would like more information about the funding of your plan, contact [Insert Name, title, business address and phone number of individual or entity]. For more information about the PBGC and the benefits it guarantees, you may request a free copy of Your Guaranteed Pension by writing to Consumer Information Center, Dept. YGP, Pueblo, Colorado 81009. [The following sentence may be included:] "Your Guaranteed Pension" is also available on the PBGC's Web site at www.pbgc.gov. Issued: [Insert at least month and year] [FR Doc. 04-10406 Filed 5-6-04; 8:45 am] Billing Code 7708-01-P

Department of Labor

Prohibited Transaction Class Exemption 2002-51

Class Exemption to Permit Certain Transactions Identified in the Voluntary Fiduciary Correction Program

March 28, 2002 (67 FR 15083)

Recap

Permits sponsors and officials to self-correct 15 specific transactions, involving delinquent participant contributions and other violations, and provides relief from penalties and excise taxes otherwise associated with the transactions.

Class Exemption

Agency: Department of Labor, Employee Benefits Security Administration

Action: Grant of Class Exemption

Effective Date: November 25, 2002

Exemption

Section I: Eligible Transactions

The sanctions resulting from the application of section 4975(a) and (b) of the Code, by reason of section 4975(c)(1)(A) through (E) of the Code, shall not apply to the following eligible transactions described in section 7 of the Voluntary Fiduciary Correction (VFC) Program (67 FR 15061, March 28, 2002), provided that the applicable conditions set forth in Sections II, III and IV are met:

A. Failure to transmit participant contributions to a pension plan within the time frames described in the Department's regulation at 29 CFR section 2510.3-102, (see VFC Program, section 7.A.1.), and/or the failure to transmit participant loan repayments to a pension plan within a reasonable time after withholding or receipt by the employer.

B. Loan at a fair market interest rate to a party in interest with respect to a plan. (See VFC Program, section 7.B.1.).

C. Purchase or sale of an asset (including real property) between a plan and a party in interest at fair market value. (See VFC Program, sections 7.C.1. and 7.C.2.).

D. Sale of real property to a plan by the employer and the leaseback of the property to the employer, at fair market value and fair market rental value, respectively. (See VFC Program, section 7.C.3.).

Section II: Conditions

A. With respect to a transaction involving participant contributions or loan repayments to pension plans described in Section I.A., the contributions or repayments were transmitted to the pension plan not more than 180 calendar days from the date the amounts were received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or the date the amounts otherwise would have been payable to the participant in cash (in the case of amounts withheld by an employer from a

participant's wages).

B. With respect to the transactions described in Sections I.B., I.C., or I.D., the plan assets involved in the transaction, or series of related transactions, did not, in the aggregate, exceed 10 percent of the fair market value of all the assets of the plan at the time of the transaction.

C. The fair market value of any plan asset involved in a transaction described in Sections I.C. or I.D. was determined in accordance with section 5 of the VFC Program.

D. The terms of a transaction described in Sections I.B., I.C., or I.D. were at least as favorable to the plan as the terms generally available in arm's-length transactions between unrelated parties.

E. With respect to any transaction described in Section I, the transaction was not part of an agreement, arrangement or understanding designed to benefit a party in interest.

F. (1) With respect to any transaction described in Section I, the applicant has not taken advantage of the relief provided by the VFC Program and this exemption for a similar type of transaction(s) identified in the current application during the period which is three years prior to submission of the current application. (2) Notwithstanding the foregoing, Section II.F.(1) shall not apply to an applicant provided that: (a) The applicant was a broker-dealer registered under the Securities Exchange Act of 1934, a bank supervised by the United States or a State thereof, a broker-dealer or bank subject to foreign government regulation, an insurance company qualified to do business in a State, or an affiliate thereof; (b) The applicant was a party in interest (including a fiduciary) solely by reason of providing services to the plan or solely by reason of a relationship to such service provider described in section 3(14)(F), (G), (H) or (I) (and/or the corresponding provisions of section 4975 of the Code); (c) Neither the applicant nor any affiliate (i) was a fiduciary (within the meaning of section 3(21)(A) of ERISA) with respect to the assets of the plan involved in the transaction and (ii) used its discretion to cause the plan to engage in the transaction; (d) Individuals acting on behalf of the applicant had no actual knowledge or reason to know that the transaction was not exempt pursuant to a statutory or administrative exemption under ERISA and/or the Code; and (e) Prior to the transaction, the applicant established written policies and procedures that were reasonably designed to ensure compliance with the prohibited transaction rules and the applicant engaged in periodic monitoring for compliance.

Section III: Compliance with VFC Program

A. The applicant has met all of the applicable requirements of the VFC Program.

B. PWBA has issued a no action letter to the applicant pursuant to the VFC Program with respect to a transaction described in Section I.

Section IV: Notice

A. Written notice of the transaction(s) for which the applicant is seeking relief pursuant to the VFC Program and this exemption, and the method of correcting the transaction, was provided to interested persons within 60 calendar days following the date of the submission of an application under the VFC Program. A copy of the notice was provided to the appropriate Regional Office of the United States

Department of Labor, Pension and Welfare Benefits Administration within the same 60-day period, and the applicant indicated the date upon which notice was distributed to interested persons. Plan assets were not used to pay for the notice. The notice included an objective description of the transaction and the steps taken to correct it, written in a manner reasonably calculated to be understood by the average plan participant or beneficiary. The notice provided for a period of 30 calendar days, beginning on the date the notice was distributed, for interested persons to provide comments to the appropriate Regional Office. The notice included the address and telephone number of such Regional Office.

B. Notice was given in a manner that was reasonably calculated, taking into consideration the particular circumstances of the plan, to result in the receipt of such notice by interested persons, including but not limited to posting, regular mail, or electronic mail, or any combination thereof. The notice informed interested persons of the applicant's participation in the VFC Program and intention of availing itself of relief under the exemption.

Signed at Washington, DC, this 11th day of November, 2002.

Ivan L. Strasfeld,

Director of Exemption Determinations, Pension and Welfare Benefits

Administration, U.S. Department of Labor.

[FR Doc. 02-29799 Filed 11-22-02; 8:45 am]

Appendix E — Employee Benefit Law

IRS Determination Letters

Department of the Treasury

Internal Revenue Service

Publication 794

(Rev. April 1994)

Favorable Determination Letter

Introduction

This publication explains the significance of your favorable determination letter, points out some features that may affect the qualified status of your employee retirement plan and nullify your determination letter without specific notice from us, and provides general information on the reporting requirements for your plan. An example of a determination letter is included.

Significance of a Favorable Determination Letter

An employee retirement plan qualified under Internal Revenue Code section 401(a) (qualified plan) is entitled to favorable tax treatment. For example, contributions made in accordance with the plan document are generally currently deductible. However, participants will not include these contributions into income until the time they receive a distribution from the plan, at which time special income averaging rates for lump sum distributions may serve to reduce the tax liability. In some cases, taxation may be further deferred by rollover to another qualified plan or individual retirement arrangement. (See Publication 575, Pension and Annuity Income, for further details.) Finally, plan earnings may accumulate free of tax.

Employee retirement plans that fail to satisfy the requirements under Code section 401(a) are not entitled to favorable tax treatment. Therefore, many employers desire advance assurance that the terms of their plans satisfy the qualification requirements. The Internal Revenue Service provides such advance assurance by means of the determination letter program. A favorable determination letter indicates that, in the opinion of the Service, the terms of the plan conform to the requirements of Internal Revenue Code section 401(a). In addition, a favorable determination letter may indicate that, on the basis of other information provided in your application, it has been demonstrated that the plan satisfies certain nondiscrimination requirements of Code section 401(a). See the following topic, Limitations of a Favorable Determination Letter, for more details.

Limitations of a Favorable Determination Letter

A favorable determination letter is limited in scope and may also have a limited useful life. A determination letter generally applies to qualification requirements regarding the form of the plan. A determination letter may also apply to other qualification requirements pertaining to the prohibition against discrimination in favor of highly compensated employees. These requirements are generally referred to as the coverage and nondiscrimination requirements. They include the nondiscrimination requirements of section 401(a)(4) of the Code, the minimum coverage requirements of section 410(b), and certain related requirements.

The extent to which a determination letter applies to the coverage and nondiscrimination requirements depends on the terms of the plan, the scope of the determination you requested, and the additional information

you supplied with your application. Your determination letter will contain specific statements that will describe the scope of reliance represented by the letter.

In addition, the following apply generally to all determination letters:

The determination letter may not include a statement regarding the minimum coverage requirements of Code section 410(b); this means that you have demonstrated that the plan satisfies these requirements by satisfying the ratio-percentage test.

- A favorable determination letter means that you have demonstrated that the plan satisfies the minimum participation requirements of Code section 401(a)(26). (Letters for certain governmental plans may also include a statement regarding a special effective date rule.)

- If you maintain two or more retirement plans some of which were either not submitted to the Service for determination or not disclosed on each application, certain limitations and requirements will not have been considered on an aggregate basis. Therefore, you may not rely on the determination letter regarding the plans when considered as a total package.

- A determination letter does not consider the special requirements relating to affiliated service groups or leased employees unless the letter includes a statement that the requirements of Internal Revenue Code section 414(m) (affiliated service groups), or 414(n) (leased employees) have been considered.

- For plans that are not amended to comply with the final nondiscrimination regulations retroactively to the 1989 plan year, a determination letter may not be relied upon as to whether plan provisions satisfy a good faith interpretation of the requirements of section 401(a)(4) and related sections of the Code.

- No determination letter may be relied on with respect to the effective availability of benefits, rights, or features under the plan. (See section 1.401(a)(4)-4(c) of the Income Tax Regulations.) Reliance on whether benefits, rights, or features are currently available to a non-discriminatory group of employees is provided to the extent specified in the letter.

- A determination letter does not consider whether actuarial assumptions are reasonable for funding or deduction purposes or whether a specific contribution is deductible.

- A determination letter does not consider and may not be relied on with respect to certain other matters described in section 4.08 of Rev. Proc. 93-39, 199331 I.R.B. 7 (i.e., whether a plan amendment is part of a pattern of amendments that significantly discriminates in favor of highly compensated employees; the use of the substantiation guidelines contained in Rev. Proc. 93-42, 1993-31 I.R.B. 32; and certain qualified separate lines of business requirements of section 414(r) of the Code).

- The determination letter applies only to the employer and its participants on whose behalf the determination letter was issued.

Become familiar with the terms of the determination letter. Please call the contact person listed on the determination letter if you do not understand any terms in your determination letter.

Retention of Information. Whether a plan qualifies is determined from the information in the written plan document and the supporting information submitted by the employer. **Therefore, you must retain copies of any demonstrations or other information submitted with your application. Such demonstrations determine the extent of reliance provided by your determination letter. Failure to retain such Information may limit the scope of reliance on issues for which demonstrations were provided**. The determination letter will not provide reliance if:

1. there has been a misstatement or omission of material facts,
2. the facts subsequently developed are materially different than the facts on which the determination was made, or
3. there is a change in applicable law.

Law changes affecting the plan. In general, a determination letter is issued based on the law in effect at the time the application is received. However, your letter may include a statement indicating any exception to this rule.

Amendments to the plan. A favorable determination letter may no longer apply if there is a change in a statute, regulation, or revenue ruling applicable to the qualification of the plan. However, the determination letter will continue to apply for years before the effective date of the statute, regulation, or revenue ruling. If the letter no longer applies to the plan, the plan must be amended to comply with the new requirements to maintain its qualified status.

Generally, if a regulation changes, the amendment must be adopted by the end of the first plan year beginning after the adoption date of the regulation. Generally, if a revenue ruling changes, the amendment must be adopted by the end of the first plan year beginning after the publication date of the revenue ruling. Generally the amendment must be effective not later than the first day of such plan year.

Amendments required by Internal Revenue Code sections 401(a)(17) and 401(a)(31). If the plan is a master or prototype or regional prototype plan, the determination letter may be relied on with respect to the direct rollover requirements of Internal Revenue Code section 401(a)(31) and the $150,000 compensation limitation of Internal Revenue Code section 401(a)(17), only if the sponsor amends the master or prototype or regional prototype plan on behalf of all adopting employers to satisfy these requirements by December 31, 1994. In the case of **individually designed plans**, letters issued under Rev. Proc. 93-39 consider these requirements.

Extended Reliance. In general, individually designed plans (not master or prototype, or regional prototype plans) submitted for a determination letter before July 1, 1994 need not be amended for, or comply in operation with subsequent Treasury regulations or other guidance (for example, revenue rulings, notices, etc.) issued by the Service after the date of the plan determination letter until the last day of the last plan year commencing prior to January 1, 1999, unless specifically stated otherwise.

However, plans must be amended by any date(s) established for plan amendment by subsequent legislation. If the determination letter is dated after June 30, 1994, this extended reliance will apply only d so stated in the determination letter. Similar reliance applies to **master and prototype or regional prototype plans** if the plan sponsor requested a notification or opinion letter before April 1, 1991.

Plan Must Qualify in Operation

Generally, a plan qualifies in operation if it continues to satisfy the coverage and nondiscrimination requirements and is maintained according to the terms on which the favorable determination letter was issued. Changes in facts and other bases on which the determination letter was issued may mean that the determination letter may no longer be relied upon.

Some examples of the effect of a plan's operation on a favorable determination are:

Not meeting nondiscrimination in amount requirement. If the determination letter states that the plan satisfies the nondiscrimination in amount requirement of section 1.401(a)(4)-1(b)(2) of the regulations on the basis of a design-based safe harbor, the plan will generally continue to satisfy this requirement in operation n the plan is maintained according to its terms. If the determination letter states that the plan satisfies the nondiscrimination in amount requirement on the basis of a nondesign-based safe harbor or a general test, and the plan subsequently fails to meet this requirement in operation, the letter may no longer be relied upon with respect to this requirement.

Not meeting minimum coverage requirements. If the determination letter does not include a statement regarding the minimum coverage requirements of Code section 410(b), this means that the plan satisfies these requirements by satisfying the ratio-percentage test. However, if the plan subsequently fails to satisfy the ratio-percentage test in operation, the letter may no longer be relied upon with respect to the coverage requirements. Likewise, if the determination letter states the plan satisfies the average benefit test, the letter may no longer be relied on with respect to the coverage requirements once the plan fails to satisfy the average benefit test in operation.

Changes in testing methods. If the determination letter is based in part on a demonstration that a coverage or nondiscrimination requirement is satisfied, and, in the operation of the plan, the method used to test that this requirement continues to be satisfied is changed (or is required to be changed because the facts have changed) from the method employed in the demonstration, the letter may no longer be relied upon with respect to this requirement.

Contributions or benefits in excess of the limitations under Code section 415. A retirement plan may not provide retirement benefits or, in the case of a defined contribution plan, contributions and other additions, that exceed the limitations specified in Internal Revenue Code section 415. Your plan contains provisions designed to provide benefits within these limitations. Please become familiar with these limitations for your plan will be

disqualified if these limitations are exceeded.

Top heavy minimums. If this plan primarily benefits employees who are highly compensated, it may be a top heavy plan and must provide certain minimum benefits and vesting for lower compensated employees. If your plan provides the accelerated benefits and vesting only for years during which the plan is top heavy, failure to identify such years and to provide the accelerated vesting and benefits will disqualify the plan.

Actual deferral percentage or contribution percentage tests. If this plan provides for cash or deferred arrangements, employer matching contributions, or employee contributions, the determination letter

does not consider whether special discrimination tests described in Code section 401(k)(3) or 401(m)(2) have been satisfied in operation.

Reporting Requirements

Most plan administrators or employers who maintain an employee benefit plan must file an annual return/report with the Internal Revenue Service. The following is a general discussion of the forms to be used for this purpose. See the instructions to each form for specific information:

Form 5500-EZ, Annual Return of One Participant (Owners and their Spouses) Pension Benefit Plans - generally for a "One-participant Plan', which is a plan that covers only:

1. an individual, or an individual and his or her spouse who wholly own a business whether incorporated or not; or
2. partner(s) in a partnership or the partner(s) and the partner's spouse.

If Form 5500-EZ cannot be used, the one-participant plan should use Form 5500-C/R, Return/Report of Employee Benefit Plan.

> **Note.** A "one-participant' plan that has no more than $100,000 in assets at the end of the plan year is not required to file a return. However, Form 5500-EZ must be filed for any subsequent year in which plan assets exceed $100,000. If two or more one-participant plans have more than $100,000 in assets, a separate Form 5500-EZ must be filed for each plan.

A "Final' Form 5500-EZ must be filed if the plan is terminated or if assets drop below $100,000 and you wish to stop filing Form 5500-EZ.

Form 5500, Annual Return/Report Of Employee Benefit Plan - for a pension benefit plan with 100 or more participants at the beginning of the plan year.

Form 5500-C/R, Return/Report of Employee Benefit Plan - for each pension benefit plan with more than one but fewer than 100 participants at the beginning of the plan year. Form 5500-C/R takes the place of separate Forms 5500-C and 5500-R. Filing only the first two pages of Form 5500-C/R constitutes the filing of Form 5500-R for plan years for which Form 5500-C is not filed.

> Note. Keogh (HR-10) plans having over $100,000 in assets are required to file an annual return even if the only participants are owner-employees. The term "owner-employee' includes a partner who owns more than 10% interest in either the capital or profits of the partnership. This applies to both defined contribution and defined benefit plans.

When to file. Forms 5500 and 5500-EZ must be filed annually. Form 5500-C must be filed for (i) the initial plan year, (ii) the year a final return/report would be filed, and (iii) at three-year intervals.

Form 5500-R pages 1 and 2 of Form 5500-C/R) must be filed in the years when 5500-C is not filed. However, 5500-C will be accepted in place of 5500-R.

Form 5330 for prohibited transactions - Transactions between a plan and someone having a relationship to the plan (disqualified person) are prohibited, unless specifically exempted from this requirement. A few examples are loans, sales and exchanges of property, leasing of property, furnishing goods or services, and use of plan assets by the disqualified person. Disqualified persons

who engage in a prohibited transaction for which there is no exception must file Form 5330 by the last day of the seventh month after the end of the tax year of the disqualified person.

Form 5330 for tax on nondeductible employer contributions to qualified plans - If contributions are made to this

plan in excess of the amount deductible, a tax is imposed upon the excess contribution. Form 5330 must be filed by the last day of the seventh month after the end of the employer's tax year.

Form 5330 for tax on excess contributions to cash or deferred arrangements or excess employee contributions or employer matching contributions - If a plan includes a cash or deferred arrangement (Code section 401(k)) or provides for employee contributions or employer matching contributions (Code section 401(m)), then excess contributions that would cause the plan to fail the actual deferral percentage or the actual contribution percentage test are subject to a tax unless the excess is eliminated within 2 1/2 months after the end of the plan year. Form 5330 must be filed by the due date of the employer's tax return for the plan year in which the tax was incurred.

Form 5330 for tax on reversions of plan assets - Under Code section 4980, a tax is payable on the amount of any employer reversion of plan assets. Form 5330 must be filed by the last day of the month following the month in which the reversion occurred.

Form 5310-A for certain transactions - Under Code section 6058(b), an actuarial statement is required at least 30 days before a merger, consolidation, or transfers (including spin-offs) of assets to another plan. This statement is required for all plans. However, penalties for non-filing will not apply to defined contribution plans for which:

1. The sum of the account balances in each plan equals the fair market value of all plan assets,
2. The assets of each plan are combined to form the assets of the plan as merged,
3. Immediately after a merger, the account balance of each participant is equal to the sum of the account balances of the participant immediately before the merger, and
4. The plans must not have an unamortized waiver or unallocated suspense account.

Penalties will also not apply if the assets transferred are less than three percent of the assets of the plan involved in the transfer (spin-off), and the transaction is not one of a series of two or more transfers (spin-off transactions) that are, in substance, one transaction.

The purpose of the above discussions is to illustrate some of the principal filing requirements that apply to pension plans. This listing is not an exclusive listing of all returns and schedules that must be filed.

Disclosure. The Internal Revenue Service will process the returns and provide the Department of Labor and the Pension Benefit Guaranty Corporation with the necessary information and copies of the returns on microfilm for disclosure purposes.

Example - IRS Determination Letter

Department of the Treasury

Internal Revenue Service

1100 Commerce St. Code 431 In reply refer to: 75260006Springfield

AS 99001 Dec. 04, 1987 LTR 835AU

73-0793565P 0000 74 001

Input 0p: 75018508 00016

Flimflam & Jones, P.C.

1000 Ajax Life Bldg

PLANO AS 99103

District Office Code and

Case Serial Number: 73737028 EP

Name of Plan: Flimflam & Jones Profit Sharing Plan

Application Form: 5301

Date Amended: 030386

Employer Identification Number: 73-0793565

Plan Number: 001

File Number: 730000488

Dear Applicant:

Based on the information supplied, we have made a favorable determination on your application identified above. Please keep this letter in your permanent records.

Continued qualification of the plan will depend on its effect in operation under its present form. (See Section 1.401-1(b)(3) of the Income Tax Regulations.) The status of the plan in operation will be reviewed periodically.

The enclosed document describes some events that could occur after you receive this letter that would automatically nullify it without specific notice from us. The document also explains how operation of the plan may affect a favorable determination letter, and contains information about filing requirements.

This letter relates only to the status of your plan under the Internal Revenue Code. It is not a determination regarding the effect of other federal or local statutes.

This determination is not a ruling on the effect of reclamination on the deferred percentage test.

If you have any questions, please contact E P Tech Assistor at 703-754-1234.

Sincerely your,

James P. Huttonski

District Director

Enclosures:

Publication 794

U.S. Treasury Notice 2004-8

Abusive Roth IRA Transactions

December 31, 2003

Summary

Identifies specific transactions used to avoid Roth IRA contribution limitations, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of Procedure and Administration Regulations.

Notice 2004-8

Part III - Administrative, Procedural and Miscellaneous

December 31, 2003

U.S. Treasury Notice

Abusive Roth IRA Transactions

Notice 2004-8

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that taxpayers are using to avoid the limitations on contributions to Roth IRAs. This notice alerts taxpayers and their representatives that these transactions are tax avoidance transactions and identifies these transactions, as well as substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 301.6111-2(b)(2) and 301.6112-1(b)(2) of the Procedure and Administration Regulations. This notice also alerts parties involved with these transactions of certain responsibilities that may arise from their involvement with these transactions.

Background

Section 408A was added to the Internal Revenue Code by section 302 of the Taxpayer Relief Act of 1997, Pub. L. 105-34, 105th Cong., 1st Sess. 40 (1997). This section created Roth IRAs as a new type of nondeductible individual retirement arrangement (IRA). The maximum annual contribution to Roth IRAs is the same maximum amount that would be allowable as a deduction under § 219 with respect to the individual for the taxable year over the aggregate amount of contributions for that taxable year to all other IRAs. Neither the contributions to a Roth IRA nor the earnings on those contributions are subject to tax on distribution, if distributed as a qualified distribution described in § 408A(d)(2).

A contribution to a Roth IRA above the statutory limits generates a 6 - percent excise tax described in § 4973. The excise tax is imposed each year until the excess contribution is eliminated.

Facts

In general, these transactions involve the following parties: (1) an individual (the Taxpayer) who owns a pre-existing business such as a corporation or a sole proprietorship (the Business), (2) a Roth IRA within the meaning of § 408A that is maintained for the Taxpayer, and (3) a corporation (the Roth IRA Corporation), substantially all the shares of which are owned or acquired by the Roth IRA. The Business and the Roth IRA Corporation enter into transactions as described below. The acquisition of shares, the transactions or both are not fairly valued and thus have the effect of shifting value into the Roth IRA.

Examples include transactions in which the Roth IRA Corporation acquires property, such as accounts receivable, from the Business for less than fair market value, contributions of property, including intangible property, by a person other than the Roth IRA, without a commensurate receipt of stock ownership, or any other arrangement between the Roth IRA Corporation and the Taxpayer, a related party described in § 267(b) or 707(b), or the Business that has the effect of transferring value to the Roth IRA Corporation comparable to a contribution to the Roth IRA.

Analysis

The transactions described in this notice have been designed to avoid the statutory limits on contributions to a Roth IRA contained in § 408A. Because the Taxpayer controls the Business and is the beneficial owner of substantially all of the Roth IRA Corporation, the Taxpayer is in the position to shift value from the Business to the Roth IRA Corporation. The Service intends to challenge the purported tax benefits claimed for these arrangements on a number of grounds.

In challenging the purported tax benefits, the Service will, in appropriate cases, assert that the substance of the transaction is that the amount of the value shifted from the Business to the Roth IRA Corporation is a payment to the Taxpayer, followed by a contribution by the Taxpayer to the Roth IRA and a contribution by the Roth IRA to the Roth IRA Corporation. In such cases, the Service will deny or reduce the deduction to the Business; may require the Business, if the Business is a corporation, to recognize gain on the transfer under § 311(b); and may require inclusion of the payment in the income of the Taxpayer (for example, as a taxable dividend if the Business is a C corporation). See Sammons v. United States, 433 F.2d 728 (5th Cir. 1970); Worcester v. Commissioner, 370 F.2d 713 (1st Cir. 1966).

Depending on the facts of the specific case, the Service may apply § 482 to allocate income from the Roth IRA Corporation to the Taxpayer, Business, or other entities under the control of the Taxpayer. Section 482 provides the Secretary with authority to allocate gross income, deductions, credits or allowances among persons owned or controlled directly or indirectly by the same interests, if such allocation is necessary to prevent evasion of taxes or clearly to reflect income. The § 482 regulations provide that the standard to be applied is that of a person dealing at arm's length with an uncontrolled person. See generally § 1.482-1(b) of the Income Tax Regulations. To the extent that the consideration paid or received in transactions between the Business and the Roth IRA Corporation is not in accordance with the arm's length standard, the Service may apply § 482 as necessary to prevent evasion of taxes or clearly to reflect income. In the event of a § 482 allocation between the Roth IRA Corporation and the Business or other parties, correlative allocations and

other conforming adjustments would be made pursuant to § 1.482-1(g). Also see, Rev. Rul. 78-83, 1978-1 C.B. 79.

In addition to any other tax consequences that may be present, the amount treated as a contribution as described above is subject to the excise tax described in § 4973 to the extent that it is an excess contribution within the meaning of § 4973(f). This is an annual tax that is imposed until the excess amount is eliminated.

Moreover, under § 408(e)(2)(A), the Service may take the position in appropriate cases that the transaction gives rise to one or more prohibited transactions between a Roth IRA and a disqualified person described in § 4975(e)(2). For example, the Department of Labor [1] has advised the Service that, to the extent that the Roth IRA Corporation constitutes a plan asset under the Department of Labor's plan asset regulation (29 C.F.R. § 2510.3-101), the provision of services by the Roth IRA Corporation to the Taxpayer's Business (which is a disqualified person with respect to the Roth IRA under § 4975(e)(2)) would constitute a prohibited transaction under § 4975(c)(1)(C). [2] Further, the Department of Labor has advised the Service that, if a transaction between a disqualified person and the Roth IRA would be a prohibited transaction, then a transaction between that disqualified person and the Roth IRA Corporation would be a prohibited transaction if the Roth IRA may, by itself, require the Roth IRA Corporation to enter into the transaction. [3]

Listed Transactions

The following transactions are identified as "listed transactions" for purposes of §§ 1.6011-4(b)(2), 301.6111-2(b)(2) and 301.6112-1(b)(2) effective December 31, 2003, the date this document is released to the public: arrangements in which an individual, related persons described in § 267(b) or 707(b), or a business controlled by such individual or related persons, engage in one or more transactions with a corporation, including contributions of property to such corporation, substantially all the shares of which are owned by one or more Roth IRAs maintained for the benefit of the individual, related persons described in § 267(b)(1), or both. The transactions are listed transactions with respect to the individuals for whom the Roth IRAs are maintained, the business (if not a sole proprietorship) that is a party to the transaction, and the corporation substantially all the shares of which are owned by the Roth IRAs. Independent of their classification as "listed transactions," these transactions may already be subject to the disclosure requirements of § 6011 (§ 1.6011-4), the tax shelter registration requirements of § 6111 (§§ 301.6111-1T and 301.6111-2), or the list maintenance requirements of § 6112 (§ 301.6112-1).

Substantially similar transactions include transactions that attempt to use a single structure with the intent of achieving the same or substantially same tax effect for multiple taxpayers. For example, if the Roth IRA Corporation is owned by multiple taxpayers' Roth IRAs, a substantially similar transaction occurs whenever that Roth IRA Corporation enters into a transaction with a business of any of the taxpayers if distributions from the Roth IRA Corporation are made to that taxpayer's Roth IRA based on the purported business transactions done with that taxpayer's business or otherwise based on the value shifted from that taxpayer's business to the Roth IRA Corporation.

Persons required to register these tax shelters under § 6111 who have failed to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of investors under § 6112 who have fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose penalties on participants in this transaction or substantially similar transactions, including the accuracy related penalty under § 6662, and as applicable, persons who participate in the reporting of this transaction or substantially similar transactions, including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The Service and the Treasury recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

Drafting Information

The principal author of this notice is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. However, other personnel from the Service and Treasury participated in its development. Mr. Rubin may be reached at (202) 283-9888 (not a toll-free call).

[1] Under section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of Labor has interpretive jurisdiction over § 4975 of the Internal Revenue Code.

[2] For the Roth IRA Corporation to be considered as holding plan assets under the Department of Labor's plan asset regulation, the Roth IRA's investment in the Roth IRA Corporation must be an equity interest, the Roth IRA Corporation's securities must not be publicly-offered securities, and the Roth IRA's investment in the Roth IRA Corporation must be significant. 29 C.F.R. §§ 2510.3-101(a)(2), 2510.3-101(b)(1), 2510.3-101(b)(2), and 2510.3-101(f). Although the Roth IRA Corporation would not be treated as holding plan assets if the Roth IRA Corporation constituted an operating company within the meaning of 29 C.F.R. § 2510.3-101(c), given the context of the examples described in this notice, it is unlikely that the Roth IRA Corporation would qualify as an operating company.

[3] See 29 C.F.R. § 2509.75-2(c).

FDIC FEDERAL DEPOSIT INSURANCE CORPORATION

PENSION PROTECTION ACT OF 2006

Public Law 109-280
109th Congress

An Act

To provide economic security for all Americans, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE AND TABLE OF CONTENTS.

(a) Short Title.--This Act may be cited as the ``Pension Protection Act of 2006''.

(b) Table of Contents.--The table of contents for this Act (other than so much of title XIV as follows section 1401) is as follows:

Sec. 1. Short title and table of contents.

TITLE I--REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

Subtitle A--Amendments to Employee Retirement Income Security Act of 1974

Sec. 101. Minimum funding standards.
Sec. 102. Funding rules for single-employer defined benefit pension plans.
Sec. 103. Benefit limitations under single-employer plans.
Sec. 104. Special rules for multiple employer plans of certain cooperatives.
Sec. 105. Temporary relief for certain PBGC settlement plans.
Sec. 106. Special rules for plans of certain government contractors.
Sec. 107. Technical and conforming amendments.

Subtitle B--Amendments to Internal Revenue Code of 1986

Sec. 111. Minimum funding standards.
Sec. 112. Funding rules for single-employer defined benefit pension plans.
Sec. 113. Benefit limitations under single-employer plans.
Sec. 114. Technical and conforming amendments.
Sec. 115. Modification of transition rule to pension funding requirements.
Sec. 116. Restrictions on funding of nonqualified deferred compensation plans by employers maintaining underfunded or terminated single-employer plans.

TITLE II--FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS AND RELATED PROVISIONS

Subtitle A--Amendments to Employee Retirement Income Security Act of 1974

Sec. 201. Funding rules for multiemployer defined benefit plans.
Sec. 202. Additional funding rules for multiemployer plans in endangered or critical status.
Sec. 203. Measures to forestall insolvency of multiemployer plans.
Sec. 204. Withdrawal liability reforms.
Sec. 205. Prohibition on retaliation against employers exercising their rights to petition the Federal Government.
Sec. 206. Special rule for certain benefits funded under an agreement approved by the Pension Benefit Guaranty Corporation.

Subtitle B--Amendments to Internal Revenue Code of 1986

Sec. 211. Funding rules for multiemployer defined benefit plans.
Sec. 212. Additional funding rules for multiemployer plans in endangered or critical status.
Sec. 213. Measures to forestall insolvency of multiemployer plans.
Sec. 214. Exemption from excise taxes for certain multiemployer pension

plans.
Subtitle C--Sunset of Additional Funding Rules
Sec. 221. Sunset of additional funding rules.
TITLE III--INTEREST RATE ASSUMPTIONS
Sec. 301. Extension of replacement of 30-year Treasury rates.
Sec. 302. Interest rate assumption for determination of lump sum distributions.
Sec. 303. Interest rate assumption for applying benefit limitations to lump sum distributions.
TITLE IV--PBGC GUARANTEE AND RELATED PROVISIONS
Sec. 401. PBGC premiums.
Sec. 402. Special funding rules for certain plans maintained by commercial airlines.
Sec. 403. Limitation on PBGC guarantee of shutdown and other benefits.
Sec. 404. Rules relating to bankruptcy of employer.
Sec. 405. PBGC premiums for small plans.
Sec. 406. Authorization for PBGC to pay interest on premium overpayment refunds.
Sec. 407. Rules for substantial owner benefits in terminated plans.
Sec. 408. Acceleration of PBGC computation of benefits attributable to recoveries from employers.
Sec. 409. Treatment of certain plans where cessation or change in membership of a controlled group.
Sec. 410. Missing participants.
Sec. 411. Director of the Pension Benefit Guaranty Corporation.
Sec. 412. Inclusion of information in the PBGC annual report.
TITLE V--DISCLOSURE
Sec. 501. Defined benefit plan funding notice.
Sec. 502. Access to multiemployer pension plan information.
Sec. 503. Additional annual reporting requirements.
Sec. 504. Electronic display of annual report information.
Sec. 505. Section 4010 filings with the PBGC.
Sec. 506. Disclosure of termination information to plan participants.
Sec. 507. Notice of freedom to divest employer securities.
Sec. 508. Periodic pension benefit statements.
Sec. 509. Notice to participants or beneficiaries of blackout periods.
TITLE VI--INVESTMENT ADVICE, PROHIBITED TRANSACTIONS, AND FIDUCIARY RULES
Subtitle A--Investment Advice
Sec. 601. Prohibited transaction exemption for provision of investment advice.
Subtitle B--Prohibited Transactions
Sec. 611. Prohibited transaction rules relating to financial investments.
Sec. 612. Correction period for certain transactions involving securities and commodities.
Subtitle C--Fiduciary and Other Rules
Sec. 621. Inapplicability of relief from fiduciary liability during suspension of ability of participant or beneficiary to direct investments.
Sec. 622. Increase in maximum bond amount.
Sec. 623. Increase in penalties for coercive interference with exercise of ERISA rights.
Sec. 624. Treatment of investment of assets by plan where participant fails to exercise investment election.
Sec. 625. Clarification of fiduciary rules.
TITLE VII--BENEFIT ACCRUAL STANDARDS
Sec. 701. Benefit accrual standards.
Sec. 702. Regulations relating to mergers and acquisitions.
TITLE VIII--PENSION RELATED REVENUE PROVISIONS
Subtitle A--Deduction Limitations
Sec. 801. Increase in deduction limit for single-employer plans.
Sec. 802. Deduction limits for multiemployer plans.
Sec. 803. Updating deduction rules for combination of plans.
Subtitle B--Certain Pension Provisions Made Permanent
Sec. 811. Pensions and individual retirement arrangement provisions of Economic Growth and Tax Relief Reconciliation Act of 2001

made permanent.
Sec. 812. Saver's credit.
Subtitle C--Improvements in Portability, Distribution, and Contribution Rules
Sec. 821. Clarifications regarding purchase of permissive service credit.
Sec. 822. Allow rollover of after-tax amounts in annuity contracts.
Sec. 823. Clarification of minimum distribution rules for governmental plans.
Sec. 824. Allow direct rollovers from retirement plans to Roth IRAs.
Sec. 825. Eligibility for participation in retirement plans.
Sec. 826. Modifications of rules governing hardships and unforseen financial emergencies.
Sec. 827. Penalty-free withdrawals from retirement plans for individuals called to active duty for at least 179 days.
Sec. 828. Waiver of 10 percent early withdrawal penalty tax on certain distributions of pension plans for public safety employees.
Sec. 829. Allow rollovers by nonspouse beneficiaries of certain retirement plan distributions.
Sec. 830. Direct payment of tax refunds to individual retirement plans.
Sec. 831. Allowance of additional IRA payments in certain bankruptcy cases.
Sec. 832. Determination of average compensation for section 415 limits.
Sec. 833. Inflation indexing of gross income limitations on certain retirement savings incentives.
Subtitle D--Health and Medical Benefits
Sec. 841. Use of excess pension assets for future retiree health benefits and collectively bargained retiree health benefits.
Sec. 842. Transfer of excess pension assets to multiemployer health plan.
Sec. 843. Allowance of reserve for medical benefits of plans sponsored by bona fide associations.
Sec. 844. Treatment of annuity and life insurance contracts with a long-term care insurance feature.
Sec. 845. Distributions from governmental retirement plans for health and long-term care insurance for public safety officers.
Subtitle E--United States Tax Court Modernization
Sec. 851. Cost-of-living adjustments for Tax Court judicial survivor annuities.
Sec. 852. Cost of life insurance coverage for Tax Court judges age 65 or over.
Sec. 853. Participation of Tax Court judges in the Thrift Savings Plan.
Sec. 854. Annuities to surviving spouses and dependent children of special trial judges of the Tax Court.
Sec. 855. Jurisdiction of Tax Court over collection due process cases.
Sec. 856. Provisions for recall.
Sec. 857. Authority for special trial judges to hear and decide certain employment status cases.
Sec. 858. Confirmation of authority of Tax Court to apply doctrine of equitable recoupment.
Sec. 859. Tax Court filing fee in all cases commenced by filing petition.
Sec. 860. Expanded use of Tax Court practice fee for pro se taxpayers.
Subtitle F--Other Provisions
Sec. 861. Extension to all governmental plans of current moratorium on application of certain nondiscrimination rules applicable to State and local plans.
Sec. 862. Elimination of aggregate limit for usage of excess funds from black lung disability trusts.
Sec. 863. Treatment of death benefits from corporate-owned life insurance.
Sec. 864. Treatment of test room supervisors and proctors who assist in the administration of college entrance and placement exams.
Sec. 865. Grandfather rule for church plans which self-annuitize.
Sec. 866. Exemption for income from leveraged real estate held by church plans.
Sec. 867. Church plan rule.
Sec. 868. Gratuitous transfer for benefits of employees.
TITLE IX--INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION AND OTHER PENSION PROVISIONS

Sec. 901. Defined contribution plans required to provide employees with freedom to invest their plan assets.
Sec. 902. Increasing participation through automatic contribution arrangements.
Sec. 903. Treatment of eligible combined defined benefit plans and qualified cash or deferred arrangements.
Sec. 904. Faster vesting of employer nonelective contributions.
Sec. 905. Distributions during working retirement.
Sec. 906. Treatment of certain pension plans of Indian tribal governments.
TITLE X--PROVISIONS RELATING TO SPOUSAL PENSION PROTECTION
Sec. 1001. Regulations on time and order of issuance of domestic relations orders.
Sec. 1002. Entitlement of divorced spouses to railroad retirement annuities independent of actual entitlement of employee.
Sec. 1003. Extension of tier II railroad retirement benefits to surviving former spouses pursuant to divorce agreements.
Sec. 1004. Requirement for additional survivor annuity option.
TITLE XI--ADMINISTRATIVE PROVISIONS
Sec. 1101. Employee plans compliance resolution system.
Sec. 1102. Notice and consent period regarding distributions.
Sec. 1103. Reporting simplification.
Sec. 1104. Voluntary early retirement incentive and employment retention plans maintained by local educational agencies and other entities.
Sec. 1105. No reduction in unemployment compensation as a result of pension rollovers.
Sec. 1106. Revocation of election relating to treatment as multiemployer plan.
Sec. 1107. Provisions relating to plan amendments.
TITLE XII--PROVISIONS RELATING TO EXEMPT ORGANIZATIONS
Subtitle A--Charitable Giving Incentives
Sec. 1201. Tax-free distributions from individual retirement plans for charitable purposes.
Sec. 1202. Extension of modification of charitable deduction for contributions of food inventory.
Sec. 1203. Basis adjustment to stock of S corporation contributing property.
Sec. 1204. Extension of modification of charitable deduction for contributions of book inventory.
Sec. 1205. Modification of tax treatment of certain payments to controlling exempt organizations.
Sec. 1206. Encouragement of contributions of capital gain real property made for conservation purposes.
Sec. 1207. Excise taxes exemption for blood collector organizations.
Subtitle B--Reforming Exempt Organizations
Part 1--General Reforms
Sec. 1211. Reporting on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold an interest.
Sec. 1212. Increase in penalty excise taxes relating to public charities, social welfare organizations, and private foundations.
Sec. 1213. Reform of charitable contributions of certain easements in registered historic districts and reduced deduction for portion of qualified conservation contribution attributable to rehabilitation credit.
Sec. 1214. Charitable contributions of taxidermy property.
Sec. 1215. Recapture of tax benefit for charitable contributions of exempt use property not used for an exempt use.
Sec. 1216. Limitation of deduction for charitable contributions of clothing and household items.
Sec. 1217. Modification of recordkeeping requirements for certain charitable contributions.
Sec. 1218. Contributions of fractional interests in tangible personal property.
Sec. 1219. Provisions relating to substantial and gross overstatements of valuations.
Sec. 1220. Additional standards for credit counseling organizations.
Sec. 1221. Expansion of the base of tax on private foundation net

investment income.
Sec. 1222. Definition of convention or association of churches.
Sec. 1223. Notification requirement for entities not currently required to file.
Sec. 1224. Disclosure to State officials relating to exempt organizations.
Sec. 1225. Public disclosure of information relating to unrelated business income tax returns.
Sec. 1226. Study on donor advised funds and supporting organizations.
Part 2--Improved Accountability of Donor Advised Funds
Sec. 1231. Excise taxes relating to donor advised funds.
Sec. 1232. Excess benefit transactions involving donor advised funds and sponsoring organizations.
Sec. 1233. Excess business holdings of donor advised funds.
Sec. 1234. Treatment of charitable contribution deductions to donor advised funds.
Sec. 1235. Returns of, and applications for recognition by, sponsoring organizations.
Part 3--Improved Accountability of Supporting Organizations
Sec. 1241. Requirements for supporting organizations.
Sec. 1242. Excess benefit transactions involving supporting organizations.
Sec. 1243. Excess business holdings of supporting organizations.
Sec. 1244. Treatment of amounts paid to supporting organizations by private foundations.
Sec. 1245. Returns of supporting organizations.
TITLE XIII--OTHER PROVISIONS
Sec. 1301. Technical corrections relating to mine safety.
Sec. 1302. Going-to-the-sun road.
Sec. 1303. Exception to the local furnishing requirement of the tax-exempt bond rules.
Sec. 1304. Qualified tuition programs.
TITLE XIV--TARIFF PROVISIONS
Sec. 1401. Short title; table of contents.

TITLE I--REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

Subtitle A--Amendments to Employee Retirement Income Security Act of 1974

SEC. 101. MINIMUM FUNDING STANDARDS.

(a) Repeal of Existing Funding Rules.--Sections 302 through 308 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1082 through 1086) are repealed.

(b) New Minimum Funding Standards.--Part 3 of subtitle B of title I of such Act (as amended by subsection (a)) is amended by inserting after section 301 the following new section:

``SEC. 302. MINIMUM FUNDING STANDARDS.

``(a) Requirement To Meet Minimum Funding Standard.--

``(1) In general.--A plan to which this part applies shall satisfy the minimum funding standard applicable to the plan for any plan year.

``(2) Minimum funding standard.--For purposes of paragraph (1), a plan shall be treated as satisfying the minimum funding standard for a plan year if--

``(A) in the case of a defined benefit plan which is a single-employer plan, the employer makes contributions to or under the plan for the plan year which, in the aggregate, are not less than the minimum required contribution determined under section 303 for the plan for the plan year,

``(B) in the case of a money purchase plan which is a single-employer plan, the employer makes contributions to or under the plan for the plan year which are required under the terms of the plan, and

``(C) in the case of a multiemployer plan, the employers make contributions to or under the plan for any plan year which, in the aggregate, are sufficient to ensure that the plan does not have an accumulated funding deficiency under section 304 as of the end of the plan year.

``(b) Liability for Contributions.--

``(1) In general.--Except as provided in paragraph (2), the amount of any contribution required by this section (including any required installments under paragraphs (3) and (4) of section 303(j)) shall be paid by the employer responsible for making contributions to or under the plan.

``(2) Joint and several liability where employer member of controlled group.--If the employer referred to in paragraph (1) is a member of a controlled group, each member of such group shall be jointly and severally liable for payment of such contributions.

``(c) Variance From Minimum Funding Standards.--

``(1) Waiver in case of business hardship.--

``(A) In general.--If--

``(i) an employer is (or in the case of a multiemployer plan, 10 percent or more of the number of employers contributing to or under the plan is) unable to satisfy the minimum funding standard for a plan year without temporary substantial business hardship (substantial business hardship in the case of a multiemployer plan), and

``(ii) application of the standard would be adverse to the interests of plan participants in the aggregate,

the Secretary of the Treasury may, subject to subparagraph (C), waive the requirements of subsection (a) for such year with respect to all or any portion of the minimum funding standard. The Secretary of the Treasury shall not waive the minimum funding standard with respect to a plan for more than 3 of any 15 (5 of any 15 in the case of a multiemployer plan) consecutive plan years.

``(B) Effects of waiver.--If a waiver is granted under subparagraph (A) for any plan year--

``(i) in the case of a single-employer plan, the minimum required contribution under section 303 for the plan year shall be reduced by the amount of the waived funding deficiency and such amount shall be amortized as required under section 303(e), and

``(ii) in the case of a multiemployer plan, the funding standard account shall be credited under section 304(b)(3)(C) with the amount of the waived funding deficiency and such amount shall be amortized as required under section 304(b)(2)(C).

``(C) Waiver of amortized portion not allowed.--The Secretary of the Treasury may not waive under subparagraph (A) any portion of the minimum funding standard under subsection (a) for a plan year which is attributable to any waived funding deficiency for any preceding plan year.

``(2) Determination of business hardship.--For purposes of this subsection, the factors taken into account in determining temporary substantial business hardship (substantial business hardship in the case of a multiemployer plan) shall include (but shall not be limited to) whether or not--

``(A) the employer is operating at an economic loss,

``(B) there is substantial unemployment or underemployment in the trade or business and in the industry concerned,

``(C) the sales and profits of the industry concerned are depressed or declining, and

``(D) it is reasonable to expect that the plan will be continued only if the waiver is granted.

``(3) Waived funding deficiency.--For purposes of this part, the term `waived funding deficiency' means the portion of the minimum funding standard under subsection (a) (determined without regard to the waiver) for a plan year waived by the Secretary of the Treasury and not satisfied by employer contributions.

``(4) Security for waivers for single-employer plans, consultations.--

``(A) Security may be required.--

``(i) In general.--Except as provided in subparagraph (C), the Secretary of the Treasury may require an employer maintaining a defined benefit plan which is a single-employer plan (within the meaning of section 4001(a)(15)) to provide security to such plan as a condition for granting or modifying a waiver under paragraph (1).

``(ii) Special rules.--Any security provided under clause (i) may be perfected and enforced only by the Pension Benefit Guaranty Corporation, or at the direction of the Corporation, by a contributing sponsor (within the meaning of section 4001(a)(13)), or a member of such

sponsor's controlled group (within the meaning of
section 4001(a)(14)).
``(B) Consultation with the pension benefit guaranty
corporation.--Except as provided in subparagraph (C),
the Secretary of the Treasury shall, before granting or
modifying a waiver under this subsection with respect to
a plan described in subparagraph (A)(i)--
``(i) provide the Pension Benefit Guaranty
Corporation with--
``(I) notice of
the completed application for any waiver
or modification, and
``(II) an
opportunity to comment on such
application within 30 days after receipt
of such notice, and
``(ii) consider--
``(I) any comments of the
Corporation under clause (i)(II), and
``(II) any views of any employee
organization (within the meaning of
section 3(4)) representing participants
in the plan which are submitted in
writing to the Secretary of the Treasury
in connection with such application.
Information provided to the Corporation under this
subparagraph shall be considered tax return information
and subject to the safeguarding and reporting
requirements of section 6103(p) of the Internal Revenue
Code of 1986.
``(C) Exception for certain waivers.--
``(i) In general.--The preceding provisions of
this paragraph shall not apply to any plan with
respect to which the sum of--
``(I) the aggregate unpaid minimum
required contributions for the plan year
and all preceding plan years, and
``(II) the present value of all
waiver amortization installments
determined for the plan year and
succeeding plan years under section
303(e)(2),
is less than $1,000,000.
``(ii) Treatment of waivers for which
applications are pending.--The amount described in
clause (i)(I) shall include any increase in such
amount which would result if all applications for
waivers of the minimum funding standard under this
subsection which are pending with respect to such
plan were denied.
``(iii) Unpaid minimum required
contribution.--For purposes of this subparagraph--
``(I) In general.--The term `unpaid
minimum required contribution' means,
with respect to any plan year, any
minimum required contribution under
section 303 for the plan year which is
not paid on or before the due date (as
determined under section 303(j)(1)) for
the plan year.
``(II) Ordering rule.--For purposes
of subclause (I), any payment to or
under a plan for any plan year shall be
allocated first to unpaid minimum
required contributions for all preceding
plan years on a first-in, first-out
basis and then to the minimum required
contribution under section 303 for the
plan year.
``(5) Special rules for single-employer plans.--
``(A) Application must be submitted before date 2\1/
2\ months after close of year.--
In the case of a single-employer
plan, no waiver may be granted under this subsection
with respect to any plan for any plan year unless an
application therefor is submitted to the Secretary of
the Treasury not later than the 15th day of the 3rd
month beginning after the close of such plan year.
``(B) Special rule if employer is member of
controlled group.--In the case of a single-employer
plan, if an employer is a member of a controlled group,
the temporary substantial business hardship requirements

of paragraph (1) shall be treated as met only if such requirements are met--

``(i) with respect to such employer, and

``(ii) with respect to the controlled group of which such employer is a member (determined by treating all members of such group as a single employer).

The Secretary of the Treasury may provide that an analysis of a trade or business or industry of a member need not be conducted if such Secretary determines such analysis is not necessary because the taking into account of such member would not significantly affect the determination under this paragraph.

``(6) Advance notice.--

``(A) In general.--The Secretary of the Treasury shall, before granting a waiver under this subsection, require each applicant to provide evidence satisfactory to such Secretary that the applicant has provided notice of the filing of the application for such waiver to each affected party (as defined in section 4001(a)(21)). Such notice shall include a description of the extent to which the plan is funded for benefits which are guaranteed under title IV and for benefit liabilities.

``(B) Consideration of relevant information.--The Secretary of the Treasury shall consider any relevant information provided by a person to whom notice was given under subparagraph (A).

``(7) Restriction on plan amendments.--

``(A) In general.--No amendment of a plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan shall be adopted if a waiver under this subsection or an extension of time under section 304(d) is in effect with respect to the plan, or if a plan amendment described in subsection (d)(2) has been made at any time in the preceding 12 months (24 months in the case of a multiemployer plan). If a plan is amended in violation of the preceding sentence, any such waiver, or extension of time, shall not apply to any plan year ending on or after the date on which such amendment is adopted.

``(B) Exception.--Subparagraph (A) shall not apply to any plan amendment which--

``(i) the Secretary of the Treasury determines to be reasonable and which provides for only de minimis increases in the liabilities of the plan,

``(ii) only repeals an amendment described in subsection (d)(2), or

``(iii) is required as a condition of qualification under part I of subchapter D of chapter 1 of the Internal Revenue Code of 1986.

``(8) Cross reference.--For corresponding duties of the Secretary of the Treasury with regard to implementation of the Internal Revenue Code of 1986, see section 412(c) of such Code.

``(d) Miscellaneous Rules.--

``(1) Change in method or year.--If the funding method, the valuation date, or a plan year for a plan is changed, the change shall take effect only if approved by the Secretary of the Treasury.

``(2) Certain retroactive plan amendments.--For purposes of this section, any amendment applying to a plan year which--

``(A) is adopted after the close of such plan year but no later than 2\1/2\ months after the close of the plan year (or, in the case of a multiemployer plan, no later than 2 years after the close of such plan year),

``(B) does not reduce the accrued benefit of any participant determined as of the beginning of the first plan year to which the amendment applies, and

``(C) does not reduce the accrued benefit of any participant determined as of the time of adoption except to the extent required by the circumstances,

shall, at the election of the plan administrator, be deemed to have been made on the first day of such plan year. No amendment described in this paragraph which reduces the accrued benefits of any participant shall take effect unless the plan administrator files a notice with the Secretary of the Treasury notifying him of such amendment and such Secretary has approved such amendment, or within 90 days after the date on which such notice was filed, failed to disapprove such amendment. No amendment described in this subsection shall be approved by the

Secretary of the Treasury unless such Secretary determines that such amendment is necessary because of a temporary substantial business hardship (as determined under subsection (c)(2)) or a substantial business hardship (as so determined) in the case of a multiemployer plan and that a waiver under subsection (c) (or, in the case of a multiemployer plan, any extension of the amortization period under section 304(d)) is unavailable or inadequate.

``(3) Controlled group.--For purposes of this section, the term `controlled group' means any group treated as a single employer under subsection (b), (c), (m), or (o) of section 414 of the Internal Revenue Code of 1986.''.

(c) Clerical Amendment.--The table of contents in section 1 of such Act is amended by striking the items relating to sections 302 through 308 and inserting the following new item:

``Sec. 302. Minimum funding standards.''.

(d) Effective Date.--The amendments made by this section shall apply to plan years beginning after 2007.

SEC. 102. FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS.

(a) In General.--Part 3 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 (as amended by section 101 of this Act) is amended by inserting after section 302 the following new section:

``SEC. 303. MINIMUM FUNDING STANDARDS FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS.

``(a) Minimum Required Contribution.--For purposes of this section and section 302(a)(2)(A), except as provided in subsection (f), the term `minimum required contribution' means, with respect to any plan year of a single-employer plan--

``(1) in any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) is less than the funding target of the plan for the plan year, the sum of--

``(A) the target normal cost of the plan for the plan year,

``(B) the shortfall amortization charge (if any) for the plan for the plan year determined under subsection (c), and

``(C) the waiver amortization charge (if any) for the plan for the plan year as determined under subsection (e); or

``(2) in any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) equals or exceeds the funding target of the plan for the plan year, the target normal cost of the plan for the plan year reduced (but not below zero) by such excess.

``(b) Target Normal Cost.--For purposes of this section, except as provided in subsection (i)(2) with respect to plans in at-risk status, the term `target normal cost' means, for any plan year, the present value of all benefits which are expected to accrue or to be earned under the plan during the plan year. For purposes of this subsection, if any benefit attributable to services performed in a preceding plan year is increased by reason of any increase in compensation during the current plan year, the increase in such benefit shall be treated as having accrued during the current plan year.

``(c) Shortfall Amortization Charge.--

``(1) In general.--For purposes of this section, the shortfall amortization charge for a plan for any plan year is the aggregate total (not less than zero) of the shortfall amortization installments for such plan year with respect to the shortfall amortization bases for such plan year and each of the 6 preceding plan years.

``(2) Shortfall amortization installment.--For purposes of paragraph (1)--

``(A) Determination.--The shortfall amortization installments are the amounts necessary to amortize the shortfall amortization base of the plan for any plan year in level annual installments over the 7-plan-year period beginning with such plan year.

``(B) Shortfall installment.--The shortfall amortization installment for any plan year in the 7-plan-year period under subparagraph (A) with respect to any shortfall amortization base is the annual installment determined under subparagraph (A) for that year for that base.

``(C) Segment rates.--In determining any shortfall amortization installment under this paragraph, the plan sponsor shall use the segment rates determined under subparagraph (C) of subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2).

``(3) Shortfall amortization base.--For purposes of this

section, the shortfall amortization base of a plan for a plan year is--
``(A) the funding shortfall of such plan for such plan year, minus
``(B) the present value (determined using the segment rates determined under subparagraph (C) of subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2)) of the aggregate total of the shortfall amortization installments and waiver amortization installments which have been determined for such plan year and any succeeding plan year with respect to the shortfall amortization bases and waiver amortization bases of the plan for any plan year preceding such plan year.
``(4) Funding shortfall.--For purposes of this section, the funding shortfall of a plan for any plan year is the excess (if any) of--
``(A) the funding target of the plan for the plan year, over
``(B) the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) for the plan year which are held by the plan on the valuation date.
``(5) Exemption from new shortfall amortization base.--
``(A) In general.--In any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(A)) is equal to or greater than the funding target of the plan for the plan year, the shortfall amortization base of the plan for such plan year shall be zero.
``(B) Transition rule.--
``(i) In general.--Except as provided in clauses (iii) and (iv), in the case of plan years beginning after 2007 and before 2011, only the applicable percentage of the funding target shall be taken into account under paragraph (3)(A) in determining the funding shortfall for the plan year for purposes of subparagraph (A).
``(ii) Applicable percentage.--For purposes of subparagraph (A), the applicable percentage shall be determined in accordance with the following table:

``In the case of a plan year beginning in calendar year:	The applicable percentage is:
2008	92
2009	94
2010	96.

``(iii) Limitation.--Clause (i) shall not apply with respect to any plan year after 2008 unless the shortfall amortization base for each of the preceding years beginning after 2007 was zero (determined after application of this subparagraph).
``(iv) Transition relief not available for new or deficit reduction plans.--Clause (i) shall not apply to a plan--
``(I) which was not in effect for a plan year beginning in 2007, or
``(II) which was in effect for a plan year beginning in 2007 and which was subject to section 302(d) (as in effect for plan years beginning in 2007), determined after the application of paragraphs (6) and (9) thereof.
``(6) Early deemed amortization upon attainment of funding target.--In any case in which the funding shortfall of a plan for a plan year is zero, for purposes of determining the shortfall amortization charge for such plan year and succeeding plan years, the shortfall amortization bases for all preceding plan years (and all shortfall amortization installments determined with respect to such bases) shall be reduced to zero.
``(d) Rules Relating to Funding Target.--For purposes of this section--
``(1) Funding target.--Except as provided in subsection (i)(1) with respect to plans in at-risk status, the funding target of a plan for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year.
``(2) Funding target attainment percentage.--The `funding target attainment percentage' of a plan for a plan year is the ratio (expressed as a percentage) which--

``(A) the value of plan assets for the plan year (as reduced under subsection (f)(4)(B)), bears to
``(B) the funding target of the plan for the plan year (determined without regard to subsection (i)(1)).
``(e) Waiver Amortization Charge.--
``(1) Determination of waiver amortization charge.--The waiver amortization charge (if any) for a plan for any plan year is the aggregate total of the waiver amortization installments for such plan year with respect to the waiver amortization bases for each of the 5 preceding plan years.
``(2) Waiver amortization installment.--For purposes of paragraph (1)--
``(A) Determination.--The waiver amortization installments are the amounts necessary to amortize the waiver amortization base of the plan for any plan year in level annual installments over a period of 5 plan years beginning with the succeeding plan year.
``(B) Waiver installment.--The waiver amortization installment for any plan year in the 5-year period under subparagraph (A) with respect to any waiver amortization base is the annual installment determined under subparagraph (A) for that year for that base.
``(3) Interest rate.--In determining any waiver amortization installment under this subsection, the plan sponsor shall use the segment rates determined under subparagraph (C) of subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2).
``(4) Waiver amortization base.--The waiver amortization base of a plan for a plan year is the amount of the waived funding deficiency (if any) for such plan year under section 302(c).
``(5) Early deemed amortization upon attainment of funding target.--In any case in which the funding shortfall of a plan for a plan year is zero, for purposes of determining the waiver amortization charge for such plan year and succeeding plan years, the waiver amortization bases for all preceding plan years (and all waiver amortization installments determined with respect to such bases) shall be reduced to zero.
``(f) Reduction of Minimum Required Contribution by Prefunding Balance and Funding Standard Carryover Balance.--
``(1) Election to maintain balances.--
``(A) Prefunding balance.--The plan sponsor of a single-employer plan may elect to maintain a prefunding balance.
``(B) Funding standard carryover balance.--
``(i) In general.--In the case of a single-employer plan described in clause (ii), the plan sponsor may elect to maintain a funding standard carryover balance, until such balance is reduced to zero.
``(ii) Plans maintaining funding standard account in 2007.--A plan is described in this clause if the plan--
``(I) was in effect for a plan year beginning in 2007, and
``(II) had a positive balance in the funding standard account under section 302(b) as in effect for such plan year and determined as of the end of such plan year.
``(2) Application of balances.--A prefunding balance and a funding standard carryover balance maintained pursuant to this paragraph--
``(A) shall be available for crediting against the minimum required contribution, pursuant to an election under paragraph (3),
``(B) shall be applied as a reduction in the amount treated as the value of plan assets for purposes of this section, to the extent provided in paragraph (4), and
``(C) may be reduced at any time, pursuant to an election under paragraph (5).
``(3) Election to apply balances against minimum required contribution.--
``(A) In general.--Except as provided in subparagraphs (B) and (C), in the case of any plan year in which the plan sponsor elects to credit against the minimum required contribution for the current plan year all or a portion of the prefunding balance or the funding standard carryover balance for the current plan year (not in excess of such minimum required contribution), the minimum required contribution for the plan year shall be reduced as of the first day of the

plan year by the amount so credited by the plan sponsor. For purposes of the preceding sentence, the minimum required contribution shall be determined after taking into account any waiver under section 302(c).

``(B) Coordination with funding standard carryover balance.--To the extent that any plan has a funding standard carryover balance greater than zero, no amount of the prefunding balance of such plan may be credited under this paragraph in reducing the minimum required contribution.

``(C) Limitation for underfunded plans.--The preceding provisions of this paragraph shall not apply for any plan year if the ratio (expressed as a percentage) which--

``(i) the value of plan assets for the preceding plan year (as reduced under paragraph (4)(C)), bears to

``(ii) the funding target of the plan for the preceding plan year (determined without regard to subsection (i)(1)),

is less than 80 percent. In the case of plan years beginning in 2008, the ratio under this subparagraph may be determined using such methods of estimation as the Secretary of the Treasury may prescribe.

``(4) Effect of balances on amounts treated as value of plan assets.--In the case of any plan maintaining a prefunding balance or a funding standard carryover balance pursuant to this subsection, the amount treated as the value of plan assets shall be deemed to be such amount, reduced as provided in the following subparagraphs:

``(A) Applicability of shortfall amortization base.--For purposes of subsection (c)(5), the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance, but only if an election under paragraph (2) applying any portion of the prefunding balance in reducing the minimum required contribution is in effect for the plan year.

``(B) Determination of excess assets, funding shortfall, and funding target attainment percentage.--

``(i) In general.--For purposes of subsections (a), (c)(4)(B), and (d)(2)(A), the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance and the funding standard carryover balance.

``(ii) Special rule for certain binding agreements with pbgc.--For purposes of subsection (c)(4)(B), the value of plan assets shall not be deemed to be reduced for a plan year by the amount of the specified balance if, with respect to such balance, there is in effect for a plan year a binding written agreement with the Pension Benefit Guaranty Corporation which provides that such balance is not available to reduce the minimum required contribution for the plan year. For purposes of the preceding sentence, the term `specified balance' means the prefunding balance or the funding standard carryover balance, as the case may be.

``(C) Availability of balances in plan year for crediting against minimum required contribution.--For purposes of paragraph (3)(C)(i) of this subsection, the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance.

``(5) Election to reduce balance prior to determinations of value of plan assets and crediting against minimum required contribution.--

``(A) In general.--The plan sponsor may elect to reduce by any amount the balance of the prefunding balance and the funding standard carryover balance for any plan year (but not below zero). Such reduction shall be effective prior to any determination of the value of plan assets for such plan year under this section and application of the balance in reducing the minimum required contribution for such plan for such plan year pursuant to an election under paragraph (2).

``(B) Coordination between prefunding balance and funding standard carryover balance.--To the extent that any plan has a funding standard carryover balance greater than zero, no election may be made under subparagraph (A) with respect to the prefunding balance.

``(6) Prefunding balance.--

``(A) In general.--A prefunding balance maintained

by a plan shall consist of a beginning balance of zero, increased and decreased to the extent provided in subparagraphs (B) and (C), and adjusted further as provided in paragraph (8).

``(B) Increases.--

``(i) In general.--As of the first day of each plan year beginning after 2008, the prefunding balance of a plan shall be increased by the amount elected by the plan sponsor for the plan year. Such amount shall not exceed the excess (if any) of--

``(I) the aggregate total of employer contributions to the plan for the preceding plan year, over--

``(II) the minimum required contribution for such preceding plan year.

``(ii) Adjustments for interest.--Any excess contributions under clause (i) shall be properly adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined by using the effective interest rate for the preceding plan year and by treating contributions as being first used to satisfy the minimum required contribution.

``(iii) Certain contributions necessary to avoid benefit limitations disregarded.--The excess described in clause (i) with respect to any preceding plan year shall be reduced (but not below zero) by the amount of contributions an employer would be required to make under paragraph (1), (2), or (4) of section 206(g) to avoid a benefit limitation which would otherwise be imposed under such paragraph for the preceding plan year. Any contribution which may be taken into account in satisfying the requirements of more than 1 of such paragraphs shall be taken into account only once for purposes of this clause.

``(C) Decrease.--The prefunding balance of a plan shall be decreased (but not below zero) by--

``(i) as of the first day of each plan year after 2008, the amount of such balance credited under paragraph (2) (if any) in reducing the minimum required contribution of the plan for the preceding plan year, and

``(ii) as of the time specified in paragraph (5)(A), any reduction in such balance elected under paragraph (5).

``(7) Funding standard carryover balance.--

``(A) In general.--A funding standard carryover balance maintained by a plan shall consist of a beginning balance determined under subparagraph (B), decreased to the extent provided in subparagraph (C), and adjusted further as provided in paragraph (8).

``(B) Beginning balance.--The beginning balance of the funding standard carryover balance shall be the positive balance described in paragraph (1)(B)(ii)(II).

``(C) Decreases.--The funding standard carryover balance of a plan shall be decreased (but not below zero) by--

``(i) as of the first day of each plan year after 2008, the amount of such balance credited under paragraph (2) (if any) in reducing the minimum required contribution of the plan for the preceding plan year, and

``(ii) as of the time specified in paragraph (5)(A), any reduction in such balance elected under paragraph (5).

``(8) Adjustments for investment experience.--In determining the prefunding balance or the funding standard carryover balance of a plan as of the first day of the plan year, the plan sponsor shall, in accordance with regulations prescribed by the Secretary of the Treasury, adjust such balance to reflect the rate of return on plan assets for the preceding plan year. Notwithstanding subsection (g)(3), such rate of return shall be determined on the basis of fair market value and shall properly take into account, in accordance with such regulations, all contributions, distributions, and other plan payments made during such period.

``(9) Elections.--Elections under this subsection shall be made at such times, and in such form

and manner, as shall be prescribed in regulations of the Secretary of the Treasury.

``(g) Valuation of Plan Assets and Liabilities.--

``(1) Timing of determinations.--Except as otherwise provided under this subsection, all determinations under this section for a plan year shall be made as of the valuation date of the plan for such plan year.

``(2) Valuation date.--For purposes of this section--

``(A) In general.--Except as provided in subparagraph (B), the valuation date of a plan for any plan year shall be the first day of the plan year.

``(B) Exception for small plans.--If, on each day during the preceding plan year, a plan had 100 or fewer participants, the plan may designate any day during the plan year as its valuation date for such plan year and succeeding plan years. For purposes of this subparagraph, all defined benefit plans which are single-employer plans and are maintained by the same employer (or any member of such employer's controlled group) shall be treated as 1 plan, but only participants with respect to such employer or member shall be taken into account.

``(C) Application of certain rules in determination of plan size.--For purposes of this paragraph--

``(i) Plans not in existence in preceding year.--In the case of the first plan year of any plan, subparagraph (B) shall apply to such plan by taking into account the number of participants that the plan is reasonably expected to have on days during such first plan year.

``(ii) Predecessors.--Any reference in subparagraph (B) to an employer shall include a reference to any predecessor of such employer.

``(3) Determination of value of plan assets.--For purposes of this section--

``(A) In general.--Except as provided in subparagraph (B), the value of plan assets shall be the fair market value of the assets.

``(B) Averaging allowed.--A plan may determine the value of plan assets on the basis of the averaging of fair market values, but only if such method--

``(i) is permitted under regulations prescribed by the Secretary of the Treasury,

``(ii) does not provide for averaging of such values over more than the period beginning on the last day of the 25th month preceding the month in which the valuation date occurs and ending on the valuation date (or a similar period in the case of a valuation date which is not the 1st day of a month), and

``(iii) does not result in a determination of the value of plan assets which, at any time, is lower than 90 percent or greater than 110 percent of the fair market value of such assets at such time.

Any such averaging shall be adjusted for contributions and distributions (as provided by the Secretary of the Treasury).

``(4) Accounting for contribution receipts.--For purposes of determining the value of assets under paragraph (3)--

``(A) Prior year contributions.--If--

``(i) an employer makes any contribution to the plan after the valuation date for the plan year in which the contribution is made, and

``(ii) the contribution is for a preceding plan year,

the contribution shall be taken into account as an asset of the plan as of the valuation date, except that in the case of any plan year beginning after 2008, only the present value (determined as of the valuation date) of such contribution may be taken into account. For purposes of the preceding sentence, present value shall be determined using the effective interest rate for the preceding plan year to which the contribution is properly allocable.

``(B) Special rule for current year contributions made before valuation date.--If any contributions for any plan year are made to or under the plan during the plan year but before the valuation date for the plan year, the assets of the plan as of the valuation date shall not include--

``(i) such contributions, and

``(ii) interest on such contributions for the period between the date of the contributions and the valuation date, determined by using the effective interest rate for the plan year.

``(h) Actuarial Assumptions and Methods.--

``(1) In general.--Subject to this subsection, the determination of any present value or other computation under this section shall be made on the basis of actuarial assumptions and methods--

``(A) each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and

``(B) which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

``(2) Interest rates.--

``(A) Effective interest rate.--For purposes of this section, the term `effective interest rate' means, with respect to any plan for any plan year, the single rate of interest which, if used to determine the present value of the plan's accrued or earned benefits referred to in subsection (d)(1), would result in an amount equal to the funding target of the plan for such plan year.

``(B) Interest rates for determining funding target.--For purposes of determining the funding target and normal cost of a plan for any plan year, the interest rate used in determining the present value of the benefits of the plan shall be--

``(i) in the case of benefits reasonably determined to be payable during the 5-year period beginning on the first day of the plan year, the first segment rate with respect to the applicable month,

``(ii) in the case of benefits reasonably determined to be payable during the 15-year period beginning at the end of the period described in clause (i), the second segment rate with respect to the applicable month, and

``(iii) in the case of benefits reasonably determined to be payable after the period described in clause (ii), the third segment rate with respect to the applicable month.

``(C) Segment rates.--For purposes of this paragraph--

``(i) First segment rate.--The term `first segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary of the Treasury for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during the 5-year period commencing with such month.

``(ii) Second segment rate.--The term `second segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary of the Treasury for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during the 15-year period beginning at the end of the period described in clause (i).

``(iii) Third segment rate.--The term `third segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary of the Treasury for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during periods beginning after the period described in clause (ii).

``(D) Corporate bond yield curve.--For purposes of this paragraph--

``(i) In general.--The term `corporate bond yield curve' means, with respect to any month, a yield curve which is prescribed by the Secretary of the Treasury for such month and which reflects the average, for the 24-month period ending with the month preceding such month, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top 3 quality levels available.

``(ii) Election to use yield curve.--Solely for purposes of determining the minimum required contribution under this section, the plan sponsor may, in lieu of the segment rates determined under subparagraph (C), elect to use interest rates under the corporate bond yield curve. For purposes of the preceding sentence such curve shall be determined without regard to the 24-month averaging described in clause (i). Such election, once made, may be revoked only with the consent of the Secretary of the Treasury.

``(E) Applicable month.--For purposes of this paragraph, the term `applicable month' means, with respect to any plan for any plan year, the month which includes the valuation date of such plan for such plan year or, at the election of the plan sponsor, any of the 4 months which precede such month. Any election made under this subparagraph shall apply to the plan year for which the election is made and all succeeding plan years, unless the election is revoked with the consent of the Secretary of the Treasury.

``(F) Publication requirements.--The Secretary of the Treasury shall publish for each month the corporate bond yield curve (and the corporate bond yield curve reflecting the modification described in section 205(g)(3)(B)(iii)(I)) for such month and each of the rates determined under subparagraph (B) for such month. The Secretary of the Treasury shall also publish a description of the methodology used to determine such yield curve and such rates which is sufficiently detailed to enable plans to make reasonable projections regarding the yield curve and such rates for future months based on the plan's projection of future interest rates.

``(G) Transition rule.--

``(i) In general.--Notwithstanding the preceding provisions of this paragraph, for plan years beginning in 2008 or 2009, the first, second, or third segment rate for a plan with respect to any month shall be equal to the sum of--

``(I) the product of such rate for such month determined without regard to this subparagraph, multiplied by the applicable percentage, and

``(II) the product of the rate determined under the rules of section 302(b)(5)(B)(ii)(II) (as in effect for plan years beginning in 2007), multiplied by a percentage equal to 100 percent minus the applicable percentage.

``(ii) Applicable percentage.--For purposes of clause (i), the applicable percentage is 33\1/3\ percent for plan years beginning in 2008 and 66\2/3\ percent for plan years beginning in 2009.

``(iii) New plans ineligible.--Clause (i) shall not apply to any plan if the first plan year of the plan begins after December 31, 2007.

``(iv) Election.--The plan sponsor may elect not to have this subparagraph apply. Such election, once made, may be revoked only with the consent of the Secretary of the Treasury.

``(3) Mortality tables.--

``(A) In general.--Except as provided in subparagraph (C) or (D), the Secretary of the Treasury shall by regulation prescribe mortality tables to be used in determining any present value or making any computation under this section. Such tables shall be based on the actual experience of pension plans and projected trends in such experience. In prescribing such tables, the Secretary of the Treasury shall take into account results of available independent studies of mortality of individuals covered by pension plans.

``(B) Periodic revision.--The Secretary of the Treasury shall (at least every 10 years) make revisions in any table in effect under subparagraph (A) to reflect the actual experience of pension plans and projected trends in such experience.

``(C) Substitute mortality table.--

``(i) In general.--Upon request by the plan sponsor and approval by the Secretary of the Treasury, a mortality table which meets the

requirements of clause (iii) shall be used in determining any present value or making any computation under this section during the period of consecutive plan years (not to exceed 10) specified in the request.

``(ii) Early termination of period.--Notwithstanding clause (i), a mortality table described in clause (i) shall cease to be in effect as of the earliest of--

``(I) the date on which there is a significant change in the participants in the plan by reason of a plan spinoff or merger or otherwise, or

``(II) the date on which the plan actuary determines that such table does not meet the requirements of clause (iii).

``(iii) Requirements.--A mortality table meets the requirements of this clause if--

``(I) there is a sufficient number of plan participants, and the pension plans have been maintained for a sufficient period of time, to have credible information necessary for purposes of subclause (II), and

``(II) such table reflects the actual experience of the pension plans maintained by the sponsor and projected trends in general mortality experience.

``(iv) All plans in controlled group must use separate table.--Except as provided by the Secretary of the Treasury, a plan sponsor may not use a mortality table under this subparagraph for any plan maintained by the plan sponsor unless--

``(I) a separate mortality table is established and used under this subparagraph for each other plan maintained by the plan sponsor and if the plan sponsor is a member of a controlled group, each member of the controlled group, and

``(II) the requirements of clause (iii) are met separately with respect to the table so established for each such plan, determined by only taking into account the participants of such plan, the time such plan has been in existence, and the actual experience of such plan.

``(v) Deadline for submission and disposition of application.--

``(I) Submission.--The plan sponsor shall submit a mortality table to the Secretary of the Treasury for approval under this subparagraph at least 7 months before the 1st day of the period described in clause (i).

``(II) Disposition.--Any mortality table submitted to the Secretary of the Treasury for approval under this subparagraph shall be treated as in effect as of the 1st day of the period described in clause (i) unless the Secretary of the Treasury, during the 180-day period beginning on the date of such submission, disapproves of such table and provides the reasons that such table fails to meet the requirements of clause (iii). The 180-day period shall be extended upon mutual agreement of the Secretary of the Treasury and the plan sponsor.

``(D) Separate mortality tables for the disabled.--Notwithstanding subparagraph (A)--

``(i) In general.--The Secretary of the Treasury shall establish mortality tables which may be used (in lieu of the tables under subparagraph (A)) under this subsection for individuals who are entitled to benefits under the plan on account of disability. The Secretary of the Treasury shall establish separate tables for individuals whose disabilities occur in plan years

beginning before January 1, 1995, and for individuals whose disabilities occur in plan years beginning on or after such date.

``(ii) Special rule for disabilities occurring after 1994.--In the case of disabilities occurring in plan years beginning after December 31, 1994, the tables under clause (i) shall apply only with respect to individuals described in such subclause who are disabled within the meaning of title II of the Social Security Act and the regulations thereunder.

``(iii) Periodic revision.--The Secretary of the Treasury shall (at least every 10 years) make revisions in any table in effect under clause (i) to reflect the actual experience of pension plans and projected trends in such experience.

``(4) Probability of benefit payments in the form of lump sums or other optional forms.--For purposes of determining any present value or making any computation under this section, there shall be taken into account--

``(A) the probability that future benefit payments under the plan will be made in the form of optional forms of benefits provided under the plan (including lump sum distributions, determined on the basis of the plan's experience and other related assumptions), and

``(B) any difference in the present value of such future benefit payments resulting from the use of actuarial assumptions, in determining benefit payments in any such optional form of benefits, which are different from those specified in this subsection.

``(5) Approval of large changes in actuarial assumptions.--

``(A) In general.--No actuarial assumption used to determine the funding target for a plan to which this paragraph applies may be changed without the approval of the Secretary of the Treasury.

``(B) Plans to which paragraph applies.--This paragraph shall apply to a plan only if--

``(i) the plan is a single-employer plan to which title IV applies,

``(ii) the aggregate unfunded vested benefits as of the close of the preceding plan year (as determined under section 4006(a)(3)(E)(iii)) of such plan and all other plans maintained by the contributing sponsors (as defined in section 4001(a)(13)) and members of such sponsors' controlled groups (as defined in section 4001(a)(14)) which are covered by title IV (disregarding plans with no unfunded vested benefits) exceed $50,000,000, and

``(iii) the change in assumptions (determined after taking into account any changes in interest rate and mortality table) results in a decrease in the funding shortfall of the plan for the current plan year that exceeds $50,000,000, or that exceeds $5,000,000 and that is 5 percent or more of the funding target of the plan before such change.

``(i) Special Rules for At-Risk Plans.--

``(1) Funding target for plans in at-risk status.--

``(A) In general.--In the case of a plan which is in at-risk status for a plan year, the funding target of the plan for the plan year shall be equal to the sum of--

``(i) the present value of all benefits accrued or earned under the plan as of the beginning of the plan year, as determined by using the additional actuarial assumptions described in subparagraph (B), and

``(ii) in the case of a plan which also has been in at-risk status for at least 2 of the 4 preceding plan years, a loading factor determined under subparagraph (C).

``(B) Additional actuarial assumptions.--The actuarial assumptions described in this subparagraph are as follows:

``(i) All employees who are not otherwise assumed to retire as of the valuation date but who will be eligible to elect benefits during the plan year and the 10 succeeding plan years shall be assumed to retire at the earliest retirement date

under the plan but not before the end of the plan year for which the at-risk funding target and at-risk target normal cost are being determined.

``(ii) All employees shall be assumed to elect the retirement benefit available under the plan at the assumed retirement age (determined after application of clause (i)) which would result in the highest present value of benefits.

``(C) Loading factor.--The loading factor applied with respect to a plan under this paragraph for any plan year is the sum of--

``(i) $700, times the number of participants in the plan, plus

``(ii) 4 percent of the funding target (determined without regard to this paragraph) of the plan for the plan year.

``(2) Target normal cost of at-risk plans.--In the case of a plan which is in at-risk status for a plan year, the target normal cost of the plan for such plan year shall be equal to the sum of--

``(A) the present value of all benefits which are expected to accrue or be earned under the plan during the plan year, determined using the additional actuarial assumptions described in paragraph (1)(B), plus

``(B) in the case of a plan which also has been in at-risk status for at least 2 of the 4 preceding plan years, a loading factor equal to 4 percent of the target normal cost (determined without regard to this paragraph) of the plan for the plan year.

``(3) Minimum amount.--In no event shall--

``(A) the at-risk funding target be less than the funding target, as determined without regard to this subsection, or

``(B) the at-risk target normal cost be less than the target normal cost, as determined without regard to this subsection.

``(4) Determination of at-risk status.--For purposes of this subsection--

``(A) In general.--A plan is in at-risk status for a plan year if--

``(i) the funding target attainment percentage for the preceding plan year (determined under this section without regard to this subsection) is less than 80 percent, and

``(ii) the funding target attainment percentage for the preceding plan year (determined under this section by using the additional actuarial assumptions described in paragraph (1)(B) in computing the funding target) is less than 70 percent.

``(B) Transition rule.--
In the case of plan years beginning in 2008, 2009, and 2010, subparagraph (A)(i) shall be applied by substituting the following percentages for `80 percent':

``(i) 65 percent in the case of 2008.

``(ii) 70 percent in the case of 2009.

``(iii) 75 percent in the case of 2010.

In the case of plan years beginning in 2008, the funding target attainment percentage for the preceding plan year under subparagraph (A)(ii) may be determined using such methods of estimation as the Secretary of the Treasury may provide.

``(C) Special rule for employees offered early retirement in 2006.--

``(i) In general.--For purposes of subparagraph (A)(ii), the additional actuarial assumptions described in paragraph (1)(B) shall not be taken into account with respect to any employee if--

``(I) such employee is employed by a specified automobile manufacturer,

``(II) such employee is offered a substantial amount of additional cash compensation, substantially enhanced retirement benefits under the plan, or materially reduced employment duties on the condition that by a specified date (not later than December 31, 2010) the employee retires (as defined under the terms of the plan),

``(III) such offer is made during 2006 and pursuant to a bona fide retirement incentive program and requires, by the terms of the offer, that such offer can be accepted not later than a specified date (not later than December 31, 2006), and

``(IV) such employee does not elect to accept such offer before the specified date on which the offer expires.

``(ii) Specified automobile manufacturer.--For purposes of clause (i), the term `specified automobile manufacturer' means--

``(I) any manufacturer of automobiles, and

``(II) any manufacturer of automobile parts which supplies such parts directly to a manufacturer of automobiles and which, after a transaction or series of transactions ending in 1999, ceased to be a member of a controlled group which included such manufacturer of automobiles.

``(5) Transition between applicable funding targets and between applicable target normal costs.--

``(A) In general.--In any case in which a plan which is in at-risk status for a plan year has been in such status for a consecutive period of fewer than 5 plan years, the applicable amount of the funding target and of the target normal cost shall be, in lieu of the amount determined without regard to this paragraph, the sum of--

``(i) the amount determined under this section without regard to this subsection, plus

``(ii) the transition percentage for such plan year of the excess of the amount determined under this subsection (without regard to this paragraph) over the amount determined under this section without regard to this subsection.

``(B) Transition percentage.--For purposes of subparagraph (A), the transition percentage shall be determined in accordance with the following table:

``If the consecutive number of years (including the plan year) the plan is in at-risk status is--	The transition percentage is--
1	20
2	40
3	60
4	80.

``(C) Years before effective date.--For purposes of this paragraph, plan years beginning before 2008 shall not be taken into account.

``(6) Small plan exception.--If, on each day during the preceding plan year, a plan had 500 or fewer participants, the plan shall not be treated as in at-risk status for the plan year. For purposes of this paragraph, all defined benefit plans (other than multiemployer plans) maintained by the same employer (or any member of such employer's controlled group) shall be treated as 1 plan, but only participants with respect to such employer or member shall be taken into account and the rules of subsection (g)(2)(C) shall apply.

``(j) Payment of Minimum Required Contributions.--

``(1) In general.--For purposes of this section, the due date for any payment of any minimum required contribution for any plan year shall be 8\1/2\ months after the close of the plan year.

``(2) Interest.--Any payment required under paragraph (1) for a plan year that is made on a date other than the valuation date for such plan year shall be adjusted for interest accruing for the period between the valuation date and the payment date, at the effective rate of interest for the plan for such plan year.

``(3) Accelerated quarterly contribution schedule for underfunded plans.--

``(A) Failure to timely make required installment.--In any case in which the plan has a funding shortfall for the preceding plan year, the employer maintaining

the plan shall make the required installments under this paragraph and if the employer fails to pay the full amount of a required installment for the plan year, then the amount of interest charged under paragraph (2) on the underpayment for the period of underpayment shall be determined by using a rate of interest equal to the rate otherwise used under paragraph (2) plus 5 percentage points.

``(B) Amount of underpayment, period of underpayment.--For purposes of subparagraph (A)--

``(i) Amount.--The amount of the underpayment shall be the excess of--

``(I) the required installment, over

``(II) the amount (if any) of the installment contributed to or under the plan on or before the due date for the installment.

``(ii) Period of underpayment.--The period for which any interest is charged under this paragraph with respect to any portion of the underpayment shall run from the due date for the installment to the date on which such portion is contributed to or under the plan.

``(iii) Order of crediting contributions.--For purposes of clause (i)(II), contributions shall be credited against unpaid required installments in the order in which such installments are required to be paid.

``(C) Number of required installments; due dates.--For purposes of this paragraph--

``(i) Payable in 4 installments.--There shall be 4 required installments for each plan year.

``(ii) Time for payment of installments.--The due dates for required installments are set forth in the following table:

``In the case of the following required installment:	The due date is:
1st............................	April 15
2nd............................	July 15
3rd............................	October 15
4th............................	January 15 of the following year.

``(D) Amount of required installment.--For purposes of this paragraph--

``(i) In general.--The amount of any required installment shall be 25 percent of the required annual payment.

``(ii) Required annual payment.--For purposes of clause (i), the term `required annual payment' means the lesser of--

``(I) 90 percent of the minimum required contribution (determined without regard to this subsection) to the plan for the plan year under this section, or

``(II) 100 percent of the minimum required contribution (determined without regard to this subsection or to any waiver under section 302(c)) to the plan for the preceding plan year.

Subclause (II) shall not apply if the preceding plan year referred to in such clause was not a year of 12 months.

``(E) Fiscal years and short years.--

``(i) Fiscal years.--In applying this paragraph to a plan year beginning on any date other than January 1, there shall be substituted for the months specified in this paragraph, the months which correspond thereto.

``(ii) Short plan year.--This subparagraph shall be applied to plan years of less than 12 months in accordance with regulations prescribed by the Secretary of the Treasury.

``(4) Liquidity requirement in connection with quarterly contributions.--

``(A) In general.--A plan to which this paragraph applies shall be treated as failing to pay the full amount of any required installment under paragraph (3) to the extent that the value of the liquid assets paid in such installment is less than the liquidity shortfall (whether or not such liquidity shortfall exceeds the amount of such installment required to be paid but for

this paragraph).

``(B) Plans to which paragraph applies.--This paragraph shall apply to a plan (other than a plan described in subsection (g)(2)(B)) which--

``(i) is required to pay installments under paragraph (3) for a plan year, and

``(ii) has a liquidity shortfall for any quarter during such plan year.

``(C) Period of underpayment.--For purposes of paragraph (3)(A), any portion of an installment that is treated as not paid under subparagraph (A) shall continue to be treated as unpaid until the close of the quarter in which the due date for such installment occurs.

``(D) Limitation on increase.--If the amount of any required installment is increased by reason of subparagraph (A), in no event shall such increase exceed the amount which, when added to prior installments for the plan year, is necessary to increase the funding target attainment percentage of the plan for the plan year (taking into account the expected increase in funding target due to benefits accruing or earned during the plan year) to 100 percent.

``(E) Definitions.--For purposes of this paragraph--

``(i) Liquidity shortfall.--The term `liquidity shortfall' means, with respect to any required installment, an amount equal to the excess (as of the last day of the quarter for which such installment is made) of--

``(I) the base amount with respect to such quarter, over

``(II) the value (as of such last day) of the plan's liquid assets.

``(ii) Base amount.--

``(I) In general.--The term `base amount' means, with respect to any quarter, an amount equal to 3 times the sum of the adjusted disbursements from the plan for the 12 months ending on the last day of such quarter.

``(II) Special rule.--If the amount determined under subclause (I) exceeds an amount equal to 2 times the sum of the adjusted disbursements from the plan for the 36 months ending on the last day of the quarter and an enrolled actuary certifies to the satisfaction of the Secretary of the Treasury that such excess is the result of nonrecurring circumstances, the base amount with respect to such quarter shall be determined without regard to amounts related to those nonrecurring circumstances.

``(iii) Disbursements from the plan.--The term `disbursements from the plan' means all disbursements from the trust, including purchases of annuities, payments of single sums and other benefits, and administrative expenses.

``(iv) Adjusted disbursements.--The term `adjusted disbursements' means disbursements from the plan reduced by the product of--

``(I) the plan's funding target attainment percentage for the plan year, and

``(II) the sum of the purchases of annuities, payments of single sums, and such other disbursements as the Secretary of the Treasury shall provide in regulations.

``(v) Liquid assets.--The term `liquid assets' means cash, marketable securities, and such other assets as specified by the Secretary of the Treasury in regulations.

``(vi) Quarter.--The term `quarter' means, with respect to any required installment, the 3-month period preceding the month in which the due date for such installment occurs.

``(F) Regulations.--The Secretary of the Treasury may prescribe such regulations as are necessary to carry out this paragraph.

``(k) Imposition of Lien Where Failure to Make Required

Contributions.--
``(1) In general.--In the case of a plan to which this subsection applies (as provided under paragraph (2)), if--
``(A) any person fails to make a contribution payment required by section 302 and this section before the due date for such payment, and
``(B) the unpaid balance of such payment (including interest), when added to the aggregate unpaid balance of all preceding such payments for which payment was not made before the due date (including interest), exceeds $1,000,000,
then there shall be a lien in favor of the plan in the amount determined under paragraph (3) upon all property and rights to property, whether real or personal, belonging to such person and any other person who is a member of the same controlled group of which such person is a member.
``(2) Plans to which subsection applies.--This subsection shall apply to a single-employer plan covered under section 4021 for any plan year for which the funding target attainment percentage (as defined in subsection (d)(2)) of such plan is less than 100 percent.
``(3) Amount of lien.--For purposes of paragraph (1), the amount of the lien shall be equal to the aggregate unpaid balance of contribution payments required under this section and section 302 for which payment has not been made before the due date.
``(4) Notice of failure; lien.--
``(A) Notice of failure.--
A person committing a failure described in paragraph (1) shall notify the Pension Benefit Guaranty Corporation of such failure within 10 days of the due date for the required contribution payment.
``(B) Period of lien.--The lien imposed by paragraph (1) shall arise on the due date for the required contribution payment and shall continue until the last day of the first plan year in which the plan ceases to be described in paragraph (1)(B). Such lien shall continue to run without regard to whether such plan continues to be described in paragraph (2) during the period referred to in the preceding sentence.
``(C) Certain rules to apply.--Any amount with respect to which a lien is imposed under paragraph (1) shall be treated as taxes due and owing the United States and rules similar to the rules of subsections (c), (d), and (e) of section 4068 shall apply with respect to a lien imposed by subsection (a) and the amount with respect to such lien.
``(5) Enforcement.--Any lien created under paragraph (1) may be perfected and enforced only by the Pension Benefit Guaranty Corporation, or at the direction of the Pension Benefit Guaranty Corporation, by the contributing sponsor (or any member of the controlled group of the contributing sponsor).
``(6) Definitions.--For purposes of this subsection--
``(A) Contribution payment.--The term `contribution payment' means, in connection with a plan, a contribution payment required to be made to the plan, including any required installment under paragraphs (3) and (4) of subsection (j).
``(B) Due date; required installment.--The terms `due date' and `required installment' have the meanings given such terms by subsection (j), except that in the case of a payment other than a required installment, the due date shall be the date such payment is required to be made under section 303.
``(C) Controlled group.--The term `controlled group' means any group treated as a single employer under subsections (b), (c), (m), and (o) of section 414 of the Internal Revenue Code of 1986.
``(l) Qualified Transfers to Health Benefit Accounts.--In the case of a qualified transfer (as defined in section 420 of the Internal Revenue Code of 1986), any assets so transferred shall not, for purposes of this section, be treated as assets in the plan.''.
(b) Clerical Amendment.--The table of sections in section 1 of such Act (as amended by section 101) is amended by inserting after the item relating to section 302 the following new item:
``Sec. 303. Minimum funding standards for single-employer defined benefit pension plans.''.
(c) Effective Date.--The amendments made by this section shall apply with respect to plan years beginning after 2007.
SEC. 103. BENEFIT LIMITATIONS UNDER SINGLE-EMPLOYER PLANS.

(a) Funding-Based Limits on Benefits and Benefit Accruals Under Single-Employer Plans.--Section 206 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1056) is amended by adding at the end the following new subsection:

``(g) Funding-Based Limits on Benefits and Benefit Accruals Under Single-Employer Plans.--

``(1) Funding-based limitation on shutdown benefits and other unpredictable contingent event benefits under single-employer plans.--

``(A) In general.--If a participant of a defined benefit plan which is a single-employer plan is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan shall provide that such benefit may not be provided if the adjusted funding target attainment percentage for such plan year--

``(i) is less than 60 percent, or

``(ii) would be less than 60 percent taking into account such occurrence.

``(B) Exemption.--Subparagraph (A) shall cease to apply with respect to any plan year, effective as of the first day of the plan year, upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 303) equal to--

``(i) in the case of subparagraph (A)(i), the amount of the increase in the funding target of the plan (under section 303) for the plan year attributable to the occurrence referred to in subparagraph (A), and

``(ii) in the case of subparagraph (A)(ii), the amount sufficient to result in a funding target attainment percentage of 60 percent.

``(C) Unpredictable contingent event.--For purposes of this paragraph, the term `unpredictable contingent event benefit' means any benefit payable solely by reason of--

``(i) a plant shutdown (or similar event, as determined by the Secretary of the Treasury), or

``(ii) an event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or occurrence of death or disability.

``(2) Limitations on plan amendments increasing liability for benefits.--

``(A) In general.--No amendment to a defined benefit plan which is a single-employer plan which has the effect of increasing liabilities of the plan by reason of increases in benefits, establishment of new benefits, changing the rate of benefit accrual, or changing the rate at which benefits become nonforfeitable may take effect during any plan year if the adjusted funding target attainment percentage for such plan year is--

``(i) less than 80 percent, or

``(ii) would be less than 80 percent taking into account such amendment.

``(B) Exemption.--Subparagraph (A) shall cease to apply with respect to any plan year, effective as of the first day of the plan year (or if later, the effective date of the amendment), upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 303) equal to--

``(i) in the case of subparagraph (A)(i), the amount of the increase in the funding target of the plan (under section 303) for the plan year attributable to the amendment, and

``(ii) in the case of subparagraph (A)(ii), the amount sufficient to result in an adjusted funding target attainment percentage of 80 percent.

``(C) Exception for certain benefit increases.--Subparagraph (A) shall not apply to any amendment which provides for an increase in benefits under a formula which is not based on a participant's compensation, but only if the rate of such increase is not in excess of the contemporaneous rate of increase in average wages of participants covered by the amendment.

``(3) Limitations on accelerated benefit distributions.--

``(A) Funding percentage less than 60 percent.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's

adjusted
funding target attainment percentage for a plan year is less than 60 percent, the plan may not pay any prohibited payment after the valuation date for the plan year.

``(B) Bankruptcy.--
A defined benefit plan which is
a single-employer plan shall provide that, during any period in which the plan sponsor is a debtor in a case under title 11, United States Code, or similar Federal or State law, the plan may not pay any prohibited payment. The preceding sentence shall not apply on or after the date on which the enrolled actuary of the plan certifies that the adjusted funding target attainment percentage of such plan is not less than 100 percent.

``(C) Limited payment if percentage at least 60 percent but less than 80 percent.--

``(i) In general.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater but less than 80 percent, the plan may not pay any prohibited payment after the valuation date for the plan year to the extent the amount of the payment exceeds the lesser of--

``(I) 50 percent of the amount of the payment which could be made without regard to this subsection, or

``(II) the present value (determined under guidance prescribed by the Pension Benefit Guaranty Corporation, using the interest and mortality assumptions under section 205(g)) of the maximum guarantee with respect to the participant under section 4022.

``(ii) One-time application.--

``(I) In general.--The plan shall also provide that only 1 prohibited payment meeting the requirements of clause (i) may be made with respect to any participant during any period of consecutive plan years to which the limitations under either subparagraph (A) or (B) or this subparagraph applies.

``(II) Treatment of beneficiaries.--
For purposes of this clause, a participant and any beneficiary on his behalf (including an alternate payee, as defined in section 206(d)(3)(K)) shall be treated as 1 participant. If the accrued benefit of a participant is allocated to such an alternate payee and 1 or more other persons, the amount under clause (i) shall be allocated among such persons in the same manner as the accrued benefit is allocated unless the qualified domestic relations order (as defined in section 206(d)(3)(B)(i)) provides otherwise.

``(D) Exception.--This paragraph shall not apply to any plan for any plan year if the terms of such plan (as in effect for the period beginning on September 1, 2005, and ending with such plan year) provide for no benefit accruals with respect to any participant during such period.

``(E) Prohibited payment.--For purpose of this paragraph, the term `prohibited payment' means--

``(i) any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 204(b)(1)(G)), to a participant or beneficiary whose annuity starting date (as defined in section 205(h)(2)) occurs during any period a limitation under subparagraph (A) or (B) is in effect,

``(ii) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and

``(iii) any other
payment specified by the Secretary of the Treasury by regulations.

``(4) Limitation on benefit accruals for plans with severe funding shortfalls.--

``(A) In general.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, benefit accruals under the plan shall cease as of the valuation date for the plan year.

``(B) Exemption.--Subparagraph (A) shall cease to apply with respect to any plan year, effective as of the first day of the plan year, upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 303) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

``(5) Rules relating to contributions required to avoid benefit limitations.--

``(A) Security may be provided.--

``(i) In general.--For purposes of this subsection, the adjusted funding target attainment percentage shall be determined by treating as an asset of the plan any security provided by a plan sponsor in a form meeting the requirements of clause (ii).

``(ii) Form of security.--The security required under clause (i) shall consist of--

``(I) a bond issued by a corporate surety company that is an acceptable surety for purposes of section 412 of this Act,

``(II) cash, or United States obligations which mature in 3 years or less, held in escrow by a bank or similar financial institution, or

``(III) such other form of security as is satisfactory to the Secretary of the Treasury and the parties involved.

``(iii) Enforcement.--Any security provided under clause (i) may be perfected and enforced at any time after the earlier of--

``(I) the date on which the plan terminates,

``(II) if there is a failure to make a payment of the minimum required contribution for any plan year beginning after the security is provided, the due date for the payment under section 303(j), or

``(III) if the adjusted funding target attainment percentage is less than 60 percent for a consecutive period of 7 years, the valuation date for the last year in the period.

``(iv) Release of security.--The security shall be released (and any amounts thereunder shall be refunded together with any interest accrued thereon) at such time as the Secretary of the Treasury may prescribe in regulations, including regulations for partial releases of the security by reason of increases in the funding target attainment percentage.

``(B) Prefunding balance or funding standard carryover balance may not be used.--No prefunding balance or funding standard carryover balance under section 303(f) may be used under paragraph (1), (2), or (4) to satisfy any payment an employer may make under any such paragraph to avoid or terminate the application of any limitation under such paragraph.

``(C) Deemed reduction of funding balances.--

``(i) In general.--Subject to clause (iii), in any case in which a benefit limitation under paragraph (1), (2), (3), or (4) would (but for this subparagraph and determined without regard to paragraph (1)(B), (2)(B), or (4)(B)) apply to such plan for the plan year, the plan sponsor of such plan shall be treated for purposes of this Act as having made an election under section 303(f) to reduce the prefunding balance or funding standard carryover balance by such amount as is necessary for such benefit limitation to not apply to the plan for such plan year.

``(ii) Exception for insufficient funding balances.--Clause (i) shall not apply with respect to a benefit limitation for any plan year if the application of clause (i) would not result in the benefit limitation not applying for such plan year.

``(iii) Restrictions of certain rules to collectively bargained plans.--With respect to any benefit limitation under paragraph (1), (2), or (4), clause (i) shall only apply in the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers.

``(6) New plans.--Paragraphs (1), (2), and (4) shall not apply to a plan for the first 5 plan years of the plan. For purposes of this paragraph, the reference in this paragraph to a plan shall include a reference to any predecessor plan.

``(7) Presumed underfunding for purposes of benefit limitations.--

``(A) Presumption of continued underfunding.--In any case in which a benefit limitation under paragraph (1), (2), (3), or (4) has been applied to a plan with respect to the plan year preceding the current plan year, the adjusted funding target attainment percentage of the plan for the current plan year shall be presumed to be equal to the adjusted funding target attainment percentage of the plan for the preceding plan year until the enrolled actuary of the plan certifies the actual adjusted funding target attainment percentage of the plan for the current plan year.

``(B) Presumption of underfunding after 10th month.--In any case in which no certification of the adjusted funding target attainment percentage for the current plan year is made with respect to the plan before the first day of the 10th month of such year, for purposes of paragraphs (1), (2), (3), and (4), such first day shall be deemed, for purposes of such paragraph, to be the valuation date of the plan for the current plan year and the plan's adjusted funding target attainment percentage shall be conclusively presumed to be less than 60 percent as of such first day.

``(C) Presumption of underfunding after 4th month for nearly underfunded plans.--In any case in which--

``(i) a benefit limitation under paragraph (1), (2), (3), or (4) did not apply to a plan with respect to the plan year preceding the current plan year, but the adjusted funding target attainment percentage of the plan for such preceding plan year was not more than 10 percentage points greater than the percentage which would have caused such paragraph to apply to the plan with respect to such preceding plan year, and

``(ii) as of the first day of the 4th month of the current plan year, the enrolled actuary of the plan has not certified the actual adjusted funding target attainment percentage of the plan for the current plan year,

until the enrolled actuary so certifies, such first day shall be deemed, for purposes of such paragraph, to be the valuation date of the plan for the current plan year and the adjusted funding target attainment percentage of the plan as of such first day shall, for purposes of such paragraph, be presumed to be equal to 10 percentage points less than the adjusted funding target attainment percentage of the plan for such preceding plan year.

``(8) Treatment of plan as of close of prohibited or cessation period.--For purposes of applying this part--

``(A) Operation of plan after period.--Unless the plan provides otherwise, payments and accruals will resume effective as of the day following the close of the period for which any limitation of payment or accrual of benefits under paragraph (3) or (4) applies.

``(B) Treatment of affected benefits.--Nothing in this paragraph shall be construed as affecting the plan's treatment of benefits which would have been paid or accrued but for this subsection.

``(9) Terms relating to funding target attainment

percentage.--For purposes of this subsection--
``(A) In general.--The term `funding target attainment percentage' has the same meaning given such term by section 303(d)(2).
``(B) Adjusted funding target attainment percentage.--The term `adjusted funding target attainment percentage' means the funding target attainment percentage which is determined under subparagraph (A) by increasing each of the amounts under subparagraphs (A) and (B) of section 303(d)(2) by the aggregate amount of purchases of annuities for employees other than highly compensated employees (as defined in section 414(q) of the Internal Revenue Code of 1986) which were made by the plan during the preceding 2 plan years.
``(C) Application to plans which are fully funded without regard to reductions for funding balances.--
``(i) In general.--In the case of a plan for any plan year, if the funding target attainment percentage is 100 percent or more (determined without regard to this subparagraph and without regard to the reduction in the value of assets under section 303(f)(4)), the funding target attainment percentage for purposes of subparagraphs (A) and (B) shall be determined without regard to such reduction.
``(ii) Transition rule.--Clause (i) shall be applied to plan years beginning after 2007 and before 2011 by substituting for `100 percent' the applicable percentage determined in accordance with the following table:

``In the case year beginning in year:	The applicable percentage is:
2008	92
2009	94
2010	96.

``(iii) Limitation.--Clause (ii) shall not apply with respect to any plan year after 2008 unless the funding target attainment percentage (determined without regard to this subparagraph) of the plan for each preceding plan year after 2007 was not less than the applicable percentage with respect to such preceding plan year determined under clause (ii).
``(10) Special rule for 2008.--For purposes of this subsection, in the case of plan years beginning in 2008, the funding target attainment percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of the Treasury may provide.''.
(b) Notice Requirement.--
(1) In general.--Section 101 of such Act (29 U.S.C. 1021) is amended--
(A) by redesignating subsection (j) as subsection (k); and
(B) by inserting after subsection (i) the following new subsection:
``(j) Notice of Funding-Based Limitation on Certain Forms of Distribution.--The plan administrator of a single-employer plan shall provide a written notice to plan participants and beneficiaries within 30 days--
``(1) after the plan has become subject to a restriction described in paragraph (1) or (3) of section 206(g)),
``(2) in the case of a plan to which section 206(g)(4) applies, after the valuation date for the plan year described in section 206(g)(4)(B) for which the plan's adjusted funding target attainment percentage for the plan year is less than 60 percent (or, if earlier, the date such percentage is deemed to be less than 60 percent under section 206(g)(7)), and
``(3) at such other time as may be determined by the Secretary of the Treasury.
The notice required to be provided under this subsection shall be in writing, except that such notice may be in electronic or other form to the extent that such form is reasonably accessible to the recipient.''.
(2) Enforcement.--Section 502(c)(4) of such Act (29 U.S.C. 1132(c)(4)) is amended by striking ``section 302(b)(7)(F)(iv)'' and inserting ``section 101(j) or 302(b)(7)(F)(iv)''.
(c) Effective Dates.--
(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

(2) Collective bargaining exception.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before January 1, 2008, the amendments made by this section shall not apply to plan years beginning before the earlier of--

(A) the later of--

(i) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of the enactment of this Act), or

(ii) the first day of the first plan year to which the amendments made by this subsection would (but for this subparagraph) apply, or

(B) January 1, 2010.

For purposes of subparagraph (A)(i), any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section shall not be treated as a termination of such collective bargaining agreement.

SEC. 104. SPECIAL RULES FOR MULTIPLE EMPLOYER PLANS OF CERTAIN COOPERATIVES.

(a) General Rule.--Except as provided in this section, if a plan in existence on July 26, 2005, was an eligible cooperative plan for its plan year which includes such date, the amendments made by this subtitle and subtitle B shall not apply to plan years beginning before the earlier of--

(1) the first plan year for which the plan ceases to be an eligible cooperative plan, or

(2) January 1, 2017.

(b) Interest Rate.--In applying section 302(b)(5)(B) of the Employee Retirement Income Security Act of 1974 and section 412(b)(5)(B) of the Internal Revenue Code of 1986 (as in effect before the amendments made by this subtitle and subtitle B) to an eligible cooperative plan for plan years beginning after December 31, 2007, and before the first plan year to which such amendments apply, the third segment rate determined under section 303(h)(2)(C)(iii) of such Act and section 430(h)(2)(C)(iii) of such Code (as added by such amendments) shall be used in lieu of the interest rate otherwise used.

(c) Eligible Cooperative Plan Defined.--For purposes of this section, a plan shall be treated as an eligible cooperative plan for a plan year if the plan is maintained by more than 1 employer and at least 85 percent of the employers are--

(1) rural cooperatives (as defined in section 401(k)(7)(B) of such Code without regard to clause (iv) thereof), or

(2) organizations which are--

(A) cooperative organizations described in section 1381(a) of such Code which are more than 50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or

(B) more than 50-percent owned, or controlled by, one or more cooperative organizations described in subparagraph (A).

A plan shall also be treated as an eligible cooperative plan for any plan year for which it is described in section 210(a) of the Employee Retirement Income Security Act of 1974 and is maintained by a rural telephone cooperative association described in section 3(40)(B)(v) of such Act.

SEC. 105. TEMPORARY RELIEF FOR CERTAIN PBGC SETTLEMENT PLANS.

(a) General Rule.--Except as provided in this section, if a plan in existence on July 26, 2005, was a PBGC settlement plan as of such date, the amendments made by this subtitle and subtitle B shall not apply to plan years beginning before January 1, 2014.

(b) Interest Rate.--In applying section 302(b)(5)(B) of the Employee Retirement Income Security Act of 1974 and section 412(b)(5)(B) of the Internal Revenue Code of 1986 (as in effect before the amendments made by this subtitle and subtitle B), to a PBGC settlement plan for plan years beginning after December 31, 2007, and before January 1, 2014, the third segment rate determined under section 303(h)(2)(C)(iii) of such Act and section 430(h)(2)(C)(iii) of such Code (as added by such amendments) shall be used in lieu of the interest rate otherwise used.

(c) PBGC Settlement Plan.--For purposes of this section, the term ``PBGC settlement plan'' means a defined benefit plan (other than a multiemployer plan) to which section 302 of such Act and section 412 of such Code apply and--

(1) which was sponsored by an employer which was in bankruptcy, giving rise to a claim by the Pension Benefit Guaranty Corporation of not greater than $150,000,000, and the sponsorship of which was assumed by another employer that was not a member of the same controlled group as the bankrupt

sponsor and the claim of the Pension Benefit Guaranty Corporation was settled or withdrawn in connection with the assumption of the sponsorship, or

(2) which, by agreement with the Pension Benefit Guaranty Corporation, was spun off from a plan subsequently terminated by such Corporation under section 4042 of the Employee Retirement Income Security Act of 1974.

SEC. 106. SPECIAL RULES FOR PLANS OF CERTAIN GOVERNMENT CONTRACTORS.

(a) General Rule.--Except as provided in this section, if a plan is an eligible government contractor plan, this subtitle and subtitle B shall not apply to plan years beginning before the earliest of--

(1) the first plan year for which the plan ceases to be an eligible government contractor plan,

(2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, or

(3) January 1, 2011.

(b) Interest Rate.--In applying section 302(b)(5)(B) of the Employee Retirement Income Security Act of 1974 and section 412(b)(5)(B) of the Internal Revenue Code of 1986 (as in effect before the amendments made by this subtitle and subtitle B) to an eligible government contractor plan for plan years beginning after December 31, 2007, and before the first plan year to which such amendments apply, the third segment rate determined under section 303(h)(2)(C)(iii) of such Act and section 430(h)(2)(C)(iii) of such Code (as added by such amendments) shall be used in lieu of the interest rate otherwise used.

(c) Eligible Government Contractor Plan Defined.--For purposes of this section, a plan shall be treated as an eligible government contractor plan if it is maintained by a corporation or a member of the same affiliated group (as defined by section 1504(a) of the Internal Revenue Code of 1986), whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations (chapter 1 of title 48, CFR) and that are also subject to the Defense Federal Acquisition Regulation Supplement (chapter 2 of title 48, CFR), and whose revenue derived from such business in the previous fiscal year exceeded $5,000,000,000, and whose pension plan costs that are assignable under those contracts are subject to sections 412 and 413 of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413).

(d) Cost Accounting Standards Pension Harmonization Rule.--The Cost Accounting Standards Board shall review and revise sections 412 and 413 of the Cost Accounting Standards (48 CFR 9904.412 and 9904.413) to harmonize the minimum required contribution under the Employee Retirement Income Security Act of 1974 of eligible government contractor plans and government reimbursable pension plan costs not later than January 1, 2010. Any final rule adopted by the Cost Accounting Standards Board shall be deemed the Cost Accounting Standards Pension Harmonization Rule.

SEC. 107. TECHNICAL AND CONFORMING AMENDMENTS.

(a) Miscellaneous Amendments to Title I.--Subtitle B of title I of such Act (29 U.S.C. 1021 et seq.) is amended--

(1) in section 101(d)(3), by striking ``section 302(e)'' and inserting ``section 303(j)'';

(2) in section 103(d)(8)(B), by striking ``the requirements of section 302(c)(3)'' and inserting ``the applicable requirements of sections 303(h) and 304(c)(3)'';

(3) in section 103(d), by striking paragraph (11) and inserting the following:

``(11) If the current value of the assets of the plan is less than 70 percent of--

``(A) in the case of a single-employer plan, the funding target (as defined in section 303(d)(1)) of the plan, or

``(B) in the case of a multiemployer plan, the current liability (as defined in section 304(c)(6)(D)) under the plan,

the percentage which such value is of the amount described in subparagraph (A) or (B).'';

(4) in section 203(a)(3)(C), by striking ``section 302(c)(8)'' and inserting ``section 302(d)(2)'';

(5) in section 204(g)(1), by striking ``section 302(c)(8)'' and inserting ``section 302(d)(2)'';

(6) in section 204(i)(2)(B), by striking ``section 302(c)(8)'' and inserting ``section 302(d)(2)'';

(7) in section 204(i)(3), by striking ``funded current liability percentage (within the meaning of section 302(d)(8) of this Act)'' and inserting ``funding target attainment percentage (as defined in section 303(d)(2))'';

(8) in section 204(i)(4), by striking ``section 302(c)(11)(A), without regard to section 302(c)(11)(B)'' and

inserting ``section 302(b)(1), without regard to section
302(b)(2)'';
(9) in section 206(e)(1), by striking
``section 302(d)'' and inserting ``section 303(j)(4)'', and by
striking ``section 302(e)(5)'' and inserting ``section
303(j)(4)(E)(i)'';
(10) in section 206(e)(3), by striking ``section 302(e) by
reason of paragraph (5)(A) thereof'' and inserting ``section
303(j)(3) by reason of section 303(j)(4)(A)''; and
(11) in sections 101(e)(3), 403(c)(1), and 408(b)(13), by striking
``American Jobs
Creation Act of 2004'' and inserting ``Pension Protection Act of
2006''.

(b) Miscellaneous Amendments to Title IV.--Title IV of such Act is
amended--

(1) in section 4001(a)(13) (29 U.S.C. 1301(a)(13)), by
striking ``302(c)(11)(A)'' and inserting ``302(b)(1)'', by
striking ``412(c)(11)(A)'' and inserting ``412(b)(1)'', by
striking ``302(c)(11)(B)'' and inserting ``302(b)(2)'', and by
striking ``412(c)(11)(B)'' and inserting ``412(b)(2)'';
(2) in section 4003(e)(1) (29 U.S.C. 1303(e)(1)), by
striking ``302(f)(1)(A) and (B)'' and inserting ``303(k)(1)(A)
and (B)'', and by striking ``412(n)(1)(A) and (B)'' and
inserting ``430(k)(1)(A) and (B)'';
(3) in section 4010(b)(2) (29 U.S.C. 1310(b)(2)), by
striking ``302(f)(1)(A) and (B)'' and inserting ``303(k)(1)(A)
and (B)'', and by striking ``412(n)(1)(A) and (B)'' and
inserting ``430(k)(1)(A) and (B)'';
(4) in section 4062(c) (29 U.S.C. 1362(c)), by striking
paragraphs (1), (2), and (3) and inserting the following:
``(1) the sum of the shortfall amortization charge (within
the meaning of section 303(c)(1) of this Act and 430(d)(1) of
the Internal Revenue Code of 1986) with respect to the plan (if
any) for the plan year in which the termination date occurs,
plus the aggregate total of shortfall amortization installments
(if any) determined for succeeding plan years under section
303(c)(2) of this Act and section 430(d)(2) of such Code (which,
for purposes of this subparagraph, shall include any increase in
such sum which would result if all applications for waivers of
the minimum funding standard under section 302(c) of this Act
and section 412(c) of such Code which are pending with respect
to such plan were denied and if no additional contributions
(other than those already made by the termination date) were
made for the plan year in which the termination date occurs or
for any previous plan year), and
``(2) the sum of the waiver amortization charge (within the
meaning of section 303(e)(1) of this Act and 430(e)(1) of the
Internal Revenue Code of 1986) with respect to the plan
(if any) for the plan year in which the termination date occurs,
plus the aggregate total of waiver amortization installments (if
any) determined for succeeding plan years under section
303(e)(2) of this Act and section 430(e)(2) of such Code,'';
(5) in section 4071 (29 U.S.C. 1371), by striking
``302(f)(4)'' and inserting ``303(k)(4)'';
(6) in section 4243(a)(1)(B) (29 U.S.C. 1423(a)(1)(B)), by
striking ``302(a)'' and inserting ``304(a)'', and, in clause
(i), by striking ``302(a)'' and inserting ``304(a)'';
(7) in section 4243(f)(1) (29 U.S.C. 1423(f)(1)), by
striking ``303(a)'' and inserting ``302(c)'';
(8) in section 4243(f)(2) (29 U.S.C. 1423(f)(2)), by
striking ``303(c)'' and inserting ``302(c)(3)''; and
(9) in section 4243(g) (29 U.S.C. 1423(g)), by striking
``302(c)(3)'' and inserting ``304(c)(3)''.

(c) Amendments to Reorganization Plan
No. 4 of 1978.--Section 106(b)(ii) of Reorganization Plan No. 4 of 1978
(ratified and affirmed as law by Public Law 98-532 (98 Stat. 2705)) is
amended by striking ``302(c)(8)'' and inserting ``302(d)(2)'', by
striking ``304(a) and (b)(2)(A)'' and inserting ``304(d)(1), (d)(2), and
(e)(2)(A)'', and by striking ``412(c)(8), (e), and (f)(2)(A)'' and
inserting ``412(c)(2) and 431(d)(1), (d)(2), and (e)(2)(A)''.

(d) Repeal of Expired Authority for Temporary Variances.--Section
207 of such Act (29 U.S.C. 1057) is repealed.

(e) Effective Date.--The amendments made
by this section shall apply to plan years beginning after 2007.

Subtitle B--Amendments to Internal Revenue Code of 1986

SEC. 111. MINIMUM FUNDING STANDARDS.

(a) New Minimum Funding Standards.--Section 412 of the Internal
Revenue Code of 1986 (relating to minimum funding
standards) is amended to read as follows:

``SEC. 412. MINIMUM FUNDING STANDARDS.

``(a) Requirement to Meet Minimum Funding Standard.--
``(1) In general.--A plan to which this section applies

shall satisfy the minimum funding standard applicable to the plan for any plan year.

``(2) Minimum funding standard.--For purposes of paragraph (1), a plan shall be treated as satisfying the minimum funding standard for a plan year if--

``(A) in the case of a defined benefit plan which is not a multiemployer plan, the employer makes contributions to or under the plan for the plan year which, in the aggregate, are not less than the minimum required contribution determined under section 430 for the plan for the plan year,

``(B) in the case of a money purchase plan which is not a multiemployer plan, the employer makes contributions to or under the plan for the plan year which are required under the terms of the plan, and

``(C) in the case of a multiemployer plan, the employers make contributions to or under the plan for any plan year which, in the aggregate, are sufficient to ensure that the
plan does not have an accumulated funding deficiency under section 431 as of the end of the plan year.

``(b) Liability for Contributions.--

``(1) In general.--Except as provided in paragraph (2), the amount of any contribution required by this section (including any required installments under paragraphs (3) and (4) of section 430(j)) shall be paid by the employer responsible for making contributions to or under the plan.

``(2) Joint and several liability where employer member of controlled group.--If the employer referred to in paragraph (1) is a member of a controlled group, each member of such group shall be jointly and severally liable for payment of such contributions.

``(c) Variance From Minimum Funding Standards.--

``(1) Waiver in case of business hardship.--

``(A) In general.--If--

``(i) an employer is (or in the case of a multiemployer plan, 10 percent or more of the number of employers contributing to or under the plan is) unable to satisfy the minimum funding standard for a plan year without temporary substantial business hardship (substantial business hardship in the case of a multiemployer plan), and

``(ii) application of the standard would be adverse to the interests of plan participants in the aggregate,

the Secretary may, subject to subparagraph (C), waive the requirements of subsection (a) for such year with respect to all or any portion of the minimum funding standard. The Secretary shall not waive the minimum funding standard with respect to a plan for more than 3 of any 15 (5 of any 15 in the case of a multiemployer plan) consecutive plan years

``(B) Effects of waiver.--If a waiver is granted under subparagraph (A) for any plan year--

``(i) in the case of a defined benefit plan which is not a multiemployer plan, the minimum required contribution under section 430 for the plan year shall be reduced by the amount of the waived funding deficiency and such amount shall be amortized as required under section 430(e), and

``(ii) in the case of a multiemployer plan, the funding standard account shall be credited under section 431(b)(3)(C) with the amount of the waived funding deficiency and such amount shall be amortized as required under section 431(b)(2)(C).

``(C) Waiver of amortized portion not allowed.--The Secretary may not waive under subparagraph (A) any portion of the minimum funding standard under subsection (a) for a plan year which is attributable to any waived funding deficiency for any preceding plan year.

``(2) Determination of business hardship.--For purposes of this subsection, the factors taken into account in determining temporary substantial business hardship (substantial business hardship in the case of a multiemployer plan) shall include (but shall not be limited to) whether or not--

``(A) the employer is operating at an economic loss,

``(B) there is substantial unemployment or underemployment in the trade or business and in the industry concerned,

``(C) the sales and profits of the industry concerned are depressed or declining, and

``(D) it is reasonable to expect that the plan will be continued only if the waiver is granted.

``(3) Waived funding deficiency.--For purposes of this section and part III of this subchapter, the term `waived funding deficiency' means the portion of the minimum funding standard under subsection (a) (determined without regard to the waiver) for a plan year waived by the Secretary and not satisfied by employer contributions.

``(4) Security for waivers for single-employer plans, consultations.--

``(A) Security may be required.--

``(i) In general.--Except as provided in subparagraph (C), the Secretary may require an employer maintaining a defined benefit plan which is a single-employer plan (within the meaning of section 4001(a)(15) of the Employee Retirement Income Security Act of 1974) to provide security to such plan as a condition for granting or modifying a waiver under paragraph (1).

``(ii) Special rules.--Any security provided under clause (i) may be perfected and enforced only by the Pension Benefit Guaranty Corporation, or at the direction of the Corporation, by a contributing sponsor (within the meaning of section 4001(a)(13) of the Employee Retirement Income Security Act of 1974), or a member of such sponsor's controlled group (within the meaning of section 4001(a)(14) of such Act).

``(B) Consultation with the pension benefit guaranty corporation.--Except as provided in subparagraph (C), the Secretary shall, before granting or modifying a waiver under this subsection with respect to a plan described in subparagraph (A)(i)--

``(i) provide the Pension Benefit Guaranty Corporation with--

``(I) notice of the completed application for any waiver or modification, and

``(II) an opportunity to comment on such application within 30 days after receipt of such notice, and

``(ii) consider--

``(I) any comments of the Corporation under clause (i)(II), and

``(II) any views of any employee organization (within the meaning of section 3(4) of the Employee Retirement Income Security Act of 1974) representing participants in the plan which are submitted in writing to the Secretary in connection with such application.

Information provided to the Corporation under this subparagraph shall be considered tax return information and subject to the safeguarding and reporting requirements of section 6103(p).

``(C) Exception for certain waivers.--

``(i) In general.--The preceding provisions of this paragraph shall not apply to any plan with respect to which the sum of--

``(I) the aggregate unpaid minimum required contributions (within the meaning of section 4971(c)(4)) for the plan year and all preceding plan years, and

``(II) the present value of all waiver amortization installments determined for the plan year and succeeding plan years under section 430(e)(2),

is less than $1,000,000.

``(ii) Treatment of waivers for which applications are pending.--The amount described in clause (i)(I) shall include any increase in such amount which would result if all applications for waivers of the minimum funding standard under this subsection which are pending with respect to such plan were denied.

``(5) Special rules for single-employer plans.--

``(A) Application must be submitted before date 2\1/2\ months after close of year.--In

the case of a defined benefit plan
which is not a multiemployer plan, no waiver may be granted under this subsection with respect to any plan for any plan year unless an application therefor is submitted to the Secretary not later than the 15th day of the 3rd month beginning after the close of such plan year.

``(B) Special rule if employer is member of controlled group.--In the case of a defined benefit plan which is not a multiemployer plan, if an employer is a member of a controlled group, the temporary substantial business hardship requirements of paragraph (1) shall be treated as met only if such requirements are met--

``(i) with respect to such employer, and

``(ii) with respect to the controlled group of which such employer is a member (determined by treating all members of such group as a single employer).

The Secretary may provide that an analysis of a trade or business or industry of a member need not be conducted if the Secretary determines such analysis is not necessary because the taking into account of such member would not significantly affect the determination under this paragraph.

``(6) Advance notice.--

``(A) In general.--The Secretary shall, before granting a waiver under this subsection, require each applicant to provide evidence satisfactory to the Secretary that the applicant has provided notice of the filing of the application for such waiver to each affected party (as defined in section 4001(a)(21) of the Employee Retirement Income Security Act of 1974). Such notice shall include a description of the extent to which the plan is funded for benefits which are guaranteed under title IV of the Employee Retirement Income Security Act of 1974 and for benefit liabilities.

``(B) Consideration of relevant information.--The Secretary shall consider any relevant information provided
by a person to whom notice was given under subparagraph (A).

``(7) Restriction on plan amendments.--

``(A) In general.--No amendment of a plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan shall be adopted if a waiver under this subsection or an extension of time under section 431(d) is in effect with respect to the plan, or if a plan amendment described in subsection (d)(2) has been made at any time in the preceding 12 months (24 months in the case of a multiemployer plan). If a plan is amended in violation of the preceding sentence, any such waiver, or extension of time, shall not apply to any plan year ending on or after the date on which such amendment is adopted.

``(B) Exception.--Subparagraph (A) shall not apply to any plan amendment which--

``(i) the Secretary determines to be reasonable and which provides for only de minimis increases in the liabilities of the plan,

``(ii) only repeals an amendment described in subsection (d)(2), or

``(iii) is required as a condition of qualification under part I of subchapter D, of chapter 1.

``(d) Miscellaneous Rules.--

``(1) Change in method or year.--If the funding method, the valuation date, or a plan year for a plan is changed, the change shall take effect only if approved by the Secretary.

``(2) Certain retroactive plan amendments.--For purposes of this section, any amendment applying to a plan year which--

``(A) is adopted after the close
of such plan year but no later than 2\1/2\ months after the close of the plan year (or, in the case of a multiemployer plan, no later than 2 years after the close of such plan year),

``(B) does not reduce the accrued benefit of any participant determined as of the beginning of the first plan year to which the amendment applies, and

``(C) does not reduce the accrued benefit of any participant determined as of the time of adoption except

to the extent required by the circumstances,
shall, at the election of the plan administrator, be deemed to have been made on the first day of
such plan year. No amendment described in this paragraph which reduces the accrued benefits of any participant shall take effect unless the plan administrator files a notice with the Secretary notifying him of such amendment and the Secretary has approved such amendment, or within 90 days after the date on which such notice was filed, failed to disapprove such amendment. No amendment described in this subsection shall be approved by the Secretary unless the Secretary determines that such amendment is necessary because of a temporary substantial business hardship (as determined under subsection (c)(2)) or a substantial business hardship (as so determined) in the case of a multiemployer plan and that a waiver under subsection (c) (or, in the case of a multiemployer plan, any extension of the amortization period under section 431(d)) is unavailable or inadequate.

``(3) Controlled group.--For purposes of this section, the term `controlled group' means any group treated as a single employer under subsection (b), (c), (m), or (o) of section 414.

``(e) Plans to Which Section Applies.--

``(1) In general.--Except as provided in paragraphs (2) and (4), this section applies to a plan if, for any plan year beginning on or after the effective date of this section for such plan under the Employee Retirement Income Security Act of 1974--

``(A) such plan included a trust which qualified (or was determined by the Secretary to have qualified) under section 401(a), or

``(B) such plan satisfied (or was determined by the Secretary to have satisfied) the requirements of section 403(a).

``(2) Exceptions.--This section shall not apply to--

``(A) any profit-sharing or stock bonus plan,

``(B) any insurance contract plan described in paragraph (3),

``(C) any governmental plan (within the meaning of section 414(d)),

``(D) any church plan (within the meaning of section 414(e)) with respect to which the election provided by section 410(d) has not been made,

``(E) any plan which has not, at any time after September 2, 1974, provided for employer contributions, or

``(F) any plan established and maintained by a society, order, or association described in section 501(c)(8) or (9), if no part of the contributions to or under such plan are made by employers of participants in such plan.

No plan described in subparagraph (C), (D), or (F) shall be treated as a qualified plan for purposes of section 401(a) unless such plan meets the requirements of section 401(a)(7) as in effect on September 1, 1974.

``(3) Certain insurance contract plans.--A plan is described in this paragraph if--

``(A) the plan is funded exclusively by the purchase of individual insurance contracts,

``(B) such contracts provide for level annual premium payments to be paid extending not later than the retirement age for each individual participating in the plan, and commencing with the date the individual became a participant in the plan (or, in the case of an increase in benefits, commencing at the time such increase becomes effective),

``(C) benefits provided by the plan are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an insurance carrier (licensed under the laws of a State to do business with the plan) to the extent premiums have been paid,

``(D) premiums payable for the plan year, and all prior plan years, under such contracts have been paid before lapse or there is reinstatement of the policy,

``(E) no rights under such contracts have been subject to a security interest at any time during the plan year, and

``(F) no policy loans are outstanding at any time during the plan year.

A plan funded exclusively by the purchase of group insurance contracts which is determined under regulations prescribed by the Secretary to have the same characteristics as contracts

described in the preceding sentence shall be treated as a plan described in this paragraph.

``(4) Certain terminated multiemployer plans.--This section applies with respect to a terminated multiemployer plan to which section 4021 of the Employee Retirement Income Security Act of 1974 applies until the last day of the plan year in which the plan terminates (within the meaning of section 4041A(a)(2) of such Act).''.

(b) Effective Date.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

SEC. 112. FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS.

(a) In General.--Subchapter D of chapter 1 of the Internal Revenue Code of 1986 (relating to deferred compensation, etc.) is amended by adding at the end the following new part:

``PART III--MINIMUM FUNDING STANDARDS FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

``SEC. 430. MINIMUM FUNDING STANDARDS FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS.

``(a) Minimum Required Contribution.--For purposes of this section and section 412(a)(2)(A), except as provided in subsection (f), the term `minimum required contribution' means, with respect to any plan year of a defined benefit plan which is not a multiemployer plan--

``(1) in any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) is less than the funding target of the plan for the plan year, the sum of--

``(A) the target normal cost of the plan for the plan year,

``(B) the shortfall amortization charge (if any) for the plan for the plan year determined under subsection (c), and

``(C) the waiver amortization charge (if any) for the plan for the plan year as determined under subsection (e);

``(2) in any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) equals or exceeds the funding target of the plan for the plan year, the target normal cost of the plan for the plan year reduced (but not below zero) by such excess.

``(b) Target Normal Cost.--For purposes of this section, except as provided in subsection (i)(2) with respect to plans in at-risk status, the term `target normal cost' means, for any plan year, the present value of all benefits which are expected to accrue or to be earned under the plan during the plan year. For purposes of this subsection, if any benefit attributable to services performed in a preceding plan year is increased by reason of any increase in compensation during the current plan year, the increase in such benefit shall be treated as having accrued during the current plan year.

``(c) Shortfall Amortization Charge.--

``(1) In general.--For purposes of this section, the shortfall amortization charge for a plan for any plan year is the aggregate total (not less than zero) of the shortfall amortization installments for such plan year with respect to the shortfall amortization bases for such plan year and each of the 6 preceding plan years.

``(2) Shortfall amortization installment.--For purposes of paragraph (1)--

``(A) Determination.--The shortfall amortization installments are the amounts necessary to amortize the shortfall amortization base of the plan for any plan year in level annual installments over the 7-plan-year period beginning with such plan year.

``(B) Shortfall installment.--The shortfall amortization installment for any plan year in the 7-plan-year period under subparagraph (A) with respect to any shortfall amortization base is the annual installment determined under subparagraph (A) for that year for that base.

``(C) Segment rates.--In determining any shortfall amortization installment under this paragraph, the plan sponsor shall use the segment rates determined under subparagraph (C) of subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2).

``(3) Shortfall amortization base.--For purposes of this section, the shortfall amortization base of a plan for a plan year is--

``(A) the funding shortfall of such plan for such plan year, minus

``(B) the present value (determined using the segment rates determined under subparagraph (C) of

subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2)) of the aggregate total of the shortfall amortization installments and waiver amortization installments which have been determined for such plan year and any succeeding plan year with respect to the shortfall amortization bases and waiver amortization bases of the plan for any plan year preceding such plan year.

``(4) Funding shortfall.--For purposes of this section, the funding shortfall of a plan for any plan year is the excess (if any) of--

``(A) the funding target of the plan for the plan year, over

``(B) the value of plan assets of the plan (as reduced under subsection (f)(4)(B)) for the plan year which are held by the plan on the valuation date.

``(5) Exemption from new shortfall amortization base.--

``(A) In general.--In any case in which the value of plan assets of the plan (as reduced under subsection (f)(4)(A)) is equal to or greater than the funding target of the plan for the plan year, the shortfall amortization base of the plan for such plan year shall be zero.

``(B) Transition rule.--

``(i) In general.--Except as provided in clauses (iii) and (iv), in the case of plan years beginning after 2007 and before 2011, only the applicable percentage of the funding target shall be taken into account under paragraph (3)(A) in determining the funding shortfall for the plan year for purposes of subparagraph (A).

``(ii) Applicable percentage.--For purposes of subparagraph (A), the applicable percentage shall be determined in accordance with the following table:

``In the case year beginning in year:	The applicable percentage is
2008	92
2009	94
2010	96.

``(iii) Limitation.--Clause (i) shall not apply with respect to any plan year after 2008 unless the shortfall amortization base for each of the preceding years beginning after 2007 was zero (determined after application of this subparagraph).

``(iv) Transition relief not available for new or deficit reduction plans.--Clause (i) shall not apply to a plan--

``(I) which was not in effect for a plan year beginning in 2007, or

``(II) which was in effect for a plan year beginning in 2007 and which was subject to section 412(l) (as in effect for plan years beginning in 2007), determined after the application of paragraphs (6) and (9) thereof.

``(6) Early deemed amortization upon attainment of funding target.--In any case in which the funding shortfall of a plan for a plan year is zero, for purposes of determining the shortfall amortization charge for such plan year and succeeding plan years, the shortfall amortization bases for all preceding plan years (and all shortfall amortization installments determined with respect to such bases) shall be reduced to zero.

``(d) Rules Relating to Funding Target.--For purposes of this section--

``(1) Funding target.--Except as provided in subsection (i)(1) with respect to plans in at-risk status, the funding target of a plan for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year.

``(2) Funding target attainment percentage.--The `funding target attainment percentage' of a plan for a plan year is the ratio (expressed as a percentage) which--

``(A) the value of plan assets for the plan year (as reduced under subsection (f)(4)(B)), bears to

``(B) the funding target of the plan for the plan year (determined without regard to subsection (i)(1)).

``(e) Waiver Amortization Charge.--

``(1) Determination of waiver amortization charge.--The

waiver amortization charge (if any) for a plan for any plan year is the aggregate total of the waiver amortization installments for such plan year with respect to the waiver amortization bases for each of the 5 preceding plan years.

``(2) Waiver amortization installment.--For purposes of paragraph (1)--

``(A) Determination.--The waiver amortization installments are the amounts necessary to amortize the waiver amortization base of the plan for any plan year in level annual installments over a period of 5 plan years beginning with the succeeding plan year.

``(B) Waiver installment.--The waiver amortization installment for any plan year in the 5-year period under subparagraph (A) with respect to any waiver amortization base is the annual installment determined under subparagraph (A) for that year for that base.

``(3) Interest rate.--In determining any waiver amortization installment under this subsection, the plan sponsor shall use the segment rates determined under subparagraph (C) of subsection (h)(2), applied under rules similar to the rules of subparagraph (B) of subsection (h)(2).

``(4) Waiver amortization base.--The waiver amortization base of a plan for a plan year is the amount of the waived funding deficiency (if any) for such plan year under section 412(c).

``(5) Early deemed amortization upon attainment of funding target.--In any case in which the funding shortfall of a plan for a plan year is zero, for purposes of determining the waiver amortization charge for such plan year and succeeding plan years, the waiver amortization bases for all preceding plan years (and all waiver amortization installments determined with respect to such bases) shall be reduced to zero.

``(f) Reduction of Minimum Required Contribution by Prefunding Balance and Funding Standard Carryover Balance.--

``(1) Election to maintain balances.--

``(A) Prefunding balance.--The plan sponsor of a defined benefit plan which is not a multiemployer plan may elect to maintain a prefunding balance.

``(B) Funding standard carryover balance.--

``(i) In general.--In the case of a defined benefit plan (other than a multiemployer plan) described in clause (ii), the plan sponsor may elect to maintain a funding standard carryover balance, until such balance is reduced to zero.

``(ii) Plans maintaining funding standard account in 2007.--A plan is described in this clause if the plan--

``(I) was in effect for a plan year beginning in 2007, and

``(II) had a positive balance in the funding standard account under section 412(b) as in effect for such plan year and determined as of the end of such plan year.

``(2) Application of balances.--A prefunding balance and a funding standard carryover balance maintained pursuant to this paragraph--

``(A) shall be available for crediting against the minimum required contribution, pursuant to an election under paragraph (3),

``(B) shall be applied as a reduction in the amount treated as the value of plan assets for purposes of this section, to the extent provided in paragraph (4), and

``(C) may be reduced at any time, pursuant to an election under paragraph (5).

``(3) Election to apply balances against minimum required contribution.--

``(A) In general.--Except as provided in subparagraphs (B) and (C), in the case of any plan year in which the plan sponsor elects to credit against the minimum required contribution for the current plan year all or a portion of the prefunding balance or the funding standard carryover balance for the current plan year (not in excess of such minimum required contribution), the minimum required contribution for the plan year shall be reduced as of the first day of the plan year by the amount so credited by the plan sponsor as of the first day of the plan year. For purposes of the preceding sentence, the minimum required contribution shall be determined after taking into account any waiver under section 412(c).

``(B) Coordination with funding standard carryover

balance.--To the extent that any plan has a funding standard carryover balance greater than zero, no amount of the prefunding balance of such plan may be credited under this paragraph in reducing the minimum required contribution.

``(C) Limitation for underfunded plans.--The preceding provisions of this paragraph shall not apply for any plan year if the ratio (expressed as a percentage) which--

``(i) the value of plan assets for the preceding plan year (as reduced under paragraph (4)(C)), bears to

``(ii) the funding target of the plan for the preceding plan year (determined without regard to subsection (i)(1)),

is less than 80 percent. In the case of plan years beginning in 2008, the ratio under this subparagraph may be determined using such methods of estimation as the Secretary may prescribe.

``(4) Effect of balances on amounts treated as value of plan assets.--In the case of any plan maintaining a prefunding balance or a funding standard carryover balance pursuant to this subsection, the amount treated as the value of plan assets shall be deemed to be such amount, reduced as provided in the following subparagraphs:

``(A) Applicability of shortfall amortization base.--For purposes of subsection (c)(5), the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance, but only if an election under paragraph (2) applying any portion of the prefunding balance in reducing the minimum required contribution is in effect for the plan year.

``(B) Determination of excess assets, funding shortfall, and funding target attainment percentage.--

``(i) In general.--For purposes of subsections (a), (c)(4)(B), and (d)(2)(A), the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance and the funding standard carryover balance.

``(ii) Special rule for certain binding agreements with pbgc.--For purposes of subsection (c)(4)(B), the value of plan assets shall not be deemed to be reduced for a plan year by the amount of the specified balance if, with respect to such balance, there is in effect for a plan year a binding written agreement with the Pension Benefit Guaranty Corporation which provides that such balance is not available to reduce the minimum required contribution for the plan year. For purposes of the preceding sentence, the term `specified balance' means the prefunding balance or the funding standard carryover balance, as the case may be.

``(C) Availability of balances in plan year for crediting against minimum required contribution.--For purposes of paragraph (3)(C)(i) of this subsection, the value of plan assets is deemed to be such amount, reduced by the amount of the prefunding balance.

``(5) Election to reduce balance prior to determinations of value of plan assets and crediting against minimum required contribution.--

``(A) In general.--The plan sponsor may elect to reduce by any amount the balance of the prefunding balance and the funding standard carryover balance for any plan year (but not below zero). Such reduction shall be effective prior to any determination of the value of plan assets for such plan year under this section and application of the balance in reducing the minimum required contribution for such plan for such plan year pursuant to an election under paragraph (2).

``(B) Coordination between prefunding balance and funding standard carryover balance.--To the extent that any plan has a funding standard carryover balance greater than zero, no election may be made under subparagraph (A) with respect to the prefunding balance.

``(6) Prefunding balance.--

``(A) In general.--A prefunding balance maintained by a plan shall consist of a beginning balance of zero, increased and decreased to the extent provided in subparagraphs (B) and (C), and adjusted further as

provided in paragraph (8).
``(B) Increases.--
``(i) In general.--As of the first day of each plan year beginning
after 2008, the prefunding balance of a plan shall be increased by the amount elected by
the plan sponsor for the plan year. Such amount shall not exceed the excess (if any) of--
``(I) the aggregate total of employer contributions to the plan for the preceding plan year, over--
``(II) the minimum required contribution for such preceding plan year.
``(ii) Adjustments for interest.--Any excess contributions under clause (i) shall be properly adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined by using the effective interest rate for the preceding plan year and by treating contributions as being first used to satisfy the minimum required contribution.
``(iii) Certain contributions necessary to avoid benefit limitations disregarded.--The excess described in clause (i) with respect to any preceding plan year shall be reduced (but not below zero) by the amount of contributions an employer would be required to make under paragraph (1), (2), or (4) of section 206(g) to avoid a benefit limitation which would otherwise be imposed under such paragraph for the preceding plan year. Any contribution which may be taken into account in satisfying the requirements of more than 1 of such paragraphs shall be taken into account only once for purposes of this clause.
``(C) Decreases.--The prefunding balance of a plan shall be decreased (but not below zero) by the sum of--
``(i) as of the first day of each plan year after 2008, the amount of such balance credited under paragraph (2) (if any) in reducing the minimum required contribution of the plan for the preceding plan year, and
``(ii) as of the time specified in paragraph (5)(A), any reduction in such balance elected under paragraph (5).
``(7) Funding standard carryover balance.--
``(A) In general.--A funding standard carryover balance maintained by a plan shall consist of a beginning balance determined under subparagraph (B), decreased to the extent provided in subparagraph (C), and adjusted further as provided in paragraph (8).
``(B) Beginning balance.--The beginning balance of the funding standard carryover balance shall be the positive balance described in paragraph (1)(B)(ii)(II).
``(C) Decreases.--The funding standard carryover balance of a plan shall be decreased (but not below zero) by--
``(i) as of the first day of each plan year after 2008, the amount of such balance credited under paragraph (2) (if any) in reducing the minimum required contribution of the plan for the preceding plan year, and
``(ii) as of the time specified in paragraph (5)(A), any reduction in such balance elected under paragraph (5).
``(8) Adjustments for investment experience.--In determining the prefunding balance or the funding standard carryover balance of a plan as of the first day of the plan year, the plan sponsor shall, in accordance with regulations prescribed by the Secretary of the Treasury, adjust such balance to reflect the rate of return on plan assets for the preceding plan year. Notwithstanding subsection (g)(3), such rate of return shall be determined on the basis of fair market value and shall properly take into account, in accordance with such regulations, all contributions, distributions, and other plan payments made during such period.
``(9) Elections.--Elections under this subsection shall be made at such times, and in such form and manner, as shall be prescribed in regulations of the Secretary.
``(g) Valuation of Plan Assets and Liabilities.--

``(1) Timing of determinations.--Except as otherwise provided under this subsection, all determinations under this section for a plan year shall be made as of the valuation date of the plan for such plan year.

``(2) Valuation date.--For purposes of this section--

``(A) In general.--Except as provided in subparagraph (B), the valuation date of a plan for any plan year shall be the first day of the plan year.

``(B) Exception for small plans.--If, on each day during the preceding plan year, a plan had 100 or fewer participants, the plan may designate any day during the plan year as its valuation date for such plan year and succeeding plan years. For purposes of this subparagraph, all defined benefit plans (other than multiemployer plans) maintained by the same employer (or any member of such employer's controlled group) shall be treated as 1 plan, but only participants with respect to such employer or member shall be taken into account.

``(C) Application of certain rules in determination of plan size.--For purposes of this paragraph--

``(i) Plans not in existence in preceding year.--In the case of the first plan year of any plan, subparagraph (B) shall apply to such plan by taking into account the number of participants that the plan is reasonably expected to have on days during such first plan year.

``(ii) Predecessors.--Any reference in subparagraph (B) to an employer shall include a reference to any predecessor of such employer.

``(3) Determination of value of plan assets.--For purposes of this section--

``(A) In general.--Except as provided in subparagraph (B), the value of plan assets shall be the fair market value of the assets.

``(B) Averaging allowed.--A plan may determine the value of plan assets on the basis of the averaging of fair market values, but only if such method--

``(i) is permitted under regulations prescribed by the Secretary,

``(ii) does not provide for averaging of such values over more than the period beginning on the last day of the 25th month preceding the month in which the valuation date occurs and ending on the valuation date (or a similar period in the case of a valuation date which is not the 1st day of a month), and

``(iii) does not result in a determination of the value of plan assets which, at any time, is lower than 90 percent or greater than 110 percent of the fair market value of such assets at such time.

Any such averaging shall be adjusted for contributions and distributions (as provided by the Secretary).

``(4) Accounting for contribution receipts.--For purposes of determining the value of assets under paragraph (3)--

``(A) Prior year contributions.--If--

``(i) an employer makes any contribution to the plan after the valuation date for the plan year in which the contribution is made, and

``(ii) the contribution is for a preceding plan year,

the contribution shall be taken into account as an asset of the plan as of the valuation date, except that in the case of any plan year beginning after 2008, only the present value (determined as of the valuation date) of such contribution may be taken into account. For purposes of the preceding sentence, present value shall be determined using the effective interest rate for the preceding plan year to which the contribution is properly allocable.

``(B) Special rule for current year contributions made before valuation date.--If any contributions for any plan year are made to or under the plan during the plan year but before the valuation date for the plan year, the assets of the plan as of the valuation date shall not include--

``(i) such contributions, and

``(ii) interest on such contributions for the period between the date of the contributions and the valuation date, determined by using the effective interest rate for the plan year.

``(h) Actuarial Assumptions and Methods.--
``(1) In general.--Subject to this subsection, the determination of any present value or other computation under this section shall be made on the basis of actuarial assumptions and methods--
``(A) each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and
``(B) which, in combination, offer the actuary's best estimate of anticipated experience under the plan.
``(2) Interest rates.--
``(A) Effective interest rate.--For purposes of this section, the term `effective interest rate' means, with respect to any plan for any plan year, the single rate of interest which, if used to determine the present value of the plan's accrued or earned benefits referred to in subsection (d)(1), would result in an amount equal to the funding target of the plan for such plan year.
``(B) Interest rates for determining funding target.--For purposes of determining the funding target of
a plan for any plan year, the interest rate used in determining the present value of the liabilities of the plan shall be--
``(i) in the case of benefits reasonably determined to be payable during the 5-year period beginning on the first day of the plan year, the first segment rate with respect to the applicable month,
``(ii) in the case of benefits reasonably determined to be payable during the 15-year period beginning at the end of the period described in clause (i), the second segment rate with respect to the applicable month, and
``(iii) in the case of benefits reasonably determined to be payable after the period described in clause (ii), the third segment rate with respect to the applicable month.
``(C) Segment rates.--For purposes of this paragraph--
``(i) First segment rate.--The term `first segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during the 5-year period commencing with such month.
``(ii) Second segment rate.--The term `second segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during the 15-year period beginning at the end of the period described in clause (i).
``(iii) Third segment rate.--The term `third segment rate' means, with respect to any month, the single rate of interest which shall be determined by the Secretary for such month on the basis of the corporate bond yield curve for such month, taking into account only that portion of such yield curve which is based on bonds maturing during periods beginning after the period described in clause (ii).
``(D) Corporate bond yield curve.--For purposes of this paragraph--
``(i) In general.--The term `corporate bond yield curve' means, with respect to any month, a yield curve which is prescribed by the Secretary for such month and which reflects the average, for the 24-month period ending with the month preceding such month, of monthly yields on investment grade corporate bonds with varying maturities and that are in the top 3 quality levels available.
``(ii) Election to use yield curve.--Solely for purposes of determining the minimum required contribution under this section, the plan sponsor may,

in lieu of the segment rates determined under subparagraph (C), elect to use interest rates under the corporate bond yield curve. For purposes of the preceding sentence such curve shall be determined without regard to the 24-month averaging described in clause (i). Such election, once made, may be revoked only with the consent of the Secretary.

``(E) Applicable month.--For purposes of this paragraph, the term `applicable month' means, with respect to any plan for any plan year, the month which includes the valuation date of such plan for such plan year or, at the election of the plan sponsor, any of the 4 months which precede such month. Any election made under this subparagraph shall apply to the plan year for which the election is made and all succeeding plan years, unless the election is revoked with the consent of the Secretary.

``(F) Publication requirements.--The Secretary shall publish for each month the corporate bond yield curve (and the corporate bond yield curve reflecting the modification described in section 417(e)(3)(D)(i)) for such month and each of the rates determined under subparagraph (B) for such month. The Secretary shall also publish a description of the methodology used to determine such yield curve and such rates which is sufficiently detailed to enable plans to make reasonable projections regarding the yield curve and such rates for future months based on the plan's projection of future interest rates.

``(G) Transition rule.--

``(i) In general.--Notwithstanding the preceding provisions of this paragraph, for plan years beginning in 2008 or 2009, the first, second, or third segment rate for a plan with respect to any month shall be equal to the sum of--

``(I) the product of such rate for such month determined without regard to this subparagraph, multiplied by the applicable percentage, and

``(II) the product of the rate determined under the rules of section 412(b)(5)(B)(ii)(II) (as in effect for plan years beginning in 2007), multiplied by a percentage equal to 100 percent minus the applicable percentage.

``(ii) Applicable percentage.--For purposes of clause (i), the applicable percentage is 33\1/3\ percent for plan years beginning in 2008 and 66\2/3\ percent for plan years beginning in 2009.

``(iii) New plans ineligible.--Clause (i) shall not apply to any plan if the first plan year of the plan begins after December 31, 2007.

``(iv) Election.--The plan sponsor may elect not to have this subparagraph apply. Such election, once made, may be revoked only with the consent of the Secretary.

``(3) Mortality tables.--

``(A) In general.--Except as provided in subparagraph (C) or (D), the Secretary shall by regulation prescribe mortality tables to be used in determining any present value or making any computation under this section. Such tables shall be based on the actual experience of pension plans and projected trends in such experience. In prescribing such tables, the Secretary shall take into account results of available independent studies of mortality of individuals covered by pension plans.

``(B) Periodic revision.--The Secretary shall (at least every 10 years) make revisions in any table in effect under subparagraph (A) to reflect the actual experience of pension plans and projected trends in such experience.

``(C) Substitute mortality table.--

``(i) In general.--Upon request by the plan sponsor and approval by the Secretary, a mortality table which meets the requirements of clause (iii) shall be used in determining any present value or making any computation under this section during the period of consecutive plan years (not to

exceed 10) specified in the request.
``(ii) Early termination of period.--
Notwithstanding clause (i), a mortality table
described in clause (i) shall cease to be in
effect as of the earliest of--
``(I) the date on which there is a
significant change in the participants
in the plan by reason of a plan spinoff
or merger or otherwise, or
``(II) the date on which the plan
actuary determines that such table does
not meet the requirements of clause
(iii).
``(iii) Requirements.--A mortality table meets
the requirements of this clause if--
``(I) there is a sufficient number
of plan participants, and the pension
plans have been maintained for a
sufficient period of time, to have
credible information necessary for
purposes of subclause (II), and
``(II) such table reflects the
actual experience of the pension plans
maintained by the sponsor and projected
trends in general mortality experience.
``(iv) All plans in controlled group must use
separate table.--Except as provided by the
Secretary, a plan sponsor may not use a mortality
table under this subparagraph for any plan
maintained by the plan sponsor unless--
``(I) a separate mortality table is
established and used under this
subparagraph for each other plan
maintained by the plan sponsor and if
the plan sponsor is a member of a
controlled group, each member of the
controlled group, and
``(II) the requirements of clause
(iii) are met separately with respect to
the table so established for each such
plan, determined by only taking into
account the participants of such plan,
the time such plan has been in
existence, and the actual experience of
such plan.
``(v) Deadline for submission and disposition
of application.--
``(I) Submission.--The plan sponsor
shall submit a mortality table to the
Secretary for
approval under this subparagraph at
least 7 months before the 1st day of the
period described in clause (i).
``(II) Disposition.--Any mortality
table submitted to the Secretary for
approval under this subparagraph shall
be treated as in effect as of the 1st
day of the period described in clause
(i) unless the Secretary, during the
180-day period beginning on the date of
such submission, disapproves of such
table and provides the reasons that such
table fails to meet the requirements of
clause (iii). The
180-day period shall be extended upon
mutual agreement of the Secretary and
the plan sponsor.
``(D) Separate mortality tables for the disabled.--
Notwithstanding subparagraph (A)--
``(i) In general.--The Secretary shall
establish mortality tables which may be used (in
lieu of the tables under subparagraph (A)) under
this subsection for individuals who are entitled
to benefits under the plan on account of
disability. The Secretary shall establish separate
tables for individuals whose disabilities occur in
plan years beginning before January 1, 1995, and
for individuals whose disabilities occur in plan
years beginning on or after such date.
``(ii) Special rule for disabilities occurring
after 1994.--In the case
of disabilities occurring

in plan years beginning after December 31, 1994, the tables under clause (i) shall apply only with respect to individuals described in such subclause who are disabled within the meaning of title II of the Social Security Act and the regulations thereunder.

``(iii) Periodic revision.--The Secretary shall (at least every 10 years) make revisions in any table in effect under clause (i) to reflect the actual experience of pension plans and projected trends in such experience.

``(4) Probability of benefit payments in the form of lump sums or other optional forms.--For purposes of determining any present value or making any computation under this section, there shall be taken into account--

``(A) the probability that future benefit payments under the plan will be made in the form of optional forms of benefits provided under the plan (including lump sum distributions, determined on the basis of the plan's experience and other related assumptions), and

``(B) any difference in the present value of such future benefit payments resulting from the use of actuarial assumptions, in determining benefit payments in any such optional form of benefits, which are different from those specified in this subsection.

``(5) Approval of large changes in actuarial assumptions.--

``(A) In general.--No actuarial assumption used to determine the funding target for a plan to which this paragraph applies may be changed without the approval of the Secretary.

``(B) Plans to which paragraph applies.--This paragraph shall apply to a plan only if--

``(i) the plan is a defined benefit plan (other than a multiemployer plan) to which title IV of the Employee Retirement Income Security Act of 1974 applies,

``(ii) the aggregate unfunded vested benefits as of the close of the preceding plan year (as determined under section 4006(a)(3)(E)(iii) of the Employee Retirement Income Security Act of 1974) of such plan and all other plans maintained by the contributing sponsors (as defined in section 4001(a)(13) of such Act) and members of such sponsors' controlled groups (as defined in section 4001(a)(14) of such Act) which are covered by title IV (disregarding plans with no unfunded vested benefits) exceed $50,000,000, and

``(iii) the change in assumptions (determined after taking into account any changes in interest rate and mortality table) results in a decrease in the funding shortfall of the plan for the current plan year that exceeds $50,000,000, or that exceeds $5,000,000 and that is 5 percent or more of the funding target of the plan before such change.

``(i) Special Rules for At-Risk Plans.--

``(1) Funding target for plans in at-risk status.--

``(A) In general.--In the case of a plan which is in at-risk status for a plan year, the funding target of the plan for the plan year shall be equal to the sum of--

``(i) the present value of all benefits accrued or earned under the plan as of the beginning of the plan year, as determined by using the additional actuarial assumptions described in subparagraph (B), and

``(ii) in the case of a plan which also has been in at-risk status for at least 2 of the 4 preceding plan years, a loading factor determined under subparagraph (C).

``(B) Additional actuarial assumptions.--The actuarial assumptions described in this subparagraph are as follows:

``(i) All employees who are not otherwise assumed to retire as of the valuation date but who will be eligible to elect benefits during the plan year and the 10 succeeding plan years shall be assumed to retire at the earliest retirement date under the plan but not before the end of the plan year for which the at-risk funding target and at-risk target normal cost are being determined.

``(ii) All employees shall be assumed to elect

the retirement benefit available under the plan at the assumed retirement age (determined after application of clause (i)) which would result in the highest present value of benefits.

``(C) Loading factor.--The loading factor applied with respect to a plan under this paragraph for any plan year is the sum of--

``(i) $700, times the number of participants in the plan, plus

``(ii) 4 percent of the funding target (determined without regard to this paragraph) of the plan for the plan year.

``(2) Target normal cost of at-risk plans.--In the case of a plan which is in at-risk status for a plan year, the target normal cost of the plan for such plan year shall be equal to the sum of--

``(A) the present value of all benefits which are expected to accrue or be earned under the plan during the plan year, determined using the additional actuarial assumptions described in paragraph (1)(B), plus

``(B) in the case of a plan which also has been in at-risk status for at least 2 of the 4 preceding plan years, a loading factor equal to 4 percent of the target normal cost (determined without regard to this paragraph) of the plan for the plan year.

``(3) Minimum amount.--In no event shall--

``(A) the at-risk funding target be less than the funding target, as determined without regard to this subsection, or

``(B) the at-risk target normal cost be less than the target normal cost, as determined without regard to this subsection.

``(4) Determination of at-risk status.--For purposes of this subsection--

``(A) In general.--A plan is in at-risk status for a plan year if--

``(i) the funding target attainment percentage for the preceding plan year (determined under this section without regard to this subsection) is less than 80 percent, and

``(ii) the funding target attainment percentage for the preceding plan year (determined under this section by using the additional actuarial assumptions described in paragraph (1)(B) in computing the funding target) is less than 70 percent.

``(B) Transition rule.--In the case of plan years beginning in 2008, 2009, and 2010, subparagraph (A)(i) shall be applied by substituting the following percentages for `80 percent':

``(i) 65 percent in the case of 2008.

``(ii) 70 percent in the case of 2009.

``(iii) 75 percent in the case of 2010.

In the case of plan years beginning in 2008, the funding target attainment percentage for the preceding plan year under subparagraph (A)(ii) may be determined using such methods of estimation as the Secretary may provide.

``(C) Special rule for employees offered early retirement in 2006.--

``(i) In general.--For purposes of subparagraph (A)(ii), the additional actuarial assumptions described in paragraph (1)(B) shall not be taken into account with respect to any employee if--

``(I) such employee is employed by a specified automobile manufacturer,

``(II) such employee is offered a substantial amount of additional cash compensation, substantially enhanced retirement benefits under the plan, or materially reduced employment duties on the condition that by a specified date (not later than December 31, 2010) the employee retires (as defined under the terms of the plan),

``(III) such offer is made during 2006 and pursuant to a bona fide retirement incentive program and requires, by the terms of the offer, that such offer can be

accepted not later than a specified date (not later than December 31, 2006), and
``(IV) such employee does not elect to accept such offer before the specified date on which the offer expires.
``(ii) Specified automobile manufacturer.--For purposes of clause (i), the term `specified automobile manufacturer' means--
``(I) any manufacturer of automobiles, and
``(II) any manufacturer of automobile parts which supplies such parts directly to a manufacturer of automobiles and which, after a transaction or series of transactions ending in 1999, ceased to be a member of a controlled group which included such manufacturer of automobiles.

``(5) Transition between applicable funding targets and between applicable target normal costs.--
``(A) In general.--In any case in which a plan which is in at-risk status for a plan year has been in such status for a consecutive period of fewer than 5 plan years, the applicable amount of the funding target and of the target normal cost shall be, in lieu of the amount determined without regard to this paragraph, the sum of--
``(i) the amount determined under this section without regard to this subsection, plus
``(ii) the transition percentage for such plan year of the excess of the amount determined under this subsection (without regard to this paragraph) over the amount determined under this section without regard to this subsection.
``(B) Transition percentage.--For purposes of subparagraph (A), the transition percentage shall be determined in accordance with the following table:

``If the consecutive number of years (including the plan year) the plan is in at-risk status is--	The transition percentage is--
1	20
2	40
3	60
4	80.

``(C) Years before effective date.--For purposes of this paragraph, plan years beginning before 2008 shall not be taken into account.

``(6) Small plan exception.--If, on each day during the preceding plan year, a plan had 500 or fewer participants, the plan shall not be treated as in at-risk status for the plan year. For purposes of this paragraph, all defined benefit plans (other than multiemployer plans) maintained by the same employer (or any member of such employer's controlled group) shall be treated as 1 plan, but only participants with respect to such employer or member shall be taken into account and the rules of subsection (g)(2)(C) shall apply.

``(j) Payment of Minimum Required Contributions.--
``(1) In general.--For purposes of this section, the due date for any payment of any minimum required contribution for any plan year shall be 8\1/2\ months after the close of the plan year.
``(2) Interest.--Any payment required under paragraph (1) for a plan year that is made on a date other than the valuation date for such plan year shall be adjusted for interest accruing for the period between the valuation date and the payment date, at the effective rate of interest for the plan for such plan year.
``(3) Accelerated quarterly contribution schedule for underfunded plans.--
``(A) Failure to timely make required installment.-- In any case in which the plan has a funding shortfall for the preceding plan year, the employer maintaining the plan shall make the required installments under this paragraph and if the employer fails to pay the full amount of a required installment for the plan year, then the amount of interest charged under paragraph (2) on the underpayment for the period of underpayment shall be

determined by using a rate of interest equal to the rate otherwise used under paragraph (2) plus 5 percentage points.

``(B) Amount of underpayment, period of underpayment.--For purposes of subparagraph (A)--

``(i) Amount.--The amount of the underpayment shall be the excess of--

``(I) the required installment, over

``(II) the amount (if any) of the installment contributed to or under the plan on or before the due date for the installment.

``(ii) Period of underpayment.--The period for which any interest is charged under this paragraph with respect to any portion of the underpayment shall run from the due date for the installment to the date on which such portion is contributed to or under the plan.

``(iii) Order of crediting contributions.--For purposes of clause (i)(II), contributions shall be credited against unpaid required installments in the order in which such installments are required to be paid.

``(C) Number of required installments; due dates.--For purposes of this paragraph--

``(i) Payable in 4 installments.--There shall be 4 required installments for each plan year.

``(ii) Time for payment of installments.--The due dates for required installments are set forth in the following table:

``In the case of the following required installment:	The due date is:
1st............................	April 15
2nd............................	July 15
3rd............................	October 15
4th............................	January 15 of the following year.

``(D) Amount of required installment.--For purposes of this paragraph--

``(i) In general.--The amount of any required installment shall be 25 percent of the required annual payment.

``(ii) Required annual payment.--For purposes of clause (i), the term `required annual payment' means the lesser of--

``(I) 90 percent of the minimum required contribution (determined without regard to this subsection) to the plan for the plan year under this section, or

``(II) 100 percent of the minimum required contribution (determined without regard to this subsection or to any waiver under section 302(c)) to the plan for the preceding plan year.

Subclause (II) shall not apply if the preceding plan year referred to in such clause was not a year of 12 months.

``(E) Fiscal years and short years.--

``(i) Fiscal years.--In applying this paragraph to a plan year beginning on any date other than January 1, there shall be substituted for the months specified in this paragraph, the months which correspond thereto.

``(ii) Short plan year.--This subparagraph shall be applied to plan years of less than 12 months in accordance with regulations prescribed by the Secretary.

``(4) Liquidity requirement in connection with quarterly contributions.--

``(A) In general.--A plan to which this paragraph applies shall be treated as failing to pay the full amount of any required installment under paragraph (3) to the extent that the value of the liquid assets paid in such installment is less than the liquidity shortfall (whether or not such liquidity shortfall exceeds the amount of such installment required to be paid but for this paragraph).

``(B) Plans to which paragraph applies.--This paragraph shall apply to a plan (other than a plan described in subsection (g)(2)(B)) which--

``(i) is required to pay installments under paragraph (3) for a plan year, and

``(ii) has a liquidity shortfall for any quarter during such plan year.

``(C) Period of underpayment.--For purposes of paragraph (3)(A), any portion of an installment that is treated as not paid under subparagraph (A) shall continue to be
treated as unpaid until the close of the quarter in which the due date for such installment occurs.

``(D) Limitation on increase.--If the amount of any required installment is increased by reason of subparagraph (A), in no event shall such increase exceed the amount which, when added to prior installments for the plan year, is necessary to increase the funding target attainment percentage of the plan for the plan year (taking into account the expected increase in funding target due to benefits accruing or earned during the plan year) to 100 percent.

``(E) Definitions.--For purposes of this paragraph--

``(i) Liquidity shortfall.--The term `liquidity shortfall' means, with respect to any required installment, an amount equal to the excess (as of the last day of the quarter for which such installment is made) of--

``(I) the base amount with respect to such quarter, over

``(II) the value (as of such last day) of the plan's liquid assets.

``(ii) Base amount.--

``(I) In general.--The term `base amount' means, with respect to any quarter, an amount equal to 3 times the sum of the adjusted disbursements from the plan for the 12 months ending on the last day of such quarter.

``(II) Special rule.--If the amount determined under subclause (I) exceeds an amount equal to 2 times the sum of the adjusted disbursements from the plan for the 36 months ending on the last day of the quarter and an enrolled actuary certifies to the satisfaction of the Secretary that such excess is the result of nonrecurring circumstances, the base amount with respect to such quarter shall be determined without regard to amounts related to those nonrecurring circumstances.

``(iii) Disbursements from the plan.--The term `disbursements from the plan' means all disbursements from the trust, including purchases of annuities, payments of single sums and other benefits, and administrative expenses.

``(iv) Adjusted disbursements.--The term `adjusted disbursements' means disbursements from the plan reduced by the product of--

``(I) the plan's funding target attainment percentage for the plan year, and

``(II) the
sum of the purchases of annuities, payments of single sums, and such other disbursements as the Secretary shall provide in regulations.

``(v) Liquid assets.--
The term `liquid assets'
means cash, marketable securities, and such other assets as specified by the Secretary in regulations.

``(vi) Quarter.--The term `quarter' means, with respect to any required installment, the 3-month period
preceding the month in which the due date for such installment occurs.

``(F) Regulations.--The Secretary may prescribe such regulations as are necessary to carry out this paragraph.

``(k) Imposition of Lien Where Failure to Make Required Contributions.--

``(1) In general.--In the case of a plan to which this subsection applies, if--

``(A) any person fails to make a contribution payment required by section 412 and this section before

the due date for such payment, and

``(B) the unpaid balance of such payment (including interest), when added to the aggregate unpaid balance of all preceding such payments for which payment was not made before the due date (including interest), exceeds $1,000,000,

then there shall be a lien in favor of the plan in the amount determined under paragraph (3) upon all property and rights to property, whether real or personal, belonging to such person and any other person who is a member of the same controlled group of which such person is a member.

``(2) Plans to which subsection applies.--This subsection shall apply to a defined benefit plan (other than a multiemployer plan) covered under section 4021 of the Employee Retirement Income Security Act of 1974 for any plan year for which the funding target attainment percentage (as defined in subsection (d)(2)) of such plan is less than 100 percent.

``(3) Amount of lien.--For purposes of paragraph (1), the amount of the lien shall be equal to the aggregate unpaid balance of contribution payments required under this section and section 412 for which payment has not been made before the due date.

``(4) Notice of failure; lien.--

``(A) Notice of failure.--
A person committing a failure described in paragraph (1) shall notify the Pension Benefit Guaranty Corporation of such failure within 10 days of the due date for the required contribution payment.

``(B) Period of lien.--The lien imposed by paragraph (1) shall arise on the due date for the required contribution payment and shall continue until the last day of the first plan year in which the plan ceases to be described in paragraph (1)(B). Such lien shall continue to run without regard to whether such plan continues to be described in paragraph (2) during the period referred to in the preceding sentence.

``(C) Certain rules to apply.--Any amount with respect to which a lien is imposed under paragraph (1) shall be treated as taxes due and owing the United States and rules similar to the rules of subsections (c), (d), and (e) of section 4068 of the Employee Retirement Income Security Act of 1974 shall apply with respect to a lien imposed by subsection (a) and the amount with respect to such lien.

``(5) Enforcement.--Any lien created under paragraph (1) may be perfected and enforced only by the Pension Benefit Guaranty Corporation, or at the direction of the Pension Benefit Guaranty Corporation, by the contributing sponsor (or any member of the controlled group of the contributing sponsor).

``(6) Definitions.--For purposes of this subsection--

``(A) Contribution payment.--The term `contribution payment' means, in connection with a plan, a contribution payment required to be made to the plan, including any required installment under paragraphs (3) and (4) of subsection (j).

``(B) Due date; required installment.--The terms `due date' and `required installment' have the meanings given such terms by subsection (j), except that in the case of a payment other than a required installment, the due date shall be the date such payment is required to be made under section 430.

``(C) Controlled group.--The term `controlled group' means any group treated as a single employer under subsections (b), (c), (m), and (o) of section 414.

``(l) Qualified Transfers to Health Benefit Accounts.--In the case of a qualified transfer (as defined in section 420), any assets so transferred shall not, for purposes of this section, be treated as assets in the plan.''.

(b) Effective Date.--The amendments made by this section shall apply with respect to plan years beginning after December 31, 2007.

SEC. 113. BENEFIT LIMITATIONS UNDER SINGLE-EMPLOYER PLANS.

(a) Prohibition of Shutdown Benefits and Other Unpredictable Contingent Event Benefits Under Single-Employer Plans.--

(1) In general.--Part III of subchapter D of chapter 1 of the Internal Revenue Code of 1986 (relating to deferred compensation, etc.) is amended--

(A) by striking the heading and inserting the following:

``PART III--RULES RELATING TO MINIMUM FUNDING STANDARDS AND BENEFIT LIMITATIONS

``subpart a. minimum funding standards for pension plans.
``subpart b. benefit limitations under single-employer plans.
``Subpart A--Minimum Funding Standards for Pension Plans
``Sec. 430. Minimum funding standards for single-employer defined benefit pension plans.'',
and
(B) by adding at the end the following new subpart:
``Subpart B--Benefit Limitations Under Single-Employer Plans
``Sec. 436. Funding-based limitation on shutdown benefits and other unpredictable contingent event benefits under single-employer plans.
``SEC. 436. FUNDING-BASED LIMITS ON BENEFITS AND BENEFIT ACCRUALS UNDER SINGLE-EMPLOYER PLANS.

``(a) General Rule.--For purposes of section 401(a)(29), a defined benefit plan which is a single-employer plan shall be treated as meeting the requirements of this section if the plan meets the requirements of subsections (b), (c), (d), and (e).

``(b) Funding-Based Limitation on Shutdown Benefits and Other Unpredictable Contingent Event Benefits Under Single-Employer Plans.--

``(1) In general.--If a participant of a defined benefit plan which is a single-employer plan is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan shall provide that such benefit may not be provided if the adjusted funding target attainment percentage for such plan year--

``(A) is less than 60 percent, or

``(B) would be less than 60 percent taking into account such occurrence.

``(2) Exemption.--Paragraph (1) shall cease to apply with respect to any plan year,
effective as of the first day of the plan year, upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 303) equal to--

``(A) in the case of paragraph (1)(A), the amount of the increase in the funding target of the plan (under section 430) for the plan year attributable to the occurrence referred to in paragraph (1), and

``(B) in the case of paragraph (1)(B), the amount sufficient to result in a funding target attainment percentage of 60 percent.

``(3) Unpredictable contingent event.--For purposes of this subsection, the term `unpredictable contingent event benefit' means any benefit payable solely by reason of--

``(A) a plant shutdown (or similar event, as determined by the Secretary), or

``(B) any event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or occurrence of death or disability.

``(c) Limitations on Plan Amendments Increasing Liability for Benefits.--

``(1) In general.--No amendment to a defined benefit plan which is a single-employer plan which has the effect of increasing liabilities of the plan by reason of increases in benefits, establishment of new benefits, changing the rate of benefit accrual, or changing the rate at which benefits become nonforfeitable may take effect during any plan year if the adjusted funding target attainment percentage for such plan year is--

``(A) less than 80 percent, or

``(B) would be less than 80 percent taking into account such amendment.

``(2) Exemption.--Paragraph (1)
shall cease to apply with respect to any plan year, effective as of the first day of the plan year (or if later, the effective date of the amendment), upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 430) equal to--

``(A) in the case of paragraph (1)(A), the amount of the increase in the funding target of the plan (under section 430) for the plan year attributable to the amendment, and

``(B) in the case of paragraph (1)(B), the amount sufficient to result in an adjusted funding target attainment percentage of 80 percent.

``(3) Exception for certain benefit increases.--Paragraph (1) shall not apply to any amendment which provides for an increase in benefits under a formula which is not based on a participant's compensation, but only if the rate of such increase is not in excess of the contemporaneous rate of increase in average wages of participants covered by the amendment.

``(d) Limitations on Accelerated Benefit Distributions.--
``(1) Funding percentage less than 60 percent.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan may not pay any prohibited payment after the valuation date for the plan year.
``(2) Bankruptcy.--A defined benefit plan which is a single-employer plan shall provide that, during any period in which the plan sponsor is a debtor in a case under title 11, United States Code, or similar Federal or State law, the plan may not pay any prohibited payment. The preceding sentence shall not apply on or after the date on which the enrolled actuary of the plan certifies that the adjusted funding target attainment percentage of such plan is not less than 100 percent.
``(3) Limited payment if percentage at least 60 percent but less than 80 percent.--
``(A) In general.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater but less than 80 percent, the plan may not pay any prohibited payment after the valuation date for the plan year to the extent the amount of the payment exceeds the lesser of--
``(i) 50 percent of the amount of the payment which could be made without regard to this section, or
``(ii) the present value (determined under guidance prescribed by the Pension Benefit Guaranty Corporation, using the interest and mortality assumptions under section 417(e)) of the maximum guarantee with respect to the participant under section 4022 of the Employee Retirement Income Security Act of 1974.
``(B) One-time application.--
``(i) In general.--The plan shall also provide that only 1 prohibited payment meeting the requirements of subparagraph (A) may be made with respect to any participant during any period of consecutive plan years to which the limitations under either paragraph (1) or (2) or this paragraph applies.
``(ii) Treatment of beneficiaries.--For purposes of this subparagraph, a participant and any beneficiary on his behalf (including an alternate payee, as defined in section 414(p)(8)) shall be treated as 1 participant. If the accrued benefit of a participant is allocated to such an alternate payee and 1 or more other persons, the amount under subparagraph (A) shall be allocated among such persons in the same manner as the accrued benefit is allocated unless the qualified domestic relations order (as defined in section 414(p)(1)(A)) provides otherwise.
``(4) Exception.--This subsection shall not apply to any plan for any plan year if the terms of such plan (as in effect for the period beginning on September 1, 2005, and ending with such plan year) provide for no benefit accruals with respect to any participant during such period.
``(5) Prohibited payment.--For purpose of this subsection, the term `prohibited payment' means--
``(A) any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 411(a)(9)), to a participant or beneficiary whose annuity starting date (as defined in section 417(f)(2)) occurs during any period a limitation under paragraph (1) or (2) is in effect,
``(B) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and
``(C) any other payment specified by the Secretary by regulations.
``(e) Limitation on Benefit Accruals for Plans With Severe Funding Shortfalls.--
``(1) In general.--A defined benefit plan which is a single-employer plan shall provide that, in any case in which the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, benefit accruals under the plan shall cease as of the valuation date for the plan year.
``(2) Exemption.--Paragraph (1) shall cease to apply with

respect to any plan year, effective as of the first day of the plan year, upon payment by the plan sponsor of a contribution (in addition to any minimum required contribution under section 430) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

``(f) Rules Relating to Contributions Required to Avoid Benefit Limitations.--

``(1) Security may be provided.--

``(A) In general.--For purposes of this section, the adjusted funding target attainment percentage shall be determined by treating as an asset of the plan any security provided by a plan sponsor in a form meeting the requirements of subparagraph (B).

``(B) Form of security.--The security required under subparagraph (A) shall consist of--

``(i) a bond issued by a corporate surety company that is an acceptable surety for purposes of section
412 of the Employee Retirement Income Security Act of 1974,

``(ii) cash, or United States obligations which mature in 3 years or less, held in escrow by a bank or similar financial institution, or

``(iii) such other form of security as is satisfactory to the Secretary and the parties involved.

``(C) Enforcement.--Any security provided under subparagraph (A) may be perfected and enforced at any time after the earlier of--

``(i) the date on which the plan terminates,

``(ii) if there is a failure to make a payment of the minimum required contribution for any plan year beginning after the security is provided, the due date for the payment under section 430(j), or

``(iii) if the adjusted funding target attainment percentage is less than 60 percent for a consecutive period of 7 years, the valuation date for the last year in the period.

``(D) Release of security.--
The security shall be released
(and any amounts thereunder shall be refunded together with any interest accrued thereon) at such time as the Secretary may prescribe in regulations, including regulations for partial releases of the security by reason of increases in the funding target attainment percentage.

``(2) Prefunding balance or funding standard carryover balance may not be used.--No prefunding balance under section 430(f) or funding standard carryover balance may be used under subsection (b), (c), or (e) to satisfy any payment an employer may make under any such subsection to avoid or terminate the application of any limitation under such subsection.

``(3) Deemed reduction of funding balances.--

``(A) In general.--Subject to subparagraph (C), in any case in which a benefit limitation under subsection (b), (c), (d), or (e) would (but for this subparagraph and determined without regard to subsection (b)(2), (c)(2), or (e)(2)) apply to such plan for the plan year, the plan sponsor of such plan shall be treated for purposes of this title as having made an election under section 430(f) to reduce the prefunding balance or funding standard carryover balance by such amount as is necessary for such benefit limitation to not apply to the plan for such plan year.

``(B) Exception for insufficient funding balances.--
Subparagraph (A) shall not apply with respect to a benefit limitation for any plan year if the application of subparagraph (A) would not result in the benefit limitation not applying for such plan year.

``(C) Restrictions of certain rules to collectively bargained plans.--With respect to any benefit limitation under subsection (b), (c), or (e), subparagraph (A) shall only apply in the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers.

``(g) New Plans.--Subsections (b), (c), and (e) shall not apply to a plan for the first 5 plan years of the plan. For purposes of this subsection, the reference in this subsection to a plan shall include a reference to any predecessor plan.

``(h) Presumed Underfunding for Purposes of Benefit Limitations.--

``(1) Presumption of continued underfunding.--In any case in which a benefit limitation under subsection (b), (c), (d), or (e) has been applied to a plan with respect to the plan year preceding the current plan year, the adjusted funding target attainment percentage of the plan for the current plan year shall be presumed to be equal to the adjusted funding target attainment percentage of the plan for the preceding plan year until the enrolled actuary of the plan certifies the actual adjusted funding target attainment percentage of the plan for the current plan year.

``(2) Presumption of underfunding after 10th month.--In any case in which no certification of the adjusted funding target attainment percentage for the current plan year is made with respect to the plan before the first day of the 10th month of such year, for purposes of subsections (b), (c), (d), and (e), such first day shall be deemed, for purposes of such subsection, to be the valuation date of the plan for the current plan year and the plan's adjusted funding target attainment percentage shall be conclusively presumed to be less than 60 percent as of such first day.

``(3) Presumption of underfunding after 4th month for nearly underfunded plans.--In any case in which--

``(A) a benefit limitation under subsection (b), (c), (d), or (e) did not apply to a plan with respect to the plan year preceding the current plan year, but the adjusted funding target attainment percentage of the plan for such preceding plan year was not more than 10 percentage points greater than the percentage which would have caused such subsection to apply to the plan with respect to such preceding plan year, and

``(B) as of the first day of the 4th month of the current plan year, the enrolled actuary of the plan has not certified the actual adjusted funding target attainment percentage of the plan for the current plan year,

until the enrolled actuary so certifies, such first day shall be deemed, for purposes of such subsection, to be the valuation date of the plan for the current plan year and the adjusted funding target attainment percentage of the plan as of such first day shall, for purposes of such subsection, be presumed to be equal to 10 percentage points less than the adjusted funding target attainment percentage of the plan for such preceding plan year.

``(i) Treatment of Plan as of Close of Prohibited or Cessation Period.--For purposes of applying this title--

``(1) Operation of plan after period.--Unless the plan provides otherwise, payments and accruals will resume effective as of the day following the close of the period for which any limitation of payment or accrual of benefits under subsection (d) or (e) applies.

``(2) Treatment of affected benefits.--Nothing in this subsection shall be construed as affecting the plan's treatment of benefits which would have been paid or accrued but for this section.

``(j) Terms Relating to Funding Target Attainment Percentage.--For purposes of this section--

``(1) In general.--The term `funding target attainment percentage' has the same meaning given such term by section 430(d)(2).

``(2) Adjusted funding target attainment percentage.--The term `adjusted funding target attainment percentage' means the funding target attainment percentage which is determined under paragraph (1) by increasing each of the amounts under subparagraphs (A) and (B) of section 430(d)(2) by the aggregate amount of purchases of annuities for employees other than highly compensated employees (as defined in section 414(q)) which were made by the plan during the preceding 2 plan years.

``(3) Application to plans which are fully funded without regard to reductions for funding balances.--

``(A) In general.--In the case of a plan for any plan year, if the funding target attainment percentage is 100 percent or more (determined without regard to this paragraph and without regard to the reduction in the value of assets under section 430(f)(4)(A)), the funding target attainment percentage for purposes of paragraph (1) shall be determined without regard to such reduction.

``(B) Transition rule.--
Subparagraph (A) shall be applied to plan years beginning after 2007 and before 2011 by substituting for `100 percent' the applicable percentage determined in accordance with the following table:

``In the case of a pThe applicable...........................
beginning in calenpercentage is............................

2008...	92
2009...	94
2010...	96.

``(C) Limitation.--Subparagraph (B) shall not apply with respect to any plan year after 2008 unless the funding target attainment percentage (determined without regard to this paragraph) of the plan for each preceding plan year after 2007 was not less than the applicable percentage with respect to such preceding plan year determined under subparagraph (B).

``(k) Special Rule for 2008.--For purposes of this section, in the case of plan years beginning in 2008, the funding target attainment percentage for the preceding plan year may be determined using such methods of estimation as the Secretary may provide.''.

(2) Clerical amendment.--The table of parts for subchapter D of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new item:

``Part III--Rules Relating to Minimum Funding Standards and Benefit Limitations''.

(b) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

(2) Collective bargaining exception.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified before January 1, 2008, the amendments made by this section shall not apply to plan years beginning before the earlier of--

(A) the later of--

(i) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of the enactment of this Act), or

(ii) the first day of the first plan year to which the amendments made by this subsection would (but for this subparagraph) apply, or

(B) January 1, 2010.

For purposes of subparagraph (A)(i), any plan amendment made pursuant to a collective bargaining agreement relating to the plan which amends the plan solely to conform to any requirement added by this section shall not be treated as a termination of such collective bargaining agreement.

SEC. 114. TECHNICAL AND CONFORMING AMENDMENTS.

(a) Amendments Related to Qualification Requirements.--

(1) Section 401(a)(29) of the Internal Revenue Code of 1986 is amended to read as follows:

``(29) Benefit limitations on plans in at-risk status.--In the case of a defined benefit plan (other than a multiemployer plan) to which the requirements of section 412 apply, the trust of which the plan is a part shall not constitute a qualified trust under this subsection unless the plan meets the requirements of section 436.''.

(2) Section 401(a)(32) of such Code is amended--

(A) in subparagraph (A), by striking ``412(m)(5)'' each place it appears and inserting ``section 430(j)(4)'', and

(B) in subparagraph (C), by striking ``section 412(m)'' and inserting ``section 430(j)''.

(3) Section 401(a)(33) of such Code is amended--

(A) in subparagraph (B)(i), by striking ``funded current liability percentage (within the meaning of section 412(l)(8))'' and inserting ``funding target attainment percentage (as defined in section 430(d)(2))'',

(B) in subparagraph (B)(iii), by striking ``subsection 412(c)(8)'' and inserting ``section 412(c)(2)'', and

(C) in subparagraph (D), by striking ``section 412(c)(11) (without regard to subparagraph (B) thereof)'' and inserting ``section 412(b)(2) (without regard to subparagraph (B) thereof)''.

(b) Vesting Rules.--Section 411 of such Code is amended--

(1) by striking ``section 412(c)(8)'' in subsection (a)(3)(C) and inserting ``section 412(c)(2)'',

(2) in subsection (b)(1)(F)--

(A) by striking ``paragraphs (2) and (3) of section 412(i)'' in clause (ii) and inserting ``subparagraphs (B) and (C) of section 412(e)(3)'', and

(B) by striking ``paragraphs (4), (5), and (6) of section 412(i)'' and inserting ``subparagraphs (D), (E), and (F) of section 412(e)(3)'', and

(3) by striking ``section 412(c)(8)'' in subsection (d)(6)(A) and inserting ``section 412(e)(2)''.

(c) Mergers and Consolidations of Plans.--Subclause (I) of section 414(l)(2)(B)(i) of such Code is amended to read as follows:

``(I) the amount determined under section 431(c)(6)(A)(i) in the case of a multiemployer plan (and the sum of the funding shortfall and target normal cost determined under section 430 in the case of any other plan), over''.

(d) Transfer of Excess Pension Assets to Retiree Health Accounts.--

(1) Section 420(e)(2) of such Code is amended to read as follows:

``(2) Excess pension assets.--The term `excess pension assets' means the excess (if any) of--

``(A) the lesser of--

``(i) the fair market value of the plan's assets (reduced by the prefunding balance and funding standard carryover balance determined under section 430(f)), or

``(ii) the value of plan assets as determined under section 430(g)(3) after reduction under section 430(f), over

``(B) 125 percent of the sum of the funding shortfall and the target normal cost determined under section 430 for such plan year.''.

(2) Section 420(e)(4) of such Code is amended to read as follows:

``(4) Coordination with section 430.--In the case of a qualified transfer, any assets so transferred shall not, for purposes of this section and section 430, be treated as assets in the plan.''.

(e) Excise Taxes.--

(1) In general.--Subsections (a) and (b) of section 4971 of such Code are amended to read as follows:

``(a) Initial Tax.--If at any time during any taxable year an employer maintains a plan to which section 412 applies, there is hereby imposed for the taxable year a tax equal to--

``(1) in the case of a single-employer plan, 10 percent of the aggregate unpaid minimum required contributions for all plan years remaining unpaid as of the end of any plan year ending with or within the taxable year, and

``(2) in the case of a multiemployer plan, 5 percent of the accumulated funding deficiency determined under section 431 as of the end of any plan year ending with or within the taxable year.

``(b) Additional Tax.--If--

``(1) a tax is imposed under subsection (a)(1) on any unpaid required minimum contribution and such amount remains unpaid as of the close of the taxable period, or

``(2) a tax is imposed under subsection (a)(2) on any accumulated funding deficiency and the accumulated funding deficiency is not corrected within the taxable period,

there is hereby imposed a tax equal to 100 percent of the unpaid minimum required contribution or accumulated funding deficiency, whichever is applicable, to the extent not so paid or corrected.''.

(2) Section 4971(c) of such Code is amended--

(A) by striking ``the last two sentences of section 412(a)'' in paragraph (1) and inserting ``section 431'', and

(B) by adding at the end the following new paragraph:

``(4) Unpaid minimum required contribution.--

``(A) In general.--The term `unpaid minimum required contribution' means, with respect to any plan year, any minimum required contribution under section 430 for the plan year which is not paid on or before the due date (as determined under section 430(j)(1)) for the plan year.

``(B) Ordering rule.--Any payment to or under a plan for any plan year shall be allocated first to unpaid minimum required contributions for all preceding plan years on a first-in, first-out basis and then to the minimum required contribution under section 430 for the plan year.''.

(3) Section 4971(e)(1) of such Code is amended by striking ``section 412(b)(3)(A)'' and inserting ``section 412(a)(1)(A)''.

(4) Section 4971(f)(1) of such Code is amended--

(A) by striking ``section 412(m)(5)'' and inserting ``section 430(j)(4)'', and

(B) by striking ``section 412(m)'' and inserting ``section 430(j)''.

(5) Section 4972(c)(7) of such Code is amended by striking ``except to the extent that such contributions exceed the full-funding limitation (as defined in section 412(c)(7), determined without regard to subparagraph (A)(i)(I) thereof)'' and inserting ``except, in the case of a multiemployer plan, to the extent that such contributions exceed the full-funding limitation (as defined in section 431(c)(6))''.

(f) Reporting Requirements.--Section 6059(b) of such Code is amended--

(1) by striking ``the accumulated funding deficiency (as defined in section 412(a))'' in paragraph (2) and inserting ``the minimum required contribution determined under section 430, or the accumulated funding deficiency determined under section 431,'', and

(2) by striking paragraph (3)(B) and inserting:

``(B) the requirements for reasonable actuarial assumptions under section 430(h)(1) or 431(c)(3), whichever are applicable, have been complied with.''.

SEC. 115. MODIFICATION OF TRANSITION RULE TO PENSION FUNDING REQUIREMENTS.

(a) In General.--In the case of a plan that--

(1) was not required to pay a variable rate premium for the plan year beginning in 1996,

(2) has not, in any plan year beginning after 1995, merged with another plan (other than a plan sponsored by an employer that was in 1996 within the controlled group of the plan sponsor), and

(3) is sponsored by a company that is engaged primarily in the interurban or interstate passenger bus service,

the rules described in subsection (b) shall apply for any plan year beginning after December 31, 2007.

(b) Modified Rules.--The rules described in this subsection are as follows:

(1) For purposes of section 430(j)(3) of the Internal Revenue Code of 1986 and section 303(j)(3) of the Employee Retirement Income Security Act of 1974, the plan shall be treated as not having a funding shortfall for any plan year.

(2) For purposes of--

(A) determining unfunded vested benefits under section 4006(a)(3)(E)(iii) of such Act, and

(B) determining any present value or making any computation under section 412 of such Code or section 302 of such Act,

the mortality table shall be the mortality table used by the plan.

(3) Section 430(c)(5)(B) of such Code and section 303(c)(5)(B) of such Act (relating to phase-in of funding target for exemption from new shortfall amortization base) shall each be applied by substituting ``2012'' for ``2011'' therein and by substituting for the table therein the following:

``In the case of a plan year beginning in calendar year:	The applicable percentage is:
2008	90 percent
2009	92 percent
2010	94 percent
2011	96 percent.

(c) Definitions.--Any term used in this section which is also used in section 430 of such Code or section 303 of such Act shall have the meaning provided such term in such section. If the same term has a different meaning in such Code and such Act, such term shall, for purposes of this section, have the meaning provided by such Code when applied with respect to such Code and the meaning provided by such Act when applied with respect to such Act.

(d) Special Rule for 2006 and 2007.--

(1) In general.--Section 769(c)(3) of the Retirement Protection Act of 1994, as added by section 201 of the Pension Funding Equity Act of 2004, is amended by striking ``and 2005'' and inserting ``, 2005, 2006, and 2007''.

(2) Effective date.--The amendment made by paragraph (1) shall apply to plan years beginning after December 31, 2005.

(e) Conforming Amendment.--

(1) Section 769 of the Retirement Protection Act of 1994 is amended by striking subsection (c).

(2) The amendment

made by paragraph (1) shall take effect on December 31, 2007, and shall apply to plan years beginning after such date.

SEC. 116. RESTRICTIONS ON FUNDING OF NONQUALIFIED DEFERRED COMPENSATION PLANS BY EMPLOYERS MAINTAINING UNDERFUNDED OR TERMINATED SINGLE-EMPLOYER PLANS.

(a) Amendments of Internal Revenue Code.--Subsection (b) of section 409A of the Internal Revenue Code of 1986 (providing rules relating to funding) is amended by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively, and by inserting after paragraph (2) the following new paragraph:

``(3) Treatment of employer's defined benefit plan during restricted period.--

``(A) In general.--If--

``(i) during any restricted period with respect to a single-employer defined benefit plan, assets are set aside or reserved (directly or indirectly) in a trust (or other arrangement as determined by the Secretary) or transferred to such a trust or other arrangement for purposes of paying deferred compensation of an applicable covered employee under a nonqualified deferred compensation plan of the plan sponsor or member of a controlled group which includes the plan sponsor, or

``(ii) a nonqualified deferred compensation plan of the plan sponsor or member of a controlled group which includes the plan sponsor provides that assets will become restricted to the provision of benefits under the plan in connection with such restricted period (or other similar financial measure determined by the Secretary) with respect to the defined benefit plan, or assets are so restricted,

such assets shall, for purposes of section 83, be treated as property transferred in connection with the performance of services whether or not such assets are available to satisfy claims of general creditors. Clause (i) shall not apply with respect to any assets which are so set aside before the restricted period with respect to the defined benefit plan.

``(B) Restricted period.--For purposes of this section, the term `restricted period' means, with respect to any plan described in subparagraph (A)--

``(i) any period during which the plan is in at-risk status (as defined in section 430(i));

``(ii) any period the plan sponsor is a debtor in a case under title 11, United States Code, or similar Federal or State law, and

``(iii) the 12-month period beginning on the date which is 6 months before the termination date of the plan if, as of the termination date, the plan is not sufficient for benefit liabilities (within the meaning of section 4041 of the Employee Retirement Income Security Act of 1974).

``(C) Special rule for payment of taxes on deferred compensation included in income.--If an employer provides directly or indirectly for the payment of any Federal, State, or local income taxes with respect to any compensation required to be included in gross income by reason of this paragraph--

``(i) interest shall be imposed under subsection (a)(1)(B)(i)(I) on the amount of such payment in the same manner as if such payment was part of the deferred compensation to which it relates,

``(ii) such payment shall be taken into account in determining the amount of the additional tax under subsection (a)(1)(B)(i)(II) in the same manner as if such payment was part of the deferred compensation to which it relates, and

``(iii) no deduction shall be allowed under this title with respect to such payment.

``(D) Other definitions.--For purposes of this section--

``(i) Applicable covered employee.--The term `applicable covered employee' means any--

``(I) covered employee of a plan sponsor,

``(II) covered employee of a member of a controlled group which includes the plan sponsor, and

``(III) former employee who was a

covered employee at the time of
termination of employment with the plan
sponsor or a member of a controlled
group which includes the plan sponsor.

``(ii) Covered employee.--The term `covered
employee' means an individual described in section
162(m)(3) or an individual subject to the
requirements of section 16(a) of the Securities
Exchange Act of 1934.''.

(b) Conforming Amendments.--Paragraphs (4) and (5) of section
409A(b) of such Code, as redesignated by subsection (a) of this
subsection, are each amended by striking ``paragraph (1) or (2)'' each
place it appears and inserting ``paragraph (1), (2), or (3)''.

(c) Effective Date.--The amendments made
by this section shall apply to transfers or other reservation of assets
after the date of the enactment of this Act.

TITLE II--FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS AND
RELATED PROVISIONS

Subtitle A--Amendments to Employee Retirement Income Security Act of
1974

SEC. 201. FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS.

(a) In General.--Part 3 of subtitle B of title I of the Employee
Retirement Income Security Act of 1974 (as amended by this Act) is
amended by inserting after section 303 the following new section:

``MINIMUM FUNDING STANDARDS FOR MULTIEMPLOYER PLANS

``Sec. 304. (a) In General.--For purposes of
section 302, the accumulated funding deficiency of a multiemployer plan
for any plan year is--

``(1) except as provided in paragraph (2), the amount,
determined as of the end of the plan year, equal to the excess
(if any) of the total charges to the funding standard account of
the plan for all plan years (beginning with the first plan year
for which this part applies to the plan) over the total credits
to such account for such years, and

``(2) if the multiemployer plan is in reorganization for any
plan year, the accumulated funding deficiency of the plan
determined under section 4243.

``(b) Funding Standard Account.--

``(1) Account required.--Each multiemployer plan to which
this part applies shall establish and maintain a funding
standard account. Such account shall be credited and charged
solely as provided in this section.

``(2) Charges to account.--For a plan year, the funding
standard account shall be charged with the sum of--

``(A) the normal cost of the plan for the plan year,

``(B) the amounts necessary to amortize in equal
annual installments (until fully amortized)--

``(i) in the case of a plan which comes into
existence on or after January 1, 2008, the
unfunded past service liability under the plan on
the first day of the first plan year to which this
section applies, over a period of 15 plan years,

``(ii) separately, with respect to each plan
year, the net increase (if any) in unfunded past
service liability under the plan arising from plan
amendments adopted in such year, over a period of
15 plan years,

``(iii) separately, with respect to each plan
year, the net experience loss (if any) under the
plan, over a period of 15 plan years, and

``(iv) separately, with respect to each plan
year, the net loss (if any) resulting from changes
in actuarial assumptions used under the plan, over
a period of 15 plan years,

``(C) the amount necessary to amortize each waived
funding deficiency (within the meaning of section
302(c)(3)) for each prior plan year in equal annual
installments (until fully amortized) over a period of 15
plan years,

``(D) the amount necessary to amortize in equal
annual installments (until fully amortized) over a
period of 5 plan years any amount credited to the
funding standard account under section 302(b)(3)(D) (as
in effect on the day before the date of the enactment of
the Pension Protection Act of 2006), and

``(E) the amount necessary to amortize in equal
annual installments (until fully amortized) over a
period of 20 years the contributions which would be
required to be made under the plan but for the
provisions of section 302(c)(7)(A)(i)(I) (as in effect
on the day before the date of the enactment of the
Pension Protection Act of 2006).

``(3) Credits to account.--For a plan year, the funding standard account shall be credited with the sum of--

``(A) the amount considered contributed by the employer to or under the plan for the plan year,

``(B) the amount necessary to amortize in equal annual installments (until fully amortized)--

``(i) separately, with respect to each plan year, the net decrease (if any) in unfunded past service liability under the plan arising from plan amendments adopted in such year, over a period of 15 plan years,

``(ii) separately, with respect to each plan year, the net experience gain (if any) under the plan, over a period of 15 plan years, and

``(iii) separately, with respect to each plan year, the net gain (if any) resulting from changes in actuarial assumptions used under the plan, over a period of 15 plan years,

``(C) the amount of the waived funding deficiency (within the meaning of section 302(c)(3)) for the plan year, and

``(D) in the case of a plan year for which the accumulated funding deficiency is determined under the funding standard account if such plan year follows a plan year for which such deficiency was determined under the alternative minimum funding standard under section 305 (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006), the excess (if any) of any debit balance in the funding standard account (determined without regard to this subparagraph) over any debit balance in the alternative minimum funding standard account.

``(4) Special rule for amounts first amortized in plan years before 2008.--In the case of any amount amortized under section 302(b) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006) over any period beginning with a plan year beginning before 2008, in lieu of the amortization described in paragraphs (2)(B) and (3)(B), such amount shall continue to be amortized under such section as so in effect.

``(5) Combining and offsetting amounts to be amortized.--Under regulations prescribed by the Secretary of the Treasury, amounts required to be amortized under paragraph (2) or paragraph (3), as the case may be--

``(A) may be combined into one amount under such paragraph to be amortized over a period determined on the basis of the remaining amortization period for all items entering into such combined amount, and

``(B) may be offset against amounts required to be amortized under the other such paragraph, with the resulting amount to be amortized over a period determined on the basis of the remaining amortization periods for all items entering into whichever of the two amounts being offset is the greater.

``(6) Interest.--The funding standard account (and items therein) shall be charged or credited (as determined under regulations prescribed by the Secretary of the Treasury) with interest at the appropriate rate consistent with the rate or rates of interest used under the plan to determine costs.

``(7) Special rules relating to charges and credits to funding standard account.--For purposes of this part--

``(A) Withdrawal liability.--Any amount received by a multiemployer plan in payment of all or part of an employer's withdrawal liability under part 1 of subtitle E of title IV shall be considered an amount contributed by the employer to or under the plan. The Secretary of the Treasury may prescribe by regulation additional charges and credits to a multiemployer plan's funding standard account to the extent necessary to prevent withdrawal liability payments from being unduly reflected as advance funding for plan liabilities.

``(B) Adjustments when a multiemployer plan leaves reorganization.--If a multiemployer plan is not in reorganization in the plan year but was in reorganization in the immediately preceding plan year, any balance in the funding standard account at the close of such immediately preceding plan year--

``(i) shall be eliminated by an offsetting credit or charge (as the case may be), but

``(ii) shall be taken into account in

subsequent plan years by being amortized in equal annual installments (until fully amortized) over 30 plan years.

The preceding sentence shall not apply to the extent of any accumulated funding deficiency under section 4243(a) as of the end of the last plan year that the plan was in reorganization.

``(C) Plan payments to supplemental program or withdrawal liability payment fund.--Any amount paid by a plan during a plan year to the Pension Benefit Guaranty Corporation pursuant to section 4222 of this Act or to a fund exempt under section 501(c)(22) of the Internal Revenue Code of 1986 pursuant to section 4223 of this Act shall reduce the amount of contributions considered received by the plan for the plan year.

``(D) Interim withdrawal liability payments.--Any amount paid by an employer pending a final determination of the employer's withdrawal liability under part 1 of subtitle E of title IV and subsequently refunded to the employer by the plan shall be charged to the funding standard account in accordance with regulations prescribed by the Secretary of the Treasury.

``(E) Election for deferral of charge for portion of net experience loss.--If an election is in effect under section 302(b)(7)(F) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006) for any plan year, the funding standard account shall be charged in the plan year to which the portion of the net experience loss deferred by such election was deferred with the amount so deferred (and paragraph (2)(B)(iii) shall not apply to the amount so charged).

``(F) Financial assistance.--Any amount of any financial assistance from the Pension Benefit Guaranty Corporation to any plan, and any repayment of such amount, shall be taken into account under this section and section 302 in such manner as is determined by the Secretary of the Treasury.

``(G) Short-term benefits.--To the extent that any plan amendment increases the unfunded past service liability under the plan by reason of an increase in benefits which are not payable as a life annuity but are payable under the terms of the plan for a period that does not exceed 14 years from the effective date of the amendment, paragraph (2)(B)(ii) shall be applied separately with respect to such increase in unfunded past service liability by substituting the number of years of the period during which such benefits are payable for `15'.

``(c) Additional Rules.--

``(1) Determinations to be made under funding method.--For purposes of this part, normal costs, accrued liability, past service liabilities, and experience gains and losses shall be determined under the funding method used to determine costs under the plan.

``(2) Valuation of assets.--

``(A) In general.--

For purposes of this part, the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary of the Treasury.

``(B) Election with respect to bonds.--The value of a bond or other evidence of indebtedness which is not in default as to principal or interest may, at the election of the plan administrator, be determined on an amortized basis running from initial cost at purchase to par value at maturity or earliest call date. Any election under this subparagraph shall be made at such time and in such manner as the Secretary of the Treasury shall by regulations provide, shall apply to all such evidences of indebtedness, and may be revoked only with the consent of such Secretary.

``(3) Actuarial assumptions must be reasonable.--For purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods--

``(A) each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and

``(B) which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

``(4) Treatment of certain changes as experience gain or loss.--For purposes of this section, if--

``(A) a change in benefits under the Social Security Act or in other retirement benefits created under Federal or State law, or

``(B) a change in the definition of the term `wages' under section 3121 of the Internal Revenue Code of 1986, or a change in the amount of such wages taken into account under regulations prescribed for purposes of section 401(a)(5) of such Code,

results in an increase or decrease in accrued liability under a plan, such increase or decrease shall be treated as an experience loss or gain.

``(5) Full funding.--If, as of the close of a plan year, a plan would (without regard to this paragraph) have an accumulated funding deficiency in excess of the full funding limitation--

``(A) the funding standard account shall be credited with the amount of such excess, and

``(B) all amounts described in subparagraphs (B), (C), and (D) of subsection (b) (2) and subparagraph (B) of subsection (b)(3) which are required to be amortized shall be considered fully amortized for purposes of such subparagraphs.

``(6) Full-funding limitation.--

``(A) In general.--For purposes of paragraph (5), the term `full-funding limitation' means the excess (if any) of--

``(i) the accrued liability (including normal cost) under the plan (determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan), over

``(ii) the lesser of--

``(I) the fair market value of the plan's assets, or

``(II) the value of such assets determined under paragraph (2).

``(B) Minimum amount.--

``(i) In general.--In no event shall the full-funding limitation determined under subparagraph (A) be less than the excess (if any) of--

``(I) 90 percent of the current liability of the plan (including the expected increase in current liability due to benefits accruing during the plan year), over

``(II) the value of the plan's assets determined under paragraph (2).

``(ii) Assets.--For purposes of clause (i), assets shall not be reduced by any credit balance in the funding standard account.

``(C) Full funding limitation.--For purposes of this paragraph, unless otherwise provided by the plan, the accrued liability under a multiemployer plan shall not include benefits which are not nonforfeitable under the plan after the termination of the plan (taking into consideration section 411(d)(3) of the Internal Revenue Code of 1986).

``(D) Current liability.--For purposes of this paragraph--

``(i) In general.--The term `current liability' means all liabilities to employees and their beneficiaries under the plan.

``(ii) Treatment of unpredictable contingent event benefits.--For purposes of clause (i), any benefit contingent on an event other than--

``(I) age, service, compensation, death, or disability, or

``(II) an event which is reasonably and reliably predictable (as determined by the Secretary of the Treasury),

shall not be taken into account until the event on which the benefit is contingent occurs.

``(iii) Interest rate used.--The rate of interest used to determine current liability under this paragraph shall be the rate of interest determined under subparagraph (E).

``(iv) Mortality tables.--

``(I) Commissioners' standard table.--In the case of plan years beginning before the first plan year to which the first tables prescribed under subclause (II) apply, the mortality table used in determining current liability under this paragraph shall be the table prescribed by the Secretary of the Treasury which is based on the prevailing commissioners' standard table (described in section 807(d)(5)(A) of the Internal Revenue Code of 1986) used to determine reserves for group annuity contracts issued on January 1, 1993.

``(II) Secretarial authority.--The Secretary of the Treasury may by regulation prescribe for plan years beginning after December 31, 1999, mortality tables to be used in determining current liability under this subsection. Such tables shall be based upon the actual experience of pension plans and projected trends in such experience. In prescribing such tables, such Secretary shall take into account results of available independent studies of mortality of individuals covered by pension plans.

``(v) Separate mortality tables for the disabled.--Notwithstanding clause (iv)--

``(I) In general.--The Secretary of the Treasury shall establish mortality tables which may be used (in lieu of the tables under clause (iv)) to determine current liability under this subsection for individuals who are entitled to benefits under the plan on account of disability. Such Secretary shall establish separate tables for individuals whose disabilities occur in plan years beginning before January 1, 1995, and for individuals whose disabilities occur in plan years beginning on or after such date.

``(II) Special rule for disabilities occurring after 1994.--In the case of disabilities occurring in plan years beginning after December 31, 1994, the tables under subclause (I) shall apply only with respect to individuals described in such subclause who are disabled within the meaning of title II of the Social Security Act and the regulations thereunder.

``(vi) Periodic review.--The Secretary of the Treasury shall periodically (at least every 5 years) review any tables in effect under this subparagraph and shall, to the extent such Secretary determines necessary, by regulation update the tables to reflect the actual experience of pension plans and projected trends in such experience.

``(E) Required change of interest rate.--For purposes of determining a plan's current liability for purposes of this paragraph--

``(i) In general.--If any rate of interest used under the plan under subsection (b)(6) to determine cost is not within the permissible range, the plan shall establish a new rate of interest within the permissible range.

``(ii) Permissible range.--For purposes of this subparagraph--

``(I) In general.--Except as provided in subclause (II), the term `permissible range' means a rate of interest which is not more than 5 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year

Treasury securities during the 4-year period
ending on the last day before the beginning of the plan year.

``(II) Secretarial authority.--If the Secretary of the Treasury finds that the lowest rate of interest permissible under subclause (I) is unreasonably high, such Secretary may prescribe a lower rate of interest, except that such rate may not be less than 80 percent of the average rate determined under such subclause.

``(iii) Assumptions.--Notwithstanding paragraph (3)(A), the interest rate used under the plan shall be--

``(I) determined without taking into account the experience of the plan and reasonable expectations, but

``(II) consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.

``(7) Annual valuation.--

``(A) In general.--
For purposes of this section, a determination of experience gains and losses and a valuation of the plan's liability shall be made not less frequently than once every year, except that such determination shall be made more frequently to the extent required in particular cases under regulations prescribed by the Secretary of the Treasury.

``(B) Valuation date.--

``(i) Current year.--Except as provided in clause (ii), the valuation referred to in subparagraph (A) shall be made as of a date within the plan year to which the valuation refers or within one month prior to the beginning of such year.

``(ii) Use of prior year valuation.--The valuation referred to in subparagraph (A) may be made as of a date within the plan year prior to the year to which the valuation refers if, as of such date, the value of the assets of the plan are not less than 100 percent of the plan's current liability (as defined in paragraph (6)(D) without regard to clause (iv) thereof).

``(iii) Adjustments.--Information under clause (ii) shall, in accordance with regulations, be actuarially adjusted to reflect significant differences in participants.

``(iv) Limitation.--A change in funding method to use a prior year valuation, as provided in clause (ii), may not be made unless as of the valuation date within the prior plan year, the value of the assets of the plan are not less than 125 percent of the plan's current liability (as defined in paragraph (6)(D) without regard to clause (iv) thereof).

``(8) Time when certain contributions deemed made.--For purposes of this section, any contributions for a plan year made by an employer after the last day of such plan year, but not later than two and one-half months after such day, shall be deemed to have been made on such last day. For purposes of this subparagraph, such two and one-half month period may be extended for not more than six months under regulations prescribed by the Secretary of the Treasury.

``(d) Extension of Amortization Periods for Multiemployer Plans.--

``(1) Automatic extension upon application by certain plans.--

``(A) In general.--If the plan sponsor of a multiemployer plan--

``(i) submits to the Secretary of the Treasury an application for an extension of the period of years required to amortize any unfunded liability described in any clause of subsection (b)(2)(B) or described in subsection (b)(4), and

``(ii) includes with the application a certification by the plan's actuary described in subparagraph (B),

the Secretary of the Treasury shall extend the amortization period for the period of time (not in excess of 5 years) specified in the application. Such extension shall be in addition to any extension under paragraph (2).

``(B) Criteria.--A certification with respect to a multiemployer plan is described in this subparagraph if the plan's actuary certifies that, based on reasonable assump- tions--

``(i) absent the extension under subparagraph (A), the plan would have an accumulated funding deficiency in the current plan year or any of the 9 succeeding plan years,

``(ii) the plan sponsor has adopted a plan to improve the plan's funding status,

``(iii) the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period as extended, and

``(iv) the notice required under paragraph (3)(A) has been provided.

``(C) Termination.--The preceding provisions of this paragraph shall not apply with respect to any application submitted after December 31, 2014.

``(2) Alternative extension.--

``(A) In general.--If the plan sponsor of a multiemployer plan submits to the Secretary of the Treasury an application for an extension of the period of years required to amortize any unfunded liability described in any clause of subsection (b)(2)(B) or described in subsection (b)(4), the Secretary of the Treasury may extend the amortization period for a period of time (not in excess of 10 years reduced by the number of years of any extension under paragraph (1) with respect to such unfunded liability) if the Secretary of the Treasury makes the determination described in subparagraph (B). Such extension shall be in addition to any extension under paragraph (1).

``(B) Determination.--The Secretary of the Treasury may grant an extension under subparagraph (A) if such Secretary determines that--

``(i) such extension would carry out the purposes of this Act and would provide adequate protection for participants under the plan and their beneficiaries, and

``(ii) the failure to permit such extension would--

``(I) result in a substantial risk to the voluntary continuation of the plan, or a substantial curtailment of pension benefit levels or employee compensation, and

``(II) be adverse to the interests of plan participants in the aggregate.

``(C) Action by secretary of the treasury.--The Secretary of the Treasury shall act upon any application for an extension under this paragraph within 180 days of the submission of such application. If such Secretary rejects the application for an extension under this paragraph, such Secretary shall provide notice to the plan detailing the specific reasons for the rejection, including references to the criteria set forth above.

``(3) Advance notice.--

``(A) In general.--The Secretary of the Treasury shall, before granting an extension under this subsection, require each applicant to provide evidence satisfactory to such Secretary that the applicant has provided notice of the filing of the application for such extension to each affected party (as defined in section 4001(a)(21)) with respect to the affected plan. Such notice shall include a description of the extent to which the plan is funded for benefits which are guaranteed under title IV and for benefit liabilities.

``(B) Consideration of relevant information.--The Secretary of the Treasury shall consider any relevant information provided by a person to whom notice was given under paragraph (1).''.

(b) Shortfall Funding Method.--

(1) In general.--A multiemployer plan meeting the criteria of paragraph (2) may adopt, use, or cease using, the shortfall funding method and such adoption, use, or cessation of use of such method, shall be deemed approved by the Secretary of the Treasury under section 302(d)(1) of the Employee Retirement Income Security Act of 1974 and section 412(d)(1) of the Internal Revenue Code of 1986.

(2) Criteria.--A multiemployer pension plan meets the criteria of this clause if--

(A) the plan has not used the shortfall funding method during the 5-year period ending on the day before the date the plan is to use the method under paragraph (1); and

(B) the plan is not operating under an amortization period extension under section 304(d) of such Act and did not operate under such an extension during such 5-year period.

(3) Shortfall funding method defined.--For purposes of this subsection, the term ``shortfall funding method'' means the shortfall funding method described in Treasury Regulations section 1.412(c)(1)-2 (26 CFR 1.412(c)(1)-2).

(4) Benefit restrictions to apply.--The benefit restrictions under section 302(c)(7) of such Act and section 412(c)(7) of such Code shall apply during any period a multiemployer plan is on the shortfall funding method pursuant to this subsection.

(5) Use of shortfall method not to preclude other options.--Nothing in this subsection shall be construed to affect a multiemployer plan's ability to adopt the shortfall funding method with the Secretary's permission under otherwise applicable regulations or to affect a multiemployer plan's right to change funding methods, with or without the Secretary's consent, as provided in applicable rules and regulations.

(c) Conforming Amendments.--

(1) Section 301 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1081) is amended by striking subsection (d).

(2) The table of contents in section 1 of such Act (as amended by this Act) is amended by inserting after the item relating to section 303 the following new item:

``Sec. 304. Minimum funding standards for multiemployer plans.''.

(d) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after 2007.

(2) Special rule for certain amortization extensions.--If the Secretary of the Treasury grants an extension under section 304 of the Employee Retirement Income Security Act of 1974 and section 412(e) of the Internal Revenue Code of 1986 with respect to any application filed with the Secretary of the Treasury on or before June 30, 2005, the extension (and any modification thereof) shall be applied and administered under the rules of such sections as in effect before the enactment of this Act, including the use of the rate of interest determined under section 6621(b) of such Code.

SEC. 202. ADDITIONAL FUNDING RULES FOR MULTIEMPLOYER PLANS IN ENDANGERED OR CRITICAL STATUS.

(a) In General.--Part 3 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 (as amended by the preceding provisions of this Act) is amended by inserting after section 304 the following new section:

``ADDITIONAL FUNDING RULES FOR MULTIEMPLOYER PLANS IN ENDANGERED STATUS OR CRITICAL STATUS

``Sec. 305. (a) General Rule.--For purposes of this part, in the case of a multiemployer plan in effect on July 16, 2006--

``(1) if the plan is in endangered status--

``(A) the plan sponsor shall adopt and implement a funding improvement plan in accordance with the requirements of subsection (c), and

``(B) the requirements of subsection (d) shall apply during the funding plan adoption period and the funding improvement period, and

``(2) if the plan is in critical status--

``(A) the plan sponsor shall adopt and implement a rehabilitation plan in accordance with the requirements of subsection (e), and

``(B) the requirements of subsection (f) shall apply during the rehabilitation plan adoption period and the rehabilitation period.

``(b) Determination of Endangered and Critical Status.--For purposes of this section--

``(1) Endangered status.--A multiemployer plan is in

endangered status for a plan year if, as determined by the plan actuary under paragraph (3), the plan is not in critical status for the plan year and, as of the beginning of the plan year, either--

``(A) the plan's funded percentage for such plan year is less than 80 percent, or

``(B) the plan has an accumulated funding deficiency for such plan year, or is projected to have such an accumulated funding deficiency for any of the 6 succeeding plan years, taking into account any extension of amortization periods under section 304(d).

For purposes of this section, a plan shall be treated as in seriously endangered status for a plan year if the plan is described in both subparagraphs (A) and (B).

``(2) Critical status.--A multiemployer plan is in critical status for a plan year if, as determined by the plan actuary under paragraph (3), the plan is described in 1 or more of the following subparagraphs as of the beginning of the plan year:

``(A) A plan is described in this subparagraph if--

``(i) the funded percentage of the plan is less than 65 percent, and

``(ii) the sum of--

``(I) the fair market value of plan assets, plus

``(II) the present value of the reasonably anticipated employer contributions for the current plan year and each of the 6 succeeding plan years, assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years,

is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the 6 succeeding plan years (plus administrative expenses for such plan years).

``(B) A plan is described in this subparagraph if--

``(i) the plan has an accumulated funding deficiency for the current plan year, not taking into account any extension of amortization periods under section 304(d), or

``(ii) the plan is projected to have an accumulated funding deficiency for any of the 3 succeeding plan years (4 succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any extension of amortization periods under section 304(d).

``(C) A plan is described in this subparagraph if--

``(i)(I) the plan's normal cost for the current plan year, plus interest (determined at the rate used for determining costs under the plan) for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last date of the preceding plan year, exceeds

``(II) the present value of the reasonably anticipated employer and employee contributions for the current plan year,

``(ii) the present value, as of the beginning of the current plan year, of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and

``(iii) the plan has an accumulated funding deficiency for the current plan year, or is projected to have such a deficiency for any of the 4 succeeding plan years, not taking into account any extension of amortization periods under section 304(d).

``(D) A plan is described in this subparagraph if the sum of--

``(i) the fair market value of plan assets, plus

``(ii) the present value of the reasonably anticipated employer contributions for the current plan year and each of the 4 succeeding plan years, assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years,

is less than the present value of all benefits projected

to be payable under the plan during the current plan year and each of the 4 succeeding plan years (plus administrative expenses for such plan years).

``(3) Annual certification by plan actuary.--

``(A) In general.--Not later than the 90th day of each plan year of a multiemployer plan, the plan actuary shall certify to the Secretary of the Treasury and to the plan sponsor--

``(i) whether or not the plan is in endangered status for such plan year and whether or not the plan is or will be in critical status for such plan year, and

``(ii) in the case of a plan which is in a funding improvement or rehabilitation period, whether or not the plan is making the scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

``(B) Actuarial projections of assets and liabilities.--

``(i) In general.--In making the determinations and projections under this subsection, the plan actuary shall make projections required for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. The actuary's projections shall be based on reasonable actuarial estimates, assumptions, and methods that, except as provided in clause (iii), offer the actuary's best estimate of anticipated experience under the plan. The projected present value of liabilities as of the beginning of such year shall be determined based on the most recent of either--

``(I) the actuarial statement required under section 103(d) with respect to the most recently filed annual report, or

``(II) the actuarial valuation for the preceding plan year.

``(ii) Determinations of future contributions.--Any actuarial projection of plan assets shall assume--

``(I) reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of the one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years, or

``(II) that employer contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines there have been no significant demographic changes that would make such assumption unreasonable.

``(iii) Projected industry activity.--Any projection of activity in the industry or industries covered by the plan, including future covered employment and contribution levels, shall be based on information provided by the plan sponsor, which shall act reasonably and in good faith.

``(C) Penalty for failure to secure timely actuarial certification.--Any failure of the plan's actuary to certify the plan's status under this subsection by the date specified in subparagraph (A) shall be treated for purposes of section 502(c)(2) as a failure or refusal by the plan administrator to file the annual report required to be filed with the Secretary under section 101(b)(4).

``(D) Notice.--

``(i) In general.--In any case in which it is certified under subparagraph (A) that a multiemployer plan is or will be in endangered or critical status for a plan year, the plan sponsor shall, not later than 30 days after the date of the certification, provide notification of the endangered or critical status to the participants and beneficiaries, the

bargaining parties, the Pension Benefit Guaranty Corporation, and the Secretary.

``(ii) Plans in critical status.--If it is certified under subparagraph (A) that a multiemployer plan is or will be in critical status, the plan sponsor shall include in the notice under clause (i) an explanation of the possibility that--

``(I) adjustable benefits (as defined in subsection (e)(8)) may be reduced, and

``(II) such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status.

``(iii) Model notice.--The Secretary shall prescribe a model notice that a multiemployer plan may use to satisfy the requirements under clause (ii).

``(c) Funding Improvement Plan Must Be Adopted for Multiemployer Plans in Endangered Status.--

``(1) In general.--In any case in which a multiemployer plan is in endangered status for a plan year, the plan sponsor, in accordance with this subsection--

``(A) shall adopt a funding improvement plan not later than 240 days following the required date for the actuarial certification of endangered status under subsection (b)(3)(A), and

``(B) within 30 days after the adoption of the funding improvement plan--

``(i) shall provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan, including--

``(I) one proposal for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law), and

``(II) one proposal for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan, and

``(ii) may, if the plan sponsor deems appropriate, prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to achieving the applicable benchmarks in accordance with the funding improvement plan.

For purposes of this section, the term `applicable benchmarks' means the requirements applicable to the multiemployer plan under paragraph (3) (as modified by paragraph (5)).

``(2) Exception for years after process begins.--Paragraph (1) shall not apply to a plan year if such year is in a funding plan adoption period or funding improvement period by reason of the plan being in endangered status for a preceding plan year. For purposes of this section, such preceding plan year shall be the initial determination year with respect to the funding improvement plan to which it relates.

``(3) Funding improvement plan.--For purposes of this section--

``(A) In general.--A funding improvement plan is a plan which consists of the actions, including options or a range of options to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan during the funding improvement period of the following

requirements:
``(i) Increase in plan's funding percentage.--
The plan's funded percentage as of the close of
the funding improvement period equals or exceeds a
percentage equal to the sum of--
``(I) such percentage as of the
beginning of such period, plus
``(II) 33 percent of the difference
between 100 percent and the percentage
under subclause (I).
``(ii) Avoidance of accumulated funding
deficiencies.--No accumulated funding deficiency
for any plan year during the funding improvement
period (taking into account any extension of
amortization periods under section 304(d)).
``(B) Seriously endangered
plans.--In the case of a plan in seriously endangered
status, except as provided in paragraph (5),
subparagraph (A)(i)(II) shall be applied by substituting
`20 percent' for `33 percent'.
``(4) Funding improvement period.--For purposes of this
section--
``(A) In general.--The funding improvement period
for any funding improvement plan adopted pursuant to
this subsection is the 10-year period beginning on the
first day of the first plan year of the multiemployer
plan beginning after the earlier of--
``(i) the second anniversary of the date of
the adoption of the funding improvement plan, or
``(ii) the expiration of the collective
bargaining agreements in effect on the due date
for the actuarial certification of endangered
status for the initial determination year under
subsection (b)(3)(A) and covering, as of such due
date, at least 75 percent of the active
participants in such multiemployer plan.
``(B) Seriously endangered
plans.--In the case of a plan in seriously endangered
status, except as provided in paragraph (5),
subparagraph (A) shall be applied by substituting `15-
year period' for `10-year period'.
``(C) Coordination with changes in status.--
``(i) Plans no longer in endangered status.--
If the plan's actuary certifies under subsection
(b)(3)(A) for a plan year in any funding plan
adoption period or funding improvement period that
the plan is no longer in endangered status and is
not in critical status, the funding plan adoption
period or funding improvement period, whichever is
applicable, shall end as of the close of the
preceding plan year.
``(ii) Plans in critical status.--If the
plan's actuary certifies under subsection
(b)(3)(A) for a plan year in any funding plan
adoption period or funding improvement period that
the plan is in critical status, the funding plan
adoption period or funding improvement period,
whichever is applicable, shall end as of the close
of the plan year preceding the first plan year in
the rehabilitation period with respect to such
status.
``(D) Plans in endangered status at end of period.--
If the plan's actuary certifies under subsection
(b)(3)(A) for the first plan year following the close of
the
period described in subparagraph (A) that the plan is in
endangered status, the provisions of this subsection and
subsection (d) shall be applied as if such first plan
year were an initial determination year, except that the
plan may not be amended in a manner inconsistent with
the funding improvement plan in effect for the preceding
plan year until a new funding improvement plan is
adopted.
``(5) Special rules for seriously endangered plans more than
70 percent funded.--
``(A) In general.--If the funded percentage of a
plan in seriously endangered status was more than 70
percent as of the beginning of the initial determination
year--
``(i) paragraphs
(3)(B) and (4)(B) shall apply only if the plan's
actuary certifies, within 30 days after the

certification under subsection (b)(3)(A) for the initial determination year, that, based on the terms of the plan and the collective bargaining agreements in effect at the time of such certification, the plan is not projected to meet the requirements of paragraph (3)(A) (without regard to paragraphs (3)(B) and (4)(B)), and

``(ii) if there is a certification under clause (i), the plan may, in formulating its funding improvement plan, only take into account the rules of paragraph (3)(B) and (4)(B) for plan years in the funding improvement period beginning on or before the date on which the last of the collective bargaining agreements described in paragraph (4)(A)(ii) expires.

``(B) Special rule after expiration of agreements.--Notwithstanding subparagraph (A)(ii), if, for any plan year ending after the date described in subparagraph (A)(ii), the plan actuary certifies (at the time of the annual certification under subsection (b)(3)(A) for such plan year) that, based on the terms of the plan and collective bargaining agreements in effect at the time of that annual certification, the plan is not projected to be able to meet the requirements of paragraph (3)(A) (without regard to paragraphs (3)(B) and (4)(B)), paragraphs (3)(B) and (4)(B) shall continue to apply for such year.

``(6) Updates to funding improvement plan and schedules.--

``(A) Funding improvement plan.--The plan sponsor shall annually update the funding improvement plan and shall file the update with the plan's annual report under section 104.

``(B) Schedules.--The plan sponsor shall annually update any schedule of contribution rates provided under this subsection to reflect the experience of the plan.

``(C) Duration of schedule.--A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement shall remain in effect for the duration of that collective bargaining agreement.

``(7) Imposition of default schedule where failure to adopt funding improvement plan.--

``(A) In general.--If--

``(i) a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and

``(ii) after receiving one or more schedules from the plan sponsor under paragraph (1)(B), the bargaining parties with respect to such agreement fail to agree on changes to contribution or benefit schedules necessary to meet the applicable benchmarks in accordance with the funding improvement plan,

the plan sponsor shall implement the schedule described in paragraph (1)(B)(i)(I) beginning on the date specified in subparagraph (B).

``(B) Date of implementation.--The date specified in this subparagraph is the earlier of the date--

``(i) on which the Secretary certifies that the parties are at an impasse, or

``(ii) which is 180 days after the date on which the collective bargaining agreement described in subparagraph (A) expires.

``(8) Funding plan adoption period.--For purposes of this section, the term `funding plan adoption period' means the period beginning on the date of the certification under subsection (b)(3)(A) for the initial determination year and ending on the day before the first day of the funding improvement period.

``(d) Rules for Operation of Plan During Adoption and Improvement Periods.--

``(1) Special rules for plan adoption period.--During the funding plan adoption period--

``(A) the plan sponsor may not accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation,

``(B) no amendment of the plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan may be adopted unless the amendment is required as a condition of qualification under part I of subchapter D of chapter 1 of the Internal Revenue Code of 1986 or to comply with other applicable law, and

``(C) in the case of a plan in seriously endangered status, the plan sponsor shall take all reasonable actions which are consistent with the terms of the plan and applicable law and which are expected, based on reasonable assumptions, to achieve--

``(i) an increase in the plan's funded percentage, and

``(ii) postponement of an accumulated funding deficiency for at least 1 additional plan year.

Actions under subparagraph (C) include applications for extensions of amortization periods under section 304(d), use of the shortfall funding method in making funding standard account computations, amendments to the plan's benefit structure, reductions in future benefit accruals, and other reasonable actions consistent with the terms of the plan and applicable law.

``(2) Compliance with funding improvement plan.--

``(A) In general.--A plan may not be amended after the date of the adoption of a funding improvement plan so as to be inconsistent with the funding improvement plan.

``(B) No reduction in contributions.--A plan sponsor may not during any funding improvement period accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation.

``(C) Special rules for benefit increases.--A plan may not be amended after the date of the adoption of a funding improvement plan so as to increase benefits, including future benefit accruals, unless the plan actuary certifies that the benefit increase is consistent with the funding improvement plan and is paid for out of contributions not required by the funding improvement plan to meet the applicable benchmark in accordance with the schedule contemplated in the funding improvement plan.

``(e) Rehabilitation Plan Must Be Adopted for Multiemployer Plans in Critical Status.--

``(1) In general.--In any case in which a multiemployer plan is in critical status for a plan year, the plan sponsor, in accordance with this subsection--

``(A) shall adopt a rehabilitation plan not later than 240 days following the required date for the actuarial certification of critical status under subsection (b)(3)(A), and

``(B) within 30 days after the adoption of the rehabilitation plan--

``(i) shall provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan, and

``(ii) may, if the plan sponsor deems appropriate, prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to emerging from critical status in accordance with the rehabilitation plan.

The schedule or schedules described in subparagraph (B)(i) shall reflect reductions in future benefit accruals and adjustable

benefits, and increases in contributions, that the plan sponsor determines are reasonably necessary to emerge from critical status. One schedule shall be designated as the default schedule and such schedule shall assume that there are no increases in contributions under the plan other than the increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under section 204(g)) have been reduced to the maximum extent permitted by law.

``(2) Exception for years after process begins.--Paragraph (1) shall not apply to a plan year if such year is in a rehabilitation plan adoption period or rehabilitation period by reason of the plan being in critical status for a preceding plan year. For purposes of this section, such preceding plan year shall be the initial critical year with respect to the rehabilitation plan to which it relates.

``(3) Rehabilitation plan.--For purposes of this section--

``(A) In general.--A rehabilitation plan is a plan which consists of--

``(i) actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonably anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefit accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions, or

``(ii) if the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan can not reasonably be expected to emerge from critical status by the end of the rehabilitation period, reasonable measures to emerge from critical status at a later time or to forestall possible insolvency (within the meaning of section 4245).

A rehabilitation plan must provide annual standards for meeting the requirements of such rehabilitation plan. Such plan shall also include the schedules required to be provided under paragraph (1)(B)(i) and if clause (ii) applies, shall set forth the alternatives considered, explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

``(B) Updates to rehabilitation plan and schedules.--

``(i) Rehabilitation plan.--The plan sponsor shall annually update the rehabilitation plan and shall file the update with the plan's annual report under section 104.

``(ii) Schedules.--The plan sponsor shall annually update any schedule of contribution rates provided under this subsection to reflect the experience of the plan.

``(iii) Duration of schedule.--A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement shall remain in effect for the duration of that collective bargaining agreement.

``(C) Imposition of default schedule where failure to adopt rehabilitation plan.--

``(i) In general.--If--

``(I) a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered critical status expires, and

``(II) after receiving one or more schedules from the plan sponsor under paragraph (1)(B), the bargaining parties with respect to such agreement fail to adopt a contribution or benefit schedules with terms consistent with the rehabilitation plan and the schedule from the plan sponsor under paragraph (1)(B)(i),

the plan sponsor shall implement the default schedule described in the last sentence of paragraph (1) beginning on the date specified in clause (ii).

``(ii) Date of implementation.--The date specified in this clause is the earlier of the date--

``(I) on which the Secretary certifies that the parties are at an impasse, or

``(II) which is 180 days after the date on which the collective bargaining agreement described in clause (i) expires.

``(4) Rehabilitation period.--For purposes of this section--

``(A) In general.--The rehabilitation period for a plan in critical status is the 10-year period beginning on the first day of the first plan year of the multiemployer plan following the earlier of--

``(i) the second anniversary of the date of the adoption of the rehabilitation plan, or

``(ii) the expiration of the collective bargaining agreements in effect on the date of the due date for the actuarial certification of critical status for the initial critical year under subsection (a)(1) and covering, as of such date at least 75 percent of the active participants in such multiemployer plan.

If a plan emerges from critical status as provided under subparagraph (B) before the end of such 10-year period, the rehabilitation period shall end with the plan year preceding the plan year for which the determination under subparagraph (B) is made.

``(B) Emergence.--A plan in critical status shall remain in such status until a plan year for which the plan actuary certifies, in accordance with subsection (b)(3)(A), that the plan is not projected to have an accumulated funding deficiency for the plan year or any of the 9 succeeding plan years, without regard to the use of the shortfall method and taking into account any extension of amortization periods under section 304(d).

``(5) Rehabilitation plan adoption period.--For purposes of this section, the term `rehabilitation plan adoption period' means the period beginning on the date of the certification under subsection (b)(3)(A) for the initial critical year and ending on the day before the first day of the rehabilitation period.

``(6) Limitation on reduction in rates of future accruals.--Any reduction in the rate of future accruals under the default schedule described in paragraph (1)(B)(i) shall not reduce the rate of future accruals below--

``(A) a monthly benefit (payable as a single life annuity commencing at the participant's normal retirement age) equal to 1 percent of the contributions required to be made with respect to a participant, or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the initial critical year, or

``(B) if lower, the accrual rate under the plan on such first day.

The equivalent standard accrual rate shall be determined by the plan sponsor based on the standard or average contribution base units which the plan sponsor determines to be representative for active participants and such other factors as the plan sponsor determines to be relevant. Nothing in this paragraph shall be construed as limiting the ability of the plan sponsor to prepare and provide the bargaining parties with alternative schedules to the default schedule that established lower or higher accrual and contribution rates than the rates otherwise described in this paragraph.

``(7) Automatic employer surcharge.--

``(A) Imposition of surcharge.--Each employer otherwise obligated to make contributions for the initial critical year shall be obligated to pay to the plan for such year a surcharge equal to 5 percent of the contributions otherwise required under the applicable collective bargaining agreement (or other agreement pursuant to which the employer contributes). For each succeeding plan year in which the plan is in critical status for a consecutive period of years beginning with

the initial critical year, the surcharge shall be 10 percent of the contributions otherwise so required.

``(B) Enforcement of surcharge.--The surcharges under subparagraph (A) shall be due and payable on the same schedule as the contributions on which the surcharges are based. Any failure to make a surcharge payment shall be treated as a delinquent contribution under section 515 and shall be enforceable as such.

``(C) Surcharge to terminate upon collective bargaining agreement renegotiation.--The surcharge under this paragraph shall cease to be effective with respect to employees covered by a collective bargaining agreement (or other agreement pursuant to which the employer contributes), beginning on the effective date of a collective bargaining agreement (or other such agreement) that includes terms consistent with a schedule presented by the plan sponsor under paragraph (1)(B)(i), as modified under subparagraph (B) of paragraph (3).

``(D) Surcharge not to apply until employer receives notice.--The surcharge under this paragraph shall not apply to an employer until 30 days after the employer has been notified by the plan sponsor that the plan is in critical status and that the surcharge is in effect.

``(E) Surcharge not to generate increased benefit accruals.--Notwithstanding any provision of a plan to the contrary, the amount of any surcharge under this paragraph shall not be the basis for any benefit accrual under the plan.

``(8) Benefit adjustments.--

``(A) Adjustable benefits.--

``(i) In general.--Notwithstanding section 204(g), the plan sponsor shall, subject to the notice requirements in subparagraph (C), make any reductions to adjustable benefits which the plan sponsor deems appropriate, based upon the outcome of collective bargaining over the schedule or schedules provided under paragraph (1)(B)(i).

``(ii) Exception for retirees.--Except in the case of adjustable benefits described in clause (iv)(III), the plan sponsor of a plan in critical status shall not reduce adjustable benefits of any participant or beneficiary whose benefit commencement date is before the date on which the plan provides notice to the participant or beneficiary under subsection (b)(3)(D) for the initial critical year.

``(iii) Plan sponsor flexibility.--The plan sponsor shall include in the schedules provided to the bargaining parties an allowance for funding the benefits of participants with respect to whom contributions are not currently required to be made, and shall reduce their benefits to the extent permitted under this title and considered appropriate by the plan sponsor based on the plan's then current overall funding status.

``(iv) Adjustable benefit defined.--For purposes of this paragraph, the term `adjustable benefit' means--

``(I) benefits, rights, and features under the plan, including post-retirement death benefits, 60-month guarantees, disability benefits not yet in pay status, and similar benefits,

``(II) any early retirement benefit or retirement-type subsidy (within the meaning of section 204(g)(2)(A)) and any benefit payment option (other than the qualified joint and survivor annuity), and

``(III) benefit increases that would not be eligible for a guarantee under section 4022A on the first day of initial critical year because the increases were adopted (or, if later, took effect) less than 60 months before such first day.

``(B) Normal retirement benefits protected.--Except as provided in subparagraph (A)(iv)(III), nothing in this paragraph shall be construed to permit a plan to reduce the level of a participant's accrued benefit payable at normal retirement age.

``(C) Notice requirements.--
``(i) In general.--
No reduction may be made to adjustable benefits under subparagraph (A) unless notice of such reduction has been given at least 30 days before the general effective date of such reduction for all participants and beneficiaries to--
``(I) plan participants and beneficiaries,
``(II) each employer who has an obligation to contribute (within the meaning of section 4212(a)) under the plan, and
``(III) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such an employer.
``(ii) Content of notice.--The notice under clause (i) shall contain--
``(I) sufficient information to enable participants and beneficiaries to understand the effect of any reduction on their benefits, including an estimate (on an annual or monthly basis) of any affected adjustable benefit that a participant or beneficiary would otherwise have been eligible for as of the general effective date described in clause (i), and
``(II) information as to the rights and remedies of plan participants and beneficiaries as well as how to contact the Department of Labor for further information and assistance where appropriate.
``(iii) Form and manner.--Any notice under clause (i)--
``(I) shall be provided in a form and manner prescribed in regulations of the Secretary,
``(II) shall be written in a manner so as to be understood by the average plan participant, and
``(III) may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to persons to whom the notice is required to be provided.
The Secretary shall in the regulations prescribed under subclause (I) establish a model notice that a plan sponsor may use to meet the requirements of this subparagraph.
``(9) Adjustments disregarded in withdrawal liability determination.--
``(A) Benefit reductions.--Any benefit reductions under this subsection shall be disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability under section 4201.
``(B) Surcharges.--Any surcharges under paragraph (7) shall be disregarded in determining an employer's withdrawal liability under section 4211, except for purposes of determining the unfunded vested benefits attributable to an employer under section 4211(c)(4) or a comparable method approved under section 4211(c)(5).
``(C) Simplified calculations.--The Pension Benefit Guaranty Corporation shall prescribe simplified methods for the application of this paragraph in determining withdrawal liability.
``(f) Rules for Operation of Plan During Adoption and Rehabilitation Period.--
``(1) Compliance with rehabilitation plan.--
``(A) In general.--A plan may not be amended after the date of the adoption of a rehabilitation plan under subsection (e) so as to be inconsistent with the rehabilitation plan.
``(B) Special rules for benefit increases.--A plan may not be amended after the date of the adoption of a rehabilitation plan under subsection (e) so as to increase benefits, including future benefit accruals,

unless the plan actuary certifies that such increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

``(2) Restriction on lump sums and similar benefits.--

``(A) In general.--Effective on the date the notice of certification of the plan's critical status for the initial critical year under subsection (b)(3)(D) is sent, and notwithstanding section 204(g), the plan shall not pay--

``(i) any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 204(b)(1)(G)),

``(ii) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and

``(iii) any other payment specified by the Secretary of the Treasury by regulations.

``(B) Exception.--Subparagraph (A) shall not apply to a benefit which under section 203(e) may be immediately distributed without the consent of the participant or to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

``(3) Adjustments disregarded in withdrawal liability determination.--Any benefit reductions under this subsection shall be disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability under section 4201.

``(4) Special rules for plan adoption period.--During the rehabilitation plan adoption period--

``(A) the plan sponsor may not accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation, and

``(B) no amendment of the plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan may be adopted unless the amendment is required as a condition of qualification under part I of subchapter D of chapter 1 of the Internal Revenue Code of 1986 or to comply with other applicable law.

``(g) Expedited Resolution of Plan Sponsor Decisions.--If, within 60 days of the due date for adoption of a funding improvement plan or a rehabilitation plan under subsection (e), the plan sponsor of a plan in endangered status or a plan in critical status has not agreed on a funding improvement plan or rehabilitation plan, then any member of the board or group that constitutes the plan sponsor may require that the plan sponsor enter into an expedited dispute resolution procedure for the development and adoption of a funding improvement plan or rehabilitation plan.

``(h) Nonbargained Participation.--

``(1) Both bargained and nonbargained employee-participants.--In the case of an employer that contributes to a multiemployer plan with respect to both employees who are covered by one or more collective bargaining agreements and employees who are not so covered, if the plan is in endangered status or in critical status, benefits of and contributions for the nonbargained employees, including surcharges on those contributions, shall be determined as if those nonbargained employees were covered under the first to expire of the employer's collective bargaining agreements in effect when the plan entered endangered or critical status.

``(2) Nonbargained employees only.--In the case of an employer that contributes to a multiemployer plan only with respect to employees who are not covered by a collective bargaining agreement, this section shall be applied as if the employer were the bargaining party, and its participation agreement with the plan were a collective bargaining agreement

with a term ending on the first day of the plan year beginning after the employer is provided the schedule or schedules described in subsections (c) and (e).

``(i) Definitions; Actuarial Method.--For purposes of this section--

``(1) Bargaining party.--The term `bargaining party' means--

``(A)(i) except as provided in clause (ii), an employer who has an obligation to contribute under the plan; or

``(ii) in the case of a plan described under section 404(c) of the Internal Revenue Code of 1986, or a continuation of such a plan, the association of employers that is the employer settlor of the plan; and

``(B) an employee organization which, for purposes of collective bargaining, represents plan participants employed by an employer who has an obligation to contribute under the plan.

``(2) Funded percentage.--The term `funded percentage' means the percentage equal to a fraction--

``(A) the numerator of which is the value of the plan's assets, as determined under section 304(c)(2), and

``(B) the denominator of which is the accrued liability of the plan, determined using actuarial assumptions described in section 304(c)(3).

``(3) Accumulated funding deficiency.--The term `accumulated funding deficiency' has the meaning given such term in section 304(a).

``(4) Active participant.--The term `active participant' means, in connection with a multiemployer plan, a participant who is in covered service under the plan.

``(5) Inactive participant.--The term `inactive participant' means, in connection with a multiemployer plan, a participant, or the beneficiary or alternate payee of a participant, who--

``(A) is not in covered service under the plan, and

``(B) is in pay status under the plan or has a nonforfeitable right to benefits under the plan.

``(6) Pay status.--A person is in pay status under a multiemployer plan if--

``(A) at any time during the current plan year, such person is a participant or beneficiary under the plan and is paid an early, late, normal, or disability retirement benefit under the plan (or a death benefit under the plan related to a retirement benefit), or

``(B) to the extent provided in regulations of the Secretary of the Treasury, such person is entitled to such a benefit under the plan.

``(7) Obligation to contribute.--The term `obligation to contribute' has the meaning given such term under section 4212(a).

``(8) Actuarial method.--Notwithstanding any other provision of this section, the actuary's determinations with respect to a plan's normal cost, actuarial accrued liability, and improvements in a plan's funded percentage under this section shall be based upon the unit credit funding method (whether or not that method is used for the plan's actuarial valuation).

``(9) Plan sponsor.--In the case of a plan described under section 404(c) of the Internal Revenue Code of 1986, or a continuation of such a plan, the term `plan sponsor' means the bargaining parties described under paragraph (1).

``(10) Benefit commencement date.--The term `benefit commencement date' means the annuity starting date (or in the case of a retroactive annuity starting date, the date on which benefit payments begin).''.

(b) Enforcement.--Section 502 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1132) is amended--

(1) in subsection (a)(6) by striking ``(6), or (7)'' and inserting ``(6), (7), or (8)'';

(2) by redesignating subsection (c)(8) as subsection (c)(9); and

(3) by inserting after subsection (c)(7) the following new paragraph:

``(8) The Secretary may assess against any plan sponsor of a multiemployer plan a civil penalty of not more than $1,100 per day--

``(A) for each violation by such sponsor of the requirement under section 305 to adopt by the deadline established
in that section a funding improvement plan or rehabilitation plan with respect to a multiemployer which is in endangered or critical status, or

``(B) in the case of a plan in endangered status which is not in seriously endangered status, for failure

by the plan to meet the applicable benchmarks under section 305 by the end of the funding improvement period with respect to the plan.''.

(c) Cause of Action To Compel Adoption or Implementation of Funding Improvement or Rehabilitation Plan.--Section 502(a) of the Employee Retirement Income Security Act of 1974 is amended by striking ``or'' at the end of paragraph (8), by striking the period at the end of paragraph (9) and inserting ``; or'' and by adding at the end the following:

``(10) in the case of a multiemployer plan that has been certified by the actuary to be in endangered or critical status under section 305, if the plan sponsor--

``(A) has not adopted a funding improvement or rehabilitation plan under that section by the deadline established in such section, or

``(B) fails to update or comply with the terms of the funding improvement or rehabilitation plan in accordance with the requirements of such section,

by an employer that has an obligation to contribute with respect to the multiemployer plan or an employee organization that represents active participants in the multiemployer plan, for an order compelling the plan sponsor to adopt a funding improvement or rehabilitation plan or to update or comply with the terms of the funding improvement or rehabilitation plan in accordance with the requirements of such section and the funding improvement or rehabilitation plan.''.

(d) No Additional Contributions Required.--Section 302(b) of the Employee Retirement Income Security Act of 1974, as amended by this Act, is amended by adding at the end the following new paragraph:

``(3) Multiemployer plans in critical status.--Paragraph (1) shall not apply in the case of a multiemployer plan for any plan year in which the plan is in critical status pursuant to section 305. This paragraph shall only apply if the plan adopts a rehabilitation plan in accordance with section 305(e) and complies with the terms of such rehabilitation plan (and any updates or modifications of the plan).''.

(e) Conforming Amendment.--The table of contents in section 1 of such Act (as amended by the preceding provisions of this Act) is amended by inserting after the item relating to section 304 the following new item:

``Sec. 305. Additional funding rules for multiemployer plans in endangered status or critical status.''.

(f) Effective Dates.--

(1) In general.--The amendments made by this section shall apply with respect to plan years beginning after 2007.

(2) Special rule for certain notices.--In any case in which a plan's actuary certifies that it is reasonably expected that a multiemployer plan will be in critical status under section 305(b)(3) of the Employee Retirement Income Security Act of 1974, as added by this section, with respect to the first plan year beginning after 2007, the notice required under subparagraph (D) of such section may be provided at any time after the date of enactment, so long as it is provided on or before the last date for providing the notice under such subparagraph.

(3) Special rule for certain restored benefits.--In the case of a multiemployer plan--

(A) with respect to which benefits were reduced pursuant to a plan amendment adopted on or after January 1, 2002, and before June 30, 2005, and

(B) which, pursuant to the plan document, the trust agreement, or a formal written communication from the plan sponsor to participants provided before June 30, 2005, provided for the restoration of such benefits,

the amendments made by this section shall not apply to such benefit restorations to the extent that any restriction on the providing or accrual of such benefits would otherwise apply by reason of such amendments.

SEC. 203. MEASURES TO FORESTALL INSOLVENCY OF MULTIEMPLOYER PLANS.

(a) Advance Determination of Impending Insolvency Over 5 Years.--Section 4245(d)(1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1426(d)(1)) is amended--

(1) by striking ``3 plan years'' the second place it appears and inserting ``5 plan years''; and

(2) by adding at the end the following new sentence: ``If the plan sponsor makes such a determination that the plan will be insolvent in any of the next 5 plan years, the plan sponsor shall make the comparison under this paragraph at least annually until the plan sponsor makes a determination that the plan will not be insolvent in any of the next 5 plan years.''.

(b) Effective Date.--The amendments made

by this section shall apply with respect to determinations made in plan years beginning after 2007.

SEC. 204. WITHDRAWAL LIABILITY REFORMS.

(a) Update of Rules Relating to Limitations on Withdrawal Liability.--

(1) Increase in limits.--Section 4225(a)(2) of such Act (29 U.S.C. 1405(a)(2)) is amended by striking the table contained therein and inserting the following new table:

``If the liquidation or distribution value of the employer after the sale or exchange is--	The portion is--
Not more than $5,000,000............	30 percent of the amount.
More than $5,000,000, but not more than $10,000,000.	$1,500,000, plus 35 percent of the amount in excess of $5,000,000.
More than $10,000,000, but not more than $15,000,000.	$3,250,000, plus 40 percent of the amount in excess of $10,000,000.
More than $15,000,000, but not more than $17,500,000.	$5,250,000, plus 45 percent of the amount in excess of $15,000,000.
More than $17,500,000, but not more than $20,000,000.	$6,375,000, plus 50 percent of the amount in excess of $17,500,000.
More than $20,000,000, but not more than $22,500,000.	$7,625,000, plus 60 percent of the amount in excess of $20,000,000.
More than $22,500,000, but not more than $25,000,000.	$9,125,000, plus 70 percent of the amount in excess of $22,500,000.
More than $25,000,000...............	$10,875,000, plus 80 percent of the amount in excess of $25,000,000.''.

(2) Plans using attributable method.--Section 4225(a)(1)(B) of such Act (29 U.S.C. 1405(a)(1)(B)) is amended to read as follows:

``(B) in the case of a plan using the attributable method of allocating withdrawal liability, the unfunded vested benefits attributable to employees of the employer.''.

(3) Effective date.--The amendments made by this subsection shall apply to sales occurring on or after January 1, 2007.

(b) Withdrawal Liability Continues if Work Contracted Out.--

(1) In general.--Clause (i) of section 4205(b)(2)(A) of such Act (29 U.S.C. 1385(b)(2)(A)) is amended by inserting ``or to an entity or entities owned or controlled by the employer'' after ``to another location''.

(2) Effective date.--The amendment made by this subsection shall apply with respect to work transferred on or after the date of the enactment of this Act.

(c) Application of Rules to Plans Primarily Covering Employees in the Building and Construction Industry.--

(1) In general.--Section 4210(b) of such Act (29 U.S.C. 1390(b)) is amended--

(A) by striking paragraph (1); and

(B) by redesignating paragraphs (2) through (4) as paragraphs (1) through (3), respectively.

(2) Fresh start option.--Section 4211(c)(5) of such Act (29 U.S.C. 1391(c)(5)) is amended by adding at the end the following new subparagraph:

``(E) Fresh start option.--Notwithstanding paragraph (1), a plan may be amended to provide that the withdrawal liability method described in subsection (b) shall be applied by substituting the plan year which is specified in the amendment and for which the plan has no unfunded vested benefits for the plan year ending before September 26, 1980.''.

(3) Effective date.--The amendments made by this subsection shall apply with respect to plan withdrawals occurring on or after January 1, 2007.

(d) Procedures Applicable to Disputes Involving Pension Plan Withdrawal Liability.--

(1) In general.--Section 4221 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1401) is amended by adding at the end the following:

``(g) Procedures Applicable to Certain Disputes.--

``(1) In general.--If--

``(A) a plan sponsor of a plan determines that--
``(i) a complete or partial withdrawal of an employer has occurred, or
``(ii) an employer is liable for withdrawal liability payments with respect to such complete or partial withdrawal, and
``(B) such determination is based in whole or in part on a finding by the plan sponsor under section 4212(c) that a principal purpose of any transaction which occurred after December 31, 1998, and at least 5 years (2 years in the case of a small employer) before the date of the complete or partial withdrawal was to evade or avoid withdrawal liability under this subtitle,
then the person against which the withdrawal liability is assessed based solely on the application of section 4212(c) may elect to use the special rule under paragraph (2) in applying subsection (d) of this section and section 4219(c) to such person.

``(2) Special rule.--Notwithstanding subsection (d) and section 4219(c), if an electing person contests the plan sponsor's determination with respect to withdrawal liability payments under paragraph (1) through an arbitration proceeding pursuant to subsection (a), through an action brought in a court of competent jurisdiction for review of such an arbitration decision, or as otherwise permitted by law, the electing person shall not be obligated to make the withdrawal liability payments until a final decision in the arbitration proceeding, or in court, upholds the plan sponsor's determination, but only if the electing person--
``(A) provides notice to the plan sponsor of its election to apply the special rule in this paragraph within 90 days after the plan sponsor notifies the electing person of its liability by reason of the application of section 4212(c); and
``(B) if a final decision in the arbitration proceeding, or in court, of the withdrawal liability dispute has not been rendered within 12 months from the date of such notice, the electing person provides to the plan, effective as of the first day following the 12-month period, a bond issued by a corporate surety company that is an acceptable surety for purposes of section 412 of this Act, or an amount held in escrow by a bank or similar financial institution satisfactory to the plan, in an amount equal to the sum of the withdrawal liability payments that would otherwise be due under subsection (d) and section 4219(c) for the 12-month period beginning with the first anniversary of such notice. Such bond or escrow shall remain in effect until there is a final decision in the arbitration proceeding, or in court, of the withdrawal liability dispute, at which time such bond or escrow shall be paid to the plan if such final decision upholds the plan sponsor's determination.

``(3) Definition of small employer.--For purposes of this subsection--
``(A) In general.--The term `small employer' means any employer which, for the calendar year in which the transaction referred to in paragraph (1)(B) occurred and for each of the 3 preceding years, on average--
``(i) employs not more than 500 employees, and
``(ii) is required to make contributions to the plan for not more than 250 employees.
``(B) Controlled group.--Any group treated as a single employer under subsection (b)(1) of section 4001, without regard to any transaction that was a basis for the plan's finding under section 4212, shall be treated as a single employer for purposes of this subparagraph.

``(4) Additional security pending resolution of dispute.--If a withdrawal liability dispute to which this subsection applies is not concluded by 12 months after the electing person posts the bond or escrow described in paragraph (2), the electing person shall, at the start of each succeeding 12-month period, provide an additional bond or amount held in escrow equal to the sum of the withdrawal liability payments that would otherwise be payable to the plan during that period.

``(5) The liability of the party furnishing a bond or escrow under this subsection shall be reduced, upon the payment of the bond or escrow to the plan, by the amount thereof.''.

(2) Effective date.--The amendments made by this subsection shall apply to any person that receives a notification under section 4219(b)(1) of the Employee Retirement Income Security Act of 1974 on or after the

date of enactment of this Act with respect to a transaction that occurred after December 31, 1998.

SEC. 205. PROHIBITION ON RETALIATION AGAINST EMPLOYERS EXERCISING THEIR RIGHTS TO PETITION THE FEDERAL GOVERNMENT.

Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140) is amended by inserting before the last sentence thereof the following new sentence: ``In the case of a multiemployer plan, it shall be unlawful for the plan sponsor or any other person to discriminate against any contributing employer for exercising rights under this Act or for giving information or testifying in any inquiry or proceeding relating to this Act before Congress.''.

SEC. 206. SPECIAL RULE FOR CERTAIN BENEFITS FUNDED UNDER AN AGREEMENT APPROVED BY THE PENSION BENEFIT GUARANTY CORPORATION.

In the case of a multiemployer plan that is a party to an agreement that was approved by the Pension Benefit Guaranty Corporation prior to June 30, 2005, and that--

(1) increases benefits, and

(2) provides for special withdrawal liability rules under section 4203(f) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1383),

the amendments made by sections 201, 202, 211, and 212 of this Act shall not apply to the benefit increases under any plan amendment adopted prior to June 30, 2005, that are funded pursuant to such agreement if the plan is funded in compliance with such agreement (and any amendments thereto).

Subtitle B--Amendments to Internal Revenue Code of 1986

SEC. 211. FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS.

(a) In General.--Subpart A of part III of subchapter D of chapter 1 of the Internal Revenue Code of 1986 (as added by this Act) is amended by inserting after section 430 the following new section:

``SEC. 431. MINIMUM FUNDING STANDARDS FOR MULTIEMPLOYER PLANS.

``(a) In General.--For purposes of section 412, the accumulated funding deficiency of a multiemployer plan for any plan year is--

``(1) except as provided in paragraph (2), the amount, determined as of the end of the plan year, equal to the excess (if any) of the total charges to the funding standard account of the plan for all plan years (beginning with the first plan year for which this part applies to the plan) over the total credits to such account for such years, and

``(2) if the multiemployer plan is in reorganization for any plan year, the accumulated funding deficiency of the plan determined under section 4243 of the Employee Retirement Income Security Act of 1974.

``(b) Funding Standard Account.--

``(1) Account required.--Each multiemployer plan to which this part applies shall establish and maintain a funding standard account. Such account shall be credited and charged solely as provided in this section.

``(2) Charges to account.--For a plan year, the funding standard account shall be charged with the sum of--

``(A) the normal cost of the plan for the plan year,

``(B) the amounts necessary to amortize in equal annual installments (until fully amortized)--

``(i) in the case of a plan which comes into existence on or after January 1, 2008, the unfunded past service liability under the plan on the first day of the first plan year to which this section applies, over a period of 15 plan years,

``(ii) separately, with respect to each plan year, the net increase (if any) in unfunded past service liability under the plan arising from plan amendments adopted in such year, over a period of 15 plan years,

``(iii) separately, with respect to each plan year, the net experience loss (if any) under the plan, over a period of 15 plan years, and

``(iv) separately, with respect to each plan year, the net loss (if any) resulting from changes in actuarial assumptions used under the plan, over a period of 15 plan years,

``(C) the amount necessary to amortize each waived funding deficiency (within the meaning of section 412(c)(3)) for each prior plan year in equal annual installments (until fully amortized) over a period of 15 plan years,

``(D) the amount necessary to amortize in equal annual installments (until fully amortized) over a period of 5 plan years any amount credited to the funding standard account under section 412(b)(3)(D) (as in effect on the

day before the date of the enactment of the Pension Protection Act of 2006), and

``(E) the amount necessary to amortize in equal annual installments (until fully amortized) over a period of 20 years the contributions which would be required to be made under the plan but for the provisions of section 412(c)(7)(A)(i)(I) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006).

``(3) Credits to account.--For a plan year, the funding standard account shall be credited with the sum of--

``(A) the amount considered contributed by the employer to or under the plan for the plan year,

``(B) the amount necessary to amortize in equal annual installments (until fully amortized)--

``(i) separately, with respect to each plan year, the net decrease (if any) in unfunded past service liability under the plan arising from plan amendments adopted in such year, over a period of 15 plan years,

``(ii) separately, with respect to each plan year, the net experience gain (if any) under the plan, over a period of 15 plan years, and

``(iii) separately, with respect to each plan year, the net gain (if any) resulting from changes in actuarial assumptions used under the plan, over a period of 15 plan years,

``(C) the amount of the waived funding deficiency (within the meaning of section 412(c)(3)) for the plan year, and

``(D) in the case of a plan year for which the accumulated funding deficiency is determined under the funding standard account if such plan year follows a plan year for which such deficiency was determined under the alternative minimum funding standard under section 412(g) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006), the excess (if any) of any debit balance in the funding standard account (determined without regard to this subparagraph) over any debit balance in the alternative minimum funding standard account.

``(4) Special rule for amounts first amortized in plan years before 2008.--In the case of any amount amortized under section 412(b) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006) over any period beginning with a plan year beginning before 2008 in lieu of the amortization described in paragraphs (2)(B) and (3)(B), such amount shall continue to be amortized under such section as so in effect.

``(5) Combining and offsetting amounts to be amortized.--Under regulations prescribed by the Secretary, amounts required to be amortized under paragraph (2) or paragraph (3), as the case may be--

``(A) may be combined into one amount under such paragraph to be amortized over a period determined on the basis of the remaining amortization period for all items entering into such combined amount, and

``(B) may be offset against amounts required to be amortized under the other such paragraph, with the resulting amount to be amortized over a period determined on the basis of the remaining amortization periods for all items entering into whichever of the two amounts being offset is the greater.

``(6) Interest.--The funding standard account (and items therein) shall be charged or credited (as determined under regulations prescribed by the Secretary of the Treasury) with interest at the appropriate rate consistent with the rate or rates of interest used under the plan to determine costs.

``(7) Special rules relating to charges and credits to funding standard account.--For purposes of this part--

``(A) Withdrawal liability.--Any amount received by a multiemployer plan in payment of all or part of an employer's withdrawal liability under part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 shall be considered an amount contributed by the employer to or under the plan. The Secretary may prescribe by regulation additional charges and credits to a multiemployer plan's funding standard account to the extent necessary to prevent withdrawal liability payments from being unduly reflected as advance funding for plan liabilities.

``(B) Adjustments when a multiemployer plan leaves

reorganization.--If a multiemployer plan is not in reorganization in the plan year but was in reorganization in the immediately preceding plan year, any balance in the funding standard account at the close of such immediately preceding plan year--

``(i) shall be eliminated by an offsetting credit or charge (as the case may be), but

``(ii) shall be taken into account in subsequent plan years by being amortized in equal annual installments (until fully amortized) over 30 plan years.

The preceding sentence shall not apply to the extent of any accumulated funding deficiency under section 4243(a) of such Act as of the end of the last plan year that the plan was in reorganization.

``(C) Plan payments to supplemental program or withdrawal liability payment fund.--Any amount paid by a plan during a plan year to the Pension Benefit Guaranty Corporation pursuant to section 4222 of such Act or to a fund exempt under section 501(c)(22) pursuant to section 4223 of such Act shall reduce the amount of contributions considered received by the plan for the plan year.

``(D) Interim withdrawal liability payments.--Any amount paid by an employer pending a final determination of the employer's withdrawal liability under part 1 of subtitle E of title IV of such Act and subsequently refunded to the employer by the plan shall be charged to the funding standard account in accordance with regulations prescribed by the Secretary.

``(E) Election for deferral of charge for portion of net experience loss.--If an election is in effect under section 412(b)(7)(F) (as in effect on the day before the date of the enactment of the Pension Protection Act of 2006) for any plan year, the funding standard account shall be charged in the plan year to which the portion of the net experience loss deferred by such election was deferred with the amount so deferred (and paragraph (2)(B)(iii) shall not apply to the amount so charged).

``(F) Financial assistance.--Any amount of any financial assistance from the Pension Benefit Guaranty Corporation to any plan, and any repayment of such amount, shall be taken into account under this section and section 412 in such manner as is determined by the Secretary.

``(G) Short-term benefits.--
To the extent that any plan amendment increases the unfunded past service liability under the plan by reason of an increase in benefits which are not payable as a life annuity but are payable under the terms of the plan for a period that does not exceed 14 years from the effective date of the amendment, paragraph (2)(B)(ii) shall be applied separately with respect to such increase in unfunded past service liability by substituting the number of years of the period during which such benefits are payable for `15'.

``(c) Additional Rules.--

``(1) Determinations to be made under funding method.--For purposes of this part, normal costs, accrued liability, past service liabilities, and experience gains and losses shall be determined under the funding method used to determine costs under the plan. I22 ``(2) Valuation of assets.--

``(A) In general.--
For purposes of this part, the value of the plan's assets shall be determined on the basis of any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary.

``(B) Election with respect to bonds.--
The value of a bond or other evidence of indebtedness which is not in default as to principal or interest may, at the election of the plan administrator, be determined on an amortized basis running from initial cost at purchase to par value at maturity or earliest call date. Any election under this subparagraph shall be made at such time and in such manner as the Secretary shall by regulations provide, shall apply to all such evidences of indebtedness, and may be revoked only with the consent of the Secretary.

``(3) Actuarial assumptions must be reasonable.--For

purposes of this section, all costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods--

``(A) each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and

``(B) which, in combination, offer the actuary's best estimate of anticipated experience under the plan.

``(4) Treatment of certain changes as experience gain or loss.--For purposes of this section, if--

``(A) a change in benefits under the Social Security Act or in other retirement benefits created under Federal or State law, or

``(B) a change in the definition of the term `wages' under section 3121, or a change in the amount of such wages taken into account under regulations prescribed for purposes of section 401(a)(5),

results in an increase or decrease in accrued liability under a plan, such increase or decrease shall be treated as an experience loss or gain.

``(5) Full funding.--If, as of the close of a plan year, a plan would (without regard to this paragraph) have an accumulated funding deficiency in excess of the full funding limitation--

``(A) the funding standard account shall be credited with the amount of such excess, and

``(B) all amounts described in subparagraphs (B), (C), and (D) of subsection (b)(2) and subparagraph (B) of subsection (b)(3) which are required to be amortized shall be considered fully amortized for purposes of such subparagraphs.

``(6) Full-funding limitation.--

``(A) In general.--For purposes of paragraph (5), the term `full-funding limitation' means the excess (if any) of--

``(i) the accrued liability (including normal cost) under the plan (determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan), over

``(ii) the lesser of--

``(I) the fair market value of the plan's assets, or

``(II) the value of such assets determined under paragraph (2).

``(B) Minimum amount.--

``(i) In general.--In no event shall the full-funding limitation determined under subparagraph (A) be less than the excess (if any) of--

``(I) 90 percent of the current liability of the plan (including the expected increase in current liability due to benefits accruing during the plan year), over

``(II) the value of the plan's assets determined under paragraph (2).

``(ii) Assets.--For purposes of clause (i), assets shall not be reduced by any credit balance in the funding standard account.

``(C) Full funding limitation.--For purposes of this paragraph, unless otherwise provided by the plan, the accrued liability under a multiemployer plan shall not include benefits which are not nonforfeitable under the plan after the termination of the plan (taking into consideration section 411(d)(3)).

``(D) Current liability.--For purposes of this paragraph--

``(i) In general.--The term `current liability' means all liabilities to employees and their beneficiaries under the plan.

``(ii) Treatment of unpredictable contingent event benefits.--For purposes of clause (i), any benefit contingent on an event other than--

``(I) age, service, compensation, death, or disability, or

``(II) an event which is reasonably and reliably predictable (as determined by the Secretary),

shall not be taken into account until the event on which the benefit is contingent occurs.

``(iii) Interest rate used.--The rate of interest used to determine current liability under

this paragraph shall be the rate of interest
determined under subparagraph (E).
``(iv) Mortality tables.--
``(I) Commissioners' standard
table.--In the case of plan years
beginning before the first plan year to
which the first tables prescribed under
subclause (II) apply, the mortality
table used in determining current
liability under this paragraph shall be
the table prescribed by the Secretary
which is based on the prevailing
commissioners' standard table (described
in section 807(d)(5)(A)) used to
determine reserves for group annuity
contracts issued on January 1, 1993.
``(II) Secretarial authority.--The
Secretary may by regulation prescribe
for plan years beginning after December
31, 1999, mortality tables to be used in
determining current liability under this
subsection. Such tables shall be based
upon the actual experience of pension
plans and projected trends in such
experience. In prescribing such tables,
the Secretary shall take into account
results of available independent studies
of mortality of individuals covered by
pension plans.
``(v) Separate mortality tables for the
disabled.--Notwithstanding clause (iv)--
``(I) In general.--The Secretary
shall establish mortality tables which
may be used (in lieu of the tables under
clause (iv)) to determine current
liability under this subsection for
individuals who are entitled to benefits
under the plan on account of disability.
The Secretary shall establish separate
tables for individuals whose
disabilities occur in plan years
beginning before January 1, 1995, and
for individuals whose disabilities occur
in plan years beginning on or after such
date.
``(II) Special rule for disabilities
occurring after 1994.--
In <<NOTE: Applicability.>> the case of
disabilities occurring in plan years
beginning after December 31, 1994, the
tables under subclause (I) shall apply
only with respect to individuals
described in such subclause who are
disabled within the meaning of title II
of the Social Security Act and the
regulations thereunder.
``(vi) Periodic review.--
The Secretary shall
periodically (at least every 5 years) review any
tables in effect under this subparagraph and
shall, to the
extent such Secretary determines necessary, by
regulation update the tables to reflect the actual
experience of pension plans and projected trends
in such experience.
``(E) Required change of interest rate.--For
purposes of determining a plan's current liability for
purposes of this paragraph--
``(i) In general.--If any rate of interest
used under the plan under subsection (b)(6) to
determine cost is not within the permissible
range, the plan shall establish a new rate of
interest within the permissible range.
``(ii) Permissible range.--For purposes of
this subparagraph--
``(I) In general.--Except as
provided in subclause (II), the term
`permissible range' means a rate of
interest which is not more than 5
percent above, and not more than 10
percent below, the weighted average of
the rates of interest on 30-year

Treasury securities during the 4-year period ending on the last day before the beginning of the plan year.

``(II) Secretarial authority.--If the Secretary finds that the lowest rate of interest permissible under subclause (I) is unreasonably high, the Secretary may prescribe a lower rate of interest, except that such rate may not be less than 80 percent of the average rate determined under such subclause.

``(iii) Assumptions.--Notwithstanding paragraph (3)(A), the interest rate used under the plan shall be--

``(I) determined without taking into account the experience of the plan and reasonable expectations, but

``(II) consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.

``(7) Annual valuation.--

``(A) In general.--
For purposes of this section, a determination of experience gains and losses and a valuation of the plan's liability shall be made not less frequently than once every year, except that such determination shall be made more frequently to the extent required in particular cases under regulations prescribed by the Secretary.

``(B) Valuation date.--

``(i) Current year.--Except as provided in clause (ii), the valuation referred to in subparagraph (A) shall be made as of a date within the plan year to which the valuation refers or within one month prior to the beginning of such year.

``(ii) Use of prior year valuation.--The valuation referred to in subparagraph (A) may be made as of a date within the plan year prior to the year to which the valuation refers if, as of such date, the value of the assets of the plan are not less than 100
percent of the plan's current liability (as defined in paragraph (6)(D) without regard to clause (iv) thereof).

``(iii) Adjustments.--Information under clause (ii) shall, in accordance with regulations, be actuarially adjusted to reflect significant differences in participants.

``(iv) Limitation.--A change in funding method to use a prior year valuation, as provided in clause (ii), may not be made unless as of the valuation date within the prior plan year, the value of the assets of the plan are not less than 125 percent of the plan's current liability (as defined in paragraph (6)(D) without regard to clause (iv) thereof).

``(8) Time when certain contributions deemed made.--
For purposes of this section, any contributions for a plan year made by an employer after the last day of such plan year, but not later than two and one-half months after such day, shall be deemed to have been made on such last day. For purposes of this subparagraph, such two and one-half month period may be extended for not more than six months under regulations prescribed by the Secretary.

``(d) Extension of Amortization Periods for Multiemployer Plans.--

``(1) Automatic extension upon application by certain plans.--

``(A) In general.--If the plan sponsor of a multiemployer plan--

``(i) submits to the Secretary an application for an extension of the period of years required to amortize any unfunded liability described in any clause of subsection (b)(2)(B) or described in subsection (b)(4), and

``(ii) includes with the application a certification by the plan's actuary described in subparagraph (B),

the Secretary shall extend the amortization period for the period of time (not in excess of 5 years) specified

in the application. Such extension shall be in addition to any extension under paragraph (2).

``(B) Criteria.--

A certification with respect to a multiemployer plan is described in this subparagraph if the plan's actuary certifies that, based on reasonable assump- tions--

``(i) absent the extension under subparagraph (A), the plan would have an accumulated funding deficiency in the current plan year or any of the 9 succeeding plan years,

``(ii) the plan sponsor has adopted a plan to improve the plan's funding status,

``(iii) the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period as extended, and

``(iv) the notice required under paragraph (3)(A) has been provided.

``(C) Termination.--The preceding provisions of this paragraph shall not apply with respect to any application submitted after December 31, 2014.

``(2) Alternative extension.--

``(A) In general.--If the plan sponsor of a multiemployer plan submits to the Secretary an application for an extension of the period of years required to amortize any unfunded liability described in any clause of subsection (b)(2)(B) or described in subsection (b)(4), the Secretary may extend the amortization period for a period of time (not in excess of 10 years reduced by the number of years of any extension under paragraph (1) with respect to such unfunded liability) if the Secretary makes the determination described in subparagraph (B). Such extension shall be in addition to any extension under paragraph (1).

``(B) Determination.--The Secretary may grant an extension under subparagraph (A) if the Secretary determines that--

``(i) such extension would carry out the purposes of this Act and would provide adequate protection for participants under the plan and their beneficiaries, and

``(ii) the failure to permit such extension would--

``(I) result in a substantial risk to the voluntary continuation of the plan, or a substantial curtailment of pension benefit levels or employee compensation, and

``(II) be adverse to the interests of plan participants in the aggregate.

``(C) Action by secretary.--

The Secretary shall act upon any application for an extension under this paragraph within 180 days of the submission of such application. If the Secretary rejects the application for an extension under this paragraph, the Secretary shall provide notice to the plan detailing the specific reasons for the rejection, including references to the criteria set forth above.

``(3) Advance notice.--

``(A) In general.--The Secretary shall, before granting an extension under this subsection, require each applicant to provide evidence satisfactory to such Secretary that the applicant has provided notice of the filing of the application for such extension to each affected party (as defined in section 4001(a)(21) of the Employee Retirement Income Security Act of 1974) with respect to the affected plan. Such notice shall include a description of the extent to which the plan is funded for benefits which are guaranteed under title IV of such Act and for benefit liabilities.

``(B) Consideration of relevant information.--The Secretary shall consider any relevant information provided by a person to whom notice was given under paragraph (1).''.

(b) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after 2007.

(2) Special rule for certain amortization extensions.--

If the Secretary of the

Treasury grants an extension under section 304 of the Employee Retirement Income Security Act of 1974 and section 412(e) of the Internal Revenue Code of 1986 with respect to any application filed with the Secretary of the Treasury on or before June 30, 2005, the extension
(and any modification thereof) shall be applied and administered under the rules of such sections as in effect before the enactment of this Act, including the use of the rate of interest determined under section 6621(b) of such Code.

SEC. 212. ADDITIONAL FUNDING RULES FOR MULTIEMPLOYER PLANS IN ENDANGERED OR CRITICAL STATUS.

(a) In General.--Subpart A of part III of subchapter D of chapter 1 of the Internal Revenue Code of 1986 (as amended by this Act) is amended by inserting after section 431 the following new section:

``SEC. 432. ADDITIONAL FUNDING RULES FOR MULTIEMPLOYER PLANS IN ENDANGERED STATUS OR CRITICAL STATUS.

``(a) General Rule.--For purposes of this part, in the case of a multiemployer plan in effect on July 16, 2006--

``(1) if the plan is in endangered status--

``(A) the plan sponsor shall adopt and implement a funding improvement plan in accordance with the requirements of subsection (c), and

``(B) the requirements of subsection (d) shall apply during the funding plan adoption period and the funding improvement period, and

``(2) if the plan is in critical status--

``(A) the plan sponsor shall adopt and implement a rehabilitation plan in accordance with the requirements of subsection (e), and

``(B) the requirements of subsection (f) shall apply during the rehabilitation plan adoption period and the rehabilitation period.

``(b) Determination of Endangered and Critical Status.--For purposes of this section--

``(1) Endangered status.--A multiemployer plan is in endangered status for a plan year if, as determined by the plan actuary under paragraph (3), the plan is not in critical status for the plan year and, as of the beginning of the plan year, either--

``(A) the plan's funded percentage for such plan year is less than 80 percent, or

``(B) the plan has an accumulated funding deficiency for such plan year, or is projected to have such an accumulated funding deficiency for any of the 6 succeeding plan years, taking into account any extension of amortization periods under section 431(d).

For purposes of this section, a plan shall be treated as in seriously endangered status for a plan year if the plan is described in both subparagraphs (A) and (B).

``(2) Critical status.--A multiemployer plan is in critical status for a plan year if, as determined by the plan actuary under paragraph (3), the plan is described in 1 or more of the following subparagraphs as of the beginning of the plan year:

``(A) A plan is described in this subparagraph if--

``(i) the funded percentage of the plan is less than 65 percent, and

``(ii) the sum of--

``(I) the fair market value of plan assets, plus

``(II) the present value of the reasonably anticipated employer contributions for the current plan year and each of the 6 succeeding plan years, assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years,

is less than the present value of all nonforfeitable benefits projected to be payable under the plan during the current plan year and each of the 6 succeeding plan years (plus administrative expenses for such plan years).

``(B) A plan is described in this subparagraph if--

``(i) the plan has an accumulated funding deficiency for the current plan year, not taking into account any extension of amortization periods under section 431(d), or

``(ii) the plan is projected to have an accumulated funding deficiency for any of the 3 succeeding plan years (4 succeeding plan years if the funded percentage of the plan is 65 percent or

less), not taking into account any extension of amortization periods under section 431(d).

``(C) A plan is described in this subparagraph if--

``(i)(I) the plan's normal cost for the current plan year, plus interest (determined at the rate used for determining costs under the plan) for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last date of the preceding plan year, exceeds

``(II) the present value of the reasonably anticipated employer and employee contributions for the current plan year,

``(ii) the present value, as of the beginning of the current plan year, of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and

``(iii) the plan has an accumulated funding deficiency for the current plan year, or is projected to have such a deficiency for any of the 4 succeeding plan years, not taking into account any extension of amortization periods under section 431(d).

``(D) A plan is described in this subparagraph if the sum of--

``(i) the fair market value of plan assets, plus

``(ii) the present value of the reasonably anticipated employer contributions for the current plan year and each of the 4 succeeding plan years, assuming that the terms of all collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years,

is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the 4 succeeding plan years (plus administrative expenses for such plan years).

``(3) Annual certification by plan actuary.--

``(A) In general.--Not later than the 90th day of each plan year of a multiemployer plan, the plan actuary shall certify to the Secretary and to the plan sponsor--

``(i) whether or not the plan is in endangered status for such plan year and whether or not the plan is or will be in critical status for such plan year, and

``(ii) in the case of a plan which is in a funding improvement or rehabilitation period, whether or not the plan is making the scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

``(B) Actuarial projections of assets and liabilities.--

``(i) In general.--In making the determinations and projections under this subsection, the plan actuary shall make projections required for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. The actuary's projections shall be based on reasonable actuarial estimates, assumptions, and methods that, except as provided in clause (iii), offer the actuary's best estimate of anticipated experience under the plan. The projected present value of liabilities as of the beginning of such year shall be determined based on the most recent of either--

``(I) the actuarial statement required under section 103(d) of the Employee Retirement Income Security Act of 1974 with respect to the most recently filed annual report, or

``(II) the actuarial valuation for the preceding plan year.

``(ii) Determinations of future contributions.--Any actuarial projection of plan assets shall assume--

``(I) reasonably anticipated employer contributions for the current

and succeeding plan years, assuming that the terms of the one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for succeeding plan years, or

``(II) that employer contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines there have been no significant demographic changes that would make such assumption unreasonable.

``(iii) Projected industry activity.--Any projection of activity in the industry or industries covered by the plan, including future covered employment and contribution levels, shall be based on information provided by the plan sponsor, which shall act reasonably and in good faith.

``(C) Penalty for failure to secure timely actuarial certification.--Any failure of the plan's actuary to certify the plan's status under this subsection by the date specified in subparagraph (A) shall be treated for purposes of section 502(c)(2) of the Employee Retirement Income Security Act of 1974 as a failure or refusal by the plan administrator to file the annual report required to be filed with the Secretary under section 101(b)(4) of such Act.

``(D) Notice.--

``(i) In general.--In any case in which it is certified under subparagraph (A) that a multiemployer plan is or will be in endangered or critical status for a plan year, the plan sponsor shall, not later than 30 days after the date of the certification, provide notification of the endangered or critical status to the participants and beneficiaries, the bargaining parties, the Pension Benefit Guaranty Corporation, and the Secretary of Labor.

``(ii) Plans in critical status.--If it is certified under subparagraph (A) that a multiemployer plan is or will be in critical status, the plan sponsor shall include in the notice under clause (i) an explanation of the possibility that--

``(I) adjustable benefits (as defined in subsection (e)(8)) may be reduced, and

``(II) such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status.

``(iii) Model notice.--The Secretary of Labor shall prescribe a model notice that a multiemployer plan may use to satisfy the requirements under clause (ii).

``(c) Funding Improvement Plan Must Be Adopted for Multiemployer Plans in Endangered Status.--

``(1) In general.--In any case in which a multiemployer plan is in endangered status for a plan year, the plan sponsor, in accordance with this subsection--

``(A) shall adopt a funding improvement plan not later than 240 days following the required date for the actuarial certification of endangered status under subsection (b)(3)(A), and

``(B) within 30 days after the adoption of the funding improvement plan--

``(i) shall provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan, including--

``(I) one proposal for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing

contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law), and

``(II) one proposal for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan, and

``(ii) may, if the plan sponsor deems appropriate, prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to achieving the applicable benchmarks in accordance with the funding improvement plan.

For purposes of this section, the term `applicable benchmarks' means the requirements applicable to the multiemployer plan under paragraph (3) (as modified by paragraph (5)).

``(2) Exception for years after process begins.--Paragraph (1) shall not apply to a plan year if such year is in a funding plan adoption period or funding improvement period by reason of the plan being in endangered status for a preceding plan year. For purposes of this section, such preceding plan year shall be the initial determination year with respect to the funding improvement plan to which it relates.

``(3) Funding improvement plan.--For purposes of this section--

``(A) In general.--A funding improvement plan is a plan which consists of the actions, including options or a range of options to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan during the funding improvement period of the following requirements:

``(i) Increase in plan's funding percentage.--The plan's funded percentage as of the close of the funding improvement period equals or exceeds a percentage equal to the sum of--

``(I) such percentage as of the beginning of such period, plus

``(II) 33 percent of the difference between 100 percent and the percentage under subclause (I).

``(ii) Avoidance of accumulated funding deficiencies.--No accumulated funding deficiency for any plan year during the funding improvement period (taking into account any extension of amortization periods under section 304(d)).

``(B) Seriously endangered plans.--In the case of a plan in seriously endangered status, except as provided in paragraph (5), subparagraph (A)(i)(II) shall be applied by substituting `20 percent' for `33 percent'.

``(4) Funding improvement period.--For purposes of this section--

``(A) In general.--The funding improvement period for any funding improvement plan adopted pursuant to this subsection is the 10-year period beginning on the first day of the first plan year of the multiemployer plan beginning after the earlier of--

``(i) the second anniversary of the date of the adoption of the funding improvement plan, or

``(ii) the expiration of the collective bargaining agreements in effect on the due date for the actuarial certification of endangered status for the initial determination year under subsection (b)(3)(A) and covering, as of such due date, at least 75 percent of the active participants in such multiemployer plan.

``(B) Seriously endangered plans.--In the case of a plan in seriously endangered status, except as provided in paragraph (5), subparagraph (A) shall be applied by substituting `15-year period' for `10-year period'.

``(C) Coordination with changes in status.--

``(i) Plans no longer in endangered status.--If the plan's actuary certifies under subsection

(b)(3)(A) for a plan year in any funding plan adoption period or funding improvement period that the plan is no longer in endangered status and is not in critical status, the funding plan adoption period or funding improvement period, whichever is applicable, shall end as of the close of the preceding plan year.

``(ii) Plans in critical status.--If the plan's actuary certifies under subsection (b)(3)(A) for a plan year in any funding plan adoption period or funding improvement period that the plan is in critical status, the funding plan adoption period or funding improvement period, whichever is applicable, shall end as of the close of the plan year preceding the first plan year in the rehabilitation period with respect to such status.

``(D) Plans in endangered status at end of period.--If the plan's actuary certifies under subsection (b)(3)(A) for the first plan year following the close of the period described in subparagraph (A) that the plan is in endangered status, the provisions of this subsection and subsection (d) shall be applied as if such first plan year were an initial determination year, except that the plan may not be amended in a manner inconsistent with the funding improvement plan in effect for the preceding plan year until a new funding improvement plan is adopted.

``(5) Special rules for seriously endangered plans more than 70 percent funded.--

``(A) In general.--If the funded percentage of a plan in seriously endangered status was more than 70 percent as of the beginning of the initial determination year--

``(i) paragraphs (3)(B) and (4)(B) shall apply only if the plan's actuary certifies, within 30 days after the certification under subsection (b)(3)(A) for the initial determination year, that, based on the terms of the plan and the collective bargaining agreements in effect at the time of such certification, the plan is not projected to meet the requirements of paragraph (3)(A) (without regard to paragraphs (3)(B) and (4)(B)), and

``(ii) if there is a certification under clause (i), the plan may, in formulating its funding improvement plan, only take into account the rules of paragraph (3)(B) and (4)(B) for plan years in the funding improvement period beginning on or before the date on which the last of the collective bargaining agreements described in paragraph (4)(A)(ii) expires.

``(B) Special rule after expiration of agreements.--Notwithstanding subparagraph (A)(ii), if, for any plan year ending after the date described in subparagraph (A)(ii), the plan actuary certifies (at the time of the annual certification under subsection (b)(3)(A) for such plan year) that, based on the terms of the plan and collective bargaining agreements in effect at the time of that annual certification, the plan is not projected to be able to meet the requirements of paragraph (3)(A) (without regard to paragraphs (3)(B) and (4)(B)), paragraphs (3)(B) and (4)(B) shall continue to apply for such year.

``(6) Updates to funding improvement plans and schedules.--

``(A) Funding improvement plan.--The plan sponsor shall annually update the funding improvement plan and shall file the update with the plan's annual report under section 104 of the Employee Retirement Income Security Act of 1974.

``(B) Schedules.--The plan sponsor shall annually update any schedule of contribution rates provided under this subsection to reflect the experience of the plan.

``(C) Duration of schedule.--A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement shall remain in effect for the duration of that collective bargaining agreement.

``(7) Imposition of default schedule where failure to adopt funding improvement plan.--

``(A) In general.--If--

``(i) a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and

``(ii) after receiving one or more schedules from the plan sponsor under paragraph (1)(B), the bargaining parties with respect to such agreement fail to agree on changes to contribution or benefit schedules necessary to meet the applicable benchmarks in accordance with the funding improvement plan,

the plan sponsor shall implement the schedule described in paragraph (1)(B)(i)(I) beginning on the date specified in subparagraph (B).

``(B) Date of implementation.--The date specified in this subparagraph is the earlier of the date--

``(i) on which the Secretary of Labor certifies that the parties are at an impasse, or

``(ii) which is 180 days after the date on which the collective bargaining agreement described in subparagraph (A) expires.

``(8) Funding plan adoption period.--For purposes of this section, the term `funding plan adoption period' means the period beginning on the date of the certification under subsection (b)(3)(A) for the initial determination year and ending on the day before the first day of the funding improvement period.

``(d) Rules for Operation of Plan During Adoption and Improvement Periods.--

``(1) Special rules for plan adoption period.--During the funding plan adoption period--

``(A) the plan sponsor may not accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation,

``(B) no amendment of the plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan may be adopted unless the amendment is required as a condition of qualification under part I of subchapter D of chapter 1 or to comply with other applicable law, and

``(C) in the case of a plan in seriously endangered status, the plan sponsor shall take all reasonable actions which are consistent with the terms of the plan and applicable law and which are expected, based on reasonable assumptions, to achieve--

``(i) an increase in the plan's funded percentage, and

``(ii) postponement of an accumulated funding deficiency for at least 1 additional plan year.

Actions under subparagraph (C) include applications for extensions of amortization periods under section 431(d), use of the shortfall funding method in making funding standard account computations, amendments to the plan's benefit structure, reductions in future benefit accruals, and other reasonable actions consistent with the terms of the plan and applicable law.

``(2) Compliance with funding improvement plan.--

``(A) In general.--A plan may not be amended after the date of the adoption of a funding improvement plan so as to be inconsistent with the funding improvement plan.

``(B) No reduction in contributions.--A plan sponsor may not during any funding improvement period accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation.

``(C) Special rules for benefit increases.--A plan may not be amended after the date of the adoption of a funding improvement plan so as to increase benefits, including future benefit accruals, unless the plan actuary certifies that the benefit increase is consistent with the funding improvement plan and is paid for out of contributions not required by the funding improvement plan to meet the applicable benchmark in accordance with the schedule contemplated in the funding improvement plan.

``(e) Rehabilitation Plan Must Be Adopted for Multiemployer Plans in Critical Status.--

``(1) In general.--In any case in which a multiemployer plan is in critical status for a plan year, the plan sponsor, in accordance with this subsection--

``(A) shall adopt a rehabilitation plan not later than 240 days following the required date for the actuarial certification of critical status under subsection (b)(3)(A), and

``(B) within 30 days after the adoption of the rehabilitation plan--

``(i) shall provide to the bargaining parties 1 or more schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan, and

``(ii) may, if the plan sponsor deems appropriate, prepare and provide the bargaining parties with additional information relating to contribution rates or benefit reductions, alternative schedules, or other information relevant to emerging from critical status in accordance with the rehabilitation plan.

The schedule or schedules described in subparagraph (B)(i) shall reflect reductions in future benefit accruals and adjustable benefits, and increases in contributions, that the plan sponsor determines are reasonably necessary to emerge from critical status. One schedule shall be designated as the default schedule and such schedule shall assume that there are no increases in contributions under the plan other than the increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under section 411(d)(6)) have been reduced to the maximum extent permitted by law.

``(2) Exception for years after process begins.--Paragraph (1) shall not apply to a plan year if such year is in a rehabilitation plan adoption period or rehabilitation period by reason of the plan being in critical status for a preceding plan year. For purposes of this section, such preceding plan year shall be the initial critical year with respect to the rehabilitation plan to which it relates.

``(3) Rehabilitation plan.--For purposes of this section--

``(A) In general.--A rehabilitation plan is a plan which consists of--

``(i) actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonably anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefit accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions, or

``(ii) if the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan can not reasonably be expected to emerge from critical status by the end of the rehabilitation period, reasonable measures to emerge from critical status at a later time or to forestall possible insolvency (within the meaning of section 4245 of the Employee Retirement Income Security Act of 1974).

A rehabilitation plan must provide annual standards for meeting the requirements of such rehabilitation plan. Such plan shall also include the schedules required to be provided under paragraph (1)(B)(i) and if clause (ii) applies, shall set forth the alternatives considered,

explain why the plan is not reasonably expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

``(B) Updates to rehabilitation plan and schedules.--

``(i) Rehabilitation plan.--The plan sponsor shall annually update the rehabilitation plan and shall file the update with the plan's annual report under section 104 of the Employee Retirement Income Security Act of 1974.

``(ii) Schedules.--The plan sponsor shall annually update any schedule of contribution rates provided under this subsection to reflect the experience of the plan.

``(iii) Duration of schedule.--A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement shall remain in effect for the duration of that collective bargaining agreement.

``(C) Imposition of default schedule where failure to adopt rehabilitation plan.--

``(i) In general.--If--

``(I) a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered critical status expires, and

``(II) after receiving one or more schedules from the plan sponsor under paragraph (1)(B), the bargaining parties with respect to such agreement fail to adopt a contribution or benefit schedules with terms consistent with the rehabilitation plan and the schedule from the plan sponsor under paragraph (1)(B)(i),

the plan sponsor shall implement the default schedule described in the last sentence of paragraph (1) beginning on the date specified in clause (ii).

``(ii) Date of implementation.--The date specified in this clause is the earlier of the date--

``(I) on which the Secretary of Labor certifies that the parties are at an impasse, or

``(II) which is 180 days after the date on which the collective bargaining agreement described in clause (i) expires.

``(4) Rehabilitation period.--For purposes of this section--

``(A) In general.--The rehabilitation period for a plan in critical status is the 10-year period beginning on the first day of the first plan year of the multiemployer plan following the earlier of--

``(i) the second anniversary of the date of the adoption of the rehabilitation plan, or

``(ii) the expiration of the collective bargaining agreements in effect on the date of the due date for the actuarial certification of critical status for the initial critical year under subsection (a)(1) and covering, as of such date at least 75 percent of the active participants in such multiemployer plan.

If a plan emerges from critical status as provided under subparagraph (B) before the end of such 10-year period, the rehabilitation period shall end with the plan year preceding the plan year for which the determination under subparagraph (B) is made.

``(B) Emergence.--A plan in critical status shall remain in such status until a plan year for which the plan actuary certifies, in accordance with subsection (b)(3)(A), that the plan is not projected to have an accumulated funding deficiency for the plan year or any of the 9 succeeding plan years, without regard to the use of the shortfall method and taking into account any extension of amortization periods under section 431(d).

``(5) Rehabilitation plan adoption period.--For purposes of

this section, the term `rehabilitation plan adoption period' means the period beginning on the date of the certification under subsection (b)(3)(A) for the initial critical year and ending on the day before the first day of the rehabilitation period.

``(6) Limitation on reduction in rates of future accruals.--Any reduction in the rate of future accruals under the default schedule described in paragraph (1)(B)(i) shall not reduce the rate of future accruals below--

``(A) a monthly benefit (payable as a single life annuity commencing at the participant's normal retirement age) equal to 1 percent of the contributions required to be made with respect to a participant, or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the initial critical year, or

``(B) if lower, the accrual rate under the plan on such first day.

The equivalent standard accrual rate shall be determined by the plan sponsor based on the standard or average contribution base units which the plan sponsor determines to be representative for active participants and such other factors as the plan sponsor determines to be relevant. Nothing in this paragraph shall be construed as limiting the ability of the plan sponsor to prepare and provide the bargaining parties with alternative schedules to the default schedule that established lower or higher accrual and contribution rates than the rates otherwise described in this paragraph.

``(7) Automatic employer surcharge.--

``(A) Imposition of surcharge.--Each employer otherwise obligated to make a contribution for the initial critical year shall be obligated to pay to the plan for such year a surcharge equal to 5 percent of the contribution otherwise required under the applicable collective bargaining agreement (or other agreement pursuant to which the employer contributes). For each succeeding plan year in which the plan is in critical status for a consecutive period of years beginning with the initial critical year, the surcharge shall be 10 percent of the contribution otherwise so required.

``(B) Enforcement of surcharge.--The surcharges under subparagraph (A) shall be due and payable on the same schedule as the contributions on which the surcharges are based. Any failure to make a surcharge payment shall be treated as a delinquent contribution under section 515 of the Employee Retirement Income Security Act of 1974 and shall be enforceable as such.

``(C) Surcharge to terminate upon collective bargaining agreement renegotiation.--
The surcharge under this
paragraph shall cease to be effective with respect to employees covered by a collective bargaining agreement (or other agreement pursuant to which the employer contributes), beginning on the effective date of a collective bargaining agreement (or other such agreement) that includes terms consistent with a schedule presented by the plan sponsor under paragraph (1)(B)(i), as modified under subparagraph (B) of paragraph (3).

``(D) Surcharge not to apply until employer receives notice.--The surcharge under
this paragraph shall not apply to an employer until 30 days after the employer has been notified by the plan sponsor that the plan is in critical status and that the surcharge is in effect.

``(E) Surcharge not to generate increased benefit accruals.--Notwithstanding any provision of a plan to the contrary, the amount of any surcharge under this paragraph shall not be the basis for any benefit accrual under the plan.

``(8) Benefit adjustments.--

``(A) Adjustable benefits.--

``(i) In general.--Notwithstanding section 204(g), the plan sponsor shall, subject to the notice requirement under subparagraph (C), make any reductions to adjustable benefits which the plan sponsor deems appropriate, based upon the outcome of collective bargaining over the schedule or schedules provided under paragraph (1)(B)(i).

``(ii) Exception for retirees.--Except in the case of adjustable benefits described in clause

(iv)(III), the plan sponsor of a plan in critical status shall not reduce adjustable benefits of any participant or beneficiary whose benefit commencement date is before the date on which the plan provides notice to the participant or beneficiary under subsection (b)(3)(D) for the initial critical year.

``(iii) Plan sponsor flexibility.--The plan sponsor shall include in the schedules provided to the bargaining parties an allowance for funding the benefits of participants with respect to whom contributions are not currently required to be made, and shall reduce their benefits to the extent permitted under this title and considered appropriate by the plan sponsor based on the plan's then current overall funding status.

``(iv) Adjustable benefit defined.--For purposes of this paragraph, the term `adjustable benefit' means--

``(I) benefits, rights, and features under the plan, including post-retirement death benefits, 60-month guarantees, disability benefits not yet in pay status, and similar benefits,

``(II) any early retirement benefit or retirement-type subsidy (within the meaning of section 411(d)(6)(B)(i)) and any benefit payment option (other than the qualified joint and survivor annuity), and

``(III) benefit increases that would not be eligible for a guarantee under section 4022A of the Employee Retirement Income Security Act of 1974 on the first day of initial critical year because the increases were adopted (or, if later, took effect) less than 60 months before such first day.

``(B) Normal retirement benefits protected.--Except as provided in subparagraph (A)(iv)(III), nothing in this paragraph shall be construed to permit a plan to reduce the level of a participant's accrued benefit payable at normal retirement age.

``(C) Notice requirements.--

``(i) In general.--No reduction may be made to adjustable benefits under subparagraph (A) unless notice of such reduction has been given at least 30 days before the general effective date of such reduction for all participants and beneficiaries to--

``(I) plan participants and beneficiaries,

``(II) each employer who has an obligation to contribute (within the meaning of section 4212(a)) under the plan, and

``(III) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such an employer.

``(ii) Content of notice.--The notice under clause (i) shall contain--

``(I) sufficient information to enable participants and beneficiaries to understand the effect of any reduction on their benefits, including an estimate (on an annual or monthly basis) of any affected adjustable benefit that a participant or beneficiary would otherwise have been eligible for as of the general effective date described in clause (i), and

``(II) information as to the rights and remedies of plan participants and beneficiaries as well as how to contact the Department of Labor for further information and assistance where appropriate.

``(iii) Form and manner.--Any notice under clause (i)--

``(I) shall be provided in a form and manner prescribed in regulations of

the Secretary of Labor,
``(II) shall be written in a manner so as to be understood by the average plan participant, and
``(III) may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to persons to whom the notice is required to be provided.

The Secretary of Labor shall in the regulations prescribed under subclause (I) establish a model notice that a plan sponsor may use to meet the requirements of this subparagraph.

``(9) Adjustments disregarded in withdrawal liability determination.--

``(A) Benefit reductions.--Any benefit reductions under this subsection shall be disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability under section 4201 of the Employee Retirement Income Security Act of 1974.

``(B) Surcharges.--Any surcharges under paragraph (7) shall be disregarded in determining an employer's withdrawal liability under section 4211 of such Act, except for purposes of determining the unfunded vested benefits attributable to an employer under section 4211(c)(4) of such Act or a comparable method approved under section 4211(c)(5) of such Act.

``(C) Simplified calculations.--
The Pension Benefit Guaranty
Corporation shall prescribe simplified methods for the application of this paragraph in determining withdrawal liability.

``(f) Rules for Operation of Plan During Adoption and Rehabilitation Period.--

``(1) Compliance with rehabilitation plan.--

``(A) In general.--A plan may not be amended after the date of the adoption of a rehabilitation plan under subsection (e) so as to be inconsistent with the rehabilitation plan.

``(B) Special rules for benefit increases.--A plan may not be amended after the date of the adoption of a rehabilitation plan under subsection (e) so as to increase benefits, including future benefit accruals, unless the plan actuary certifies that such increase is paid for out of additional contributions not contemplated by the rehabilitation plan, and, after taking into account the benefit increase, the multiemployer plan still is reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated in the rehabilitation plan.

``(2) Restriction on lump sums and similar benefits.--

``(A) In general.--Effective on the date the notice of certification of the
plan's critical status for the initial critical year under subsection (b)(3)(D) is sent, and notwithstanding section 411(d)(6), the plan shall not pay--

``(i) any payment, in excess of the monthly amount paid under a single life annuity (plus any social security supplements described in the last sentence of section 411(b)(1)(A)),

``(ii) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits, and

``(iii) any other payment specified by the Secretary by regulations.

``(B) Exception.--Subparagraph (A) shall not apply to a benefit which under section 411(a)(11) may be immediately distributed without the consent of the participant or to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

``(3) Adjustments disregarded in withdrawal liability determination.--Any benefit reductions under this subsection shall be disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability under section 4201 of the Employee Retirement Income Security Act of 1974.

``(4) Special rules for plan adoption period.--During the rehabilitation plan adoption period--

``(A) the plan sponsor may not accept a collective

bargaining agreement or participation agreement with respect to the multiemployer plan that provides for--

``(i) a reduction in the level of contributions for any participants,

``(ii) a suspension of contributions with respect to any period of service, or

``(iii) any new direct or indirect exclusion of younger or newly hired employees from plan participation, and

``(B) no amendment of the plan which increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan may be adopted unless the amendment is required as a condition of qualification under part I of subchapter D of chapter 1 or to comply with other applicable law.

``(g) Expedited Resolution of Plan Sponsor Decisions.--If, within 60 days of the due date for adoption of a funding improvement plan or a rehabilitation plan under subsection (e), the plan sponsor of a plan in endangered status or a plan in critical status has not agreed on a funding improvement plan or rehabilitation plan, then any member of the board or group that constitutes the plan sponsor may require that the plan sponsor enter into an expedited dispute resolution procedure for the development and adoption of a funding improvement plan or rehabilitation plan.

``(h) Nonbargained Participation.--

``(1) Both bargained and nonbargained employee-participants.--In the case of an employer that contributes to a multiemployer plan with respect to both employees who are covered by one or more collective bargaining agreements and employees who are not so covered, if the plan is in endangered status or in critical status, benefits of and contributions for the nonbargained employees, including surcharges on those contributions, shall be determined as if those nonbargained employees were covered under the first to expire of the employer's collective bargaining agreements in effect when the plan entered endangered or critical status.

``(2) Nonbargained employees only.--In the case of an employer that contributes to a multiemployer plan only with respect to employees who are not covered by a collective bargaining agreement, this section shall be applied as if the employer were the bargaining party, and its participation agreement with the plan were a collective bargaining agreement with a term ending on the first day of the plan year beginning after the employer is provided the schedule or schedules described in subsections (c) and (e).

``(i) Definitions; Actuarial Method.--For purposes of this section--

``(1) Bargaining party.--The term `bargaining party' means--

``(A)(i) except as provided in clause (ii), an employer who has an obligation to contribute under the plan; or

``(ii) in the case of a plan described under section 404(c), or a continuation of such a plan, the association of employers that is the employer settlor of the plan; and

``(B) an employee organization which, for purposes of collective bargaining, represents plan participants employed by an employer who has an obligation to contribute under the plan.

``(2) Funded percentage.--The term `funded percentage' means the percentage equal to a fraction--

``(A) the numerator of which is the value of the plan's assets, as determined under section 431(c)(2), and

``(B) the denominator of which is the accrued liability of the plan, determined using actuarial assumptions described in section 431(c)(3).

``(3) Accumulated funding deficiency.--The term `accumulated funding deficiency' has the meaning given such term in section 412(a).

``(4) Active participant.--The term `active participant' means, in connection with a multiemployer plan, a participant who is in covered service under the plan.

``(5) Inactive participant.--The term `inactive participant' means, in connection with a multiemployer plan, a participant, or the beneficiary or alternate payee of a participant, who--

``(A) is not in covered service under the plan, and

``(B) is in pay status under the plan or has a nonforfeitable right to benefits under the plan.

``(6) Pay status.--A person is in pay status under a multiemployer plan if--

``(A) at any time during the current plan year, such person is a participant or beneficiary under the plan and is paid an early, late, normal, or disability retirement benefit under the plan (or a death benefit under the plan related to a retirement benefit), or

``(B) to the extent provided in regulations of the Secretary, such person is entitled to such a benefit under the plan.

``(7) Obligation to contribute.--The term `obligation to contribute' has the meaning given such term under section 4212(a) of the Employee Retirement Income Security Act of 1974.

``(8) Actuarial method.--Notwithstanding any other provision of this section, the actuary's determinations with respect to a plan's normal cost, actuarial accrued liability, and improvements in a plan's funded percentage under this section shall be based upon the unit credit funding method (whether or not that method is used for the plan's actuarial valuation).

``(9) Plan sponsor.--In the case of a plan described under section 404(c), or a continuation of such a plan, the term `plan sponsor' means the bargaining parties described under paragraph (1).

``(10) Benefit commencement date.--The term `benefit commencement date' means the annuity starting date (or in the case of a retroactive annuity starting date, the date on which benefit payments begin).''

(b) Excise Taxes on Failures Relating to Multiemployer Plans in Endangered or Critical Status.--

(1) In general.--Section 4971 of the Internal Revenue Code of 1986 is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following:

``(g) Multiemployer Plans in Endangered or Critical Status.--

``(1) In general.--Except as provided in this subsection--

``(A) no tax shall be imposed under this section for a taxable year with respect to a multiemployer plan if, for the plan years ending with or within the taxable year, the plan is in critical status pursuant to section 432, and

``(B) any tax imposed under this subsection for a taxable year with respect to a multiemployer plan if, for the plan years ending with or within the taxable year, the plan is in endangered status pursuant to section 432 shall be in addition to any other tax imposed by this section.

``(2) Failure to comply with funding improvement or rehabilitation plan.--

``(A) In general.--If any funding improvement plan or rehabilitation plan in effect under section 432 with respect to a multiemployer plan requires an employer to make a contribution to the plan, there is hereby imposed a tax on each failure of the employer to make the required contribution within the time required under such plan.

``(B) Amount of tax.--The amount of the tax imposed by subparagraph (A) shall be equal to the amount of the required contribution the employer failed to make in a timely manner.

``(C) Liability for tax.--The tax imposed by subparagraph (A) shall be paid by the employer responsible for contributing to or under the rehabilitation plan which fails to make the contribution.

``(3) Failure to meet requirements for plans in endangered or critical status.--If--

``(A) a plan which is in seriously endangered status fails to meet the applicable benchmarks by the end of the funding improvement period, or

``(B) a plan which is in critical status either--

``(i) fails to meet the requirements of section 432(e) by the end of the rehabilitation period, or

``(ii) has received a certification under section 432(b)(3)(A)(ii) for 3 consecutive plan years that the plan is not making the scheduled progress in meeting its requirements under the rehabilitation plan,

the plan shall be treated as having an accumulated funding deficiency for purposes of this section for the last plan year in such funding improvement, rehabilitation, or 3-consecutive year period (and each succeeding plan year until such benchmarks or requirements are met) in an amount equal to the greater

of the amount of the contributions necessary to meet such benchmarks or requirements or the amount of such accumulated funding deficiency without regard to this paragraph.

``(4) Failure to adopt rehabilitation plan.--

``(A) In general.--In the case of a multiemployer plan which is in critical status, there is hereby imposed a tax on the failure of such plan to adopt a rehabilitation plan within the time prescribed under section 432.

``(B) Amount of tax.--The amount of the tax imposed under subparagraph (A) with respect to any plan sponsor for any taxable year shall be the greater of--

``(i) the amount of tax imposed under subsection (a) for the taxable year (determined without regard to this subsection), or

``(ii) the amount equal to $1,100 multiplied by the number of days during the taxable year which are included in the period beginning on the first day of the 240-day period described in section 432(e)(1)(A) and ending on the day on which the rehabilitation plan is adopted.

``(C) Liability for tax.--

``(i) In general.--The tax imposed by subparagraph (A) shall be paid by each plan sponsor.

``(ii) Plan sponsor.--For purposes of clause (i), the term `plan sponsor' in the case of a multiemployer plan means the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

``(5) Waiver.--In the case of a failure described in paragraph (2) or (3) which is due to reasonable cause and not to willful neglect, the Secretary may waive part or all of the tax imposed by this subsection. For purposes of this paragraph, reasonable cause includes unanticipated and material market fluctuations, the loss of a significant contributing employer, or other factors to the extent that the payment of tax under this subsection with respect to the failure would be excessive or otherwise inequitable relative to the failure involved.

``(6) Terms used in section 432.--For purposes of this subsection, any term used in this subsection which is also used in section 432 shall have the meaning given such term by section 432.''.

(2) Controlled groups.--Section 4971(c)(2) of such Code is amended--

(A) by striking ``In the case of a plan other than a multiemployer plan, if the'' and inserting ``If an'', and

(B) by striking ``or (f)'' and inserting ``(f), or (g)''.

(c) No Additional Contribution Required.--Section 412(b) of the Internal Revenue Code of 1986, as amended by this Act, is amended by adding at the end the following new paragraph:

``(3) Multiemployer plans in critical status.--Paragraph (1) shall not apply in the case of a multiemployer plan for any plan year in which the plan is in critical status pursuant to section 432. This paragraph shall only apply if the plan adopts a rehabilitation plan in accordance with section 432(e) and complies with such rehabilitation plan (and any modifications of the plan).''.

(d) Clerical Amendment.--The table of sections for subpart A of part III of subchapter D of chapter 1 of such Code is amended by adding at the end the following new item:

``Sec. 432. Additional funding rules for multiemployer plans in endangered status or critical status.''.

(e) Effective Dates.--

(1) In general.--The amendments made by this section shall apply with respect to plan years beginning after 2007.

(2) Special rule for certain notices.--In any case in which a plan's actuary certifies that it is reasonably expected that a multiemployer plan will be in critical status under section 305(b)(3) of the Employee Retirement Income Security Act of 1974, as added by this section, with respect to the first plan year beginning after 2007, the notice required under subparagraph (D) of such section may be provided at any time after the date of enactment, so long as it is provided on or before the last date for providing the notice under such subparagraph.

(3) Special rule for certain restored benefits.--In the case of a multiemployer plan--

(A) with respect to which benefits were reduced

pursuant to a plan amendment adopted on or after January 1, 2002, and before June 30, 2005, and

(B) which, pursuant to the plan document, the trust agreement, or a formal written communication from the plan sponsor to participants provided before June 30, 2005, provided for the restoration of such benefits,

the amendments made by this section shall not apply to such benefit restorations to the extent that any restriction on the providing or accrual of such benefits would otherwise apply by reason of such amendments.

SEC. 213. MEASURES TO FORESTALL INSOLVENCY OF MULTIEMPLOYER PLANS.

(a) Advance Determination of Impending Insolvency Over 5 Years.--Section 418E(d)(1) of the Internal Revenue Code of 1986 is amended--

(1) by striking ``3 plan years'' the second place it appears and inserting ``5 plan years''; and

(2) by adding at the end the following new sentence: ``If the plan sponsor makes such a determination that the plan will be insolvent in any of the next 5 plan years, the plan sponsor shall make the comparison under this paragraph at least annually until the plan sponsor makes a determination that the plan will not be insolvent in any of the next 5 plan years.''.

(b) Effective Date.--The amendments made by this section shall apply with respect to the determinations made in plan years beginning after 2007.

SEC. 214. EXEMPTION FROM EXCISE TAXES FOR CERTAIN MULTIEMPLOYER PENSION PLANS.

(a) In General.--Notwithstanding any other provision of law, no tax shall be imposed under subsection (a) or (b) of section 4971 of the Internal Revenue Code of 1986 with respect to any accumulated funding deficiency of a plan described in subsection (b) of this section for any taxable year beginning before the earlier of--

(1) the taxable year in which the plan sponsor adopts a rehabilitation plan under section 305(e) of the Employee Retirement Income Security Act of 1974 and section 432(e) of such Code (as added by this Act); or

(2) the taxable year that contains January 1, 2009.

(b) Plan Described.--A plan described under this subsection is a multiemployer pension plan--

(1) with less than 100 participants;

(2) with respect to which the contributing employers participated in a Federal fishery capacity reduction program;

(3) with respect to which employers under the plan participated in the Northeast Fisheries Assistance Program; and

(4) with respect to which the annual normal cost is less than $100,000 and the plan is experiencing a funding deficiency on the date of enactment of this Act.

Subtitle C--Sunset of Additional Funding Rules

SEC. 221. SUNSET OF ADDITIONAL FUNDING RULES.

(a) Report.--Not later than December 31, 2011, the Secretary of Labor, the Secretary of the Treasury, and the Executive Director of the Pension Benefit Guaranty Corporation shall conduct a study of the effect of the amendments made by this subtitle on the operation and funding status of multiemployer plans and shall report the results of such study, including any recommendations for legislation, to the Congress.

(b) Matters Included in Study.--The study required under subsection (a) shall include--

(1) the effect of funding difficulties, funding rules in effect before the date of the enactment of this Act, and the amendments made by this subtitle on small businesses participating in multiemployer plans,

(2) the effect on the financial status of small employers of--

(A) funding targets set in funding improvement and rehabilitation plans and associated contribution increases,

(B) funding deficiencies,

(C) excise taxes,

(D) withdrawal liability,

(E) the possibility of alternative schedules and procedures for financially troubled employers, and

(F) other aspects of the multiemployer system, and

(3) the role of the multiemployer pension plan system in helping small employers to offer pension benefits.

(c) Sunset.--

(1) In general.--Except as provided in this subsection, notwithstanding any other provision of this Act, the provisions of, and the amendments made by, sections 201(b), 202, and 212 shall not apply to plan years beginning after December 31, 2014.

(2) Funding improvement and rehabilitation plans.--If a plan is operating under a funding improvement or rehabilitation plan under section 305 of such Act or 432 of such Code for its last year beginning before January 1, 2015, such plan shall continue

to operate under such funding improvement or rehabilitation plan during any period after December 31, 2014, such funding improvement or rehabilitation plan is in effect and all provisions of such Act or Code relating to the operation of such funding improvement or rehabilitation plan shall continue in effect during such period.

TITLE III--INTEREST RATE ASSUMPTIONS

SEC. 301. EXTENSION OF REPLACEMENT OF 30-YEAR TREASURY RATES.

(a) Amendments of ERISA.--

(1) Determination of range.--Subclause (II) of section 302(b)(5)(B)(ii) of the Employee Retirement Income Security Act of 1974 is amended--

(A) by striking ``2006'' and inserting ``2008'', and

(B) by striking ``and 2005'' in the heading and inserting ``, 2005, 2006, and 2007''.

(2) Determination of current liability.--Subclause (IV) of section 302(d)(7)(C)(i) of such Act is amended--

(A) by striking ``or 2005'' and inserting ``, 2005, 2006, or 2007'', and

(B) by striking ``and 2005'' in the heading and inserting ``, 2005, 2006, and 2007''.

(3) PBGC premium rate.--Subclause (V) of section 4006(a)(3)(E)(iii) of such Act is amended by striking ``2006'' and inserting ``2008''.

(b) Amendments of Internal Revenue Code.--

(1) Determination of range.--Subclause (II) of section 412(b)(5)(B)(ii) of the Internal Revenue Code of 1986 is amended--

(A) by striking ``2006'' and inserting ``2008'', and

(B) by striking ``and 2005'' in the heading and inserting ``, 2005, 2006, and 2007''.

(2) Determination of current liability.--Subclause (IV) of section 412(l)(7)(C)(i) of such Code is amended--

(A) by striking ``or 2005'' and inserting ``, 2005, 2006, or 2007'', and

(B) by striking ``and 2005'' in the heading and inserting ``, 2005, 2006, and 2007''.

(c) Plan Amendments.--Clause (ii) of section 101(c)(2)(A) of the Pension Funding Equity Act of 2004 is amended by striking ``2006'' and inserting ``2008''.

SEC. 302. INTEREST RATE ASSUMPTION FOR DETERMINATION OF LUMP SUM DISTRIBUTIONS.

(a) Amendment to Employee Retirement Income Security Act of 1974.--Paragraph (3) of section 205(g) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1055(g)(3)) is amended to read as follows:

``(3)(A) For purposes of paragraphs (1) and (2), the present value shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate.

``(B) For purposes of subparagraph (A)--

``(i) The term `applicable mortality table' means a mortality table, modified as appropriate by the Secretary of the Treasury, based on the mortality table specified for the plan year under subparagraph (A) of section 303(h)(3) (without regard to subparagraph (C) or (D) of such section).

``(ii) The term `applicable interest rate' means the adjusted first, second, and third segment rates applied under rules similar to the rules of section 303(h)(2)(C) for the month before the date of the distribution or such other time as the Secretary of the Treasury may by regulations prescribe.

``(iii) For purposes of clause (ii), the adjusted first, second, and third segment rates are the first, second, and third segment rates which would be determined under section 303(h)(2)(C) if--

``(I) section 303(h)(2)(D) were applied by substituting the average yields for the month described in clause (ii) for the average yields for the 24-month period described in such section,

``(II) section 303(h)(2)(G)(i)(II) were applied by substituting `section 205(g)(3)(B)(iii)(II)' for `section 302(b)(5)(B)(ii)(II)', and

``(III) the applicable percentage under section 303(h)(2)(G) were determined in accordance with the following table:

``In the case of plan years beginning in:	The applicable percentage is:
2008	20 percent
2009	40 percent
2010	60 percent
2011	80 percent.''.

(b) Amendment to Internal Revenue Code of 1986.--Paragraph (3) of section 417(e) of the Internal Revenue Code of 1986 is amended to read as follows:

``(3) Determination of present value.--

``(A) In general.--For purposes of paragraphs (1) and (2), the present value shall not be less than the present value calculated by using the applicable mortality table and the applicable interest rate.

``(B) Applicable mortality table.--For purposes of subparagraph (A), the term `applicable mortality table' means a mortality table, modified as appropriate by the Secretary, based on the mortality table specified for the plan year under subparagraph (A) of section 430(h)(3) (without regard to subparagraph (C) or (D) of such section).

``(C) Applicable interest rate.--For purposes of subparagraph (A), the term `applicable interest rate' means the adjusted first, second, and third segment rates applied under rules similar to the rules of section 430(h)(2)(C) for the month before the date of the distribution or such other time as the Secretary may by regulations prescribe.

``(D) Applicable segment rates.--For purposes of subparagraph (C), the adjusted first, second, and third segment rates are the first, second, and third segment rates which would be determined under section 430(h)(2)(C) if--

``(i) section 430(h)(2)(D) were applied by substituting the average yields for the month described in clause (ii) for the average yields for the 24-month period described in such section,

``(ii) section 430(h)(2)(G)(i)(II) were applied by substituting `section 417(e)(3)(A)(ii)(II)' for `section 412(b)(5)(B)(ii)(II)', and

``(iii) the applicable percentage under section 430(h)(2)(G) were determined in accordance with the following table:

``In the case of plan years beginning in:	The applicable percentage is:
2008...........................	20 percent
2009...........................	40 percent
2010...........................	60 percent
2011...........................	80 percent.''.

(c) Effective Date.--The amendments made by this section shall apply with respect to plan years beginning after December 31, 2007.

SEC. 303. INTEREST RATE ASSUMPTION FOR APPLYING BENEFIT LIMITATIONS TO LUMP SUM DISTRIBUTIONS.

(a) In General.--Clause (ii) of section 415(b)(2)(E) of the Internal Revenue Code of 1986 is amended to read as follows:

``(ii) For purposes of adjusting any benefit under subparagraph (B) for any form of benefit subject to section 417(e)(3), the interest rate assumption shall not be less than the greatest of--

``(I) 5.5 percent,

``(II) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the applicable interest rate (as defined in section 417(e)(3)) were the interest rate assumption, or

``(III) the rate specified under the plan.''.

(b) Effective Date.--The amendment made by subsection (a) shall apply to distributions made in years beginning after December 31, 2005.

TITLE IV--PBGC GUARANTEE AND RELATED PROVISIONS

SEC. 401. PBGC PREMIUMS.

(a) Variable-Rate Premiums.--

(1) Conforming amendments related to funding rules for single-employer plans.--Section 4006(a)(3)(E) of the Employee Retirement Income and Security Act of 1974 (29 U.S.C. 1306(a)(3)(E)) is amended by striking clauses (iii) and (iv) and inserting the following:

``(iii) For purposes of clause (ii), the term `unfunded vested benefits' means, for a plan year, the excess (if any) of--

``(I) the funding target of the plan as determined under section 303(d) for the plan year by only taking into account vested benefits and by using the interest rate described in clause (iv), over

``(II) the fair market value of plan assets for the plan year which are held by the plan on the valuation date.

``(iv) The interest rate used in valuing benefits for purposes of

subclause (I) of clause (iii) shall be equal to the first, second, or third segment rate for the month preceding the month in which the plan year begins, which would be determined under section 303(h)(2)(C) if section 303(h)(2)(D) were applied by using the monthly yields for the month preceding the month in which the plan year begins on investment grade corporate bonds with varying maturities and in the top 3 quality levels rather than the average of such yields for a 24-month period.''.

(2) Effective date.--The amendments made by paragraph (1) shall apply with respect to plan years beginning after 2007.

(b) Termination Premiums.--

(1) Repeal of sunset provision.--Subparagraph (E) of section 4006(a)(7) of such Act is repealed.

(2) Technical correction.--

(A) In general.--Section 4006(a)(7)(C)(ii) of such Act is amended by striking ``subparagraph (B)(i)(I)'' and inserting ``subparagraph (B)''.

(B) Effective date.--The amendment made by this paragraph shall take effect as if included in the provision of the Deficit Reduction Act of 2005 to which it relates.

SEC. 402. SPECIAL FUNDING RULES FOR CERTAIN PLANS MAINTAINED BY COMMERCIAL AIRLINES.

(a) In General.--The plan sponsor of an eligible plan may elect to either--

(1) have the rules of subsection (b) apply, or

(2) have section 303 of the Employee Retirement Income Security Act of 1974 and section 430 of the Internal Revenue Code of 1986 applied to its first taxable year beginning in 2008 by amortizing the shortfall amortization base for such taxable year over a period of 10 plan years (rather than 7 plan years) beginning with such plan year.

(b) Alternative Funding Schedule.--

(1) In general.--If an election is made under subsection (a)(1) to have this subsection apply to an eligible plan and the requirements of paragraphs (2) and (3) are met with respect to the plan--

(A) in the case of any applicable plan year beginning before January 1, 2008, the plan shall not have an accumulated funding deficiency for purposes of section 302 of the Employee Retirement Income Security Act of 1974 and sections 412 and 4971 of the Internal Revenue Code of 1986 if contributions to the plan for the plan year are not less than the minimum required contribution determined under subsection (e) for the plan for the plan year, and

(B) in the case of any applicable plan year beginning on or after January 1, 2008, the minimum required contribution determined under sections 303 of such Act and 430 of such Code shall, for purposes of sections 302 and 303 of such Act and sections 412, 430, and 4971 of such Code, be equal to the minimum required contribution determined under subsection (e) for the plan for the plan year.

(2) Accrual restrictions.--

(A) In general.--The requirements of this paragraph are met if, effective as of the first day of the first applicable plan year and at all times thereafter while an election under this section is in effect, the plan provides that--

(i) the accrued benefit, any death or disability benefit, and any social security supplement described in the last sentence of section 411(a)(9) of such Code and section 204(b)(1)(G) of such Act, of each participant are frozen at the amount of such benefit or supplement immediately before such first day, and

(ii) all other benefits under the plan are eliminated,

but only to the extent the freezing or elimination of such benefits would have been permitted under section 411(d)(6) of such Code and section 204(g) of such Act if they had been implemented by a plan amendment adopted immediately before such first day.

(B) Increases in section 415 limits.--If a plan provides that an accrued benefit of a participant which has been subject to any limitation under section 415 of such Code will be increased if such limitation is increased, the plan shall not be treated as meeting the requirements of this section unless, effective as of the first day of the first applicable plan year (or, if later, the date of the enactment of this Act) and at all

times thereafter while an election under this section is in effect, the plan provides that any such increase shall not take effect. A plan shall not fail to meet the requirements of section 411(d)(6) of such Code and section 204(g) of such Act solely because the plan is amended to meet the requirements of this subparagraph.

(3) Restriction on applicable benefit increases.--

(A) In general.--The requirements of this paragraph are met if no applicable benefit increase takes effect at any time during the period beginning on July 26, 2005, and ending on the day before the first day of the first applicable plan year.

(B) Applicable benefit increase.--For purposes of this paragraph, the term ``applicable benefit increase'' means, with respect to any plan year, any increase in liabilities of the plan by plan amendment (or otherwise provided in regulations provided by the Secretary) which, but for this paragraph, would occur during the plan year by reason of--

(i) any increase in benefits,

(ii) any change in the accrual of benefits, or

(iii) any change in the rate at which benefits become nonforfeitable under the plan.

(4) Exception for imputed disability service.--Paragraphs (2) and (3) shall not apply to any accrual or increase with respect to imputed service provided to a participant during any period of the participant's disability occurring on or after the effective date of the plan amendment providing the restrictions under paragraph (2) (or on or after July 26, 2005, in the case of the restrictions under paragraph (3)) if the partici- pant--

(A) was receiving disability benefits as of such date, or

(B) was receiving sick pay and subsequently determined to be eligible for disability benefits as of such date.

(c) Definitions.--For purposes of this section--

(1) Eligible plan.--The term ``eligible plan'' means a defined benefit plan (other than a multiemployer plan) to which sections 302 of such Act and 412 of such Code applies which is sponsored by an employer--

(A) which is a commercial airline passenger airline, or

(B) the principal business of which is providing catering services to a commercial passenger airline.

(2) Applicable plan year.--The term ``applicable plan year'' means each plan year to which the election under subsection (a)(1) applies under subsection (d)(1)(A).

(d) Elections and Related Terms.--

(1) Years for which election made.--

(A) Alternative funding schedule.--If an election under subsection (a)(1) was made with respect to an eligible plan, the plan sponsor may select either a plan year beginning in 2006 or a plan year beginning in 2007 as the first plan year to which such election applies. The election shall apply to such plan year and all subsequent years. The election shall be made--

(i) not later than December 31, 2006, in the case of an election for a plan year beginning in 2006, or

(ii) not later than December 31, 2007, in the case of an election for a plan year beginning in 2007.

(B) 10 year amortization.--An election under subsection (a)(2) shall be made not later than December 31, 2007.

(C) Election of new plan year for alternative funding schedule.--In the case of an election under subsection (a)(1), the plan sponsor may specify a new plan year in such election and the plan year of the plan may be changed to such new plan year without the approval of the Secretary of the Treasury.

(2) Manner of election.--A plan sponsor shall make any election under subsection (a) in such manner as the Secretary of the Treasury may prescribe. Such election, once made, may be revoked only with the consent of such Secretary.

(e) Minimum Required Contribution.--In the case of an eligible plan with respect to which an election is made under subsection (a)(1)--

(1) In general.--In the case of any applicable plan year during the amortization period, the minimum required contribution shall be the amount necessary to amortize the unfunded liability of the plan, determined as of the first day of the plan year, in equal annual installments (until fully

amortized) over the remainder of the amortization period. Such amount shall be separately determined for each applicable plan year.

(2) Years after amortization period.--In the case of any plan year beginning after the end of the amortization period, section 302(a)(2)(A) of such Act and section 412(a)(2)(A) of such Code shall apply to such plan, but the prefunding balance and funding standard carryover balance as of the first day of the first of such years under section 303(f) of such Act and section 430(f) of such Code shall be zero.

(3) Definitions.--For purposes of this section--

(A) Unfunded liability.--The term ``unfunded liability'' means the unfunded accrued liability under the plan, determined under the unit credit funding method.

(B) Amortization period.--The term ``amortization period'' means the 17-plan year period beginning with the first applicable plan year.

(4) Other rules.--In determining the minimum required contribution and amortization amount under this subsection--

(A) the provisions of section 302(c)(3) of such Act and section 412(c)(3) of such Code, as in effect before the date of enactment of this section, shall apply,

(B) a rate of interest of 8.85 percent shall be used for all calculations requiring an interest rate, and

(C) the value of plan assets shall be equal to their fair market value.

(5) Special rule for certain plan spinoffs.--For purposes of subsection (b), if, with respect to any eligible plan to which this subsection applies--

(A) any applicable plan year includes the date of the enactment of this Act,

(B) a plan was spun off from the eligible plan during the plan year but before such date of enactment,

the minimum required contribution under paragraph (1) for the eligible plan for such applicable plan year shall be an aggregate amount determined as if the plans were a single plan for that plan year (based on the full 12-month plan year in effect prior to the spin-off). The employer shall designate the allocation of such aggregate amount between such plans for the applicable plan year.

(f) Special Rules for Certain Balances and Waivers.--In the case of an eligible plan with respect to which an election is made under subsection (a)(1)--

(1) Funding standard account and credit balances.--Any charge or credit in the funding standard account under section 302 of such Act or section 412 of such Code, and any prefunding balance or funding standard carryover balance under section 303 of such Act or section 430 of such Code, as of the day before the first day of the first applicable plan year, shall be reduced to zero.

(2) Waived funding deficiencies.--Any waived funding deficiency under sections 302 and 303 of such Act or section 412 of such Code, as in effect before the date of enactment of this section, shall be deemed satisfied as of the first day of the first applicable plan year and the amount of such waived funding deficiency shall be taken into account in determining the plan's unfunded liability under subsection (e)(3)(A). In the case of a plan amendment adopted to satisfy the requirements of subsection (b)(2), the plan shall not be deemed to violate section 304(b) of such Act or section 412(f) of such Code, as so in effect, by reason of such amendment or any increase in benefits provided to such plan's participants under a separate plan that is a defined contribution plan or a multiemployer plan.

(g) Other Rules for Plans Making Election Under This Section.--

(1) Successor plans to certain plans.--If--

(A) an election under paragraph (1) or (2) of subsection (a) is in effect with respect to any eligible plan, and

(B) the eligible plan is maintained by an employer that establishes or maintains 1 or more other defined benefit plans (other than any multiemployer plan), and such other plans in combination provide benefit accruals to any substantial number of successor employees,

the Secretary of the Treasury may, in the Secretary's discretion, determine that any trust of which any other such plan is a part does not constitute a qualified trust under section 401(a) of the Internal Revenue Code of 1986 unless all benefit obligations of the eligible plan have been satisfied. For purposes of this paragraph, the term ``successor employee'' means any employee who is or was covered by the eligible plan

and any employees who perform substantially the same type of work with respect to the same business operations as an employee covered by such eligible plan.

(2) Special rules for terminations.--

(A) PBGC liability limited.--Section 4022 of the Employee Retirement Income Security Act of 1974, as amended by this Act, is amended by adding at the end the following new subsection:

``(h) Special Rule for Plans Electing Certain Funding Requirements.--If any plan makes an election under section 402(a)(1) of the Pension Protection Act of 2006 and is terminated effective before the end of the 10-year period beginning on the first day of the first applicable plan year--

``(1) this section shall be applied--

``(A) by treating the first day of the first applicable plan year as the termination date of the plan, and

``(B) by determining the amount of guaranteed benefits on the basis of plan assets and liabilities as of such assumed termination date, and

``(2) notwithstanding section 4044(a), plan assets shall first be allocated to pay the amount, if any, by which--

``(A) the amount of guaranteed benefits under this section (determined without regard to paragraph (1) and on the basis of plan assets and liabilities as of the actual date of plan termination), exceeds

``(B) the amount determined under paragraph (1).''.

(B) Termination premium.--In applying section 4006(a)(7)(A) of the Employee Retirement Income Security Act of 1974 to an eligible plan during any period in which an election under subsection (a)(1) is in effect--

(i) ``$2,500'' shall be substituted for ``$1,250'' in such section if such plan terminates during the 5-year period beginning on the first day of the first applicable plan year with respect to such plan, and

(ii) such section shall be applied without regard to subparagraph (B) of section 8101(d)(2) of the Deficit Reduction Act of 2005 (relating to special rule for plans terminated in bankruptcy).

The substitution described in clause (i) shall not apply with respect to any plan if the Secretary of Labor determines that such plan terminated as a result of extraordinary circumstances such as a terrorist attack or other similar event.

(3) Limitation on deductions under certain plans.--Section 404(a)(7)(C)(iv) of the Internal Revenue Code of 1986, as added by this Act, shall not apply with respect to any taxable year of a plan sponsor of an eligible plan if any applicable plan year with respect to such plan ends with or within such taxable year.

(4) Notice.--In the case of a plan amendment adopted in order to comply with this section, any notice required under section 204(h) of such Act or section 4980F(e) of such Code shall be provided within 15 days of the effective date of such plan amendment. This subsection shall not apply to any plan unless such plan is maintained pursuant to one or more collective bargaining agreements between employee representatives and 1 or more employers.

(h) Exclusion of Certain Employees From Minimum Coverage Requirements.--

(1) In general.--Section 410(b)(3) of such Code is amended by striking the last sentence and inserting the following: ``For purposes of subparagraph (B), management pilots who are not represented in accordance with title II of the Railway Labor Act shall be treated as covered by a collective bargaining agreement described in such subparagraph if the management pilots manage the flight operations of air pilots who are so represented and the management pilots are, pursuant to the terms of the agreement, included in the group of employees benefitting under the trust described in such subparagraph. Subparagraph (B) shall not apply in the case of a plan which provides contributions or benefits for employees whose principal duties are not customarily performed aboard an aircraft in flight (other than management pilots described in the preceding sentence).''

(2) Effective date.--The amendment made by this subsection shall apply to years beginning before, on, or after the date of the enactment of this Act.

(i) Extension of Special Rule for Additional Funding Requirements.--In the case of an employer which is a commercial passenger airline,

section 302(d)(12) of the Employee Retirement Income Security Act of 1974 and section 412(l)(12) of the Internal Revenue Code of 1986, as in effect before the date of the enactment of this Act, shall each be applied--

(1) by substituting ``December 28, 2007'' for ``December 28, 2005'' in subparagraph (D)(i) thereof, and

(2) without regard to subparagraph (D)(ii).

(j) Effective Date.--Except as otherwise provided in this section, the provisions of and amendments made by this section shall apply to plan years ending after the date of the enactment of this Act.

SEC. 403. LIMITATION ON PBGC GUARANTEE OF SHUTDOWN AND OTHER BENEFITS.

(a) In General.--Section 4022(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1322(b)) is amended by adding at the end the following:

``(8) If an unpredictable contingent event benefit (as defined in section 206(g)(1)) is payable by reason of the occurrence of any event, this section shall be applied as if a plan amendment had been adopted on the date such event occurred.''.

(b) Effective Date.--The amendment made by this section shall apply to benefits that become payable as a result of an event which occurs after July 26, 2005.

SEC. 404. RULES RELATING TO BANKRUPTCY OF EMPLOYER.

(a) Guarantee.--Section 4022 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1322) is amended by adding at the end the following:

``(g) Bankruptcy Filing Substituted for Termination Date.--If a contributing sponsor of a plan has filed or has had filed against such person a petition seeking liquidation or reorganization in a case under title 11, United States Code, or under any similar Federal law or law of a State or political subdivision, and the case has not been dismissed as of the termination date of the plan, then this section shall be applied by treating the date such petition was filed as the termination date of the plan.''.

(b) Allocation of Assets Among Priority Groups in Bankruptcy Proceedings.--Section 4044 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1344) is amended by adding at the end the following:

``(e) Bankruptcy Filing Substituted for Termination Date.--If a contributing sponsor of a plan has filed or has had filed against such person a petition seeking liquidation or reorganization in a case under title 11, United States Code, or under any similar Federal law or law of a State or political subdivision, and the case has not been dismissed as of the termination date of the plan, then subsection (a)(3) shall be applied by treating the date such petition was filed as the termination date of the plan.''.

(c) Effective Date.--The amendments made this section shall apply with respect to proceedings initiated under title 11, United States Code, or under any similar Federal law or law of a State or political subdivision, on or after the date that is 30 days after the date of enactment of this Act.

SEC. 405. PBGC PREMIUMS FOR SMALL PLANS.

(a) Small Plans.--Paragraph (3) of section 4006(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1306(a)) is amended--

(1) by striking ``The additional'' in subparagraph (E)(i) and inserting ``Except as provided in subparagraph (H), the additional'', and

(2) by inserting after subparagraph (G) the following new subparagraph:

``(H)(i) In the case of an employer who has 25 or fewer employees on the first day of the plan year, the additional premium determined under subparagraph (E) for each participant shall not exceed $5 multiplied by the number of participants in the plan as of the close of the preceding plan year.

``(ii) For purposes of clause (i), whether an employer has 25 or fewer employees on the first day of the plan year is determined by taking into consideration all of the employees of all members of the contributing sponsor's controlled group. In the case of a plan maintained by two or more contributing sponsors, the employees of all contributing sponsors and their controlled groups shall be aggregated for purposes of determining whether the 25-or-fewer-employees limitation has been satisfied.''

(b) Effective Dates.--The amendment made by this section shall apply to plan years beginning after December 31, 2006.

SEC. 406. AUTHORIZATION FOR PBGC TO PAY INTEREST ON PREMIUM OVERPAYMENT REFUNDS.

(a) In General.--Section 4007(b) of the Employment Retirement Income Security Act of 1974 (29 U.S.C. 1307(b)) is amended--

(1) by striking ``(b)'' and inserting ``(b)(1)'', and

(2) by inserting at the end the following new paragraph:

``(2) The corporation is authorized to pay,

subject to regulations prescribed by the corporation, interest on the amount of any overpayment of premium refunded to a designated payor. Interest under this paragraph shall be calculated at the same rate and in the same manner as interest is calculated for underpayments under paragraph (1).''

(b) Effective Date.--The amendments made by subsection (a) shall apply to interest accruing for periods beginning not earlier than the date of the enactment of this Act.

SEC. 407. RULES FOR SUBSTANTIAL OWNER BENEFITS IN TERMINATED PLANS.

(a) Modification of Phase-In of Guarantee.--Section 4022(b)(5) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1322(b)(5)) is amended to read as follows:

``(5)(A) For purposes of this paragraph, the term `majority owner' means an individual who, at any time during the 60-month period ending on the date the determination is being made--

``(i) owns the entire interest in an unincorporated trade or business,

``(ii) in the case of a partnership, is a partner who owns, directly or indirectly, 50 percent or more of either the capital interest or the profits interest in such partnership, or

``(iii) in the case of a corporation, owns, directly or indirectly, 50 percent or more in value of either the voting stock of that corporation or all the stock of that corporation.

For purposes of clause (iii), the constructive ownership rules of section 1563(e) of the Internal Revenue Code of 1986 (other than paragraph (3)(C) thereof) shall apply, including the application of such rules under section 414(c) of such Code.

``(B) In the case of a participant who is a majority owner, the amount of benefits guaranteed under this section shall equal the product of--

``(i) a fraction (not to exceed 1) the numerator of which is the number of years from the later of the effective date or the adoption date of the plan to the termination date, and the denominator of which is 10, and

``(ii) the amount of benefits that would be guaranteed under this section if the participant were not a majority owner.''

(b) Modification of Allocation of Assets.--

(1) Section 4044(a)(4)(B) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1344(a)(4)(B)) is amended by striking ``section 4022(b)(5)'' and inserting ``section 4022(b)(5)(B)''.

(2) Section 4044(b) of such Act (29 U.S.C. 1344(b)) is amended--

(A) by striking ``(5)'' in paragraph (2) and inserting ``(4), (5),'', and

(B) by redesignating paragraphs (3) through (6) as paragraphs (4) through (7), respectively, and by inserting after paragraph (2) the following new paragraph:

``(3) If assets available for allocation under paragraph (4) of subsection (a) are insufficient to satisfy in full the benefits of all individuals who are described in that paragraph, the assets shall be allocated first to benefits described in subparagraph (A) of that paragraph. Any remaining assets shall then be allocated to benefits described in subparagraph (B) of that paragraph. If assets allocated to such subparagraph (B) are insufficient to satisfy in full the benefits described in that subparagraph, the assets shall be allocated pro rata among individuals on the basis of the present value (as of the termination date) of their respective benefits described in that subparagraph.''.

(c) Conforming Amendments.--

(1) Section 4021 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1321) is amended--

(A) in subsection (b)(9), by striking ``as defined in section 4022(b)(6)'', and

(B) by adding at the end the following new subsection:

``(d) For purposes of subsection (b)(9), the term `substantial owner' means an individual who, at any time during the 60-month period ending on the date the determination is being made--

``(1) owns the entire interest in an unincorporated trade or business,

``(2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in such partnership, or

``(3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of that corporation or all the stock of that corporation.

For purposes of paragraph (3), the constructive ownership rules of section 1563(e) of the Internal Revenue Code of 1986 (other than paragraph (3)(C) thereof) shall apply, including the application of such

rules under section 414(c) of such Code.''.
(2) Section 4043(c)(7) of such Act (29 U.S.C. 1343(c)(7)) is amended by striking ``section 4022(b)(6)'' and inserting ``section 4021(d)''.
(d) Effective Dates.--
(1) In general.--Except as provided in paragraph (2), the amendments made by this section shall apply to plan terminations--
(A) under section 4041(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1341(c)) with respect to which notices of intent to terminate are provided under section 4041(a)(2) of such Act (29 U.S.C. 1341(a)(2)) after December 31, 2005, and
(B) under section 4042 of such Act (29 U.S.C. 1342) with respect to which notices of determination are provided under such section after such date.
(2) Conforming amendments.--The amendments made by subsection (c) shall take effect on
January 1, 2006.

SEC. 408. ACCELERATION OF PBGC COMPUTATION OF BENEFITS ATTRIBUTABLE TO RECOVERIES FROM EMPLOYERS.

(a) Modification of Average Recovery Percentage of Outstanding Amount of Benefit Liabilities Payable by Corporation to Participants and Beneficiaries.--Section 4022(c)(3)(B)(ii) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1322(c)(3)(B)(ii)) is amended to read as follows:
``(ii) notices of intent to terminate were provided (or in the case of a termination by the corporation, a notice of determination under section 4042 was issued) during the 5-Federal fiscal year period ending with the third fiscal year preceding the fiscal year in which occurs the date of the notice of intent to terminate (or the notice of determination under section 4042) with respect to the plan termination for which the recovery ratio is being determined.''
(b) Valuation of Section 4062(c) Liability for Determining Amounts Payable by Corporation to Participants and Beneficiaries.--
(1) Single-employer plan benefits guaranteed.--Section 4022(c)(3)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 13) is amended to read
as follows:
``(A) In general.--Except as provided in subparagraph (C), the term `recovery ratio' means the ratio which--
``(i) the sum of the values of all recoveries under section 4062, 4063, or 4064, determined by the corporation in connection with plan terminations described under subparagraph (B), bears to
``(ii) the sum of all unfunded benefit liabilities under such plans as of the termination date in connection with any such prior termination.''.
(2) Allocation of assets.--Section 4044 of the Employee Retirement Income Security Act of 1974
(29 U.S.C. 1362) is amended by adding at the end the following new subsection:
``(e) Valuation of Section 4062(c) Liability for Determining Amounts Payable by Corporation to Participants and Beneficiaries.--
``(1) In general.--In the case of a terminated plan, the value of the recovery of liability under section 4062(c) allocable as a plan asset under this section for purposes of determining the amount of benefits payable by the corporation shall be determined by multiplying--
``(A) the amount of liability under section 4062(c) as of the termination date of the plan, by
``(B) the applicable section 4062(c) recovery ratio.
``(2) Section 4062(c) recovery ratio.--For purposes of this subsection--
``(A) In general.--Except as provided in subparagraph (C), the term `section 4062(c) recovery ratio' means the ratio which--
``(i) the sum of the values of all recoveries under section 4062(c) determined by the corporation in connection with plan terminations described under subparagraph (B), bears to
``(ii) the sum of all the amounts of liability under section 4062(c) with respect to such plans as of the termination date in connection with any such prior termination.
``(B) Prior terminations.--A plan termination

described in this subparagraph is a termination with respect to which--
``(i) the value of recoveries under section 4062(c) have been determined by the corporation, and
``(ii) notices of intent to terminate were provided (or in the case of a termination by the corporation, a notice of determination under section 4042 was issued) during the 5-Federal fiscal year period ending with the third fiscal year preceding the fiscal year in which occurs the date of the notice of intent to terminate (or the notice of determination under section 4042) with respect to the plan termination for which the recovery ratio is being determined.
``(C) Exception.--In the case of a terminated plan with respect to which the outstanding amount of benefit liabilities exceeds $20,000,000, the term `section 4062(c) recovery ratio' means, with respect to the termination of such plan, the ratio of--
``(i) the value of the recoveries on behalf of the plan under section 4062(c), to
``(ii) the amount of the liability owed under section 4062(c) as of the date of plan termination to the trustee appointed under section 4042 (b) or (c).
``(3) Subsection not to apply.--This subsection shall not apply with respect to the determination of--
``(A) whether the amount of outstanding benefit liabilities exceeds $20,000,000, or
``(B) the amount of any liability under section 4062 to the corporation or the trustee appointed under section 4042 (b) or (c).
``(4) Determinations.--Determinations under this subsection shall be made by the corporation. Such determinations shall be binding unless shown by clear and convincing evidence to be unreasonable.''.
(c) Effective Date.--The amendments made by this section shall apply for any termination for which notices of intent to terminate are provided (or in the case of a termination by the corporation, a notice of determination under section 4042 under the Employee Retirement Income Security Act of 1974 is issued) on or after the date which is 30 days after the date of enactment of this section.

SEC. 409. TREATMENT OF CERTAIN PLANS WHERE CESSATION OR CHANGE IN MEMBERSHIP OF A CONTROLLED GROUP.

(a) In General.--Section 4041(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1341(b)) is amended by adding at the end the following new paragraph:
``(5) Special rule for certain plans where cessation or change in membership of a controlled group.--
``(A) In general.--Except as provided in subparagraph (B), if--
``(i) there is transaction or series of transactions which result in a person ceasing to be a member of a controlled group, and
``(ii) such person immediately before the transaction or series of transactions maintained a single-employer plan which is a defined benefit plan which is fully funded,
then the interest rate used in determining whether the plan is sufficient for benefit liabilities or to otherwise assess plan liabilities for purposes of this subsection or section 4042(a)(4) shall be not less than the interest rate used in determining whether the plan is fully funded.
``(B) Limitations.--Subparagraph (A) shall not apply to any transaction or series of transactions unless--
``(i) any employer maintaining the plan immediately before or after such transaction or series of transactions--
``(I) has an outstanding senior unsecured debt instrument which is rated investment grade by each of the nationally recognized statistical rating organizations for corporate bonds that has issued a credit rating for such instrument, or
``(II) if no such debt instrument of such employer has been rated by such an organization but 1 or more of such organizations has made an issuer credit rating for such employer, all such

organizations which have so rated the employer have rated such employer investment grade, and

``(ii) the employer maintaining the plan after the transaction or series of transactions employs at least 20 percent of the employees located in the United States who were employed by such employer immediately before the transaction or series of transactions.

``(C) Fully funded.--For purposes of subparagraph (A), a plan shall be treated as fully funded with respect to any transaction or series of transactions if--

``(i) in the case of a transaction or series of transactions which occur in a plan year beginning before January 1, 2008, the funded current liability percentage determined under section 302(d) for the plan year is at least 100 percent, and

``(ii) in the case of a transaction or series of transactions which occur in a plan year beginning on or after such date, the funding target attainment percentage determined under section 303 is, as of the valuation date for such plan year, at least 100 percent.

``(D) 2 year limitation.--Subparagraph (A) shall not apply to any transaction or series of transactions if the plan referred to in subparagraph (A)(ii) is terminated under section 4041(c) or 4042 after the close of the 2-year period beginning on the date on which the first such transaction occurs.''.

(b) Effective Date.--The amendments made by this section shall apply to any transaction or series of transactions occurring on and after the date of the enactment of this Act.

SEC. 410. MISSING PARTICIPANTS.

(a) In General.--Section 4050 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1350) is amended by redesignating subsection (c) as subsection (e) and by inserting after subsection (b) the following new subsections:

``(c) Multiemployer Plans.--The corporation shall prescribe rules similar to the rules in subsection (a) for multiemployer plans covered by this title that terminate under section 4041A.

``(d) Plans Not Otherwise Subject to Title.--

``(1) Transfer to corporation.--The plan administrator of a plan described in paragraph (4) may elect to transfer a missing participant's benefits to the corporation upon termination of the plan.

``(2) Information to the corporation.--To the extent provided in regulations, the plan administrator of a plan described in paragraph (4) shall, upon termination of the plan, provide the corporation information with respect to benefits of a missing participant if the plan transfers such benefits--

``(A) to the corporation, or

``(B) to an entity other than the corporation or a plan described in paragraph (4)(B)(ii).

``(3) Payment by the corporation.--If benefits of a missing participant were transferred to the corporation under paragraph (1), the corporation shall, upon location of the participant or beneficiary, pay to the participant or beneficiary the amount transferred (or the appropriate survivor benefit) either--

``(A) in a single sum (plus interest), or

``(B) in such other form as is specified in regulations of the corporation.

``(4) Plans described.--A plan is described in this paragraph if--

``(A) the plan is a pension plan (within the meaning of section 3(2))--

``(i) to which the provisions of this section do not apply (without regard to this subsection), and

``(ii) which is not a plan described in paragraphs (2) through (11) of section 4021(b), and

``(B) at the time the assets are to be distributed upon termination, the plan--

``(i) has missing participants, and

``(ii) has not provided for the transfer of assets to pay the benefits of all missing participants to another pension plan (within the meaning of

section 3(2)).
``(5) Certain provisions not to apply.--Subsections (a)(1) and (a)(3) shall not apply to a plan described in paragraph (4).''.

(b) Conforming Amendments.--Section 206(f) of such Act (29 U.S.C. 1056(f)) is amended--

(1) by striking ``title IV'' and inserting ``section 4050''; and

(2) by striking ``the plan shall provide that,''.

(c) Effective Date.--The amendments made by this section shall apply to distributions made after final regulations implementing subsections (c) and (d) of section 4050 of the Employee Retirement Income Security Act of 1974 (as added by subsection (a)), respectively, are prescribed.

SEC. 411. DIRECTOR OF THE PENSION BENEFIT GUARANTY CORPORATION.

(a) In General.--Title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1301 et seq.) is amended--

(1) by striking the second sentence of section 4002(a) and inserting the following: ``In carrying out its functions under this title, the corporation shall be administered by a Director, who shall be appointed by the President, by and with the advice and consent of the Senate, and who shall act in accordance with the policies established by the board.''; and

(2) in section 4003(b), by--

(A) striking ``under this title, any member'' and inserting ``under this title, the Director, any member''; and

(B) striking ``designated by the chairman'' and inserting ``designated by the Director or chairman''.

(b) Compensation of Director.--Section 5314 of title 5, United States Code, is amended by adding at the end the following new item:

``Director, Pension Benefit Guaranty Corporation.''.

(c) Jurisdiction of Nomination.--

(1) In general.--The Committee on Finance of the Senate and the Committee on Health, Education, Labor, and Pensions of the Senate shall have joint jurisdiction over the nomination of a person nominated by the President to fill the position of Director of the Pension Benefit Guaranty Corporation under section 4002 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1302) (as amended by this Act), and if one committee votes to order reported such a nomination, the other shall report within 30 calendar days, or be automatically discharged.

(2) Rulemaking of the senate.--This subsection is enacted by Congress--

(A) as an exercise of rulemaking power of the Senate, and as such it is deemed a part of the rules of the Senate, but applicable only with respect to the procedure to be followed in the Senate in the case of a nomination described in such sentence, and it supersedes other rules only to the extent that it is inconsistent with such rules; and

(B) with full recognition of the constitutional right of the Senate to change the rules (so far as relating to the procedure of the Senate) at any time, in the same manner and to the same extent as in the case of any other rule of the Senate.

(d) Transition.--The term of the individual serving as Executive Director of the Pension Benefit Guaranty Corporation on the date of enactment of this Act shall expire on such date of enactment. Such individual, or any other individual, may serve as interim Director of such Corporation until an individual is appointed as Director of such Corporation under section 4002 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1302) (as amended by this Act).

SEC. 412. INCLUSION OF INFORMATION IN THE PBGC ANNUAL REPORT.

Section 4008 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1308) is amended by--

(1) striking ``As soon as practicable'' and inserting ``(a) As soon as practicable''; and

(2) adding at the end the following:

``(b) The report under subsection (a) shall include--

``(1) a summary of the Pension Insurance Modeling System microsimulation model, including the specific simulation parameters, specific initial values, temporal parameters, and policy parameters used to calculate the financial statements for the corporation;

``(2) a comparison of--

``(A) the average return on investments earned with respect to assets invested by the corporation for the

year to which the report relates; and
``(B) an amount equal to 60 percent of the average return on investment for such year in the Standard & Poor's 500 Index, plus 40 percent of the average return on investment for such year in the Lehman Aggregate Bond Index (or in a similar fixed income index); and
``(3) a statement regarding the deficit or surplus for such year that the corporation would have had if the corporation had earned the return described in paragraph (2)(B) with respect to assets invested by the corporation.''.

TITLE V--DISCLOSURE

SEC. 501. DEFINED BENEFIT PLAN FUNDING NOTICE.

(a) In General.--Section 101(f) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1021(f)) is amended to read as follows:
``(f) Defined Benefit Plan Funding Notices.--
``(1) In general.--The administrator of a defined benefit plan to which title IV applies shall for each plan year provide a plan funding notice to the Pension Benefit Guaranty Corporation, to each plan participant and beneficiary, to each labor organization representing such participants or beneficiaries, and, in the case of a multiemployer plan, to each employer that has an obligation to contribute to the plan.
``(2) Information contained in notices.--
``(A) Identifying information.--Each notice required under paragraph (1) shall contain identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan's principal administrative officer, each plan sponsor's employer identification number, and the plan number of the plan.
``(B) Specific information.--A plan funding notice under paragraph (1) shall include--
``(i)(I) in the case of a single-employer plan, a statement as to whether the plan's funding target attainment percentage (as defined in section 303(d)(2)) for the plan year to which the notice relates, and for the 2 preceding plan years, is at least 100 percent (and, if not, the actual percentages), or
``(II) in the case of a multiemployer plan, a statement as to whether the plan's funded percentage (as defined in section 305(i)) for the plan year to which the notice relates, and for the 2 preceding plan years, is at least 100 percent (and, if not, the actual percentages),
``(ii)(I) in the case of a single-employer plan, a statement of--
``(aa) the total assets (separately stating the prefunding balance and the funding standard carryover balance) and liabilities of the plan, determined in the same manner as under section 303, for the plan year for which the latest annual report filed under section 104(a) was filed and for the 2 preceding plan years, as reported in the annual report for each such plan year, and
``(bb) the value of the plan's assets and liabilities for the plan year to which the notice relates as of the last day of the plan year to which the notice relates determined using the asset valuation under subclause (II) of section 4006(a)(3)(E)(iii) and the interest rate under section 4006(a)(3)(E)(iv), and
``(II) in the case of a multiemployer plan, a statement of the value of the plan's assets and liabilities for the plan year to which the notice relates as the last day of such plan year and the preceding 2 plan years,
``(iii) a statement of the number of participants who are--
``(I) retired or separated from service and are receiving benefits,
``(II) retired or separated participants entitled to future benefits, and
``(III) active participants under the plan,
``(iv) a statement setting forth the funding policy of the plan and the asset allocation of

investments under the plan (expressed as percentages of total assets) as of the end of the plan year to which the notice relates,

``(v) in the case of a multiemployer plan, whether the plan was in critical or endangered status under section 305 for such plan year and, if so--

``(I) a statement describing how a person may obtain a copy of the plan's funding improvement or rehabilitation plan, as appropriate, adopted under section 305 and the actuarial and financial data that demonstrate any action taken by the plan toward fiscal improvement, and

``(II) a summary of any funding improvement plan, rehabilitation plan, or modification thereof adopted under section 305 during the plan year to which the notice relates,

``(vi) in the case of any plan amendment, scheduled benefit increase or reduction, or other known event taking effect in the current plan year and having a material effect on plan liabilities or assets for the year (as defined in regulations by the Secretary), an explanation of the amendment, schedule increase or reduction, or event, and a projection to the end of such plan year of the effect of the amendment, scheduled increase or reduction, or event on plan liabilities,

``(vii)(I) in the case of a single-employer plan, a summary of the rules governing termination of single-employer plans under subtitle C of title IV, or

``(II) in the case of a multiemployer plan, a summary of the rules governing reorganization or insolvency, including the limitations on benefit payments,

``(viii) a general description of the benefits under the plan which are eligible to be guaranteed by the Pension Benefit Guaranty Corporation, along with an explanation of the limitations on the guarantee and the circumstances under which such limitations apply,

``(ix) a statement that a person may obtain a copy of the annual report of the plan filed under section 104(a) upon request, through the Internet website of the Department of Labor, or through an Intranet website maintained by the applicable plan sponsor (or plan administrator on behalf of the plan sponsor), and

``(x) if applicable, a statement that each contributing sponsor, and each member of the contributing sponsor's controlled group, of the single-employer plan was required to provide the information under section 4010 for the plan year to which the notice relates.

``(C) Other information.--Each notice under paragraph (1) shall include--

``(i) in the case of a multiemployer plan, a statement that the plan administrator shall provide, upon written request, to any labor organization representing plan participants and beneficiaries and any employer that has an obligation to contribute to the plan, a copy of the annual report filed with the Secretary under section 104(a), and

``(ii) any additional information which the plan administrator elects to include to the extent not inconsistent with regulations prescribed by the Secretary.

``(3) Time for providing notice.--

``(A) In general.--Any notice under paragraph (1) shall be provided not later than 120 days after the end of the plan year to which the notice relates.

``(B) Exception for small plans.--In the case of a small plan (as such term is used under section 303(g)(2)(B)) any notice under paragraph (1) shall be provided upon filing of the annual report under section 104(a).

``(4) Form and manner.--Any notice under paragraph (1)--
``(A) shall be provided in a form and manner prescribed in regulations of the Secretary,
``(B) shall be written in a manner so as to be understood by the average plan participant, and
``(C) may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to persons to whom the notice is required to be provided.''.

(b) Repeal of Notice to Participants of Funding Status.--
(1) In general.--Title IV of such Act (29 U.S.C. 1301 et seq.) is amended by striking section 4011.
(2) Clerical amendment.--Section 1 of such Act is amended in the table of contents by striking the item relating to section 4011.

(c) Model Notice.--Not later than 1 year after the date of the enactment of this Act, the Secretary of Labor shall publish a model version of the notice required by section 101(f) of the Employee Retirement Income Security Act of 1974. The Secretary of Labor may promulgate any interim final rules as the Secretary determines appropriate to carry out the provisions of this subsection.

(d) Effective Date.--
(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2007, except that the amendment made by subsection (b) shall apply to plan years beginning after December 31, 2006.
(2) Transition rule.--Any requirement under section 101(f) of the Employee Retirement Income Security Act of 1974 (as amended by this section) to report the funding target attainment percentage or funded percentage of a plan with respect to any plan year beginning before January 1, 2008, shall be treated as met if the plan reports--
(A) in the case of a plan year beginning in 2006, the funded current liability percentage (as defined in section 302(d)(8) of such Act) of the plan for such plan year, and
(B) in the case of a plan year beginning in 2007, the funding target attainment percentage or funded percentage as determined using such methods of estimation as the Secretary of the Treasury may provide.

SEC. 502. ACCESS TO MULTIEMPLOYER PENSION PLAN INFORMATION.

(a) Financial Information With Respect to Multiemployer Plans.--
(1) In general.--Section 101 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1021), as amended by section 103, is amended--
(A) by redesignating subsection (k) as subsection (l); and
(B) by inserting after subsection (j) the following new subsection:

``(k) Multiemployer Plan Information Made Available on Request.--
``(1) In general.--Each administrator of a multiemployer plan shall, upon written request, furnish to any plan participant or beneficiary, employee representative, or any employer that has an obligation to contribute to the plan--
``(A) a copy of any periodic actuarial report (including any sensitivity testing) received by the plan for any plan year which has been in the plan's possession for at least 30 days,
``(B) a copy of any quarterly, semi-annual, or annual financial report prepared for the plan by any plan investment manager or advisor or other fiduciary which has been in the plan's possession for at least 30 days, and
``(C) a copy of any application filed with the Secretary of the Treasury requesting an extension under section 304 of this Act or section 431(d) of the Internal Revenue Code of 1986 and the determination of such Secretary pursuant to such application.
``(2) Compliance.--Information required to be provided under paragraph (1)--
``(A) shall be provided to the requesting participant, beneficiary, or employer within 30 days after the request in a form and manner prescribed in regulations of the Secretary,
``(B) may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to persons to whom the information is required to be provided, and
``(C) shall not--

``(i) include any individually identifiable information regarding any plan participant, beneficiary, employee, fiduciary, or contributing employer, or

``(ii) reveal any proprietary information regarding the plan, any contributing employer, or entity providing services to the plan.

``(3) Limitations.--In no case shall a participant, beneficiary, or employer be entitled under this subsection to receive more than one copy of any report or application described in paragraph (1) during any one 12-month period. The administrator may make a reasonable charge to cover copying, mailing, and other costs of furnishing copies of information pursuant to paragraph (1). The Secretary may by regulations prescribe the maximum amount which will constitute a reasonable charge under the preceding sentence.''.

(2) Enforcement.--Section 502(c)(4) of such Act (29 U.S.C. 1132(c)(4)) is amended by striking ``section 101(j)'' and inserting ``subsection (j) or (k) of section 101''.

(3) Regulations.--The Secretary shall prescribe regulations under section 101(k)(2) of the Employee Retirement Income Security Act of 1974 (as added by paragraph (1)) not later than 1 year after the date of the enactment of this Act.

(b) Notice of Potential Withdrawal Liability to Multiemployer Plans.--

(1) In general.--Section 101 of such Act (as amended by subsection (a)) is amended--

(A) by redesignating subsection (l) as subsection (m); and

(B) by inserting after subsection (k) the following new subsection:

``(l) Notice of Potential Withdrawal Liability.--

``(1) In general.--The plan sponsor or administrator of a multiemployer plan shall, upon written request, furnish to any employer who has an obligation to contribute to the plan a notice of--

``(A) the estimated amount which would be the amount of such employer's withdrawal liability under part 1 of subtitle E of title IV if such employer withdrew on the last day of the plan year preceding the date of the request, and

``(B) an explanation of how such estimated liability amount was determined, including the actuarial assumptions and methods used to determine the value of the plan liabilities and assets, the data regarding employer contributions, unfunded vested benefits, annual changes in the plan's unfunded vested benefits, and the application of any relevant limitations on the estimated withdrawal liability.

For purposes of subparagraph (B), the term `employer contribution' means, in connection with a participant, a contribution made by an employer as an employer of such participant.

``(2) Compliance.--Any notice required to be provided under paragraph (1)--

``(A) shall be provided in a form and manner prescribed in regulations of the Secretary to the requesting employer within--

``(i) 180 days after the request, or

``(ii) subject to regulations of the Secretary, such longer time as may be necessary in the case of a plan that determines withdrawal liability based on any method described under paragraph (4) or (5) of section 4211(c); and

``(B) may be provided in written, electronic, or other appropriate form to the extent such form is reasonably accessible to employers to whom the information is required to be provided.

``(3) Limitations.--In no case shall an employer be entitled under this subsection to receive more than one notice described in paragraph (1) during any one 12-month period. The person required to provide such notice may make a reasonable charge to cover copying, mailing, and other costs of furnishing such notice pursuant to paragraph (1). The Secretary may by regulations prescribe the maximum amount which will constitute a reasonable charge under the preceding sentence.''.

(2) Enforcement.--Section 502(c)(4) of such Act (29 U.S.C. 1132(c)(4)) is amended by striking ``section 101(j) or (k)'' and inserting ``subsection (j), (k), or (l) of section 101''.

(c) Notice of Amendment Reducing Future Accruals.--

(1) Amendment of erisa.--Section 204(h)(1) of such Act (29 U.S.C. 1054(h)(1)) is amended by inserting at the end before the period the following: ``and to each employer who has an obligation to contribute to the plan''.

(2) Amendment of internal revenue code.--Section 4980F(e)(1) of such Code is amended by adding at the end before the period the following: ``and to each employer who has an obligation to contribute to the plan''.

(d) Effective Date.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

SEC. 503. ADDITIONAL ANNUAL REPORTING REQUIREMENTS.

(a) Additional Annual Reporting Requirements With Respect to Defined Benefit Plans.--

(1) In general.--Section 103 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1023) is amended--

(A) in subsection (a)(1)(B), by striking ``subsections (d) and (e)'' and inserting ``subsections (d), (e), and (f)''; and

(B) by adding at the end the following new subsection:

``(f) Additional Information With Respect to Defined Benefit Plans.--

``(1) Liabilities under 2 or more plans.--

``(A) In general.--In any case in which any liabilities to participants or their beneficiaries under a defined benefit plan as of the end of a plan year consist (in whole or in part) of liabilities to such participants and beneficiaries under 2 or more pension plans as of immediately before such plan year, an annual report under this section for such plan year shall include the funded percentage of each of such 2 or more pension plans as of the last day of such plan year and the funded percentage of the plan with respect to which the annual report is filed as of the last day of such plan year.

``(B) Funded percentage.--For purposes of this paragraph, the term `funded percentage'--

``(i) in the case of a single-employer plan, means the funding target attainment percentage, as defined in section 303(d)(2), and

``(ii) in the case of a multiemployer plan, has the meaning given such term in section 305(i)(2).

``(2) Additional information for multiemployer plans.--With respect to any defined benefit plan which is a multiemployer plan, an annual report under this section for a plan year shall include, in addition to the information required under paragraph (1), the following, as of the end of the plan year to which the report relates:

``(A) The number of employers obligated to contribute to the plan.

``(B) A list of the employers that contributed more than 5 percent of the total contributions to the plan during such plan year.

``(C) The number of participants under the plan on whose behalf no contributions were made by an employer as an employer of the participant for such plan year and for each of the 2 preceding plan years.

``(D) The ratios of--

``(i) the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during the plan year, to

``(ii) the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during each of the 2 preceding plan years.

``(E) Whether the plan received an amortization extension under section 304(d) of this Act or section 431(d) of the Internal Revenue Code of 1986 for such plan year and, if so, the amount of the difference between the minimum required contribution for the year and the minimum required contribution which would have been required without regard to the extension, and the period of such extension.

``(F) Whether the plan used the shortfall funding method (as such term is used in section 305) for such plan year and, if so, the amount of the difference between the minimum required contribution for the year and the minimum required contribution which would have

been required without regard to the use of such method, and the period of use of such method.

``(G) Whether the plan was in critical or endangered status under section 305 for such plan year, and if so, a summary of any funding improvement or rehabilitation plan (or modification thereto) adopted during the plan year, and the funded percentage of the plan.

``(H) The number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against such withdrawn employers.

``(I) In the case of a multiemployer plan that has merged with another plan or to which assets and liabilities have been transferred, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as the Secretary may prescribe by regulation.''.

(2) Guidance by secretary of labor.--Not later than 1 year after the date of enactment of this Act, the Secretary of Labor shall publish guidance to assist multiemployer defined benefit plans to--

(A) identify and enumerate plan participants for whom there is no employer with an obligation to make an employer contribution under the plan; and

(B) report such information under section 103(f)(2)(D) of the Employee Retirement Income Security Act of 1974 (as added by this section).

(b) Additional Information in Annual Actuarial Statement Regarding Plan Retirement Projections.--Section 103(d) of such Act (29 U.S.C. 1023(d)) is amended--

(1) by redesignating paragraphs (12) and (13) as paragraphs (13) and (14), respectively; and

(2) by inserting after paragraph (11) the following new paragraph:

``(12) A statement explaining the actuarial assumptions and methods used in projecting future retirements and forms of benefit distributions under the plan.''.

(c) Repeal of Summary Annual Report Requirement for Defined Benefit Plans.--

(1) In general.--Section 104(b)(3) of such Act (29 U.S.C. 1024(b)(3)) is amended by inserting ``(other than an administrator of a defined benefit plan to which the requirements of section 103(f) applies)'' after ``the administrators''.

(2) Conforming amendment.--Section 101(a)(2) of such Act (29 U.S.C. 1021(a)(2)) is amended by inserting ``subsection (f) and'' before ``sections 104(b)(3) and 105(a) and (c)''.

(d) Furnishing Summary Plan Information to Employers and Employee Representatives of Multiemployer Plans.--Section 104 of such Act (29 U.S.C. 1024) is amended--

(1) in the header, by striking ``participants'' and inserting ``participants and certain employers'';

(2) by redesignating subsection (d) as subsection (e); and

(3) by inserting after subsection (c) the following:

``(d) Furnishing Summary Plan Information to Employers and Employee Representatives of Multiemployer Plans.--

``(1) In general.--With respect to a multiemployer plan subject to this section, within 30 days after the due date under subsection (a)(1) for the filing of the annual report for the fiscal year of the plan, the administrators shall furnish to each employee organization and to each employer with an obligation to contribute to the plan a report that contains--

``(A) a description of the contribution schedules and benefit formulas under the plan, and any modification to such schedules and formulas, during such plan year;

``(B) the number of employers obligated to contribute to the plan;

``(C) a list of the employers that contributed more than 5 percent of the total contributions to the plan during such plan year;

``(D) the number of participants under the plan on whose behalf no contributions were made by an employer as an employer of the participant for such plan year and for each of the 2 preceding plan years;

``(E) whether the plan was in critical or endangered status under section 305 for such plan year and, if so,

include--
``(i) a list of the actions taken by the plan to improve its funding status; and
``(ii) a statement describing how a person may obtain a copy of the plan's improvement or rehabilitation plan, as applicable, adopted under section 305 and the actuarial and financial data that demonstrate any action taken by the plan toward fiscal improvement;
``(F) the number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against such withdrawn employers, as reported on the annual report for the plan year to which the report under this subsection relates;
``(G) in the case of a multiemployer plan that has merged with another plan or to which assets and liabilities have been transferred, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as the Secretary may prescribe by regulation;
``(H) a description as to whether the plan--
``(i) sought or received an amortization extension under section 304(d) of this Act or section 431(d) of the Internal Revenue Code of 1986 for such plan year; or
``(ii) used the shortfall funding method (as such term is used in section 305) for such plan year; and
``(I) notification of the right under this section of the recipient to a copy of the annual report filed with the Secretary under subsection (a), summary plan description, summary of any material modification of the plan, upon written request, but that--
``(i) in no case shall a recipient be entitled to receive more than one copy of any such document described during any one 12-month period; and
``(ii) the administrator may make a reasonable charge to cover copying, mailing, and other costs of furnishing copies of information pursuant to this subparagraph.
``(2) Effect of subsection.--Nothing in this subsection waives any other provision under this title requiring plan administrators to provide, upon request, information to employers that have an obligation to contribute under the plan.''.
(e) Model Form.--Not later than 1 year after the date of the enactment of this Act, the Secretary of Labor shall publish a model form for providing the statements, schedules, and other material required to be provided under section 101(f) of the Employee Retirement Income Security Act of 1974, as amended by this section. The Secretary of Labor may promulgate any interim final rules as the Secretary determines appropriate to carry out the provisions of this subsection.
(f) Effective Date.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

SEC. 504. ELECTRONIC DISPLAY OF ANNUAL REPORT INFORMATION.

(a) Electronic Display of Information.--Section 104(b) of such Act (29 U.S.C. 1024(b)) is amended by adding at the end the following:
``(5) Identification and basic plan information and actuarial information included in the annual report for any plan year shall be filed with the Secretary in an electronic format which accommodates display on the Internet, in accordance with regulations which shall be prescribed by the Secretary. The Secretary shall provide for display of such information included in the annual report, within 90 days after the date of the filing of the annual report, on an Internet website maintained by the Secretary and other appropriate media. Such information shall also be displayed on any Intranet website maintained by the plan sponsor (or by the plan administrator on behalf of the plan sponsor) for the purpose of communicating with employees and not the public, in accordance with regulations which shall be prescribed by the Secretary.''.
(b) Effective Date.--The amendment made by this section shall apply to plan years beginning after December 31, 2007.

SEC. 505. SECTION 4010 FILINGS WITH THE PBGC.

(a) Change in Criteria for Persons Required To Provide Information to PBGC.--Section 4010(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1310(b)) is amended by striking paragraph (1) and inserting the following:

``(1) the funding target attainment percentage (as defined in subsection (d)) at the end of the preceding plan year of a plan maintained by the contributing sponsor or any member of its controlled group is less than 80 percent;''.

(b) Additional Information Required.--Section 4010 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1310) is amended by adding at the end the following new subsection:

``(d) Additional Information Required.--

``(1) In general.--The information submitted to the corporation under subsection (a) shall include--

``(A) the amount of benefit liabilities under the plan determined using the assumptions used by the corporation in determining liabilities;

``(B) the funding target of the plan determined as if the plan has been in at-risk status for at least 5 plan years; and

``(C) the funding target attainment percentage of the plan.

``(2) Definitions.--For purposes of this subsection:

``(A) Funding target.--The term `funding target' has the meaning provided under section 303(d)(1).

``(B) Funding target attainment percentage.--The term `funding target attainment percentage' has the meaning provided under section 302(d)(2).

``(C) At-risk status.--The term `at-risk status' has the meaning provided in section 303(i)(4).

``(e) Notice to Congress.--The corporation shall, on an annual basis, submit to the Committee on Health, Education, Labor, and Pensions and the Committee on Finance of the Senate and the Committee on Education and the Workforce and the Committee on Ways and Means of the House of Representatives, a summary report in the aggregate of the information submitted to the corporation under this section.''.

(c) Effective Date.--The amendments made by this section shall apply with respect to years beginning after 2007.

SEC. 506. DISCLOSURE OF TERMINATION INFORMATION TO PLAN PARTICIPANTS.

(a) Distress Terminations.--

(1) In general.--Section 4041(c)(2) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1341(c)(2)) is amended by adding at the end the following:

``(D) Disclosure of termination information.--

``(i) In general.--A plan administrator that has filed a notice of intent to terminate under subsection (a)(2) shall provide to an affected party any information provided to the corporation under subsection (a)(2) not later than 15 days after--

``(I) receipt of a request from the affected party for the information; or

``(II) the provision of new information to the corporation relating to a previous request.

``(ii) Confidentiality.--

``(I) In general.--The plan administrator shall not provide information under clause (i) in a form that includes any information that may directly or indirectly be associated with, or otherwise identify, an individual participant or beneficiary.

``(II) Limitation.--A court may limit disclosure under this subparagraph of confidential information described in section 552(b) of title 5, United States Code, to any authorized representative of the participants or beneficiaries that agrees to ensure the confidentiality of such information.

``(iii) Form and manner of information; charges.--

``(I) Form and manner.--The corporation may prescribe the form and manner of the provision of information under this subparagraph, which shall include delivery in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to individuals to whom the information is required to be provided.

``(II) Reasonable charges.--A plan administrator may charge a reasonable fee for any information provided under this subparagraph in other than electronic form.
``(iv) Authorized representative.--For purposes of this subparagraph, the term `authorized representative' means any employee organization representing participants in the pension plan.''.
(2) Conforming amendment.--Section 4041(c)(1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1341(c)(1)) is amended in subparagraph (C) by striking ``subparagraph (B)'' and inserting ``subparagraphs (B) and (D)''.
(b) Involuntary Terminations.--
(1) In general.--Section 4042(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1342(c)) is amended by--
(A) striking ``(c) If the'' and inserting ``(c)(1) If the'';
(B) redesignating paragraph (3) as paragraph (2); and
(C) adding at the end the following:
``(3) Disclosure of termination information.--
``(A) In general.--
``(i) Information from plan sponsor or administrator.--A plan sponsor or plan administrator of a single-employer plan that has received a notice from the corporation of a determination that the plan should be terminated under this section shall provide to an affected party any information provided to the corporation in connection with the plan termination.
``(ii) Information from corporation.--The corporation shall provide a copy of the administrative record, including the trusteeship decision record of a termination of a plan described under clause (i).
``(B) Timing of disclosure.--The plan sponsor, plan administrator, or the corporation, as applicable, shall provide the information described in subparagraph (A) not later than 15 days after--
``(i) receipt of a request from an affected party for such information; or
``(ii) in the case of information described under subparagraph (A)(i), the provision of any new information to the corporation relating to a previous request by an affected party.
``(C) Confidentiality.--
``(i) In general.--The plan administrator and plan sponsor shall not provide information under subparagraph (A)(i) in a form which includes any information that may directly or indirectly be associated with, or otherwise identify, an individual participant or beneficiary.
``(ii) Limitation.--A court may limit disclosure under this paragraph of confidential information described in section 552(b) of title 5, United States Code, to authorized representatives (within the meaning of section 4041(c)(2)(D)(iv)) of the participants or beneficiaries that agree to ensure the confidentiality of such information.
``(D) Form and manner of information; charges.--
``(i) Form and manner.--The corporation may prescribe the form and manner of the provision of information under this paragraph, which shall include delivery in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to individuals to whom the information is required to be provided.
``(ii) Reasonable charges.--A plan sponsor may charge a reasonable fee for any information provided under this paragraph in other than electronic form.''.
(c) Effective Date.--
(1) In general.--The amendments made by this section shall apply to any plan termination under title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1301 et seq.) with respect to which the notice of intent to terminate (or in the case of a termination by the Pension Benefit Guaranty Corporation, a notice of determination under section 4042 of

such Act (29 U.S.C. 1342)) occurs after the date of enactment of this Act.

(2) Transition rule.--If notice under section 4041(c)(2)(D) or 4042(c)(3) of the Employee Retirement Income Security Act of 1974 (as added by this section) would otherwise be required to be provided before the 90th day after the date of the enactment of this Act, such notice shall not be required to be provided until such 90th day.

SEC. 507. NOTICE OF FREEDOM TO DIVEST EMPLOYER SECURITIES.

(a) In General.--Section 101 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1021), as amended by this Act, is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following:

``(m) Notice of Right To Divest.--Not later than 30 days before the first date on which an applicable individual of an applicable individual account plan is eligible to exercise the right under section 204(j) to direct the proceeds from the divestment of employer securities with respect to any type of contribution, the administrator shall provide to such individual a notice--

``(1) setting forth such right under such section, and

``(2) describing the importance of diversifying the investment of retirement account assets.

The notice required by this subsection shall be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the recipient.''.

(b) Penalties.--Section 502(c)(7) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1132(c)(7)) is amended by striking ``section 101(i)'' and inserting ``subsection (i) or (m) of section 101''.

(c) Model Notice.--The Secretary of the Treasury shall, within 180 days after the date of the enactment of this subsection, prescribe a model notice for purposes of satisfying the requirements of the amendments made by this section.

(d) Effective Dates.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2006.

(2) Transition rule.--If notice under section 101(m) of the Employee Retirement Income Security Act of 1974 (as added by this section) would otherwise be required to be provided before the 90th day after the date of the enactment of this Act, such notice shall not be required to be provided until such 90th day.

SEC. 508. PERIODIC PENSION BENEFIT STATEMENTS.

(a) Amendments of ERISA.--

(1) In general.--Section 105(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1025(a)) is amended to read as follows:

``(a) Requirements To Provide Pension Benefit Statements.--

``(1) Requirements.--

``(A) Individual account plan.--The administrator of an individual account plan (other than a one-participant retirement plan described in section 101(i)(8)(B)) shall furnish a pension benefit statement--

``(i) at least once each calendar quarter to a participant or beneficiary who has the right to direct the investment of assets in his or her account under the plan,

``(ii) at least once each calendar year to a participant or beneficiary who has his or her own account under the plan but does not have the right to direct the investment of assets in that account, and

``(iii) upon written request to a plan beneficiary not described in clause (i) or (ii).

``(B) Defined benefit plan.--The administrator of a defined benefit plan (other than a one-participant retirement plan described in section 101(i)(8)(B)) shall furnish a pension benefit statement--

``(i) at least once every 3 years to each participant with a nonforfeitable accrued benefit and who is employed by the employer maintaining the plan at the time the statement is to be furnished, and

``(ii) to a participant or beneficiary of the plan upon written request.

Information furnished under clause (i) to a participant may be based on reasonable estimates determined under regulations prescribed by the Secretary, in consultation with the Pension Benefit Guaranty Corporation.

``(2) Statements.--

``(A) In general.--A pension benefit statement under paragraph (1)--

``(i) shall indicate, on the basis of the latest available information--

``(I) the total benefits accrued, and

``(II) the nonforfeitable pension benefits, if any, which have accrued, or the earliest date on which benefits will become nonforfeitable,

``(ii) shall include an explanation of any permitted disparity under section 401(l) of the Internal Revenue Code of 1986 or any floor-offset arrangement that may be applied in determining any accrued benefits described in clause (i),

``(iii) shall be written in a manner calculated to be understood by the average plan participant, and

``(iv) may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the participant or beneficiary.

``(B) Additional information.--In the case of an individual account plan, any pension benefit statement under clause (i) or (ii) of paragraph (1)(A) shall include--

``(i) the value of each investment to which assets in the individual account have been allocated, determined as of the most recent valuation date under the plan, including the value of any assets held in the form of employer securities, without regard to whether such securities were contributed by the plan sponsor or acquired at the direction of the plan or of the participant or beneficiary, and

``(ii) in the case of a pension benefit statement under paragraph (1)(A)(i)--

``(I) an explanation of any limitations or restrictions on any right of the participant or beneficiary under the plan to direct an investment,

``(II) an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified, and

``(III) a notice directing the participant or beneficiary to the Internet website of the Department of Labor for sources of information on individual investing and diversification.

``(C) Alternative notice.--The requirements of subparagraph (A)(i)(II) are met if, at least annually and in accordance with requirements of the Secretary, the plan--

``(i) updates the information described in such paragraph which is provided in the pension benefit statement, or

``(ii) provides in a separate statement such information as is necessary to enable a participant or beneficiary to determine their nonforfeitable vested benefits.

``(3) Defined benefit plans.--

``(A) Alternative notice.--In the case of a defined benefit plan, the requirements of paragraph (1)(B)(i) shall be treated as met with respect to a participant if at least once each year the administrator provides to the participant notice of the availability of the pension benefit statement and the ways in which the participant may obtain such statement. Such notice may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the participant.

``(B) Years in which no benefits accrue.--The Secretary may provide that years in which no employee or

former employee benefits (within the meaning of section 410(b) of the Internal Revenue Code of 1986) under the plan need not be taken into account in determining the 3-year period under paragraph (1)(B)(i).''.

(2) Conforming amendments.--

(A) Section 105 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1025) is amended by striking subsection (d).

(B) Section 105(b) of such Act (29 U.S.C. 1025(b)) is amended to read as follows:

``(b) Limitation on Number of Statements.--In no case shall a participant or beneficiary of a plan be entitled to more than 1 statement described in subparagraph (A)(iii) or (B)(ii) of subsection (a)(1), whichever is applicable, in any 12-month period.''.

(C) Section 502(c)(1) of such Act (29 U.S.C. 1132(c)(1)) is amended by striking ``or section 101(f)'' and inserting ``section 101(f), or section 105(a)''.

(b) Model Statements.--

(1) In general.--The Secretary of Labor shall, within 1 year after the date of the enactment of this section, develop 1 or more model benefit statements that are written in a manner calculated to be understood by the average plan participant and that may be used by plan administrators in complying with the requirements of section 105 of the Employee Retirement Income Security Act of 1974.

(2) Interim final rules.--The Secretary of Labor may promulgate any interim final rules as the Secretary determines appropriate to carry out the provisions of this subsection.

(c) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2006.

(2) Special rule for collectively bargained agreements.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act, paragraph (1) shall be applied to benefits pursuant to, and individuals covered by, any such agreement by substituting for ``December 31, 2006'' the earlier of--

(A) the later of--

(i) December 31, 2007, or

(ii) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after such date of enactment), or

(B) December 31, 2008.

SEC. 509. NOTICE TO PARTICIPANTS OR BENEFICIARIES OF BLACKOUT PERIODS.

(a) In General.--Section 101(i)(8)(B) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1021(i)(8)(B)) is amended by striking clauses (i) through (iv), by redesignating clause (v) as clause (ii), and by inserting before clause (ii), as so redesignated, the following new clause:

``(i) on the first day of the plan year--

``(I) covered only one individual (or the individual and the individual's spouse) and the individual (or the individual and the individual's spouse) owned 100 percent of the plan sponsor (whether or not incorporated), or

``(II) covered only one or more partners (or partners and their spouses) in the plan sponsor, and''.

(b) Effective Date.--The amendments made by this subsection shall take effect as if included in the provisions of section 306 of Public Law 107-204 (116 Stat. 745 et seq.).

TITLE VI--INVESTMENT ADVICE, PROHIBITED TRANSACTIONS, AND FIDUCIARY RULES

Subtitle A--Investment Advice

SEC. 601. PROHIBITED TRANSACTION EXEMPTION FOR PROVISION OF INVESTMENT ADVICE.

(a) Amendments to the Employee Retirement Income Security Act of 1974.--

(1) Exemption from prohibited transactions.--Section 408(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1108(b)) is amended by adding at the end the following new paragraph:

``(14) Any transaction in connection with the provision of investment advice described in section 3(21)(A)(ii) to a participant or beneficiary of an individual account plan that permits such participant or beneficiary to direct the investment of assets in their individual account, if--

``(A) the transaction is--

``(i) the provision of the investment advice

to the participant or beneficiary of the plan with respect to a security or other property available as an investment under the plan,

``(ii) the acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice, or

``(iii) the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative of the fiduciary adviser or affiliate) in connection with the provision of the advice or in connection with an acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice; and

``(B) the requirements of subsection (g) are met.''.

(2) Requirements.--Section 408 of such Act is amended further by adding at the end the following new subsection:

``(g) Provision of Investment Advice to Participant and Beneficiaries.--

``(1) In general.--The prohibitions provided in section 406 shall not apply to transactions described in subsection (b)(14) if the investment advice provided by a fiduciary adviser is provided under an eligible investment advice arrangement.

``(2) Eligible investment advice arrangement.--For purposes of this subsection, the term `eligible investment advice arrangement' means an arrangement--

``(A) which either--

``(i) provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected, or

``(ii) uses a computer model under an investment advice program meeting the requirements of paragraph (3) in connection with the provision of investment advice by a fiduciary adviser to a participant or beneficiary, and

``(B) with respect to which the requirements of paragraph (4), (5), (6), (7), (8), and (9) are met.

``(3) Investment advice program using computer model.--

``(A) In general.--An investment advice program meets the requirements of this paragraph if the requirements of subparagraphs (B), (C), and (D) are met.

``(B) Computer model.--The requirements of this subparagraph are met if the investment advice provided under the investment advice program is provided pursuant to a computer model that--

``(i) applies generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time,

``(ii) utilizes relevant information about the participant, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments,

``(iii) utilizes prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan,

``(iv) operates in a manner that is not biased in favor of investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser, and

``(v) takes into account all investment options under the plan in specifying how a participant's account balance should be invested and is not inappropriately weighted with respect to any investment option.

``(C) Certification.--

``(i) In general.--The requirements of this subparagraph are met with respect to any investment advice program if an eligible investment expert certifies, prior to the utilization of the computer model and in accordance with rules prescribed by the Secretary, that the computer model meets the requirements of

subparagraph (B).
``(ii) Renewal of certifications.--If, as determined under regulations prescribed by the Secretary, there are material modifications to a computer model, the requirements of this subparagraph are met only if a certification described in clause (i) is obtained with respect to the computer model as so modified.
``(iii) Eligible investment expert.--The term `eligible investment expert' means any person--
``(I) which meets such requirements as the Secretary may provide, and
``(II) does not bear any material affiliation or contractual relationship with any investment adviser or a related person thereof (or any employee, agent, or registered representative of the investment adviser or related person).
``(D) Exclusivity of recommendation.--The requirements of this subparagraph are met with respect to any investment advice program if--
``(i) the only investment advice provided under the program is the advice generated by the computer model described in subparagraph (B), and
``(ii) any transaction described in subsection (b)(14)(B)(ii) occurs solely at the direction of the participant or beneficiary.
Nothing in the preceding sentence shall preclude the participant or beneficiary from requesting investment advice other than that described in subparagraph (A), but
only if such request has not been solicited by any person connected with carrying out the arrangement.
``(4) Express authorization by separate fiduciary.--The requirements of this paragraph are met with respect to an arrangement if the arrangement is expressly authorized by a plan fiduciary other than the person offering the investment advice program, any person providing investment options under the plan, or any affiliate of either.
``(5) Annual audit.--The requirements of this paragraph are met if an independent auditor, who has appropriate technical training or experience and proficiency and so represents in writing--
``(A) conducts an annual audit of the arrangement for compliance with the requirements of this subsection, and
``(B) following completion of the annual audit, issues a written report to the fiduciary who authorized use of the arrangement which presents its specific findings regarding compliance of the arrangement with the requirements of this subsection.
For purposes of this paragraph, an auditor is considered independent if it is not related to the person offering the arrangement to the plan and is not related to any person providing investment options under the plan.
``(6) Disclosure.--The requirements of this paragraph are met if--
``(A) the fiduciary adviser provides to a participant or a beneficiary before the initial provision of the investment advice with regard to any security or other property offered as an investment option, a written notification (which may consist of notification by means of electronic communication)--
``(i) of the role of any party that has a material affiliation or contractual relationship with the financial adviser in the development of the investment advice program and in the selection of investment options available under the plan,
``(ii) of the past performance and historical rates of return of the investment options available under the plan,
``(iii) of all fees or other compensation relating to the advice that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with the provision of the advice or in connection with the sale, acquisition, or holding of the security or other property,
``(iv) of any material affiliation or contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property,

``(v) the manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed,

``(vi) of the types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser,

``(vii) that the adviser is acting as a fiduciary of the plan in connection with the provision of the advice, and

``(viii) that a recipient of the advice may separately arrange for the provision of advice by another adviser, that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property, and

``(B) at all times during the provision of advisory services to the participant or beneficiary, the fiduciary adviser--

``(i) maintains the information described in subparagraph (A) in accurate form and in the manner described in paragraph (8),

``(ii) provides, without charge, accurate information to the recipient of the advice no less frequently than annually,

``(iii) provides, without charge, accurate information to the recipient of the advice upon request of the recipient, and

``(iv) provides, without charge, accurate information to the recipient of the advice concerning any material change to the information required to be provided to the recipient of the advice at a time reasonably contemporaneous to the change in information.

``(7) Other conditions.--The requirements of this paragraph are met if--

``(A) the fiduciary adviser provides appropriate disclosure, in connection with the sale, acquisition, or holding of the security or other property, in accordance with all applicable securities laws,

``(B) the sale, acquisition, or holding occurs solely at the direction of the recipient of the advice,

``(C) the compensation received by the fiduciary adviser and affiliates thereof in connection with the sale, acquisition, or holding of the security or other property is reasonable, and

``(D) the terms of the sale, acquisition, or holding of the security or other property are at least as favorable to the plan as an arm's length transaction would be.

``(8) Standards for presentation of information.--

``(A) In general.--The requirements of this paragraph are met if the notification required to be provided to participants and beneficiaries under paragraph (6)(A) is written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and is sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be provided in the notification.

``(B) Model form for disclosure of fees and other compensation.--The Secretary shall issue a model form for the disclosure of fees and other compensation required in paragraph (6)(A)(iii) which meets the requirements of subparagraph (A).

``(9) Maintenance for 6 years of evidence of compliance.--The requirements of this paragraph are met if a fiduciary adviser who has provided advice referred to in paragraph (1) maintains, for a period of not less than 6 years after the provision of the advice, any records necessary for determining whether the requirements of the preceding provisions of this subsection and of subsection (b)(14) have been met. A transaction prohibited under section 406 shall not be considered to have occurred solely because the records are lost or destroyed prior to the end of the 6-year period due to circumstances beyond the control of the fiduciary adviser.

``(10) Exemption for plan sponsor and certain other fiduciaries.--

``(A) In general.--Subject to subparagraph (B), a plan sponsor or other person who is a fiduciary (other than a fiduciary adviser) shall not be treated as

failing to meet the requirements of this part solely by
reason of the provision of investment advice referred to
in section 3(21)(A)(ii) (or solely by reason of
contracting for or otherwise arranging for the provision
of the advice), if--

``(i) the advice is provided by a fiduciary
adviser pursuant to an eligible investment advice
arrangement between the plan sponsor or other
fiduciary and the fiduciary adviser for the
provision by the fiduciary adviser of investment
advice referred to in such section,

``(ii) the terms of the eligible investment
advice arrangement require compliance by the
fiduciary adviser with the requirements of this
subsection, and

``(iii) the terms of the eligible investment
advice arrangement include a written
acknowledgment by the fiduciary adviser that the
fiduciary adviser is a fiduciary of the plan with
respect to the provision of the advice.

``(B) Continued duty of prudent selection of adviser
and periodic review.--Nothing in subparagraph (A) shall
be construed to exempt a plan sponsor or other person
who is a fiduciary from any requirement of this part for
the prudent selection and periodic review of a fiduciary
adviser with whom the plan sponsor or other person
enters into an eligible investment advice arrangement
for the provision of investment advice referred to in
section 3(21)(A)(ii). The plan sponsor or other person
who is a fiduciary has no duty under this part to
monitor the specific investment advice given by the
fiduciary adviser to any particular recipient of the
advice.

``(C) Availability of plan assets for payment for
advice.--Nothing in this part shall be construed to
preclude the use of plan assets to pay for reasonable
expenses in providing investment advice referred to in
section 3(21)(A)(ii).

``(11) Definitions.--For purposes of this subsection and
subsection (b)(14)--

``(A) Fiduciary adviser.--The term `fiduciary
adviser' means, with respect to a plan, a person who is
a fiduciary of the plan by reason of the provision of
investment advice referred to in section 3(21)(A)(ii) by
the person to the participant or beneficiary of the plan
and who is--

``(i) registered as an investment adviser
under the Investment Advisers Act of 1940 (15
U.S.C. 80b-1 et seq.) or under the laws of the
State in which the fiduciary maintains its
principal office and place of business,

``(ii) a bank or similar financial institution
referred to in section 408(b)(4) or a savings
association (as defined in section 3(b)(1) of the
Federal Deposit Insurance Act (12 U.S.C.
1813(b)(1)), but only if the advice is provided
through a trust department of the bank or similar
financial institution or savings association which
is subject to periodic examination and review by
Federal or State banking authorities,

``(iii) an insurance company qualified to do
business under the laws of a State,

``(iv) a person registered as a broker or
dealer under the Securities Exchange Act of 1934
(15 U.S.C. 78a et seq.),

``(v) an affiliate of a person described in
any of clauses (i) through (iv), or

``(vi) an employee, agent, or registered
representative of a person described in clauses
(i) through (v) who satisfies the requirements of
applicable insurance, banking, and securities laws
relating to the provision of the advice.

For purposes of this part, a person who develops the
computer model described in paragraph (3)(B) or markets
the investment advice program or computer model shall be
treated as a person who is a fiduciary of the plan by
reason of the provision of investment advice referred to
in section 3(21)(A)(ii) to the participant or
beneficiary and shall be treated as a fiduciary adviser
for purposes of this subsection and subsection (b)(14),
except that the Secretary may prescribe rules under
which only 1 fiduciary adviser may elect to be treated

as a fiduciary with respect to the plan.
``(B) Affiliate.--The term `affiliate' of another entity means an affiliated person of the entity (as defined in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3))).
``(C) Registered representative.--The term `registered representative' of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)) (substituting the entity for the investment adviser referred to in such section).''.

(3) Effective date.--The amendments made by this subsection shall apply with respect to advice referred to in section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 provided after December 31, 2006.

(b) Amendments to Internal Revenue Code of 1986.--

(1) Exemption from prohibited transactions.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemption from tax on prohibited transactions) is amended--
(A) in paragraph (15), by striking ``or'' at the end;
(B) in paragraph (16), by striking the period at the end and inserting ``;or''; and
(C) by adding at the end the following new paragraph:

``(17) Any transaction in connection with the provision of investment advice described in subsection (e)(3)(B) to a participant or beneficiary in a plan and that permits such participant or beneficiary to direct the investment of plan assets in an individual account, if--
``(A) the transaction is--
``(i) the provision of the investment advice to the participant or beneficiary of the plan with respect to a security or other property available as an investment under the plan,
``(ii) the acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice, or
``(iii) the direct or indirect receipt of fees or other compensation by the fiduciary adviser or an affiliate thereof (or any employee, agent, or registered representative of the fiduciary adviser or affiliate) in connection with the provision of the advice or in connection with an acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to the investment advice; and
``(B) the requirements of subsection (f)(8) are met.''.

(2) Requirements.--Subsection (f) of such section 4975 (relating to other definitions and special rules) is amended by adding at the end the following new paragraph:

``(8) Provision of investment advice to participant and beneficiaries.-- I24 ``(A) In general.--The prohibitions provided in subsection (c) shall not apply to transactions described in subsection (b)(14) if the investment advice provided by a fiduciary adviser is provided under an eligible investment advice arrangement.
``(B) Eligible investment advice arrangement.--For purposes of this paragraph, the term `eligible investment advice arrangement' means an arrangement--
``(i) which either--
``(I) provides that any fees (including any commission or other compensation) received by the fiduciary adviser for investment advice or with respect to the sale, holding, or acquisition of any security or other property for purposes of investment of plan assets do not vary depending on the basis of any investment option selected, or
``(II) uses a computer model under an investment advice program meeting the

requirements of subparagraph (C) in
connection with the provision of
investment advice by a fiduciary adviser
to a participant or beneficiary, and
``(ii) with respect to which the requirements
of subparagraphs (D), (E), (F), (G), (H), and (I)
are met.
``(C) Investment advice program using computer
model.--
``(i) In general.--An investment advice
program meets the requirements of this
subparagraph if the requirements of clauses (ii),
(iii), and (iv) are met.
``(ii) Computer model.--The requirements of
this clause are met if the investment advice
provided under
the investment advice program is provided pursuant
to a computer model that--
``(I) applies generally accepted
investment theories that take into
account the historic returns of
different asset classes over defined
periods of time,
``(II) utilizes relevant information
about the participant, which may include
age, life expectancy, retirement age,
risk tolerance, other assets or sources
of income, and preferences as to certain
types of investments,
``(III) utilizes prescribed
objective criteria to provide asset
allocation portfolios comprised of
investment options available under the
plan,
``(IV) operates in a manner that is
not biased in favor of investments
offered by the fiduciary adviser or a
person with a material affiliation or
contractual relationship with the
fiduciary adviser, and
``(V) takes into account all
investment options under the plan in
specifying how a participant's account
balance should be invested and is not
inappropriately weighted with respect to
any investment option.
``(iii) Certification.--
``(I) In general.--The requirements
of this clause are met with respect to
any investment advice program if an
eligible investment expert certifies,
prior to the utilization of the computer
model and in accordance with rules
prescribed by the Secretary of Labor,
that the computer model meets the
requirements of clause (ii).
``(II) Renewal of certifications.--
If, as determined under regulations
prescribed by the Secretary of Labor,
there are material modifications to a
computer model, the requirements of this
clause are met only if a certification
described in subclause (I) is obtained
with respect to the computer model as so
modified.
``(III) Eligible investment
expert.--The term `eligible investment
expert' means any person which meets
such requirements as the Secretary of
Labor may provide and which does not
bear any material affiliation or
contractual relationship with any
investment adviser or a related person
thereof (or any employee, agent, or
registered representative of the
investment adviser or related person).
``(iv) Exclusivity of recommendation.--The
requirements of this clause are met with respect
to any investment advice program if--
``(I) the only investment advice
provided under the program is the advice
generated by the computer model

described in clause (ii), and
``(II) any transaction described in subsection (b)(14)(B)(ii) occurs solely at the direction of the participant or beneficiary.

Nothing in the preceding sentence shall preclude the participant or beneficiary from requesting investment advice other than that described in clause (i), but only if such request has not been solicited by any person connected with carrying out the arrangement.

``(D) Express authorization by separate fiduciary.--The requirements of this subparagraph are met with respect to an arrangement if the arrangement is expressly authorized by a plan fiduciary other than the person offering the investment advice program, any person providing investment options under the plan, or any affiliate of either.

``(E) Audits.--

``(i) In general.--The requirements of this subparagraph are met if an independent auditor, who has appropriate technical training or experience and proficiency and so represents in writing--

``(I) conducts an annual audit of the arrangement for compliance with the requirements of this paragraph, and

``(II) following completion of the annual audit, issues a written report to the fiduciary who authorized use of the arrangement which presents its specific findings regarding compliance of the arrangement with the requirements of this paragraph.

``(ii) Special rule for individual retirement and similar plans.--In the case of a plan described in subparagraphs (B) through (F) (and so much of subparagraph (G) as relates to such subparagraphs) of subsection (e)(1), in lieu of the requirements of clause (i), audits of the arrangement shall be conducted at such times and in such manner as the Secretary of Labor may prescribe.

``(iii) Independent auditor.--For purposes of this subparagraph, an auditor is considered independent if it is not related to the person offering the arrangement to the plan and is not related to any person providing investment options under the plan.

``(F) Disclosure.--The requirements of this subparagraph are met if--

``(i) the fiduciary adviser provides to a participant or a beneficiary before the initial provision of the investment advice with regard to any security or other property offered as an investment option, a written notification (which may consist of notification by means of electronic communication)--

``(I) of the role of any party that has a material affiliation or contractual relationship with the financial adviser in the development of the investment advice program and in the selection of investment options available under the plan,

``(II) of the past performance and historical rates of return of the investment options available under the plan,

``(III) of all fees or other compensation relating to the advice that the fiduciary adviser or any affiliate thereof is to receive (including compensation provided by any third party) in connection with the provision of the advice or in connection with the sale, acquisition, or holding of the security or other property,

``(IV) of any material affiliation or contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property,

``(V) the manner, and under what circumstances, any participant or beneficiary information provided under the arrangement will be used or disclosed,

``(VI) of the types of services provided by the fiduciary adviser in connection with the provision of investment advice by the fiduciary adviser,

``(VII) that the adviser is acting as a fiduciary of the plan in connection with the provision of the advice, and

``(VIII) that a recipient of the advice may separately arrange for the provision of advice by another adviser, that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property, and

``(ii) at all times during the provision of advisory services to the participant or beneficiary, the fiduciary adviser--

``(I) maintains the information described in clause (i) in accurate form and in the manner described in subparagraph (H),

``(II) provides, without charge, accurate information to the recipient of the advice no less frequently than annually,

``(III) provides, without charge, accurate information to the recipient of the advice upon request of the recipient, and

``(IV) provides, without charge, accurate information to the recipient of the advice concerning any material change to the information required to be provided to the recipient of the advice at a time reasonably contemporaneous to the change in information.

``(G) Other conditions.--The requirements of this subparagraph are met if--

``(i) the fiduciary adviser provides appropriate disclosure, in connection with the sale, acquisition, or holding of the security or other property, in accordance with all applicable securities laws,

``(ii) the sale, acquisition, or holding occurs solely at the direction of the recipient of the advice,

``(iii) the compensation received by the fiduciary adviser and affiliates thereof in connection with the sale, acquisition, or holding of the security or other property is reasonable, and

``(iv) the terms of the sale, acquisition, or holding of the security or other property are at least as favorable to the plan as an arm's length transaction would be.

``(H) Standards for presentation of information.--

``(i) In general.--The requirements of this subparagraph are met if the notification required to be provided to participants and beneficiaries under subparagraph (F)(i) is written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and is sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be provided in the notification.

``(ii) Model form for disclosure of fees and other compensation.--The Secretary of Labor shall issue a model form for the disclosure of fees and other compensation required in subparagraph (F)(i)(III) which meets the requirements of clause (i).

``(I) Maintenance for 6 years of evidence of compliance.--The requirements of this subparagraph are met if a fiduciary adviser who has provided advice referred to in subparagraph (A) maintains, for a period

of not less than 6 years after the provision of the advice, any records necessary for determining whether the requirements of the preceding provisions of this paragraph and of subsection (d)(17) have been met. A transaction prohibited under section 406 shall not be considered to have occurred solely because the records are lost or destroyed prior to the end of the 6-year period due to circumstances beyond the control of the fiduciary adviser.

``(J) Definitions.--For purposes of this paragraph and subsection (d)(17)--

``(i) Fiduciary adviser.--The term `fiduciary adviser' means, with respect to a plan, a person who is a fiduciary of the plan by reason of the provision of investment advice by the person to the participant or beneficiary of the plan and who is--

``(I) registered as an investment adviser under the Investment Advisers Act of 1940 (15 U.S.C. 80b-1 et seq.) or under the laws of the State in which the fiduciary maintains its principal office and place of business,

``(II) a bank or similar financial institution referred to in section 408(b)(4) or a savings association (as defined in section 3(b)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(b)(1)), but only if the advice is provided through a trust department of the bank or similar financial institution or savings association which is subject to periodic examination and review by Federal or State banking authorities,

``(III) an insurance company qualified to do business under the laws of a State,

``(IV) a person registered as a broker or dealer under the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.),

``(V) an affiliate of a person described in any of subclauses (I) through (IV), or

``(VI) an employee, agent, or registered representative of a person described in subclauses (I) through (V) who satisfies the requirements of applicable insurance, banking, and securities laws relating to the provision of the advice.

For purposes of this title, a person who develops the computer model described in subparagraph (C)(ii) or markets the investment advice program or computer model shall be treated as a person who is a fiduciary of the plan by reason of the provision of investment advice referred to in subsection (e)(3)(B) to the participant or beneficiary and shall be treated as a fiduciary adviser for purposes of this paragraph and subsection (d)(17), except that the Secretary of Labor may prescribe rules under which only 1 fiduciary adviser may elect to be treated as a fiduciary with respect to the plan.

``(ii) Affiliate.--The term `affiliate' of another entity means an affiliated person of the entity (as defined in section 2(a)(3) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(3))).

``(iii) Registered representative.--The term `registered representative' of another entity means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(18)) (substituting the entity for the broker or dealer referred to in such section) or a person described in section 202(a)(17) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(17)) (substituting the entity for the investment adviser referred to in such section).''.

(3) Determination of feasibility

of application of computer model investment advice programs for individual retirement and similar plans.--
(A) Solicitation of information.--As soon as practicable after the date of the enactment of this Act, the Secretary of Labor, in consultation with the Secretary of the Treasury, shall--
(i) solicit information as to the feasibility of the application of computer model investment advice programs for plans described in subparagraphs (B) through (F) (and so much of subparagraph (G) as relates to such subparagraphs) of section 4975(e)(1) of the Internal Revenue Code of 1986, including soliciting information from--
(I) at least the top 50 trustees of such plans, determined on the basis of assets held by such trustees, and
(II) other persons offering computer model investment advice programs based on nonproprietary products, and
(ii) shall on the basis of such information make the determination under subparagraph (B).
The information solicited by the Secretary of Labor under clause (i) from persons described in subclauses (I) and (II) of clause (i) shall include information on computer
modeling capabilities of such persons with respect to the current year and preceding year, including such capabilities for investment accounts maintained by such persons.
(B) Determination of feasibility.--The Secretary of Labor, in consultation with the Secretary of the Treasury, shall, on the basis of information received under subparagraph (A), determine whether there is any computer model investment advice program which may be utilized by a plan described in subparagraph (A)(i) to provide investment advice to the account beneficiary of the plan which--
(i) utilizes relevant information about the account beneficiary, which may include age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments,
(ii) takes into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the account beneficiary, and
(iii) allows the account beneficiary, in directing the investment of assets, sufficient flexibility in obtaining advice to evaluate and select investment options.
The Secretary of Labor
shall report the results of such determination to the committees of Congress referred to in subparagraph (D)(ii) not later than December 31, 2007.
(C) Application of computer model investment advice program.--
(i) Certification required for use of computer model.--
(I) Restriction on use.--Subclause (II) of section 4975(f)(8)(B)(i) of the Internal Revenue Code of 1986 shall not apply to a plan described in subparagraph (A)(i).
(II) Restriction lifted if model certified.--If the Secretary of Labor determines under subparagraph (B) or (D) that there is a computer model investment advice program described in subparagraph (B), subclause (I) shall cease to apply as of the date of such determination.
(ii) Class exemption if no initial certification by secretary.--If the Secretary of Labor determines under subparagraph (B) that there is no computer model investment advice program described in subparagraph (B), the Secretary of Labor shall grant a class exemption from treatment as a prohibited transaction under section 4975(c) of the Internal Revenue Code of 1986 to any transaction described in section 4975(d)(17)(A) of such Code with respect to plans described in subparagraph (A)(i), subject to such conditions as

set forth in such exemption as are in the interests of the plan and its account beneficiary and protective of the rights of the account beneficiary and as are necessary to--

(I) ensure the requirements of sections 4975(d)(17) and 4975(f)(8) (other than subparagraph (C) thereof) of the Internal Revenue Code of 1986 are met, and

(II) ensure the investment advice provided under the investment advice program utilizes prescribed objective criteria to provide asset allocation portfolios comprised of securities or other property available as investments under the plan.

If the Secretary of Labor solicits any information under subparagraph (A) from a person and such person does not provide such information within 60 days after the solicitation, then, unless such failure was due to reasonable cause and not wilful neglect, such person shall not be entitled to utilize the class exemption under this clause.

(D) Subsequent determination.--

(i) In general.--If the Secretary of Labor initially makes a determination described in subparagraph (C)(ii), the Secretary may subsequently determine that there is a computer model investment advice program described in subparagraph (B). If the Secretary makes such subsequent determination, then the class exemption described in subparagraph (C)(ii) shall cease to apply after the later of--

(I) the date which is 2 years after such subsequent determination, or

(II) the date which is 3 years after the first date on which such exemption took effect.

(ii) Requests for determination.--Any person may request the Secretary of Labor to make a determination under this subparagraph with respect to any computer model investment advice program, and the Secretary of Labor shall make a determination with respect to such request within 90 days. If the Secretary of Labor makes a determination that such program is not described in subparagraph (B), the Secretary shall, within 10 days of such determination, notify the Committee on Ways and Means and the Committee on Education and the Workforce of the House of Representatives and the Committee on Finance and the Committee on Health, Education, Labor, and Pensions of the Senate of such determination and the reasons for such determination.

(E) Effective date.--The provisions of this paragraph shall take effect on the date of the enactment of this Act.

(4) Effective date.--Except as provided in this subsection, the amendments made by this subsection shall apply with respect to advice referred to in section 4975(c)(3)(B) of the Internal Revenue Code of 1986 provided after December 31, 2006.

(c) Coordination With Existing Exemptions.--Any exemption under section 408(b) of the Employee Retirement Income Security Act of 1974 and section 4975(d) of the Internal Revenue Code of 1986 provided by the amendments made by this section shall not in any manner alter existing individual or class exemptions, provided by statute or administrative action.

Subtitle B--Prohibited Transactions

SEC. 611. PROHIBITED TRANSACTION RULES RELATING TO FINANCIAL INVESTMENTS.

(a) Exemption for Block Trading.--

(1) Amendments to employee retirement income security act of 1974.--Section 408(b) of such Act (29 U.S.C. 1108(b)), as amended by section 601, is amended by adding at the end the following new paragraph:

``(15)(A) Any transaction involving the purchase or sale of securities, or other property (as determined by the Secretary), between a plan and a party in interest (other than a fiduciary

described in section 3(21)(A)) with respect to a plan if--
``(i) the transaction involves a block trade,
``(ii) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor), does not exceed 10 percent of the aggregate size of the block trade,
``(iii) the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction, and
``(iv) the compensation associated with the purchase and sale is not greater than the compensation associated with an arm's length transaction with an unrelated party.
``(B) For purposes of this paragraph, the term `block trade' means any trade of at least 10,000 shares or with a market value of at least $200,000 which will be allocated across two or more unrelated client accounts of a fiduciary.''.
(2) Amendments to internal revenue code of 1986.--
(A) In general.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemptions), as amended by section 601, is amended by striking ``or'' at the end of paragraph (16), by striking the period at the end of paragraph (17) and inserting ``, or'', and by adding at the end the following new paragraph:
``(18) any transaction involving the purchase or sale of securities, or other property (as determined by the Secretary of Labor), between a plan and a party in interest (other than a fiduciary described in subsection (e)(3)(B)) with respect to a plan if--
``(A) the transaction involves a block trade,
``(B) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor), does not exceed 10 percent of the aggregate size of the block trade,
``(C) the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction, and
``(D) the compensation associated with the purchase and sale is not greater than the compensation associated with an arm's length transaction with an unrelated party.''.
(B) Special rule relating to block trade.--Subsection (f) of section 4975 of such Code (relating to other definitions and special rules), as amended by section 601, is amended by adding at the end the following new paragraph:
``(9) Block trade.--The term `block trade' means any trade of at least 10,000 shares or with a market value of at least $200,000 which will be allocated across two or more unrelated client accounts of a fiduciary.''.
(b) Bonding Relief.--Section 412(a) of such Act (29 U.S.C. 1112(a)) is amended--
(1) by redesignating paragraph (2) as paragraph (3),
(2) by striking ``and'' at the end of paragraph (1), and
(3) by inserting after paragraph (1) the following new paragraph:
``(2) no bond shall be required of any entity which is registered as a broker or a dealer under section 15(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(b)) if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization (within the meaning of section 3(a)(26) of such Act (15 U.S.C. 78c(a)(26)).''.
(c) Exemption for Electronic Communication Network.--
(1) Amendments to employee retirement income security act of 1974.--Section 408(b) of such Act, as amended by subsection (a), is amended by adding at the end the following:
``(16) Any transaction involving the purchase or sale of securities, or other property (as determined by the Secretary), between a plan and a party in interest if--
``(A) the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue subject to regulation and oversight by--
``(i) the applicable Federal regulating entity, or
``(ii) such foreign regulatory entity as the Secretary may determine by regulation,

``(B) either--
``(i) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the Securities and Exchange Commission or other relevant governmental authority, or
``(ii) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades,
``(C) the price and compensation associated with the purchase and sale are not greater than the price and compensation associated with an arm's length transaction with an unrelated party,
``(D) if the party in interest has an ownership interest in the system or venue described in subparagraph (A), the system or venue has been authorized by the plan sponsor or other independent fiduciary for transactions described in this paragraph, and
``(E) not less than 30
days prior to the initial transaction described in this paragraph executed through any system or venue described in subparagraph (A), a plan fiduciary is provided written or electronic notice of the
execution of such transaction through such system or venue.''.
(2) Amendments to internal revenue code of 1986.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemptions), as amended by subsection (a), is amended by striking ``or'' at the end of paragraph (17), by striking the period at the end of paragraph (18) and inserting ``, or'', and by adding at the end the following new paragraph:
``(19) any transaction involving the purchase or sale of securities, or other property (as determined by the Secretary of Labor), between a plan and a party in interest if--
``(A) the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue subject to regulation and oversight by--
``(i) the applicable Federal regulating entity, or
``(ii) such foreign regulatory entity as the Secretary of Labor may determine by regulation,
``(B) either--
``(i) the transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the Securities and Exchange Commission or other relevant governmental authority, or
``(ii) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades,
``(C) the price and compensation associated with the purchase and sale are not greater than the price and compensation associated with an arm's length transaction with an unrelated party,
``(D) if the party in interest has an ownership interest in the system or venue described in subparagraph (A), the system or venue has been authorized by the plan sponsor or other independent fiduciary for transactions described in this paragraph, and
``(E) not less than 30
days prior to the initial transaction described in this paragraph executed through any system or venue described in subparagraph (A), a plan fiduciary is provided written or electronic notice of the execution of such transaction through such system or venue.''.
(d) Exemption for Service Providers.--
(1) Amendments to employee retirement income security act of 1974.--Section 408(b) of such Act (29
U.S.C. 1106), as amended by subsection (c), is amended by adding at the end the following new paragraph:
``(17)(A) Transactions described in subparagraphs (A), (B), and (D) of section 406(a)(1) between a plan and a person that is a party in interest other than a fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the plan assets involved in the

transaction or renders investment advice (within the meaning of
section 3(21)(A)(ii)) with respect to those assets, solely by
reason of providing services to the plan or solely by reason of
a relationship to such a service provider described
in subparagraph (F), (G), (H), or (I) of section 3(14), or both,
but only if in connection with such transaction the plan
receives no less, nor pays no more, than adequate consideration.

``(B) For purposes of this paragraph, the term `adequate
consideration' means--

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

``(I) the price of the security
prevailing on a national securities
exchange which is registered under
section 6 of the Securities Exchange Act
of 1934, taking into account factors
such as the size of the transaction and
marketability of the security, or

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

``(ii) in the case of an asset other than a
security for which there is a generally recognized
market, the fair market value of the asset as
determined in good faith by a fiduciary or
fiduciaries in accordance with regulations
prescribed by the Secretary.''.

(2) Amendment to internal revenue code of 1986.--

(A) In general.--Subsection (d) of section 4975 of
the Internal Revenue Code of 1986 (relating to
exemptions), as amended by subsection (c), is amended by
striking ``or'' at the end of paragraph (18), by
striking the period at the end of paragraph (19) and
inserting ``, or'', and by adding at the end the
following new paragraph:

``(20) transactions described in subparagraphs (A), (B), and
(D) of subsection (c)(1) between a plan and a person that is a
party in interest other than a fiduciary (or an affiliate) who
has or exercises any discretionary authority or control with
respect to the investment of the plan assets involved in the
transaction or renders investment advice (within the meaning of
subsection (e)(3)(B)) with respect to those assets, solely by
reason of providing services to the plan or solely by reason of
a relationship to such a service provider described in
subparagraph (F), (G), (H), or (I) of subsection (e)(2), or
both, but only if in connection with such transaction the plan
receives no less, nor pays no more, than adequate
consideration.''.

(B) Special rule relating to service providers.--
Subsection (f) of section 4975 of such Code (relating to
other definitions and special rules), as amended by
subsection (a), is amended by adding at the end the
following new paragraph:

``(10) Adequate consideration.--The term `adequate
consideration' means--

``(A) in the case of a security for which there is a
generally recognized market--

``(i) the price of the security prevailing on
a national securities exchange which is registered
under
section 6 of the Securities Exchange Act of 1934,
taking into account factors such as the size of
the transaction and marketability of the security,
or

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

``(B) in the case of an asset other than a security
for which there is a generally recognized market, the

fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary of Labor.''.

(e) Relief for Foreign Exchange Transactions.--

(1) Amendments to employee retirement income security act of 1974.--Section 408(b) of such Act (29 U.S.C. 1108(b)), as amended by subsection (d), is amended by adding at the end the following new paragraph:

``(18) Foreign exchange transactions.--Any foreign exchange transactions, between a bank or broker-dealer (or any affiliate of either), and a plan (as defined in section 3(3)) with respect to which such bank or broker-dealer (or affiliate) is a trustee, custodian, fiduciary, or other party in interest, if--

``(A) the transaction is in connection with the purchase, holding, or sale of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets),

``(B) at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties, or the terms afforded by the bank or broker-dealer (or any affiliate of either) in comparable arm's-length foreign exchange transactions involving unrelated parties,

``(C) the exchange rate used by such bank or broker-dealer (or affiliate) for a particular foreign exchange transaction does not deviate by more or less than 3 percent from the interbank bid and asked rates for transactions of comparable size and maturity at the time of the transaction as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency, and

``(D) the bank or broker-dealer (or any affiliate of either) does not have investment discretion, or provide investment advice, with respect to the transaction.''.

(2) Amendment to internal revenue code of 1986.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemptions), as amended by subsection (d), is amended by striking ``or'' at the end of paragraph (19), by striking the period at the end of paragraph (20) and inserting ``, or'', and by adding at the end the following new paragraph:

``(21) any foreign exchange transactions, between a bank or broker-dealer (or any affiliate of either) and a plan (as defined in this section) with respect to which such bank or broker-dealer (or affiliate) is a trustee, custodian, fiduciary, or other party in interest person, if--

``(A) the transaction is in connection with the purchase, holding, or sale of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets),

``(B) at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties, or the terms afforded by the bank or broker-dealer (or any affiliate of either) in comparable arm's-length foreign exchange transactions involving unrelated parties,

``(C) the exchange rate used by such bank or broker-dealer (or affiliate) for a particular foreign exchange transaction does not deviate by more or less than 3 percent from the interbank bid and asked rates for transactions of comparable size and maturity at the time of the transaction as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency, and

``(D) the bank or broker-dealer (or any affiliate of either) does not have investment discretion, or provide investment advice, with respect to the transaction.''.

(f) Definition of Plan Asset Vehicle.--Section 3 of such Act (29 U.S.C. 1002) is amended by adding at the end the following new paragraph:

``(42) the term `plan assets' means plan assets as defined by such regulations as the Secretary may prescribe, except that under such regulations the assets of any entity shall not be treated as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total value of each class of equity interest in the entity is held by benefit plan investors. For purposes of determinations pursuant to this paragraph, the value of any

equity interest held by a person (other than such a benefit plan investor) who has discretionary authority or control with respect to the assets of the entity or any person who provides investment advice for a fee (direct or indirect) with respect to such assets, or any affiliate of such a person, shall be disregarded for purposes of calculating the 25 percent threshold. An entity shall be considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors. For purposes of this paragraph, the term `benefit plan investor' means an employee benefit plan subject to part 4, any plan to which section 4975 of the Internal Revenue Code of 1986 applies, and any entity whose underlying assets include plan assets by reason of a plan's investment in such entity.''.

(g) Exemption for Cross Trading.--

(1) Amendments to employee retirement income security act of 1974.--Section 408(b) of such Act (29 U.S.C. 1108(b)), as amended by subsection (e), is amended by adding at the end the following new paragraph:

``(19) Cross trading.--Any transaction described in sections 406(a)(1)(A) and 406(b)(2) involving the purchase and sale of a security between a plan and any other account managed by the same investment manager, if--

``(A) the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available,

``(B) the transaction is effected at the independent current market price of the security (within the meaning of section 270.17a-7(b) of title 17, Code of Federal Regulations),

``(C) no brokerage commission, fee (except for customary transfer fees, the fact of which is disclosed pursuant to subparagraph (D)), or other remuneration is paid in connection with the transaction,

``(D) a fiduciary (other than the investment manager engaging in the cross-trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of the parties) the investment manager to engage in cross trades at the investment manager's discretion, after such fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if such disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager described in subparagraph (H),

``(E) each plan participating in the transaction has assets of at least $100,000,000, except that if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group (as defined in section 407(d)(7)), the master trust has assets of at least $100,000,000,

``(F) the investment manager provides to the plan fiduciary who authorized cross trading under subparagraph (D) a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information, as applicable: (i) the identity of each security bought or sold; (ii) the number of shares or units traded; (iii) the parties involved in the cross-trade; and (iv) trade price and the method used to establish the trade price,

``(G) the investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading,

``(H) the investment manager has adopted, and cross-trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program, and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program, and

``(I) the investment manager has designated an individual responsible for periodically reviewing such purchases and sales to ensure compliance with the written policies and

procedures described in subparagraph (H), and following such review, the individual shall issue an annual written report no later than 90 days following the period to which it relates signed under penalty of perjury to the plan fiduciary who authorized cross trading under subparagraph (D) describing the steps performed during the course of the review, the level of compliance, and any specific instances of non-compliance.

The written report under subparagraph (I) shall also notify the plan fiduciary of the plan's right to terminate participation in the investment manager's cross-trading program at any time.''.

(2) Amendments of internal revenue code of 1986.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemptions), as amended by subsection (e), is amended by striking ``or'' at the end of paragraph (20), by striking the period at the end of paragraph (21) and inserting ``, or'', and by adding at the end the following new paragraph:

``(22) any transaction described in subsection (c)(1)(A) involving the purchase and sale of a security between a plan and any other account managed by the same investment manager, if--

``(A) the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available,

``(B) the transaction is effected at the independent current market price of the security (within the meaning of section 270.17a-7(b) of title 17, Code of Federal Regulations),

``(C) no brokerage commission, fee (except for customary transfer fees, the fact of which is disclosed pursuant to subparagraph (D)), or other remuneration is paid in connection with the transaction,

``(D) a fiduciary (other than the investment manager engaging in the cross-trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of the parties) the investment manager to engage in cross trades at the investment manager's discretion, after such fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if such disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager described in subparagraph (H),

``(E) each plan participating in the transaction has assets of at least $100,000,000, except that if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group (as defined in section 407(d)(7) of the Employee Retirement Income Security Act of 1974), the master trust has assets of at least $100,000,000,

``(F) the investment manager provides to the plan fiduciary who authorized cross trading under subparagraph (D) a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information, as applicable: (i) the identity of each security bought or sold; (ii) the number of shares or units traded; (iii) the parties involved in the cross-trade; and (iv) trade price and the method used to establish the trade price,

``(G) the investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading,

``(H) the investment manager has adopted, and cross-trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program, and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program, and

``(I) the investment manager has designated an individual responsible for

periodically reviewing such purchases and sales to ensure compliance with the written policies and procedures described in subparagraph (H), and following such review, the individual shall issue an annual written report no later than 90 days following the period to which it relates signed under penalty of perjury to the plan fiduciary who authorized cross trading under subparagraph (D) describing the steps performed during the course of the review, the level of compliance, and any specific instances of non-compliance.

The written report shall also notify the plan fiduciary of the plan's right to terminate participation in the investment manager's cross-trading program at any time.''.

(3) Regulations.--No later than 180 days after the date of the enactment of this Act, the Secretary of Labor, after consultation with the Securities and Exchange Commission, shall issue regulations regarding the content of policies and procedures required to be adopted by an investment manager under section 408(b)(19) of the Employee Retirement Income Security Act of 1974.

(h) Effective Dates.--

(1) In general.--Except as provided in paragraph (2), the amendments made by this section shall apply to transactions occurring after the date of the enactment of this Act.

(2) Bonding rule.--The amendments made by subsection (b) shall apply to plan years beginning after such date.

SEC. 612. CORRECTION PERIOD FOR CERTAIN TRANSACTIONS INVOLVING SECURITIES AND COMMODITIES.

(a) Amendment of Employee Retirement Income Security Act of 1974.--Section 408(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1108(b)), as amended by sections 601 and 611, is further amended by adding at the end the following new paragraph:

``(20)(A) Except as provided in subparagraphs (B) and (C), a transaction described in section 406(a) in connection with the acquisition, holding, or disposition of any security or commodity, if the transaction is corrected before the end of the correction period.

``(B) Subparagraph (A) does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of an employer security (as defined in section 407(d)(1)) or the acquisition, sale, or lease of employer real property (as defined in section 407(d)(2)).

``(C) In the case of any fiduciary or other party in interest (or any other person knowingly participating in such transaction), subparagraph (A) does not apply to any transaction if, at the time the transaction occurs, such fiduciary or party in interest (or other person) knew (or reasonably should have known) that the transaction would (without regard to this paragraph) constitute a violation of section 406(a).

``(D) For purposes of this paragraph, the term `correction period' means, in connection with a fiduciary or party in interest (or other person knowingly participating in the transaction), the 14-day period beginning on the date on which such fiduciary or party in interest (or other person) discovers, or reasonably should have discovered, that the transaction would (without regard to this paragraph) constitute a violation of section 406(a).

``(E) For purposes of this paragraph--

``(i) The term `security' has the meaning given such term by section 475(c)(2) of the Internal Revenue Code of 1986 (without regard to subparagraph (F)(iii) and the last sentence thereof).

``(ii) The term `commodity' has the meaning given such term by section 475(e)(2) of such Code (without regard to subparagraph (D)(iii) thereof).

``(iii) The term `correct' means, with respect to a trans- action--

``(I) to undo the transaction to the extent possible and in any case to make good to the plan or affected account any losses resulting from the transaction, and

``(II) to restore to the plan or affected account any profits made through the use of assets of the plan.''.

(b) Amendment of Internal Revenue Code of 1986.--

(1) In general.--Subsection (d) of section 4975 of the Internal Revenue Code of 1986 (relating to exemptions), as amended by sections 601 and 611, is amended by striking ``or'' at the end of paragraph (21), by striking the period at the end of paragraph (22) and inserting ``, or'', and by adding at the

end the following new paragraph:
``(23) except as provided in subsection (f)(11), a transaction described in subparagraph (A), (B), (C), or (D) of subsection (c)(1) in connection with the acquisition, holding, or disposition of any security or commodity, if the transaction is corrected before the end of the correction period.''.

(2) Special rules relating to correction period.--Subsection (f) of section 4975 of such Code (relating to other definitions and special rules), as amended by sections 601 and 611, is amended by adding at the end the following new paragraph:

``(11) Correction period.--

``(A) In general.--For purposes of subsection (d)(23), the term `correction period' means the 14-day period beginning on the date on which the disqualified person discovers, or reasonably should have discovered, that the transaction would (without regard to this paragraph and subsection (d)(23)) constitute a prohibited transaction.

``(B) Exceptions.--

``(i) Employer securities.--Subsection (d)(23) does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of an employer security (as defined in section 407(d)(1)) or the acquisition, sale, or lease of employer real property (as defined in section 407(d)(2)).

``(ii) Knowing prohibited transaction.--In the case of any disqualified person, subsection (d)(23) does not apply to a transaction if, at the time the transaction is entered into, the disqualified person knew (or reasonably should have known) that the transaction would (without regard to this paragraph) constitute a prohibited transaction.

``(C) Abatement of tax where there is a correction.--If a transaction is not treated as a prohibited transaction by reason of subsection (d)(23), then no tax under subsections (a) and (b) shall be assessed with respect to such transaction, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

``(D) Definitions.--For purposes of this paragraph and subsection (d)(23)--

``(i) Security.--The term `security' has the meaning given such term by section 475(c)(2) (without regard to subparagraph (F)(iii) and the last sentence thereof).

``(ii) Commodity.--The term `commodity' has the meaning given such term by section 475(e)(2) (without regard to subparagraph (D)(iii) thereof).

``(iii) Correct.--The term `correct' means, with respect to a transaction--

``(I) to undo the transaction to the extent possible and in any case to make good to the plan or affected account any losses resulting from the transaction, and

``(II) to restore to the plan or affected account any profits made through the use of assets of the plan.''.

(c) Effective Date.--The amendments made by this section shall apply to any transaction which the fiduciary or disqualified person discovers, or reasonably should have discovered, after the date of the enactment of this Act constitutes a prohibited transaction.

Subtitle C--Fiduciary and Other Rules

SEC. 621. INAPPLICABILITY OF RELIEF FROM FIDUCIARY LIABILITY DURING SUSPENSION OF ABILITY OF PARTICIPANT OR BENEFICIARY TO DIRECT INVESTMENTS.

(a) In General.--Section 404(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1104(c)) is amended--

(1) in paragraph (1)--

(A) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively, and by inserting ``(A)'' after ``(c)(1)'',

(B) in subparagraph (A)(ii) (as redesignated by paragraph (1)), by inserting before the period the following: ``, except that this clause shall not apply in connection with such participant or beneficiary for any blackout period during which the ability of such

participant or beneficiary to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary'', and

(C) by adding at the end the following new subparagraphs:

``(B) If a person referred to in subparagraph (A)(ii) meets the requirements of this title in connection with authorizing and implementing the blackout period, any person who is otherwise a fiduciary shall not be liable under this title for any loss occurring during such period.

``(C) For purposes of this paragraph, the term `blackout period' has the meaning given such term by section 101(i)(7).''; and

(2) by adding at the end the following:

``(4)(A) In any case in which a qualified change in investment options occurs in connection with an individual account plan, a participant or beneficiary shall not be treated for purposes of paragraph (1) as not exercising control over the assets in his account in connection with such change if the requirements of subparagraph (C) are met in connection with such change.

``(B) For purposes of subparagraph (A), the term `qualified change in investment options' means, in connection with an individual account plan, a change in the investment options offered to the participant or beneficiary under the terms of the plan, under which--

``(i) the account of the participant or beneficiary is reallocated among one or more remaining or new investment options which are offered in lieu of one or more investment options offered immediately prior to the effective date of the change, and

``(ii) the stated characteristics of the remaining or new investment options provided under clause (i), including characteristics relating to risk and rate of return, are, as of immediately after the change, reasonably similar to those of the existing investment options as of immediately before the change.

``(C) The requirements of this subparagraph are met in connection with a qualified change in investment options if--

``(i) at least 30 days and no more than 60 days prior to the effective date of the change, the plan administrator furnishes written notice of the change to the participants
and beneficiaries, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant or beneficiary to the contrary, the account of the participant or beneficiary will be invested in the manner described in subparagraph (B),

``(ii) the participant or beneficiary has not provided to the plan administrator, in advance of the effective date of the change, affirmative investment instructions contrary to the change, and

``(iii) the investments under the plan of the participant or beneficiary as in effect immediately prior to the effective date of the change were the product of the exercise by such participant or beneficiary of control over the assets of the account within the meaning of paragraph (1).''.

(b) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

(2) Special rule for collectively
bargained agreements.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act, paragraph (1) shall be applied to benefits pursuant to, and individuals covered by, any such agreement by substituting for ``December 31, 2007'' the earlier of--

(A) the later of--

(i) December 31, 2008, or

(ii) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after such date of enactment), or

(B) December 31, 2009.

SEC. 622. INCREASE IN MAXIMUM BOND AMOUNT.

(a) In General.--Section 412(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1112), as amended by section 611(b), is amended by adding at the end the following: ``In the case of a plan that holds employer securities (within the meaning of section 407(d)(1)),

this subsection shall be applied by substituting `$1,000,000' for `$500,000' each place it appears.''.

(b) Effective Date.--The amendment made by this section shall apply to plan years beginning after December 31, 2007.

SEC. 623. INCREASE IN PENALTIES FOR COERCIVE INTERFERENCE WITH EXERCISE OF ERISA RIGHTS.

(a) In General.--Section 511 of the Employment Retirement Income Security Act of 1974 (29 U.S.C. 1141) is amended--

(1) by striking ``$10,000'' and inserting ``$100,000'', and

(2) by striking ``one year'' and inserting ``10 years''.

(b) Effective Date.--The amendments made by this section shall apply to violations occurring on and after the date of the enactment of this Act.

SEC. 624. TREATMENT OF INVESTMENT OF ASSETS BY PLAN WHERE PARTICIPANT FAILS TO EXERCISE INVESTMENT ELECTION.

(a) In General.--Section 404(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1104(c)), as amended by section 622, is amended by adding at the end the following new paragraph:

``(5) Default investment arrangements.--

``(A) In general.--For purposes of paragraph (1), a participant in an individual account plan meeting the notice requirements of subparagraph (B) shall be treated as exercising control over the assets in the account with respect to the amount of contributions and earnings which, in the absence of an investment election by the participant, are invested by the plan in accordance with regulations prescribed by the Secretary. The regulations under this subparagraph shall provide guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a blend of both.

``(B) Notice requirements.--

``(i) In general.--The requirements of this subparagraph are met if each participant--

``(I) receives, within a reasonable period of time before each plan year, a notice explaining the employee's right under the plan to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election by the participant, such contributions and earnings will be invested, and

``(II) has a reasonable period of time after receipt of such notice and before the beginning of the plan year to make such designation.

``(ii) Form of notice.--The requirements of clauses (i) and (ii) of section 401(k)(12)(D) of the Internal Revenue Code of 1986 shall apply with respect to the notices described in this subparagraph.''.

(b) Effective Date.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2006.

(2) Regulations.--Final regulations under section 404(c)(5)(A) of the Employee Retirement Income Security Act of 1974 (as added by this section) shall be issued no later than 6 months after the date of the enactment of this Act.

SEC. 625. CLARIFICATION OF FIDUCIARY RULES.

(a) In General.--Not later than 1 year after the date of the enactment of this Act, the Secretary of Labor shall issue final regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan to a participant or beneficiary--

(1) is not subject to the safest available annuity standard under Interpretive Bulletin 95-1 (29 CFR 2509.95-1), and

(2) is subject to all otherwise applicable fiduciary standards.

(b) Effective Date.--This section shall take effect on the date of enactment of this Act.

TITLE VII--BENEFIT ACCRUAL STANDARDS

SEC. 701. BENEFIT ACCRUAL STANDARDS.

(a) Amendments to the Employee Retirement Income Security Act of 1974.--

(1) Rules relating to reduction in rate of benefit accrual.--Section 204(b) of the Employee Retirement Income

Security Act of 1974 (29 U.S.C. 1054(b)) is amended by adding at the end the following new paragraph:

``(5) Special rules relating to age.--

``(A) Comparison to similarly situated younger individual.--

``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H)(i) if a participant's accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant.

``(ii) Similarly situated.--For purposes of this subparagraph, a participant is similarly situated to any other individual if such participant is identical to such other individual in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age.

``(iii) Disregard of subsidized early retirement benefits.--In determining the accrued benefit as of any date for purposes of this clause, the subsidized portion of any early retirement benefit or retirement-type subsidy shall be disregarded.

``(iv) Accrued benefit.--For purposes of this subparagraph, the accrued benefit may, under the terms of the plan, be expressed as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation.

``(B) Applicable defined benefit plans.--

``(i) Interest credits.--

``(I) In general.--An applicable defined benefit plan shall be treated as failing to meet the requirements of paragraph (1)(H) unless the terms of the plan provide that any interest credit (or an equivalent amount) for any plan year shall be at a rate which is not greater than a market rate of return. A plan shall not be treated as failing to meet the requirements of this subclause merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return.

``(II) Preservation of capital.--An interest credit (or an equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account.

``(III) Market rate of return.--The Secretary of the Treasury may provide by regulation for rules governing the calculation of a market rate of return for purposes of subclause (I) and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of subclause (I).

``(ii) Special rule for plan conversions.--If, after June 29, 2005, an applicable plan amendment is adopted, the plan shall be treated as failing to meet the requirements of paragraph (1)(H) unless the requirements of clause (iii) are met with respect to each individual who was a participant in the plan immediately before the adoption of the amendment.

``(iii) Rate of benefit accrual.--Subject to clause (iv), the requirements of this clause are met with respect to any participant if the accrued benefit of the participant under the terms of the plan as in effect after the amendment is not less than the sum of--

``(I) the participant's accrued benefit for years of service before the

effective date of the amendment,
determined under the terms of the plan
as in effect before the amendment, plus
``(II) the participant's accrued
benefit for years of service after the
effective date of the amendment,
determined under the terms of the plan
as in effect after the amendment.
``(iv) Special rules for early retirement
subsidies.--For purposes of clause (iii)(I), the
plan shall credit the accumulation account or
similar amount with the amount of any early
retirement benefit or retirement-type subsidy for
the plan year in which the participant retires if,
as of such time, the participant has met the age,
years of service, and other requirements under the
plan for entitlement to such benefit or subsidy.
``(v) Applicable plan amendment.--For purposes
of this subparagraph--
``(I) In general.--The term
`applicable plan amendment' means an
amendment to a defined benefit plan
which has the effect of converting the
plan to an applicable defined benefit
plan.
``(II) Special rule for coordinated
benefits.--If the benefits of 2 or more
defined benefit plans established or
maintained by an employer are
coordinated in such a manner as to have
the effect of the adoption of an
amendment described in subclause (I),
the sponsor of the defined benefit plan
or plans providing for such coordination
shall be treated as having adopted such
a plan amendment as of the date such
coordination begins.
``(III) Multiple amendments.--
The Secretary of
the Treasury shall issue regulations to
prevent the avoidance of the purposes of
this subparagraph
through the use of 2 or more plan
amendments rather than a single
amendment.
``(IV) Applicable defined benefit
plan.--For purposes of this
subparagraph, the term `applicable
defined benefit plan' has the meaning
given such term by section 203(f)(3).
``(vi) Termination requirements.--An
applicable defined benefit plan shall not be
treated as meeting the requirements of clause (i)
unless the plan provides that, upon the
termination of the plan--
``(I) if the interest credit rate
(or an equivalent amount) under the plan
is a variable rate, the rate of interest
used to determine accrued benefits under
the plan shall be equal to the average
of the rates of interest used under the
plan during the 5-year period ending on
the termination date, and
``(II) the interest rate and
mortality table used to determine the
amount of any benefit under the plan
payable in the form of an annuity
payable at normal retirement age shall
be the rate and table specified under
the plan for such purpose as of the
termination date, except that if such
interest rate is a variable rate, the
interest rate shall be determined under
the rules of subclause (I).
``(C) Certain offsets permitted.--A plan shall not
be treated as failing to meet the requirements of
paragraph (1)(H)(i) solely because the plan provides
offsets against benefits under the plan to the extent
such offsets are allowable in applying the requirements
of section 401(a) of the Internal Revenue Code of 1986.
``(D) Permitted disparities in plan contributions or
benefits.--A plan shall not be treated as failing to

meet the requirements of paragraph (1)(H) solely because the plan provides a disparity in contributions or benefits with respect to which the requirements of section 401(l) of the Internal Revenue Code of 1986 are met.

``(E) Indexing permitted.--

``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H) solely because the plan provides for indexing of accrued benefits under the plan.

``(ii) Protection against loss.--Except in the case of any benefit provided in the form of a variable annuity, clause (i) shall not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing.

``(iii) Indexing.--For purposes of this subparagraph, the term `indexing' means, in connection with an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology.

``(F) Early retirement benefit or retirement-type subsidy.--For purposes of this paragraph, the terms `early retirement benefit' and `retirement-type subsidy' have the meaning given such terms in subsection (g)(2)(A).

``(G) Benefit accrued to date.--For purposes of this paragraph, any reference to the accrued benefit shall be a reference to such benefit accrued to date.''.

(2) Determinations of accrued benefit as balance of benefit account or equivalent amounts.--Section 203 of such Act (29 U.S.C. 1053) is amended by adding at the end the following new subsection:

``(f) Special Rules for Plans Computing Accrued Benefits by Reference to Hypothetical Account Balance or Equivalent Amounts.--

``(1) In general.--An applicable defined benefit plan shall not be treated as failing to meet--

``(A) subject to paragraph (2), the requirements of subsection (a)(2), or

``(B) the requirements of section 204(c) or section 205(g) with respect to contributions other than employee contributions,

solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in the hypothetical account described in paragraph (3) or as an accumulated percentage of the participant's final average compensation.

``(2) 3-year vesting.--In the case of an applicable defined benefit plan, such plan shall be treated as meeting the requirements of subsection (a)(2) only if an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

``(3) Applicable defined benefit plan and related rules.--For purposes of this subsection--

``(A) In general.--The term `applicable defined benefit plan' means a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation.

``(B) Regulations to include similar plans.--The Secretary of the Treasury shall issue regulations which include in the definition of an applicable defined benefit plan any defined benefit plan (or any portion of such a plan) which has an effect similar to an applicable defined benefit plan.''.

(b) Amendments to the Internal Revenue Code of 1986.--

(1) Rules relating to reduction in rate of benefit accrual.--Subsection (b) of section 411 of the Internal Revenue Code of 1986 is amended by adding at the end the following new paragraph:

``(5) Special rules relating to age.--

``(A) Comparison to similarly situated younger individual.--

``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H)(i) if a participant's accrued benefit, as determined as of any date under the terms of the

plan, would be
equal to or greater than that of any similarly situated, younger individual who is or could be a participant.

``(ii) Similarly situated.--For purposes of this subparagraph, a participant is similarly situated to any other individual if such participant is identical to such other individual in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age.

``(iii) Disregard of subsidized early retirement benefits.--In determining the accrued benefit as of any date for purposes of this clause, the subsidized portion of any early retirement benefit or retirement-type subsidy shall be disregarded.

``(iv) Accrued benefit.--For purposes of this subparagraph, the accrued benefit may, under the terms of the plan, be expressed as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation.

``(B) Applicable defined benefit plans.--

``(i) Interest credits.--

``(I) In general.--An applicable defined benefit plan shall be treated as failing to meet the requirements of paragraph (1)(H) unless the terms of the plan provide that any interest credit (or an equivalent amount) for any plan year shall be at a rate which is not greater than a market rate of return. A plan shall not be treated as failing to meet the requirements of this subclause merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return.

``(II) Preservation of capital.--An interest credit (or an equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account.

``(III) Market rate of return.--The Secretary may provide by regulation for rules governing the calculation of a market rate of return for purposes of subclause (I) and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of subclause (I).

``(ii) Special rule for plan conversions.--If, after June 29, 2005, an applicable plan amendment is adopted, the plan shall be treated as failing to meet the requirements of paragraph (1)(H) unless the requirements of clause (iii) are met with respect to each individual who was a participant in the plan immediately before the adoption of the amendment.

``(iii) Rate of benefit accrual.--Subject to clause (iv), the requirements of this clause are met with respect to any participant if the accrued benefit of
the participant under the terms of the plan as in effect after the amendment is not less than the sum of--

``(I) the participant's accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect before the amendment, plus

``(II) the participant's accrued benefit for years of service after the effective date of the amendment, determined under the terms of the plan

as in effect after the amendment.
``(iv) Special rules for early retirement subsidies.--For purposes of clause (iii)(I), the plan shall credit the accumulation account or similar amount with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy.
``(v) Applicable plan amendment.--For purposes of this subparagraph--
``(I) In general.--The term `applicable plan amendment' means an amendment to a defined benefit plan which has the effect of converting the plan to an applicable defined benefit plan.
``(II) Special rule for coordinated benefits.--If the benefits of 2 or more defined benefit plans established or maintained by an employer are coordinated in such a manner as to have the effect of the adoption of an amendment described in subclause (I), the sponsor of the defined benefit plan or plans providing for such coordination shall be treated as having adopted such a plan amendment as of the date such coordination begins.
``(III) Multiple amendments.--
The Secretary
shall issue regulations to prevent the avoidance of the purposes of this subparagraph through the use of 2 or more plan amendments rather than a single amendment.
``(IV) Applicable defined benefit plan.--For purposes of this subparagraph, the term `applicable defined benefit plan' has the meaning given such term by section 411(a)(13).
``(vi) Termination requirements.--An applicable defined benefit plan shall not be treated as meeting the requirements of clause (i) unless the plan provides that, upon the termination of the plan--
``(I) if the interest credit rate (or an equivalent amount) under the plan is a variable rate, the rate of interest used to determine accrued benefits under the plan shall be equal to the average of the rates of interest used under the plan during the 5-year period ending on the termination date, and
``(II) the interest rate and mortality table used to determine the amount of any benefit under the plan payable in the form of an annuity payable at normal retirement age shall be the rate and table specified under the plan for such purpose as of the termination date, except that if such interest rate is a variable rate, the interest rate shall be determined under the rules of subclause (I).
``(C) Certain offsets permitted.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H)(i) solely because the plan provides offsets against benefits under the plan to the extent such offsets are allowable in applying the requirements of section 401(a).
``(D) Permitted disparities in plan contributions or benefits.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H) solely because the plan provides a disparity in contributions or benefits with respect to which the requirements of section 401(l) are met.
``(E) Indexing permitted.--
``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1)(H) solely because the plan provides for

indexing of accrued benefits under the plan.
``(ii) Protection against loss.--Except in the case of any benefit provided in the form of a variable annuity, clause (i) shall not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing.
``(iii) Indexing.--For purposes of this subparagraph, the term `indexing' means, in connection with an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology.
``(F) Early retirement benefit or retirement-type subsidy.--For purposes of this paragraph, the terms `early retirement benefit' and `retirement-type subsidy' have the meaning given such terms in subsection (d)(6)(B)(i).
``(G) Benefit accrued to date.--For purposes of this paragraph, any reference to the accrued benefit shall be a reference to such benefit accrued to date.''.
(2) Determinations of accrued benefit as balance of benefit account or equivalent amounts.--Subsection (a) of section 411 of such Code is amended by adding at the end the following new paragraph:
``(13) Special rules for plans computing accrued benefits by reference to hypothetical account balance or equivalent amounts.--
``(A) In general.--An applicable defined benefit plan shall not be treated as failing to meet--
``(i) subject to paragraph (2), the requirements of subsection (a)(2), or
``(ii) the requirements of subsection (c) or section 417(e) with respect to contributions other than employee contributions,
solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the
terms of the plan, equal to the amount expressed as the balance in the hypothetical account described in paragraph (3) or as an accumulated percentage of the participant's final average compensation.
``(B) 3-year vesting.--In the case of an applicable defined benefit plan, such plan shall be treated as meeting the requirements of subsection (a)(2) only if an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.
``(C) Applicable defined benefit plan and related rules.--For purposes of this subsection--
``(i) In general.--The term `applicable defined benefit plan' means a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation.
``(ii) Regulations to include similar plans.--The Secretary shall issue regulations which include in the definition of an applicable defined benefit plan any defined benefit plan (or any portion of such a plan) which has an effect similar to an applicable defined benefit plan.''.
(c) Amendments to Age Discrimination in Employment Act.--Section 4(i) of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623(i)) is amended by adding at the end the following new paragraph:
``(10) Special rules relating to age.--
``(A) Comparison to similarly situated younger individual.--
``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1) if a participant's accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant.
``(ii) Similarly situated.--For purposes of this subparagraph, a participant is similarly situated to any other individual if such participant is identical to such other individual in every respect (including period of service,

compensation, position, date of hire, work history, and any other respect) except for age.

``(iii) Disregard of subsidized early retirement benefits.--In determining the accrued benefit as of any date for purposes of this clause, the subsidized portion of any early retirement benefit or retirement-type subsidy shall be disregarded.

``(iv) Accrued benefit.--For purposes of this subparagraph, the accrued benefit may, under the terms of the plan, be expressed as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation.

``(B) Applicable defined benefit plans.--

``(i) Interest credits.--

``(I) In general.--An applicable defined benefit plan shall be treated as failing to meet the requirements of paragraph (1) unless the terms of the plan provide that any interest credit (or an equivalent amount) for any plan year shall be at a rate which is not greater than a market rate of return. A plan shall not be treated as failing to meet the requirements of this subclause merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate of return that is equal to the greater of a fixed or variable rate of return.

``(II) Preservation of capital.--An interest credit (or an equivalent amount) of less than zero shall in no event result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account.

``(III) Market rate of return.--The Secretary of the Treasury may provide by regulation for rules governing the calculation of a market rate of return for purposes of subclause (I) and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return meeting the requirements of subclause (I).

``(ii) Special rule for plan conversions.--If, after June 29, 2005, an applicable plan amendment is adopted, the plan shall be treated as failing to meet the requirements of paragraph (1)(H) unless the requirements of clause (iii) are met with respect to each individual who was a participant in the plan immediately before the adoption of the amendment.

``(iii) Rate of benefit accrual.--Subject to clause (iv), the requirements of this clause are met with respect to any participant if the accrued benefit of the participant under the terms of the plan as in effect after the amendment is not less than the sum of--

``(I) the participant's accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect before the amendment, plus

``(II) the participant's accrued benefit for years of service after the effective date of the amendment, determined under the terms of the plan as in effect after the amendment.

``(iv) Special rules for early retirement subsidies.--For purposes of clause (iii)(I), the plan shall credit the accumulation account or similar amount with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy.

``(v) Applicable plan amendment.--For purposes of this subparagraph--

``(I) In general.--The term `applicable plan amendment' means an amendment to a defined benefit plan which has the effect of converting the plan to an applicable defined benefit plan.

``(II) Special rule for coordinated benefits.--If the benefits of 2 or more defined benefit plans established or maintained by an employer are coordinated in such a manner as to have the effect of the adoption of an amendment described in subclause (I), the sponsor of the defined benefit plan or plans providing for such coordination shall be treated as having adopted such a plan amendment as of the date such coordination begins.

``(III) Multiple amendments.--The Secretary of the Treasury shall issue regulations to prevent the avoidance of the purposes of this subparagraph through the use of 2 or more plan amendments rather than a single amendment.

``(IV) Applicable defined benefit plan.--For purposes of this subparagraph, the term `applicable defined benefit plan' has the meaning given such term by section 203(f)(3) of the Employee Retirement Income Security Act of 1974.

``(vi) Termination requirements.--An applicable defined benefit plan shall not be treated as meeting the requirements of clause (i) unless the plan provides that, upon the termination of the plan--

``(I) if the interest credit rate (or an equivalent amount) under the plan is a variable rate, the rate of interest used to determine accrued benefits under the plan shall be equal to the average of the rates of interest used under the plan during the 5-year period ending on the termination date, and

``(II) the interest rate and mortality table used to determine the amount of any benefit under the plan payable in the form of an annuity payable at normal retirement age shall be the rate and table specified under the plan for such purpose as of the termination date, except that if such interest rate is a variable rate, the interest rate shall be determined under the rules of subclause (I).

``(C) Certain offsets permitted.--A plan shall not be treated as failing to meet the requirements of paragraph (1) solely because the plan provides offsets against benefits under the plan to the extent such offsets are allowable in applying the requirements of section 401(a) of the Internal Revenue Code of 1986.

``(D) Permitted disparities in plan contributions or benefits.--A plan shall not be treated as failing to meet the requirements of paragraph (1) solely because the plan provides a disparity in contributions or benefits with respect to which the requirements of section 401(l) of the Internal Revenue Code of 1986 are met.

``(E) Indexing permitted.--

``(i) In general.--A plan shall not be treated as failing to meet the requirements of paragraph (1) solely because the plan provides for indexing of accrued benefits under the plan.

``(ii) Protection against loss.--Except in the case of any benefit provided in the form of a variable annuity, clause (i) shall not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing.

``(iii) Indexing.--For purposes of this subparagraph, the term `indexing' means, in connection with an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology.

``(F) Early retirement benefit or retirement-type subsidy.--For purposes of this paragraph, the terms `early retirement benefit' and `retirement-type subsidy' have the meaning given such terms in section 203(g)(2)(A) of the Employee Retirement Income Security Act of 1974.

``(G) Benefit accrued to date.--For purposes of this paragraph, any reference to the accrued benefit shall be a reference to such benefit accrued to date.''.

(d) No Inference.--Nothing in the amendments made by this section shall be construed to create an inference with respect to--

(1) the treatment of applicable defined benefit plans or conversions to applicable defined benefit plans under sections 204(b)(1)(H) of the Employee Retirement Income Security Act of 1974, 4(i)(1) of the Age Discrimination in Employment Act of 1967, and 411(b)(1)(H) of the Internal Revenue Code of 1986, as in effect before such amendments, or

(2) the determination of whether an applicable defined benefit plan fails to meet the requirements of sections 203(a)(2), 204(c), or 204(g) of the Employee Retirement Income Security Act of 1974 or sections 411(a)(2), 411(c), or 417(e) of such Code, as in effect before such amendments, solely because the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the amount expressed as the balance in a hypothetical account or as an accumulated percentage of the participant's final average compensation.

For purposes of this subsection, the term ``applicable defined benefit plan'' has the meaning given such term by section 203(f)(3) of the Employee Retirement Income Security Act of 1974 and section 411(a)(13)(C) of such Code, as in effect after such amendments.

(e) Effective Date.--

(1) In general.--The amendments made by this section shall apply to periods beginning on or after June 29, 2005.

(2) Present value of accrued benefit.--The amendments made by subsections (a)(2) and (b)(2) shall apply to distributions made after the date of the enactment of this Act.

(3) Vesting and interest credit requirements.--In the case of a plan in existence on June 29, 2005, the requirements of clause (i) of section 411(b)(5)(B) of the Internal Revenue Code of 1986, clause (i) of section 204(b)(5)(B) of the Employee Retirement Income Security Act of 1974, and clause (i) of section 4(i)(10)(B) of the Age Discrimination in Employment Act of 1967 (as added by this Act) and the requirements of 203(f)(2) of the Employee Retirement Income Security Act of 1974 and section 411(a)(13)(B) of the Internal Revenue Code of 1986 (as so added) shall, for purposes of applying the amendments made by subsections (a) and (b), apply to years beginning after December 31, 2007, unless the plan sponsor elects the application of such requirements for any period after June 29, 2005, and before the first year beginning after December 31, 2007.

(4) Special rule for collectively bargained plans.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act, the requirements described in paragraph (3) shall, for purposes of applying the amendments made by subsections (a) and (b), not apply to plan years beginning before--

(A) the earlier of--

(i) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after such date of enactment), or

(ii) January 1, 2008, or

(B) January 1, 2010.

(5) Conversions.--The requirements of clause (ii) of section 411(b)(5)(B) of the Internal Revenue Code of 1986, clause (ii) of section 204(b)(5)(B) of the Employee Retirement Income Security Act of 1974, and clause (ii) of section 4(i)(10)(B) of the Age Discrimination in Employment Act of 1967 (as added by this Act), shall apply to plan amendments adopted after, and taking effect after, June 29, 2005, except that the plan sponsor may elect to have such amendments apply to plan amendments adopted before, and taking effect after, such date.

SEC. 702. REGULATIONS RELATING TO

MERGERS AND ACQUISITIONS.

The Secretary of the Treasury or his delegate shall, not later than 12 months after the date of the enactment of this Act, prescribe regulations for the application of the amendments made by, and the provisions of, this title in cases where the conversion of a plan to an applicable defined benefit plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar transaction.

TITLE VIII--PENSION RELATED REVENUE PROVISIONS

Subtitle A--Deduction Limitations

SEC. 801. INCREASE IN DEDUCTION LIMIT FOR SINGLE-EMPLOYER PLANS.

(a) In General.--Section 404 of the Internal Revenue Code of 1986 (relating to deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan) is amended--

(1) in subsection (a)(1)(A), by inserting ``in the case of a defined benefit plan other than a multiemployer plan, in an amount determined under subsection (o), and in the case of any other plan'' after ``section 501(a),'', and

(2) by inserting at the end the following new subsection:

``(o) Deduction Limit for Single-Employer Plans.--For purposes of subsection (a)(1)(A)--

``(1) In general.--In the case of a defined benefit plan to which subsection (a)(1)(A) applies (other than a multiemployer plan), the amount determined under this subsection for any taxable year shall be equal to the greater of--

``(A) the sum of the amounts determined under paragraph (2) with respect to each plan year ending with or within the taxable year, or

``(B) the sum of the minimum required contributions under section 430 for such plan years.

``(2) Determination of amount.--

``(A) In general.--The amount determined under this paragraph for any plan year shall be equal to the excess (if any) of--

``(i) the sum of--

``(I) the funding target for the plan year,

``(II) the target normal cost for the plan year, and

``(III) the cushion amount for the plan year, over

``(ii) the value (determined under section 430(g)(2)) of the assets of the plan which are held by the plan as of the valuation date for the plan year.

``(B) Special rule for certain employers.--If section 430(i) does not apply to a plan for a plan year, the amount determined under subparagraph (A)(i) for the plan year shall in no event be less than the sum of--

``(i) the funding target for the plan year (determined as if section 430(i) applied to the plan), plus

``(ii) the target normal cost for the plan year (as so determined).

``(3) Cushion amount.--For purposes of paragraph (2)(A)(i)(III)--

``(A) In general.--The cushion amount for any plan year is the sum of--

``(i) 50 percent of the funding target for the plan year, and

``(ii) the amount by which the funding target for the plan year would increase if the plan were to take into account--

``(I) increases in compensation which are expected to occur in succeeding plan years, or

``(II) if the plan does not base benefits for service to date on compensation, increases in benefits which are expected to occur in succeeding plan years (determined on the basis of the average annual increase in benefits over the 6 immediately preceding plan years).

``(B) Limitations.--

``(i) In general.--In making the computation under subparagraph (A)(ii), the plan's actuary shall assume that the limitations under subsection (l) and section 415(b) shall apply.

``(ii) Expected increases.--In the case of a plan year during which a plan is covered under section 4021 of the Employee Retirement Income Security Act of 1974, the plan's actuary may, notwithstanding subsection (l), take into account increases in the limitations which are expected to occur in succeeding plan years.

``(4) Special rules for plans with 100 or fewer participants.--

``(A) In general.--For purposes of determining the amount under paragraph (3) for any plan year, in the case of a plan which has 100 or fewer participants for the plan year, the liability of the plan attributable to benefit increases for highly compensated employees (as defined in section 414(q)) resulting from a plan amendment which is made or becomes effective, whichever is later, within the last 2 years shall not be taken into account in determining the target liability.

``(B) Rule for determining number of participants.--For purposes of determining the number of plan participants, all defined benefit plans maintained by the same employer (or any member of such employer's controlled group (within the meaning of section 412(f)(4))) shall be treated as one plan, but only participants of such member or employer shall be taken into account.

``(5) Special rule for terminating plans.--In the case of a plan which, subject to section 4041 of the Employee Retirement Income Security Act of 1974, terminates during the plan year, the amount determined under paragraph (2) shall in no event be less than the amount required to make the plan sufficient for benefit liabilities (within the meaning of section 4041(d) of such Act).

``(6) Actuarial assumptions.--Any computation under this subsection for any plan year shall use the same actuarial assumptions which are used for the plan year under section 430.

``(7) Definitions.--Any term used in this subsection which is also used in section 430 shall have the same meaning given such term by section 430.''.

(b) Exception From Limitation on Deduction Where Combination of Defined Contribution and Defined Benefit Plans.--Section 404(a)(7)(C) of such Code, as amended by this Act, is amended by adding at the end the following new clause:

``(iv) Guaranteed plans.--In applying this paragraph, any single-employer plan covered under section 4021 of the Employee Retirement Income Security Act of 1974 shall not be taken into account.''.

(c) Technical and Conforming Amendments.--

(1) The last sentence of section 404(a)(1)(A) of such Code is amended by striking ``section 412'' each place it appears and inserting ``section 431''.

(2) Section 404(a)(1)(B) of such Code is amended--

(A) by striking ``In the case of a plan'' and inserting ``In the case of a multiemployer plan'',

(B) by striking ``section 412(c)(7)'' each place it appears and inserting ``section 431(c)(6)'',

(C) by striking ``section 412(c)(7)(B)'' and inserting ``section 431(c)(6)(A)(ii)'',

(D) by striking ``section 412(c)(7)(A)'' and inserting ``section 431(c)(6)(A)(i)'', and

(E) by striking ``section 412'' and inserting ``section 431''.

(3) Section 404(a)(7) of such Code, as amended by this Act, is amended--

(A) by adding at the end of subparagraph (A) the following new sentence: ``In the case of a defined benefit plan which is a single employer plan, the amount necessary to satisfy the minimum funding standard provided by section 412 shall not be less than the plan's funding shortfall determined under section 430.'', and

(B) by striking subparagraph (D) and inserting:

``(D) Insurance contract plans.--For purposes of this paragraph, a plan described in section 412(e)(3) shall be treated as a defined benefit plan.''.

(4) Section 404A(g)(3)(A) of such Code is amended by striking ``paragraphs (3) and (7) of section 412(c)'' and inserting ``paragraphs (3) and (6) of section 431(c)''.

(d) Special Rule for 2006 and 2007.--

(1) In general.--Clause (i) of section 404(a)(1)(D) of the Internal Revenue Code of 1986

(relating to special rule in case of certain plans) is amended by striking ``section 412(l)'' and inserting ``section 412(l)(8)(A), except that section 412(l)(8)(A) shall be applied for purposes of this clause by substituting `150 percent (140 percent in the case of a multiemployer plan) of current liability' for `the current liability' in clause (i).''.

(2) Conforming amendment.--Section 404(a)(1) of the Internal Revenue Code of 1986 is amended by striking subparagraph (F).

(e) Effective Dates.--

(1) In general.--Except as provided in paragraph (2), the amendments made by this section shall apply to years beginning after December 31, 2007.

(2) Special rules.--The amendments made by subsection (d) shall apply to years beginning after December 31, 2005.

SEC. 802. DEDUCTION LIMITS FOR MULTIEMPLOYER PLANS.

(a) Increase in Deduction.--Section 404(a)(1)(D) of the Internal Revenue Code of 1986, as amended by this Act, is amended to read as follows:

``(D) Amount determined on basis of unfunded current liability.--In the case of a defined benefit plan which is a multiemployer plan, except as provided in regulations, the maximum amount deductible under the limitations of this paragraph shall not be less than the excess (if any) of--

``(i) 140 percent of the current liability of the plan determined under section 431(c)(6)(C), over

``(ii) the value of the plan's assets determined under section 431(c)(2).''.

(b) Effective Date.--The amendment made by subsection (a) shall apply to years beginning after December 31, 2007.

SEC. 803. UPDATING DEDUCTION RULES FOR COMBINATION OF PLANS.

(a) In General.--Subparagraph (C) of section 404(a)(7) of the Internal Revenue Code of 1986 (relating to limitation on deductions where combination of defined contribution plan and defined benefit plan) is amended by adding after clause (ii) the following new clause:

``(iii) Limitation.--In the case of employer contributions to 1 or more defined contribution plans, this paragraph shall only apply to the extent that such contributions exceed 6 percent of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under such plans. For purposes of this clause, amounts carried over from preceding taxable years under subparagraph (B) shall be treated as employer contributions to 1 or more defined contributions to the extent attributable to employer contributions to such plans in such preceding taxable years.''.

(b) Exception From Limitation on Deduction Where Combination of Defined Contribution and Defined Benefit Plans.--Section 404(a)(7)(C) of such Code, as amended by this Act, is amended by adding at the end the following new clause:

``(v) Multiemployer plans.--In applying this paragraph, any multiemployer plan shall not be taken into account.''.

(c) Conforming Amendment.--Subparagraph (A) of section 4972(c)(6) of such Code (relating to nondeductible contributions) is amended to read as follows:

``(A) so much of the contributions to 1 or more defined contribution plans which are not deductible when contributed solely because of section 404(a)(7) as does not exceed the amount of contributions described in section 401(m)(4)(A), or''.

(d) Effective Date.--The amendments made by this section shall apply to contributions for taxable years beginning after December 31, 2005.

Subtitle B--Certain Pension Provisions Made Permanent

SEC. 811. PENSIONS AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS OF ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001 MADE PERMANENT.

Title IX of the Economic Growth and Tax Relief Reconciliation Act of 2001 shall not apply to the provisions of, and amendments made by, subtitles A through F of title VI of such Act (relating to pension and individual retirement arrangement provisions).

SEC. 812. SAVER'S CREDIT.

Section 25B of the Internal Revenue Code of 1986 (relating to elective deferrals and IRA contributions by certain individuals) is amended by striking subsection (h).

Subtitle C--Improvements in Portability, Distribution, and Contribution

Rules

SEC. 821. CLARIFICATIONS REGARDING PURCHASE OF PERMISSIVE SERVICE CREDIT.

(a) In General.--Section 415(n) of the Internal Revenue Code of 1986 (relating to special rules for the purchase of permissive service credit) is amended--

(1) by striking ``an employee'' in paragraph (1) and inserting ``a participant'', and

(2) by adding at the end of paragraph (3)(A) the following new flush sentence:

``Such term may include service credit for periods for which there is no performance of service, and, notwithstanding clause (ii), may include service credited in order to provide an increased benefit for service credit which a participant is receiving under the plan.''.

(b) Special Rules for Trustee-to-Trustee Transfers.--Section 415(n)(3) of such Code is amended by adding at the end the following new subparagraph:

``(D) Special rules for trustee-to-trustee transfers.--In the case of a trustee-to-trustee transfer to which section 403(b)(13)(A) or 457(e)(17)(A) applies (without regard to whether the transfer is made between plans maintained by the same employer)--

``(i) the limitations of subparagraph (B) shall not apply in determining whether the transfer is for the purchase of permissive service credit, and

``(ii) the distribution rules applicable under this title to the defined benefit governmental plan to which any amounts are so transferred shall apply to such amounts and any benefits attributable to such amounts.''.

(c) Nonqualified Service.--Section 415(n)(3) of such Code is amended--

(1) by striking ``permissive service credit attributable to nonqualified service'' each place it appears in subparagraph (B) and inserting ``nonqualified service credit'',

(2) by striking so much of subparagraph (C) as precedes clause (i) and inserting:

``(C) Nonqualified service credit.--For purposes of subparagraph (B), the term `nonqualified service credit' means permissive service credit other than that allowed with respect to--'', and

(3) by striking ``elementary or secondary education (through grade 12), as determined under State law'' in subparagraph (C)(ii) and inserting ``elementary or secondary education (through grade 12), or a comparable level of education, as determined under the applicable law of the jurisdiction in which the service was performed''.

(d) Effective Dates.--

(1) In general.--The amendments made by subsections (a) and (c) shall take effect as if included in the amendments made by section 1526 of the Taxpayer Relief Act of 1997.

(2) Subsection (b).--The amendments made by subsection (b) shall take effect as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

SEC. 822. ALLOW ROLLOVER OF AFTER-TAX AMOUNTS IN ANNUITY CONTRACTS.

(a) In General.--Subparagraph (A) of section 402(c)(2) (relating to the maximum amount which may be rolled over) is amended--

(1) by striking ``which is part of a plan which is a defined contribution plan and which agrees to separately account'' and inserting ``or to an annuity contract described in section 403(b) and such trust or contract provides for separate accounting''; and

(2) by inserting ``(and earnings thereon)'' after ``so transferred''.

(b) Effective Date.--The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 2006.

SEC. 823. CLARIFICATION OF MINIMUM DISTRIBUTION RULES FOR GOVERNMENTAL PLANS.

The Secretary of the Treasury shall issue regulations under which a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986) shall, for all years to which section 401(a)(9) of such Code applies to such plan, be treated as having complied with such section 401(a)(9) if such plan complies with a reasonable good faith interpretation of such section 401(a)(9).

SEC. 824. ALLOW DIRECT ROLLOVERS FROM RETIREMENT PLANS TO ROTH IRAS.

(a) In General.--Subsection (e) of section 408A of the Internal Revenue Code of 1986 (defining qualified rollover contribution) is amended to read as follows:

``(e) Qualified Rollover Contribution.--For purposes of this section, the term `qualified rollover contribution' means a rollover contribution--

``(1) to a Roth IRA from another such account,

``(2) from an eligible retirement plan, but only if--

``(A) in the case of an individual retirement plan, such rollover contribution meets the requirements of section 408(d)(3), and

``(B) in the case of any eligible retirement plan (as defined in section 402(c)(8)(B) other than clauses (i) and (ii) thereof), such rollover contribution meets the requirements of section 402(c), 403(b)(8), or 457(e)(16), as applicable.

For purposes of section 408(d)(3)(B), there shall be disregarded any qualified rollover contribution from an individual retirement plan (other than a Roth IRA) to a Roth IRA.''.

(b) Conforming Amendments.--

(1) Section 408A(c)(3)(B) of such Code, as in effect before the Tax Increase Prevention and Reconciliation Act of 2005, is amended--

(A) in the text by striking ``individual retirement plan'' and inserting ``an eligible retirement plan (as defined by section 402(c)(8)(B))'', and

(B) in the heading by striking ``IRA'' the first place it appears and inserting ``eligible retirement plan''.

(2) Section 408A(d)(3) of such Code is amended--

(A) in subparagraph (A), by striking ``section 408(d)(3)'' inserting ``sections 402(c), 403(b)(8), 408(d)(3), and 457(e)(16)'',

(B) in subparagraph (B), by striking ``individual retirement plan'' and inserting ``eligible retirement plan (as defined by section 402(c)(8)(B))'',

(C) in subparagraph (D), by inserting ``or 6047'' after ``408(i)'',

(D) in subparagraph (D), by striking ``or both'' and inserting ``persons subject to section 6047(d)(1), or all of the foregoing persons'', and

(E) in the heading, by striking ``IRA'' the first place it appears and inserting ``eligible retirement plan''.

(c) Effective Date.--The amendments made by this section shall apply to distributions after December 31, 2007.

SEC. 825. ELIGIBILITY FOR PARTICIPATION IN RETIREMENT PLANS.

An individual shall not be precluded from participating in an eligible deferred compensation plan by reason of having received a distribution under section 457(e)(9) of the Internal Revenue Code of 1986, as in effect prior to the enactment of the Small Business Job Protection Act of 1996.

SEC. 826. MODIFICATIONS OF RULES GOVERNING HARDSHIPS AND UNFORSEEN FINANCIAL EMERGENCIES.

Within 180 days after the date of the enactment of this Act, the Secretary of the Treasury shall modify the rules for determining whether a participant has had a hardship for purposes of section 401(k)(2)(B)(i)(IV) of the Internal Revenue Code of 1986 to provide that if an event (including the occurrence of a medical expense) would constitute a hardship under the plan if it occurred with respect to the participant's spouse or dependent (as defined in section 152 of such Code), such event shall, to the extent permitted under a plan, constitute a hardship if it occurs with respect to a person who is a beneficiary under the plan with respect to the participant. The Secretary of the Treasury shall issue similar rules for purposes of determining whether a participant has had--

(1) a hardship for purposes of section 403(b)(11)(B) of such Code; or

(2) an unforeseen financial emergency for purposes of sections 409A(a)(2)(A)(vi), 409A(a)(2)(B)(ii), and 457(d)(1)(A)(iii) of such Code.

SEC. 827. PENALTY-FREE WITHDRAWALS FROM RETIREMENT PLANS FOR INDIVIDUALS CALLED TO ACTIVE DUTY FOR AT LEAST 179 DAYS.

(a) In General.--Paragraph (2) of section 72(t) of the Internal Revenue Code of 1986 (relating to 10-percent additional tax on early distributions from qualified retirement plans) is amended by adding at the end the following new subparagraph:

``(G) Distributions from retirement plans to individuals called to active duty.--

``(i) In general.--Any qualified reservist distribution.

``(ii) Amount distributed may be repaid.--Any individual who receives a qualified reservist distribution may, at any time during the 2-year period beginning on the day after the end of the active duty period, make one or more contributions to an individual retirement plan of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to individual retirement plans shall not apply to any contribution made pursuant to the preceding sentence. No deduction shall be allowed for any contribution pursuant to this clause.

``(iii) Qualified reservist distribution.--For purposes of this subparagraph, the term `qualified reservist distribution' means any distribution to an individual if--

``(I) such distribution is from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii),

``(II) such individual was (by reason of being a member of a reserve component (as defined in section 101 of title 37, United States Code)) ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and

``(III) such distribution is made during the period beginning on the date of such order or call and ending at the close of the active duty period.

``(iv) Application of subparagraph.--This subparagraph applies to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007. In no event shall the 2-year period referred to in clause (ii) end before the date which is 2 years after the date of the enactment of this subparagraph.''.

(b) Conforming Amendments.--

(1) Section 401(k)(2)(B)(i) of such Code is amended by striking ``or'' at the end of subclause (III), by striking ``and'' at the end of subclause (IV) and inserting ``or'', and by inserting after subclause (IV) the following new subclause:

``(V) in the case of a qualified reservist distribution (as defined in section 72(t)(2)(G)(iii)), the date on which a period referred to in subclause (III) of such section begins, and''.

(2) Section 403(b)(7)(A)(ii) of such Code is amended by inserting ``(unless such amount is a distribution to which section 72(t)(2)(G) applies)'' after ``distributee''.

(3) Section 403(b)(11) of such Code is amended by striking ``or'' at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ``, or'', and by inserting after subparagraph (B) the following new subparagraph:

``(C) for distributions to which section 72(t)(2)(G) applies.''.

(c) Effective Date; Waiver of Limitations.--

(1) Effective date.--The amendment made by this section shall apply to distributions after September 11, 2001.

(2) Waiver of limitations.--If refund or credit of any overpayment of tax resulting from the amendments made by this section is prevented at any time before the close of the 1-year period beginning on the date of the enactment of this Act by the operation of any law or rule of law (including res judicata), such refund or credit may nevertheless be made or allowed if claim therefor is filed before the close of such period.

SEC. 828. WAIVER OF 10 PERCENT EARLY WITHDRAWAL PENALTY TAX ON CERTAIN DISTRIBUTIONS OF PENSION PLANS FOR PUBLIC SAFETY EMPLOYEES.

(a) In General.--Section 72(t) of the Internal Revenue Code of 1986 (relating to subsection not to apply to certain distributions) is amended by adding at the end the following new paragraph:

``(10) Distributions to qualified public safety employees in governmental plans.--

``(A) In general.--In the case of a distribution to

a qualified public safety employee from a governmental plan (within the meaning of section 414(d)) which is a defined benefit plan, paragraph (2)(A)(v) shall be applied by substituting `age 50' for `age 55'.

``(B) Qualified public safety employee.--For purposes of this paragraph, the term `qualified public safety employee' means any employee of a State or political subdivision of a State who provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.''.

(b) Effective Date.--The amendment made by this section shall apply to distributions after the date of the enactment of this Act.

SEC. 829. ALLOW ROLLOVERS BY NONSPOUSE BENEFICIARIES OF CERTAIN RETIREMENT PLAN DISTRIBUTIONS.

(a) In General.--

(1) Qualified plans.--Section 402(c) of the Internal Revenue Code of 1986 (relating to rollovers from exempt trusts) is amended by adding at the end the following new paragraph:

``(11) Distributions to inherited individual retirement plan of nonspouse beneficiary.--

``(A) In general.--If, with respect to any portion of a distribution from an eligible retirement plan of a deceased employee, a direct trustee-to-trustee transfer is made to an individual retirement plan described in clause (i) or (ii) of paragraph (8)(B) established for the purposes of receiving the distribution on behalf of an individual who is a designated beneficiary (as defined by section 401(a)(9)(E)) of the employee and who is not the surviving spouse of the employee--

``(i) the transfer shall be treated as an eligible rollover distribution for purposes of this subsection,

``(ii) the individual retirement plan shall be treated as an inherited individual retirement account or individual retirement annuity (within the meaning of section 408(d)(3)(C)) for purposes of this title, and

``(iii) section 401(a)(9)(B) (other than clause (iv) thereof) shall apply to such plan.

``(B) Certain trusts treated as beneficiaries.--For purposes of this paragraph, to the extent provided in rules prescribed by the Secretary, a trust maintained for the benefit of one or more designated beneficiaries shall be treated in the same manner as a trust designated beneficiary.''.

(2) Section 403(a) plans.--Subparagraph (B) of section 403(a)(4) of such Code (relating to rollover amounts) is amended by inserting ``and (11)'' after ``(7)''.

(3) Section 403(b) plans.--Subparagraph (B) of section 403(b)(8) of such Code (relating to rollover amounts) is amended by striking ``and (9)'' and inserting ``, (9), and (11)''.

(4) Section 457 plans.--Subparagraph (B) of section 457(e)(16) of such Code (relating to rollover amounts) is amended by striking ``and (9)'' and inserting ``, (9), and (11)''.

(b) Effective Date.--The amendments made by this section shall apply to distributions after December 31, 2006.

SEC. 830. DIRECT PAYMENT OF TAX REFUNDS TO INDIVIDUAL RETIREMENT PLANS.

(a) In General.--The Secretary of the Treasury (or the Secretary's delegate) shall make available a form (or modify existing forms) for use by individuals to direct that a portion of any refund of overpayment of tax imposed by chapter 1 of the Internal Revenue Code of 1986 be paid directly to an individual retirement plan (as defined in section 7701(a)(37) of such Code) of such individual.

(b) Effective Date.--The form required by subsection (a) shall be made available for taxable years beginning after December 31, 2006.

SEC. 831. ALLOWANCE OF ADDITIONAL IRA PAYMENTS IN CERTAIN BANKRUPTCY CASES.

(a) Allowance of Contributions.--Section 219(b)(5) of the Internal Revenue Code of 1986 (relating to deductible amount) is amended by redesignating subparagraph (C) as subparagraph (D) and by inserting after subparagraph (B) the following new subparagraph:

``(C) Catchup contributions for certain individuals.--

``(i) In general.--In the case of an applicable individual who elects to make a qualified retirement contribution in addition to

the deductible amount determined under
subparagraph (A)--
``(I) the deductible amount for any
taxable year shall be increased by an
amount equal to 3 times the applicable
amount determined under subparagraph (B)
for such taxable year, and
``(II) subparagraph (B) shall not
apply.
``(ii) Applicable individual.--For purposes of
this subparagraph, the term `applicable
individual' means, with respect to any taxable
year, any individual who was a qualified
participant in a qualified cash or
deferred arrangement (as defined in section
401(k)) of an employer described in clause (iii)
under which the employer matched at least 50
percent of the employee's contributions to such
arrangement with stock of such employer.
``(iii) Employer described.--An employer is
described in this clause if, in any taxable year
preceding the taxable year described in clause
(ii)--
``(I) such employer (or any
controlling corporation of such
employer) was a debtor in a case under
title 11 of the United States Code, or
similar Federal or State law, and
``(II) such employer (or any other
person) was subject to an indictment or
conviction resulting from business
transactions related to such case.
``(iv) Qualified participant.--For purposes of
clause (ii), the term `qualified participant'
means any applicable individual who was a
participant in the cash or deferred arrangement
described in such clause on the date that is 6
months before the filing of the case described in
clause (iii).
``(v) Termination.--This subparagraph shall
not apply to taxable years beginning after
December 31, 2009.''.

(b) Effective Date.--The amendments made
by this section shall apply to taxable years beginning after December
31, 2006.

SEC. 832. DETERMINATION OF AVERAGE COMPENSATION FOR SECTION 415 LIMITS.

(a) In General.--Section 415(b)(3) of the Internal Revenue Code of
1986 is amended by striking ``both was an active
participant in the plan and''.

(b) Effective Date.--The amendment made
by this section shall apply to years beginning after December 31, 2005.

SEC. 833. INFLATION INDEXING OF GROSS INCOME LIMITATIONS ON CERTAIN
RETIREMENT SAVINGS INCENTIVES.

(a) Saver's Credit.--Subsection (b) of section 25B of the Internal
Revenue Code of 1986 is amended to read as follows:
``(b) Applicable Percentage.--For purposes of this section--
``(1) Joint returns.--In the case of a joint return, the
applicable percentage is--
``(A) if the adjusted gross income of the taxpayer
is not over $30,000, 50 percent,
``(B) if the adjusted gross income of the taxpayer
is over $30,000 but not over $32,500, 20 percent,
``(C) if the adjusted gross income of the taxpayer
is over $32,500 but not over $50,000, 10 percent, and
``(D) if the adjusted gross income of the taxpayer
is over $50,000, zero percent.
``(2) Other returns.--In the case of--
``(A) a head of household, the applicable percentage
shall be determined under paragraph (1) except that such
paragraph shall be applied by substituting for each
dollar amount therein (as adjusted under paragraph (3))
a dollar amount equal to 75 percent of such dollar
amount, and
``(B) any taxpayer not
described in paragraph (1) or subparagraph (A), the
applicable percentage shall be determined under
paragraph (1) except that such paragraph shall be
applied by substituting for each dollar amount therein
(as adjusted under paragraph (3)) a dollar amount equal
to 50 percent of such dollar amount.
``(3) Inflation adjustment.--In the case of any taxable year
beginning in a calendar year after 2006, each of the dollar

amounts in paragraph (1) shall be increased by an amount equal to--
``(A) such dollar amount, multiplied by
``(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting `calendar year 2005' for `calendar year 1992' in subparagraph (B) thereof.
Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $500.''.

(b) Deduction of Retirement Contributions for Active Participants.--Section 219(g) of such Code is amended by adding at the end the following new paragraph:

``(8) Inflation adjustment.--In the case of any taxable year beginning in a calendar year after 2006, the dollar amount in the last row of the table contained in paragraph (3)(B)(i), the dollar amount in the last row of the table contained in paragraph (3)(B)(ii), and the dollar amount contained in paragraph (7)(A), shall each be increased by an amount equal to--
``(A) such dollar amount, multiplied by
``(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting `calendar year 2005' for `calendar year 1992' in subparagraph (B) thereof.
Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $1,000.''.

(c) Contribution Limitation for Roth IRAs.--Section 408A(c)(3) of such Code is amended by adding at the end the following new subparagraph:

``(C) Inflation adjustment.--In the case of any taxable year beginning in a calendar year after 2006, the dollar amounts in subclauses (I) and (II) of subparagraph (C)(ii) shall each be increased by an amount equal to--
``(i) such dollar amount, multiplied by
``(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting `calendar year 2005' for `calendar year 1992' in subparagraph (B) thereof.
Any increase determined under the preceding sentence shall be rounded to the nearest multiple of $1,000.''.

(d) Effective Date.--The amendments made by this section shall apply to taxable years beginning after 2006.

Subtitle D--Health and Medical Benefits

SEC. 841. USE OF EXCESS PENSION ASSETS FOR FUTURE RETIREE HEALTH BENEFITS AND COLLECTIVELY BARGAINED RETIREE HEALTH BENEFITS.

(a) In General.--Section 420 of the Internal Revenue Code of 1986 (relating to transfers of excess pension assets to retiree health accounts) is amended by adding at the end the following new subsection:

``(f) Qualified Transfers To Cover Future Retiree Health Costs and Collectively Bargained Retiree Health Benefits.--

``(1) In general.--An employer maintaining a defined benefit plan (other than a multiemployer plan) may, in lieu of a qualified transfer, elect for any taxable year to have the plan make--
``(A) a qualified future transfer, or
``(B) a collectively bargained transfer.
Except as provided in this subsection, a qualified future transfer and a collectively bargained transfer shall be treated for purposes of this title and the Employee Retirement Income Security Act of 1974 as if it were a qualified transfer.

``(2) Qualified future and collectively bargained transfers.--For purposes of this subsection--
``(A) In general.--The terms `qualified future transfer' and `collectively bargained transfer' mean a transfer which meets all of the requirements for a qualified transfer, except that--
``(i) the determination of excess pension assets shall be made under subparagraph (B),
``(ii) the limitation on the amount transferred shall be determined under subparagraph (C),
``(iii) the minimum cost requirements of subsection (c)(3) shall be modified as provided under subparagraph (D), and
``(iv) in the case of a collectively bargained transfer, the requirements of subparagraph (E) shall be met with respect to the transfer.

``(B) Excess pension assets.--
``(i) In general.--In determining excess pension assets for purposes of this subsection, subsection (e)(2) shall be applied by substituting `120 percent' for `125 percent'.
``(ii) Requirement to maintain funded status.--If, as of any valuation date of any plan year in the transfer period, the amount determined under subsection (e)(2)(B) (after application of clause (i)) exceeds the amount determined under subsection (e)(2)(A), either--
``(I) the employer maintaining the plan shall make contributions to the plan in an amount not less than the amount required to reduce such excess to zero as of such date, or
``(II) there is transferred from the health benefits account to the plan an amount not less than the amount required to reduce such excess to zero as of such date.
``(C) Limitation on amount transferred.--Notwithstanding subsection (b)(3), the amount of the excess pension assets which may be transferred--
``(i) in the case of a qualified future transfer shall be equal to the sum of--
``(I) if the transfer period includes the taxable year of the transfer, the amount determined under subsection (b)(3) for such taxable year, plus
``(II) in the case of all other taxable years in the transfer period, the sum of the qualified current retiree health liabilities which the plan reasonably estimates, in accordance with guidance issued by the Secretary, will be incurred for each of such years, and
``(ii) in the case of a collectively bargained transfer, shall not exceed the amount which is reasonably estimated, in accordance with the provisions of the collective bargaining agreement and generally accepted accounting principles, to be the amount the employer maintaining the plan will pay (whether directly or through reimbursement) out of such account during the collectively bargained cost maintenance period for collectively bargained retiree health liabilities.
``(D) Minimum cost requirements.--
``(i) In general.--The requirements of subsection (c)(3) shall be treated as met if--
``(I) in the case of a qualified future transfer, each group health plan or arrangement under which applicable health benefits are provided provides applicable health benefits during the period beginning with the first year of the transfer period and ending with the last day of the 4th year following the transfer period such that the annual average amount of such the applicable employer cost during such period is not less than the applicable employer cost determined under subsection (c)(3)(A) with respect to the transfer, and
``(II) in the case of a collectively bargained transfer, each collectively bargained group health plan under which collectively bargained health benefits are provided provides that the collectively bargained employer cost for each taxable year during the collectively bargained cost maintenance period shall not be less than the amount specified by the collective bargaining agreement.
``(ii) Election to maintain benefits for future transfers.--An employer may elect, in lieu of the requirements of clause (i)(I), to meet the requirements of subsection (c)(3) by meeting the requirements of such subsection (as in effect before the amendments made by section 535 of the

Tax Relief Extension Act of 1999) for each of the
years described in the period under clause (i)(I).
``(iii) Collectively bargained employer
cost.--For purposes of this subparagraph, the term
`collectively bargained employer cost' means the
average cost
per covered individual of providing collectively
bargained retiree health benefits as determined in
accordance with the applicable collective
bargaining agreement. Such agreement may provide
for an appropriate reduction in the collectively
bargained employer cost to take into account any
portion of the collectively bargained retiree
health benefits that is provided or financed by a
government program or other source.
``(E) Special rules for collectively bargained
transfers.--
``(i) In general.--A collectively bargained
transfer shall only include a transfer which--
``(I) is made in accordance with a
collective bargaining agreement,
``(II) before the transfer, the
employer designates, in a written notice
delivered to each employee organization
that is a party to the collective
bargaining agreement, as a collectively
bargained transfer in accordance with
this section, and
``(III) involves a plan maintained
by an employer which, in its taxable
year ending in 2005, provided health
benefits or coverage to retirees and
their spouses and dependents under all
of the benefit plans maintained by the
employer, but only if the aggregate cost
(including administrative expenses) of
such benefits or coverage which would
have been allowable as a deduction to
the employer (if such benefits or
coverage had been provided directly by
the employer and the employer used the
cash receipts and disbursements method
of accounting) is at least 5 percent of
the gross receipts of the employer
(determined in accordance with the last
sentence of subsection
(c)(2)(E)(ii)(II)) for such taxable
year, or a plan maintained by a
successor to such employer.
``(ii) Use of assets.--Any assets transferred
to a health benefits account in a collectively
bargained transfer (and any income allocable
thereto) shall be used only to pay collectively
bargained retiree health liabilities (other than
liabilities of key employees not taken into
account under paragraph (6)(B)(iii)) for the
taxable year of the transfer or for any subsequent
taxable year during the collectively bargained
cost maintenance period (whether directly or
through reimbursement).
``(3) Coordination with other transfers.--In applying
subsection (b)(3) to any subsequent transfer during a taxable
year in a transfer period or collectively bargained cost
maintenance period, qualified current retiree health liabilities
shall be reduced by any such liabilities taken into account with
respect to the qualified future transfer or collectively
bargained transfer to which such period relates.
``(4) Special deduction rules for collectively bargained
transfers.--In the case of a collectively bargained transfer--
``(A) the limitation under subsection (d)(1)(C)
shall not apply, and
``(B) notwithstanding subsection (d)(2), an employer
may contribute an amount to a health benefits account or
welfare benefit fund (as defined in section 419(e)(1))
with respect to collectively bargained retiree health
liabilities for which transferred assets are required to
be used under subsection (c)(1)(B), and the
deductibility of any such contribution shall be governed
by the limits applicable to the deductibility of
contributions to a welfare benefit fund under a
collective bargaining agreement (as determined under
section 419A(f)(5)(A)) without regard to whether such

contributions are made to a health benefits account or welfare benefit fund and without regard to the provisions of section 404 or the other provisions of this section.

The Secretary shall provide rules to ensure that the application of this paragraph does not result in a deduction being allowed more than once for the same contribution or for 2 or more contributions or expenditures relating to the same collectively bargained retiree health liabilities.

``(5) Transfer period.--For purposes of this subsection, the term `transfer period' means, with respect to any transfer, a period of consecutive taxable years (not less than 2) specified in the election under paragraph (1) which begins and ends during the 10-taxable-year period beginning with the taxable year of the transfer.

``(6) Terms relating to collectively bargained transfers.--For purposes of this subsection--

``(A) Collectively bargained cost maintenance period.--The term `collectively bargained cost maintenance period' means, with respect to each covered retiree and his covered spouse and dependents, the shorter of--

``(i) the remaining lifetime of such covered retiree and his covered spouse and dependents, or

``(ii) the period of coverage provided by the collectively bargained health plan (determined as of the date of the collectively bargained transfer) with respect to such covered retiree and his covered spouse and dependents.

``(B) Collectively bargained retiree health liabilities.--

``(i) In general.--The term `collectively bargained retiree health liabilities' means the present value, as of the beginning of a taxable year and determined in accordance with the applicable collective bargaining agreement, of all collectively bargained health benefits (including administrative expenses) for such taxable year and all subsequent taxable years during the collectively bargained cost maintenance period.

``(ii) Reduction for amounts previously set aside.--The amount determined under clause (i) shall be reduced by the value (as of the close of the plan year preceding the year of the collectively bargained transfer) of the assets in all health benefits accounts or welfare benefit funds (as defined in section 419(e)(1)) set aside to pay for the collectively bargained retiree health liabilities.

``(iii) Key employees excluded.--If an employee is a key employee (within the meaning of section 416(I)(1)) with respect to any plan year ending in a taxable year, such employee shall not be taken into account in computing collectively bargained retiree health liabilities for such taxable year or in calculating collectively bargained employer cost under subsection (c)(3)(C).

``(C) Collectively bargained health benefits.--The term `collectively bargained health benefits' means health benefits or coverage which are provided to--

``(i) retired employees who, immediately before the collectively bargained transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan, and their spouses and dependents, and

``(ii) if specified by the provisions of the collective bargaining agreement governing the collectively bargained transfer, active employees who, following their retirement, are entitled to receive such benefits and who are entitled to pension benefits under the plan, and their spouses and dependents.

``(D) Collectively bargained health plan.--The term `collectively bargained health plan' means a group health plan or arrangement for retired employees and their spouses and dependents that is maintained pursuant to 1 or more collective bargaining agreements.''.

(b) Effective Date.--The amendments made by this section shall apply to transfers after the date of the enactment of this Act.

SEC. 842. TRANSFER OF EXCESS PENSION ASSETS TO MULTIEMPLOYER HEALTH

PLAN.

(a) In General.--Section 420 of the Internal Revenue Code of 1986 is amended--

(1) by striking ``(other than a multiemployer plan)'' in subsection (a), and

(2) by adding at the end of subsection (e) the following new paragraph:

``(5) Application to multiemployer plans.--In the case of a multiemployer plan, this section shall be applied to any such plan--

``(A) by treating any reference in this section to an employer as a reference to all employers maintaining the plan (or, if appropriate, the plan sponsor), and

``(B) in accordance with such modifications of this section (and the provisions of this title relating to this section) as the Secretary determines appropriate to reflect the fact the plan is not maintained by a single employer.''.

(b) Effective Date.--The amendment made by this section shall apply to transfers made in taxable years beginning after December 31, 2006.

SEC. 843. ALLOWANCE OF RESERVE FOR MEDICAL BENEFITS OF PLANS SPONSORED BY BONA FIDE ASSOCIATIONS.

(a) In General.--Section 419A(c) of the Internal Revenue Code of 1986 (relating to account limit) is amended by adding at the end the following new paragraph:

``(6) Additional reserve for medical benefits of bona fide association plans.--

``(A) In general.--An applicable account limit for any taxable year may include a reserve in an amount not to exceed 35 percent of the sum of--

``(i) the qualified direct costs, and

``(ii) the change in claims incurred but unpaid,

for such taxable year with respect to medical benefits (other than post-retirement medical benefits).

``(B) Applicable account limit.--For purposes of this subsection, the term `applicable account limit' means an account limit for a qualified asset account with respect to medical benefits provided through a plan maintained by a bona fide association (as defined in section 2791(d)(3) of the Public Health Service Act (42 U.S.C. 300gg-91(d)(3)).''.

(b) Effective Date.--The amendment made by this section shall apply to taxable years beginning after December 31, 2006.

SEC. 844. TREATMENT OF ANNUITY AND LIFE INSURANCE CONTRACTS WITH A LONG-TERM CARE INSURANCE FEATURE.

(a) Exclusion From Gross Income.--Subsection (e) of section 72 of the Internal Revenue Code of 1986 (relating to amounts not received as annuities) is amended by redesignating paragraph (11) as paragraph (12) and by inserting after paragraph (10) the following new paragraph:

``(11) Special rules for certain combination contracts providing long-term care insurance.--Notwithstanding paragraphs (2), (5)(C), and (10), in the case of any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract which is part of or a rider on such annuity or life insurance contract--

``(A) the investment in the contract shall be reduced (but not below zero) by such charge, and

``(B) such charge shall not be includible in gross income.''.

(b) Tax-Free Exchanges Among Certain Insurance Policies.--

(1) Annuity contracts can include qualified long-term care insurance riders.--Paragraph (2) of section 1035(b) of such Code is amended by adding at the end the following new sentence: ``For purposes of the preceding sentence, a contract shall not fail to be treated as an annuity contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.''.

(2) Life insurance contracts can include qualified long-term care insurance riders.--Paragraph (3) of section 1035(b) of such Code is amended by adding at the end the following new sentence: ``For purposes of the preceding sentence, a contract shall not fail to be treated as a life insurance contract solely because a qualified long-term care insurance contract is a part of or a rider on such contract.''.

(3) Expansion of tax-free exchanges of life insurance, endowment, and annuity contracts for long-term care contracts.--Subsection (a) of section 1035 of such Code (relating to certain exchanges of insurance

policies) is amended--
(A) in paragraph (1) by inserting ``or for a qualified long-term care insurance contract'' before the semicolon at the end,
(B) in paragraph (2) by inserting ``, or (C) for a qualified long-term care insurance contract'' before the semicolon at the end, and
(C) in paragraph (3) by inserting ``or for a qualified long-term care insurance contract'' before the period at the end.
(4) Tax-free exchanges of qualified long-term care insurance contract.--Subsection (a) of section 1035 of such Code (relating to certain exchanges of insurance policies) is amended by striking ``or'' at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting ``; or'', and by inserting after paragraph (3) the following new paragraph:
``(4) a qualified long-term care insurance contract for a qualified long-term care insurance contract.''.
(c) Treatment of Coverage Provided as Part of a Life Insurance or Annuity Contract.--Subsection (e) of section 7702B of such Code (relating to treatment of qualified long-term care insurance) is amended to read as follows:
``(e) Treatment of Coverage Provided as Part of a Life Insurance or Annuity Contract.--Except as otherwise provided in regulations prescribed by the Secretary, in the case of any long-term care insurance coverage (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract--
``(1) In general.--This title shall apply as if the portion of the contract providing such coverage is a separate contract.
``(2) Denial of deduction under section 213.--No deduction shall be allowed under section 213(a) for any payment made for coverage under a qualified long-term care insurance contract if such payment is made as a charge against the cash surrender value of a life insurance contract or the cash value of an annuity contract.
``(3) Portion defined.--For purposes of this subsection, the term `portion' means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care insurance coverage.
``(4) Annuity contracts to which paragraph (1) does not apply.--For purposes of this subsection, none of the following shall be treated as an annuity contract:
``(A) A trust described in section 401(a) which is exempt from tax under section 501(a).
``(B) A contract--
``(i) purchased by a trust described in subparagraph (A),
``(ii) purchased as part of a plan described in section 403(a),
``(iii) described in section 403(b),
``(iv) provided for employees of a life insurance company under a plan described in section 818(a)(3), or
``(v) from an individual retirement account or an individual retirement annuity.
``(C) A contract purchased by an employer for the benefit of the employee (or the employee's spouse).
Any dividend described in section 404(k) which is received by a participant or beneficiary shall, for purposes of this paragraph, be treated as paid under a separate contract to which subparagraph (B)(i) applies.''.
(d) Information Reporting.--
(1) Subpart B of part III of subchapter A of chapter 61 of such Code (relating to information concerning transactions with other persons) is amended by adding at the end the following new section:

``SEC. 6050U. CHARGES OR PAYMENTS FOR QUALIFIED LONG-TERM CARE INSURANCE CONTRACTS UNDER COMBINED ARRANGEMENTS.

``(a) Requirement of Reporting.--Any person who makes a charge against the cash value of an annuity contract, or the cash surrender value of a life insurance contract, which is excludible from gross income under section 72(e)(11) shall make a return, according to the forms or regulations prescribed by the Secretary, setting forth--
``(1) the amount of the aggregate of such charges against each such contract for the calendar year,
``(2) the amount of the reduction in the investment in each such contract by reason of such charges, and
``(3) the name, address, and TIN of the individual who is the holder of each such contract.

``(b) Statements To Be Furnished to Persons With Respect to Whom Information Is Required.--Every person required to make a return under subsection (a) shall furnish to each individual whose name is required to be set forth in such return a written statement showing--

``(1) the name, address, and phone number of the information contact of the person making the payments, and

``(2) the information required to be shown on the return with respect to such individual.

The written statement required under the preceding sentence shall be furnished to the individual on or before January 31 of the year following the calendar year for which the return under subsection (a) was required to be made.''.

(2) Penalty for failure to file.--

(A) Return.--Subparagraph (B) of section 6724(d)(1) of such Code is amended by striking ``or'' at the end of clause (xvii), by striking ``and'' at the end of clause (xviii) and inserting ``or'', and by adding at the end the following new clause:

``(xix) section 6050U (relating to charges or payments for qualified long-term care insurance contracts under combined arrangements), and''.

(B) Statement.--Paragraph (2) of section 6724(d) of such Code is amended by striking ``or'' at the end of subparagraph (AA), by striking the period at the end of subparagraph (BB), and by inserting after subparagraph (BB) the following new subparagraph:

``(CC) section 6050U (relating to charges or payments for qualified long-term care insurance contracts under combined arrangements).''.

(3) Clerical amendment.--The table of sections for subpart B of part III of subchapter A of such chapter 61 of such Code is amended by adding at the end the following new item:

``Sec. 6050U. Charges or payments for qualified long-term care insurance contracts under combined arrangements.''.

(e) Treatment of Policy Acquisition Expenses.--Subsection (e) of section 848 of such Code (relating to classification of contracts) is amended by adding at the end the following new paragraph:

``(6) Treatment of certain qualified long-term care insurance contract arrangements.--An annuity or life insurance contract which includes a qualified long-term care insurance contract as a part of or a rider on such annuity or life insurance contract shall be treated as a specified insurance contract not described in subparagraph (A) or (B) of subsection (c)(1).''.

(f) Technical Amendment.--Paragraph (1) of section 7702B(e) of such Code (as in effect before amendment by subsection (c)) is amended by striking ``section'' and inserting ``title''.

(g) Effective Dates.--

(1) In general.--Except as otherwise provided in this subsection, the amendments made by this section shall apply to contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009.

(2) Tax-free exchanges.--The amendments made by subsection (b) shall apply with respect to exchanges occurring after December 31, 2009.

(3) Information reporting.--The amendments made by subsection (d) shall apply to charges made after December 31, 2009.

(4) Policy acquisition expenses.--The amendment made by subsection (e) shall apply to specified policy acquisition expenses determined for taxable years beginning after December 31, 2009.

(5) Technical amendment.--The amendment made by subsection (f) shall take effect as if included in section 321(a) of the Health Insurance Portability and Accountability Act of 1996.

SEC. 845. DISTRIBUTIONS FROM GOVERNMENTAL RETIREMENT PLANS FOR HEALTH AND LONG-TERM CARE INSURANCE FOR PUBLIC SAFETY OFFICERS.

(a) In General.--Section 402 of the Internal Revenue Code of 1986 (relating to taxability of beneficiary of employees' trust) is amended by adding at the end the following new subsection:

``(l) Distributions From Governmental Plans for Health and Long-Term Care Insurance.--

``(1) In general.--In the case of an employee who is an eligible retired public safety officer who makes the election described in paragraph (6) with respect to any taxable year of such employee, gross income of such employee for such taxable year does not include any distribution from an eligible retirement plan to the extent that the aggregate amount of such distributions does not exceed the amount paid by such employee for qualified health insurance premiums of the employee, his spouse, or dependents (as defined in section 152) for such

taxable year.

``(2) Limitation.--The amount which may be excluded from gross income for the taxable year by reason of paragraph (1) shall not exceed $3,000.

``(3) Distributions must otherwise be includible.--

``(A) In general.--An amount shall be treated as a distribution for purposes of paragraph (1) only to the extent that such amount would be includible in gross income without regard to paragraph (1).

``(B) Application of section 72.--Notwithstanding section 72, in determining the extent to which an amount is treated as a distribution for purposes of subparagraph (A), the aggregate amounts distributed from an eligible retirement plan in a taxable year (up to the amount excluded under paragraph (1)) shall be treated as includible in gross income (without regard to subparagraph (A)) to the extent that such amount does not exceed the aggregate amount which would have been so includible if all amounts distributed from all eligible retirement plans were treated as 1 contract for purposes of determining the inclusion of such distribution under section 72. Proper adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent taxable years.

``(4) Definitions.--For purposes of this subsection--

``(A) Eligible retirement plan.--For purposes of paragraph (1), the term `eligible retirement plan' means a governmental plan (within the meaning of section 414(d)) which is described in clause (iii), (iv), (v), or (vi) of subsection (c)(8)(B).

``(B) Eligible retired public safety officer.--The term `eligible retired public safety officer' means an individual who, by reason of disability or attainment of normal retirement age, is separated from service as a public safety officer with the employer who maintains the eligible retirement plan from which distributions subject to paragraph (1) are made.

``(C) Public safety officer.--The term `public safety officer' shall have the same meaning given such term by section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796b(9)(A)).

``(D) Qualified health insurance premiums.--The term `qualified health insurance premiums' means premiums for coverage for the eligible retired public safety officer, his spouse, and dependents, by an accident or health insurance plan or qualified long-term care insurance contract (as defined in section 7702B(b)).

``(5) Special rules.--For purposes of this subsection--

``(A) Direct payment to insurer required.--Paragraph (1) shall only apply to a distribution if payment of the premiums is made directly to the provider of the accident or health insurance plan or qualified long-term care insurance contract by deduction from a distribution from the eligible retirement plan.

``(B) Related plans treated as 1.--All eligible retirement plans of an employer shall be treated as a single plan.

``(6) Election described.--

``(A) In general.--For purposes of paragraph (1), an election is described in this paragraph if the election is made by an employee after separation from service with respect to amounts not distributed from an eligible retirement plan to have amounts from such plan distributed in order to pay for qualified health insurance premiums.

``(B) Special rule.--A plan shall not be treated as violating the requirements of section 401, or as engaging in a prohibited transaction for purposes of section 503(b), merely because it provides for an election with respect to amounts that are otherwise distributable under the plan or merely because of a distribution made pursuant to an election described in subparagraph (A).

``(7) Coordination with medical expense deduction.--The amounts excluded from gross income under paragraph (1) shall not be taken into account under section 213.

``(8) Coordination with deduction for health insurance costs of self-employed individuals.--The amounts excluded from gross income under paragraph (1) shall not be taken into account under section 162(l).''.

(b) Conforming Amendments.--

(1) Section 403(a) of such Code (relating to taxability of beneficiary

under a qualified
annuity plan) is amended by inserting after paragraph (1) the following new paragraph:

``(2) Special rule for health and long-term care insurance.--To the extent provided in section 402(l), paragraph (1) shall not apply to the amount distributed under the contract which is otherwise includible in gross income under this subsection.''.

(2) Section 403(b) of such Code (relating to taxability of beneficiary under annuity purchased by section 501(c)(3) organization or public school) is amended by inserting after paragraph (1) the following new paragraph:

``(2) Special rule for health and long-term care insurance.--To the extent provided in section 402(l), paragraph (1) shall not apply to the amount distributed under the contract which is otherwise includible in gross income under this subsection.''.

(3) Section 457(a) of such Code (relating to year of inclusion in gross income) is amended by adding at the end the following new paragraph:

``(3) Special rule for health and long-term care insurance.--In the case of a plan of an eligible employer described in subsection (e)(1)(A), to the extent provided in section 402(l), paragraph (1) shall not apply to amounts otherwise includible in gross income under this subsection.''.

(c) Effective Date.--The amendments made by this section shall apply to distributions in taxable years beginning after December 31, 2006.

Subtitle E--United States Tax Court Modernization

SEC. 851. COST-OF-LIVING ADJUSTMENTS FOR TAX COURT JUDICIAL SURVIVOR ANNUITIES.

(a) In General.--Subsection (s) of section 7448 of the Internal Revenue Code of 1986 (relating to annuities to surviving spouses and dependent children of judges) is amended to read as follows:

``(s) Increases in Survivor Annuities.--Each time that an increase is made under section 8340(b) of title 5, United States Code, in annuities payable under subchapter III of chapter 83 of that title, each annuity payable from the survivors annuity fund under this section shall be increased at the same time by the same percentage by which annuities are increased under such section 8340(b).''.

(b) Effective Date.--The amendment made by this section shall apply with respect to increases made under section 8340(b) of title 5, United States Code, in annuities payable under subchapter III of chapter 83 of that title, taking effect after the date of the enactment of this Act.

SEC. 852. COST OF LIFE INSURANCE COVERAGE FOR TAX COURT JUDGES AGE 65 OR OVER.

Section 7472 of the Internal Revenue Code of 1986 (relating to expenditures) is amended by inserting after the first sentence the following new sentence: ``Notwithstanding any other provision of law, the Tax Court is authorized to pay on behalf of its judges, age 65 or over, any increase in the cost of Federal Employees' Group Life Insurance imposed after the date of the enactment of the Pension Protection Act of 2006, including any expenses generated by such payments, as authorized by the chief judge in a manner consistent with such payments authorized by the Judicial Conference of the United States pursuant to section 604(a)(5) of title 28, United States Code.''.

SEC. 853. PARTICIPATION OF TAX COURT JUDGES IN THE THRIFT SAVINGS PLAN.

(a) In General.--Section 7447 of the Internal Revenue Code of 1986 (relating to retirement of judges) is amended by adding at the end the following new subsection:

``(j) Thrift Savings Plan.--

``(1) Election to contribute.--

``(A) In general.--A judge of the Tax Court may elect to contribute to the Thrift Savings Fund established by section 8437 of title 5, United States Code.

``(B) Period of election.--An election may be made under this paragraph only during a period provided under section 8432(b) of title 5, United States Code, for individuals subject to chapter 84 of such title.

``(2) Applicability of title 5 provisions.--Except as otherwise provided in this subsection, the provisions of subchapters III and VII of chapter 84 of title 5, United States Code, shall apply with respect to a judge who makes an election under paragraph (1).

``(3) Special rules.--

``(A) Amount contributed.--The amount contributed by a judge to the Thrift Savings Fund in any pay period shall not exceed the maximum percentage of such judge's basic pay for such period as allowable under section

8440f of title 5, United States Code. Basic pay does not include any retired pay paid pursuant to this section.

``(B) Contributions for benefit of judge.--No contributions may be made for the benefit of a judge under section 8432(c) of title 5, United States Code.

``(C) Applicability of section 8433(b) of title 5 whether or not judge retires.--Section 8433(b) of title 5, United States Code, applies with respect to a judge who makes an election under paragraph (1) and who either--

``(i) retires under subsection (b), or

``(ii) ceases to serve as a judge of the Tax Court but does not retire under subsection (b).

Retirement under subsection (b) is a separation from service for purposes of subchapters III and VII of chapter 84 of that title.

``(D) Applicability of section 8351(b)(5) of title 5.--The provisions of section 8351(b)(5) of title 5, United States Code, shall apply with respect to a judge who makes an election under paragraph (1).

``(E) Exception.--
Notwithstanding subparagraph (C), if any judge retires under this section, or resigns without having met the age and service requirements set forth under subsection (b)(2), and such judge's nonforfeitable account balance is less than an amount that the Executive Director of the Federal Retirement Thrift Investment Board prescribes by regulation, the Executive Director shall pay the nonforfeitable account balance to the participant in a single payment.''.

(b) Effective Date.--The amendment made by this section shall take effect on the date of the enactment of this Act, except that United States Tax Court judges may only begin to participate in the Thrift Savings Plan at the next open season beginning after such date.

SEC. 854. ANNUITIES TO SURVIVING SPOUSES AND DEPENDENT CHILDREN OF SPECIAL TRIAL JUDGES OF THE TAX COURT.

(a) Definitions.--Section 7448(a) of the Internal Revenue Code of 1986 (relating to definitions), as amended by this Act, is amended by redesignating paragraphs (5), (6), (7), and (8) as paragraphs (7), (8), (9), and (10), respectively, and by inserting after paragraph (4) the following new paragraphs:

``(5) The term `special trial judge' means a judicial officer appointed pursuant to section 7443A, including any individual receiving an annuity under chapter 83 or 84 of title 5, United States Code, whether or not performing judicial duties under section 7443B.

``(6) The term `special trial judge's salary' means the salary of a special trial judge received under section 7443A(d), any amount received as an annuity under chapter 83 or 84 of title 5, United States Code, and compensation received under section 7443B.''.

(b) Election.--Subsection (b) of section 7448 of such Code (relating to annuities to surviving spouses and dependent children of judges) is amended--

(1) by striking the subsection heading and inserting the following:

``(b) Election.--

``(1) Judges.--'',

(2) by moving the text 2 ems to the right, and

(3) by adding at the end the following new paragraph:

``(2) Special trial judges.--Any special trial judge may by written election filed with the chief judge bring himself or herself within the purview of this section. Such election shall be filed not later than the later of 6 months after--

``(A) 6 months after the date of the enactment of this paragraph,

``(B) the date the judge takes office, or

``(C) the date the judge marries.''.

(c) Conforming Amendments.--

(1) The heading of section 7448 of such Code is amended by inserting ``and special trial judges'' after ``judges''.

(2) The item relating to section 7448 in the table of sections for part I of subchapter C of chapter 76 of such Code is amended by inserting ``and special trial judges'' after ``judges''.

(3) Subsections (c)(1), (d), (f), (g), (h), (j), (m), (n), and (u) of section 7448 of such Code, as amended by this Act, are each amended--

(A) by inserting ``or special trial judge'' after ``judge'' each place it appears other than in the phrase

``chief judge'', and
(B) by inserting ``or special trial judge's'' after ``judge's'' each place it appears.
(4) Section 7448(c) of such Code is amended--
(A) in paragraph (1), by striking ``Tax Court judges'' and inserting ``Tax Court judicial officers'', and
(B) in paragraph (2)--
(i) in subparagraph (A), by inserting ``and section 7443A(d)'' after ``(a)(4)'', and
(ii) in subparagraph (B), by striking ``subsection (a)(4)'' and inserting ``subsection (a)(4) and (a)(6)''.
(5) Section 7448(j)(1) of such Code is amended--
(A) in subparagraph (A), by striking ``service or retired'' and inserting ``service, retired'', and by inserting ``, or receiving any annuity under chapter 83 or 84 of title 5, United States Code,'' after ``section 7447'', and
(B) in the last sentence, by striking ``subsections (a) (6) and (7)'' and inserting ``paragraphs (8) and (9) of subsection (a)''.
(6) Section 7448(m)(1) of such Code, as amended by this Act, is amended by inserting ``or any annuity under chapter 83 or 84 of title 5, United States Code'' after ``7447(d)''.
(7) Section 7448(n) of such Code is amended by inserting ``his years of service pursuant to any appointment under section 7443A,'' after ``of the Tax Court,''.
(8) Section 3121(b)(5)(E) of such Code is amended by inserting ``or special trial judge'' before ``of the United States Tax Court''.
(9) Section 210(a)(5)(E) of the Social Security Act is amended by inserting ``or special trial judge'' before ``of the United States Tax Court''.

SEC. 855. JURISDICTION OF TAX COURT OVER COLLECTION DUE PROCESS CASES.

(a) In General.--Paragraph (1) of section 6330(d) of the Internal Revenue Code of 1986 (relating to proceeding after hearing) is amended to read as follows:
``(1) Judicial review of determination.--
The person may, within 30 days of a determination under this section, appeal such determination to the Tax Court (and the Tax Court shall have jurisdiction with respect to such matter).''.
(b) Effective Date.--The amendment made by this section shall apply to determinations made after the date which is 60 days after the date of the enactment of this Act.

SEC. 856. PROVISIONS FOR RECALL.

(a) In General.--Part I of subchapter C of chapter 76 of the Internal Revenue Code of 1986 is amended by inserting after section 7443A the following new section:

``SEC. 7443B. RECALL OF SPECIAL TRIAL JUDGES OF THE TAX COURT.

``(a) Recalling of Retired Special Trial Judges.--Any individual who has retired pursuant to the applicable provisions of title 5, United States Code, upon reaching the age and service requirements established therein, may at or after retirement be called upon by the chief judge of the Tax Court to perform such judicial duties with the Tax Court as may be requested of such individual for any period or periods specified by the chief judge; except that in the case of any such individual--
``(1) the aggregate of such periods in any 1 calendar year shall not (without such individual's consent) exceed 90 calendar days, and
``(2) such individual shall be relieved of performing such duties during any period in which illness or disability precludes the performance of such duties.
Any act, or failure to act, by an individual performing judicial duties pursuant to this subsection shall have the same force and effect as if it were the act (or failure to act) of a special trial judge of the Tax Court.
``(b) Compensation.--For the year in which a period of recall occurs, the special trial judge shall receive, in addition to the annuity provided under the applicable provisions of title 5, United States Code, an amount equal to the difference between that annuity and the current salary of the office to which the special trial judge is recalled.
``(c) Rulemaking Authority.--The provisions of this section may be implemented under such rules as may be promulgated by the Tax Court.''.
(b) Conforming Amendment.--The table of sections for part I of subchapter C of chapter 76 of such Code is amended by inserting after the item relating to section 7443A the following new item:
``Sec. 7443B. Recall of special trial judges of the Tax Court.''.

SEC. 857. AUTHORITY FOR SPECIAL TRIAL JUDGES TO HEAR AND DECIDE CERTAIN

EMPLOYMENT STATUS CASES.

(a) In General.--Section 7443A(b) of the Internal Revenue Code of 1986 (relating to proceedings which may be assigned to special trial judges) is amended by striking ``and'' at the end of paragraph (4), by redesignating paragraph (5) as paragraph (6), and by inserting after paragraph (4) the following new paragraph:

``(5) any proceeding under section 7436(c), and''.

(b) Conforming Amendment.--Section 7443A(c) of such Code is amended by striking ``or (4)'' and inserting ``(4), or (5)''.

(c) Effective Date.--The amendments made by this section shall apply to any proceeding under section 7436(c) of the Internal Revenue Code of 1986 with respect to which a decision has not become final (as determined under section 7481 of such Code) before the date of the enactment of this Act.

SEC. 858. CONFIRMATION OF AUTHORITY OF TAX COURT TO APPLY DOCTRINE OF EQUITABLE RECOUPMENT.

(a) Confirmation of Authority of Tax Court To Apply Doctrine of Equitable Recoupment.--Section 6214(b) of the Internal Revenue Code of 1986 (relating to jurisdiction over other years and quarters) is amended by adding at the end the following new sentence: ``Notwithstanding the preceding sentence, the Tax Court may apply the doctrine of equitable recoupment to the same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims.''.

(b) Effective Date.--The amendment made by this section shall apply to any action or proceeding in the United States Tax Court with respect to which a decision has not become final (as determined under section 7481 of the Internal Revenue Code of 1986) as of the date of the enactment of this Act.

SEC. 859. TAX COURT FILING FEE IN ALL CASES COMMENCED BY FILING PETITION.

(a) In General.--Section 7451 of the Internal Revenue Code of 1986 (relating to fee for filing a Tax Court petition) is amended by striking all that follows ``petition'' and inserting a period.

(b) Effective Date.--The amendment made by this section shall take effect on the date of the enactment of this Act.

SEC. 860. EXPANDED USE OF TAX COURT PRACTICE FEE FOR PRO SE TAXPAYERS.

(a) In General.--Section 7475(b) of the Internal Revenue Code of 1986 (relating to use of fees) is amended by inserting before the period at the end ``and to provide services to pro se taxpayers''.

(b) Effective Date.--The amendment made by this section shall take effect on the date of the enactment of this Act.

Subtitle F--Other Provisions

SEC. 861. EXTENSION TO ALL GOVERNMENTAL PLANS OF CURRENT MORATORIUM ON APPLICATION OF CERTAIN NONDISCRIMINATION RULES APPLICABLE TO STATE AND LOCAL PLANS.

(a) In General.--

(1) Subparagraph (G) of section 401(a)(5) and subparagraph (G) of section 401(a)(26) of the Internal Revenue Code of 1986 are each amended by striking ``section 414(d))'' and all that follows and inserting ``section 414(d)).''.

(2) Subparagraph (G) of section 401(k)(3) of such Code and paragraph (2) of section 1505(d) of the Taxpayer Relief Act of 1997 (Public Law 105-34; 111 Stat. 1063) are each amended by striking ``maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof)''.

(b) Conforming Amendments.--

(1) The heading of subparagraph (G) of section 401(a)(5) of the Internal Revenue Code of 1986 is amended by striking ``State and local governmental'' and inserting ``Governmental''.

(2) The heading of subparagraph (G) of section 401(a)(26) of such Code is amended by striking ``Exception for state and local'' and inserting ``Exception for''.

(3) Section 401(k)(3)(G) of such Code is amended by inserting ``Governmental plan.--'' after ``(G)''.

(c) Effective Date.--The amendments made by this section shall apply to any year beginning after the date of the enactment of this Act.

SEC. 862. ELIMINATION OF AGGREGATE LIMIT FOR USAGE OF EXCESS FUNDS FROM BLACK LUNG DISABILITY TRUSTS.

(a) In General.--So much of section 501(c)(21)(C) of the Internal Revenue Code of 1986 (relating to black lung disability trusts) as precedes the last sentence is amended to read as follows:

``(C) Payments described in subparagraph (A)(i)(IV) may be made from such trust during a taxable year only to the extent that the aggregate amount of such payments during such taxable year does not exceed the excess (if any), as of the close of the preceding taxable year, of--

``(i) the fair market value of the assets of the trust, over
``(ii) 110 percent of the present value of the liability described in subparagraph (A)(i)(I) of such person.''.

(b) Effective Date.--The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

SEC. 863. TREATMENT OF DEATH BENEFITS FROM CORPORATE-OWNED LIFE INSURANCE.

(a) In General.--Section 101 of the Internal Revenue Code of 1986 (relating to certain death benefits) is amended by adding at the end the following new subsection:

``(j) Treatment of Certain Employer-Owned Life Insurance Contracts.--

``(1) General rule.--In the case of an employer-owned life insurance contract, the amount excluded from gross income of an applicable policyholder by reason of paragraph (1) of subsection (a) shall not exceed an amount equal to the sum of the premiums and other amounts paid by the policyholder for the contract.

``(2) Exceptions.--In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of paragraph (4) are met, paragraph (1) shall not apply to any of the following:

``(A) Exceptions based on insured's status.--Any amount received by reason of the death of an insured who, with respect to an applicable policyholder--

``(i) was an employee at any time during the 12-month period before the insured's death, or

``(ii) is, at the time the contract is issued--

``(I) a director,

``(II) a highly compensated employee within the meaning of section 414(q) (without regard to paragraph (1)(B)(ii) thereof), or

``(III) a highly compensated individual within the meaning of section 105(h)(5), except that `35 percent' shall be substituted for `25 percent' in subparagraph (C) thereof.

``(B) Exception for amounts paid to insured's heirs.--Any amount received by reason of the death of an insured to the extent--

``(i) the amount is paid to a member of the family (within the meaning of section 267(c)(4)) of the insured, any individual who is the designated beneficiary of the insured under the contract (other than the applicable policyholder), a trust established for the benefit of any such member of the family or designated beneficiary, or the estate of the insured, or

``(ii) the amount is used to purchase an equity (or capital or profits) interest in the applicable policyholder from any person described in clause (i).

``(3) Employer-owned life insurance contract.--

``(A) In general.--For purposes of this subsection, the term `employer-owned life insurance contract' means a life insurance contract which--

``(i) is owned by a person engaged in a trade or business and under which such person (or a related person described in subparagraph (B)(ii)) is directly or indirectly a beneficiary under the contract, and

``(ii) covers the life of an insured who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

For purposes of the preceding sentence, if coverage for each insured under a master contract is treated as a separate contract for purposes of sections 817(h), 7702, and 7702A, coverage for each such insured shall be treated as a separate contract.

``(B) Applicable policyholder.--For purposes of this subsection--

``(i) In general.--The term `applicable policyholder' means, with respect to any employer-owned life insurance contract, the person described in subparagraph (A)(i) which owns the contract.

``(ii) Related persons.--The term `applicable

policyholder' includes any person which--
``(I) bears a relationship to the person described in clause (i) which is specified in section 267(b) or 707(b)(1), or
``(II) is engaged in trades or businesses with such person which are under common control (within the meaning of subsection (a) or (b) of section 52).

``(4) Notice and consent requirements.--The notice and consent requirements of this paragraph are met if, before the issuance of the contract, the employee--

``(A) is notified in writing that the applicable policyholder intends to insure the employee's life and the maximum face amount for which the employee could be insured at the time the contract was issued,

``(B) provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and

``(C) is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable upon the death of the employee.

``(5) Definitions.--For purposes of this subsection--

``(A) Employee.--The term `employee' includes an officer, director, and highly compensated employee (within the meaning of section 414(q)).

``(B) Insured.--The term `insured' means, with respect to an employer-owned life insurance contract, an individual covered by the contract who is a United States citizen or resident. In the case of a contract covering the joint lives of 2 individuals, references to an insured include both of the individuals.''.

(b) Reporting Requirements.--Subpart A of part III of subchapter A of chapter 61 of the Internal Revenue Code of 1986 (relating to information concerning persons subject to special provisions) is amended by inserting after section 6039H the following new section:

``SEC. 6039I. RETURNS AND RECORDS WITH RESPECT TO EMPLOYER-OWNED LIFE INSURANCE CONTRACTS.

``(a) In General.--Every applicable policyholder owning 1 or more employer-owned life insurance contracts issued after the date of the enactment of this section shall file a return (at such time and in such manner as the Secretary shall by regulations prescribe) showing for each year such contracts are owned--

``(1) the number of employees of the applicable policyholder at the end of the year,

``(2) the number of such employees insured under such contracts at the end of the year,

``(3) the total amount of insurance in force at the end of the year under such contracts,

``(4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which the policyholder is engaged, and

``(5) that the applicable policyholder has a valid consent for each insured employee (or, if all such consents are not obtained, the number of insured employees for whom such consent was not obtained).

``(b) Recordkeeping Requirement.--Each applicable policyholder owning 1 or more employer-owned life insurance contracts during any year shall keep such records as may be necessary for purposes of determining whether the requirements of this section and section 101(j) are met.

``(c) Definitions.--Any term used in this section which is used in section 101(j) shall have the same meaning given such term by section 101(j).''.

(c) Conforming Amendments.--

(1) Paragraph (1) of section 101(a) of the Internal Revenue Code of 1986 is amended by striking ``and subsection (f)'' and inserting ``subsection (f), and subsection (j)''.

(2) The table of sections for subpart A of part III of subchapter A of chapter 61 of such Code is amended by inserting after the item relating to section 6039H the following new item:

``Sec. 6039I. Returns and records with respect to employer-owned life insurance contracts.''.

(d) Effective Date.--The amendments made by this section shall apply to life insurance contracts issued after the date of the enactment of this Act, except for a contract issued after such date pursuant to an exchange described in section 1035 of the Internal Revenue Code of 1986 for a contract issued on or prior to that date. For purposes of the preceding sentence, any material increase in the death benefit or other material change shall cause the contract to be treated as a new contract except that, in the

case of a master contract (within the meaning of section 264(f)(4)(E) of such Code), the addition of covered lives shall be treated as a new contract only with respect to such additional covered lives.

SEC. 864. TREATMENT OF TEST ROOM SUPERVISORS AND PROCTORS WHO ASSIST IN THE ADMINISTRATION OF COLLEGE ENTRANCE AND PLACEMENT EXAMS.

(a) In General.--Section 530 of the Revenue Reconciliation Act of 1978 is amended by adding at the end the following new subsection:

``(f) Treatment of Test Room Supervisors and Proctors Who Assist in the Administration of College Entrance and Placement Exams.--

``(1) In general.--In the case of an individual described in paragraph (2) who is providing services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations, this section shall be applied to such services performed after December 31, 2006 (and remuneration paid for such services) without regard to subsection (a)(3) thereof.

``(2) Applicability.--An individual is described in this paragraph if the individual--

``(A) is providing the services described in subsection (a) to an organization described in section 501(c), and exempt from tax under section 501(a), of the Internal Revenue Code of 1986, and

``(B) is not otherwise treated as an employee of such organization for purposes of subtitle C of such Code (relating to employment taxes).''.

(b) Effective Date.--The amendment made by this section shall apply to remuneration for services performed after December 31, 2006.

SEC. 865. GRANDFATHER RULE FOR CHURCH PLANS WHICH SELF-ANNUITIZE.

(a) In General.--In the case of any plan year ending after the date of the enactment of this Act, annuity payments provided with respect to any account maintained for a participant or beneficiary under a qualified church plan shall not fail to satisfy the requirements of section 401(a)(9) of the Internal Revenue Code of 1986 merely because the payments are not made under an annuity contract purchased from an insurance company if such payments would not fail such requirements if provided with respect to a retirement income account described in section 403(b)(9) of such Code.

(b) Qualified Church Plan.--For purposes of this section, the term ``qualified church plan'' means any money purchase pension plan described in section 401(a) of such Code which--

(1) is a church plan (as defined in section 414(e) of such Code) with respect to which the election provided by section 410(d) of such Code has not been made, and

(2) was in existence on April 17, 2002.

SEC. 866. EXEMPTION FOR INCOME FROM LEVERAGED REAL ESTATE HELD BY CHURCH PLANS.

(a) In General.--Section 514(c)(9)(C) of the Internal Revenue Code of 1986 is amended by striking ``or'' after clause (ii), by striking the period at the end of clause (iii) and inserting ``; or'', and by inserting after clause (iii) the following:

``(iv) a retirement income account described in section 403(b)(9).''.

(b) Effective Date.--The amendment made by subsection (a) shall apply to taxable years beginning on or after the date of enactment of this Act.

SEC. 867. CHURCH PLAN RULE.

(a) In General.--Paragraph (11) of section 415(b) of the Internal Revenue Code of 1986 is amended by adding at the end the following: ``Subparagraph (B) of paragraph (1) shall not apply to a plan maintained by an organization described in section 3121(w)(3)(A) except with respect to highly compensated benefits. For purposes of this paragraph, the term `highly compensated benefits' means any benefits accrued for an employee in any year on or after the first year in which such employee is a highly compensated employee (as defined in section 414(q)) of the organization described in section 3121(w)(3)(A). For purposes of applying paragraph (1)(B) to highly compensated benefits, all benefits of the employee otherwise taken into account (without regard to this paragraph) shall be taken into account.''.

(b) Effective Date.--The amendment made by this section shall apply to years beginning after December 31, 2006.

SEC. 868. GRATUITOUS TRANSFER FOR BENEFITS OF EMPLOYEES.

(a) In General.--Subparagraph (E) of section 664(g)(3) of the Internal Revenue Code of 1986 is amended by inserting ``(determined on the basis of fair market value of securities when allocated to participants)'' after ``paragraph (7)''.

(b) Effective Date.--The amendment made by this section shall take effect on the date of the enactment of this Act.

TITLE IX--INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION AND

OTHER PENSION PROVISIONS

SEC. 901. DEFINED CONTRIBUTION PLANS REQUIRED TO PROVIDE EMPLOYEES WITH FREEDOM TO INVEST THEIR PLAN ASSETS.

(a) Amendments of Internal Revenue Code.--

(1) Qualification requirement.--Section 401(a) of the Internal Revenue Code of 1986 (relating to qualified pension, profit-sharing, and stock bonus plans) is amended by inserting after paragraph (34) the following new paragraph:

``(35) Diversification requirements for certain defined contribution plans.--

``(A) In general.--A trust which is part of an applicable defined contribution plan shall not be treated as a qualified trust unless the plan meets the diversification requirements of subparagraphs (B), (C), and (D).

``(B) Employee contributions and elective deferrals invested in employer securities.--In the case of the portion of an applicable individual's account attributable to employee contributions and elective deferrals which is invested in employer securities, a plan meets the requirements of this subparagraph if the applicable individual may elect to direct the plan to divest any such securities and to reinvest an equivalent amount in other investment options meeting the requirements of subparagraph (D).

``(C) Employer contributions invested in employer securities.--In the case of the portion of the account attributable to employer contributions other than elective deferrals which is invested in employer securities, a plan meets the requirements of this subparagraph if each applicable individual who--

``(i) is a participant who has completed at least 3 years of service, or

``(ii) is a beneficiary of a participant described in clause (i) or of a deceased participant,

may elect to direct the plan to divest any such securities and to reinvest an equivalent amount in other investment options meeting the requirements of subparagraph (D).

``(D) Investment options.--

``(i) In general.--The requirements of this subparagraph are met if the plan offers not less than 3 investment options, other than employer securities, to which an applicable individual may direct the proceeds from the divestment of employer securities pursuant to this paragraph, each of which is diversified and has materially different risk and return characteristics.

``(ii) Treatment of certain restrictions and conditions.--

``(I) Time for making investment choices.--A plan shall not be treated as failing to meet the requirements of this subparagraph merely because the plan limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

``(II) Certain restrictions and conditions not allowed.--Except as provided in regulations, a plan shall not meet the requirements of this subparagraph if the plan imposes restrictions or conditions with respect to the investment of employer securities which are not imposed on the investment of other assets of the plan. This subclause shall not apply to any restrictions or conditions imposed by reason of the application of securities laws.

``(E) Applicable defined contribution plan.--For purposes of this paragraph--

``(i) In general.--The term `applicable defined contribution plan' means any defined contribution plan which holds any publicly traded employer securities.

``(ii) Exception for certain esops.--Such term does not include an employee stock ownership plan if--

``(I) there are no contributions to such plan (or earnings thereunder) which are held within such plan and are subject to subsection (k) or (m), and

``(II) such plan is a separate plan for purposes of section 414(l) with respect to any other defined benefit plan or defined contribution plan maintained by the same employer or employers.

``(iii) Exception for one participant plans.--Such term does not include a one-participant retirement plan.

``(iv) One-participant retirement plan.--For purposes of clause (iii), the term `one-participant retirement plan' means a retirement plan that--

``(I) on the first day of the plan year covered only one individual (or the individual and the individual's spouse) and the individual owned 100 percent of the plan sponsor (whether or not incorporated), or covered only one or more partners (or partners and their spouses) in the plan sponsor,

``(II) meets the minimum coverage requirements of section 410(b) without being combined with any other plan of the business that covers the employees of the business,

``(III) does not provide benefits to anyone except the individual (and the individual's spouse) or the partners (and their spouses),

``(IV) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control, and

``(V) does not cover a business that uses the services of leased employees (within the meaning of section 414(n)).

For purposes of this clause, the term `partner' includes a 2-percent shareholder (as defined in section 1372(b)) of an S corporation.

``(F) Certain plans treated as holding publicly traded employer securities.--

``(i) In general.--Except as provided in regulations or in clause (ii), a plan holding employer securities which are not publicly traded employer securities shall be treated as holding publicly traded employer securities if any employer corporation, or any member of a controlled group of corporations which includes such employer corporation, has issued a class of stock which is a publicly traded employer security.

``(ii) Exception for certain controlled groups with publicly traded securities.--Clause (i) shall not apply to a plan if--

``(I) no employer corporation, or parent corporation of an employer corporation, has issued any publicly traded employer security, and

``(II) no employer corporation, or parent corporation of an employer corporation, has issued any special class of stock which grants particular rights to, or bears particular risks for, the holder or issuer with respect to any corporation described in clause (i) which has issued any publicly traded employer security.

``(iii) Definitions.--For purposes of this subparagraph, the term--

``(I) `controlled group of corporations' has the meaning given such term by section 1563(a), except that `50 percent' shall be substituted for `80 percent' each place it appears,

``(II) `employer corporation' means a corporation which is an employer

maintaining the plan, and
``(III) `parent corporation' has the meaning given such term by section 424(e).
``(G) Other definitions.--For purposes of this paragraph--
``(i) Applicable individual.--The term `applicable individual' means--
``(I) any participant in the plan, and
``(II) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.
``(ii) Elective deferral.--The term `elective deferral' means an employer contribution described in section 402(g)(3)(A).
``(iii) Employer security.--The term `employer security' has the meaning given such term by section 407(d)(1) of the Employee Retirement Income Security Act of 1974.
``(iv) Employee stock ownership plan.--The term `employee stock ownership plan' has the meaning given such term by section 4975(e)(7).
``(v) Publicly traded employer securities.--The term `publicly traded employer securities' means employer securities which are readily tradable on an established securities market.
``(vi) Year of service.--The term `year of service' has the meaning given such term by section 411(a)(5).
``(H) Transition rule for securities attributable to employer contributions.--
``(i) Rules phased in over 3 years.--
``(I) In general.--In the case of the portion of an account to which subparagraph (C) applies and which consists of employer securities acquired in a plan year beginning before January 1, 2007, subparagraph (C) shall only apply to the applicable percentage of such securities. This subparagraph shall be applied separately with respect to each class of securities.
``(II) Exception for certain participants aged 55 or over.--Subclause (I) shall not apply to an applicable individual who is a participant who has attained age 55 and completed at least 3 years of service before the first plan year beginning after December 31, 2005.
``(ii) Applicable percentage.--For purposes of clause (i), the applicable percentage shall be determined as follows:

``Plan year to which subparagraph (C) applies:	The applicable percentage is:
1st	33
2d	66
3d and following	100.''.

(2) Conforming amendments.--
(A) Section 401(a)(28)(B) of such Code (relating to additional requirements relating to employee stock ownership plans) is amended by adding at the end the following new clause:
``(v) Exception.--This subparagraph shall not apply to an applicable defined contribution plan (as defined in paragraph (35)(E)).''.
(B) Section 409(h)(7) of such Code is amended by inserting ``or subparagraph (B) or (C) of section 401(a)(35)'' before the period at the end.
(C) Section 4980(c)(3)(A) of such Code is amended by striking ``if--'' and all that follows and inserting ``if the requirements of subparagraphs (B), (C), and (D) are met.''.
(b) Amendments of ERISA.--
(1) In general.--Section 204 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1054) is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:
``(j) Diversification Requirements for Certain Individual Account

Plans.--

``(1) In general.--An applicable individual account plan shall meet the diversification requirements of paragraphs (2), (3), and (4).

``(2) Employee contributions and elective deferrals invested in employer securities.--In the case of the portion of an applicable individual's account attributable to employee contributions and elective deferrals which is invested in employer securities, a plan meets the requirements of this paragraph if the applicable individual may elect to direct the plan to divest any such securities and to reinvest an equivalent amount in other investment options meeting the requirements of paragraph (4).

``(3) Employer contributions invested in employer securities.--In the case of the portion of the account attributable to employer contributions other than elective deferrals which is invested in employer securities, a plan meets the requirements of this paragraph if each applicable individual who--

``(A) is a participant who has completed at least 3 years of service, or

``(B) is a beneficiary of a participant described in subparagraph (A) or of a deceased participant,

may elect to direct the plan to divest any such securities and to reinvest an equivalent amount in other investment options meeting the requirements of paragraph (4).

``(4) Investment options.--

``(A) In general.--The requirements of this paragraph are met if the plan offers not less than 3 investment options, other than employer securities, to which an applicable individual may direct the proceeds from the divestment of employer securities pursuant to this subsection, each of which is diversified and has materially different risk and return characteristics.

``(B) Treatment of certain restrictions and conditions.--

``(i) Time for making investment choices.--A plan shall not be treated as failing to meet the requirements of this paragraph merely because the plan limits the time for divestment and reinvestment to periodic, reasonable opportunities occurring no less frequently than quarterly.

``(ii) Certain restrictions and conditions not allowed.--Except as provided in regulations, a plan shall not meet the requirements of this paragraph if the plan imposes restrictions or conditions with respect to the investment of employer securities which are not imposed on the investment of other assets of the plan. This subparagraph shall not apply to any restrictions or conditions imposed by reason of the application of securities laws.

``(5) Applicable individual account plan.--For purposes of this subsection--

``(A) In general.--The term `applicable individual account plan' means any individual account plan (as defined in section 3(34)) which holds any publicly traded employer securities.

``(B) Exception for certain esops.--Such term does not include an employee stock ownership plan if--

``(i) there are no contributions to such plan (or earnings thereunder) which are held within such plan and are subject to subsection (k) or (m) of section 401 of the Internal Revenue Code of 1986, and

``(ii) such plan is a separate plan (for purposes of section 414(l) of such Code) with respect to any other defined benefit plan or individual account plan maintained by the same employer or employers.

``(C) Exception for one participant plans.--Such term shall not include a one-participant retirement plan (as defined in section 101(i)(8)(B)).

``(D) Certain plans treated as holding publicly traded employer securities.--

``(i) In general.--Except as provided in regulations or in clause (ii), a plan holding employer securities which are not publicly traded employer securities shall be treated as holding publicly traded employer securities if any employer corporation, or any member of a controlled group of corporations which includes

such employer corporation, has issued a class of stock which is a publicly traded employer security.

``(ii) Exception for certain controlled groups with publicly traded securities.--Clause (i) shall not apply to a plan if--

``(I) no employer corporation, or parent corporation of an employer corporation, has issued any publicly traded employer security, and

``(II) no employer corporation, or parent corporation of an employer corporation, has issued any special class of stock which grants particular rights to, or bears particular risks for, the holder or issuer with respect to any corporation described in clause (i) which has issued any publicly traded employer security.

``(iii) Definitions.--For purposes of this subparagraph, the term--

``(I) `controlled group of corporations' has the meaning given such term by section 1563(a) of the Internal Revenue Code of 1986, except that `50 percent' shall be substituted for `80 percent' each place it appears,

``(II) `employer corporation' means a corporation which is an employer maintaining the plan, and

``(III) `parent corporation' has the meaning given such term by section 424(e) of such Code.

``(6) Other definitions.--For purposes of this paragraph--

``(A) Applicable individual.--The term `applicable individual' means--

``(i) any participant in the plan, and

``(ii) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

``(B) Elective deferral.--The term `elective deferral' means an employer contribution described in section 402(g)(3)(A) of the Internal Revenue Code of 1986.

``(C) Employer security.--The term `employer security' has the meaning given such term by section 407(d)(1).

``(D) Employee stock ownership plan.--The term `employee stock ownership plan' has the meaning given such term by section 4975(e)(7) of such Code.

``(E) Publicly traded employer securities.--The term `publicly traded employer securities' means employer securities which are readily tradable on an established securities market.

``(F) Year of service.--The term `year of service' has the meaning given such term by section 203(b)(2).

``(7) Transition rule for securities attributable to employer contributions.--

``(A) Rules phased in over 3 years.--

``(i) In general.--In the case of the portion of an account to which paragraph (3) applies and which consists of employer securities acquired in a plan year beginning before January 1, 2007, paragraph (3) shall only apply to the applicable percentage of such securities. This subparagraph shall be applied separately with respect to each class of securities.

``(ii) Exception for certain participants aged 55 or over.--Clause (i) shall not apply to an applicable individual who is a participant who has attained age 55 and completed at least 3 years of service before the first plan year beginning after December 31, 2005.

``(B) Applicable percentage.--For purposes of subparagraph (A), the applicable percentage shall be determined as follows:

``Plan year to which paragraph (3) appl	The applicable percentage is:
1st	33
2d	66

3d..100.''.
(2) Conforming amendment.--Section 407(b)(3) of such Act (29 U.S.C. 1107(b)(3)) is amended by adding at the end the following:
``(D) For diversification requirements for qualifying employer securities held in certain individual account plans, see section 204(j).''.

(c) Effective Dates.--
(1) In general.--Except as provided in paragraphs (2) and (3), the amendments made by this section shall apply to plan years beginning after December 31, 2006.
(2) Special rule for collectively bargained agreements.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act, paragraph (1) shall be applied to benefits pursuant to, and individuals covered by, any such agreement by substituting for ``December 31, 2006'' the earlier of--
(A) the later of--
(i) December 31, 2007, or
(ii) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after such date of enactment), or
(B) December 31, 2008.
(3) Special rule for certain employer securities held in an esop.--
(A) In general.--In the case of employer securities to which this paragraph applies, the amendments made by this section shall apply to plan years beginning after the earlier of--
(i) December 31, 2007, or
(ii) the first date on which the fair market value of such securities exceeds the guaranteed minimum value described in subparagraph (B)(ii).
(B) Applicable securities.--This paragraph shall apply to employer securities which are attributable to employer contributions other than elective deferrals, and which, on September 17, 2003--
(i) consist of preferred stock, and
(ii) are within an employee stock ownership plan (as defined in section 4975(e)(7) of the Internal Revenue Code of 1986), the terms of which provide that the value of the securities cannot be less than the guaranteed minimum value specified by the plan on such date.
(C) Coordination with transition rule.--In applying section 401(a)(35)(H) of the Internal Revenue Code of 1986 and section 204(j)(7) of the Employee Retirement Income Security Act of 1974 (as added by this section) to employer securities to which this paragraph applies, the applicable percentage shall be determined without regard to this paragraph.

SEC. 902. INCREASING PARTICIPATION THROUGH AUTOMATIC CONTRIBUTION ARRANGEMENTS.

(a) In General.--Section 401(k) of the Internal Revenue Code of 1986 (relating to cash or deferred arrangement) is amended by adding at the end the following new paragraph:
``(13) Alternative method for automatic contribution arrangements to meet nondiscrimination requirements.--
``(A) In general.--A qualified automatic contribution arrangement shall be treated as meeting the requirements of paragraph (3)(A)(ii).
``(B) Qualified automatic contribution arrangement.--For purposes of this paragraph, the term `qualified automatic contribution arrangement' means any cash or deferred arrangement which meets the requirements of subparagraphs (C) through (E).
``(C) Automatic deferral.--
``(i) In general.--The requirements of this subparagraph are met if, under the arrangement, each employee eligible to participate in the arrangement is treated as having elected to have the employer make elective contributions in an amount equal to a qualified percentage of compensation.
``(ii) Election out.--The election treated as having been made under clause (i) shall cease to apply with respect to any employee if such employee makes an affirmative election--
``(I) to not have such contributions

made, or
``(II) to make elective contributions at a level specified in such affirmative election.
``(iii) Qualified percentage.--For purposes of this subparagraph, the term `qualified percentage' means, with respect to any employee, any percentage determined under the arrangement if such percentage is applied uniformly, does not exceed 10 percent, and is at least--
``(I) 3 percent during the period ending on the last day of the first plan year which begins after the date on which the first elective contribution described in clause (i) is made with respect to such employee,
``(II) 4 percent during the first plan year following the plan year described in subclause (I),
``(III) 5 percent during the second plan year following the plan year described in subclause (I), and
``(IV) 6 percent during any subsequent plan year.
``(iv) Automatic deferral for current employees not required.--Clause (i) may be applied without taking into account any employee who--
``(I) was eligible to participate in the arrangement (or a predecessor arrangement) immediately before the date on which such arrangement becomes a qualified automatic contribution arrangement (determined after application of this clause), and
``(II) had an election in effect on such date either to participate in the arrangement or to not participate in the arrangement.
``(D) Matching or nonelective contributions.--
``(i) In general.--The requirements of this subparagraph are met if, under the arrangement, the employer--
``(I) makes matching contributions on behalf of each employee who is not a highly compensated employee in an amount equal to the sum of 100 percent of the elective contributions of the employee to the extent that such contributions do not exceed 1 percent of compensation plus 50 percent of so much of such compensation as exceeds 1 percent but does not exceed 6 percent of compensation, or
``(II) is required, without regard to whether the employee makes an elective contribution or employee contribution, to make a contribution to a defined contribution plan on behalf of each employee who is not a highly compensated employee and who is eligible to participate in the arrangement in an amount equal to at least 3 percent of the employee's compensation.
``(ii) Application of rules for matching contributions.--The rules of clauses (ii) and (iii) of paragraph (12)(B) shall apply for purposes of clause (i)(I).
``(iii) Withdrawal and vesting restrictions.--An arrangement shall not be treated as meeting the requirements of clause (i) unless, with respect to employer contributions (including matching contributions) taken into account in determining whether the requirements of clause (i) are met--
``(I) any employee who has completed at least 2 years of service (within the meaning of section 411(a)) has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from such employer contributions, and
``(II) the requirements of subparagraph (B) of paragraph (2) are

met with respect to all such employer contributions.
``(iv) Application of certain other rules.--The rules of subparagraphs (E)(ii) and (F) of paragraph (12) shall apply for purposes of subclauses (I) and (II) of clause (i).
``(E) Notice requirements.--
``(i) In general.--The requirements of this subparagraph are met if, within a reasonable period before each plan year, each employee eligible to participate in the arrangement for such year receives written notice of the employee's rights and obligations under the arrangement which--
``(I) is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and
``(II) is written in a manner calculated to be understood by the average employee to whom the arrangement applies.
``(ii) Timing and content requirements.--A notice shall not be treated as meeting the requirements of clause (i) with respect to an employee unless--
``(I) the notice explains the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage),
``(II) in the case of an arrangement under which the employee may elect among 2 or more investment options, the notice explains how contributions made under the arrangement will be invested in the absence of any investment election by the employee, and
``(III) the employee has a reasonable period of time after receipt of the notice described in subclauses (I) and (II) and before the first elective contribution is made to make either such election.''.

(b) Matching Contributions.--Section 401(m) of such Code (relating to nondiscrimination test for matching contributions and employee contributions) is amended by redesignating paragraph (12) as paragraph (13) and by inserting after paragraph (11) the following new paragraph:
``(12) Alternative method for automatic contribution arrangements.--A defined contribution plan shall be treated as meeting the requirements of paragraph (2) with respect to matching contributions if the plan--
``(A) is a qualified automatic contribution arrangement (as defined in subsection (k)(13)), and
``(B) meets the requirements of paragraph (11)(B).''.

(c) Exclusion From Definition of Top-Heavy Plans.--
(1) Elective contribution rule.--Clause (i) of section 416(g)(4)(H) of such Code is amended by inserting ``or 401(k)(13)'' after ``section 401(k)(12)''.
(2) Matching contribution rule.--Clause (ii) of section 416(g)(4)(H) of such Code is amended by inserting ``or 401(m)(12)'' after ``section 401(m)(11)''.

(d) Treatment of Withdrawals of Contributions During First 90 Days.--
(1) In general.--Section 414 of the Internal Revenue Code of 1986 is amended by adding at the end the following new subsection:

``(w) Special Rules for Certain Withdrawals From Eligible Automatic Contribution Arrangements.--
``(1) In general.--If an eligible automatic contribution arrangement allows an employee to elect to make permissible withdrawals--
``(A) the amount of any such withdrawal shall be includible in the gross income of the employee for the taxable year of the employee in which the distribution is made,
``(B) no tax shall be imposed under section 72(t) with respect to the distribution, and

``(C) the arrangement shall not be treated as violating any restriction on distributions under this title solely by reason of allowing the withdrawal.

In the case of any distribution to an employee by reason of an election under this paragraph, employer matching contributions shall be forfeited or subject to such other treatment as the Secretary may prescribe.

``(2) Permissible withdrawal.--For purposes of this sub-section--

``(A) In general.--The term `permissible withdrawal' means any withdrawal from an eligible automatic contribution arrangement meeting the requirements of this paragraph which--

``(i) is made pursuant to an election by an employee, and

``(ii) consists of elective contributions described in paragraph (3)(B) (and earnings attributable thereto).

``(B) Time for making election.--Subparagraph (A) shall not apply to an election by an employee unless the election is made no later than the date which is 90 days after the date of the first elective contribution with respect to the employee under the arrangement.

``(C) Amount of distribution.--Subparagraph (A) shall not apply to any election by an employee unless the amount of any distribution by reason of the election is equal to the amount of elective contributions made with respect to the first payroll period to which the eligible automatic contribution arrangement applies to the employee and any succeeding payroll period beginning before the effective date of the election (and earnings attributable thereto).

``(3) Eligible automatic contribution arrangement.--For purposes of this subsection, the term `eligible automatic contribution arrangement' means an arrangement under an applicable employer plan--

``(A) under which a participant may elect to have the employer make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash,

``(B) under which the participant is treated as having elected to have the employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage),

``(C) under which, in the absence of an investment election by the participant, contributions described in subparagraph (B) are invested in accordance with regulations prescribed by the Secretary of Labor under section 404(c)(5) of the Employee Retirement Income Security Act of 1974, and

``(D) which meets the requirements of paragraph (4).

``(4) Notice requirements.--

``(A) In general.--The administrator of a plan containing an arrangement described in paragraph (3) shall, within a reasonable period before each plan year, give to each employee to whom an arrangement described in paragraph (3) applies for such plan year notice of the employee's rights and obligations under the arrangement which--

``(i) is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and

``(ii) is written in a manner calculated to be understood by the average employee to whom the arrangement applies.

``(B) Time and form of notice.--A notice shall not be treated as meeting the requirements of subparagraph (A) with respect to an employee unless--

``(i) the notice includes an explanation of the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage),

``(ii) the employee has a reasonable period of time after receipt of the notice described in clause (i) and before the first elective contribution is made to make such election, and

``(iii) the notice explains how contributions made under the arrangement will be invested in the

absence of any investment election by the
employee.
``(5) Applicable employer plan.--For purposes of this
subsection, the term `applicable employer plan' means--
``(A) an employees' trust described in section
401(a) which is exempt from tax under section 501(a),
``(B) a plan under which amounts are contributed by
an individual's employer for an annuity contract
described in section 403(b), and
``(C) an eligible deferred compensation plan
described in section 457(b) which is maintained by an
eligible employer described in section 457(e)(1)(A).
``(6) Special rule.--A withdrawal described in paragraph (1)
(subject to the limitation of paragraph (2)(C)) shall not be
taken into account for purposes of section 401(k)(3).''.
(2) Vesting conforming amendments.--
(A) Section 411(a)(3)(G) of such Code is amended by inserting
``an erroneous automatic
contribution under section 414(w),'' after
``402(g)(2)(A),''.
(B) The heading of section 411(a)(3)(G) of such Code
is amended by inserting ``or erroneous automatic
contribution'' before the period.
(C) Section 401(k)(8)(E) of such Code is amended by
inserting ``an erroneous automatic contribution under
section 414(w),'' after ``402(g)(2)(A),''.
(D) The heading of section 401(k)(8)(E) of such Code
is amended by inserting ``or erroneous automatic
contribution'' before the period.
(E) Section 203(a)(3)(F) of the Employee Retirement
Income Security Act of 1974 (29 U.S.C. 1053(a)(3)(F)) is
amended by inserting ``an erroneous automatic
contribution under section 414(w) of such Code,'' after
``402(g)(2)(A) of such Code,''.
(e) Excess Contributions.--
(1) Expansion of corrective distribution period for
automatic contribution arrangements.--Subsection (f) of section
4979 of the Internal Revenue Code of 1986 is amended--
(A) by inserting ``(6 months in the case of an
excess contribution or excess aggregate contribution to
an eligible automatic contribution arrangement (as
defined in section 414(w)(3)))'' after ``2\1/2\ months''
in paragraph (1), and
(B) by striking ``2\1/2\ Months of'' in the heading
and inserting ``Specified Period After''.
(2) Year of inclusion.--Paragraph (2) of section 4979(f) of
such Code is amended to read as follows:
``(2) Year of inclusion.--Any amount distributed as provided
in paragraph (1) shall be treated as earned and received by the
recipient in the recipient's taxable year in which such
distributions were made.''.
(3) Simplification of allocable earnings.--
(A) Section 4979.--Paragraph (1) of section 4979(f)
of such Code is amended by adding ``through the end of
the plan year for which the contribution was made''
after ``thereto''.
(B) Section 401(k) and 401(m).--
(i) Clause (i) of section 401(k)(8)(A) of such
Code is amended by adding ``through the end of
such year'' after ``such contributions''.
(ii) Subparagraph (A) of section 401(m)(6) of
such Code is amended by
adding ``through the end of such year'' after ``to
such contributions''.
(f) Preemption of Conflicting State Regulation.--
(1) In general.--Section 514 of the Employee Retirement
Income Security Act of 1974 (29 U.S.C. 1144) is amended by
adding at the end the following new subsection:
``(e)(1) Notwithstanding any other provision of this section, this
title shall supersede any law of a State which would directly or
indirectly prohibit or restrict the inclusion in any plan of an
automatic contribution arrangement. The Secretary may prescribe
regulations which would establish minimum standards that such an
arrangement would be required to satisfy in order for this subsection to
apply in the case of such arrangement.
``(2) For purposes of this subsection, the term `automatic
contribution arrangement' means an arrangement--
``(A) under which a participant may elect to have the plan
sponsor make payments as contributions under the plan on behalf
of the participant, or to the participant directly in cash,
``(B) under which a participant is treated as having elected
to have the plan sponsor make such contributions in an amount

equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage), and

``(C) under which such contributions are invested in accordance with regulations prescribed by the Secretary under section 404(c)(5).

``(3)(A) The plan administrator of an automatic contribution arrangement shall, within a reasonable period before such plan year, provide to each participant to whom the arrangement applies for such plan year notice of the participant's rights and obligations under the arrangement which--

``(i) is sufficiently accurate and comprehensive to apprise the participant of such rights and obligations, and

``(ii) is written in a manner calculated to be understood by the average participant to whom the arrangement applies.

``(B) A notice shall not be treated as meeting the requirements of subparagraph (A) with respect to a participant unless--

``(i) the notice includes an explanation of the participant's right under the arrangement not to have elective contributions made on the participant's behalf (or to elect to have such contributions made at a different percentage),

``(ii) the participant has a reasonable period of time, after receipt of the notice described in clause (i) and before the first elective contribution is made, to make such election, and

``(iii) the notice explains how contributions made under the arrangement will be invested in the absence of any investment election by the participant.''.

(2) Enforcement.--Section 502(c)(4) of such Act (29 U.S.C. 1132(c)(4)) is amended by striking ``or section 302(b)(7)(F)(vi)'' inserting ``, section 302(b)(7)(F)(vi), or section 514(e)(3)''.

(g) Effective Date.--The amendments made by this section shall apply to plan years beginning after December 31, 2007, except that the amendments made by subsection (f) shall take effect on the date of the enactment of this Act.

SEC. 903. TREATMENT OF ELIGIBLE COMBINED DEFINED BENEFIT PLANS AND QUALIFIED CASH OR DEFERRED ARRANGEMENTS.

(a) Amendments of Internal Revenue Code.--Section 414 of the Internal Revenue Code of 1986, as amended by this Act, is amended by adding at the end the following new subsection:

``(x) Special Rules for Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements.--

``(1) General rule.--Except as provided in this subsection, the requirements of this title shall be applied to any defined benefit plan or applicable defined contribution plan which are part of an eligible combined plan in the same manner as if each such plan were not a part of the eligible combined plan.

``(2) Eligible combined plan.--For purposes of this sub-section--

``(A) In general.--The term `eligible combined plan' means a plan--

``(i) which is maintained by an employer which, at the time the plan is established, is a small employer,

``(ii) which consists of a defined benefit plan and an applicable defined contribution plan,

``(iii) the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of this title under paragraph (1), and

``(iv) with respect to which the benefit, contribution, vesting, and nondiscrimination requirements of subparagraphs (B), (C), (D), (E), and (F) are met.

For purposes of this subparagraph, the term `small employer' has the meaning given such term by section 4980D(d)(2), except that such section shall be applied by substituting `500' for `50' each place it appears.

``(B) Benefit requirements.--

``(i) In general.--The benefit requirements of this subparagraph are met with respect to the defined benefit plan forming part of the eligible combined plan if the accrued benefit of each participant derived from employer contributions, when expressed as an annual retirement benefit, is

not less than the applicable percentage of the participant's final average pay. For purposes of this clause, final average pay shall be determined using the period of consecutive years (not exceeding 5) during which the participant had the greatest aggregate compensation from the employer.

``(ii) Applicable percentage.--For purposes of clause (i), the applicable percentage is the lesser of--

``(I) 1 percent multiplied by the number of years of service with the employer, or

``(II) 20 percent.

``(iii) Special rule for applicable defined benefit plans.--If the defined benefit plan under clause (i) is an applicable defined benefit plan as defined in section 411(a)(13)(B) which meets the interest credit requirements of section 411(b)(5)(B)(i), the plan shall be treated as meeting the requirements of clause (i) with respect to any plan year if each participant receives a pay credit for the year which is not less than the percentage of compensation determined in accordance with the following table:

``If the partici as of the beginning of t is--	The percentage is--
30 or less	2
Over 30 but less than 40	4
40 or over but less than 50	6
50 or over	8.

``(iv) Years of service.--For purposes of this subparagraph, years of service shall be determined under the rules of paragraphs (4), (5), and (6) of section 411(a), except that the plan may not disregard any year of service because of a participant making, or failing to make, any elective deferral with respect to the qualified cash or deferred arrangement to which subparagraph (C) applies.

``(C) Contribution requirements.--

``(i) In general.--The contribution requirements of this subparagraph with respect to any applicable defined contribution plan forming part of an eligible combined plan are met if--

``(I) the qualified cash or deferred arrangement included in such plan constitutes an automatic contribution arrangement, and

``(II) the employer is required to make matching contributions on behalf of each employee eligible to participate in the arrangement in an amount equal to 50 percent of the elective contributions of the employee to the extent such elective contributions do not exceed 4 percent of compensation.

Rules similar to the rules of clauses (ii) and (iii) of section 401(k)(12)(B) shall apply for purposes of this clause.

``(ii) Nonelective contributions.--An applicable defined contribution plan shall not be treated as failing to meet the requirements of clause (i) because the employer makes nonelective contributions under the plan but such contributions shall not be taken into account in determining whether the requirements of clause (i)(II) are met.

``(D) Vesting requirements.--The vesting requirements of this subparagraph are met if--

``(i) in the case of a defined benefit plan forming part of an eligible combined plan an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit under the plan derived from employer contributions, and

``(ii) in the case of an applicable defined contribution plan forming part of eligible combined plan--

``(I) an employee has a nonforfeitable right to any matching contribution made under the qualified cash or deferred arrangement included in such plan by an employer with respect to any elective contribution, including matching contributions in excess of the contributions required under subparagraph (C)(i)(II), and

``(II) an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived under the arrangement from nonelective contributions of the employer.

For purposes of this subparagraph, the rules of section 411 shall apply to the extent not inconsistent with this subparagraph.

``(E) Uniform provision of contributions and benefits.--In the case of a defined benefit plan or applicable defined contribution plan forming part of an eligible combined plan, the requirements of this subparagraph are met if all contributions and benefits under each such plan, and all rights and features under each such plan, must be provided uniformly to all participants.

``(F) Requirements must be met without taking into account social security and similar contributions and benefits or other plans.--

``(i) In general.--The requirements of this subparagraph are met if the requirements of clauses (ii) and (iii) are met.

``(ii) Social security and similar contributions.--The requirements of this clause are met if--

``(I) the requirements of subparagraphs (B) and (C) are met without regard to section 401(l), and

``(II) the requirements of sections 401(a)(4) and 410(b) are met with respect to both the applicable defined contribution plan and defined benefit plan forming part of an eligible combined plan without regard to section 401(l).

``(iii) Other plans and arrangements.--The requirements of this clause are met if the applicable defined contribution plan and defined benefit plan forming part of an eligible combined plan meet the requirements of sections 401(a)(4) and 410(b) without being combined with any other plan.

``(3) Nondiscrimination requirements for qualified cash or deferred arrangement.--

``(A) In general.--A qualified cash or deferred arrangement which is included in an applicable defined contribution plan forming part of an eligible combined plan shall be treated as meeting the requirements of section 401(k)(3)(A)(ii) if the requirements of paragraph (2)(C) are met with respect to such arrangement.

``(B) Matching contributions.--In applying section 401(m)(11) to any matching contribution with respect to a contribution to which paragraph (2)(C) applies, the contribution requirement of paragraph (2)(C) and the notice requirements of paragraph (5)(B) shall be substituted for the requirements otherwise applicable under clauses (i) and (ii) of section 401(m)(11)(A).

``(4) Satisfaction of top-heavy rules.--A defined benefit plan and applicable defined contribution plan forming part of an eligible combined plan for any plan year shall be treated as meeting the requirements of section 416 for the plan year.

``(5) Automatic contribution arrangement.--For purposes of this subsection--

``(A) In general.--A qualified cash or deferred arrangement shall be treated as an automatic contribution arrangement if the arrangement--

``(i) provides that each employee eligible to participate in the arrangement is treated as having elected to have the employer make elective

contributions in an amount equal to 4 percent of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate, and

``(ii) meets the notice requirements under subparagraph (B).

``(B) Notice requirements.--

``(i) In general.--The requirements of this subparagraph are met if the requirements of clauses (ii) and (iii) are met.

``(ii) Reasonable period to make election.--The requirements of this clause are met if each employee to whom subparagraph (A)(i) applies--

``(I) receives a notice explaining the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate, and

``(II) has a reasonable period of time after receipt of such notice and before the first elective contribution is made to make such election.

``(iii) Annual notice of rights and obligations.--The requirements of this clause are met if each employee eligible to participate in the arrangement is, within a reasonable period before any year, given notice of the employee's rights and obligations under the arrangement.

The requirements of clauses (i) and (ii) of section 401(k)(12)(D) shall be met with respect to the notices described in clauses (ii) and (iii) of this subparagraph.

``(6) Coordination with other requirements.--

``(A) Treatment of separate plans.--Section 414(k) shall not apply to an eligible combined plan.

``(B) Reporting.--An eligible combined plan shall be treated as a single plan for purposes of sections 6058 and 6059.

``(7) Applicable defined contribution plan.--For purposes of this subsection--

``(A) In general.--The term `applicable defined contribution plan' means a defined contribution plan which includes a qualified cash or deferred arrangement.

``(B) Qualified cash or deferred arrangement.--The term `qualified cash or deferred arrangement' has the meaning given such term by section 401(k)(2).''.

(b) Amendments to the Employee Retirement Income Security Act of 1974.--

(1) In general.--Section 210 of the Employee Retirement Income Security Act of 1974 is amended by adding at the end the following new subsection:

``(e) Special Rules for Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements.--

``(1) General rule.--Except as provided in this subsection, this Act shall be applied to any defined benefit plan or applicable individual account plan which are part of an eligible combined plan in the same manner as if each such plan were not a part of the eligible combined plan.

``(2) Eligible combined plan.--For purposes of this sub-section--

``(A) In general.--The term `eligible combined plan' means a plan--

``(i) which is maintained by an employer which, at the time the plan is established, is a small employer,

``(ii) which consists of a defined benefit plan and an applicable individual account plan each of which qualifies under section 401(a) of the Internal Revenue Code of 1986,

``(iii) the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable individual account plan to the extent necessary for the separate application of this Act under paragraph (1), and

``(iv) with respect to which the benefit, contribution, vesting, and nondiscrimination requirements of subparagraphs (B), (C), (D), (E), and (F) are met.

For purposes of this
subparagraph, the term `small employer' has the meaning given such term by section 4980D(d)(2) of the Internal Revenue Code of 1986, except that such section shall be applied by substituting `500' for `50' each place it appears.

``(B) Benefit requirements.--

``(i) In general.--The benefit requirements of this subparagraph are met with respect to the defined benefit plan forming part of the eligible combined plan if the accrued benefit of each participant derived from employer contributions, when expressed as an annual retirement benefit, is not less than the applicable percentage of the participant's final average pay. For purposes of this clause, final average pay shall be determined using the period of consecutive years (not exceeding 5) during which the participant had the greatest aggregate compensation from the employer.

``(ii) Applicable percentage.--For purposes of clause (i), the applicable percentage is the lesser of--

``(I) 1 percent multiplied by the number of years of service with the employer, or

``(II) 20 percent.

``(iii) Special rule for applicable defined benefit plans.--If the defined benefit plan under clause (i) is an applicable defined benefit plan as defined in section 203(f)(3)(B) which meets the interest credit
requirements of section 204(b)(5)(B)(i), the plan shall be treated as meeting the requirements of clause (i) with respect to any plan year if each participant receives pay credit for the year which is not less than the percentage of compensation determined in accordance with the following table:

``If the partici as of the beginning of t is--	The percentage is--
30 or less	2
Over 30 but less than 40	4
40 or over but less than 50	6
50 or over	8.

``(iv) Years of service.--For purposes of this subparagraph, years of service shall be determined under the rules of paragraphs (1), (2), and (3) of section 203(b), except that the plan may not disregard any year of service because of a participant making, or failing to make, any elective deferral with respect to the qualified cash or deferred arrangement to which subparagraph (C) applies.

``(C) Contribution requirements.--

``(i) In general.--The contribution requirements of this subparagraph with respect to any applicable individual account plan forming part of an eligible combined plan are met if--

``(I) the qualified cash or deferred arrangement included in such plan constitutes an automatic contribution arrangement, and

``(II) the employer is required to make matching contributions on behalf of each employee eligible to participate in the arrangement in an amount equal to 50 percent of the elective contributions of the employee to the extent such elective contributions do not exceed 4 percent of compensation.

Rules similar to the
rules of clauses (ii) and (iii) of section 401(k)(12)(B) of the Internal Revenue Code of 1986 shall apply for purposes of this clause.

``(ii) Nonelective contributions.--An applicable individual account plan shall not be treated as failing to meet the requirements of clause (i) because the employer makes nonelective contributions under the plan but such contributions shall not be taken into account in determining whether the requirements of clause

(i)(II) are met.
``(D) Vesting requirements.--The vesting requirements of this subparagraph are met if--
``(i) in the case of a defined benefit plan forming part of an eligible combined plan an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit under the plan derived from employer contributions, and
``(ii) in the case of an applicable individual account plan forming part of eligible combined plan--
``(I) an employee has a nonforfeitable right to any matching contribution made under the qualified cash or deferred arrangement included in such plan by an employer with respect to any elective contribution, including matching contributions in excess of the contributions required under subparagraph (C)(i)(II), and
``(II) an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived under the arrangement from nonelective contributions of the employer.
For purposes of this subparagraph, the rules of section 203 shall apply to the extent not inconsistent with this subparagraph.
``(E) Uniform provision of contributions and benefits.--In the case of a defined benefit plan or applicable individual account plan forming part of an eligible combined plan, the requirements of this subparagraph are met if all contributions and benefits under each such plan, and all rights and features under each such plan, must be provided uniformly to all participants.
``(F) Requirements must be met without taking into account social security and similar contributions and benefits or other plans.--
``(i) In general.--The requirements of this subparagraph are met if the requirements of clauses (ii) and (iii) are met.
``(ii) Social security and similar contributions.--The requirements of this clause are met if--
``(I) the requirements of subparagraphs (B) and (C) are met without regard to section 401(l) of the Internal Revenue Code of 1986, and
``(II) the requirements of sections 401(a)(4) and 410(b) of the Internal Revenue Code of 1986 are met with respect to both the applicable defined contribution plan and defined benefit plan forming part of an eligible combined plan without regard to section 401(l) of the Internal Revenue Code of 1986.
``(iii) Other plans and arrangements.--The requirements of this clause are met if the applicable defined contribution plan and defined benefit plan forming part of an eligible combined plan meet the requirements of sections 401(a)(4) and 410(b) of the Internal Revenue Code of 1986 without being combined with any other plan.
``(3) Nondiscrimination requirements for qualified cash or deferred arrangement.--
``(A) In general.--A qualified cash or deferred arrangement which is included in an applicable individual account plan forming part of an eligible combined plan shall be treated as meeting the requirements of section 401(k)(3)(A)(ii) of the Internal Revenue Code of 1986 if the requirements of paragraph (2) are met with respect to such arrangement.
``(B) Matching contributions.--In applying section 401(m)(11) of such Code to any matching contribution with respect to a contribution to which paragraph (2)(C) applies, the contribution requirement of paragraph (2)(C) and the notice requirements of paragraph (5)(B)

shall be substituted for the requirements otherwise applicable under clauses (i) and (ii) of section 401(m)(11)(A) of such Code.

``(4) Automatic contribution arrangement.--For purposes of this subsection--

``(A) In general.--A qualified cash or deferred arrangement shall be treated as an automatic contribution arrangement if the arrangement--

``(i) provides that each employee eligible to participate in the arrangement is treated as having elected to have the employer make elective contributions in an amount equal to 4 percent of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate, and

``(ii) meets the notice requirements under subparagraph (B).

``(B) Notice requirements.--

``(i) In general.--The requirements of this subparagraph are met if the requirements of clauses (ii) and (iii) are met.

``(ii) Reasonable period to make election.--The requirements of this clause are met if each employee to whom subparagraph (A)(i) applies--

``(I) receives a notice explaining the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate, and

``(II) has a reasonable period of time after receipt of such notice and before the first elective contribution is made to make such election.

``(iii) Annual notice of rights and obligations.--The requirements of this clause are met if each employee eligible to participate in the arrangement is, within a reasonable period before any year, given notice of the employee's rights and obligations under the arrangement.

The requirements of this subparagraph shall not be treated as met unless the requirements of clauses (i) and (ii) of section 401(k)(12)(D) of the Internal Revenue Code of 1986 are met with respect to the notices described in clauses (ii) and (iii) of this subparagraph.

``(5) Coordination with other requirements.--

``(A) Treatment of separate plans.--The except clause in section 3(35) shall not apply to an eligible combined plan.

``(B) Reporting.--An eligible combined plan shall be treated as a single plan for purposes of section 103.

``(6) Applicable individual account plan.--For purposes of this subsection--

``(A) In general.--The term `applicable individual account plan' means an individual account plan which includes a qualified cash or deferred arrangement.

``(B) Qualified cash or deferred arrangement.--The term `qualified cash or deferred arrangement' has the meaning given such term by section 401(k)(2) of the Internal Revenue Code of 1986.''.

(2) Conforming changes.--

(A) The heading for section 210 of such Act is amended to read as follows:

``SEC. 210. MULTIPLE EMPLOYER PLANS AND OTHER SPECIAL RULES.''.

(B) The table of contents in section 1 of such Act is amended by striking the item relating to section 210 and inserting the following new item:

``Sec. 210. Multiple employer plans and other special rules.''.

(c) Effective Date.--The amendments made by this section shall apply to plan years beginning after December 31, 2009.

SEC. 904. FASTER VESTING OF EMPLOYER NONELECTIVE CONTRIBUTIONS.

(a) Amendments to the Internal Revenue Code of 1986.--

(1) In general.--Paragraph (2) of section 411(a) of the Internal Revenue Code of 1986 (relating to employer contributions) is amended to read as follows:

``(2) Employer contributions.--

``(A) Defined benefit plans.--

``(i) In general.--In the case of a defined benefit plan, a plan satisfies the requirements of this paragraph if it satisfies the requirements of clause (ii) or (iii).

``(ii) 5-year vesting.--A plan satisfies the requirements of this clause if an employee who has completed at least 5 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

``(iii) 3 to 7 year vesting.--A plan satisfies the requirements of this clause if an employee has a nonforfeitable right to a percentage of the employee's accrued benefit derived from employer contributions determined under the following table:

``Years of servi	The nonforfeitable percentage is:
3	20
4	40
5	60
6	80
7 or more	100.

``(B) Defined contribution plans.--

``(i) In general.--In the case of a defined contribution plan, a plan satisfies the requirements of this paragraph if it satisfies the requirements of clause (ii) or (iii).

``(ii) 3-year vesting.--A plan satisfies the requirements of this clause if an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

``(iii) 2 to 6 year vesting.--A plan satisfies the requirements of this clause if an employee has a nonforfeitable right to a percentage of the employee's accrued benefit derived from employer contributions determined under the following table:

``Years of servi	The nonforfeitable percentage is:
2	20
3	40
4	60
5	80
6 or more	100.''.

(2) Conforming amendment.--Section 411(a) of such Code (relating to general rule for minimum vesting standards) is amended by striking paragraph (12).

(b) Amendments to the Employee Retirement Income Security Act of 1974.--

(1) In general.--Paragraph (2) of section 203(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(a)(2)) is amended to read as follows:

``(2)(A)(i) In the case of a defined benefit plan, a plan satisfies the requirements of this paragraph if it satisfies the requirements of clause (ii) or (iii).

``(ii) A plan satisfies the requirements of this clause if an employee who has completed at least 5 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

``(iii) A plan satisfies the requirements of this clause if an employee has a nonforfeitable right to a percentage of the employee's accrued benefit derived from employer contributions determined under the following table:

``Years of servi	The nonforfeitable percentage is:
3	20
4	40
5	60
6	80
7 or more	100.

``(B)(i) In the case of an individual account plan, a plan satisfies the requirements of this paragraph if it satisfies the requirements of clause (ii) or (iii).

``(ii) A plan satisfies the requirements of this clause if an employee who has completed at least 3 years of service has a nonforfeitable right to 100 percent of the employee's accrued benefit derived from employer contributions.

``(iii) A plan satisfies the requirements of this clause if an employee has a nonforfeitable right to a percentage of the

employee's accrued benefit derived from employer contributions determined under the following table:

``Years of servi	The nonforfeitable percentage is:
2	20
3	40
4	60
5	80
6 or more	100.''.

(2) Conforming amendment.--Section 203(a) of such Act is amended by striking paragraph (4).

(c) Effective Dates.--

(1) In general.--Except as provided in paragraphs (2) and (4), the amendments made by this section shall apply to contributions for plan years beginning after December 31, 2006.

(2) Collective bargaining agreements.--In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before the date of the enactment of this Act, the amendments made by this section shall not apply to contributions on behalf of employees covered by any such agreement for plan years beginning before the earlier of--

(A) the later of--

(i) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after such date of the enactment); or

(ii) January 1, 2007; or

(B) January 1, 2009.

(3) Service required.--With respect to any plan, the amendments made by this section shall not apply to any employee before the date that such employee has 1 hour of service under such plan in any plan year to which the amendments made by this section apply.

(4) Special rule for stock ownership plans.--Notwithstanding paragraph (1) or (2), in the case of an employee stock ownership plan (as defined in section 4975(e)(7) of the Internal Revenue Code of 1986) which had outstanding on September 26, 2005, a loan incurred for the purpose of acquiring qualifying employer securities (as defined in section 4975(e)(8) of such Code), the amendments made by this section shall not apply to any plan year beginning before the earlier of--

(A) the date on which the loan is fully repaid, or

(B) the date on which the loan was, as of September 26, 2005, scheduled to be fully repaid.

SEC. 905. DISTRIBUTIONS DURING WORKING RETIREMENT.

(a) Amendment to the Employee Retirement Income Security Act of 1974.--Subparagraph (A) of section 3(2) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(2)) is amended by adding at the end the following new sentence: ``A distribution from a plan, fund, or program shall not be treated as made in a form other than retirement income or as a distribution prior to termination of covered employment solely because such distribution is made to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.''.

(b) Amendment to the Internal Revenue Code of 1986.--Subsection (a) of section 401 of the Internal Revenue Code of 1986 (as amended by this Act) is amended by inserting after paragraph (35) the following new paragraph:

``(36) Distributions during working retirement.--A trust forming part of a pension plan shall not be treated as failing to constitute a qualified trust under this section solely because the plan provides that a distribution may be made from such trust to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.''.

(c) Effective Date.--The amendments made by this section shall apply to distributions in plan years beginning after December 31, 2006.

SEC. 906. TREATMENT OF CERTAIN PENSION PLANS OF INDIAN TRIBAL GOVERNMENTS.

(a) Definition of Government Plan to Include Certain Pension Plans of Indian Tribal Governments.--

(1) Amendment to internal revenue code of 1986.--Section 414(d) of the Internal Revenue Code of 1986 (defining governmental plan) is amended by adding at the end the following: ``The term `governmental plan' includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity

substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).''.

(2) Amendment to employee retirement income security act of 1974.--

(A) Section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)) is amended by adding at the end the following: ``The term `governmental plan' includes a plan which is established and maintained by an Indian tribal government (as defined in section 7701(a)(40) of the Internal Revenue Code of 1986), a subdivision of an Indian tribal government (determined in accordance with section 7871(d) of such Code), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function)''.

(B) Section 4021(b)(2) of such Act is amended by adding at the end the following:

``or which is described in the last sentence of section 3(32)''.

(b) Clarification That Tribal Governments Are Subject to the Same Pension Plan Rules and Regulations Applied to State and Other Local Governments and Their Police and Firefighters.--

(1) Amendments to internal revenue code of 1986.--

(A) Police and firefighters.--Subparagraph (H) section 415(b)(2) of the Internal Revenue Code of 1986 (defining participant) is amended--

(i) in clause (i), by striking ``State or political subdivision'' and inserting ``State, Indian tribal government (as defined in section 7701(a)(40)), or any political subdivision''; and

(ii) in clause (ii)(I), by striking ``State or political subdivision'' each place it appears and inserting ``State, Indian tribal government (as so defined), or any political subdivision''.

(B) State and local government plans.--

(i) In general.--Subparagraph (A) of section 415(b)(10) of such Code (relating to limitation to equal accrued benefit) is amended by inserting ``or a governmental plan described in the last sentence of section 414(d) (relating to plans of Indian tribal governments),'' after ``foregoing,''.

(ii) Conforming amendment.--The heading of paragraph (1) of section 415(b) of such Code is amended by striking ``Special rule for state and'' and inserting ``Special rule for state, indian tribal, and''.

(C) Government pick up contributions.--Paragraph (2) of section 414(h) of such Code (relating to designation by units of government) is amended by inserting ``or a governmental plan described in the last sentence of section 414(d) (relating to plans of Indian tribal governments),'' after ``foregoing,''.

(2) Amendments to employee retirement income security act of 1974.--Section 4021(b) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1321(b)) is amended--

(A) in paragraph (12), by striking ``or'' at the end;

(B) in paragraph (13), by striking ``plan.'' and inserting ``plan; or''; and

(C) by adding at the end the following:

``(14) established and maintained by an Indian tribal government (as defined in section 7701(a)(40) of the Internal Revenue Code of 1986), a subdivision of an Indian tribal government (determined in accordance with section 7871(d) of such Code), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).''.

(c) Effective Date.--The amendments made by this section shall apply to any year beginning on or after the date of the enactment of this Act.

TITLE X--PROVISIONS RELATING TO SPOUSAL PENSION PROTECTION

SEC. 1001. REGULATIONS ON TIME AND ORDER OF ISSUANCE OF DOMESTIC RELATIONS ORDERS.

Not later than 1 year after the date of the enactment of this Act, the Secretary of Labor shall issue regulations under section 206(d)(3) of the Employee Retirement Security Act of 1974 and section 414(p) of the Internal Revenue Code of 1986 which clarify that--

(1) a domestic relations order otherwise meeting the requirements to be a qualified domestic relations order, including the requirements of section 206(d)(3)(D) of such Act and section 414(p)(3) of such Code, shall not fail to be treated as a qualified domestic relations order solely because--

(A) the order is issued after, or revises, another domestic relations order or qualified domestic relations order; or

(B) of the time at which it is issued; and

(2) any order described in paragraph (1) shall be subject to the same requirements and protections which apply to qualified domestic relations orders, including the provisions of section 206(d)(3)(H) of such Act and section 414(p)(7) of such Code.

SEC. 1002. ENTITLEMENT OF DIVORCED SPOUSES TO RAILROAD RETIREMENT ANNUITIES INDEPENDENT OF ACTUAL ENTITLEMENT OF EMPLOYEE.

(a) In General.--Section 2 of the Railroad Retirement Act of 1974 (45 U.S.C. 231a) is amended--

(1) in subsection (c)(4)(i), by striking ``(A) is entitled to an annuity under subsection (a)(1) and (B)''; and

(2) in subsection (e)(5), by striking ``or divorced wife'' the second place it appears.

(b) Effective Date.--The amendments made by this section shall take effect 1 year after the date of the enactment of this Act.

SEC. 1003. EXTENSION OF TIER II RAILROAD RETIREMENT BENEFITS TO SURVIVING FORMER SPOUSES PURSUANT TO DIVORCE AGREEMENTS.

(a) In General.--Section 5 of the Railroad Retirement Act of 1974 (45 U.S.C. 231d) is amended by adding at the end the following:

``(d) Notwithstanding any other provision of law, the payment of any portion of an annuity computed under section 3(b) to a surviving former spouse in accordance with a court decree of divorce, annulment, or legal separation or the terms of any court-approved property settlement incident to any such court decree shall not be terminated upon the death of the individual who performed the service with respect to which such annuity is so computed unless such termination is otherwise required by the terms of such court decree.''.

(b) Effective Date.--The amendment made by this section shall take effect 1 year after the date of the enactment of this Act.

SEC. 1004. REQUIREMENT FOR ADDITIONAL SURVIVOR ANNUITY OPTION.

(a) Amendments to Internal Revenue Code.--

(1) Election of survivor annuity.--Section 417(a)(1)(A) of the Internal Revenue Code of 1986 is amended--

(A) in clause (i), by striking ``, and'' and inserting a comma;

(B) by redesignating clause (ii) as clause (iii); and

(C) by inserting after clause (i) the following:

``(ii) if the participant elects a waiver under clause (i), may elect the qualified optional survivor annuity at any time during the applicable election period, and''.

(2) Definition.--Section 417 of such Code is amended by adding at the end the following:

``(g) Definition of Qualified Optional Survivor Annuity.--

``(1) In general.--For purposes of this section, the term `qualified optional survivor annuity' means an annuity--

``(A) for the life of the participant with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity which is payable during the joint lives of the participant and the spouse, and

``(B) which is the actuarial equivalent of a single annuity for the life of the participant.

Such term also includes any annuity in a form having the effect of an annuity described in the preceding sentence.

``(2) Applicable percentage.--

``(A) In general.--For purposes of paragraph (1), if the survivor annuity percentage--

``(i) is less than 75 percent, the applicable percentage is 75 percent, and

``(ii) is greater than or equal to 75 percent, the applicable percentage is 50 percent.

``(B) Survivor annuity percentage.--For purposes of

subparagraph (A), the term `survivor annuity percentage' means the percentage which the survivor annuity under the plan's qualified joint and survivor annuity bears to the annuity payable during the joint lives of the participant and the spouse.''.

(3) Notice.--Section 417(a)(3)(A)(i) of such Code is amended by inserting ``and of the qualified optional survivor annuity'' after ``annuity''.

(b) Amendments to ERISA.--

(1) Election of survivor annuity.--Section 205(c)(1)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1055(c)(1)(A)) is amended--

(A) in clause (i), by striking ``, and'' and inserting a comma;

(B) by redesignating clause (ii) as clause (iii); and

(C) by inserting after clause (i) the following:

``(ii) if the participant elects a waiver under clause (i), may elect the qualified optional survivor annuity at any time during the applicable election period, and''.

(2) Definition.--Section 205(d) of such Act (29 U.S.C. 1055(d)) is amended--

(A) by inserting ``(1)'' after ``(d)'';

(B) by redesignating paragraphs (1) and (2) as subparagraphs (A) and (B), respectively; and

(C) by adding at the end the following:

``(2)(A) For purposes of this section, the term `qualified optional survivor annuity' means an annuity--

``(i) for the life of the participant with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity which is payable during the joint lives of the participant and the spouse, and

``(ii) which is the actuarial equivalent of a single annuity for the life of the participant.

Such term also includes any annuity in a form having the effect of an annuity described in the preceding sentence.

``(B)(i) For purposes of subparagraph (A), if the survivor annuity percentage--

``(I) is less than 75 percent, the applicable percentage is 75 percent, and

``(II) is greater than or equal to 75 percent, the applicable percentage is 50 percent.

``(ii) For purposes of clause (i), the term `survivor annuity percentage' means the percentage which the survivor annuity under the plan's qualified joint and survivor annuity bears to the annuity payable during the joint lives of the participant and the spouse.''.

(3) Notice.--Section 205(c)(3)(A)(i) of such Act (29 U.S.C. 1055(c)(3)(A)(i)) is amended by inserting ``and of the qualified optional survivor annuity'' after ``annuity''.

(c) Effective Dates.--

(1) In general.--The amendments made by this section shall apply to plan years beginning after December 31, 2007.

(2) Special rule for collectively bargained plans.--In the case of a plan maintained pursuant to 1 or more collective bargaining agreements between employee representatives and 1 or more employers ratified on or before the date of the enactment of this Act, the amendments made by this section shall not apply to plan years beginning before the earlier of--

(A) the later of--

(i) January 1, 2008, or

(ii) the date on which the last collective bargaining agreement related to the plan terminates (determined without regard to any extension thereof after the date of enactment of this Act), or

(B) January 1, 2009.

TITLE XI--ADMINISTRATIVE PROVISIONS

SEC. 1101. EMPLOYEE PLANS COMPLIANCE RESOLUTION SYSTEM.

(a) In General.--The Secretary of the Treasury shall have full authority to establish and implement the Employee Plans Compliance Resolution System (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise, or other taxes to ensure that any tax, penalty, or sanction is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

(b) Improvements.--The Secretary of the Treasury shall continue to update and improve the Employee Plans Compliance Resolution System (or any successor program), giving special attention to--

(1) increasing the awareness and knowledge of small

employers concerning the availability and use of the program;
(2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures;
(3) extending the duration of the self-correction period under the Self-Correction Program for significant compliance failures;
(4) expanding the availability to correct insignificant compliance failures under the Self-Correction Program during audit; and
(5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

SEC. 1102. NOTICE AND CONSENT PERIOD REGARDING DISTRIBUTIONS.

(a) Expansion of Period.--
(1) Amendment of internal revenue code.--
(A) In general.--Section 417(a)(6)(A) of the Internal Revenue Code of 1986 is amended by striking ``90-day'' and inserting ``180-day''.
(B) Modification of regulations.--The Secretary of the Treasury shall modify the regulations under sections 402(f), 411(a)(11), and 417 of the Internal Revenue Code of 1986 by substituting ``180 days'' for ``90 days'' each place it appears in Treasury Regulations sections 1.402(f)-1, 1.411(a)-11(c), and 1.417(e)-1(b).
(2) Amendment of erisa.--
(A) In general.--Section 205(c)(7)(A) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1055(c)(7)(A)) is amended by striking ``90-day'' and inserting ``180-day''.
(B) Modification of regulations.--The Secretary of the Treasury shall modify the regulations under part 2 of subtitle B of title I of the Employee Retirement Income Security Act of 1974 relating to sections 203(e) and 205 of such Act by substituting ``180 days'' for ``90 days'' each place it appears.
(3) Effective date.--The amendments and modifications made or required by this subsection shall apply to years beginning after December 31, 2006.
(b) Notification of Right To Defer.--
(1) In general.--The Secretary of the Treasury shall modify the regulations under section 411(a)(11) of the Internal Revenue Code of 1986 and under section 205 of the Employee Retirement Income Security Act of 1974 to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.
(2) Effective date.--
(A) In general.--The modifications required by paragraph (1) shall apply to years beginning after December 31, 2006.
(B) Reasonable notice.--A plan shall not be treated as failing to meet the requirements of section 411(a)(11) of such Code or section 205 of such Act with respect to any description of consequences described in paragraph (1) made within 90 days after the Secretary of the Treasury issues the modifications required by paragraph (1) if the plan administrator makes a reasonable attempt to comply with such requirements.

SEC. 1103. REPORTING SIMPLIFICATION.

(a) Simplified Annual Filing Requirement for Owners and Their Spouses.--
(1) In general.--The Secretary of the Treasury shall modify the requirements for filing annual returns with respect to one-participant retirement plans to ensure that such plans with assets of $250,000 or less as of the close of the plan year need not file a return for that year.
(2) One-participant retirement plan defined.--For purposes of this subsection, the term ``one-participant retirement plan'' means a retirement plan with respect to which the following requirements are met:
(A) on the first day of the plan year--
(i) the plan covered only one individual (or the individual and the individual's spouse) and the individual owned 100 percent of the plan sponsor (whether or not incorporated), or
(ii) the plan covered only one or more partners (or partners and their spouses) in the plan sponsor;

(B) the plan meets the minimum coverage requirements of section 410(b) of the Internal Revenue Code of 1986 without being combined with any other plan of the business that covers the employees of the business;

(C) the plan does not provide benefits to anyone except the individual (and the individual's spouse) or the partners (and their spouses);

(D) the plan does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of businesses under common control; and

(E) the plan does not cover a business that uses the services of leased employees (within the meaning of section 414(n) of such Code).

For purposes of this paragraph, the term ``partner'' includes a 2-percent shareholder (as defined in section 1372(b) of such Code) of an S corporation.

(3) Other definitions.--Terms used in paragraph (2) which are also used in section 414 of the Internal Revenue Code of 1986 shall have the respective meanings given such terms by such section.

(4) Effective date.--The provisions of this subsection shall apply to plan years beginning on or after January 1, 2007.

(b) Simplified Annual Filing Requirement for Plans With Fewer Than 25 Participants.--In the case of plan years beginning after December 31, 2006, the Secretary of the Treasury and the Secretary of Labor shall provide for the filing of a simplified annual return for any retirement plan which covers less than 25 participants on the first day of a plan year and which meets the requirements described in subparagraphs (B), (D), and (E) of subsection (a)(2).

SEC. 1104. VOLUNTARY EARLY RETIREMENT INCENTIVE AND EMPLOYMENT RETENTION PLANS MAINTAINED BY LOCAL EDUCATIONAL AGENCIES AND OTHER ENTITIES.

(a) Voluntary Early Retirement Incentive Plans.--

(1) Treatment as plan providing severance pay.--Section 457(e)(11) of the Internal Revenue Code of 1986 (relating to certain plans excluded) is amended by adding at the end the following new subparagraph:

``(D) Certain voluntary early retirement incentive plans.--

``(i) In general.--If an applicable voluntary early retirement incentive plan--

``(I) makes payments or supplements as an early retirement benefit, a retirement-type subsidy, or a benefit described in the last sentence of section 411(a)(9), and

``(II) such payments or supplements are made in coordination with a defined benefit plan which is described in section 401(a) and includes a trust exempt from tax under section 501(a) and which is maintained by an eligible employer described in paragraph (1)(A) or by an education association described in clause (ii)(II),

such applicable plan shall be treated for purposes of subparagraph (A)(i) as a bona fide severance pay plan with respect to such payments or supplements to the extent such payments or supplements could otherwise have been provided under such defined benefit plan (determined as if section 411 applied to such defined benefit plan).

``(ii) Applicable voluntary early retirement incentive plan.--For purposes of this subparagraph, the term `applicable voluntary early retirement incentive plan' means a voluntary early retirement incentive plan maintained by--

``(I) a local educational agency (as defined in section 9101 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 7801)), or

``(II) an education association which principally represents employees of 1 or more agencies described in subclause (I) and which is described in section 501(c) (5) or (6) and exempt from tax under section 501(a).''.

(2) Age discrimination in employment act.--Section 4(l)(1) of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623(l)(1)) is amended--

(A) by inserting ``(A)'' after ``(1)'',

(B) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively,

(C) by redesignating clauses (i) and (ii) of subparagraph (B) (as in effect before the amendments made by subparagraph (B)) as subclauses (I) and (II), respectively, and

(D) by adding at the end the following:

``(B) A voluntary early retirement incentive plan that--

``(i) is maintained by--

``(I) a local educational agency (as defined in section 9101 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 7801), or

``(II) an education association which principally represents employees of 1 or more agencies described in subclause (I) and which is described in section 501(c) (5) or (6) of the Internal Revenue Code of 1986 and exempt from taxation under section 501(a) of such Code, and

``(ii) makes payments or supplements described in subclauses (I) and (II) of subparagraph (A)(ii) in coordination with a defined benefit plan (as so defined) maintained by an eligible employer described in section 457(e)(1)(A) of such Code or by an education association described in clause (i)(II),

shall be treated solely for purposes of subparagraph (A)(ii) as if it were a part of the defined benefit plan with respect to such payments or supplements. Payments or supplements under such a voluntary early retirement incentive plan shall not constitute severance pay for purposes of paragraph (2).''.

(b) Employment Retention Plans.--

(1) In general.--Section 457(f)(2) of the Internal Revenue Code of 1986 (relating to exceptions) is amended by striking ``and'' at the end of subparagraph (D), by striking the period at the end of subparagraph (E) and inserting ``, and'', and by adding at the end the following:

``(F) that portion of any applicable employment retention plan described in paragraph (4) with respect to any participant.''.

(2) Definitions and rules relating to employment retention plans.--Section 457(f) of such Code is amended by adding at the end the following new paragraph:

``(4) Employment retention plans.--For purposes of paragraph (2)(F)--

``(A) In general.--The portion of an applicable employment retention plan described in this paragraph with respect to any participant is that portion of the plan which provides benefits payable to the participant not in excess of twice the applicable dollar limit determined under subsection (e)(15).

``(B) Other rules.--

``(i) Limitation.--
Paragraph (2)(F) shall only apply to the portion of the plan described in subparagraph (A) for years preceding the year in which such portion is paid or otherwise made available to the participant.

``(ii) Treatment.--A plan shall not be treated for purposes of this title as providing for the deferral of compensation for any year with respect to the portion of the plan described in subparagraph (A).

``(C) Applicable employment retention plan.--The term `applicable employment retention plan' means an employment retention plan maintained by--

``(i) a local educational agency (as defined in section 9101 of the Elementary and Secondary Education Act of 1965 (20 U.S.C. 7801), or

``(ii) an education association which principally represents employees of 1 or more agencies described in clause (i) and which is described in section 501(c) (5) or (6) and exempt from taxation under section 501(a).

``(D) Employment retention plan.--The term `employment retention plan' means a plan to pay, upon termination of employment, compensation to an employee of a local educational agency or education association described in subparagraph (C) for purposes of--

``(i) retaining the services of the employee, or

``(ii) rewarding such employee for the employee's service with 1 or more such agencies or

associations.''.

(c) Coordination With ERISA.--Section 3(2)(B) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(2)(B)) is amended by adding at the end the following: ``An applicable voluntary early retirement incentive plan (as defined in section 457(e)(11)(D)(ii) of the Internal Revenue Code of 1986) making payments or supplements described in section 457(e)(11)(D)(i) of such Code, and an applicable employment retention plan (as defined in section 457(f)(4)(C) of such Code) making payments of benefits described in section 457(f)(4)(A) of such Code, shall, for purposes of this title, be treated as a welfare plan (and not a pension plan) with respect to such payments and supplements.''.

(d) Effective Dates.--

(1) In general.--The amendments made by this Act shall take effect on the date of the enactment of this Act.

(2) Tax amendments.--The amendments made by subsections (a)(1) and (b) shall apply to taxable years ending after the date of the enactment of this Act.

(3) ERISA amendments.--The amendment made by subsection (c) shall apply to plan years ending after the date of the enactment of this Act.

(4) Construction.--Nothing in the amendments made by this section shall alter or affect the construction of the Internal Revenue Code of 1986, the Employee Retirement Income Security Act of 1974, or the Age Discrimination in Employment Act of 1967 as applied to any plan, arrangement, or conduct to which such amendments do not apply.

SEC. 1105. NO REDUCTION IN UNEMPLOYMENT COMPENSATION AS A RESULT OF PENSION ROLLOVERS.

(a) In General.--Section 3304(a) of the Internal Revenue Code of 1986 (relating to requirements for State unemployment laws) is amended by adding at the end the following new flush sentence:

``Compensation shall not be reduced under paragraph (15) for any pension, retirement or retired pay, annuity, or similar payment which is not includible in gross income of the individual for the taxable year in which paid because it was part of a rollover distribution.''.

(b) Effective Date.--The amendment made by this section shall apply to weeks beginning on or after the date of the enactment of this Act.

SEC. 1106. REVOCATION OF ELECTION RELATING TO TREATMENT AS MULTIEMPLOYER PLAN.

(a) Amendment to ERISA.--Section 3(37) of the Employee Retirement Income Security Act of 1974 is amended by adding at the end the following new subparagraph (G):

``(G)(i) Within 1 year after the enactment of the Pension Protection Act of 2006--

``(I) an election under subparagraph (E) may be revoked, pursuant to procedures prescribed by the Pension Benefit Guaranty Corporation, if, for each of the 3 plan years prior to the date of the enactment of that Act, the plan would have been a multiemployer plan but for the election under subparagraph (E), and

``(II) a plan that meets the criteria in clauses (i) and (ii) of subparagraph (A) of this paragraph or that is described in clause (vi) may, pursuant to procedures prescribed by the Pension Benefit Guaranty Corporation, elect to be a multiemployer plan, if--

``(aa) for each of the 3 plan years immediately before the date of the enactment of the Pension Protection Act of 2006, the plan has met those criteria or is so described,

``(bb) substantially all of the plan's employer contributions for each of those plan years were made or required to be made by organizations that were exempt from tax under section 501 of the Internal Revenue Code of 1986, and

``(cc) the plan was established prior to September 2, 1974.

``(ii) An election under this paragraph shall be effective for all purposes under this Act and under the Internal Revenue Code of 1986, starting with the first plan year ending after the date of the enactment of the Pension Protection Act of 2006.

``(iii) Once made, an election under this paragraph shall be irrevocable, except that a plan described in subclause (i)(II) shall cease to be a multiemployer plan as of the plan year beginning immediately after the first plan year for which the majority of its employer contributions were made or required to be made by organizations that were not exempt from tax under section 501 of the Internal Revenue Code of 1986.

``(iv) The fact that a plan makes an election under clause (i)(II) does not imply that the plan was not a multiemployer plan prior to the date of the election or would not be a multiemployer plan without regard to the election.

``(v)(I) No later than 30 days before an election is made under this paragraph, the plan administrator shall provide notice of the pending election to each plan participant and beneficiary, each labor organization representing such participants or beneficiaries, and each employer that has an obligation to contribute to the plan, describing the principal differences between the guarantee programs under title IV and the benefit restrictions under this title for single employer and multiemployer plans, along with such other information as the plan administrator chooses to include.

``(II) Within 180 days after the date of enactment of the Pension Protection Act of 2006, the Secretary shall prescribe a model notice under this subparagraph.

``(III) A plan administrator's failure to provide the notice required under this subparagraph shall be treated for purposes of section 502(c)(2) as a failure or refusal by the plan administrator to file the annual report required to be filed with the Secretary under section 101(b)(4).

``(vi) A plan is described in this clause if it is a plan--

``(I) that was established in Chicago, Illinois, on August 12, 1881; and

``(II) sponsored by an organization described in section 501(c)(5) of the Internal Revenue Code of 1986 and exempt from tax under section 501(a) of such Code.''.

(b) Amendment to Internal Revenue Code.--Subsection (f) of section 414 of the Internal Revenue Code of 1986 is amended by adding at the end the following new paragraph (6):

``(6) Election with regard to multiemployer status.--

``(A) Within 1 year after the enactment of the Pension Protection Act of 2006--

``(i) An election under paragraph (5) may be revoked, pursuant to procedures prescribed by the Pension Benefit Guaranty Corporation, if, for each of the 3 plan years prior to the date of the enactment of that Act, the plan would have been a multiemployer plan but for the election under paragraph (5), and

``(ii) a plan that meets the criteria in subparagraph (A) and (B) of paragraph (1) of this subsection or that is described in subparagraph (E) may, pursuant to procedures prescribed by the Pension Benefit Guaranty Corporation, elect to be a multiemployer plan, if--

``(I) for each of the 3 plan years immediately before the date of enactment of the Pension Protection Act of 2006, the plan has met those criteria or is so described,

``(II) substantially all of the plan's employer contributions for each of those plan years were made or required to be made by organizations that were exempt from tax under section 501, and

``(III) the plan was established prior to September 2, 1974.

``(B) An election under this paragraph shall be effective for all purposes under this Act and under the Employee Retirement Income Security Act of 1974, starting with the first plan year ending after the date of the enactment of the Pension Protection Act of 2006.

``(C) Once made, an election under this paragraph shall be irrevocable, except that a plan described in subparagraph (A)(ii) shall cease to be a multiemployer plan as of the plan year beginning immediately after the first plan year for which the majority of its employer contributions were made or required to be made by organizations that were not exempt from tax under section 501.

``(D) The fact that a plan makes an election under subparagraph (A)(ii) does not imply that the plan was not a multiemployer plan prior to the date of the election or would not be a multiemployer plan without regard to the election.

``(E) A plan is described in this subparagraph if it

is a plan--
``(i) that was established in Chicago, Illinois, on August 12, 1881; and
``(ii) sponsored by an organization described in section 501(c)(5) and exempt from tax under section 501(a).''.

SEC. 1107. PROVISIONS RELATING TO PLAN AMENDMENTS.

(a) In General.--If this section applies to any pension plan or contract amendment--
(1) such pension plan or contract shall be treated as being operated in accordance with the terms of the plan during the period described in subsection (b)(2)(A), and
(2) except as provided by the Secretary of the Treasury, such pension plan shall not fail to meet the requirements of section 411(d)(6) of the Internal Revenue Code of 1986 and section 204(g) of the Employee Retirement Income Security Act of 1974 by reason of such amendment.
(b) Amendments to Which Section Applies.--
(1) In general.--This section shall apply to any amendment to any pension plan or annuity contract which is made--
(A) pursuant to any amendment made by this Act or pursuant to any regulation issued by the Secretary of the Treasury or the Secretary of Labor under this Act, and
(B) on or before the last day of the first plan year beginning on or after January 1, 2009.
In the case of a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986), this paragraph shall be applied by substituting ``2011'' for ``2009''.
(2) Conditions.--This section shall not apply to any amendment unless--
(A) during the period--
(i) beginning on the date the legislative or regulatory amendment described in paragraph (1)(A) takes effect (or in the case of a plan or contract amendment not required by such legislative or regulatory amendment, the effective date specified by the plan), and
(ii) ending on the date described in paragraph (1)(B) (or, if earlier, the date the plan or contract amendment is adopted), the plan or contract is operated as if such plan or contract amendment were in effect; and
(B) such plan or contract amendment applies retroactively for such period.

TITLE XII--PROVISIONS RELATING TO EXEMPT ORGANIZATIONS

Subtitle A--Charitable Giving Incentives

SEC. 1201. TAX-FREE DISTRIBUTIONS FROM INDIVIDUAL RETIREMENT PLANS FOR CHARITABLE PURPOSES.

(a) In General.--Subsection (d) of section 408 (relating to individual retirement accounts) is amended by adding at the end the following new paragraph:
``(8) Distributions for charitable purposes.--
``(A) In general.--So much of the aggregate amount of qualified charitable distributions with respect to a taxpayer made during any taxable year which does not exceed $100,000 shall not be includible in gross income of such taxpayer for such taxable year.
``(B) Qualified charitable distribution.--For purposes of this paragraph, the term `qualified charitable distribution' means any distribution from an individual retirement plan (other than a plan described in subsection (k) or (p))--
``(i) which is made directly by the trustee to an organization described in section 170(b)(1)(A) (other than any organization described in section 509(a)(3) or any fund or account described in section 4966(d)(2)), and
``(ii) which is made on or after the date that the individual for whose benefit the plan is maintained has attained age 70\1/2\.
A distribution shall be treated as a qualified charitable distribution only to the extent that the distribution would be includible in gross income without regard to subparagraph (A).
``(C) Contributions must be otherwise deductible.--For purposes of this paragraph, a distribution to an organization described in subparagraph (B)(i) shall be treated as a qualified charitable distribution only if a deduction for the entire distribution would be allowable

under section 170 (determined without regard to
subsection (b) thereof and this paragraph).
``(D) Application of section 72.--Notwithstanding
section 72, in determining the extent to which a
distribution is a qualified charitable distribution, the
entire amount of the distribution shall be treated as
includible in gross income without regard to
subparagraph (A) to the extent that such amount does not
exceed the aggregate amount which would have been so
includible if all amounts distributed from all
individual retirement plans were treated as 1 contract
under paragraph (2)(A) for purposes of determining the
inclusion of such distribution under section 72. Proper
adjustments shall be made in applying section 72 to
other distributions in such taxable year and subsequent
taxable years.
``(E) Denial of deduction.--Qualified charitable
distributions which are not includible in gross income
pursuant to subparagraph (A) shall not be taken into
account in determining the deduction under section 170.
``(F) Termination.--This paragraph shall not apply
to distributions made in taxable years beginning after
December 31, 2007.''.

(b) Modifications Relating to Information Returns by Certain
Trusts.--

(1) Returns.--Section 6034 (relating
to returns by trusts described in section 4947(a)(2) or claiming
charitable deductions under section 642(c)) is amended to read
as follows:

``SEC. 6034. RETURNS BY CERTAIN TRUSTS.

``(a) Split-Interest Trusts.--Every trust described in section
4947(a)(2) shall furnish such information with respect to the taxable
year as the Secretary may by forms or regulations require.

``(b) Trusts Claiming Certain Charitable Deductions.--

``(1) In general.--Every trust not required to file a return
under subsection (a) but claiming a deduction under section
642(c) for the taxable year shall furnish such information with
respect to such taxable year as the Secretary may by forms or
regulations prescribe, including--

``(A) the amount of the deduction taken under
section 642(c) within such year,

``(B) the amount paid out within such year which
represents amounts for which deductions under section
642(c) have been taken in prior years,

``(C) the amount for which such deductions have been
taken in prior years but which has not been paid out at
the beginning of such year,

``(D) the amount paid out of principal in the
current and prior years for the purposes described in
section 642(c),

``(E) the total income of the trust within such year
and the expenses attributable thereto, and

``(F) a balance sheet showing the assets,
liabilities, and net worth of the trust as of the
beginning of such year.

``(2) Exceptions.--Paragraph (1) shall not apply to a trust
for any taxable year if--

``(A) all the net income for such year, determined
under the applicable principles of the law of trusts, is
required to be distributed currently to the
beneficiaries, or

``(B) the trust is described in section
4947(a)(1).''.

(2) Increase in penalty relating to filing of information
return by split-interest trusts.--Paragraph (2) of section
6652(c) (relating to returns by exempt
organizations and by certain trusts) is amended by adding at the
end the following new subparagraph:

``(C) Split-interest
trusts.--In the case of a trust which is required to
file a return under section 6034(a), subparagraphs (A)
and (B) of this paragraph shall not apply and paragraph
(1) shall apply in the same manner as if such return
were required under section 6033, except that--

``(i) the 5 percent limitation in the second
sentence of paragraph (1)(A) shall not apply,

``(ii) in the case of any trust with gross
income in excess of $250,000, the first sentence
of paragraph (1)(A) shall be applied by
substituting `$100' for `$20', and the second
sentence thereof shall be applied by substituting
`$50,000' for `$10,000', and

``(iii) the third sentence of paragraph (1)(A) shall be disregarded.

In addition to any penalty imposed on the trust pursuant to this subparagraph, if the person required to file such return knowingly fails to file the return, such penalty shall also be imposed on such person who shall be personally liable for such penalty.''.

(3) Confidentiality of noncharitable beneficiaries.--Subsection (b) of section 6104 (relating to inspection of annual information returns) is amended by adding at the end the following new sentence: ``In the case of a trust which is required to file a return under section 6034(a), this subsection shall not apply to information regarding beneficiaries which are not organizations described in section 170(c).''.

(4) Clerical amendment.--The item in the table of sections for subpart A of part III of subchapter A of chapter 61 relating to section 6034 is amended to read as follows:

``Sec. 6034. Returns by certain trusts.''.

(c) Effective Dates.--

(1) Subsection (a).--The amendment made by subsection (a) shall apply to distributions made in taxable years beginning after December 31, 2005.

(2) Subsection (b).--The amendments made by subsection (b) shall apply to returns for taxable years beginning after December 31, 2006.

SEC. 1202. EXTENSION OF MODIFICATION OF CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF FOOD INVENTORY.

(a) In General.--Section 170(e)(3)(C)(iv) (relating to termination) is amended by striking ``2005'' and inserting ``2007''.

(b) Effective Date.--The amendment made by this section shall apply to contributions made after December 31, 2005.

SEC. 1203. BASIS ADJUSTMENT TO STOCK OF S CORPORATION CONTRIBUTING PROPERTY.

(a) In General.--Paragraph (2) of section 1367(a) (relating to adjustments to basis of stock of shareholders, etc.) is amended by adding at the end the following new flush sentence:

``The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning after December 31, 2007.''.

(b) Effective Date.--The amendment made by this section shall apply to contributions made in taxable years beginning after December 31, 2005.

SEC. 1204. EXTENSION OF MODIFICATION OF CHARITABLE DEDUCTION FOR CONTRIBUTIONS OF BOOK INVENTORY.

(a) In General.--Section 170(e)(3)(D)(iv) (relating to termination) is amended by striking ``2005'' and inserting ``2007''.

(b) Effective Date.--The amendment made by this section shall apply to contributions made after December 31, 2005.

SEC. 1205. MODIFICATION OF TAX TREATMENT OF CERTAIN PAYMENTS TO CONTROLLING EXEMPT ORGANIZATIONS.

(a) In General.--Paragraph (13) of section 512(b) (relating to special rules for certain amounts received from controlled entities) is amended by redesignating subparagraph (E) as subparagraph (F) and by inserting after subparagraph (D) the following new subparagraph:

``(E) Paragraph to apply only to certain excess payments.--

``(i) In general.--Subparagraph (A) shall apply only to the portion of a qualifying specified payment received or accrued by the controlling organization that exceeds the amount which would have been paid or accrued if such payment met the requirements prescribed under section 482.

``(ii) Addition to tax for valuation misstatements.--The tax imposed by this chapter on the controlling organization shall be increased by an amount equal to 20 percent of the larger of--

``(I) such excess determined without regard to any amendment or supplement to a return of tax, or

``(II) such excess determined with regard to all such amendments and supplements.

``(iii) Qualifying specified payment.--The term `qualifying specified payment' means a specified payment which is made pursuant to--

``(I) a binding written contract in effect on the date of the enactment of this subparagraph, or

``(II) a contract which is a renewal, under substantially similar terms, of a contract described in subclause (I).

``(iv) Termination.--This subparagraph shall not apply to payments received or accrued after December 31, 2007.''.

(b) Reporting.--

(1) In general.--Section 6033 (relating to returns by exempt organizations) is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

``(h) Controlling Organizations.--Each controlling organization (within the meaning of section 512(b)(13)) which is subject to the requirements of subsection (a) shall include on the return required under subsection (a)--

``(1) any interest, annuities, royalties, or rents received from each controlled entity (within the meaning of section 512(b)(13)),

``(2) any loans made to each such controlled entity, and

``(3) any transfers of funds between such controlling organization and each such controlled entity.''.

(2) Report to congress.--Not later than January 1, 2009, the Secretary of the Treasury shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on the effectiveness of the Internal Revenue Service in administering the amendments made by subsection (a) and on the extent to which payments by controlled entities (within the meaning of section 512(b)(13) of the Internal Revenue Code of 1986) to controlling organizations (within the meaning of section 512(b)(13) of such Code) meet the requirements under section 482 of such Code. Such report shall include the results of any audit of any controlling organization or controlled entity and recommendations relating to the tax treatment of payments from controlled entities to controlling organizations.

(c) Effective Date.--

(1) Subsection (a).--The amendments made by subsection (a) shall apply to payments received or accrued after December 31, 2005.

(2) Subsection (b).--The amendments made by subsection (b) shall apply to returns the due date (determined without regard to extensions) of which is after the date of the enactment of this Act.

SEC. 1206. ENCOURAGEMENT OF CONTRIBUTIONS OF CAPITAL GAIN REAL PROPERTY MADE FOR CONSERVATION PURPOSES.

(a) In General.--

(1) Individuals.--Paragraph (1) of section 170(b) (relating to percentage limitations) is amended by redesignating subparagraphs (E) and (F) as subparagraphs (F) and (G), respectively, and by inserting after subparagraph (D) the following new subparagraph:

``(E) Contributions of qualified conservation contributions.--

``(i) In general.--Any qualified conservation contribution (as defined in subsection (h)(1)) shall be allowed to the extent the aggregate of such contributions does not exceed the excess of 50 percent of the taxpayer's contribution base over the amount of all other charitable contributions allowable under this paragraph.

``(ii) Carryover.--If the aggregate amount of contributions described in clause (i) exceeds the limitation of clause (i), such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution to which clause (i) applies in each of the 15 succeeding years in order of time.

``(iii) Coordination with other subparagraphs.--For purposes of applying this subsection and subsection (d)(1), contributions described in clause (i) shall not be treated as described in subparagraph (A), (B), (C), or (D) and such subparagraphs shall apply without regard to such contributions.

``(iv) Special rule for contribution of property used in agriculture or livestock production.--

``(I) In general.--If the individual

is a qualified farmer or rancher for the
taxable year for which the contribution
is made, clause (i) shall be applied by
substituting `100 percent' for `50
percent'.
``(II) Exception.--Subclause (I)
shall not apply to any contribution of
property made after the date of the
enactment of this subparagraph which is
used in agriculture or livestock
production (or available for such
production) unless such contribution is
subject to a restriction that such
property remain available for such
production. This subparagraph shall be
applied separately with respect to
property to which subclause (I) does not
apply by reason of the preceding
sentence prior to its application to
property to which subclause (I) does
apply.
``(v) Definition.--For purposes of clause
(iv), the term `qualified farmer or rancher' means
a taxpayer whose gross income from the trade or
business of farming (within the meaning of section
2032A(e)(5)) is greater than 50 percent of the
taxpayer's gross income for the taxable year.
``(vi) Termination.--This subparagraph shall
not apply to any contribution made in taxable
years beginning after December 31, 2007.''.
(2) Corporations.--Paragraph (2) of section
170(b) is amended to read as follows:
``(2) Corporations.--In the case of a corporation--
``(A) In general.--The total deductions under
subsection (a) for any taxable year (other than for
contributions to which subparagraph (B) applies) shall
not exceed 10 percent of the taxpayer's taxable income.
``(B) Qualified conservation contributions by
certain corporate farmers and ranchers.--
``(i) In general.--Any qualified conservation
contribution (as defined in subsection (h)(1))--
``(I) which is made by a corporation
which, for the taxable year during which
the contribution is made, is a qualified
farmer or rancher (as defined in
paragraph (1)(E)(v)) and the stock of
which is not readily tradable on an
established securities market at any
time during such year, and
``(II) which, in the case of
contributions made after the date of the
enactment of this subparagraph, is a
contribution of property which is used
in agriculture or livestock production
(or available for such production) and
which is subject to a restriction that
such property remain available for such
production,
shall be allowed to the extent the aggregate of
such contributions does not exceed the excess of
the taxpayer's taxable income over the amount of
charitable contributions allowable under
subparagraph (A).
``(ii) Carryover.--If
the aggregate amount of contributions described in
clause (i) exceeds the limitation of clause (i),
such excess shall be treated (in a manner
consistent with the rules of subsection (d)(2)) as
a charitable contribution to which clause (i)
applies in each of the 15 succeeding years in
order of time.
``(iii) Termination.--This subparagraph shall
not apply to any contribution made in taxable
years beginning after December 31, 2007.
``(C) Taxable income.--For purposes of this
paragraph, taxable income shall be computed without
regard to--
``(i) this section,
``(ii) part VIII (except section 248),
``(iii) any net operating loss carryback to
the taxable year under section 172,
``(iv) section 199, and

``(v) any capital loss carryback to the taxable year under section 1212(a)(1).''.

(b) Conforming Amendments.--

(1) Paragraph (2) of section 170(d) is amended by striking ``subsection (b)(2)'' each place it appears and inserting ``subsection (b)(2)(A)''.

(2) Section 545(b)(2) is amended by striking ``and (D)'' and inserting ``(D), and (E)''.

(c) Effective Date.--The amendments made by this section shall apply to contributions made in taxable years beginning after December 31, 2005.

SEC. 1207. EXCISE TAXES EXEMPTION FOR BLOOD COLLECTOR ORGANIZATIONS.

(a) Exemption From Imposition of Special Fuels Tax.--Section 4041(g) (relating to other exemptions) is amended by striking ``and'' at the end of paragraph (3), by striking the period in paragraph (4) and inserting ``; and'', and by inserting after paragraph (4) the following new paragraph:

``(5) with respect to the sale of any liquid to a qualified blood collector organization (as defined in section 7701(a)(49)) for such organization's exclusive use in the collection, storage, or transportation of blood.''.

(b) Exemption From Manufacturers Excise Tax.--

(1) In general.--Section 4221(a) (relating to certain tax-free sales) is amended by striking ``or'' at the end of paragraph (4), by adding ``or'' at the end of paragraph (5), and by inserting after paragraph (5) the following new paragraph:

``(6) to a qualified blood collector organization (as defined in section 7701(a)(49)) for such organization's exclusive use in the collection, storage, or transportation of blood,''.

(2) No exemption with respect to vaccines and recreational equipment.--Section 4221(a) is amended by adding at the end the following new sentence: ``In the case of taxes imposed by subchapter C or D, paragraph (6) shall not apply.''.

(3) Conforming amendments.--

(A) The second sentence of section 4221(a) is amended by striking ``Paragraphs (4) and (5)'' and inserting ``Paragraphs (4), (5), and (6)''.

(B) Section 6421(c) is amended by striking ``or (5)'' and inserting ``(5), or (6)''.

(c) Exemption From Communication Excise Tax.--

(1) In general.--Section 4253 (relating to exemptions) is amended by redesignating subsection (k) as subsection (l) and inserting after subsection (j) the following new subsection:

``(k) Exemption for Qualified Blood Collector Organizations.--Under regulations provided by the Secretary, no tax shall be imposed under section 4251 on any amount paid by a qualified blood collector organization (as defined in section 7701(a)(49)) for services or facilities furnished to such organization.''.

(2) Conforming amendment.--Section 4253(l), as redesignated by paragraph (1), is amended by striking ``or (j)'' and inserting ``(j), or (k)''.

(d) Exemption From Tax on Heavy Vehicles.--Section 4483 is amended by redesignating subsection (h) as subsection (i) and by inserting after subsection (g) the following new subsection:

``(h) Exemption for Vehicles Used in Blood Collection.--

``(1) In general.--No tax shall be imposed by section 4481 on the use of any qualified blood collector vehicle by a qualified blood collector organization.

``(2) Qualified blood collector vehicle.--For purposes of this subsection, the term `qualified blood collector vehicle' means a vehicle at least 80 percent of the use of which during the prior taxable period was by a qualified blood collector organization in the collection, storage, or transportation of blood.

``(3) Special rule for vehicles first placed in service in a taxable period.--In the case of a vehicle first placed in service in a taxable period, a vehicle shall be treated as a qualified blood collector vehicle for such taxable period if such qualified blood collector organization certifies to the Secretary that the organization reasonably expects at least 80 percent of the use of such vehicle by the organization during such taxable period will be in the collection, storage, or transportation of blood.

``(4) Qualified blood collector organization.--The term `qualified blood collector organization' has the meaning given such term by section 7701(a)(49).''.

(e) Credit or Refund for Certain Taxes on Sales and Services.--

(1) Deemed overpayment.--

(A) In general.--Section 6416(b)(2) is amended by redesignating subparagraphs (E) and (F) as subparagraphs (F) and (G), respectively, and

by inserting after subparagraph (D) the following new subparagraph:

``(E) sold to a qualified blood collector organization (as defined in section 7701(a)(49)) for such organization's exclusive use in the collection, storage, or transportation of blood;''.

(B) No credit or refund for vaccines or recreational equipment.--Section 6416(b)(2) is amended by adding at the end the following new sentence: ``In the case of taxes imposed by subchapter C or D of chapter 32, subparagraph (E) shall not apply.''.

(C) Conforming amendments.--Section 6416(b)(2) is amended--

(i) by striking ``Subparagraphs (C) and (D)'' in the second sentence and inserting ``Subparagraphs (C), (D), and (E)''.

(ii) by striking ``(B), (C), and (D)'' and inserting ``(B), (C), (D), and (E)''.

(2) Sales of tires.--Section 6416(b)(4)(B) is amended by striking ``or'' at the end of clause (i), by striking the period at the end of clause (ii) and inserting ``, or'', and by adding after clause (ii) the following:

``(iii) sold to a qualified blood collector organization for its exclusive use in connection with a vehicle the organization certifies will be primarily used in the collection, storage, or transportation of blood.''.

(f) Definition of Qualified Blood Collector Organization.--Section 7701(a) is amended by inserting at the end the following new paragraph:

``(49) Qualified blood collector organization.--The term `qualified blood collector organization' means an organization which is--

``(A) described in section 501(c)(3) and exempt from tax under section 501(a),

``(B) primarily engaged in the activity of the collection of human blood,

``(C) registered with the Secretary for purposes of excise tax exemptions, and

``(D) registered by the Food and Drug Administration to collect blood.''.

(g) Effective Date.--

(1) In general.--The amendments made by this section shall take effect on January 1, 2007.

(2) Subsection (d).--The amendment made by subsection (d) shall apply to taxable periods beginning on or after July 1, 2007.

Subtitle B--Reforming Exempt Organizations

PART 1--GENERAL REFORMS

SEC. 1211. REPORTING ON CERTAIN ACQUISITIONS OF INTERESTS IN INSURANCE CONTRACTS IN WHICH CERTAIN EXEMPT ORGANIZATIONS HOLD AN INTEREST.

(a) Reporting Requirements.--

(1) In general.--Subpart B of part III of subchapter A of chapter 61 (relating to information concerning transactions with other persons), as amended by this Act, is amended by adding at the end the following new section:

``SEC. 6050V. RETURNS RELATING TO APPLICABLE INSURANCE CONTRACTS IN WHICH CERTAIN EXEMPT ORGANIZATIONS HOLD INTERESTS.

``(a) In General.--Each applicable exempt organization which makes a reportable acquisition shall make the return described in subsection (c).

``(b) Time for Making Return.--Any applicable exempt organization required to make a return under subsection (a) shall file such return at such time as may be established by the Secretary.

``(c) Form and Manner of Returns.--A return is described in this subsection if such return--

``(1) is in such form as the Secretary prescribes,

``(2) contains the name, address, and taxpayer identification number of the applicable exempt organization and the issuer of the applicable insurance contract, and

``(3) contains such other information as the Secretary may prescribe.

``(d) Definitions.--For purposes of this section--

``(1) Reportable acquisition.--The term `reportable acquisition' means the acquisition by an applicable exempt organization of a direct or indirect interest in any applicable insurance contract in any case in which such acquisition is a part of a structured transaction involving a pool of such contracts.

``(2) Applicable insurance contract.--

``(A) In general.--The term `applicable insurance

contract' means any life insurance, annuity, or endowment contract with respect to which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest in the contract (whether or not at the same time).

``(B) Exceptions.--Such term shall not include a life insurance, annuity, or endowment contract if--

``(i) all persons directly or indirectly holding any interest in the contract (other than applicable exempt organizations) have an insurable interest in the insured under the contract independent of any interest of an applicable exempt organization in the contract,

``(ii) the sole interest in the contract of an applicable exempt organization or each person other than an applicable exempt organization is as a named beneficiary, or

``(iii) the sole interest in the contract of each person other than an applicable exempt organization is--

``(I) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such beneficiary was made without consideration and solely on a purely gratuitous basis, or

``(II) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or persons otherwise described in subclause (I) or clause (i) or (ii).

``(3) Applicable exempt organization.--The term `applicable exempt organization' means--

``(A) an organization described in section 170(c),

``(B) an organization described in section 168(h)(2)(A)(iv), or

``(C) an organization not described in paragraph (1) or (2) which is described in section 2055(a) or section 2522(a).

``(e) Termination.--This section shall not apply to reportable acquisitions occurring after the date which is 2 years after the date of the enactment of this section.''.

(2) Conforming amendment.--The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by adding at the end the following new item:

``Sec. 6050V. Returns relating to applicable insurance contracts in which certain exempt organizations hold interests.''.

(b) Penalties.--

(1) In general.--Subparagraph (B) of section 6724(d)(1), as amended by this Act, is amended by redesignating clauses (xiv) through (xix) as clauses (xv) through (xx) and by inserting after clause (xiii) the following new clause:

``(xiv) section 6050V (relating to returns relating to applicable insurance contracts in which certain exempt organizations hold interests),''.

(2) Intentional disregard.--Section 6721(e)(2) is amended by striking ``or'' at the end of subparagraph (B), by striking ``and'' at the end of subparagraph (C) and inserting ``or'', and by adding at the end the following new subparagraph:

``(D) in the case of a return required to be filed under section 6050V, 10 percent of the value of the benefit of any contract with respect to which information is required to be included on the return, and''.

(c) Study.--

(1) In general.--The Secretary of the Treasury shall undertake a study on--

(A) the use by tax exempt organizations of applicable insurance contracts (as defined under section 6050V(d)(2) of the Internal Revenue Code of 1986, as added by subsection (a)) for the purpose of sharing the benefits of the organization's insurable interest in individuals insured under such contracts with investors, and

(B) whether such activities are consistent with the tax exempt status of such organizations.

(2) Report.--Not later than 30 months after the date of the

enactment of this Act, the Secretary of the Treasury shall report on the study conducted under paragraph (1) to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

(d) Effective Date.--The amendments made by this section shall apply to acquisitions of contracts after the date of enactment of this Act.

SEC. 1212. INCREASE IN PENALTY EXCISE TAXES RELATING TO PUBLIC CHARITIES, SOCIAL WELFARE ORGANIZATIONS, AND PRIVATE FOUNDATIONS.

(a) Taxes on Self-Dealing and Excess Benefit Transactions.--

(1) In general.--Section 4941(a) (relating to initial taxes) is amended--

(A) in paragraph (1), by striking ``5 percent'' and inserting ``10 percent'', and

(B) in paragraph (2), by striking ``2\1/2\ percent'' and inserting ``5 percent''.

(2) Increased limitation for managers on self-dealing.--Section 4941(c)(2) is amended by striking ``$10,000'' each place it appears in the text and heading thereof and inserting ``$20,000''.

(3) Increased limitation for managers on excess benefit transactions.--Section 4958(d)(2) is amended by striking ``$10,000'' and inserting ``$20,000''.

(b) Taxes on Failure to Distribute Income.--Section 4942(a) (relating to initial tax) is amended by striking ``15 percent'' and inserting ``30 percent''.

(c) Taxes on Excess Business Holdings.--Section 4943(a)(1) (relating to imposition) is amended by striking ``5 percent'' and inserting ``10 percent''.

(d) Taxes on Investments Which Jeopardize Charitable Purpose.--

(1) In general.--Section 4944(a) (relating to initial taxes) is amended by striking ``5 percent'' both places it appears and inserting ``10 percent''.

(2) Increased limitation for managers.--Section 4944(d)(2) is amended--

(A) by striking ``$5,000,'' and inserting ``$10,000,'', and

(B) by striking ``$10,000.'' and inserting ``$20,000.''.

(e) Taxes on Taxable Expenditures.--

(1) In general.--Section 4945(a) (relating to initial taxes) is amended--

(A) in paragraph (1), by striking ``10 percent'' and inserting ``20 percent'', and

(B) in paragraph (2), by striking ``2\1/2\ percent'' and inserting ``5 percent''.

(2) Increased limitation for managers.--Section 4945(c)(2) is amended--

(A) by striking ``$5,000,'' and inserting ``$10,000,'', and

(B) by striking ``$10,000.'' and inserting ``$20,000.''.

(f) Effective Date.--The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1213. REFORM OF CHARITABLE CONTRIBUTIONS OF CERTAIN EASEMENTS IN REGISTERED HISTORIC DISTRICTS AND REDUCED DEDUCTION FOR PORTION OF QUALIFIED CONSERVATION CONTRIBUTION ATTRIBUTABLE TO REHABILITATION CREDIT.

(a) Special Rules With Respect to Buildings in Registered Historic Districts.--

(1) In general.--Paragraph (4) of section 170(h) (relating to definition of conservation purpose) is amended by redesignating subparagraph (B) as subparagraph (C) and by inserting after subparagraph (A) the following new subparagraph:

``(B) Special rules with respect to buildings in registered historic districts.--In the case of any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in subparagraph (C)(ii), such contribution shall not be considered to be exclusively for conservation purposes unless--

``(i) such interest--

``(I) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and

``(II) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior,

``(ii) the donor and donee enter into a written agreement certifying, under penalty of perjury, that the donee--

``(I) is a qualified organization (as defined in paragraph (3)) with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and

``(II) has the resources to manage and enforce the restriction and a commitment to do so, and

``(iii) in the case of any contribution made in a taxable year beginning after the date of the enactment of this subparagraph, the taxpayer includes with the taxpayer's return for the taxable year of the contribu- tion--

``(I) a qualified appraisal (within the meaning of subsection (f)(11)(E)) of the qualified property interest,

``(II) photographs of the entire exterior of the building, and

``(III) a description of all restrictions on the development of the building.''.

(b) Disallowance of Deduction for Structures and Land in Registered Historic Districts.--Subparagraph (C) of section 170(h)(4), as redesignated by subsection (a), is amended--

(1) by striking ``any building, structure, or land area which'',

(2) by inserting ``any building, structure, or land area which'' before ``is listed'' in clause (i), and

(3) by inserting ``any building which'' before ``is located'' in clause (ii).

(c) Filing Fee for Certain Contributions.--Subsection (f) of section 170 (relating to disallowance of deduction in certain cases and special rules) is amended by adding at the end the following new paragraph:

``(13) Contributions of certain interests in buildings located in registered historic districts.--

``(A) In general.--No deduction shall be allowed with respect to any contribution described in subparagraph (B) unless the taxpayer includes with the return for the taxable year of the contribution a $500 filing fee.

``(B) Contribution described.--A contribution is described in this subparagraph if such contribution is a qualified conservation contribution (as defined in subsection (h)) which is a restriction with respect to the exterior of a building described in subsection (h)(4)(C)(ii) and for which a deduction is claimed in excess of $10,000.

``(C) Dedication of fee.--Any fee collected under this paragraph shall be used for the enforcement of the provisions of subsection (h).''.

(d) Reduced Deduction for Portion of Qualified Conservation Contribution Attributable to the Rehabilitation Credit.--Subsection (f) of section 170, as amended by subsection (c), is amended by adding at the end the following new paragraph:

``(14) Reduction for amounts attributable to rehabilitation credit.--In the case of any qualified conservation contribution (as defined in subsection (h)), the amount of the deduction allowed under this section shall be reduced by an amount which bears the same ratio to the fair market value of the contribution as--

``(A) the sum of the credits allowed to the taxpayer under section 47 for the 5 preceding taxable years with respect to any building which is a part of such contribution, bears to

``(B) the fair market value of the building on the date of the contribution.''.

(e) Effective Dates.--

(1) Special rules for buildings in registered historic districts.--The amendments made by subsection (a) shall apply to contributions made after July 25, 2006.

(2) Disallowance of deduction for structures and land; reduction for rehabilitation credit.--The amendments made by subsections (b) and (d) shall apply to contributions made after the date of the enactment of this Act.

(3) Filing fee.--The amendment made by subsection (c) shall apply to contributions made 180 days after the date of the enactment of this Act.

SEC. 1214. CHARITABLE CONTRIBUTIONS OF TAXIDERMY PROPERTY.

(a) Denial of Long-Term Capital Gain.--Subparagraph (B) of section 170(e)(1) is amended by striking ``or'' at the end of clause (ii), by inserting ``or'' at the end of clause (iii), and by inserting after clause (iii) the following new clause:

``(iv) of any taxidermy property which is contributed by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting,''.

(b) Treatment of Basis.--Subsection (f) of section 170, as amended by this Act, is amended by adding at the end the following new paragraph:

``(15) Special rule for taxidermy property.--

``(A) Basis.--For purposes of this section and notwithstanding section 1012, in the case of a charitable contribution of taxidermy property which is made by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, only the cost of the preparing, stuffing, or mounting shall be included in the basis of such property.

``(B) Taxidermy property.--For purposes of this section, the term `taxidermy property' means any work of art which--

``(i) is the reproduction or preservation of an animal, in whole or in part,

``(ii) is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal, and

``(iii) contains a part of the body of the dead animal.''.

(c) Effective Date.--The amendment made by this section shall apply to contributions made after July 25, 2006.

SEC. 1215. RECAPTURE OF TAX BENEFIT FOR CHARITABLE CONTRIBUTIONS OF EXEMPT USE PROPERTY NOT USED FOR AN EXEMPT USE.

(a) Recapture of Deduction on Certain Sales of Exempt Use Property.--

(1) In general.--Clause (i) of section 170(e)(1)(B) (related to certain contributions of ordinary income and capital gain property) is amended to read as follows:

``(i) of tangible personal property--

``(I) if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or

``(II) which is applicable property (as defined in paragraph (7)(C)) which is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which the donee has not made a certification in accordance with paragraph (7)(D),''.

(2) Dispositions after close of taxable year.--Section 170(e) is amended by adding at the end the following new paragraph:

``(7) Recapture of deduction on certain dispositions of exempt use property.--

``(A) In general.--In the case of an applicable disposition of applicable property, there shall be included in the income of the donor of such property for the taxable year of such donor in which the applicable disposition occurs an amount equal to the excess (if any) of--

``(i) the amount of the deduction allowed to the donor under this section with respect to such property, over

``(ii) the donor's basis in such property at the time such property was contributed.

``(B) Applicable disposition.--For purposes of this paragraph, the term `applicable disposition' means any sale, exchange, or other disposition by the donee of applicable property--

``(i) after the last day of the taxable year of the donor in which such property was contributed, and

``(ii) before the last day of the 3-year period beginning on the date of the contribution

of such property,
unless the donee makes a certification in accordance with subparagraph (D).
``(C) Applicable property.--For purposes of this paragraph, the term `applicable property' means charitable deduction property (as defined in section 6050L(a)(2)(A))--
``(i) which is tangible personal property the use of which is identified by the donee as related to the purpose or function constituting the basis of the donee's exemption under section 501, and
``(ii) for which a deduction in excess of the donor's basis is allowed.
``(D) Certification.--A certification meets the requirements of this subparagraph if it is a written statement which is signed under penalty of perjury by an officer of the donee organization and--
``(i) which--
``(I) certifies that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption under section 501, and
``(II) describes how the property was used and how such use furthered such purpose or function, or
``(ii) which--
``(I) states the intended use of the property by the donee at the time of the contribution, and
``(II) certifies that such intended use has become impossible or infeasible to implement.''.

(b) Reporting Requirements.--Paragraph (1) of section 6050L(a) (relating to returns relating to certain dispositions of donated property) is amended--
(1) by striking ``2 years'' and inserting ``3 years'', and
(2) by striking ``and'' at the end of subparagraph (D), by striking the period at the end of subparagraph (E) and inserting a comma, and by inserting at the end the following:
``(F) a description of the donee's use of the property, and
``(G) a statement indicating whether the use of the property was related to the purpose or function constituting the basis for the donee's exemption under section 501.
In any case in which the donee indicates that the use of applicable property (as defined in section 170(e)(7)(C)) was related to the purpose or function constituting the basis for the exemption of the donee under section 501 under subparagraph (G), the donee shall include with the return the certification described in section 170(e)(7)(D) if such certification is made under section 170(e)(7).''.

(c) Penalty.--
(1) In general.--Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6720A the following new section:

``SEC. 6720B. FRAUDULENT IDENTIFICATION OF EXEMPT USE PROPERTY.

``In addition to any criminal penalty provided by law, any person who identifies applicable property (as defined in section 170(e)(7)(C)) as having a use which is related to a purpose or function constituting the basis for the donee's exemption under section 501 and who knows that such property is not intended for such a use shall pay a penalty of $10,000.''.

(2) Clerical amendment.--The table of sections for part I of subchapter B of chapter 68 is amended by adding after the item relating to section 6720A the following new item:
``Sec. 6720B. Fraudulent identification of exempt use property.''.

(d) Effective Date.--
(1) Recapture.--The amendments made by subsection (a) shall apply to contributions after September 1, 2006.
(2) Reporting.--The amendments made by subsection (b) shall apply to returns filed after September 1, 2006.
(3) Penalty.--The amendments made by subsection (c) shall apply to identifications made after the date of the enactment of this Act.

SEC. 1216. LIMITATION OF DEDUCTION FOR CHARITABLE CONTRIBUTIONS OF CLOTHING AND HOUSEHOLD ITEMS.

(a) In General.--Subsection (f) of section 170, as amended by this

Act, is amended by adding at the end the following
new paragraph:
``(16) Contributions of clothing and household items.--
``(A) In general.--In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of clothing or a household item unless such clothing or household item is in good used condition or better.
``(B) Items of minimal value.--Notwithstanding subparagraph (A), the Secretary may by regulation deny a deduction under subsection (a) for any contribution of clothing or a household item which has minimal monetary value.
``(C) Exception for certain property.--Subparagraphs (A) and (B) shall not apply to any contribution of a single item of clothing or a household item for which a deduction of more than $500 is claimed if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.
``(D) Household items.--For purposes of this paragraph--
``(i) In general.--The term `household items' includes furniture, furnishings, electronics, appliances, linens, and other similar items.
``(ii) Excluded items.--Such term does not include--
``(I) food,
``(II) paintings, antiques, and other objects of art,
``(III) jewelry and gems, and
``(IV) collections.
``(E) Special rule for pass-thru entities.--In the case of a partnership or S corporation, this paragraph shall be applied at the entity level, except that the deduction shall be denied at the partner or shareholder level.''.
(b) Effective Date.--The amendment made by this section shall apply to contributions made after the date of enactment of this Act.

SEC. 1217. MODIFICATION OF RECORDKEEPING REQUIREMENTS FOR CERTAIN CHARITABLE CONTRIBUTIONS.

(a) Recordkeeping Requirement.--Subsection (f) of section 170, as amended by this Act, is amended by adding at the end the following new paragraph:
``(17) Recordkeeping.--No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.''.
(b) Effective Date.--The amendment made by this section shall apply to contributions made in taxable years beginning after the date of the enactment of this Act.

SEC. 1218. CONTRIBUTIONS OF FRACTIONAL INTERESTS IN TANGIBLE PERSONAL PROPERTY.

(a) Income Tax.--Section 170 (relating to charitable, etc., contributions and gifts) is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:
``(o) Special Rules for Fractional Gifts.--
``(1) Denial of deduction in certain cases.--
``(A) In general.--No deduction shall be allowed for a contribution of an undivided portion of a taxpayer's entire interest in tangible personal property unless all interest in the property is held immediately before such contribution by--
``(i) the taxpayer, or
``(ii) the taxpayer and the donee.
``(B) Exceptions.--The Secretary may, by regulation, provide for exceptions to subparagraph (A) in cases where all persons who hold an interest in the property make proportional contributions of an undivided portion of the entire interest held by such persons.
``(2) Valuation of subsequent gifts.--In the case of any additional contribution, the fair market value of such contribution shall be determined by using the lesser of--
``(A) the fair market value of the property at the time of the initial fractional contribution, or
``(B) the fair market value of the property at the time of the additional contribution.
``(3) Recapture of deduction in certain cases; addition to tax.--

``(A) Recapture.--The Secretary shall provide for the recapture of the amount of any deduction allowed under this section (plus interest) with respect to any contribution of an undivided portion of a taxpayer's entire interest in tangible personal property--

``(i) in any case in which the donor does not contribute all of the remaining interest in such property to the donee (or, if such donee is no longer in existence, to any person described in section 170(c)) before the earlier of--

``(I) the date that is 10 years after the date of the initial fractional contribution, or

``(II) the date of the death of the donor, and

``(ii) in any case in which the donee has not, during the period beginning on the date of the initial fractional contribution and ending on the date described in clause (i)--

``(I) had substantial physical possession of the property, and

``(II) used the property in a use which is related to a purpose or function constituting the basis for the organizations' exemption under section 501.

``(B) Addition to tax.--The tax imposed under this chapter for any taxable year for which there is a recapture under subparagraph (A) shall be increased by 10 percent of the amount so recaptured.

``(4) Definitions.--For purposes of this subsection--

``(A) Additional contribution.--The term `additional contribution' means any charitable contribution by the taxpayer of any interest in property with respect to which the taxpayer has previously made an initial fractional contribution.

``(B) Initial fractional contribution.--The term `initial fractional contribution' means, with respect to any taxpayer, the first charitable contribution of an undivided portion of the taxpayer's entire interest in any tangible personal property.''.

(b) Estate Tax.--Section 2055 (relating to transfers for public, charitable, and religious uses) is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

``(g) Valuation of Subsequent Gifts.--

``(1) In general.--In the case of any additional contribution, the fair market value of such contribution shall be determined by using the lesser of--

``(A) the fair market value of the property at the time of the initial fractional contribution, or

``(B) the fair market value of the property at the time of the additional contribution.

``(2) Definitions.--For purposes of this paragraph--

``(A) Additional contribution.--The term `additional contribution' means a bequest, legacy, devise, or transfer described in subsection (a) of any interest in a property with respect to which the decedent had previously made an initial fractional contribution.

``(B) Initial fractional contribution.--The term `initial fractional contribution' means, with respect to any decedent, any charitable contribution of an undivided portion of the decedent's entire interest in any tangible personal property for which a deduction was allowed under section 170.''.

(c) Gift Tax.--Section 2522 (relating to charitable and similar gifts) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

``(e) Special Rules for Fractional Gifts.--

``(1) Denial of deduction in certain cases.--

``(A) In general.--No deduction shall be allowed for a contribution of an undivided portion of a taxpayer's entire interest in tangible personal property unless all interest in the property is held immediately before such contribution by--

``(i) the taxpayer, or

``(ii) the taxpayer and the donee.

``(B) Exceptions.--The Secretary may, by regulation, provide for exceptions to subparagraph (A) in cases where all persons who hold an interest in the property make proportional contributions of an undivided portion

of the entire interest held by such persons.
``(2) Valuation of subsequent gifts.--In the case of any additional contribution, the fair market value of such contribution shall be determined by using the lesser of--
``(A) the fair market value of the property at the time of the initial fractional contribution, or
``(B) the fair market value of the property at the time of the additional contribution.
``(3) Recapture of deduction in certain cases; addition to tax.--
``(A) In general.--The Secretary shall provide for the recapture of an amount equal to any deduction allowed under this section (plus interest) with respect to any contribution of an undivided portion of a taxpayer's entire interest in tangible personal property--
``(i) in any case in which the donor does not contribute all of the remaining interest in such property to the donee (or, if such donee is no longer in existence, to any person described in section 170(c)) before the earlier of--
``(I) the date that is 10 years after the date of the initial fractional contribution, or
``(II) the date of the death of the donor, and
``(ii) in any case in which the donee has not, during the period beginning on the date of the initial fractional contribution and ending on the date described in clause (i)--
``(I) had substantial physical possession of the property, and
``(II) used the property in a use which is related to a purpose or function constituting the basis for the organizations' exemption under section 501.
``(B) Addition to tax.--The tax imposed under this chapter for any taxable year for which there is a recapture under subparagraph (A) shall be increased by 10 percent of the amount so recaptured.
``(4) Definitions.--For purposes of this subsection--
``(A) Additional contribution.--The term `additional contribution' means any gift for which a deduction is allowed under subsection (a) or (b) of any interest in a property with respect to which the donor has previously made an initial fractional contribution.
``(B) Initial fractional contribution.--The term `initial fractional contribution' means, with respect to any donor, the first gift of an undivided portion of the donor's entire interest in any tangible personal property for which a deduction is allowed under subsection (a) or (b).''.

(d) Effective Date.--The amendments made by this section shall apply to contributions, bequests, and gifts made after the date of the enactment of this Act.

SEC. 1219. PROVISIONS RELATING TO SUBSTANTIAL AND GROSS OVERSTATEMENTS OF VALUATIONS.

(a) Modification of Thresholds for Substantial and Gross Valuation Misstatements.--
(1) Substantial valuation misstatement.--
(A) Income taxes.--Subparagraph (A) of section 6662(e)(1) (relating to substantial valuation misstatement under chapter 1) is amended by striking ``200 percent'' and inserting ``150 percent''.
(B) Estate and gift taxes.--Paragraph (1) of section 6662(g) is amended by striking ``50 percent'' and inserting ``65 percent''.
(2) Gross valuation misstatement.--
(A) Income taxes.--Clauses (i) and (ii) of section 6662(h)(2)(A) (relating to increase in penalty in case of gross valuation misstatements) are amended to read as follows:
``(i) in paragraph (1)(A), `200 percent' for `150 percent',
``(ii) in paragraph (1)(B)(i)--
``(I) `400 percent' for `200 percent', and
``(II) `25 percent' for `50 percent', and''.
(B) Estate and gift taxes.--Subparagraph (C) of

section 6662(h)(2) is amended by striking `` `25 percent' for `50 percent' '' and inserting `` `40 percent' for `65 percent' ''.

(3) Elimination of reasonable cause exception for gross misstatements.--Section 6664(c)(2) (relating to reasonable cause exception for underpayments) is amended by striking ``paragraph (1) shall not apply unless'' and inserting ``paragraph (1) shall not apply. The preceding sentence shall not apply to a substantial valuation overstatement under chapter 1 if''.

(b) Penalty on Appraisers Whose Appraisals Result in Substantial or Gross Valuation Misstatements.--

(1) In general.--Part I of subchapter B of chapter 68 (relating to assessable penalties) is amended by inserting after section 6695 the following new section:

``SEC. 6695A. &SUBSTANTIAL AND GROSS VALUATION MISSTATEMENTS ATTRIBUTABLE TO INCORRECT APPRAISALS.

``(a) Imposition of Penalty.--If--

``(1) a person prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund, and

``(2) the claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement under chapter 1 (within the meaning of section 6662(e)), or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property, then such person shall pay a penalty in the amount determined under subsection (b).

``(b) Amount of Penalty.--The amount of the penalty imposed under subsection (a) on any person with respect to an appraisal shall be equal to the lesser of--

``(1) the greater of--

``(A) 10 percent of the amount of the underpayment (as defined in section 6664(a)) attributable to the misstatement described in subsection (a)(2), or

``(B) $1,000, or

``(2) 125 percent of the gross income received by the person described in subsection (a)(1) from the preparation of the appraisal.

``(c) Exception.--No penalty shall be imposed under subsection (a) if the person establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value.''.

(2) Rules applicable to penalty.--Section 6696 (relating to rules applicable with respect to sections 6694 and 6695) is amended--

(A) by striking ``6694 and 6695'' each place it appears in the text and heading thereof and inserting ``6694, 6695, and 6695A'', and

(B) by striking ``6694 or 6695'' each place it appears in the text and inserting ``6694, 6695, or 6695A''.

(3) Conforming amendment.--The table of sections for part I of subchapter B of chapter 68 is amended by striking the item relating to section 6696 and inserting the following new items:

``Sec. 6695A. Substantial and gross valuation misstatements attributable to incorrect appraisals.

``Sec. 6696. Rules applicable with respect to sections 6694, 6695, and 6695A.''.

(c) Qualified Appraisers and Appraisals.--

(1) In general.--Subparagraph (E) of section 170(f)(11) is amended to read as follows:

``(E) Qualified appraisal and appraiser.--For purposes of this paragraph--

``(i) Qualified appraisal.--The term `qualified appraisal' means, with respect to any property, an appraisal of such property which--

``(I) is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and

``(II) is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed under subclause (I).

``(ii) Qualified appraiser.--Except as provided in clause (iii), the term `qualified appraiser' means an individual who--

``(I) has earned an appraisal designation from a

recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,

``(II) regularly performs appraisals for which the individual receives compensation, and

``(III) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

``(iii) Specific appraisals.--An individual shall not be treated as a qualified appraiser with respect to any specific appraisal unless--

``(I) the individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and

``(II) the individual has not been prohibited from practicing before the Internal Revenue Service by the Secretary under section 330(c) of title 31, United States Code, at any time during the 3-year period ending on the date of the appraisal.''.

(2) Reasonable cause exception.--Subparagraphs (B) and (C) of section 6664(c)(3) are amended to read as follows:

``(B) Qualified appraisal.--The term `qualified appraisal' has the meaning given such term by section 170(f)(11)(E)(i).

``(C) Qualified appraiser.--The term `qualified appraiser' has the meaning given such term by section 170(f)(11)(E)(ii).''.

(d) Disciplinary Actions Against Appraisers.--Section 330(c) of title 31, United States Code, is amended by striking ``with respect to whom a penalty has been assessed under section 6701(a) of the Internal Revenue Code of 1986''.

(e) Effective Dates.--

(1) Misstatement penalties.--Except as provided in paragraph (3), the amendments made by subsection (a) shall apply to returns filed after the date of the enactment of this Act.

(2) Appraiser provisions.--Except as provided in paragraph (3), the amendments made by subsections (b), (c), and (d) shall apply to appraisals prepared with respect to returns or submissions filed after the date of the enactment of this Act.

(3) Special rule for certain easements.--In the case of a contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in section 170(h)(4)(C)(ii) of the Internal Revenue Code of 1986, and an appraisal with respect to the contribution, the amendments made by subsections (a) and (b) shall apply to returns filed after July 25, 2006.

SEC. 1220. ADDITIONAL STANDARDS FOR CREDIT COUNSELING ORGANIZATIONS.

(a) In General.--Section 501 (relating to exemption from tax on corporations, certain trusts, etc.) is amended by redesignating subsection (q) as subsection (r) and by inserting after subsection (p) the following new subsection:

``(q) Special Rules for Credit Counseling Organizations.--

``(1) In general.--An organization with respect to which the provision of credit counseling services is a substantial purpose shall not be exempt from tax under subsection (a) unless such organization is described in paragraph (3) or (4) of subsection (c) and such organization is organized and operated in accordance with the following requirements:

``(A) The organization--

``(i) provides credit counseling services tailored to the specific needs and circumstances of consumers,

``(ii) makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors,

``(iii) provides services for the purpose of improving a consumer's credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services, and

``(iv) does not charge any separately stated fee for services for the purpose of improving any consumer's credit record, credit history, or

credit rating.
``(B) The organization does not refuse to provide credit counseling services to a consumer due to the inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of the consumer to enroll in a debt management plan.
``(C) The organization establishes and implements a fee policy which--
``(i) requires that any fees charged to a consumer for services are reasonable,
``(ii) allows for the waiver of fees if the consumer is unable to pay, and
``(iii) except to the extent allowed by State law, prohibits charging any fee based in whole or in part on a percentage of the consumer's debt, the consumer's payments to be made pursuant to a debt management plan, or the projected or actual savings to the consumer resulting from enrolling in a debt management plan.
``(D) At all times the organization has a board of directors or other governing body--
``(i) which is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders,
``(ii) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates), and
``(iii) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees).
``(E) The organization does not own more than 35 percent of--
``(i) the total combined voting power of any corporation (other than a corporation which is an organization described in subsection (c)(3) and exempt from tax under subsection (a)) which is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, or similar services,
``(ii) the profits interest of any partnership (other than a partnership which is an organization described in subsection (c)(3) and exempt from tax under subsection (a)) which is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, or similar services, and
``(iii) the beneficial interest of any trust or estate (other than a trust which is an organization described in subsection (c)(3) and exempt from tax under subsection (a)) which is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, or similar services.
``(F) The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.
``(2) Additional requirements for organizations described in subsection (c)(3).--
``(A) In general.--In addition to the requirements under paragraph (1), an organization with respect to which the provision of credit counseling services is a substantial purpose and which is described in paragraph (3) of subsection (c) shall not be exempt from tax under subsection (a) unless such organization is organized and operated in accordance with the following requirements:
``(i) The organization does not solicit contributions from consumers during the initial counseling process or while the consumer is

receiving services from the organization.
``(ii) The aggregate revenues of the organization which are from payments of creditors of consumers of the organization and which are attributable to debt management plan services do not exceed the applicable percentage of the total revenues of the organization.
``(B) Applicable percentage.--
``(i) In general.--For purposes of subparagraph (A)(ii), the applicable percentage is 50 percent.
``(ii) Transition rule.--Notwithstanding clause (i), in the case of an organization with respect to which the provision of credit counseling services is a substantial purpose and which is described in paragraph (3) of subsection (c) and exempt from tax under subsection (a) on the date of the enactment of this subsection, the applicable percentage is--
``(I) 80 percent for the first taxable year of such organization beginning after the date which is 1 year after the date of the enactment of this subsection, and
``(II) 70 percent for the second such taxable year beginning after such date, and
``(III) 60 percent for the third such taxable year beginning after such date.
``(3) Additional requirement for organizations described in subsection (c)(4).--In addition to the requirements under paragraph (1), an organization with respect to which the provision of credit counseling services is a substantial purpose and which is described in paragraph (4) of subsection (c) shall not be exempt from tax under subsection (a) unless such organization notifies the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition as a credit counseling organization.
``(4) Credit counseling services; debt management plan services.--For purposes of this subsection--
``(A) Credit counseling services.--The term `credit counseling services' means--
``(i) the providing of educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit,
``(ii) the assisting of individuals and families with financial problems by providing them with counseling, or
``(iii) a combination of the activities described in clauses (i) and (ii).
``(B) Debt management plan services.--The term `debt management plan services' means services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.''.
(b) Debt Management Plan Services Treated as an Unrelated Business.--Section 513 (relating to unrelated trade or business) is amended by adding at the end the following:
``(j) Debt Management Plan Services.--The term `unrelated trade or business' includes the provision of debt management plan services (as defined in section 501(q)(4)(B)) by any organization other than an organization which meets the requirements of section 501(q).''.
(c) Effective Date.--
(1) In general.--Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.
(2) Transition rule for existing organizations.--In the case of any organization described in paragraph (3) or (4) of section 501(c) of the Internal Revenue Code of 1986 and with respect to which the provision of credit counseling services is a substantial purpose on the date of the enactment of this Act, the amendments made by this section shall apply to taxable years beginning after the date which is 1 year after the date of the enactment of this Act.

SEC. 1221. EXPANSION OF THE BASE OF TAX ON PRIVATE FOUNDATION NET INVESTMENT INCOME.

(a) Gross Investment Income.--
(1) In general.--Paragraph (2) of section 4940(c) (relating to gross

investment income) is amended by
adding at the end the following new sentence: ``Such term shall also include income from sources similar to those in the preceding sentence.''.

(2) Conforming amendment.--Subsection (e) of section 509 (relating to gross investment income) is amended by adding at the end the following new sentence: ``Such term shall also include income from sources similar to those in the preceding sentence.''.

(b) Capital Gain Net Income.--Paragraph (4) of section 4940(c) (relating to capital gains and losses) is amended--

(1) in subparagraph (A), by striking ``used for the production of interest, dividends, rents, and royalties'' and inserting ``used for the production of gross investment income (as defined in paragraph (2))'',

(2) in subparagraph (C), by inserting ``or carrybacks'' after ``carryovers'', and

(3) by adding at the end the following new subparagraph:

``(D) Except to the extent provided by regulation, under rules similar to the rules of section 1031 (including the exception under subsection (a)(2) thereof), no gain or loss shall be taken into account with respect to any portion of property used for a period of not less than 1 year for a purpose or function constituting the basis of the private foundation's exemption if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption.''.

(c) Effective Date.--The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1222. DEFINITION OF CONVENTION OR ASSOCIATION OF CHURCHES.

Section 7701 (relating to definitions) is amended by redesignating subsection (o) as subsection (p) and by inserting after subsection (n) the following new subsection:

``(o) Convention or Association of Churches.--For purposes of this title, any organization which is otherwise a convention or association of churches shall not fail to so qualify merely because the membership of such organization includes individuals as well as churches or because individuals have voting rights in such organization.''.

SEC. 1223. NOTIFICATION REQUIREMENT FOR ENTITIES NOT CURRENTLY REQUIRED TO FILE.

(a) In General.--Section 6033 (relating to returns by exempt organizations), as amended by this Act, is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

``(i) Additional Notification Requirements.--Any organization the gross receipts of which in any taxable year result in such organization being referred to in subsection (a)(3)(A)(ii) or (a)(3)(B)--

``(1) shall furnish annually, in electronic form, and at such time and in such manner as the Secretary may by regulations prescribe, information setting forth--

``(A) the legal name of the organization,

``(B) any name under which such organization operates or does business,

``(C) the organization's mailing address and Internet web site address (if any),

``(D) the organization's taxpayer identification number,

``(E) the name and address of a principal officer, and

``(F) evidence of the continuing basis for the organization's exemption from the filing requirements under subsection (a)(1), and

``(2) upon the termination of the existence of the organization, shall furnish notice of such termination.''.

(b) Loss of Exempt Status for Failure To File Return or Notice.--Section 6033 (relating to returns by exempt organizations), as amended by subsection (a), is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

``(j) Loss of Exempt Status for Failure To File Return or Notice.--

``(1) In general.--If an organization described in subsection (a)(1) or (i) fails to file an annual return or notice required under either subsection for 3 consecutive years, such organization's status as an organization exempt from tax under section 501(a) shall be considered revoked on and after the date set by the Secretary for the filing of the third annual return or
notice. The Secretary shall

publish and maintain a list of any organization the status of which is so revoked.

``(2) Application necessary for reinstatement.--Any organization the tax-exempt status of which is revoked under paragraph (1) must apply in order to obtain reinstatement of such status regardless of whether such organization was originally required to make such an application.

``(3) Retroactive reinstatement if reasonable cause shown for failure.--If, upon application for reinstatement of status as an organization exempt from tax under section 501(a), an organization described in paragraph (1) can show to the satisfaction of the Secretary evidence of reasonable cause for the failure described in such paragraph, the organization's exempt status may, in the discretion of the Secretary, be reinstated effective from the date of the revocation under such paragraph.''.

(c) No Declaratory Judgment Relief.--Section 7428(b) (relating to limitations) is amended by adding at the end the following new paragraph:

``(4) Nonapplication for certain revocations.--No action may be brought under this section with respect to any revocation of status described in section 6033(j)(1).''.

(d) No Monetary Penalty for Failure To Notify.--Section 6652(c)(1) (relating to annual returns under section 6033 or 6012(a)(6)) is amended by adding at the end the following new subparagraph:

``(E) No penalty for certain annual notices.--This paragraph shall not apply with respect to any notice required under section 6033(i).''.

(e) Secretarial Outreach Requirements.--

(1) Notice requirement.--The Secretary of the Treasury shall notify in a timely manner every organization described in section 6033(i) of the Internal Revenue Code of 1986 (as added by this section) of the requirement under such section 6033(i) and of the penalty established under section 6033(j) of such Code--

(A) by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and

(B) by Internet or other means of outreach, in the case of any other organization.

(2) Loss of status penalty for failure to file return.--The Secretary of the Treasury shall publicize, in a timely manner in appropriate forms and instructions and through other appropriate means, the penalty established under section 6033(j) of such Code for the failure to file a return under subsection (a)(1) or (i) of section 6033 of such Code.

(f) Effective Date.--The amendments made by this section shall apply to notices and returns with respect to annual periods beginning after 2006.

SEC. 1224. DISCLOSURE TO STATE OFFICIALS RELATING TO EXEMPT ORGANIZATIONS.

(a) In General.--Subsection (c) of section 6104 is amended by striking paragraph (2) and inserting the following new paragraphs:

``(2) Disclosure of proposed actions related to charitable organizations.--

``(A) Specific notifications.--In the case of an organization to which paragraph (1) applies, the Secretary may disclose to the appropriate State officer--

``(i) a notice of proposed refusal to recognize such organization as an organization described in section 501(c)(3) or a notice of proposed revocation of such organization's recognition as an organization exempt from taxation,

``(ii) the issuance of a letter of proposed deficiency of tax imposed under section 507 or chapter 41 or 42, and

``(iii) the names, addresses, and taxpayer identification numbers of organizations which have applied for recognition as organizations described in section 501(c)(3).

``(B) Additional disclosures.--Returns and return information of organizations with respect to which information is disclosed under subparagraph (A) may be made available for inspection by or disclosed to an appropriate State officer.

``(C) Procedures for disclosure.--Information may be inspected or disclosed under subparagraph (A) or (B) only--

``(i) upon written request by an appropriate

State officer, and
``(ii) for the purpose of, and only to the extent necessary in, the administration of State laws regulating such organizations.

Such information may only be inspected by or disclosed to a person other than the appropriate State officer if such person is an officer or employee of the State and is designated by the appropriate State officer to receive the returns or return information under this paragraph on behalf of the appropriate State officer.

``(D) Disclosures other than by request.--The Secretary may make available for inspection or disclose returns and return information of an organization to which paragraph (1) applies to an appropriate State officer of any State if the Secretary determines that such returns or return information may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer.

``(3) Disclosure with respect to certain other exempt organizations.--Upon written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of any organization described in section 501(c) (other than organizations described in paragraph (1) or (3) thereof) for the purpose of, and only to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such organizations. Such information may only be inspected by or disclosed to a person other than the appropriate State officer if such person is an officer or employee of the State and is designated by the appropriate State officer to receive the returns or return information under this paragraph on behalf of the appropriate State officer.

``(4) Use in civil judicial and administrative proceedings.--Returns and return information disclosed pursuant to this subsection may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating such organizations in a manner prescribed by the Secretary similar to that for tax administration proceedings under section 6103(h)(4).

``(5) No disclosure if impairment.--Returns and return information shall not be disclosed under this subsection, or in any proceeding described in paragraph (4), to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration.

``(6) Definitions.--For purposes of this subsection--

``(A) Return and return information.--The terms `return' and `return information' have the respective meanings given to such terms by section 6103(b).

``(B) Appropriate state officer.--The term `appropriate State officer' means--

``(i) the State attorney general,

``(ii) the State tax officer,

``(iii) in the case of an organization to which paragraph (1) applies, any other State official charged with overseeing organizations of the type described in section 501(c)(3), and

``(iv) in the case of an organization to which paragraph (3) applies, the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes.''.

(b) Conforming Amendments.--

(1) Paragraph (2) of section 6103(a) is amended by inserting ``or section 6104(c)'' after ``this section''.

(2) Subparagraph (A) of section 6103(p)(3) is amended by inserting ``and section 6104(c)'' after ``section'' in the first sentence.

(3) Paragraph (4) of section 6103(p) is amended--

(A) in the matter preceding subparagraph (A), by inserting ``, any appropriate State officer (as defined in section 6104(c)),'' before ``or any other person'',

(B) in subparagraph (F)(i), by inserting ``any appropriate State officer (as defined in section 6104(c)),'' before ``or any other person'', and

(C) in the matter following subparagraph (F), by inserting ``, an appropriate State officer (as defined in section 6104(c)),'' after ``including an agency'' each place it appears.

(4) The heading for paragraph (1) of section 6104(c) is amended by inserting ``for charitable organizations'' after

``rule''.
(5) Paragraph (2) of section 7213(a) is amended by inserting ``or under section 6104(c)'' after ``6103''.
(6) Paragraph (2) of section 7213A(a) is amended by inserting ``or under section 6104(c)'' after ``7213(a)(2)''.
(7) Paragraph (2) of section 7431(a) is amended by inserting ``or in violation of section 6104(c)'' after ``6103''.

(c) Effective Date.--The amendments made by this section shall take effect on the date of the enactment of this Act but shall not apply to requests made before such date.

SEC. 1225. PUBLIC DISCLOSURE OF INFORMATION RELATING TO UNRELATED BUSINESS INCOME TAX RETURNS.

(a) In General.--Subparagraph (A) of section 6104(d)(1) is amended by redesignating clauses (ii) and (iii) as clauses (iii) and (iv), respectively, and by inserting after clause (i) the following new clause:

``(ii) any annual return filed under section 6011 which relates to any tax imposed by section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations) by such organization, but only if such organization is described in section 501(c)(3),''.

(b) Effective Date.--The amendments made by this section shall apply to returns filed after the date of the enactment of this Act.

SEC. 1226. STUDY ON DONOR ADVISED FUNDS AND SUPPORTING ORGANIZATIONS.

(a) Study.--The Secretary of the Treasury shall undertake a study on the organization and operation of donor advised funds (as defined in section 4966(d)(2) of the Internal Revenue Code of 1986, as added by this Act) and of organizations described in section 509(a)(3) of such Code. The study shall specifically con- sider--

(1) whether the deductions allowed for the income, gift, or estate taxes for charitable contributions to sponsoring organizations (as defined in section 4966(d)(1) of such Code, as added by this Act) of donor advised funds or to organizations described in section 509(a)(3) of such Code are appropriate in consideration of--

(A) the use of contributed assets (including the type, extent, and timing of such use), or

(B) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person),

(2) whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to such donor advised fund is operating consistent with the purposes or functions constituting the basis for its exemption under section 501, or its status as an organization described in section 509(a), of such Code,

(3) whether the retention by donors to organizations described in paragraph (1) of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for a deduction for income, gift, or estate taxes, and

(4) whether the issues raised by paragraphs (1), (2), and (3) are also issues with respect to other forms of charities or charitable donations.

(b) Report.--Not later than 1 year after the date of the enactment of this Act, the Secretary of the Treasury shall submit to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on the study conducted under subsection (a) and make such recommendations as the Secretary of the Treasury considers appropriate.

PART 2--IMPROVED ACCOUNTABILITY OF DONOR ADVISED FUNDS

SEC. 1231. EXCISE TAXES RELATING TO DONOR ADVISED FUNDS.

(a) In General.--Chapter 42 (relating to private foundations and certain other tax-exempt organizations), as amended by the Tax Increase Prevention and Reconciliation Act of 2005, is amended by adding at the end the following new subchapter:

``Subchapter G--Donor Advised Funds

``Sec. 4966. Taxes on taxable distributions.
``Sec. 4967. Taxes on prohibited benefits.

``SEC. 4966. TAXES ON TAXABLE DISTRIBUTIONS.

``(a) Imposition of Taxes.--

``(1) On the sponsoring organization.--There is hereby imposed on each taxable distribution a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the sponsoring organization with respect to the donor

advised fund.
``(2) On the fund management.--There is hereby imposed on the agreement of any fund manager to the making of a distribution, knowing that it is a taxable distribution, a tax equal to 5 percent of the amount thereof. The tax imposed by this paragraph shall be paid by any fund manager who agreed to the making of the distribution.

``(b) Special Rules.--For purposes of subsection (a)--
``(1) Joint and several liability.--If more than one person is liable under subsection (a)(2) with respect to the making of a taxable distribution, all such persons shall be jointly and severally liable under such paragraph with respect to such distribution.
``(2) Limit for management.--With respect to any one taxable distribution, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $10,000.

``(c) Taxable Distribution.--For purposes of this section--
``(1) In general.--The term `taxable distribution' means any distribution from a donor advised fund--
``(A) to any natural person, or
``(B) to any other person if--
``(i) such distribution is for any purpose other than one specified in section 170(c)(2)(B), or
``(ii) the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h).
``(2) Exceptions.--Such term shall not include any distribution from a donor advised fund--
``(A) to any organization described in section 170(b)(1)(A) (other than a disqualified supporting organization),
``(B) to the sponsoring organization of such donor advised fund, or
``(C) to any other donor advised fund.

``(d) Definitions.--For purposes of this subchapter--
``(1) Sponsoring organization.--The term `sponsoring organization' means any organization which--
``(A) is described in section 170(c) (other than in paragraph (1) thereof, and without regard to paragraph (2)(A) thereof),
``(B) is not a private foundation (as defined in section 509(a)), and
``(C) maintains 1 or more donor advised funds.
``(2) Donor advised fund.--
``(A) In general.--Except as provided in subparagraph (B) or (C), the term `donor advised fund' means a fund or account--
``(i) which is separately identified by reference to contributions of a donor or donors,
``(ii) which is owned and controlled by a sponsoring organization, and
``(iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.
``(B) Exceptions.--The term `donor advised fund' shall not include any fund or account--
``(i) which makes distributions only to a single identified organization or governmental entity, or
``(ii) with respect to which a person described in subparagraph (A)(iii) advises as to which individuals receive grants for travel, study, or other similar purposes, if--
``(I) such person's advisory privileges are performed exclusively by such person in the person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization,
``(II) no combination of persons described in subparagraph (A)(iii) (or persons related to such persons) control, directly or indirectly, such committee, and
``(III) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a

procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements of paragraph (1), (2), or (3) of section 4945(g).

``(C) Secretarial authority.--The Secretary may exempt a fund or account not described in subparagraph (B) from treatment as a donor advised fund--

``(i) if such fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor for the purpose of advising with respect to distributions from such fund (and any related parties), or

``(ii) if such fund benefits a single identified charitable purpose.

``(3) Fund manager.--The term `fund manager' means, with respect to any sponsoring organization--

``(A) an officer, director, or trustee of such sponsoring organization (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization), and

``(B) with respect to any act (or failure to act), the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).

``(4) Disqualified supporting organization.--

``(A) In general.--The term `disqualified supporting organization' means, with respect to any distribution--

``(i) any type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

``(ii) any organization which is described in subparagraph (B) or (C) if--

``(I) the donor or any person designated by the donor for the purpose of advising with respect to distributions from a donor advised fund (and any related parties) directly or indirectly controls a supported organization (as defined in section 509(f)(3)) of such organization, or

``(II) the Secretary determines by regulations that a distribution to such organization otherwise is inappropriate.

``(B) Type i and type ii supporting organizations.--An organization is described in this subparagraph if the organization meets the requirements of subparagraphs (A) and (C) of section 509(a)(3) and is--

``(i) operated, supervised, or controlled by one or more organizations described in paragraph (1) or (2) of section 509(a), or

``(ii) supervised or controlled in connection with one or more such organizations.

``(C) Functionally integrated type iii supporting organizations.--An organization is described in this subparagraph if the organization is a functionally integrated type III supporting organization (as defined under section 4943(f)(5)(B)).

``SEC. 4967. TAXES ON PROHIBITED BENEFITS.

``(a) Imposition of Taxes.--

``(1) On the donor, donor advisor, or related person.--There is hereby imposed on the advice of any person described in subsection (d) to have a sponsoring organization make a distribution from a donor advised fund which results in such person or any other person described in subsection (d) receiving, directly or indirectly, a more than incidental benefit as a result of such distribution, a tax equal to 125 percent of such benefit. The tax imposed by this paragraph shall be paid by any person described in subsection (d) who advises as to the distribution or who receives such a benefit as a result of the distribution.

``(2) On the fund management.--There is hereby imposed on the agreement of any fund manager to the making of a distribution, knowing that such distribution would confer a benefit described in paragraph (1), a tax equal to 10 percent of the amount of such benefit. The tax imposed by this paragraph

shall be paid by any fund manager who agreed to the making of the distribution.

``(b) Exception.--No tax shall be imposed under this section with respect to any distribution if a tax has been imposed with respect to such distribution under section 4958.

``(c) Special Rules.--For purposes of subsection (a)--

``(1) Joint and several liability.--If more than one person is liable under paragraph (1) or (2) of subsection (a) with respect to a distribution described in subsection (a), all such persons shall be jointly and severally liable under such paragraph with respect to such distribution.

``(2) Limit for management.--With respect to any one distribution described in subsection (a), the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $10,000.

``(d) Person Described.--A person is described in this subsection if such person is described in section 4958(f)(7) with respect to a donor advised fund.''.

(b) Conforming Amendments.--

(1) Section 4963 is amended by inserting ``4966, 4967,'' after ``4958,'' each place it appears in subsections (a) and (c).

(2) The table of subchapters for chapter 42 is amended by adding at the end the following new item:

``subchapter g--donor advised funds''.

(c) Effective Date.--The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1232. EXCESS BENEFIT TRANSACTIONS INVOLVING DONOR ADVISED FUNDS AND SPONSORING ORGANIZATIONS.

(a) Disqualified Persons.--

(1) In general.--Paragraph (1) of section 4958(f) is amended by striking ``and'' at the end of subparagraph (B), by striking the period at the end of subparagraph (C) and inserting a comma, and by adding after subparagraph (C) the following new subparagraphs:

``(D) which involves a donor advised fund (as defined in section 4966(d)(2)), any person who is described in paragraph (7) with respect to such donor advised fund (as so defined), and

``(E) which involves a sponsoring organization (as defined in section 4966(d)(1)), any person who is described in paragraph (8) with respect to such sponsoring organization (as so defined).''.

(2) Donors, donor advisors, and investment advisors treated as disqualified persons.--Section 4958(f) is amended by adding at the end the following new paragraphs:

``(7) Donors and donor advisors.--For purposes of paragraph (1)(E), a person is described in this paragraph if such person--

``(A) is described in section 4966(d)(2)(A)(iii),

``(B) is a member of the family of an individual described in subparagraph (A), or

``(C) is a 35-percent controlled entity (as defined in paragraph (3) by substituting `persons described in subparagraph (A) or (B) of paragraph (7)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof).

``(8) Investment advisors.--For purposes of paragraph (1)(F)--

``(A) In general.--A person is described in this paragraph if such person--

``(i) is an investment advisor,

``(ii) is a member of the family of an individual described in clause (i), or

``(iii) is a 35-percent controlled entity (as defined in paragraph (3) by substituting `persons described in clause (i) or (ii) of paragraph (8)(A)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof).

``(B) Investment advisor defined.--For purposes of subparagraph (A), the term `investment advisor' means, with respect to any sponsoring organization (as defined in section 4966(d)(1)), any person (other than an employee of such organization) compensated by such organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (as defined in section 4966(d)(2)) owned by such organization.''.

(b) Certain Transactions Treated as Excess Benefit Transactions.--

(1) In general.--Section 4958(c) is amended by redesignating paragraph (2) as paragraph (3) and by inserting after paragraph (1) the following new paragraph:

``(2) Special rules for donor advised funds.--In the case of any donor advised fund (as defined in section 4966(d)(2))--

``(A) the term `excess benefit transaction' includes any grant, loan, compensation, or other similar payment from such fund to a person described in subsection (f)(7) with respect to such fund, and

``(B) the term `excess benefit' includes, with respect to any transaction described in subparagraph (A), the amount of any such grant, loan, compensation, or other similar payment.''.

(2) Special rule for correction of transaction.--Section 4958(f)(6) is amended by inserting ``, except that in the case of any correction of an excess benefit transaction described in subsection (c)(2), no amount repaid in a manner prescribed by the Secretary may be held in any donor advised fund'' after ``standards''.

(c) Effective Date.--The amendments made by this section shall apply to transactions occurring after the date of the enactment of this Act.

SEC. 1233. EXCESS BUSINESS HOLDINGS OF DONOR ADVISED FUNDS.

(a) In General.--Section 4943 is amended by adding at the end the following new subsection:

``(e) Application of Tax to Donor Advised Funds.--

``(1) In general.--For purposes of this section, a donor advised fund (as defined in section 4966(d)(2)) shall be treated as a private foundation.

``(2) Disqualified person.--In applying this section to any donor advised fund (as so defined), the term `disqualified person' means, with respect to the donor advised fund, any person who is--

``(A) described in section 4966(d)(2)(A)(iii),

``(B) a member of the family of an individual described in subparagraph (A), or

``(C) a 35-percent controlled entity (as defined in section 4958(f)(3) by substituting `persons described in subparagraph (A) or (B) of section 4943(e)(2)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof).

``(3) Present holdings.--For purposes of this subsection, rules similar to the rules of paragraphs (4), (5), and (6) of subsection (c) shall apply to donor advised funds (as so defined), except that--

``(A) `the date of the enactment of this subsection' shall be substituted for `May 26, 1969' each place it appears in paragraphs (4), (5), and (6), and

``(B) `January 1, 2007' shall be substituted for `January 1, 1970' in paragraph (4)(E).''.

(b) Effective Date.--The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1234. TREATMENT OF CHARITABLE CONTRIBUTION DEDUCTIONS TO DONOR ADVISED FUNDS.

(a) Income.--Section 170(f) (relating to disallowance of deduction in certain cases and special rules), as amended by this Act, is amended by adding at the end the following new paragraph:

``(18) Contributions to donor advised funds.--A deduction otherwise allowed under subsection (a) for any contribution to a donor advised fund (as defined in section 4966(d)(2)) shall only be allowed if--

``(A) the sponsoring organization (as defined in section 4966(d)(1)) with respect to such donor advised fund is not--

``(i) described in paragraph (3), (4), or (5) of subsection (c), or

``(ii) a type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

``(B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.''.

(b) Estate.--Section 2055(e) is amended by adding at the end the following new paragraph:

``(5) Contributions to donor advised funds.--A deduction otherwise allowed under subsection (a) for any contribution to a donor advised fund (as defined in section 4966(d)(2)) shall only be allowed if--

``(A) the sponsoring organization (as defined in section 4966(d)(1)) with respect to such donor advised fund is not--

``(i) described in paragraph (3) or (4) of subsection (a), or

``(ii) a type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

``(B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of section 170(f)(8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.''.

(c) Gift.--Section 2522(c) is amended by adding at the end the following new paragraph:

``(5) Contributions to donor advised funds.--A deduction otherwise allowed under subsection (a) for any contribution to a donor advised fund (as defined in section 4966(d)(2)) shall only be allowed if--

``(A) the sponsoring organization (as defined in section 4966(d)(1)) with respect to such donor advised fund is not--

``(i) described in paragraph (3) or (4) of subsection (a), or

``(ii) a type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

``(B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of section 170(f)(8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.''.

(d) Effective Date.--The amendments made by this section shall apply to contributions made after the date which is 180 days after the date of the enactment of this Act.

SEC. 1235. RETURNS OF, AND APPLICATIONS FOR RECOGNITION BY, SPONSORING ORGANIZATIONS.

(a) Matters Included on Returns.--

(1) In general.--Section 6033, as amended by this Act, is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

``(k) Additional Provisions Relating to Sponsoring Organizations.--Every organization described in section 4966(d)(1) shall, on the return required under subsection (a) for the taxable year--

``(1) list the total number of donor advised funds (as defined in section 4966(d)(2)) it owns at the end of such taxable year,

``(2) indicate the aggregate value of assets held in such funds at the end of such taxable year, and

``(3) indicate the aggregate contributions to and grants made from such funds during such taxable year.''.

(2) Effective date.--The amendments made by this subsection shall apply to returns filed for taxable years ending after the date of the enactment of this Act.

(b) Matters Included on Exempt Status Application.--

(1) In general.--Section 508 is amended by adding at the end the following new subsection:

``(f) Additional Provisions Relating to Sponsoring Organizations.--A sponsoring organization (as defined in section 4966(d)(1)) shall give notice to the Secretary (in such manner as the Secretary may provide) whether such organization maintains or intends to maintain donor advised funds (as defined in section 4966(d)(2)) and the manner in which such organization plans to operate such funds.''.

(2) Effective date.--The amendment made by this subsection shall apply to organizations applying for tax-exempt status after the date of the enactment of this Act.

PART 3--IMPROVED ACCOUNTABILITY OF SUPPORTING ORGANIZATIONS

SEC. 1241. REQUIREMENTS FOR SUPPORTING ORGANIZATIONS.

(a) Types of Supporting Organizations.--Subparagraph (B) of section 509(a)(3) is amended to read as follows:

``(B) is--

``(i) operated, supervised, or controlled by one or more organizations described in paragraph

(1) or (2),
``(ii) supervised or controlled in connection with one or more such organizations, or
``(iii) operated in connection with one or more such organizations, and''.

(b) Requirements for Supporting Organizations.--Section 509 (relating to private foundation defined) is amended by adding at the end the following new subsection:

``(f) Requirements for Supporting Organizations.--

``(1) Type iii supporting organizations.--For purposes of subsection (a)(3)(B)(iii), an organization shall not be considered to be operated in connection with any organization described in paragraph (1) or (2) of subsection (a) unless such organization meets the following requirements:

``(A) Responsiveness.--For each taxable year beginning after the date of the enactment of this subsection, the organization provides to each supported organization such information as the Secretary may require to ensure that such organization is responsive to the needs or demands of the supported organization.

``(B) Foreign supported organizations.--

``(i) In general.--The organization is not operated in connection with any supported organization that is not organized in the United States.

``(ii) Transition rule for existing organizations.--If the organization is operated in connection with an organization that is not organized in the United States on the date of the enactment of this subsection, clause (i) shall not apply until the first day of the third taxable year of the organization beginning after the date of the enactment of this subsection.

``(2) Organizations controlled by donors.--

``(A) In general.--For purposes of subsection (a)(3)(B), an organization shall not be considered to be--

``(i) operated, supervised, or controlled by any organization described in paragraph (1) or (2) of subsection (a), or

``(ii) operated in connection with any organization described in paragraph (1) or (2) of subsection (a),

if such organization accepts any gift or contribution from any person described in subparagraph (B).

``(B) Person described.--A person is described in this subparagraph if, with respect to a supported organization
of an organization described in subparagraph (A), such person is--

``(i) a person (other than an organization described in paragraph (1), (2), or (4) of section 509(a)) who directly or indirectly controls, either alone or together with persons described in clauses (ii) and (iii), the governing body of such supported organization,

``(ii) a member of the family (determined under section 4958(f)(4)) of an individual described in clause (i), or

``(iii) a 35-percent controlled entity (as defined in section 4958(f)(3) by substituting `persons described in clause (i) or (ii) of section 509(f)(2)(B)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof).

``(3) Supported organization.--For purposes of this subsection, the term `supported organization' means, with respect to an organization described in subsection (a)(3), an organization described in paragraph (1) or (2) of subsection (a)--

``(A) for whose benefit the organization described in subsection (a)(3) is organized and operated, or

``(B) with respect to which the organization performs the functions of, or carries out the purposes of.''.

(c) Charitable Trusts Which Are Type III Supporting Organizations.--For purposes of section 509(a)(3)(B)(iii) of the Internal Revenue Code of 1986, an organization which is a trust shall not be considered to be operated in connection with any organization described in paragraph (1) or (2) of section 509(a) of such Code solely because--

(1) it is a charitable trust under State law,

(2) the supported organization (as defined in section 509(f)(3) of such Code) is a beneficiary of such trust, and

(3) the supported organization (as so defined) has the power to enforce the trust and compel an accounting.

(d) Payout Requirements for Type III Supporting Organizations.--

(1) In general.--The Secretary of the Treasury shall promulgate new regulations under section 509 of the Internal Revenue Code of 1986 on payments required by type III supporting organizations which are not functionally integrated type III supporting organizations. Such regulations shall require such organizations to make distributions of a percentage of either income or assets to supported organizations (as defined in section 509(f)(3) of such Code) in order to ensure that a significant amount is paid to such organizations.

(2) Type iii supporting organization; functionally integrated type iii supporting organization.--For purposes of paragraph (1), the terms ``type III supporting organization'' and ``functionally integrated type III supporting organization'' have the meanings given such terms under subparagraphs (A) and (B) section 4943(f)(5) of the Internal Revenue Code of 1986 (as added by this Act), respectively.

(e) Effective Dates.--

(1) In general.--The amendments made by subsections (a) and (b) shall take effect on the date of the enactment of this Act.

(2) Charitable trusts which are type iii supporting organizations.--Subsection (c) shall take effect--

(A) in the case of trusts operated in connection with an organization described in paragraph (1) or (2) of section 509(a) of the Internal Revenue Code of 1986 on the date of the enactment of this Act, on the date that is one year after the date of the enactment of this Act, and

(B) in the case of any other trust, on the date of the enactment of this Act.

SEC. 1242. EXCESS BENEFIT TRANSACTIONS INVOLVING SUPPORTING ORGANIZATIONS.

(a) Disqualified Persons.--Paragraph (1) of section 4958(f), as amended by this Act, is amended by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively, and by adding after subparagraph (C) the following new subparagraph:

``(D) any person who is described in subparagraph (A), (B), or (C) with respect to an organization described in section 509(a)(3) and organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the applicable tax-exempt organization.''.

(b) Certain Transactions Treated as Excess Benefit Transactions.--Section 4958(c), as amended by this Act, is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

``(3) Special rules for supporting organizations.--

``(A) In general.--In the case of any organization described in section 509(a)(3)--

``(i) the term `excess benefit transaction' includes--

``(I) any grant, loan, compensation, or other similar payment provided by such organization to a person described in subparagraph (B), and

``(II) any loan provided by such organization to a disqualified person (other than an organization described in paragraph (1), (2), or (4) of section 509(a)), and

``(ii) the term `excess benefit' includes, with respect to any transaction described in clause (i), the amount of any such grant, loan, compensation, or other similar payment.

``(B) Person described.--A person is described in this subparagraph if such person is--

``(i) a substantial contributor to such organization,

``(ii) a member of the family (determined under section 4958(f)(4)) of an individual described in clause (i), or

``(iii) a 35-percent controlled entity (as defined in section 4958(f)(3) by substituting `persons described in clause (i) or (ii) of section 4958(c)(3)(B)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof).

``(C) Substantial contributor.--For purposes of this paragraph--

``(i) In general.--The term `substantial contributor' means any person who contributed or bequeathed an aggregate amount of more than $5,000 to the organization, if such amount is more than 2 percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, such term also means the creator of the trust. Rules similar to the rules of subparagraphs (B) and (C) of section 507(d)(2) shall apply for purposes of this subparagraph.

``(ii) Exception.--Such term shall not include any organization described in paragraph (1), (2), or (4) of section 509(a).''.

(c) Effective Dates.--

(1) Subsection (a).--The amendments made by subsection (a) shall apply to transactions occurring after the date of the enactment of this Act.

(2) Subsection (b).--The amendments made by subsection (a) shall apply to transactions occurring after July 25, 2006.

SEC. 1243. EXCESS BUSINESS HOLDINGS OF SUPPORTING ORGANIZATIONS.

(a) In General.--Section 4943, as amended by this Act, s amended by adding at the end the following new subsection:

``(f) Application of Tax to Supporting Organizations.--

``(1) In general.--For purposes of this section, an organization which is described in paragraph (3) shall be treated as a private foundation.

``(2) Exception.--The Secretary may exempt the excess business holdings of any organization from the application of this subsection if the Secretary determines that such holdings are consistent with the purpose or function constituting the basis for its exemption under section 501.

``(3) Organizations described.--An organization is described in this paragraph if such organization is--

``(A) a type III supporting organization (other than a functionally integrated type III supporting organization), or

``(B) an organization which meets the requirements of subparagraphs (A) and (C) of section 509(a)(3) and which is supervised or controlled in connection with one or more organizations described in paragraph (1) or (2) of section 509(a), but only if such organization accepts any gift or contribution from any person described in section 509(f)(2)(B).

``(4) Disqualified person.--

``(A) In general.--In applying this section to any organization described in paragraph (3), the term `disqualified person' means, with respect to the organization--

``(i) any person who was, at any time during the 5-year period ending on the date described in subsection (a)(2)(A), in a position to exercise substantial influence over the affairs of the organization,

``(ii) any member of the family (determined under section 4958(f)(4)) of an individual described in clause (i),

``(iii) any 35-percent controlled entity (as defined in section 4958(f)(3) by substituting `persons described in clause (i) or (ii) of section 4943(f)(4)(A)' for `persons described in subparagraph (A) or (B) of paragraph (1)' in subparagraph (A)(i) thereof),

``(iv) any person described in section 4958(c)(3)(B), and

``(v) any organization--

``(I) which is effectively controlled (directly or indirectly) by the same person or persons who control the organization in question, or

``(II) substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (B) or a member of the family (within the meaning of section

4946(d)) of such a person.
``(B) Persons described.--A person is described in this subparagraph if such person is--
``(i) a substantial contributor to the organization (as defined in section 4958(c)(3)(C)),
``(ii) an officer, director, or trustee of the organization (or an individual having powers or responsibilities similar to those of the officers, directors, or trustees of the organization), or
``(iii) an owner of more than 20 percent of--
``(I) the total combined voting power of a corporation,
``(II) the profits interest of a partnership, or
``(III) the beneficial interest of a trust or unincorporated enterprise,
which is a substantial contributor (as so defined) to the organization.
``(5) Type iii supporting organization; functionally integrated type iii supporting organization.--For purposes of this subsection--
``(A) Type iii supporting organization.--The term `type III supporting organization' means an organization which meets the requirements of subparagraphs (A) and (C) of section 509(a)(3) and which is operated in connection with one or more organizations described in paragraph (1) or (2) of section 509(a).
``(B) Functionally integrated type iii supporting organization.--The term `functionally integrated type III supporting organization' means a type III supporting organization which is not required under regulations established by the Secretary to make payments to supported organizations (as defined under section 509(f)(3)) due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.
``(6) Special rule for certain holdings of type iii supporting organizations.--For purposes of this subsection, the term `excess business holdings' shall not include any holdings of a type III supporting organization in any business enterprise if, as of November 18, 2005, the holdings were held (and at all times thereafter, are held) for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction over such organization.
``(7) Present holdings.--For purposes of this subsection, rules similar to the rules of paragraphs (4), (5), and (6) of subsection (c) shall apply to organizations described in section 509(a)(3), except that--
``(A) `the date of the enactment of this subsection' shall be substituted for `May 26, 1969' each place it appears in paragraphs (4), (5), and (6), and
``(B) `January 1, 2007' shall be substituted for `January 1, 1970' in paragraph (4)(E).''.
(b) Effective Date.--The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 1244. TREATMENT OF AMOUNTS PAID TO SUPPORTING ORGANIZATIONS BY PRIVATE FOUNDATIONS.

(a) Qualifying Distributions.--Paragraph (4) of section 4942(g) is amended to read as follows:
``(4) Limitation on distributions by nonoperating private foundations to supporting organizations.--
``(A) In general.--For purposes of this section, the term `qualifying distribution' shall not include any amount paid by a private foundation which is not an operating foundation to--
``(i) any type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and
``(ii) any organization which is described in subparagraph (B) or (C) if--
``(I) a disqualified person of the private foundation directly or indirectly controls such organization or a supported organization (as defined in section 509(f)(3)) of such organization, or
``(II) the Secretary determines by regulations that

a distribution to such organization
otherwise is inappropriate.
``(B) Type i and type ii supporting organizations.--
An organization is described in this subparagraph if the
organization meets the requirements of subparagraphs (A)
and (C) of section 509(a)(3) and is--
``(i) operated, supervised, or controlled by
one or more organizations described in paragraph
(1) or (2) of section 509(a), or
``(ii) supervised or controlled in connection
with one or more such organizations.
``(C) Functionally integrated type iii supporting
organizations.--An organization is described in this
subparagraph if the organization is a functionally
integrated type III supporting organization (as defined
under section 4943(f)(5)(B)).''.
(b) Taxable Expenditures.--Subparagraph (A) of section 4945(d)(4) is
amended to read as follows:
``(A) such organization--
``(i) is described in paragraph (1) or (2) of
section 509(a),
``(ii) is an organization described in section
509(a)(3) (other than an organization described in
clause (i) or (ii) of section 4942(g)(4)(A)), or
``(iii) is an exempt operating foundation (as
defined in section 4940(d)(2)), or''.
(c) Effective Date.--The amendments made
by this section shall apply to distributions and expenditures after the
date of the enactment of this Act.
SEC. 1245. RETURNS OF SUPPORTING ORGANIZATIONS.
(a) Requirement To File Return.--Subparagraph (B) of section
6033(a)(3) is amended by inserting ``(other than
an organization described in section 509(a)(3))'' after ``paragraph
(1)''.
(b) Matters Included on Returns.--Section 6033, as amended by this
Act, is amended by redesignating subsection (l) as subsection (m) and by
inserting after subsection (k) the following new subsection:
``(l) Additional Provisions Relating to Supporting Organizations.--
Every organization described in section 509(a)(3) shall, on the return
required under subsection (a)--
``(1) list the supported organizations (as defined in
section 509(f)(3)) with respect to which such organization
provides support,
``(2) indicate whether the organization meets the
requirements of clause (i), (ii), or (iii) of section
509(a)(3)(B), and
``(3) certify that the organization meets the requirements
of section 509(a)(3)(C).''.
(c) Effective Date.--The amendments made
by this section shall apply to returns filed for taxable years ending
after the date of the enactment of this Act.
TITLE XIII--OTHER PROVISIONS
SEC. 1301. TECHNICAL CORRECTIONS RELATING TO MINE SAFETY.
Section 110 of the Federal Mine Safety and Health Act of 1977 (30
U.S.C. 820), as amended by the Mine Improvement and New Emergency
Response Act of 2006 (Public Law 109-236), is
amended--
(1) by striking subsection (d); and
(2) in subsection (a)--
(A) by striking ``(1)(1) The operator'' and
inserting ``(1) The operator'';
(B) in the paragraph (2) added by section 8(a)(1)(B)
of the Mine Improvement and New Emergency Response Act
of 2006 (Public Law 109-236)--
(i) by striking ``paragraph (1)'' and
inserting ``subsection (a)(1)''; and
(ii) by redesignating such paragraph as
subsection (d) and transferring such subsection so
as to appear after subsection (c); and
(3) in subsection (b)--
(A) by striking ``Any operator'' and inserting ``(1)
Any operator''; and
(B) in the second sentence, as added by section
8(a)(2) of the Mine Improvement and New Emergency
Response
Act of 2006 (Public Law 109-236), by striking
``Violations'' and inserting the following:
``(2) Violations''.
SEC. 1302. GOING-TO-THE-SUN ROAD.
(a) In General.--Section 1940 of the Safe, Accountable, Flexible,
Efficient Transportation Equity Act: A Legacy for Users (119 Stat. 1511)
is amended--

(1) in subsection (a)--
(A) by striking paragraphs (1) and (2);
(B) by redesignating paragraphs (3) through (5) as paragraphs (1) through (3), respectively; and
(C) by striking ``$10,000,000'' each place that it appears and inserting ``$16,666,666''; and
(2) by adding at the end the following:

``(c) Contract Authority.--Except as otherwise provided in this section, funds authorized to be appropriated under this section shall be available for obligation in the same manner as if the funds were apportioned under chapter 1 of title 23, United States Code.''.

(b) Rescission.--Section 10212 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (119 Stat. 1937) is amended by striking ``$8,543,000,000'' each place it appears and inserting ``$8,593,000,000''.

SEC. 1303. EXCEPTION TO THE LOCAL FURNISHING REQUIREMENT OF THE TAX-EXEMPT BOND RULES.

(a) Snettisham Hydroelectric Facility.--For purposes of determining whether any private activity bond issued before May 31, 2006, and used to finance the acquisition of the Snettisham hydroelectric facility is a qualified bond for purposes of section 142(a)(8) of the Internal Revenue Code of 1986, the electricity furnished by such facility to the City of Hoonah, Alaska, shall not be taken into account for purposes of section 142(f)(1) of such Code.

(b) Lake Dorothy Hydroelectric Facility.--For purposes of determining whether any private activity bond issued before May 31, 2006, and used to finance the Lake Dorothy hydroelectric facility is a qualified bond for purposes of section 142(a)(8) of the Internal Revenue Code of 1986, the electricity furnished by such facility to the City of Hoonah, Alaska, shall not be taken into account for purposes of paragraphs (1) and (3) of section 142(f) of such Code.

(c) Definitions.--For purposes of this section--
(1) Lake dorothy hydroelectric facility.--The term ``Lake Dorothy hydroelectric facility'' means the hydroelectric facility located approximately 10 miles south of Juneau, Alaska, and commonly referred to as the ``Lake Dorothy project''.
(2) Snettisham hydroelectric facility.--The term ``Snettisham hydroelectric facility'' means the hydroelectric project described in section 1804 of the Small Business Job Protection Act of 1996.

SEC. 1304. QUALIFIED TUITION PROGRAMS.

(a) Permanent Extension of Modifications.--Section 901 of the Economic Growth and Tax Relief Reconciliation Act of 2001 (relating to sunset provisions) shall not apply to section 402 of such Act (relating to modifications to qualified tuition programs).

(b) Regulatory Authority To Prevent Abuse.--
Section 529 (relating to qualified tuition programs) is amended by adding at the end the following new subsection:

``(f) Regulations.--Notwithstanding any other provision of this section, the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section and to prevent abuse of such purposes, including regulations under chapters 11, 12, and 13 of this title.''.

TITLE XIV--TARIFF PROVISIONS

SEC. 1401. SHORT TITLE; TABLE OF CONTENTS.

(a) Short Title.--This title may be cited as the ``Miscellaneous Trade and Technical Corrections Act of 2006''.

(b) Table of contents.--The table of contents of this title is as follows:

TITLE XIV--TARIFF PROVISIONS
Sec. 1401. Short title; table of contents.
Sec. 1402. Reference.
Subtitle A--Temporary Duty Suspensions and Reductions
Chapter 1--New Duty Suspensions and Reductions
Sec. 1411. Certain non-knit gloves designed for use by auto mechanics.
Sec. 1412. Certain microphones for use in automotive interiors.
Sec. 1413. Acrylic or modacrylic synthetic filament tow.
Sec. 1414. Acrylic or modacrylic synthetic staple fibers, carded, combed, or otherwise processed for spinning.
Sec. 1415. Nitrocellulose.
Sec. 1416. Potassium sorbate.
Sec. 1417. Sorbic acid.
Sec. 1418. Certain capers.
Sec. 1419. Certain pepperoncini prepared or preserved otherwise than by vinegar or acetic acid.
Sec. 1420. Certain capers.
Sec. 1421. Certain pepperoncini prepared or preserved by vinegar or acetic acid in concentrations at 0.5 percent or greater.
Sec. 1422. Certain pepperoncini prepared or preserved otherwise than by vinegar or acetic acid in concentrations less than 0.5 percent.

Sec. 1423. Chloral.
Sec. 1424. Imidacloprid technical (imidacloprid).
Sec. 1425. Triadimefon.
Sec. 1426. Polyethylene HE1878.
Sec. 1427. Thiacloprid.
Sec. 1428. Pyrimethanil.
Sec. 1429. Foramsulfuron.
Sec. 1430. Fenamidone.
Sec. 1431. Cyclanilide technical.
Sec. 1432. Para-benzoquinone.
Sec. 1433. O-Anisidine.
Sec. 1434. 2,4-Xylidine.
Sec. 1435. Crotonaldehyde.
Sec. 1436. Butanedioic acid, dimethyl ester, polymer with 4-hydroxy-2,2,6,6,-tetramethyl-1-piperidineethanol.
Sec. 1437. Mixtures of CAS Nos. 106990-43-6 and 65447-77-0.
Sec. 1438. MCPA.
Sec. 1439. Bronate advanced.
Sec. 1440. Bromoxynil octanoate tech.
Sec. 1441. Bromoxynil meo.
Sec. 1442. Hydraulic control units.
Sec. 1443. Shield asy-steering gear.
Sec. 1444. 2,4-Dichloroaniline.
Sec. 1445. 2-Acetylbutyrolactone.
Sec. 1446. Alkylketone.
Sec. 1447. Cyfluthrin (baythroid).
Sec. 1448. Beta-cyfluthrin.
Sec. 1449. Cyclopropane-1,1-dicarboxylic acid, dimethyl ester.
Sec. 1450. Spiroxamine.
Sec. 1451. Spiromesifen.
Sec. 1452. 4-Chlorobenzaldehyde.
Sec. 1453. Oxadiazon.
Sec. 1454. NAHP.
Sec. 1455. Phosphorus thiochloride.
Sec. 1456. Trifloxystrobin.
Sec. 1457. Phosphoric acid, lanthanum salt, cerium terbium-doped.
Sec. 1458. Lutetium oxide.
Sec. 1459. ACM.
Sec. 1460. Permethrin.
Sec. 1461. Thidiazuron.
Sec. 1462. Flutolanil.
Sec. 1463. Resmethrin.
Sec. 1464. Clothianidin.
Sec. 1465. Certain master cylinder assembles.
Sec. 1466. Certain transaxles.
Sec. 1467. Converter asy.
Sec. 1468. Module and bracket asy-power steering.
Sec. 1469. Unit asy-battery hi volt.
Sec. 1470. Certain articles of natural cork.
Sec. 1471. Glyoxylic acid.
Sec. 1472. Cyclopentanone.
Sec. 1473. Mesotrione technical.
Sec. 1474. Malonic acid-dinitrile 50% NMP.
Sec. 1475. Formulations of NOA 446510.
Sec. 1476. DEMBB distilled-ISO tank.
Sec. 1477. Methylionone.
Sec. 1478. Certain acrylic fiber tow.
Sec. 1479. Certain acrylic fiber tow.
Sec. 1480. MKH 6561 isocyanate.
Sec. 1481. Endosulfan.
Sec. 1482. Tetraconazole.
Sec. 1483. M-alcohol.
Sec. 1484. Certain machines for use in the assembly of motorcycle wheels.
Sec. 1485. Deltamethrin.
Sec. 1486. Palm fatty acid distillate.
Sec. 1487. 4-Methoxy-2-methyldiphenylamine.
Sec. 1488. 2-Methylhydroquinone.
Sec. 1489. 1-Fluoro-2-nitrobenzene.
Sec. 1490. Cosmetic bags with a flexible outer surface of reinforced or laminated polyvinyl chloride (PVC).
Sec. 1491. Mixtures of methyl 4-iodo-2-[3-(4-methoxy-6-methyl-1,3,5-triazin-2-yl)ureidosulfonyl]benzoate, sodium salt (iodosulfuron methyl, sodium salt).
Sec. 1492. Ethyl 4,5-dihydro-5,5-diphenyl-1,2-oxazole-3-carboxylate (isoxadifen-ethyl).
Sec. 1493. (5-cyclopropyl-4-isoxazolyl)[2-(methylsulfonyl)-4-(trifluoromethyl)phenyl]methanone (isoxaflutole).
Sec. 1494. Methyl 2-[(4,6-dimethoxypyrimidin-2-ylcarbamoyl)sulfamoyl]-a-(methanesulfonamido)-p-toluate (mesosulfuron-methyl) whether or not mixed with application adjuvants.
Sec. 1495. Mixtures of foramsulfuron and iodosulfuron-methyl-sodium.

Sec. 1496. Vulcuren UPKA 1988.
Sec. 1497. Vullcanox 41010 NA/LG.
Sec. 1498. Vulkazon AFS/LG.
Sec. 1499. P-Anisaldehyde.
Sec. 1500. 1,2-Pentanediol.
Sec. 1501. Agrumex.
Sec. 1502. Cohedur RL.
Sec. 1503. Formulations of prosulfuron.
Sec. 1504. Lewatit.
Sec. 1505. Para-Chlorophenol.
Sec. 1506. Cypermethrin.
Sec. 1507. Ion-exchange resin powder.
Sec. 1508. Ion-exchange resin powder.
Sec. 1509. Desmodur E 14.
Sec. 1510. Desmodur VP LS 2253.
Sec. 1511. Desmodur R-E.
Sec. 1512. Walocel MW 3000 PFV.
Sec. 1513. TSME.
Sec. 1514. Walocel VP-M 20660.
Sec. 1515. Xama 2.
Sec. 1516. Xama 7.
Sec. 1517. Certain cases for toys.
Sec. 1518. Certain cases for toys.
Sec. 1519. Aniline 2.5-disulfonic acid.
Sec. 1520. 1,4-benzenedicarboxylic acid, polymer with n,n'-bis(2-aminoethyl)-1,2-ethanediamine, cyclized, methosulfate.
Sec. 1521. Sulfur blue 7.
Sec. 1522. Formaldehyde, reaction products with 1,4-benzenediol and m-phenylenediamine, sulfurized.
Sec. 1523. Isocyanatosulfonyl.
Sec. 1524. Isocyanatosulfonyl.
Sec. 1525. Gemifloxacin, gemifloxacin mesylate, and gemifloxacin mesylate sesquihydrate.
Sec. 1526. Butralin.
Sec. 1527. Spirodiclofen.
Sec. 1528. Propamocarb HCL (PREVICUR).
Sec. 1529. Desmodur IL.
Sec. 1530. Chloroacetone.
Sec. 1531. IPN (isophthalonitrile).
Sec. 1532. NOA 446510 technical.
Sec. 1533. Hexythiazox technical.
Sec. 1534. Crelan (self-blocked cycloaliphatic polyuretdione).
Sec. 1535. Aspirin.
Sec. 1536. Desmodur BL XP 2468.
Sec. 1537. Desmodur RF-E.
Sec. 1538. Desmodur HL.
Sec. 1539. D-Mannose.
Sec. 1540. Certain camel hair.
Sec. 1541. Waste of camel hair.
Sec. 1542. Certain camel hair.
Sec. 1543. Woven fabric of vicuna hair.
Sec. 1544. Certain camel hair.
Sec. 1545. Noils of camel hair.
Sec. 1546. Chloroacetic acid, ethyl ester.
Sec. 1547. Chloroacetic acid, sodium salt.
Sec. 1548. Low expansion laboratory glass.
Sec. 1549. Stoppers, lids, and other closures.
Sec. 1550. Pigment yellow 213.
Sec. 1551. Indoxacarb.
Sec. 1552. Dimethyl carbonate.
Sec. 1553. 5-Chloro-1-indanone (EK179).
Sec. 1554. Mixtures of famoxadone and cymoxanil.
Sec. 1555. Decanedioic acid, bis(2,2,6,6-tetramethyl-4-piperidinyl) ester.
Sec. 1556. Acid blue 80.
Sec. 1557. Pigment brown 25.
Sec. 1558. Formulations of azoxystrobin.
Sec. 1559. Formulations of pinoxaden/cloquintocet.
Sec. 1560. Mixtures of difenoconazole/mefenoxam.
Sec. 1561. Fludioxinil technical.
Sec. 1562. Mixtures of clodinafop-propargyl.
Sec. 1563. Avermectin b, 1,4"-deoxy-4"-methylamino-, (4"r)-, benzoate.
Sec. 1564. Cloquintocet-mexyl.
Sec. 1565. Metalaxyl-M technical.
Sec. 1566. Cyproconazole technical.
Sec. 1567. Pinoxaden technical.
Sec. 1568. Mixtures of tralkoxydim.
Sec. 1569. Certain chemicals.
Sec. 1570. Mixtures of (<plus-minus>)-(cis and trans)-1-[[2-(2,4-dichlorophenyl)-4-propyl-1,3-dioxolan-2-yl]-methyl]-1h-1,2,4-triazole.
Sec. 1571. Paraquat dichloride.

Sec. 1572. Certain basketballs.
Sec. 1573. Certain leather basketballs.
Sec. 1574. Certain rubber basketballs.
Sec. 1575. Certain volleyballs.
Sec. 1576. 4-Chloro-3-[[3-(4-methoxyphenyl)-1,3-dioxopropyl]-amino]-dodecyl ester.
Sec. 1577. Linuron.
Sec. 1578. N,N-Dimethylpiperidinium chloride (mepiquat chloride).
Sec. 1579. Diuron.
Sec. 1580. Formulated product Krovar I DF.
Sec. 1581. Triasulfuron technical.
Sec. 1582. Brodifacoum technical.
Sec. 1583. Pymetrozine technical.
Sec. 1584. Formulations of thiamethoxam, difenoconazole, fludioxinil, and mefenoxam.
Sec. 1585. Trifloxysulfuron-sodium technical.
Sec. 1586. 2 Benzylthio-3-ethyl sulfonyl pyridine.
Sec. 1587. 2-Amino-4-methoxy-6-methyl-1,3,5-triazine.
Sec. 1588. Formulated products containing mixtures of the active ingredient 2-chloro-n-[[(4-methoxy-6-methyl-1,3,5-triazin-2yl) amino]carbonyl] benzenesulfonamide and application adjuvants.
Sec. 1589. 2-methyl-4-methoxy-6-methylamino-1,3,5-triazine.
Sec. 1590. Mixtures of sodium-2-chloro-6-[(4,6 dimethoxypyrimidin-2-yl)thio]benzoate and application adjuvants (pyrithiobac-sodium).
Sec. 1591. Certain decorative plates, decorative sculptures, decorative plaques, and architectural miniatures.
Sec. 1592. Certain music boxes.
Sec. 1593. 2-Methyl-4-chlorophenoxyacetic acid.
Sec. 1594. Phenmedipham.
Sec. 1595. Desmedipham.
Sec. 1596. Certain footwear with open toes or heels.
Sec. 1597. Certain work footwear.
Sec. 1598. Certain refracting and reflecting telescopes.
Sec. 1600. Certain work footwear.
Sec. 1601. Certain footwear for men.
Sec. 1602. Certain rubber or plastic footwear.
Sec. 1604. Zinc dimethyldithiocarbamate.
Sec. 1605. Certain liquid crystal device (LCD) panel assemblies.
Sec. 1606. Certain watertube boilers and reactor vessel heads.

Chapter 2--Existing Duty Suspensions and Reductions

Sec. 1611. Extension of certain existing duty suspensions and reductions.

Subtitle B--Other Tariff Provisions

Chapter 1--Liquidation Or Reliquidation of Certain Entries

Sec. 1621. Certain tramway cars and associated spare parts.
Sec. 1622. Reliquidation of certain entries of candles.
Sec. 1623. Certain entries of roller chain.
Sec. 1624. Certain entries of soundspa clock radios.

Chapter 2--Miscellaneous Provisions

Sec. 1631. Vessel repair duties.
Sec. 1632. Suspension of new shipper review provision.
Sec. 1633. Extension and modification of duty suspension on wool products; wool research fund; wool duty refunds.
Sec. 1634. Authorities relating to DR-CAFTA Agreement.
Sec. 1635. Technical amendments to Customs modernization.

Subtitle C--Effective Date

Sec. 1641. Effective date.

SEC. 1402. REFERENCE.

Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a chapter, subchapter, note, additional U.S. note, heading, subheading, or other provision, the reference shall be considered to be made to a chapter, subchapter, note, additional U.S. note, heading, subheading, or other provision of the Harmonized Tariff Schedule of the United States (19 U.S.C. 3007).

Subtitle A--Temporary Duty Suspensions and Reductions

CHAPTER 1--NEW DUTY SUSPENSIONS AND REDUCTIONS

SEC. 1411. CERTAIN NON-KNIT GLOVES DESIGNED FOR USE BY AUTO MECHANICS.

(a) In General.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new headings:

`` 9902.14.01	Mechanics' work gloves, valued not over $3.50 per pair (provided for in subheading 6216.00.58)......	2.8%	No change	No change	On or before 12/31/2009
9902.14.02	Mechanics' work	2.8%	No change	No	

change   On or before 12/ ''.
                         gloves, valued
          31/2009
                         over $3.50 but
                         not over $3.70
                         per pair
                         (provided for in
                         subheading
                         6216.00.58)......
        9902.14.03   Mechanics' work   2.8%   No change   No
change   On or before 12/ ''.
                         gloves, valued
          31/2009
                         over $3.70 but
                         not over $4.99
                         per pair
                         (provided for in
                         subheading
                         6216.00.58)......
        9902.14.04   Mechanics' work   2.8%   No change   No
change   On or before 12/ ''.
                         gloves, valued
          31/2009
                         over $4.99 but
                         not over $7.72
                         per pair
                         (provided for in
                         subheading
                         6216.00.58)......
        9902.14.05   Mechanics' work   2.8%   No change   No
change   On or before 12/ ''.
                         gloves, valued
          31/2009
                         over $7.72 per
                         pair (provided
                         for in subheading
                         6216.00.58)......

(b) Amendment to U.S. Notes.--Subchapter II of chapter 99 is amended by adding at the end of the U.S. Notes to such subchapter the following new U.S. Note:

``18. For purposes of headings 9902.14.01, 9902.14.02, 9902.14.03, 9902.14.04, and 9902.14.05, the term `mechanics' work gloves' means gloves, of man-made fibers, having synthetic leather palms and fingers; fourchettes of synthetic leather or of fabric of nylon or elastomeric yarn; backs comprising either one layer of knitted fabric of elastomeric yarn or three layers, with the outer layer of knitted fabric of elastomeric yarn, the center layer of foam and the inner layer of tricot fabric; the foregoing, whether or not including an thermoplastic rubber logo or pad on the back; and elastic wrist straps with molded thermoplastic rubber hook-and-loop enclosures.''.

SEC. 1412. CERTAIN MICROPHONES FOR USE IN AUTOMOTIVE INTERIORS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.17   Unidirectional   Free   No change   No
change   On or before 12/ ''.
                         (cardioid)
          31/2009
                         electret
                         condenser
                         microphone
                         modules for use
                         in motor vehicles
                         provided for in
                         headings 8701
                         through 8705
                         (other than such
                         modules designed
                         for handheld,
                         microphone stand,
                         or lapel use),
                         the foregoing
                         each including
                         wire leads for
                         external
                         connection,
                         whether or not
                         including a multi-
                         pin board level
                         type connector
                         but not including
                         a battery
                         compartment;

having a typical
frequency
response of 250
Hertz through
7,000 Hertz with
no more than a 20
decibel deviation
in that frequency
range and an
electrostatic
discharge
immunity of 4,000
V (contact) and
8,000 V (air);
and capable of
operation and
storage in the
temperature range
of -40C through
85C and a
humidity of not
over 95 percent
(provided for in
subheading
8518.10.80)......

SEC. 1413. ACRYLIC OR MODACRYLIC SYNTHETIC FILAMENT TOW.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.21 Synthetic filament tow: acrylic or modacrylic (provided for in subheading 5501.30.00)...... 6.8% No change No change On or before 12/31/2009 ''.

SEC. 1414. ACRYLIC OR MODACRYLIC SYNTHETIC STAPLE FIBERS, CARDED, COMBED, OR OTHERWISE PROCESSED FOR SPINNING.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.22 Synthetic staple fibers, carded, combed, or otherwise processed for spinning: acrylic or modacrylic (provided for in subheading 5506.30.00)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1415. NITROCELLULOSE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.23 Cellulose nitrates (nitrocellulose, including collodions) (CAS 9004-70-0) (provided for in subheading 3912.20.00)...... 4.4% No change No change On or before 12/31/2009 ''.

SEC. 1416. POTASSIUM SORBATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.24 Potassium sorbate (CAS No. 24634-61-5) (provided for in subheading 2916.19.10)...... 1.4% No change No change On or before 12/31/2009 ''.

SEC. 1417. SORBIC ACID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.25 Sorbic acid (CAS No. 110-44-1) 1.9% No change No change On or before 12/ ''.

31/2009
(provided for in
subheading
2916.19.20)......

SEC. 1418. CERTAIN CAPERS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.26 Capers, prepared Free No change No change On or before 12/ ''.
or preserved by
31/2009
vinegar other
than such goods
in immediate
containers each
holding 3.4 kg or
less (provided
for in subheading
2001.90.20)......

SEC. 1419. CERTAIN PEPPERONCINI PREPARED OR PRESERVED OTHERWISE THAN BY VINEGAR OR ACETIC ACID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.27 Pepperoncini, Free No change No change On or before 12/ ''.
prepared or
31/2009
preserved
otherwise than by
vinegar, not
frozen (provided
for in subheading
2005.90.55)......

SEC. 1420. CERTAIN CAPERS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.28 Capers, prepared Free No change No change On or before 12/ ''.
or preserved by
31/2009
vinegar in
immediate
containers each
holding more than
3.4 kg (provided
for in subheading
2001.90.10)......

SEC. 1421. CERTAIN PEPPERONCINI PREPARED OR PRESERVED BY VINEGAR OR ACETIC ACID IN CONCENTRATIONS AT 0.5 PERCENT OR GREATER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.29 Pepperoncini, 2.2% No change No change On or before 12/ ''.
prepared or
31/2009
preserved by
vinegar (provided
for in subheading
2001.90.38)......

SEC. 1422. CERTAIN PEPPERONCINI PREPARED OR PRESERVED OTHERWISE THAN BY VINEGAR OR ACETIC ACID IN CONCENTRATIONS LESS THAN 0.5 PERCENT.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.30 Giardiniera, Free No change No change On or before 12/ ''.
prepared or
31/2009
preserved
otherwise than by
vinegar, not
frozen (provided
for in subheading
2005.90.55)......

SEC. 1423. CHLORAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.31 Trichloroacetaldeh Free No change No change On or before 12/ ''.
yde (CAS No. 75-
31/2009
87-6) (provided

for in subheading
2913.00.50)......

SEC. 1424. IMIDACLOPRID TECHNICAL (IMIDACLOPRID).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.32 1-[(6-Chloro-3- Free No change No change On or before 12/ ''.
pyrdinyl)methyl]-
31/2009
N-nitro-2-
imidazolidinimine
(Imidacloprid)
(CAS No. 138261-
41-3) (provided
for in subheading
2933.39.27)......

SEC. 1425. TRIADIMEFON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.33 1-(4- Free No change No change On or before 12/ ''.
Chlorophenoxy)-3,
31/2009
3-dimethyl-1-(1H-
1,2,4-triazol-1-
yl)-2-butanone
(CAS No. 43121-43-
3) (Triadimefon)
(provided for in
subheading
2933.99.22)......

SEC. 1426. POLYETHYLENE HE1878.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.34 Polyethylene 3.6% No change No change On or before 12/ ''.
HE1878 (CAS No.
31/2009
25087-34-7), with
l-butene as
comonomer
(provided for in
subheading
3901.20.50)......

SEC. 1427. THIACLOPRID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.35 (Z)-[3-[(6-chloro- Free No change No change On or before 12/ ''.
3-
31/2009
pyridinyl)methyl]-
2-
thiazolidinyliden
e]cyanamide
(thiacloprid)
(CAS No. 111988-
49-9) (provided
for in subheading
2934.10.10)......

SEC. 1428. PYRIMETHANIL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.36 4,6-Dimethyl-N- Free No change No change On or before 12/ ''.
phenyl-2-
31/2009
pyrimidinamine
(pyrimethanil)
(CAS No. 53112-28-
0) (provided for
in subheading
2933.59.15)......

SEC. 1429. FORAMSULFURON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.37 Foramsulfuron 2.6% No change No change On or before 12/ ''.
(Benzamide, 2-
31/2009
((((4,6-
dimethoxy-2-

pyrimidinyl)amino
)
carbonyl)amino)su
lfonyl)-4-
(formylamino)-
N,N-dimethyl-,)
(CAS No. 173159-
57-4), in bulk or
put up in forms
or packaging for
retail sale
(provided for in
subheading
2935.00.75 or
3808.30.15)......

SEC. 1430. FENAMIDONE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.38 (5S)-3,5-Dihydro-5- Free No change No
change On or before 12/ ''.
methyl-2-
31/2009
(methylthio)- 5-
phenyl-3-
(phenylamino)- 4H-
imidazol-4-one
(Fenamidone) (CAS
No. 161326-34-7)
(provided for in
subheading
2933.29.35)......

SEC. 1431. CYCLANILIDE TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.39 1-(2,4- Free No change No
change On or before 12/ ''.
Dichlorophenylami
31/2009
nocarbonyl)cyclop
ropane-
carboxylic acid
(Cyclanilide)
(CAS No. 113136-
77-9) (provided
for in subheading
2924.29.47)......

SEC. 1432. PARA-BENZOQUINONE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.40 1,4-Benzoquinone Free No change No
change On or before 12/ ''.
(CAS No. 106-51-
31/2009
4) (provided for
in subheading
2914.69.90)......

SEC. 1433. O-ANISIDINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.41 o-Anisidine (CAS Free No change No
change On or before 12/ ''.
No. 90-04-4)
31/2009
(provided for in
subheading
2922.22.10)......

SEC. 1434. 2,4-XYLIDINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.43 2,4-Xylidine (CAS Free No change No
change On or before 12/ ''.
No. 95-68-1)
31/2009
(provided for in
subheading
2921.49.10)......

SEC. 1435. CROTONALDEHYDE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.44 Crotonaldehyde (2- Free No change No
change On or before 12/ ''.
butenaldehyde)

31/2009
(CAS No. 4170-30-
3) (provided for
in subheading
2912.19.50)......

SEC. 1436. BUTANEDIOIC ACID, DIMETHYL ESTER, POLYMER WITH 4-HYDROXY-
2,2,6,6,-TETRAMETHYL-1-PIPERIDINEETHANOL.

Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.10.47 Butanedioic acid, Free No change No
change On or before 12/ ''.
dimethyl ester,
31/2009
polymer with 4-
hydroxy-2,2,6,6,-
tetramethyl-1-
piperidineethanol
(CAS No. 65447-77-
0) (provided for
in subheading
3907.99.00)......

SEC. 1437. MIXTURES OF CAS NOS. 106990-43-6 AND 65447-77-0.

Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.10.48 1,3,5-Triazine- Free No change No
change On or before 12/ ''.
2,4,6-triamine,
31/2009
N,N-[1,2-
ethanediylbis[[[4
,6-bis[butyl
(1,2,2,6,6-
pentamethyl-4-
piperidinyl)amino
]-1,3,5-triazine-
2-yl]imino]-3,1-
propanediyl]]bis[
N,N-dibutyl-N,N-
bis(1,2,2,6,6-
pentamethyl-4-
piperidinyl)-
(CAS No. 106990-
43-6) and
Butanedioic acid,
dimethylester
polymer with 4-
hyroxy-2,2,6,6-
tetramethyl-1-
piperdine ethanol
(CAS No. 65447-77-
0) (Provided for
in subheading
3812.30.90)......

SEC. 1438. MCPA.

Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.10.54 2-Ethylhexyl (4- Free No change No
change On or before 12/ ''.
chloro-2-
31/2009
methylphenoxy)ace
tate (CAS No.
29450-45-1)
(provided for in
subheading
2918.90.20)......

SEC. 1439. BRONATE ADVANCED.

Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.10.55 Formulations of 2.8% No change No
change On or before 12/ ''.
2,6-dibromo-4-
31/2009
cyanophenyl
octanoate (CAS
No. 1689-99-2),
2, 6-dibromo-4-
cyanophenyl
heptanoate (CAS
No. 56634-95-8),
and 2-ethylhexyl
(4-chloro-2-

methylphenoxy)ace
tate (CAS No.
29450-45-1)
(provided for in
subheading
3808.30.15)......

SEC. 1440. BROMOXYNIL OCTANOATE TECH.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.56 2,6-dibromo-4- Free No change No change On or before 12/ ''.
cyanophenyl
31/2009
octanoate (CAS
No. 1689-99-2)
(provided for in
subheading
2926.90.25)......

SEC. 1441. BROMOXYNIL MEO.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.57 2,6-Dibromo-4- Free No change No change On or before 12/ ''.
cyanophenyl
31/2009
octanoate/
heptanoate (CAS
Nos. 1689-99-2
and 56634-95-8)
(provided for in
subheading
3808.30.15)......

SEC. 1442. HYDRAULIC CONTROL UNITS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.62 Hydraulic control Free No change No change On or before 12/ ''.
units designed
31/2009
for use in
braking systems
of hybrid motor
vehicles of
heading 8703
(provided for in
subheading
9032.89.60)......

SEC. 1443. SHIELD ASY-STEERING GEAR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.63 Steering gear Free No change No change On or before 12/ ''.
assemblies for
31/2009
single-pinion
constant-ratio
electronic power
assisted steering
systems rated at
80 amperes at
12V, the
foregoing
designed for use
in hybrid motor
vehicles of
heading 8703
(provided for in
subheading
8708.99.73)......

SEC. 1444. 2,4-DICHLOROANILINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.64 2,4- Free No change No change On or before 12/ ''.
Dichloroaniline
31/2009
(CAS No. 554-00-
7) (provided for
in subheading
2921.42.18)......

SEC. 1445. 2-ACETYLBUTYROLACTONE.

Subchapter II of chapter 99 is amended by inserting in numerical

sequence the following new heading:
``   9902.10.65   2-   Free   No change   No
change   On or before 12/ ''.
                       Acetylbutyrolacto
          31/2009
                       ne (CAS No. 517-
                       23-7) (provided
                       for in subheading
                       2932.29.50)......
SEC. 1446. ALKYLKETONE.
    Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.10.66   1-(4-Chlorophenyl)- Free   No change   No
change   On or before 12/ ''.
                       4, 4-dimethyl-3-
          31/2009
                       pentanone (CAS
                       No. 66346-01-8)
                       (provided for in
                       subheading
                       2914.70.40)......
SEC. 1447. CYFLUTHRIN (BAYTHROID).
    Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.10.67   Cyano(4-fluoro-3-   3.5%   No change   No
change   On or before 12/ ''.
                       phenoxyphenyl)met
          31/2009
                       hyl 3-(2,2-
                       dichloroethenyl)-
                       2,2-
                       dimethylcycloprop
                       anecarboxylate
                       (Cyfluthrin,
                       excluding b-
                       Cyfluthrin) (CAS
                       No. 68359-37-5)
                       (provided for in
                       subheading
                       2926.90.30)......
SEC. 1448. BETA-CYFLUTHRIN.
    Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.10.68   Reaction mixture   Free   No change   No
change   On or before 12/ ''.
                       comprising the
          31/2009
                       enantiomeric pair
                       (R)-a-cyano-4-
                       fluoro-3-
                       phenoxybenzyl
                       (1S,3S)-3-(2,2-
                       dichlorovinyl)-2,
                       2-
                       dimethylcycloprop
                       anecarboxylate
                       and (S)-a-cyano-4-
                       fluoro-3-
                       phenoxybenzyl
                       (1R,3R)-3-(2,2-
                       dichlorovinyl)-2,
                       2-
                       dimethylcycloprop
                       anecarboxylate in
                       ratio 1:2 with
                       the enantiomeric
                       pair (R)-a-cyano-
                       4-fluoro-3-
                       phenoxybenzyl
                       (1S,3R)-3-(2,2-
                       dichlorovinyl)-2,
                       2-
                       dimethylcycloprop
                       anecarboxylate
                       and (S)-a-cyano-4-
                       fluoro-3-
                       phenoxybenzyl
                       (1R,3S)-3-(2,2-
                       dichlorovinyl)-2,
                       2-
                       dimethylcycloprop
                       anecarboxylate (b-

Cyfluthrin) (CAS
No. 68359-37-5)
(provided for in
subheading
2926.90.30)......

SEC. 1449. CYCLOPROPANE-1,1-DICARBOXYLIC ACID, DIMETHYL ESTER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.69 Cyclopropane-1,1- 1.8% No change No
change On or before 12/ ''.
dicarboxylic
31/2009
acid, dimethyl
ester (CAS No.
6914-71-2)
(provided for in
subheading
2917.20.00)......

SEC. 1450. SPIROXAMINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.70 8-(1,1- Free No change No
change On or before 12/ ''.
Dimethylethyl)-N-
31/2009
ethyl-N-propyl-
1,4-
dioxaspiro[4,5]de
cane-2-
methanamine (CAS
118134-30-8)
(provided for in
subheading
2932.99.90)......

SEC. 1451. SPIROMESIFEN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.71 3,3- Free No change No
change On or before 12/ ''.
Dimethylbutanoic
31/2009
acid, 2-oxo-3-
(2,4,6-
trimethylphenyl)-
1-
oxaspiro[4.4]non-
3-en-yl ester
(CAS 283594-90-1)
(provided for in
subheading
2932.29.10)......

SEC. 1452. 4-CHLOROBENZALDEHYDE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.72 4- Free No change No
change On or before 12/ ''.
Chlorobenzaldehyd
31/2009
e (CAS No. 104-88-
1) (provided for
in subheading
2913.00.40)......

SEC. 1453. OXADIAZON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.73 5-tert-butyl-3- Free No change No
change On or before 12/ ''.
(2,4-dichloro-5-
31/2009
isopropoxyphenyl)
-1,3,4-oxadiazol-
2(3H)-one
(Oxadiazon) (CAS
No. 19666-30-9)
(provided for in
subheading
2934.99.11)......

SEC. 1454. NAHP.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.74 2-(1,1- Free No change No
change On or before 12/ ''.

Dimethylethyl)-5-
31/2009
hydroxypyrimidine
, sodium salt
(CAS No. 146237-
62-9) (provided
for in subheading
2933.59.70)......

SEC. 1455. PHOSPHORUS THIOCHLORIDE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.75 Phosphorus Free No change No change On or before 12/ ''.
Thiochloride (CAS
31/2009
No. 3982-91-0)
(provided for in
subheading
2851.00.00)......

SEC. 1456. TRIFLOXYSTROBIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.76. Methyl (E)- 2.4% No change No change On or before 12/ ''.
methoxyimino-{(E)-
31/2009
a-[1-(a,a,a-
trifluoro-m-
tolyl)ethylidenea
minooxy]-o-
tolyl}acetate
(Trifloxystrobin)
(CAS No. 141517-
21-7) (provided
for in subheading
2929.90.20)......

SEC. 1457. PHOSPHORIC ACID, LANTHANUM SALT, CERIUM TERBIUM-DOPED.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.77 Phosphoric acid, Free No change No change On or before 12/ ''.
lanthanum salt,
31/2009
cerium terbium-
doped (CAS No.
95823-34-0)
(provided for in
subheading
2846.90.80)......

SEC. 1458. LUTETIUM OXIDE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.78 Lutetium oxide Free No change No change On or before 12/ ''.
(CAS No. 12032-20-
31/2009
1) (provided for
in subheading
2846.90.80)......

SEC. 1459. ACM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.79 (3-Acetoxy-3- 0.7% No change No change On or before 12/ ''.
cyanopropyl)
31/2009
methylphosphinic
acid, butyl ester
(CAS No. 167004-
78-6) (provided
for in subheading
2931.00.90)......

SEC. 1460. PERMETHRIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.80 (3- Free No change No change On or before 12/ ''.
Phenoxyphenyl)met
31/2009
hyl 3-(2,2-
dichloroethenyl)-
2,2-

dimethylcycloprop
anecarboxylate
(Permethrin) (CAS
No. 52645-53-1)
(provided for in
subheading
2916.20.50)......

SEC. 1461. THIDIAZURON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.81   N-Phenyl-N -   Free   No change   No
change   On or before 12/ ''.
(1,2,3-thiadiazol-
31/2009
5-yl)urea
(Thidiazuron) CAS
No. 51707-55-2),
whether or not
mixed with
application
adjuvants
(provided for in
subheading
2934.99.15 or
3808.30.15)......

SEC. 1462. FLUTOLANIL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.82   N-[3-(1-   Free   No change   No
change   On or before 12/ ''.
Methylethoxy)phen
31/2009
yl]-2-
(trifluoromethyl)
benzamide
(Flutolanil) (CAS
No. 66332-96-5)
(provided for in
subheading
2924.29.47)......

SEC. 1463. RESMETHRIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.83   [5-(Phenylmethyl)- Free   No change   No
change   On or before 12/ ''.
3-furanyl]methyl
31/2009
2,2-dimethyl-3-(2-
methyl-1-
propenyl)
cyclopropanecarbo
xylate
(Resmethrin) (CAS
No. 10453-86-8)
(provided for in
subheading
2932.19.10)......

SEC. 1464. CLOTHIANIDIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.84   (E)-1-(2-Chloro-   5.4%   No change   No
change   On or before 12/ ''.
1,3-thiazol-5-
31/2009
ylmethyl)-3-
methyl-2-
nitroguanidine
(Clothianidin)
(CAS No. 210880-
92-5) (provided
for in subheading
2934.10.90)......

SEC. 1465. CERTAIN MASTER CYLINDER ASSEMBLES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.10.92   Master cylinder   Free   No change   No
change   On or before 12/ ''.
assemblies for
31/2009
braking systems,
not incorporating
a vacuum booster,

the foregoing
designed for use
in hybrid motor
vehicles of
heading 8703
(provided for in
subheading
8708.39.50)......

SEC. 1466. CERTAIN TRANSAXLES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.93 Transaxles, each 1.5% No change No change On or before 12/ ''.
incorporating an
31/2009
integral
electronic
controller, the
foregoing
designed for use
in hybrid motor
vehicles of
heading 8703
(provided for in
subheading
8708.40.20)......

SEC. 1467. CONVERTER ASY.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.94 Static converters Free No change No change On or before 12/ ''.
capable of
31/2009
converting 300 V
direct current to
12 V direct
current, designed
for use in hybrid
motor vehicles of
heading 8703
(provided for in
subheading
8504.40.95)......

SEC. 1468. MODULE AND BRACKET ASY-POWER STEERING.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.95 Controllers for Free No change No change On or before 12/ ''.
electronic power
31/2009
assisted steering
systems, rated at
80 amperes at 12
V, designed for
use in hybrid
motor vehicles of
heading 8703
(provided for in
subheading
8537.10.90)......

SEC. 1469. UNIT ASY-BATTERY HI VOLT.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.96 Nickel metal- 2.8% No change No change On or before 12/ ''.
hydride storage
31/2009
batteries,
exceeding 300 V,
the foregoing
designed for use
in hybrid motor
vehicles of
heading 8703
(provided for in
subheading
8507.80.80)......

SEC. 1470. CERTAIN ARTICLES OF NATURAL CORK.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.10.99 Articles of 6% No change No change On or before 12/ ''.

natural cork, not
31/2009
elsewhere
specified or
included
(provided for in
subheading
4503.90.60)......

SEC. 1471. GLYOXYLIC ACID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.01   Glyoxylic acid   1.6%   No change   No change   On or before 12/ ''.
(CAS No. 298-12-
31/2009
4) (provided for
in subheading
2918.30.90)......

SEC. 1472. CYCLOPENTANONE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.02   Cyclopentanone   Free   No change   No change   On or before 12/ ''.
(CAS No. 120-92-
31/2009
3) (provided for
in subheading
2914.29.50)......

SEC. 1473. MESOTRIONE TECHNICAL.

(a) Calendar Year 2006.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.03   2-[4-   6.04%   No change   No change   On or before 12/ ''.
(Methylsulfonyl)-
31/2006
2-nitrobenzoyl]-
1,3-
cyclohexanedione
(Mesotrione) (CAS
No. 104206-82-8)
(provided for in
subheading
2930.90.10)......

(b) Calendar Year 2007.--

(1) In general.--Heading 9902.11.03, as added by subsection (a), is amended--

(A) by striking ``6.04%'' and inserting ``6.08%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2007''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2007.

(c) Calendar Years 2008 and 2009.--

(1) In general.--Heading 9902.11.03, as added by subsection (a) and amended by subsection (b), is further amended--

(A) by striking ``6.08%'' and inserting ``6.11%''; and

(B) by striking ``12/31/2007'' and inserting ``12/31/2009''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2008.

SEC. 1474. MALONIC ACID-DINITRILE 50% NMP.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.04   50% solution of   Free   No change   No change   On or before 12/ ''.
malononitrile in
31/2009
methyl-2-
pyrrolidone
solvent (CAS Nos.
109-77-3 and 872-
50-4) (provided
for in subheading
3824.90.9190)....

SEC. 1475. FORMULATIONS OF NOA 446510.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.05   Formulations of   Free   No change   No change   On or before 12/ ''.
NOA 446510 which
31/2009

include NOA
446510 Technical,
2-(4-chloro-
phenyl)-N-[2-(3-
methoxy-4-prop-2-
ynyloxy-
phenyl)ethyl]-2-
prop-2-
ynyloxyacetamide
(CAS No. 374726-
62-2) (provided
for in subheading
3808.20.15)......

SEC. 1476. DEMBB DISTILLED-ISO TANK.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.06 2-Bromo-1,3- Free No change No
change On or before 12/ ''.
diethyl-5-
31/2009
methylbenzene
(CAS No. 314084-
61-2) (DEMBB)
(provided for in
subheading
2903.69.80)......

SEC. 1477. METHYLIONONE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.10 3-Methyl-4-(2,6,6- Free No change No
change On or before 12/ ''.
trimethylcyclohex-
31/2009
2-enyl)but-3-en-2-
one
(Methylionone)
(CAS No. 1335-46-
2) (provided for
in subheading
2914.23.00)......

SEC. 1478. CERTAIN ACRYLIC FIBER TOW.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.11 Acrylic fiber tow Free No change No
change On or before 12/ ''.
(polyacrylonitril
31/2009
e tow) containing
by weight a
minimum of 92
percent
acrylonitrile,
not more than 0.1
percent zinc and
from 4 to 8
percent water,
imported in the
form of from 1 to
12 sub-bundles
crimped together,
each containing
24,000 filaments
(plus or minus
0.06 percent) and
with average
filament denier
of 1.5 decitex
(plus or minus
0.08 percent)
(provided for in
subheading
5501.30.00)......

SEC. 1479. CERTAIN ACRYLIC FIBER TOW.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.12 Acrylic fiber tow Free No change No
change On or before 12/ ''.
(polyacrylonitril
31/2009
e tow) containing
by weight a
minimum of 92

percent
acrylonitrile,
not more than 0.1
percent zinc and
from 2 to 8
percent water,
imported in the
form of 6 sub-
bundles crimped
together, each
containing 45,000
filaments (plus
or minus 0.06
percent) and with
average filament
denier of either
1.48 decitex
(plus or minus
0.08 percent) or
1.32 decitex
(plus or minus
0.09 percent)
(provided for in
subheading
5501.30.00)......

SEC. 1480. MKH 6561 ISOCYANATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.13 2-(Carbomethoxy) Free No change No change On or before 12/ ''.
benzenesulfonyl
31/2009
isocyanate (CAS
No. 74222-95-0)
(provided for in
subheading
2930.90.29)......

SEC. 1481. ENDOSULFAN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.14 6,7,8,9,10,10- Free No change No change On or before 12/ ''.
Hexachlorohexahyd
31/2009
romethano-2,4,3-
benzodioxathiepin-
3-oxide
(Endosulfan) (CAS
No. 115-29-7)
(provided for in
subheading
2920.90.50 or
3808.10.50)......

SEC. 1482. TETRACONAZOLE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.15 1-[2-(2,4- Free No change No change On or before 12/ ''.
dichlorophenyl)-3-
31/2009
(1,1,2,2-
tetrafluoroethoxy
)propyl]-1H-1,2,4-
triazole
(Tetraconazole)
(CAS No. 112281-
77-3) (provided
for in subheading
2933.99.22)......

SEC. 1483. M-ALCOHOL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.16 2-(2,4- 1% No change No change On or before 12/ ''.
Dichlorophenyl)-3-
31/2009
(1H-1,2,4-triazol-
1-yl)propanol
(CAS No. 112281-
82-0) (provided
for in subheading
2933.99.82)......

SEC. 1484. CERTAIN MACHINES FOR USE IN THE ASSEMBLY OF MOTORCYCLE WHEELS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.17	Wheel spoke tightening machines (provided for in subheading 8479.89.98), for use with wheels of vehicles of heading 8711.....	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1485. DELTAMETHRIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.26	(S)-a-Cyano-3-phenoxybenzyl (1R,3R)-3-(2,2-dibromovinyl)-2,2-dimethylcycloprop anecarboxylate (Deltamethrin) (CAS No. 52918-63-5) (provided for in subheading 2926.90.30)......	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1486. PALM FATTY ACID DISTILLATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.32	Monocarboxylic fatty acids derived from palm oil (provided for in subheading 3823.19.20)......	1%	No change	No change	On or before 12/31/2009 ''.

SEC. 1487. 4-METHOXY-2-METHYLDIPHENYLAMINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.35	4-Methoxy-2-methyldiphenylami ne (CAS No. 41317-15-1) (provided for in subheading 2922.29.60)......	1.1%	No change	No change	On or before 12/31/2009 ''.

SEC. 1488. 2-METHYLHYDROQUINONE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.36	2-Methylhydroquinon e (CAS No. 95-71-6) (provided for in subheading 2907.29.90)......	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1489. 1-FLUORO-2-NITROBENZENE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.37	1-Fluoro-2-nitrobenzene (CAS No. 1493-27-2) (provided for in subheading 2904.90.30)......	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1490. COSMETIC BAGS WITH A FLEXIBLE OUTER SURFACE OF REINFORCED OR LAMINATED POLYVINYL CHLORIDE (PVC).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.43	Vanity cases that are of a soft	13.3%	No change	No change	On or before 12/ ''.

31/2009
sided
construction, of
reinforced or
laminated
polyvinyl
chloride
plastics, and are
of a kind
normally carried
in the pocket or
in the handbag
and used to
contain and apply
cosmetic
preparations
(provided for in
subheading
4202.12.20)......

SEC. 1491. MIXTURES OF METHYL 4-IODO-2-[3-(4-METHOXY-6-METHYL-1,3,5-TRIAZIN-2-YL)UREIDOSULFONYL]BENZOATE, SODIUM SALT (IODOSULFURON METHYL, SODIUM SALT).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.44 Mixtures of Free No change No change On or before 12/ ''.
methyl 4-iodo-2-
31/2009
[3-(4-methoxy-6-
methyl-1,3,5-
triazin-2-yl)
ureidosulfonyl]
benzoate, sodium
salt
(Iodosulfuron
methyl, sodium
salt) (CAS No.
144550-36-7) and
application
adjuvants
(provided for in
subheading
3808.30.15)......

SEC. 1492. ETHYL 4,5-DIHYDRO-5,5-DIPHENYL-1,2-OXAZOLE-3-CARBOXYLATE (ISOXADIFEN-ETHYL).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.45 Ethyl 4,5-dihydro- Free No change No change On or before 12/ ''.
5,5-diphenyl-1,2-
31/2009
oxazole-3-
carboxylate
(Isoxadifen-
ethyl) (CAS No.
163520-33-0)
(provided for in
subheading
2934.99.39)......

SEC. 1493. (5-CYCLOPROPYL-4-ISOXAZOLYL)[2-(METHYLSULFONYL)-4-(TRIFLUOROMETHYL)PHENYL]METHANONE (ISOXAFLUTOLE).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.46 (5-cyclopropyl-4- 4.8% No change No change On or before 12/ ''.
isoxazolyl)[2-
31/2009
(methylsulfonyl)-
4-
(trifluoromethyl)
phenyl]methanone
(Isoxaflutole)
(CAS No. 141112-
29-0) (provided
for in subheading
2934.99.15)......

SEC. 1494. METHYL 2-[(4,6-DIMETHOXYPYRIMIDIN-2-YLCARBAMOYL)SULFAMOYL]-a-(METHANESULFONAMIDO)-P-TOLUATE (MESOSULFURON-METHYL) WHETHER OR NOT MIXED WITH APPLICATION ADJUVANTS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.48 Methyl 2-[(4,6- Free No change No

change   On or before 12/ ''.
                        dimethoxypyrimidi
          31/2009
                        n-2-
                        ylcarbamoyl)sulfa
                        moyl]-a-
                        (methanesulfonami
                        do)-p-toluate
                        (Mesosulfuron-
                        methyl) (CAS No.
                        208465-21-8)
                        whether or not
                        mixed with
                        application
                        adjuvants
                        (provided for in
                        subheading
                        2935.00.75 or
                        3808.30.15)......

SEC. 1495. MIXTURES OF FORAMSULFURON AND IODOSULFURON-METHYL-SODIUM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.49   Mixtures of N,N-   Free   No change   No
change   On or before 12/ ''.
                        dimethyl-2[3-(4,6-
          31/2009
                        dimethoxypyrimidin-
                        2-yl)
                        ureidosulfonyl]-4-
                        formylaminobenzami
                        de (Foramsulfuron)
                        (CAS No. 173159-57-
                        4), methyl 4-iodo-
                        2-[3-(4-methoxy-6-
                        methyl-1,3,5-
                        triazin-2-yl)
                        ureidosulfonyl]ben
                        zoate, sodium salt
                        (Iodosulfuron-
                        methyl-sodium)
                        (CAS No. 144550-36-
                        7) and application
                        adjuvants
                        (provided for in
                        subheading
                        3808.30.15).......

SEC. 1496. VULCUREN UPKA 1988.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.54   1,6-Bis(N,N'-   Free   No change   No
change   On or before 12/ ''.
                        dibenzylthiocarba
          31/2009
                        moyldithio)hexane
                        (CAS No. 151900-
                        44-6) (provided
                        for in subheading
                        2930.20.20)......

SEC. 1497. VULLCANOX 41010 NA/LG.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.55   N-Isopropyl-N'-   Free   No change   No
change   On or before 12/ ''.
                        phenyl-p-
          31/2009
                        phenylenediamine
                        (CAS No. 101-72-
                        4) (provided for
                        in subheading
                        2921.51.50)......

SEC. 1498. VULKAZON AFS/LG.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.56   Pentaerythritolbi Free   No change   No
change   On or before 12/ ''.
                        s(tetrahydrobenza
          31/2009
                        ldehyde acetal)
                        (CAS No. 6600-31-
                        3) (provided for
                        in subheading
                        2932.99.90)......

SEC. 1499. P-ANISALDEHYDE.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.11.57   P-Anisaldehyde   Free   No change   No change   On or before 12/ ''.
                         (CAS No. 123-11-
          31/2009
                         5) (Benzoldehyde,
                         4-methoxy-)
                         (provided for in
                         subheading
                         2912.49.10)......
SEC. 1500. 1,2-PENTANEDIOL.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.11.60   1,2-Pentanediol   Free   No change   No change   On or before 12/ ''.
                         (CAS No. 5343-92-
          31/2009
                         0) (provided for
                         in subheading
                         2905.39.90)......
SEC. 1501. AGRUMEX.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following:
``   9902.11.62   o-tert-   Free   No change   No change   On or before 12/ ''.
                         Butylcyclohexyl
          31/2009
                         acetate, cis form
                         (CAS No. 20298-69-
                         9) (Agrumex)
                         (Cyclohexanol, 2-
                         (1,1-dimethyl-)
                         (provided for in
                         subheading
                         2915.39.45)......
SEC. 1502. COHEDUR RL.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.11.63   Mixtures of   Free   No change   No change   On or before 12/ ''.
                         resorcinol (CAS
          31/2009
                         No. 108-46-3),
                         hexamethylolmelam
                         ine ether (CAS
                         No. 3089-11-0)
                         and dibutyl
                         phthalate (CAS
                         No. 84-74-2)
                         (provided for in
                         subheading
                         3824.90.28)......
SEC. 1503. FORMULATIONS OF PROSULFURON.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.11.64   Mixtures of   Free   No change   No change   On or before 12/ ''.
                         Prosulfuron (1-(4-
          31/2009
                         methoxy-6-methyl-
                         1,3,5-triazin-2-
                         yl)-3-[2-(3,3,3-
                         trifluoropropyl)-
                         phenylsulfonyl]ur
                         ea) (CAS No.
                         94125-34-5) and
                         application
                         adjuvants
                         (provided for in
                         subheading
                         3808.30.15)......
SEC. 1504. LEWATIT.
    Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.11.71   Ion-exchange   Free   No change   No change   On or before 12/ ''.
                         resins (cationic
          31/2009
                         H form),
                         consisting of

copolymers of
acrylic acid and
diethylene glycol
divinyl ether
(CAS No. 359785-
58-3) (provided
for in subheading
3914.00.60)......

SEC. 1505. PARA-CHLOROPHENOL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.72   para-Chlorophenol   Free   No change   No
change   On or before 12/ ''.
(CAS No. 106-48-
31/2009
9) (provided for
in subheading
2908.10.60)......

SEC. 1506. CYPERMETHRIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.74   Cyano(3-   Free   No change   No
change   On or before 12/ ''.
phenoxyphenyl)met
31/2009
hyl 3-(2,2-
dichloroethenyl)-
2,2-
dimethylcycloprop
anecarboxylate
(Cypermethrin)
(CAS No. 52315-07-
8) (provided for
in subheading
2926.90.30)......

SEC. 1507. ION-EXCHANGE RESIN POWDER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.78   Ion-exchange   Free   No change   No
change   On or before 12/ ''.
resin powder
31/2009
comprised of a
copolymer of
methacrylic acid
cross-linked with
divinylbenzene,
in the hydrogen
ionic form, of a
nominal partical
size between
0.025mm and 0.150
mm, dried to less
than 5% moisture
(CAS No. 50602-21-
6)(provided for
in subheading
3914.00.60)......

SEC. 1508. ION-EXCHANGE RESIN POWDER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.79   Ion-exchange   Free   No change   No
change   On or before 12/ ''.
resin powder
31/2009
comprised of a
copolymer of
methacrylic acid
cross-linked with
divinylbenzene,
in the potassium
ionic form, of a
nominal particle
size between
0.025mm and 0.150
mm, dried to less
than 10% moisture
(CAS No. 65405-55-
2) (provided for
in subheading
3914.00.60)......

SEC. 1509. DESMODUR E 14.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.80   1,2,3-   Free   No change   No
change   On or before 12/ ''.
                         Propanetriol,
          31/2009
                         polymer with 2,4-
                         diisocyanato-1-
                         methylbenzene, 2-
                         ethyl-2-
                         (hydroxymethyl)-1
                         ,3-propanediol,
                         methyloxirane and
                         oxirane (CAS No.
                         127821-00-5)
                         (provided for in
                         subheading
                         3909.50.50)......

SEC. 1510. DESMODUR VP LS 2253.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.82   Hexane, 1,6-   Free   No change   No
change   On or before 12/ ''.
                         diisocyanato-,
          31/2009
                         homopolymer, 3,5-
                         dimethyl-1H-
                         pyrazole-blocked
                         (CAS No. 163206-
                         31-3) (provided
                         for in subheading
                         3911.90.90)......

SEC. 1511. DESMODUR R-E.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.83   4,4, 4-TT Desmodur Free   No change   No
change   On or before 12/ ''.
                         R-E in solvent
          31/2009
                         (CAS No. 2422-91-
                         5) in solvent
                         (provided for in
                         subheading
                         3824.90.28)......

SEC. 1512. WALOCEL MW 3000 PFV.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.84   Methyl   Free   No change   No
change   On or before 12/ ''.
                         hydroxyethyl
          31/2009
                         cellulose
                         products
                         containing 30% or
                         greater content
                         of 2-hydroxyethyl
                         methyl ether
                         cellulose
                         (``MHEC'')
                         reaction products
                         with glyoxal (CAS
                         No. 68441-63-4)
                         (provided for in
                         subheading
                         3912.39.00)......

SEC. 1513. TSME.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.85   ortho/para-   Free   No change   No
change   On or before 12/ ''.
                         Toluenesulfonic
          31/2009
                         acid, methyl
                         ester (TSME) (CAS
                         Nos. 23373-38-8
                         and 80-48-8)
                         (provided for in
                         subheading
                         2904.10.32)......

SEC. 1514. WALOCEL VP-M 20660.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.86   Methyl   Free   No change   No
change   On or before 12/ ''.
Hydroxyethyl
31/2009
Cellulose with a
77% or greater
content of 2-
hydroxyethyl
methyl ether
cellulose (CAS
No. 9032-42-2)
(provided for in
subheading
3912.39.00)......

SEC. 1515. XAMA 2.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.87   Trimethylopropane   Free   No change   No
change   On or before 12/ ''.
tris(3-
31/2009
aziridinylpropano
ate) (CAS No.
52234-82-9)
(provided for in
subheading
2933.99.97)......

SEC. 1516. XAMA 7.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.88   Polyfunctional   Free   No change   No
change   On or before 12/ ''.
aziridine (CAS
31/2009
No. 57116-45-7)
(provided for in
subheading
2933.99.97)......

SEC. 1517. CERTAIN CASES FOR TOYS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.90   Cases or   Free   No change   No
change   On or before 12/ ''.
containers
31/2009
(provided for in
subheading
4202.92.90 and
not including
goods described
in heading
9902.01.81),
specially shaped
or fitted for,
and with
labeling, logo or
other descriptive
information on
the exterior of
the case or
container
indicating its
intention to be
used for,
electronic
drawing toys or
electronic games
of heading 9503
or 9504.........

SEC. 1518. CERTAIN CASES FOR TOYS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.11.91   Cases or   Free   No change   No
change   On or before 12/ ''.
containers
31/2009
(provided for in
subheadings
4402.12.80 or
4202.92.90),
having one or
more molded

plastic holders,
clips or
fasteners, for
holding a doll or
dolls, whether or
not the case or
container is also
capable of
holding other
goods............

SEC. 1519. ANILINE 2.5-DISULFONIC ACID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.92 Aniline 2,5- Free No change No change On or before 12/ ''.
disulfonic acid
31/2009
(CAS No. 98-44-2)
(1,4-
Benzenedisnlfonic
acid, 2-amino-)
(provided for in
subheading
2921.42.90)......

SEC. 1520. 1,4-BENZENEDICARBOXYLIC ACID, POLYMER WITH N,N'-BIS(2-AMINOETHYL)-1,2-ETHANEDIAMINE, CYCLIZED, METHOSULFATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.93 1,4- Free No change No change On or before 12/ ''.
Benzenedicarboxyl
31/2009
ic acid, polymer
With N,N-Bis(2-
aminoethyl)-1,2-
ethanediamine,
cyclized,
methosulfate (CAS
No. 68187-22-4)
(provided for in
subheading
3908.90.70)......

SEC. 1521. SULFUR BLUE 7.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.94 4-[(4-Amino-3- Free No change No change On or before 12/ ''.
methylphenyl)amin
31/2009
o]phenol,
reaction products
with sodium
sulfide (Sulfur
Blue 7) (CAS No.
1327-57-7)
(provided for in
subheading
3204.19.50)......

SEC. 1522. FORMALDEHYDE, REACTION PRODUCTS WITH 1,4-BENZENEDIOL AND M-PHENYLENEDIAMINE, SULFURIZED.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.95 Formaldehyde, Free No change No change On or before 12/ ''.
reaction products
31/2009
with 1,4-
benzenediol and m-
phenylenediamine,
sulfurized (CAS
No. 110392-46-6)
(provided for in
subheading
3204.19.50)......

SEC. 1523. ISOCYANATOSULFONYL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.11.96 2- Free No change No change On or before 12/ ''.
(Isocyanatosulfon
31/2009
yl)benzoic acid,

ethyl ester (CAS No. 77375-79-2) (provided for in subheading 2930.90.29)......

SEC. 1524. ISOCYANATOSULFONYL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``9902.11.97	2-(Isocyanatosulfonyl)benzoic acid, methyl ester (CAS No. 74222-95-0) (provided for in subheading 2930.90.29)......	Free	No change	No change	On or before 12/31/2009''.

SEC. 1525. GEMIFLOXACIN, GEMIFLOXACIN MESYLATE, AND GEMIFLOXACIN MESYLATE SESQUIHYDRATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``9902.11.99	Gemifloxacin (CAS No. 175463-14-6); gemifloxacin mesylate (CAS No. 210353-53-0 or 204519-65-3); and gemifloxacin mesylate sesquihydrate (CAS No. 210353-56-3) (the foregoing provided for in subheading 2933.99.46)......	Free	No change	No change	On or before 12/31/2009''.

SEC. 1526. BUTRALIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``9902.12.01	Butralin (CAS No. 33629-47-9) (Benzenamine, 4-(1,1-dimethylethyl)-N-(1-methylpropyl)-2,6-dintro-) (provided for in subheading 2921.43.90)......	Free	No change	No change	On or before 12/31/2009''.

SEC. 1527. SPIRODICLOFEN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``9902.12.02	2,2-Dimethylbutanoic acid, 3-(2,4-dichlorophenyl)-2-oxo-1-oxaspiro(4.5)dec-3-en-4-yl ester (Spirodiclofen) (CAS No. 148477-71-8) (provided for in subheading 2932.29.10)......	Free	No change	No change	On or before 12/31/2009''.

SEC. 1528. PROPAMOCARB HCL (PREVICUR).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``9902.12.03	Mixtures of propyl 3-(dimethylamino) propylcarbamate monohydrochloride (Propamocarb hydrochloride)	Free	No change	No change	On or before 12/31/2009''.

(CAS No. 25606-41-
1) and
application
adjuvants
(provided for in
subheading
3808.20.50)......
SEC. 1529. DESMODUR IL.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.12.04 Poly(toluene Free No change No
change On or before 12/ ''.
diisocyanate)
31/2009
(CAS No. 26006-20-
2) dissolved in
organic solvents
(provided for in
subheading
3911.90.45)......
SEC. 1530. CHLOROACETONE.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.12.05 1-Chloro-2- Free No change No
change On or before 12/ ''.
propanone (CAS
31/2009
No. 78-95-5)
(provided for in
subheading
2914.70.90)......
SEC. 1531. IPN (ISOPHTHALONITRILE).
(a) Calendar Year 2006.--Subchapter II of chapter 99 is amended by
inserting in numerical sequence the following new heading:
`` 9902.12.06 1,3- 3.04% No change No
change On or before 12/ ''.
Benzenedicarbonit
31/2006
rile (CAS No. 626-
17-5) (provided
for in subheading
2926.90.48)......
(b) Calendar Year 2007.--
(1) In general.--Heading 9902.12.06, as added by subsection
(a), is amended--
(A) by striking ``3.04%'' and inserting ``3.23%'';
and
(B) by striking ``On or before 12/31/2006'' and
inserting ``On or before 12/31/2007''.
(2) Effective date.--The amendments made by paragraph (1)
shall take effect on January 1, 2007.
(c) Calendar Years 2008 and 2009.--
(1) In general.--Heading 9902.12.06, as added by subsection
(a) and amended by subsection (b), is further amended--
(A) by striking ``3.23%'' and inserting ``3.4%'';
and
(B) by striking ``On or before 12/31/2007'' and
inserting ``On or before 12/31/2009''.
(2) Effective date.--The amendments made by paragraph (1)
shall take effect on January 1, 2008.
SEC. 1532. NOA 446510 TECHNICAL.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.12.07 4-Chloro-N-[2-[3- 1.2% No change No
change On or before 12/ ''.
methoxy-4-(2-
31/2009
propynyloxy)pheny
l]ethyl]-a-(2-
propynyloxy)benze
neacetamide
(Mandipropamid)
(CAS No. 374726-
62-2) (provided
for in subheading
2924.29.47)......
SEC. 1533. HEXYTHIAZOX TECHNICAL.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
`` 9902.12.08 trans-5-(4- Free No change No
change On or before 12/ ''.
Chlorophenyl)-N-

31/2009
cyclohexyl-4-
methyl-2-
oxothiazolidine-3-
carboxamide
(Hexythiazox
Technical) (CAS
No. 78587-05-0)
(provided for in
subheading
2934.10.10)......

SEC. 1534. CRELAN (SELF-BLOCKED CYCLOALIPHATIC POLYURETDIONE).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.10 2-Oxepanone Free No change No change On or before 12/ ''.
polymer with 1,4-
31/2009
butanediol and 5-
isocyanato-1-
(isocyanatomethyl
)-1,3,3-
trimethylcyclohex
ane, 2-ethyl-1-
hexanol-blocked
(CAS No. 189020-
69-7) (provided
for in subheading
3909.50.50)......

SEC. 1535. ASPIRIN.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.11 o-Acetylsalicylic 3.0% No change No change On or before 12/ ''.
acid (aspirin)
31/2009
(CAS No. 50-78-2)
(provided for in
subheading
2918.22.10)......

SEC. 1536. DESMODUR BL XP 2468.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.12 Copolymer of Free No change No change On or before 12/ ''.
methyl ethyl
31/2009
ketoxime and
toluenediisocyana
te (CAS No.
352462-03-4)
(provided for in
subheading
3911.90.45)......

SEC. 1537. DESMODUR RF-E.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.17 Mixtures of tris(4- Free No change No change On or before 12/ ''.
isocyanatophenyl)
31/2009
thiophosphate
(CAS No. 4151-51-
3) and ethyl
acetate and
monochlorobenzene
as solvents
(provided for in
subheading
3824.90.28)......

SEC. 1538. DESMODUR HL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.18 Benzene, 1,3- Free No change No change On or before 12/ ''.
diisocyanatomethy
31/2009
l-, polymer with
1,6-
diisocyanatohexan
e (CAS No. 63368-
95-6) dissolved

in n-butyl acetate (provided for in subheading 3911.90.45)......

SEC. 1539. D-MANNOSE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.19 D-Mannose (CAS No. 3458-28-4) (provided for in subheading 2940.00.60)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1540. CERTAIN CAMEL HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.20 Camel hair, processed beyond the degreased or carbonized condition (provided for in subheading 5102.19.90)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1541. WASTE OF CAMEL HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.21 Waste of camel hair (provided for in subheading 5103.20.00)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1542. CERTAIN CAMEL HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.22 Camel hair carded or combed (provided for in subheading 5105.39.00)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1543. WOVEN FABRIC OF VICUNA HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.23 Woven fabrics containing 85 percent or more by weight of vicuna hair (provided for in subheadings 5111.11.70, 5111.19.60, 5112.11.60, or 5112.19.95)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1544. CERTAIN CAMEL HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.24 Camel hair, not processed in any manner beyond the degreased or carbonized condition (provided for in subheading 5102.19.20)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1545. NOILS OF CAMEL HAIR.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.25 Noils of camel hair (provided Free No change No change On or before 12/ ''.

31/2009
for in subheading
5103.10.00)......

SEC. 1546. CHLOROACETIC ACID, ETHYL ESTER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.33 Chloroacetic acid, Free No change No change On or before 12/ ''.
ethyl ester (CAS
31/2009
No. 105-39-5)
(provided for in
subheading
2915.40.50)......

SEC. 1547. CHLOROACETIC ACID, SODIUM SALT.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.34 Chloroacetic acid, Free No change No change On or before 12/ ''.
sodium salt (CAS
31/2009
No. 3926-62-3)
(provided for in
subheading
2915.40.50)......

SEC. 1548. LOW EXPANSION LABORATORY GLASS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.39 Laboratory, 3.6% No change No change On or before 12/ ''.
hygienic, or
31/2009
pharmaceutical
glassware,
whether or not
graduated or
calibrated, of
low expansion
borosilicate
glass or alumino-
borosilicate
glass, having a
linear
coefficient of
expansion not
exceeding 3.3 x
10\7\ per Kelvin
within a
temperature range
of 0 to 300 C
(provided for in
subheading
7017.20.00)......

SEC. 1549. STOPPERS, LIDS, AND OTHER CLOSURES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.40 Stoppers, lids, Free No change No change On or before 12/ ''.
and other
31/2009
closures of low
expansion
borosilicate
glass or alumino-
borosilicate
glass, having a
linear
coefficient of
expansion not
exceeding 3.3 x
10\7\ per Kelvin
within a
temperature range
of 0 to 300 C,
produced by
automatic machine
(provided for in
subheading
7010.20.20) or
produced by hand
(provided for in
subheading

7010.20.30)......

SEC. 1550. PIGMENT YELLOW 213.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.41 1,4-Benzenedicarboxylic acid, 2-[[2-oxo-1-[[1,2,3,4-tetrahydro-7-methoxy-2,3-dioxo-6-quinoxalinyl) amino]carbonyl] propyl]azo]-, dimethyl ester (Pigment Yellow 213) (CAS No. 220198-21-0) (provided for in subheading 3204.17.60)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1551. INDOXACARB.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.42 (4aS) -7-Chloro-2, 5-dihydro-2-[[(methoxycarbonyl)[4-(trifluoromethoxy) phenyl] amino] carbonyl]-indeno [1,2-e][1,3,4] oxadiazine-4a (3H)-carboxylic acid methyl ester (CAS No. 173584-44-6) (provided for in subheading 2934.99.16)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1552. DIMETHYL CARBONATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.43 Dimethyl carbonate (CAS No. 616-38-6) (provided for in subheading 2920.90.50)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1553. 5-CHLORO-1-INDANONE (EK179).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.44 5-Chloro-1-indanone (CAS No. 42348-86-7) (provided for in subheading 2914.39.90)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1554. MIXTURES OF FAMOXADONE AND CYMOXANIL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.45 Mixtures of 5-methyl-5-(4-phenoxyphenyl)-3-(phenylamino)-2,4-oxazolidinedione] (famoxadone) (CAS No. 131807-57-3), 2-cyano-N-[(ethylamino)carbonyl]-2-(methoxyimino)acetamide (Cymoxanil) (CAS Free No change No change On or before 12/31/2009 ''.

No. 57966-95-7)
and application
adjuvants
(provided for in
subheading
3808.20.15)......

SEC. 1555. DECANEDIOIC ACID, BIS(2,2,6,6-TETRAMETHYL-4-PIPERIDINYL) ESTER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.47 Decanedioic acid, bis(2,2,6,6-tetramethyl-4-piperidinyl) ester (CAS No. 52829-07-9) (provided for in subheading 2933.39.91)...... Free No change No change On or Before 12/31/2009 ''.

SEC. 1556. ACID BLUE 80.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.49 Acid Blue 80 (CAS No. 4474-24-2) (provided for in subheading 3204.12.50)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1557. PIGMENT BROWN 25.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.50 Pigment Brown 25 (CAS No. 6992-11-6) (provided for in subheading 3204.17.04)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1558. FORMULATIONS OF AZOXYSTROBIN.

(a) Calendar Year 2006.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.12.51 Mixtures of benzeneacetic acid, (a E)- 2-[[6-(2-cyanophenoxy)-4-pyrimidinyl]oxy]-a-(methoxymethylene)-, methyl ester (Azoxystrobin) (CAS No. 131860-33-8) and application adjuvants (provided for in subheading 3808.20.15)...... 6.14% No change No change On or before 12/31/2006 ''.

(b) Calendar Year 2007.--

(1) In general.--Heading 9902.12.51, as added by subsection (a), is amended--

(A) by striking ``6.14%'' and inserting ``6.15%''; and

(B) by striking ``On or before 12/31/2006'' and inserting ``On or before 12/31/2007''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2007.

(c) Calendar Years 2008 and 2009.--

(1) In general.--Heading 9902.12.51, as added by subsection (a) and amended by subsection (b), is further amended--

(A) by striking ``6.15%'' and inserting ``6.17%''; and

(B) by striking ``On or before 12/31/2007'' and inserting ``On or before 12/31/2009''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2008.

SEC. 1559. FORMULATIONS OF PINOXADEN/CLOQUINTOCET.

(a) Calendar Years 2006 and 2007.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``

9902.12.52	Mixtures of 8(2,6-diethyl-p-tolyl)-1,2,4,5-tetrahydro-7-oxo-7H-pyrazolo[[1,2-d][1,4,5]oxadiazepin-9-yl 2,2-dimethylpropionate (Pinoxaden) (CAS No. 243973-20-8), acetic acid, [5-chloro-8-quinolinyl]oxy]-, 1-methylhexyl ester (Cloquintocet) (CAS No. 99607-70-2) and application adjuvants (provided for in subheading 3808.30.15)......	Free	No change	No change	On or before 12/31/2007

''.

(b) Calendar Years 2008 and 2009.--

(1) In general.--Heading 9902.12.52, as added by subsection (a), is further amended--

(A) by striking ``Free'' and inserting ``1.74%''; and

(B) by striking ``On or before 12/31/2007'' and inserting ``On or before 12/31/2009''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2008.

SEC. 1560. MIXTURES OF DIFENOCONAZOLE/MEFENOXAM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``

9902.12.53	Mixtures of 1H-1,2,4-triazole, 1-((2-chlorophenoxy)phenyl)-4-methyl-1,3-dioxolan-2-yl)methyl)-(Difenoconazole) (CAS No. 119446-68-3), (R,S)-2-((2,6-dimethylphenyl) methoxyacetylamino) propionic acid, methyl ester (Mefenoxam) (CAS Nos. 70630-17-0, and 69516-34-3) and application adjuvants (provided for in subheading 3808.20.15)......	Free	No change	No change	On or before 12/31/2009

''.

SEC. 1561. FLUDIOXINIL TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``

9902.12.54	1H-Pyrrole-3-carbonitrile, 4-(2,2-difluoro-1,3-benzodioxol-4-yl)- (fludioxinil) (CAS No. 131341-86-1) (provided for in subheading 2934.99.12)......	1.6%	No change	No change	On or before 12/31/2009

''.

SEC. 1562. MIXTURES OF CLODINAFOP-PROPARGYL.

Subchapter II of chapter 99 is amended by inserting in numerical

sequence the following new heading:
``   9902.12.55   Mixtures of   1.7%   No change   No
change   On or before 12/ ''.
                          propionic acid, 2-
          31/2009
                          (4-((5-chloro-3-
                          fluoro-2-
                          pyridynyl)oxy)phe
                          noxy-2-propynyl
                          ester,
                          (clodinafop-
                          propargyl) (CAS
                          No. 105512-06-9)
                          (provided for in
                          subheading
                          3808.30.15)......

SEC. 1563. AVERMECTIN B, 1,4"-DEOXY-4"-METHYLAMINO-, (4"R)-, BENZOATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.12.56   Avermectin B, 1,4"- Free   No change   No
change   On or before 12/ ''.
                          deoxy-4"-
          31/2009
                          methylamino-,
                          (4"R)-, benzoate
                          (CAS No. 155569-
                          91-8) (provided
                          for in subheading
                          3824.90.91 or
                          2932.29.50)......

SEC. 1564. CLOQUINTOCET-MEXYL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.12.57   Acetic acid, 5-   Free   No change   No
change   On or before 12/ ''.
                          chloro-8-
          31/2009
                          quinolinoxy-, 1-
                          methylhexyl ester
                          (Cloquintocet-
                          mexyl) (CAS No.
                          99607-70-2)
                          (provided for in
                          subheading
                          2933.49.30)......

SEC. 1565. METALAXYL-M TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.12.58   (R,S)-2-((2,6-   Free   No change   No
change   On or before 12/ ''.
                          Dimethylphenyl)
          31/2009
                          methoxyacetylamin
                          o) propionic
                          acid, methyl
                          ester (Metalaxyl-
                          M and L-
                          Metalaxylfenoxam)
                          (CAS Nos. 70630-
                          17-0 and 69516-34-
                          3) (provided for
                          in subheading
                          2924.29.47)......

SEC. 1566. CYPROCONAZOLE TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:
``   9902.12.59   [a-(4-   Free   No change   No
change   On or before 12/ ''.
                          Chlorophenyl)-a-
          31/2009
                          (1-
                          cyclopropylethyl)
                          -1H-1-1,2,4-
                          triazole-1-
                          ethanol
                          (Cyproconazole)
                          (CAS No. 94361-06-
                          5) (provided for
                          in subheading
                          2934.99.12)......

SEC. 1567. PINOXADEN TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical

sequence the following new heading:
``   9902.12.60   8-(2,6-Diethyl-4-   1.8%   No change   No
change   On or before 12/ ''.
                        methylphenyl)-1,2
          31/2009
                        ,4,5-tetrahydro-7-
                        oxo-7H-
                        pyrazolo[1,2-
                        d][1,4,5]oxadiaze
                        pin-9-yl 2,2-
                        dimethylpropanoat
                        e (Pinoxaden)
                        (CAS No. 243973-
                        20-8) (provided
                        for in subheading
                        2934.99.15)......

SEC. 1568. MIXTURES OF TRALKOXYDIM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.12.61   Mixtures of 2-[1- Free   No change   No
change   On or before 12/ ''.
                        (ethoxyimino)prop
          31/2009
                        yl]-3-hydroxy-5-
                        (2,4,6-
                        trimethylphenyl)-
                        2-cyclohexen-1-
                        one (Tralkoxydim)
                        (CAS No. 87820-88-
                        0) as the active
                        ingredient and
                        application
                        adjuvants
                        (provided for in
                        subheading
                        3808.30.15)......

SEC. 1569. CERTAIN CHEMICALS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new headings:

``   9902.12.72   Mixtures of zinc   Free   No change   No change
        On or before 12/   ...
                         dialkyldithiophos
         31/2009
                         phate (CAS No.
                         6990-43-8) with
                         an elastomer
                         binder of
                         ethylene-
                         propylene-diene
                         monomer and ethyl
                         vinyl acetate,
                         dispersing agents
                         and silica
                         (provided for in
                         subheading
                         3812.10.50)......
        9902.12.73   Mixtures of   Free   No change   No change
        On or before 12/   ...
                         dithiocarbamate,
         31/2009
                         thiazole, thiuram
                         and thiourea with
                         an elastomer
                         binder of
                         ethylene-
                         propylene-diene
                         monomer and ethyl
                         vinyl acetate,
                         and dispersing
                         agents (provided
                         for in subheading
                         3812.10.50)......
        9902.12.74   Mixtures of   Free   No change   No change
        On or before 12/   ...
                         caprolactam
         31/2009
                         disulfide (CAS
                         No. 23847-08-7)
                         with an elastomer
                         binder of
                         ethylene-
                         propylene-diene

monomer and ethyl
vinyl acetate,
and dispersing
agents (provided
for in subheading
3812.10.50)......

9902.12.75	Mixtures of N-(3,4-dichloro-phenyl)-N,N-dimethylurea (CAS No. 330-54-1) with acrylate rubber (provided for in subheading 3812.10.50)......	Free	No change	No change	On or before 12/31/2009
9902.12.76	Mixtures of zinc dicyanato diamine (CAS No. 122012-52-6) with an elastomer binder of ethylene-propylene-diene monomer and ethyl vinyl acetate, and dispersing agents (provided for in subheading 3812.10.50)......	Free	No change	No change	On or before 12/31/2009
9902.12.77	4,8-Dicyclohexyl -6-2,10-dimethyl -12H-dibenzo [d,g][1,3,2] dioxaphosphocin (CAS No. 73912-21-7) (provided for in subheading 2920.90.50)......	Free	No change	No change	On or before 12/31/2009
9902.12.78	Mixtures of benzenesulfonic acid, dodecyl-, with 2-aminoethanol (CAS No. 26836-07-7) and Poly (oxy-1,2-ethanediyl), a-[1-oxo-9-octadecenyl]-w-hydroxy-, (9Z) (CAS No. 9004-96-0) (provided for in subheading 3402.90.50)......	Free	No change	No change	On or before 12/31/2009
9902.12.79	1,3- Dihydro-3,3-bis (4-hydroxy-m-tolyl) -2H-indol-2-one (CAS No. 47465-97-4) (provided for in subheading 2933.79.08)......	Free	No change	No change	On or before 12/31/2009''.

SEC. 1570. MIXTURES OF (<plus-minus>)-(CIS AND TRANS)-1-[[2-(2,4-DICHLOROPHENYL)-4-PROPYL-1,3-DIOXOLAN-2-YL]-METHYL]-1H-1,2,4-TRIAZOLE.

(a) In General.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``

9902.12.80	Mixtures of (<plus-minus>)-(cis and trans)-1-[[2-(2,4-Dichlorophenyl)-4-propyl-1,3-	1.1%	No change	No change	On or before 12/31/2009''.

dioxolan-2-yl]-
methyl]-1H-1,2,4-
triazole (CAS No.
60207-90-1) and
application
adjuvants
(provided for in
subheading
3808.20.15)......

(b) Conforming amendment.--Subchapter II of chapter 99 is amended by striking heading 9902.32.04.

SEC. 1571. PARAQUAT DICHLORIDE.

(a) In General.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.06 Paraquat 3.59% No change No change On or before 12/ ''.
dichloride
31/2006
(1,1'dimethyl-
4,4'-bipyridinium
dichloride) (CAS
No. 1910-42-5)
(provided for in
subheading
2933.39.23)......

(b) Calendar Year 2007.--

(1) In general.--Heading 9902.13.06, as added by subsection (a), is amended--

(A) by striking ``3.59%'' and inserting ``4.02%''; and

(B) by striking ``On or before 12/31/2006'' and inserting ``On or before 12/31/2007''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2007.

(c) Calendar Years 2008 and 2009.--

(1) In general.--Heading 9902.13.06, as added by subsection (a) and amended by subsection (b), is further amended--

(A) by striking ``4.02%'' and inserting ``4.41%''; and

(B) by striking ``On or before 12/31/2007'' and inserting ``On or before 12/31/2009''.

(2) Effective date.--The amendments made by paragraph (1) shall take effect on January 1, 2008.

SEC. 1572. CERTAIN BASKETBALLS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.07 Basketballs, 0.9% No change No change On or before 12/ ''.
having an
31/2009
external surface
other than
leather, rubber,
or synthetic
(provided for in
subheading
9506.62.80)......

SEC. 1573. CERTAIN LEATHER BASKETBALLS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.08 Leather Free No change No change On or before 12/ ''.
basketballs
31/2009
(provided for in
subheading
9506.62.80)......

SEC. 1574. CERTAIN RUBBER BASKETBALLS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.09 Rubber 1.5% No change No change On or before 12/ ''.
basketballs
31/2009
(provided for in
subheading
9506.62.80)......

SEC. 1575. CERTAIN VOLLEYBALLS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.10 Volleyballs Free No change No change On or before 12/ ''.

(provided for in
31/2009
subheading
9506.62.80)......

SEC. 1576. 4-CHLORO-3-[[3-(4-METHOXYPHENYL)-1,3-DIOXOPROPYL]-AMINO]-
DODECYL ESTER.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.11 4-Chloro-3-[[3-(4- Free No change No
change On or before 12/ ''.
methoxyphenyl)-1,
31/2009
3-dioxopropyl]-
amino]-dodecyl
ester (CAS No.
33942-96-0)
(provided for in
subheading
2924.29.71)......

SEC. 1577. LINURON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.24 3-(3,4- Free No change No
change On or before 12/ ''.
Dichlorophenyl)-1-
31/2009
methoxy-1-
methylurea (CAS
No. 330-55-2)
(Linuron)
(provided for in
subheading
2924.21.16)......

SEC. 1578. N,N-DIMETHYLPIPERIDINIUM CHLORIDE (MEPIQUAT CHLORIDE).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.25 N,N- Free No change No
change On or before 12/ ''.
Dimethylpiperidin
31/2009
ium chloride
(Mepiquat
chloride) (CAS
No. 24307-26-4)
(provided for in
subheading
2933.39.25)......

SEC. 1579. DIURON.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.26 Formulations of 3- Free No change No
change On or before 12/ ''.
(3,4-
31/2009
dichlorophenyl)-1
,1-dimethylurea
(CAS No. 330-54-
1) (Diuron) and
application
adjuvants
(provided for in
subheading
3808.30.15)......

SEC. 1580. FORMULATED PRODUCT KROVAR I DF.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.27 Formulations 2.5% No change No
change On or before 12/ ''.
containing 5-
31/2009
bromo-3-sec-butyl-
6-methyluracil
(Bromacil) (CAS
No. 314-40-9), 3-
(3,4-
Dichlorophenyl)-1
,1-dimethylurea
(Diuron) (CAS No.
330-54-1), and
application
adjuvants
(provided for in

subheading
3808.30.15)......

SEC. 1581. TRIASULFURON TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.28   3-(6-Methoxy-4-   Free   No change   No
change   On or before 12/ ''.
methyl-1,3,5-
31/2009
triazin-2-yl)-1-
[2-(2-
chloroethoxy)
phenylsulfonyl]ur
ea (Triasulfuron)
(CAS No. 82097-50-
5) (provided for
in subheading
2935.00.75)......

SEC. 1582. BRODIFACOUM TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.29   3-[3-(4'-   Free   No change   No
change   On or before 12/ ''.
Bromo[1,1'-
31/2009
biphenyl]-4-yl)-
1,2,3,4-
tetrahydro-1-
naphthalenyl]-4-
hydroxy-2H-1-
benzopyran- 2-one
(Brodifacoum)
(CAS No. 56073-10-
0) (provided for
in subheading
2932.29.10)......

SEC. 1583. PYMETROZINE TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.30   1,2,4-Triazin-   Free   No change   No
change   On or before 12/ ''.
3(2H)-one, 4,5-
31/2009
dihydro-6-methyl-
4-[(3-
pyridinylmethylen
e)amino]-
(Pymetrozine)
(CAS No. 123312-
89-0) (provided
for in subheading
2933.69.60)......

SEC. 1584. FORMULATIONS OF THIAMETHOXAM, DIFENOCONAZOLE, FLUDIOXINIL, AND MEFENOXAM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.31   Formulations of 3- Free   No change   No
change   On or before 12/ ''.
[(2-chloro-5-
31/2009
thiazolyl)methyl]
tetrahydro-5-
methyl-N-nitro-
1,3,5-oxadiazin-4-
imine)
(Thiamethoxam)
(CAS No. 153719-
23-4); 1H-1,2,4-
triazole, 1-[[2-
[2-chloro-4-(4-
chlorophenoxy)phe
nyl]-4-methyl-
1,3-dioxolan-2-
yl]methyl]-
(Difenoconazole)
(CAS No. 119446-
68-3); 1H-Pyrrole-
3-carbonitrile, 4-
(2,2-difluoro-1,3-
benzodioxol-4-yl)-
(Fludioxinil)
(CAS No. 131341-

86-1); and (R,S)-
2-[(2,6-
dimethylphenylmet
hoxy)acetylamino]-
propionic acid
methyl ester
(Mefenoxam) (CAS
Nos. 70630-17-0
and 69516-34-3)
(provided for in
subheading
3808.20.15)......

SEC. 1585. TRIFLOXYSULFURON-SODIUM TECHNICAL.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.32   N-[[(4,6-   Free   No change   No change   On or before 12/ ''.
Dimethoxy-2-
31/2009
pyrimidinyl)amino
]carbonyl]-3-
(2,2,2-
trifluoroethoxy)-
2-
pyridinesulfonami
de monosodium
salt (CAS No.
199119-58-9)
(trifloxysulfuron-
sodium) (provided
for in subheading
2935.00.75)......

SEC. 1586. 2 BENZYLTHIO-3-ETHYL SULFONYL PYRIDINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.41   2-Benzylthio-3-   Free   No change   No change   On or before 12/ ''.
ethyl sulfonyl
31/2009
pyridine (CAS No.
175729-82-5)
(provided for in
subheading
2933.39.61)......

SEC. 1587. 2-AMINO-4-METHOXY-6-METHYL-1,3,5-TRIAZINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.42   2-Amino-4-methoxy- Free   No change   No change   On or before 12/ ''.
6-methyl-1,3,5-
31/2009
triazine (CAS No.
1668-54-8)
(provided for in
subheading
2933.69.60)......

SEC. 1588. FORMULATED PRODUCTS CONTAINING MIXTURES OF THE ACTIVE INGREDIENT 2-CHLORO-N-[[(4-METHOXY-6-METHYL-1,3,5-TRIAZIN-2YL) AMINO]CARBONYL] BENZENESULFONAMIDE AND APPLICATION ADJUVANTS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.43   Formulated   Free   No change   No change   On or before 12/ ''.
products
31/2009
containing
mixtures of the
active ingredient
2-chloro-N-[[(4-
methoxy-6-methyl-
1,3,5-triazin-
2yl)
amino]carbonyl]
benzenesulfonamid
e and application
adjuvants
(Chlorosulfuon)
(CAS No. 64902-72-
3) (provided for
in subheading
3808.30.15)......

SEC. 1589. 2-METHYL-4-METHOXY-6-METHYLAMINO-1,3,5-TRIAZINE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.44	2-Methyl-4-methoxy-6-methylamino-1,3,5-triazine (CAS No. 5248-39-5) (provided for in subheading 2933.69.60)......	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1590. MIXTURES OF SODIUM-2-CHLORO-6-[(4,6 DIMETHOXYPYRIMIDIN-2-YL)THIO]BENZOATE AND APPLICATION ADJUVANTS (PYRITHIOBAC-SODIUM).

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.45	Mixtures of sodium-2-chloro-6-[(4,6 dimethoxypyrimidin-2-yl)thio]benzoate (CAS No. 123343-16-8) and application adjuvants (Pyrithiobac-sodium) (provided for in subheading 3808.30.15)......	3.5%	No change	No change	On or before 12/31/2009 ''.

SEC. 1591. CERTAIN DECORATIVE PLATES, DECORATIVE SCULPTURES, DECORATIVE PLAQUES, AND ARCHITECTURAL MINIATURES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.46	Decorative plates, whether or not with decorative rim or attached sculpture; decorative sculptures, each with plate or plaque attached, and decorative plaques each not over 7.65 cm in thickness; architectural miniatures, whether or not put up in sets; all the foregoing of resin materials and containing agglomerated stone, put up for mail order retail sale, whether for wall or tabletop display and each weighing not over 1.36 kg together with their retail packaging (provided for in subheading 3926.40.00)......	Free	No change	No change	On or before 12/31/2009 ''.

SEC. 1592. CERTAIN MUSIC BOXES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.47	Music boxes with mechanical musical movements,	Free	No change	No change	On or before 12/31/2009 ''.

presented in the
immediate
packaging for
shipment to the
ultimate
purchaser, and
each weighing not
over 6 kg
together with
retail packaging
(provided for in
subheading
9208.10.00)......

SEC. 1593. 2-METHYL-4-CHLOROPHENOXYACETIC ACID.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.60 2-Methyl-4-chlorophenoxyacetic acid (CAS No. 94-74-6) (provided for in subheading 2918.90.20)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1594. PHENMEDIPHAM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.76 3-Methylcarbonylaminophenyl-3-methyl-carbanilate (Phenmedipham) (CAS No. 13684-63-4) in bulk or mixed with application adjuvants (provided for in subheadings 2924.29.47 and 3808.30.15)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1595. DESMEDIPHAM.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.77 3-Ethoxycarbonylaminophenyl-N-phenylcarbamate (Desmedipham) (CAS No. 13684-56-5) in bulk or mixed with application adjuvants (provided for in subheadings 2924.29.43 and 3808.30.15)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1596. CERTAIN FOOTWEAR WITH OPEN TOES OR HEELS.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

`` 9902.13.78 Footwear with outer soles of rubber or plastics and uppers of vegetable fibers, with open toes or open heels, other than house slippers (provided for in subheading 6404.19.25)...... Free No change No change On or before 12/31/2009 ''.

SEC. 1597. CERTAIN WORK FOOTWEAR.

Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.13.85   House slippers   Free   No change   No
change   On or before 12/ ''.
                         with outer soles
          31/2009
                         of rubber,
                         plastics, leather
                         or composition
                         leather and
                         uppers of
                         leather, valued
                         not over $2.50/
                         pair (provided
                         for in subheading
                         6403.99.75);
                         Sports footwear;
                         tennis shoes,
                         basketball shoes,
                         gym shoes,
                         training shoes
                         and the like, all
                         the foregoing
                         with outer soles
                         of rubber or
                         plastics and
                         uppers of textile
                         materials for
                         women (provided
                         for in subheading
                         6404.11.20)......
SEC. 1598. CERTAIN REFRACTING AND REFLECTING TELESCOPES.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.13.86   Refracting   Free   No change   No
change   On or before 12/ ''.
                         telescopes with
          31/2009
                         50 mm or smaller
                         objective lenses
                         and reflecting
                         telescopes with
                         76 mm or smaller
                         mirrors, and
                         parts and
                         accessories
                         thereof (provided
                         for in subheading
                         9005.80.40 or
                         9005.90.80)......
SEC. 1600. CERTAIN WORK FOOTWEAR.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.13.90   Welt footwear with Free   No change   No
change   On or before 12/ ''.
                         outer soles of
          31/2009
                         rubber, plastics,
                         leather or
                         composition
                         leather and
                         uppers of
                         pigskin,
                         incorporating a
                         protective metal
                         toe-cap (provided
                         for in subheading
                         6403.40.30)......
SEC. 1601. CERTAIN FOOTWEAR FOR MEN.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:
``   9902.13.91   Other footwear   4.5%   No change   No
change   On or before 12/ ''.
                         with uppers of
          31/2009
                         vegetable fibers,
                         for men (provided
                         for in subheading
                         6405.20.30)......
SEC. 1602. CERTAIN RUBBER OR PLASTIC FOOTWEAR.
Subchapter II of chapter 99 is amended by inserting in numerical
sequence the following new heading:

``   9902.13.92   Other footwear   6.5%   No change   No
change   On or before 12/ ''.
                        with uppers of
          31/2009
                        vegetable fibers,
                        other than such
                        footwear for men
                        or women
                        (provided for in
                        subheading
                        6405.20.30)......

SEC. 1604. ZINC DIMETHYLDITHIOCARBAMATE.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.13.97   Zinc   Free   No change   No
change   On or before 12/ ''.
                        dimethyldithiocar
          31/2009
                        bamate (Ziram)
                        (CAS No. 137-30-
                        4) (provided for
                        in subheading
                        3808.20.28)......

SEC. 1605. CERTAIN LIQUID CRYSTAL DEVICE (LCD) PANEL ASSEMBLIES.

Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.85.21   Liquid Crystal   Free   No change   No
change   On or before 12/ ''.
                        Device (LCD)
          31/2009
                        panel assemblies
                        for use in LCD
                        direct view
                        televisions
                        (provided for in
                        subheading
                        9013.80.90)......

SEC. 1606. CERTAIN WATERTUBE BOILERS AND REACTOR VESSEL HEADS.

(a) Watertube Boilers.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.84.01   Watertube boilers   Free   No change   No
change   On or before 12/ ''.
                        with a steam
          31/2010
                        production
                        exceeding 45 t
                        per hour, for use
                        in nuclear
                        facilities
                        entered after 12/
                        31/2008 and on or
                        before 12/31/2010
                        if the contract
                        for the purchase
                        of such watertube
                        boilers was
                        entered into on
                        or before 7/31/
                        2006 (provided
                        for in subheading
                        8402.11.00)......

(b) Reactor Vessel Heads.--Subchapter II of chapter 99 is amended by inserting in numerical sequence the following new heading:

``   9902.84.04   Reactor vessel   Free   No change   No
change   On or before 12/ ''.
                        heads and
          31/2010
                        pressurizers for
                        nuclear reactors
                        entered after 12/
                        31/2008 and on or
                        before 12/31/2010
                        if the contract
                        for the purchase
                        of such heads and
                        pressurizers was
                        entered into on
                        or before 7/31/
                        2006 (provided
                        for in subheading
                        8401.40.00)......

CHAPTER 2--EXISTING DUTY SUSPENSIONS AND REDUCTIONS

SEC. 1611. EXTENSION OF CERTAIN EXISTING DUTY SUSPENSIONS AND REDUCTIONS.

(a) Existing Duty Suspensions and Reduction.--Each of the following headings is amended by striking the date in the effective period column and inserting ``12/31/2009'':

(1) Heading 9902.39.08 (relating to ORGASOL polyamide powders).

(2) Heading 9902.30.90 (relating to 3-amino-2'-(sulfato-ethyl sulfonyl) ethyl benzamide).

(3) Heading 9902.32.91 (relating to MUB 738 INT).

(4) Heading 9902.30.31 (relating to 5-amino-N-(2-hydroxyethyl)-2,3-xylenesulfonamide).

(5) Heading 9902.01.83 (relating to Ethoprop).

(6) Heading 9902.01.73 (relating to Fosetyl-Al).

(7) Heading 9902.03.38 (relating to Flufenacet (FOE hydroxy)).

(8) Heading 9902.02.02 (relating to Methidathion Technical).

(9) Heading 9902.02.12 (relating to difenoconazole).

(10) Heading 9902.02.09 (relating to Lambda-Cyhalothrin).

(11) Heading 9902.02.08 (relating to cyprodinil).

(12) Heading 9902.02.04 (relating to Wakil XL).

(13) Heading 9902.02.06 (relating to Azoxystrobin Technical).

(14) Heading 9902.02.05 (relating to mucochloric acid).

(15) Heading 9902.03.06 (relating to high tenacity multiple (folded) or cabled yarn of viscose rayon).

(16) Heading 9902.05.07 (relating to high tenacity single yarn of viscose rayon with a decitex equal to or greater than 1,000).

(17) Heading 9902.38.31 (relating to Vulkalent E/C).

(18) Heading 9902.01.71 (relating to hexanedioic acid, polymer with 1,3-benzenedimethanamine).

(19) Heading 9902.29.93 (relating to Trinexapac-ethyl).

(20) Heading 9902.38.52 (relating to formulations of triasulfuron).

(21) Heading 9902.39.30 (relating to certain ion-exchange resins).

(22) Heading 9902.32.82 (relating to 2,6 Dichlorotoluene).

(23) Heading 9902.02.33 (relating to Ion exchange resin comprising a compolymer of styrene crosslinked with ethenylbenzene, aminophosphonic acid sodium form).

(24) Heading 9902.02.32 (relating toIon exchange resin comprising a copolymer of styrene crosslinked with divinylbenzene, iminodiacetic acid, sodium form)).

(25) Heading 9902.01.78 (relating to certain bags for toys).

(26) Heading 9902.01.81 (relating to cases for certain children's products).

(27) Heading 9902.01.80 (relating to certain children's products).

(28) Heading 9902.29.34 (relating to certain light absorbing photo dyes).

(29) Heading 9902.85.04 (relating to certain R-core transformers).

(30) Heading 9902.03.04 (relating to reduced vat blue 43).

(31) Heading 9902.03.03 (relating to sulfur black 1).

(32) Heading 9902.01.22 (relating to DMSIP).

(33) Heading 9902.29.35 (relating to 2-(Methoxycarbonyl)benzylsulfonamide).

(34) Heading 9902.02.52 (relating to Imidacloprid pesticides).

(35) Heading 9902.38.15 (relating to Baytron C-R).

(36) Heading 9902.29.87 (relating to 3,4-Ethylenedioxythiophene).

(37) Heading 9902.01.90 (relating to certain filament yarns).

(38) Heading 9902.01.91 (relating to certain filament yarns).

(39) Heading 9902.71.08 (relating to certain semi-manufactured forms of gold).

(40) Heading 9902.04.10 (relating to Crotonic Acid).

(41) Heading 9902.04.09 (relating to 3,6,9-Trioxaundecanedioic acid).

(42) Heading 9902.02.51 (relating to benzoic acid, 2-amino-4-[[(2,5-dichlorophenyl)amino]carbonyl]-, methyl ester).

(43) Heading 9902.32.73 (relating to Solvent blue 124).

(44) Heading 9902.32.55 (relating to Methyl thioglycolate (MTG)).

(45) Heading 9902.01.48 (relating to Ethyl pyruvate).

(46) Heading 9902.04.11 (relating to 1,3-Benzenedicarboxamide, N, N'-Bis (2,2,6,6-tetramethyl-4-piperidinyl)-).

(47) Heading 9902.04.07 (relating to reaction products of

phosphorus trichloride with 1,1'-biphenyl and 2,4-bis(1,1-dimethylethyl)phenol).

(48) Heading 9902.04.05 (relating to preparations based on ethanediamide, N-(2-ethoxyphenyl)-N'-(4-isodecylphenyl)-).

(49) Heading 9902.04.06 (relating to 1-Acetyl-4-(3-dodecyl-2,5-dioxo-1-pyrrolidinyl)-2,2,6,6-tetramethylpiperidine).

(50) Heading 9902.04.12 (relating to 3-Dodecyl-1-(2,2,6,6-tetramethyl-4-piperidinyl)-2,5-pyrrolidinedione).

(51) Heading 9902.29.70 (relating to Tetraacetylethylenediamine).

(52) Heading 9902.34.01 (relating to sodium petroleum sulfonate).

(53) Heading 9902.02.75 (relating to esters and sodium esters of parahydroxybenzoic acid).

(54) Heading 9902.30.16 (relating to Diclofop methyl).

(55) Heading 9902.33.61 (relating to ((3-((Dimethylamino)carbonyl)-2-pyridinyl)sulfonyl) carbamic acid, phenyl ester).

(56) Heading 9902.01.45 (relating to Esfenvalerate).

(57) Heading 9902.05.01 (relating to Methyl 2-[[[[[4-(dimethylamino)-6- (2,2,2-trifluoroethoxy)-1,3,5-triazin-2-yl]-amino]carbonyl]amino]sulfonyl]-3-methylbenzoate and application adjuvants).

(58) Heading 9902.01.44 (relating to Benzyl carbazate).

(59) Heading 9902.05.14 (relating to Pyromellitic Dianhydride).

(60) Heading 9902.05.13 (relating to 4,4'-Oxydiphthalic Anhydride).

(61) Heading 9902.05.12 (relating to 4,4'-Oxydianiline).

(62) Heading 9902.05.11 (relating to 3,3',4,4'-Biphenyltetracarboxylic Dianhydride).

(63) Heading 9902.29.80 (relating to 1-[[2-(2,4-dichlorophenyl)-4-propyl-1,3-dioxolan-2-yl]-methyl]-1H-1,2,4-triazole).

(64) Heading 9902.05.19 (relating to ethofumesate).

(65) Heading 9902.02.60 (relating to Nemacur VL).

(66) Heading 9902.03.77 (relating to thiophanate methyl).

(67) Heading 9902.84.14 (relating to ceiling fans).

(b) Other Modifications.--

(1) 2-Chlorobenzyl chloride.--Heading 9902.01.56 is amended--

(A) by striking ``2903.69.70'' and inserting ``2903.69.80''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(2) Triethylene glycol bis[3-(3-tert-butyl-4-hydroxy-5-methylphenyl)propionate] .--Heading 9902.01.88 is amended--

(A) by striking ``Free'' and inserting ``4.1%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(3) Formulations of triasulfuron and dicamba.--Heading 9902.38.21 is amended--

(A) in the article description column--

(i) by inserting ``(Triasulfuron)'' before ``(CAS No. 82097-50-5)''; and

(ii) by inserting ``(Dicamba)'' before ``(CAS No. 1918-00-9)''; and

(B) by striking ``12/31/2003'' and inserting ``12/31/2009''.

(4) 11-Aminoundecanoic acid.--Heading 9902.32.49 is amended--

(A) by striking ``Free'' and inserting ``2.3%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(5) PHBA.--Heading 9902.29.03 is amended--

(A) by striking ``Free'' and inserting ``3.1%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(6) Acetamiprid Technical.--Heading 9902.03.92 is amended--

(A) by striking ``Free'' and inserting ``2.5%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(7) Baytron and baytron p.--Heading 9902.39.15 is amended--

(A) by inserting ``, whether or not containing binder resin and organic solvent'' before ``(CAS No.''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(8) Iprodione.--Heading 9902.01.51 is amended--

(A) by striking ``4.1%'' and inserting ``2.0%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(9) Ethanediamide, N-(2-ethoxyphenyl)-N'-(2-ethylphenyl)-).--Heading 9902.04.13 is amended--

(A) by striking ``2924.29.76'' and inserting ``2924.29.71''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(10) Thiamethoxam technical.--Heading 9902.03.11 is amended--

(A) by striking ``3.2%'' and inserting ``3.0%''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(11) 1,3-Bis(4-aminophenoxy)benzene (RODA).--Heading 9902.05.15 is amended--

(A) by inserting ``(RODA)'' after ``benzene''; and

(B) by striking ``12/31/2006'' and inserting ``12/31/2009''.

(12) Mixtures of n-[[(4,6-dimethoxypyrimidin-2-yl)amino]carbonyl]-3-(ethylsulfonyl)-2-pyridinesulfonamide and application adjuvants.--Heading 9902.33.60 is amended--

(A) by striking the article description and inserting the following: ``Mixtures of N-[[(4,6-dimethoxypyrimidin-2-yl)amino]carbonyl]-3-(ethylsulfonyl)-2-pyridinesulfonamide and application adjuvants (CAS No. 122931-48-0) (provided for in subheading 3808.30.15)''; and

(B) by striking ``12/31/2003'' and inserting ``12/31/2009''.

Subtitle B--Other Tariff Provisions

CHAPTER 1--LIQUIDATION OR RELIQUIDATION OF CERTAIN ENTRIES

SEC. 1621. CERTAIN TRAMWAY CARS AND ASSOCIATED SPARE PARTS.

(a) In General.--The Commissioner of the Bureau of Customs and Border Protection of the Department of Homeland Security shall admit free of duty 3 tramway cars (provided for in subheading 8603.10.00 of the Harmonized Tariff Schedule of the United States) manufactured in Ostrava, Czech Republic, for the use by the city of Portland, Oregon, and imported pursuant to a contract with the city of Portland, Oregon, and associated spare parts for such tramway cars (provided for in applicable subheadings of heading 8607 or other headings of the Harmonized Tariff Schedule of the United States) imported pursuant to such contract, the foregoing to be entered into the customs territory of the United States by not later than December 31, 2006.

(b) Reliquidation; Refund of Amounts Owed.-- If the liquidation of the entry of any of the tramway cars or associated spare parts described in subsection (a) becomes final before the date of the enactment of this Act, the Commissioner of the Bureau of Customs and Border Protection, notwithstanding any other provision of law, shall--

(1) within 15 days after such date, reliquidate the entry in accordance with the provisions of this section; and

(2) at the time of such reliquidation, make the appropriate refund of any duty paid with respect to the entry.

SEC. 1622. RELIQUIDATION OF CERTAIN ENTRIES OF CANDLES.

(a) Reliquidation of Entries.--Notwithstanding sections 514 and 520 of the Tariff Act of 1930 (19 U.S.C. 1514 and 1520) or any other provision of law, the Bureau of Customs and Border Protection shall, not later than 90 days after the date of the enactment of this Act--

(1) reliquidate the entries listed in subsection (b) without assessment of antidumping duties or interest; and

(2) refund any antidumping duties and interest which were previously paid on such entries.

(b) Affected Entries.--The entries referred to in subsection (a) are the following:

Entry number	Date of entry	Port
110-3447557-3	03/18/00	Los Angeles
110-3447591-2	03/19/00	Los Angeles
110-3447595-3	03/19/00	Los Angeles
110-1201638-1	03/21/00	Detroit
110-1201639-9	03/21/00	Detroit
110-1201640-7	03/21/00	Detroit
110-3447613-4	03/21/00	Los Angeles
110-1201697-7	03/23/00	Detroit

110-1201695-1	Detroit	03/23/00
110-1201696-9	Detroit	03/23/00
110-1201756-1	Detroit	03/27/00
110-1201757-9	Detroit	03/27/00
110-1201758-7	Detroit	03/27/00
110-1740905-2	Los Angeles	03/30/00
110-1740943-3	Los Angeles	03/30/00
110-1201845-2	Detroit	03/31/00
110-1201813-0	Detroit	04/03/00
110-1201814-8	Detroit	04/03/00
110-1201815-5	Detroit	04/03/00
110-1201875-9	Detroit	04/04/00
110-1201868-4	Detroit	04/04/00
110-1201858-5	Detroit	04/04/00
110-3447959-1	Los Angeles	04/11/00
110-3447958-3	Los Angeles	04/11/00
110-3759536-9	Detroit	04/12/00
110-3759561-7	Detroit	04/12/00
110-3759542-7	Detroit	04/12/00
110-3759540-1	Detroit	04/12/00
110-3447977-3	Los Angeles	04/12/00
110-3759539-3	Detroit	04/12/00
110-3448045-8	Los Angeles	04/14/00
110-3448046-6	Los Angeles	04/14/00
110-3448110-0	Los Angeles	04/20/00
110-3759670-6	Detroit	04/25/00
110-3759673-0	Detroit	04/25/00
110-3759669-8	Detroit	04/25/00
110-3759667-2	Detroit	04/25/00
110-3759671-4	Detroit	04/25/00
110-3759668-0	Detroit	04/25/00
110-3448241-3	Los Angeles	04/27/00
110-3448247-0	Los Angeles	04/27/00
110-3448276-9	Memphis	04/28/00
110-3448274-4	Memphis	04/28/00
110-3448282-7	Memphis	05/04/00
101-4081779-1	Memphis	05/07/00
101-4088945-1	Memphis	05/23/00
101-4089954-3	Memphis	05/23/00
101-4088960-0	Memphis	05/23/00
101-4092192-4	Memphis	05/25/00

101-4089312-3	Detroit	05/26/00
101-4089942-7	Detroit	05/26/00
101-4089893-2	Detroit	05/26/00
101-4092221-1	Memphis	05/26/00
101-4089697-7	Los Angeles	05/26/00
101-4092215-3	Memphis	05/26/00
101-4086053-6	Los Angeles	05/26/00
101-4122700-8	Los Angeles	07/27/00
101-4122707-3	Los Angeles	07/27/00
101-4122712-3	Los Angeles	07/27/00
101-4127147-7	Los Angeles	08/03/00
101-4132485-4	Norfolk	08/09/00
101-4129989-0	Detroit	08/11/00
101-4130345-2	Detroit	08/17/00
101-4129976-7	Detroit	08/23/00
101-4149476-4	Los Angeles	09/06/00
101-4149483-0	Los Angeles	09/06/00
101-4149493-9	Los Angeles	09/06/00
101-4148595-2	Detroit	09/08/00
101-4153301-7	Detroit	09/18/00
101-4154523-5	Los Angeles	09/14/00
101-4153389-2	Detroit	09/18/00
101-4157161-1	Norfolk	09/20/00
101-4153333-0	Detroit	09/21/00
101-4155542-4	Detroit	09/26/00
101-4166291-5	Los Angeles	10/07/00
101-4167325-0	Detroit	10/09/00
101-4167363-1	Detroit	10/12/00
101-4164567-0	Norfolk	10/13/00
101-4168049-5	Los Angeles	10/14/00
101-4172904-5	Los Angeles	10/21/00
101-4175579-2	Los Angeles	10/30/00
101-4183996-8	Detroit	11/07/00
101-4183234-4	Detroit	11/09/00
101-4183251-8	Detroit	11/09/00
101-4183253-4	Detroit	11/09/00
101-4183257-5	Detroit	11/09/00
101-4183264-1	Detroit	11/09/00
101-4183264-1	Detroit	11/09/00
101-4184811-8	Los Angeles	11/13/00
101-4184819-1	Los Angeles	11/13/00

101-4189001-1	Tampa	11/14/00
101-4185526-1	Detroit	11/16/00
101-4185535-2	Detroit	11/16/00
101-4186580-7	Detroit	11/20/00
101-4189830-3	Detroit	11/20/00
101-4189774-3	Detroit	11/21/00
101-4191183-3	Los Angeles	11/24/00
101-4191188-2	Los Angeles	11/24/00
101-4191193-2	Los Angeles	11/24/00
101-4194796-9	Detroit	11/29/00
101-4194801-7	Detroit	11/29/00
101-4196383-4	Los Angeles	12/01/00
101-4196389-1	Los Angeles	12/01/00
101-4199308-8	Detroit	12/13/00

SEC. 1623. CERTAIN ENTRIES OF ROLLER CHAIN.

(a) Liquidation or Reliquidation of Entries.--Notwithstanding sections 514 and 520 of the Tariff Act of 1930 (19 U.S.C. 1514 and 1520) or any other provision of law, the Bureau of Customs and Border Protection shall, not later than 90 days after the date of enactment of this Act, liquidate or reliquidate the entries listed in subsection (b) without assessment of interest and shall refund any interest which was previously paid.

(b) Affected Entries.--The entries referred to in subsections (a) and (b) are the following:

Entry number	Port	Date of entry
858442975	Chicago	08/21/85
868558147	Chicago	01/28/86
868565499	Chicago	03/14/86
858440922	Chicago	07/31/85
868565499	Chicago	03/14/86
868558147	Chicago	01/28/86
858442975	Chicago	08/21/85
858440922	Chicago	07/31/85
847648353	Chicago	06/18/84
858268324	Chicago	01/04/85
858264302	Chicago	11/08/84
858265107	Chicago	11/19/84
847658150	Chicago	07/18/84
847412877	Chicago	05/09/84
837078386	Chicago	03/21/83
837077691	Chicago	02/07/83
837077701	Chicago	02/07/83
826735834	Chicago	01/13/82
826736309	Chicago	01/18/82
821020081	Chicago	02/12/82
821020052	Chicago	02/17/82

821026768	Chicago	04/13/82
827119569	Chicago	06/18/82
837075114	Chicago	10/06/82
826727088	Chicago	10/14/81
837124777	Chicago	05/19/83
847405240	Chicago	11/28/83
837127606	Chicago	08/18/83
837125132	Chicago	06/08/83
847406100	Chicago	12/22/83
847404034	Chicago	11/02/83
837128090	Chicago	09/07/83
837126762	Chicago	08/05/83
837125569	Chicago	06/22/83
837078991	Chicago	04/12/83
837129222	Chicago	10/03/83
847406414	Chicago	12/29/83
847408014	Chicago	01/31/84
868569204	Chicago	07/03/86
868730813	Chicago	08/14/86

SEC. 1624. CERTAIN ENTRIES OF SOUNDSPA CLOCK RADIOS.

(a) In General.--Notwithstanding section 514 of the Tariff Act of 1930 (19 U.S.C. 1514) or any other provision of law, the Bureau of Customs and Border Protection shall, not later than 90 days after the date of the enactment of this Act--

(1) reliquidate each entry described in subsection (c) containing any merchandise which, on the date of original liquidation, was classified under subheading 8527.19.50 of the Harmonized Tariff Schedule of the United States; and

(2) make such reliquidation at the rate of duty that would have been applicable to such merchandise if the merchandise had been liquidated under subheading 8527.19.10 of such Schedule on the date of entry of the merchandise.

(b) Refund of Amounts Owed.--Any amounts owed by the United States under subsection (a) shall be refunded with interest.

(c) Affected Entries.--The entries referred to in subsection (a) are as follows:

Entry number
110-1199345-7
110-1199542-9
110-1199558-5
110-1201694-4
110-3759754-8
110-3759785-2
101-4082299-9
101-4088073-2
101-4089053-3
101-4120875-0
101-4133671-8
101-4138302-5
101-4145092-3
101-4148477-3
101-4153108-6
101-4159322-7
101-4158601-5
101-4163243-9
101-4164448-3
101-4168318-4
101-4172197-6
101-4172489-7
101-4193123-7
101-4264820-2
101-4271724-7
101-4277850-4

101-4287672-0
101-4301588-0
101-4306238-7
101-4306235-3
101-6011727-0
101-6012796-4
101-6015492-7
101-6021099-2
101-6026903-0
101-6024120-3
101-6028079-7
101-6027052-5
101-6036728-9
101-6048069-4
101-6079830-1
101-6082949-4
101-6115954-5
101-6119379-1
101-6127048-2
101-6150035-9
101-6148556-9
101-6172630-1
101-6172406-6
101-6186497-9
101-4208407-7
101-6035939-3

CHAPTER 2--MISCELLANEOUS PROVISIONS

SEC. 1631. VESSEL REPAIR DUTIES.

(a) Exemption.--Section 466(h) of the Tariff Act of 1930 (19 U.S.C. 1466(h)) is amended by striking paragraph (4) and inserting the following:

``(4) the cost of equipment, repair parts, and materials that are installed on a vessel documented under the laws of the United States and engaged in the foreign or coasting trade, if the installation is done by members of the regular crew of such vessel while the vessel is on the high seas, in foreign waters, or in a foreign port, and does not involve foreign shipyard repairs by foreign labor.''.

(b) Amendment to HTS.--The U.S. Notes to subchapter XVIII of chapter 98 of the Harmonized Tariff Schedule of the United States are amended by amending U.S. Note 2 to read as follows:

``2. Notwithstanding the provisions of subheadings 9818.00.03 through 9818.00.07, no duty shall apply to the cost of equipment, repair parts, and materials that are installed in a vessel documented under the laws of the United States and engaged in the foreign or coasting trade, if the installation is done by members of the regular crew of such vessel while the vessel is on the high seas, in foreign waters, or in a foreign port and does not involve foreign shipyard repairs by foreign labor. Declaration and entry shall not be required with respect to such installation, equipment, parts, and materials.''.

(c) Effective Date.--The amendments made by this section apply to vessel equipment, repair parts, and materials installed on or after April 25, 2001.

SEC. 1632. SUSPENSION OF NEW SHIPPER REVIEW PROVISION.

(a) Suspension of the Availability of Bonds to New Shippers.--Clause (iii) of section 751(a)(2)(B) of the Tariff Act of 1930 (19 U.S.C. 1675(a)(2)(B)(iii)) shall not be effective during the period beginning on April 1, 2006, and ending on June 30, 2009.

(b) Report on the Impact of the Suspension.--Not later than December 31, 2008, the Secretary of the Treasury, in consultation with the Secretary of Commerce, the United States Trade Representative, and the Secretary of Homeland Security, shall submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report containing--

(1) recommendations on whether the suspension of section 751(a)(2)(B)(iii) of the Tariff Act of 1930 should be extended beyond the date provided in subsection (a); and

(2) an assessment of the effectiveness of any administrative measure that was implemented to address the difficulties that necessitated the suspension under subsection (a), including--

(A) any problem in the collection of antidumping duties on imports from new shippers; and

(B) any burden imposed on legitimate trade and commerce by the suspension of bonds to new shippers.

(c) Report on Collection Problems and Analysis of Proposed Solutions.--

(1) Report.--Not later than 180 days after the date of the enactment of this Act, the Secretary of the Treasury, in consultation with the Secretary of Homeland Security and the Secretary of Commerce, shall submit to the Committee on Ways and Means of the House of Representatives and

the Committee on Finance of the Senate a report describing--
(A) any major problem experienced in the collection of duties during the 4 most recent fiscal years for which
data are available, including any fraudulent activity intended to avoid payment of duties; and
(B) an estimate of the total amount of duties that were uncollected during the most recent fiscal year for which data are available, including, with respect to each product, a description of why the duties were uncollected.
(2) Recommendations.--The report shall include--
(A) recommendations on any additional action needed to address problems related to the collection of duties; and
(B) for each recommendation--
(i) an analysis of how the recommendation would address the specific problem; and
(ii) an assessment of the impact that implementing the recommendation would have on international trade and commerce (including any additional costs imposed on United States businesses).

SEC. 1633. EXTENSION AND MODIFICATION OF DUTY SUSPENSION ON WOOL PRODUCTS; WOOL RESEARCH FUND; WOOL DUTY REFUNDS.

(a) Extension of Temporary Duty Reductions.--Each of the following headings of the Harmonized Tariff Schedule of the United States is amended by striking the date in the effective period column and inserting ``12/31/2009'':
(1) Heading 9902.51.11 (relating to fabrics of worsted wool).
(2) Heading 9902.51.13 (relating to yarn of combed wool).
(3) Heading 9902.51.14 (relating to wool fiber, waste, garnetted stock, combed wool, or wool top).
(4) Heading 9902.51.15 (relating to fabrics of combed wool).
(5) Heading 9902.51.16 (relating to fabrics of combed wool).

(b) Extension of Duty Refunds and Wool Research Trust Fund.--
(1) In general.--Section 4002(c) of the Wool Suit and Textile Trade Extension Act of 2004 (Public Law 108-429; 118 Stat. 2603 (7 U.S.C. 7101 note)) is amended--
(A) in paragraph (3)--
(i) by striking ``2 additional payments'' and inserting ``annual additional payments''; and
(ii) by adding at the end the following:
``(C) Each subsequent annual payment to be made after January 1 of each subsequent year, but on or before April 15 of such year through calendar year 2010.''; and
(B) in paragraph (6)--
(i) in subparagraph (A), by striking ``through 2007'' and inserting ``through 2009''; and
(ii) by adding at the end the following:
``(C) Eligible manufacturers.--
Only manufacturers who weave worsted wool fabric in the United States shall be eligible for a grant under this paragraph.''.
(2) Sunset.--Section 506(f) of the Trade and Development Act of 2000 (Public 106-200; 114 Stat. 303), as amended by section 4002(c)(5) of the Wool Suit and Textile Trade Extension Act of 2004 (Public 108-429; 118 Stat. 2603), is amended by striking ``2008'' and inserting ``2010''.

SEC. 1634. AUTHORITIES RELATING TO DR-CAFTA AGREEMENT.

(a) Authority to Implement Certain Amendments to DR-CAFTA Agreement With Nicaragua, El Salvador, Honduras, and Guatemala.--
(1) Proclamation authority.--The President is authorized to proclaim modifications to the Harmonized Tariff Schedule of the United States as necessary to carry out amendments proposed by the United States and the CAFTA-DR countries to the Agreement, the terms of which are contained in the letters of understanding described in paragraph (2).
(2) Letters of understanding.--The letters of understanding referred to in paragraph (1) are the following:
(A) The letter of March 24, 2006, from Nicaraguan Vice Minister of Trade Julio Teran to United States Special Textile Negotiator Scott Quesenberry.
(B) The letter of March 27, 2006, from United States Special Textile Negotiator Scott Quesenberry to Nicaraguan Vice Minister of Trade Julio Teran.
(C) The letter of January 27, 2006, from El Salvadoran Vice Minister of Economy Eduardo Ayala to

United States Special Textile Negotiator Scott Quesenberry.

(D) The letter of January 27, 2006, from United States Special Textile Negotiator Scott Quesenberry to El Salvadoran Vice Minister of Economy Eduardo Ayala.

(E) The letter of March 7, 2006, from Honduran Vice Minister of Foreign Trade Jorge Rosa to United States Special Textile Negotiator Scott Quesenberry.

(F) The letter of March 7, 2006, from United States Special Textile Negotiator Scott Quesenberry to Honduran Vice Minister of Foreign Trade Jorge Rosa.

(G) The letter of June 23, 2006, from Guatemalan Minister of Economy Marcio Cuevas Quezada to United States Special Textile Negotiator Scott Quesenberry.

(H) The letter of June 23, 2006, from United States Special Textile Negotiator Scott Quesenberry to Guatemalan Minister of Economy Marcio Cuevas Quezada.

(3) Sunset.--The authority of the President to proclaim modifications pursuant to paragraph (1) expires on December 31, 2007.

(b) Authority to Implement Certain Amendments to DR-CAFTA Agreement With Costa Rica and the Dominican Republic.--

(1) Proclamation authority.--The President is authorized to proclaim modifications to the Harmonized Tariff Schedule of the United States as necessary to carry out amendments proposed by the United States, Costa Rica, and the Dominican Republic to the Agreement, the terms of which are contained in the letters of understanding described in paragraph (2).

(2) Letters of understanding.--

(A) In general.--The letters of understanding referred to in paragraph (1) are letters of understanding exchanged between the countries described in paragraph (1) relating to the rules of origin for articles containing pocket bag fabric described in subparagraph (B).

(B) Pocket bag fabric described.--For purposes of subparagraph (A), the term ``pocket bag fabric'' means pocket bag fabric used in an apparel article classifiable under chapter 61 or 62 of the Harmonized Tariff Schedule of the United States that contains a pocket or pockets.

(3) Consultation and layover requirements.--Any modification proclaimed by the President pursuant to paragraph (1) shall be subject to the consultation and layover provisions of section 104 of the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act (Public Law 109-53; 19 U.S.C. 4014).

(4) Congressional disapproval.--

(A) In general.--Any modification proclaimed by the President pursuant to paragraph (1) shall not be effective if a joint resolution described in subparagraph (B) is enacted into law.

(B) Joint resolution described.--For purposes of subparagraph (A), the term ``joint resolution'' means a joint resolution of Congress, the sole matter after the resolving clause of which is as follows: ``That the Congress disapproves the modification proclaimed by the President contained in the report submitted to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives pursuant to section 104(2) of the Dominican Republic--Central America--United States Free Trade Agreement Implementation Act (Public Law 109-53; 19 U.S.C. 4014(2)) on __________.'', with the blank space being filled with the appropriate date.

(5) Sunset.--The authority of the President to proclaim modifications pursuant to paragraph (1) expires on December 31, 2007.

(c) Authority Relating to Nicaraguan Tariff Preference Level Under DR-CAFTA Agreement.--

(1) Certificate of eligibility.--The Commissioner of Customs may require an importer to submit at the time the importer files a claim for preferential tariff treatment under Annex 3.28 of the Agreement a certificate of eligibility, properly completed and signed, or transmitted pursuant to an authorized electronic data interchange system, by an authorized official of the Government of Nicaragua for purposes of implementing the tariff preference level for Nicaragua provided in Annex 3.28 of the Agreement.

(2) Enforcement of commitments.--The President is authorized to proclaim a reduction in the overall limit in the tariff preference level for Nicaragua provided in Annex 3.28 of the

Agreement if the President determines that Nicaragua has failed to comply with a commitment under an agreement between the United States and Nicaragua with regard to the administration of such tariff preference level.

(3) Effective date.--Paragraph (1) applies with respect to entries made on or after April 1, 2006.

(d) Technical Correction Relating to Co-Production of Certain Textile and Apparel Goods.--Section 205(a)(2) of the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act (19 U.S.C. 4034(a)(2)) is amended by inserting after ``with respect to that country'' the following: ``or any other CAFTA-DR country''.

(e) Reporting Requirements on Certain Negotiations and Amendments to DR-CAFTA Agreement.--

(1) In general.--Not later than 30 days after the date of the enactment of this Act, and at least quarterly thereafter, the United States Trade Representative shall submit to the appropriate congressional committees a report on the status of negotiations and amendments proposed by the United States, Nicaragua, El Salvador, Honduras, Guatemala, Costa Rica, and the Dominican Republic to the Agreement regarding any change to the rule of origin or alteration of the tariff treatment of socks described in paragraph (2) or any technical correction described in paragraph (3). In addition, the United States Trade Representative shall provide to the appropriate congressional committees copies of any amendments to be proposed by the United States before the amendments are offered and copies of any amendments received by the United States relating to such negotiations.

(2) Socks described.--For purposes of paragraph (1), the term ``socks'' means articles classifiable under subheading 6111.20.6050, 6111.30.5050, 6111.90.5050, 6115.91.00, 6115.92.60, 6115.92.90, 6115.93.60, 6115.93.90, 6115.99.14, or 6115.99.18 of the Harmonized Tariff Schedule of the United States.

(3) Technical corrections described.--Technical corrections referred to in paragraph (1) are the following:

(A) Clarification of references to ``elastomeric yarns'' contained in the notes, subheading notes, additional U.S. notes, and statistical notes to chapters 50 to 63 (section XI) of the Harmonized Tariff Schedule of the United States.

(B) Clarification of the ability to apply short supply provisions to sewing thread, narrow elastics, and visible linings.

(C) Treatment of women's and girls' woven sleep bottoms under Annex 4.1 of the Agreement.

(D) Addition of a rule of origin for women's and girls' woven sleep bottoms to reflect the rule of origin provided for in subheading 6207.11.00 of the Harmonized Tariff Schedule of the United States and contained in Annex 4.1 of the Agreement.

(E) Provision of women's and girls' sleep bottoms under Annex 4.1-A of the Agreement.

(4) Definition.--In this subsection, the term ``appropriate congressional committees'' means the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

(5) Sunset.--The requirements of paragraph (1) expire on the date on which any change is made to the rule of origin pursuant to article 3.25 of the Agreement for any good described in paragraph (2), or December 31, 2007, whichever occurs later.

(f) Definitions.--In this section:

(1) Agreement.--The term ``Agreement'' has the meaning given the term in section 3(1) of the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act (Public Law 109-53; 19 U.S.C. 4002(1)).

(2) CAFTA-DR country.--The term ``CAFTA-DR country'' has the meaning given the term in section 3(2) of the Dominican Republic-Central America-United States Free Trade Agreement Implementation Act (Public Law 109-53; 19 U.S.C. 4002(2)).

SEC. 1635. TECHNICAL AMENDMENTS TO CUSTOMS MODERNIZATION.

(a) Entry of Merchandise.--Section 484(a) of the Tariff Act of 1930 (19 U.S.C. 1484(a)) is amended--

(1) in paragraph (1), by amending subparagraph (A) to read as follows:

``(A) make entry therefor by filing with the Bureau of Customs and Border Protection such documentation or, pursuant to an authorized electronic data interchange system, such information as is necessary to enable the Bureau of Customs and Border Protection to determine whether the merchandise may be released from custody of the Bureau of Customs and Border Protection;''; and

(2) in paragraph (2)(A), in the second sentence, by inserting after ``covering'' the following: ``merchandise released under a special delivery permit pursuant to section 448(b) and''.

(b) Refunds and Errors.--Section 520(a) of the Tariff Act of 1930 (19 U.S.C. 1520(a)) is amended--

(1) in paragraph (1), by striking the semicolon at the end and inserting a period;

(2) in paragraph (2), by striking ``; and'' at the end and inserting a period; and

(3) in paragraph (4)--

(A) by inserting ``an importer of record declares or'' before ``it is ascertained''; and

(B) by striking ``by reason of clerical error''.

(c) Entry From Warehouse.--Section 557(a) of the Tariff Act of 1930 (19 U.S.C. 1557(a)) is amended--

(1) in paragraph (1)--

(A) in the second sentence, by inserting after ``the date of importation'' the following: ``, or such longer period of time as the Bureau of Customs and Border Protection may at its discretion permit upon proper request being filed and good cause shown''; and

(B) in subparagraph (A), by inserting after ``the date of importation'' the following: ``or such longer period of time as the Bureau of Customs and Border Protection may at its discretion permit upon proper request being filed and good cause shown''; and

(2) in paragraph (2), by inserting after ``the date of importation'' the following: ``, or such longer period of time as the Bureau of Customs and Border Protection may at its discretion permit upon proper request being filed and good cause shown,''.

(d) Abandoned Goods.--Section 559 of the Tariff Act of 1930 (19 U.S.C. 1559) is amended by inserting after ``the date of importation'' each place it appears the following: ``, or such longer period of time as the Bureau of Customs and Border Protection may at its discretion permit upon proper request being filed and good cause shown''.

(e) Manipulation in Warehouse.--Section 562 of the Tariff Act of 1930 (19 U.S.C. 1562) is amended--

(1) by amending the first sentence to read as follows: ``Merchandise shall only be withdrawn from a bonded warehouse in such quantity and in such condition as the Secretary of the Treasury shall by regulation prescribe.''; and

(2) in the second sentence, by striking ``All merchandise so withdrawn'' and all that follows through ``except that upon permission therefor'' and inserting ``Upon permission''.

(f) Other Technical Amendments.--(1) Section 629(e) of the Tariff Act of 1930 (19 U.S.C. 1629(e)) is amended by striking ``insuring'' and inserting ``ensuring''.

(2) Section 135(f)(2)(B) of the Trade Act of 1974, as amended by section 2004(i)(1) of the Miscellaneous Trade and Technical Corrections Act of 2004, is amended by striking ``their establishment'' and insert ``its establishment''.

(3) Section 245(a) of the Trade Act of 1974 (19 U.S.C. 2317(a)) is amended by striking ``, other than subchapter D''.

(4) Section 291(2) of the Trade Act of 1974 (19 U.S.C. 2401(2)) is amended--

(A) by striking ``1001(5)'' and inserting ``1001(e)''; and

(B) by striking ``1308(5)'' and inserting ``1308(e)''.

(5) Section 13031(e)(6)(C)(i) of the Consolidated Omnibus Budget Reconciliation Act of 1985 (19 U.S.C. 58c(e)(6)(C)(i)) is amended by striking ``commonly know'' and inserting ``commonly known''.

(6) Section 2107(a)(4) of the Bipartisan Trade Promotion Authority Act of 2002 (19 U.S.C. 3807(a)(4)) is amended--

(A) by striking ``paragraph (2)(A)'' and inserting ``paragraphs (2)(A)''; and

(B) by striking ``paragraph (2)(B)'' and inserting ``paragraphs (2)(B)''.

(7) Section 514(c)(3) of the Tariff Act of 1930 (19 U.S.C. 1514(c)(3)) is amended by moving the last 2 sentences 2 ems to the left as flush left text.

Subtitle C--Effective Date

SEC. 1641. EFFECTIVE DATE.

Except as otherwise provided in this title, the amendments made by this title shall apply with respect to goods entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of the enactment of this Act.

Approved August 17, 2006.

ECONOMIC GROWTH and TAX RELIEF RECONCILIATION ACT of 2001

(Sections Made Permanent by Section 811 of the Pension Protection Act of 2006)

TITLE VI—Pension and Individual Retirement Arrangement Provisions

Subtitle A—Individual Retirement Accounts

Sec. 601. Modification of IRA contribution limits.
Sec. 602. Deemed IRAs under employer plans.

Subtitle B—Expanding Coverage

Sec. 611. Increase in benefit and contribution limits.
Sec. 612. Plan loans for subchapter S owners, partners, and sole proprietors.
Sec. 613. Modification of top-heavy rules.
Sec. 614. Elective deferrals not taken into account for purposes of deduction limits.
Sec. 615. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations.
Sec. 616. Deduction limits.
Sec. 617. Option to treat elective deferrals as after-tax Roth contributions.
Sec. 618. Nonrefundable credit to certain individuals for elective deferrals and IRA contributions.
Sec. 619. Credit for pension plan startup costs of small employers.
Sec. 620. Elimination of user fee for requests to IRS regarding pension plans.
Sec. 621. Treatment of nonresident aliens engaged in international transportation services.

Subtitle C—Enhancing Fairness for Women

Sec. 631. Catch-up contributions for individuals age 50 or over.
Sec. 632. Equitable treatment for contributions of employees to defined contribution plans.
Sec. 633. Faster vesting of certain employer matching contributions.
Sec. 634. Modification to minimum distribution rules.
Sec. 635. Clarification of tax treatment of division of section 457 plan benefits upon divorce.
Sec. 636. Provisions relating to hardship distributions.
Sec. 637. Waiver of tax on nondeductible contributions for domestic or similar workers.

Subtitle D—Increasing Portability for Participants

Sec. 641. Rollovers allowed among various types of plans.
Sec. 642. Rollovers of IRAs into workplace retirement plans.
Sec. 643. Rollovers of after-tax contributions.
Sec. 644. Hardship exception to 60-day rule.
Sec. 645. Treatment of forms of distribution.
Sec. 646. Rationalization of restrictions on distributions.
Sec. 647. Purchase of service credit in governmental defined benefit plans.
Sec. 648. Employers may disregard rollovers for purposes of cash-out amounts.
Sec. 649. Minimum distribution and inclusion requirements for section 457 plans.

Subtitle E—Strengthening Pension Security and Enforcement

PART I—GENERAL PROVISIONS

Sec. 651. Repeal of 160 percent of current liability funding limit.

Sec. 652. Maximum contribution deduction rules modified and applied to all defined benefit plans.
Sec. 653. Excise tax relief for sound pension funding.
Sec. 654. Treatment of multi-employer plans under section 415.
Sec. 655. Protection of investment of employee contributions to 401(k) plans.
Sec. 656. Prohibited allocations of stock in S corporation ESOP.
Sec. 657. Automatic rollovers of certain mandatory distributions.
Sec. 658. Clarification of treatment of contributions to multi-employer plan.

PART II—TREATMENT OF PLAN AMENDMENTS REDUCING FUTURE BENEFIT ACCRUALS

Sec. 659. Excise tax on failure to provide notice by defined benefit plans significantly reducing future benefit accruals.

Subtitle F—Reducing Regulatory Burdens

Sec. 661. Modification of timing of plan valuations.
Sec. 662. ESOP dividends may be reinvested without loss of dividend deduction.
Sec. 663. Repeal of transition rule relating to certain highly compensated employees.
Sec. 664. Employees of tax-exempt entities.
Sec. 665. Clarification of treatment of employer-provided retirement advice.
Sec. 666. Repeal of the multiple use test.

Subtitle A—Individual Retirement Accounts

Sec. 601. Modification Of IRA Contribution Limits.
(a) INCREASE IN CONTRIBUTION LIMIT.—
(1) IN GENERAL.—Paragraph (1)(A) of section 219(b) (relating to maximum amount of deduction) is amended by striking ‘‘$2,000’’ and inserting ‘‘the deductible amount’’.
(2) DEDUCTIBLE AMOUNT.—Section 219(b) is amended by adding at the end the following new paragraph:
‘‘ (5) DEDUCTIBLE AMOUNT.—For purposes of paragraph (1)(A)—
‘‘ (A) IN GENERAL.—The deductible amount shall be determined in accordance with the following table:
‘‘ For taxable years The deductible beginning in: amount is:
2002 through 2004 .... $3,000
2005 through 2007 .... $4,000
2008 and thereafter .... $5,000.
‘‘ (B) CATCH-UP CONTRIBUTIONS FOR INDIVIDUALS 50 OR OLDER.—
‘‘ (i) IN GENERAL.—In the case of an individual who has attained the age of 50 before the close of the taxable year, the deductible amount for such taxable year shall be increased by the applicable amount.
‘‘ (ii) APPLICABLE AMOUNT.—For purposes of clause (i), the applicable amount shall be the amount determined in accordance with the following table:
‘‘ For taxable years The applicable beginning in: amount is:
2002 through 2005 .... $500
2006 and thereafter .... $1,000.
‘‘ (C) COST-OF-LIVING ADJUSTMENT.—
‘‘ (i) IN GENERAL.—In the case of any taxable year beginning in a calendar year after 2008, the $5,000 amount under subparagraph (A) shall be increased by an amount equal to—
‘‘ (I) such dollar amount, multiplied by
‘‘ (II) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting ‘calendar year 2007’ for ‘calendar year 1992’ in subparagraph (B) thereof.
‘‘ (ii) ROUNDING RULES.—If any amount after adjustment under clause (i) is not a multiple of $500, such amount shall be rounded to the next lower multiple of $500.’’.
(b) CONFORMING AMENDMENTS.—
(1) Section 408(a)(1) is amended by striking ‘‘in excess of $2,000 on behalf of any individual’’ and inserting ‘‘on behalf of any individual in excess of the amount in effect for such taxable year under section 219(b)(1)(A)’’.
(2) Section 408(b)(2)(B) is amended by striking ‘‘$2,000’’ and inserting ‘‘the dollar amount in effect under section 219(b)(1)(A)’’.
(3) Section 408(b) is amended by striking ‘‘$2,000’’ in the matter following paragraph (4) and inserting ‘‘the dollar amount in effect under section 219(b)(1)(A)’’.
(4) Section 408(j) is amended by striking ‘‘$2,000’’.
(5) Section 408(p)(8) is amended by striking ‘‘$2,000’’ and inserting ‘‘the dollar amount in effect under section 219(b)(1)(A)’’.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2001.

Sec. 602. Deemed IRAs Under Employer Plans.

(a) IN GENERAL.—Section 408 (relating to individual retirement accounts) is amended by redesignating subsection (q) as subsection (r) and by inserting after subsection (p) the following new subsection:
‘‘ (q) DEEMED IRAS UNDER QUALIFIED EMPLOYER PLANS.—
‘‘ (1) GENERAL RULE.—If—
‘‘ (A) a qualified employer plan elects to allow employees to make voluntary employee contributions to a separate account or annuity established under the plan, and
‘‘ (B) under the terms of the qualified employer plan, such account or annuity meets the applicable requirements of this section or section 408A for an individual retirement account or annuity, then such account or annuity shall be treated for purposes of this title in the same manner as an individual retirement plan and not as a qualified employer plan (and contributions to such account or annuity as contributions to an individual retirement plan and not to the qualified employer plan). For purposes of subparagraph (B), the requirements of subsection (a)(5) shall not apply.
‘‘ (2) SPECIAL RULES FOR QUALIFIED EMPLOYER PLANS.—For purposes of this title, a qualified employer plan shall not fail to meet any requirement of this title solely by reason of establishing and maintaining a program described in paragraph (1).
‘‘ (3) DEFINITIONS.—For purposes of this subsection—
‘‘ (A) QUALIFIED EMPLOYER PLAN.—The term ‘qualified employer plan’ has the meaning given such term by section 72(p)(4); except such term shall not include a government plan which is not a qualified plan unless the plan is an eligible deferred compensation plan (as defined in section 457(b)).
‘‘ (B) VOLUNTARY EMPLOYEE CONTRIBUTION.—The term ‘voluntary employee contribution’ means any contribution (other than a mandatory contribution within the meaning of section 411(c)(2)(C))—
‘‘ (i) which is made by an individual as an employee under a qualified employer plan which allows employees to elect to make contributions described in paragraph (1), and ‘‘(ii) with respect to which the individual has designated the contribution as a contribution to which this subsection applies.’’.
(b) AMENDMENT OF ERISA.—
(1) IN GENERAL.—Section 4 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1003) is amended by adding at the end the following new subsection:
‘‘ (c) If a pension plan allows an employee to elect to make voluntary employee contributions to accounts and annuities as provided in section 408(q) of the Internal Revenue Code of 1986, such accounts and annuities (and contributions thereto) shall not be treated as part of such plan (or as a separate pension plan) for purposes of any provision of this title other than section 403(c), 404, or 405 (relating to exclusive benefit, and fiduciary and cofiduciary responsibilities).’’.
(2) CONFORMING AMENDMENT.—Section 4(a) of such Act (29 U.S.C. 1003(a)) is amended by inserting ‘‘or (c)’’ after ‘‘subsection (b)’’.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after December 31, 2002.

Subtitle B—Expanding Coverage

Sec. 611. Increase In Benefit And Contribution Limits.

(a) DEFINED BENEFIT PLANS.—
(1) DOLLAR LIMIT.—
(A) Subparagraph (A) of section 415(b)(1) (relating to limitation for defined benefit plans) is amended by striking ‘‘$90,000’’ and inserting ‘‘$160,000’’.
(B) Subparagraphs (C) and (D) of section 415(b)(2) are each amended in the headings and the text, by striking ‘‘$90,000’’ and inserting ‘‘$160,000’’,
(C) Paragraph (7) of section 415(b) (relating to benefits under certain collectively bargained plans) is amended by striking ‘‘the greater of $68,212 or one-half the amount otherwise applicable for such year under paragraph (1)(A) for ‘$90,000’ ’’ and inserting ‘‘one-half the amount otherwise applicable for such year under paragraph (1)(A) for ‘$160,000’ ’’.
(2) LIMIT REDUCED WHEN BENEFIT BEGINS BEFORE AGE 62.—
Subparagraph (C) of section 415(b)(2) is amended by striking ‘‘the social security retirement age’’ each place it appears in the heading and text and inserting ‘‘age 62’’ and by striking the second sentence.
(3) LIMIT INCREASED WHEN BENEFIT BEGINS AFTER AGE 65.—
Subparagraph (D) of section 415(b)(2) is amended by striking ‘‘the social security retirement age’’ each place it appears in the heading and text and inserting ‘‘age 65’’.
(4) COST-OF-LIVING ADJUSTMENTS.—Subsection (d) of section 415 (related to cost-of-living adjustments) is amended—

(A) by striking ‘‘$90,000’’ in paragraph (1)(A) and inserting ‘‘$160,000’’; and
(B) in paragraph (3)(A)— (i) by striking ‘‘$90,000’’ in the heading and inserting ‘‘$160,000’’; and (ii) by striking ‘‘October 1, 1986’’ and inserting ‘‘July 1, 2001’’.
(5) CONFORMING AMENDMENTS.—
(A) Section 415(b)(2) is amended by striking subparagraph (F).
(B) Section 415(b)(9) is amended to read as follows:
‘‘ (9) SPECIAL RULE FOR COMMERCIAL AIRLINE PILOTS.—
‘‘ (A) IN GENERAL.—Except as provided in subparagraph (B), in the case of any participant who is a commercial airline pilot, if, as of the time of the participant's retirement, regulations prescribed by the Federal Aviation Administration require an individual to separate from service as a commercial airline pilot after attaining any age occurring on or after age 60 and before age 62, paragraph (2)(C) shall be applied by substituting such age for age 62.
‘‘ (B) INDIVIDUALS WHO SEPARATE FROM SERVICE BEFORE AGE 60.—If a participant described in subparagraph (A) separates from service before age 60, the rules of paragraph (2)(C) shall apply.’’.
(C) Section 415(b)(10)(C)(i) is amended by striking ‘‘applied without regard to paragraph (2)(F)’’.
(b) DEFINED CONTRIBUTION PLANS.—
(1) DOLLAR LIMIT.—Subparagraph (A) of section 415(c)(1) (relating to limitation for defined contribution plans) is amended by striking ‘‘$30,000’’ and inserting ‘‘$40,000’’.
(2) COST-OF-LIVING ADJUSTMENTS.—Subsection (d) of section 415 (related to cost-of-living adjustments) is amended—
(A) by striking ‘‘$30,000’’ in paragraph (1)(C) and inserting ‘‘$40,000’’; and
(B) in paragraph (3)(D)— (i) by striking ‘‘$30,000’’ in the heading and inserting ‘‘$40,000’’; and (ii) by striking ‘‘October 1, 1993’’ and inserting ‘‘July 1, 2001’’.
(c) QUALIFIED TRUSTS.—
(1) COMPENSATION LIMIT.—Sections 401(a)(17), 404(l), 408(k), and 505(b)(7) are each amended by striking ‘‘$150,000’’ each place it appears and inserting ‘‘$200,000’’.
(2) BASE PERIOD AND ROUNDING OF COST-OF-LIVING ADJUSTMENT.—
Subparagraph (B) of section 401(a)(17) is amended—
(A) by striking ‘‘October 1, 1993’’ and inserting ‘‘July 1, 2001’’; and
(B) by striking ‘‘$10,000’’ both places it appears and inserting ‘‘$5,000’’.
(d) ELECTIVE DEFERRALS.—
(1) IN GENERAL.—Paragraph (1) of section 402(g) (relating to limitation on exclusion for elective deferrals) is amended to read as follows:
‘‘ (1) IN GENERAL.—
‘‘ (A) LIMITATION.—Notwithstanding subsections (e)(3) and (h)(1)(B), the elective deferrals of any individual for any taxable year shall be included in such individual's gross income to the extent the amount of such deferrals for the taxable year exceeds the applicable dollar amount.
‘‘ (B) APPLICABLE DOLLAR AMOUNT.—For purposes of subparagraph (A), the applicable dollar amount shall be the amount determined in accordance with the following table:
‘‘ For taxable years The applicable beginning in dollar amount:
calendar year:
2002 .... $11,000
2003 .... $12,000
2004 .... $13,000
2005 .... $14,000
2006 or thereafter .... $15,000.’’.
(2) COST-OF-LIVING ADJUSTMENT.—Paragraph (5) of section 402(g) is amended to read as follows:
‘‘ (5) COST-OF-LIVING ADJUSTMENT.—In the case of taxable years beginning after December 31, 2006, the Secretary shall adjust the $15,000 amount under paragraph (1)(B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2005, and any increase under this paragraph which is not a multiple of $500 shall be rounded to the next lowest multiple of $500.’’.
(3) CONFORMING AMENDMENTS.—
(A) Section 402(g) (relating to limitation on exclusion for elective deferrals), as amended by paragraphs (1) and (2), is further amended by striking paragraph (4) and redesignating paragraphs (5), (6), (7), (8), and (9) as paragraphs (4), (5), (6), (7), and (8), respectively.
(B) Paragraph (2) of section 457(c) is amended by striking ‘‘402(g)(8)(A)(iii)’’ and inserting ‘‘402(g)(7)(A)(iii)’’.
(C) Clause (iii) of section 501(c)(18)(D) is amended by striking ‘‘(other than paragraph (4) thereof)’’.
(e) DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS.—
(1) IN GENERAL.—Section 457 (relating to deferred compensation plans of State and local governments and tax-exempt organizations) is amended—

(A) in subsections (b)(2)(A) and (c)(1) by striking ''$7,500'' each place it appears and inserting ''the applicable dollar amount''; and
(B) in subsection (b)(3)(A) by striking ''$15,000'' and inserting ''twice the dollar amount in effect under subsection (b)(2)(A)''.
(2) APPLICABLE DOLLAR AMOUNT; COST-OF-LIVING ADJUSTMENT.—
Paragraph (15) of section 457(e) is amended to read as follows:
'' (15) APPLICABLE DOLLAR AMOUNT.—
'' (A) IN GENERAL.—The applicable dollar amount shall be the amount determined in accordance with the following table:
'' For taxable years The applicable beginning in dollar amount:
calendar year:
2002 .... $11,000
2003 .... $12,000
2004 .... $13,000
2005 .... $14,000
2006 or thereafter .... $15,000.
'' (B) COST-OF-LIVING ADJUSTMENTS.—In the case of taxable years beginning after December 31, 2006, the Secretary shall adjust the $15,000 amount under subparagraph (A) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2005, and any increase under this paragraph which is not a multiple of $500 shall be rounded to the next lowest multiple of $500.''.
(f) SIMPLE RETIREMENT ACCOUNTS.—
(1) LIMITATION.—Clause (ii) of section 408(p)(2)(A) (relating to general rule for qualified salary reduction arrangement) is amended by striking ''$6,000'' and inserting ''the applicable dollar amount''.
(2) APPLICABLE DOLLAR AMOUNT.—Subparagraph (E) of 408(p)(2) is amended to read as follows:
'' (E) APPLICABLE DOLLAR AMOUNT; COST-OF-LIVING ADJUSTMENT.—
'' (i) IN GENERAL.—For purposes of subparagraph (A)(ii), the applicable dollar amount shall be the amount determined in accordance with the following table:
'' For years The applicable beginning in dollar amount:
calendar year:
2002 .... $7,000
2003 .... $8,000
2004 .... $9,000
2005 or thereafter .... $10,000.
'' (ii) COST-OF-LIVING ADJUSTMENT.—In the case of a year beginning after December 31, 2005, the Secretary shall adjust the $10,000 amount under clause (i) at the same time and in the same manner as under section 415(d), except that the base period taken into account shall be the calendar quarter beginning July 1, 2004, and any increase under this subparagraph which is not a multiple of $500 shall be rounded to the next lower multiple of $500.''.
(3) CONFORMING AMENDMENTS.—
(A) Subclause (I) of section 401(k)(11)(B)(i) is amended by striking ''$6,000'' and inserting ''the amount in effect under section 408(p)(2)(A)(ii)''.
(B) Section 401(k)(11) is amended by striking subparagraph (E).
(g) CERTAIN COMPENSATION LIMITS.—
(1) IN GENERAL.—Subparagraph (A) of section 401(c)(2) (defining earned income) is amended by adding at the end thereof the following new sentence: ''For purposes of this part only (other than sections 419 and 419A), this subparagraph shall be applied as if the term 'trade or business' for purposes of section 1402 included service described in section 1402(c)(6).''.
(2) SIMPLE RETIREMENT ACCOUNTS.—Clause (ii) of section 408(p)(6)(A) (defining self-employed) is amended by adding at the end the following new sentence: ''The preceding sentence shall be applied as if the term 'trade or business' for purposes of section 1402 included service described in section 1402(c)(6).''.
(h) ROUNDING RULE RELATING TO DEFINED BENEFIT PLANS AND DEFINED CONTRIBUTION PLANS.
—Paragraph (4) of section 415(d) is amended to read as follows:
'' (4) ROUNDING.—
'' (A) $160,000 AMOUNT.—Any increase under subparagraph (A) of paragraph (1) which is not a multiple of $5,000 shall be rounded to the next lowest multiple of $5,000.
'' (B) $40,000 AMOUNT.—Any increase under subparagraph (C) of paragraph (1) which is not a multiple of $1,000 shall be rounded to the next lowest multiple of $1,000.''.
(i) EFFECTIVE DATES.—
(1) IN GENERAL.—The amendments made by this section shall apply to years beginning after December 31, 2001.
(2) DEFINED BENEFIT PLANS.—The amendments made by subsection (a) shall apply to years ending after

December 31, 2001.

Sec. 612. Plan Loans For Subchapter S Owners, Partners, And Sole Proprietors.
(a) IN GENERAL.—Subparagraph (B) of section 4975(f)(6) (relating to exemptions not to apply to certain transactions) is amended by adding at the end the following new clause:
‘‘ (iii) LOAN EXCEPTION.—For purposes of subparagraph (A)(i), the term ‘owner-employee’ shall only include a person described in subclause (II) or (III) of clause (i).’’.
(b) AMENDMENT OF ERISA.—Section 408(d)(2) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1108(d)(2)) is amended by adding at the end the following new subparagraph:
‘‘ (C) For purposes of paragraph (1)(A), the term ‘owner employee’ shall only include a person described in clause (ii) or (iii) of subparagraph (A).’’.
(c) EFFECTIVE DATE.—The amendment made by this section shall apply to years beginning after December 31, 2001.

Sec. 613. Modification Of Top-Heavy Rules.
(a) SIMPLIFICATION OF DEFINITION OF KEY EMPLOYEE.—
(1) IN GENERAL.—Section 416(i)(1)(A) (defining key employee) is amended—
(A) by striking ‘‘or any of the 4 preceding plan years’’ in the matter preceding clause (i);
(B) by striking clause (i) and inserting the following: ‘‘(i) an officer of the employer having an annual compensation greater than $130,000,’’;
(C) by striking clause (ii) and redesignating clauses (iii) and (iv) as clauses (ii) and (iii), respectively; and
(D) by striking the second sentence in the matter following clause (iii), as redesignated by subparagraph (C), and by inserting the following: ‘‘in the case of plan years beginning after December 31, 2002, the $130,000 amount in clause (i) shall be adjusted at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning July 1, 2001, and any increase under this sentence which is not a multiple of $5,000 shall be rounded to the next lower multiple of $5,000.’’.
(2) CONFORMING AMENDMENT.—Section 416(i)(1)(B)(iii) is amended by striking ‘‘and subparagraph (A)(ii)’’.
(b) MATCHING CONTRIBUTIONS TAKEN INTO ACCOUNT FOR MINIMUM CONTRIBUTION REQUIREMENTS.—Section 416(c)(2)(A) (relating to defined contribution plans) is amended by adding at the end the following: ‘‘Employer matching contributions (as defined in section 401(m)(4)(A)) shall be taken into account for purposes of this subparagraph (and any reduction under this sentence shall not be taken into account in determining whether section 401(k)(4)(A) applies).’’.
(c) DISTRIBUTIONS DURING LAST YEAR BEFORE DETERMINATION DATE TAKEN INTO ACCOUNT.—
(1) IN GENERAL.—Paragraph (3) of section 416(g) is amended to read as follows:
‘‘ (3) DISTRIBUTIONS DURING LAST YEAR BEFORE DETERMINATION DATE TAKEN INTO ACCOUNT.—
‘‘ (A) IN GENERAL.—For purposes of determining—
‘‘ (i) the present value of the cumulative accrued benefit for any employee, or ‘‘(ii) the amount of the account of any employee, such present value or amount shall be increased by the aggregate distributions made with respect to such employee under the plan during the 1-year period ending on the determination date. The preceding sentence shall also apply to distributions under a terminated plan which if it had not been terminated would have been required to be included in an aggregation group.
‘‘ (B) 5-YEAR PERIOD IN CASE OF IN-SERVICE DISTRIBUTION.—
In the case of any distribution made for a reason other than separation from service, death, or disability, subparagraph (A) shall be applied by substituting ‘5-year period’ for ‘1-year period’.’’.
(2) BENEFITS NOT TAKEN INTO ACCOUNT.—Subparagraph (E) of section 416(g)(4) is amended—
(A) by striking ‘‘LAST 5 YEARS’’ in the heading and inserting ‘‘LAST YEAR BEFORE DETERMINATION DATE’’; and
(B) by striking ‘‘5-year period’’ and inserting ‘‘1-year period’’.
(d) DEFINITION OF TOP-HEAVY PLANS.—Paragraph (4) of section 416(g) (relating to other special rules for top-heavy plans) is amended by adding at the end the following new subparagraph:
‘‘ (H) CASH OR DEFERRED ARRANGEMENTS USING ALTERNATIVE METHODS OF MEETING NONDISCRIMINATION REQUIREMENTS.—
The term ‘top-heavy plan’ shall not include a plan which consists solely of—
‘‘ (i) a cash or deferred arrangement which meets the requirements of section 401(k)(12), and‘‘ (ii) matching contributions with respect to which the requirements of section 401(m)(11) are met. If, but for this subparagraph, a plan would be treated as a top-heavy plan because it is a member of an aggregation group which is a top-heavy group, contributions under the plan may be taken into account in determining whether any other plan in the group meets the requirements of subsection (c)(2).’’.
(e) FROZEN PLAN EXEMPT FROM MINIMUM BENEFIT REQUIREMENT.—
Subparagraph (C) of section 416(c)(1) (relating to defined benefit plans) is amended—
(A) by striking ‘‘clause (ii)’’ in clause (i) and inserting ‘‘clause (ii) or (iii)’’; and

(B) by adding at the end the following:
'' (iii) EXCEPTION FOR FROZEN PLAN.—For purposes of determining an employee's years of service with the employer, any service with the employer shall be disregarded to the extent that such service occurs during a plan year when the plan benefits (within the meaning of section 410(b)) no key employee or former key employee.''.
(f) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after December 31, 2001.

Sec. 614. Elective Deferrals Not Taken Into Account For Purposes Of Deduction Limits.
(a) IN GENERAL.—Section 404 (relating to deduction for contributions of an employer to an employees' trust or annuity plan and compensation under a deferred payment plan) is amended by adding at the end the following new subsection:
'' (n) ELECTIVE DEFERRALS NOT TAKEN INTO ACCOUNT FOR PURPOSES OF DEDUCTION LIMITS.—Elective deferrals (as defined in section 402(g)(3)) shall not be subject to any limitation contained in paragraph (3), (7), or (9) of subsection (a), and such elective deferrals shall not be taken into account in applying any such limitation to any other contributions.''.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply to years beginning after December 31, 2001.

Sec. 615. Repeal Of Coordination Requirements For Deferred Compensation Plans Of State And Local Governments And Tax-Exempt Organizations.
(a) IN GENERAL.—Subsection (c) of section 457 (relating to deferred compensation plans of State and local governments and tax-exempt organizations), as amended by section 611, is amended to read as follows:
'' (c) LIMITATION.—The maximum amount of the compensation of any one individual which may be deferred under subsection (a) during any taxable year shall not exceed the amount in effect under subsection (b)(2)(A) (as modified by any adjustment provided under subsection (b)(3)).''.
(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to years beginning after December 31, 2001.

Sec. 616. Deduction Limits.
(a) MODIFICATION OF LIMITS.—
(1) STOCK BONUS AND PROFIT SHARING TRUSTS.—
(A) IN GENERAL.—Subclause (I) of section 404(a)(3)(A)(i) (relating to stock bonus and profit sharing trusts) is amended by striking ''15 percent'' and inserting ''25 percent''.
(B) CONFORMING AMENDMENT.—Subparagraph (C) of section 404(h)(1) is amended by striking ''15 percent'' each place it appears and inserting ''25 percent''.
(2) DEFINED CONTRIBUTION PLANS.—
(A) IN GENERAL.—Clause (v) of section 404(a)(3)(A) (relating to stock bonus and profit sharing trusts) is amended to read as follows:
'' (v) DEFINED CONTRIBUTION PLANS SUBJECT TO THE FUNDING STANDARDS.—Except as provided by the Secretary, a defined contribution plan which is subject to the funding standards of section 412 shall be treated in the same manner as a stock bonus or profit-sharing plan for purposes of this subparagraph.''.
(B) CONFORMING AMENDMENTS.—
(i) Section 404(a)(1)(A) is amended by inserting ''(other than a trust to which paragraph (3) applies)'' after ''pension trust''.
(ii) Section 404(h)(2) is amended by striking ''stock bonus or profit-sharing trust'' and inserting ''trust subject to subsection (a)(3)(A)''.
(iii) The heading of section 404(h)(2) is amended by striking ''STOCK BONUS AND PROFIT-SHARING TRUST'' and inserting ''CERTAIN TRUSTS''.
(b) COMPENSATION.—
(1) IN GENERAL.—Section 404(a) (relating to general rule) is amended by adding at the end the following:
'' (12) DEFINITION OF COMPENSATION.—For purposes of paragraphs (3), (7), (8), and (9), the term 'compensation' shall include amounts treated as 'participant's compensation' under subparagraph (C) or (D) of section 415(c)(3).''.
(2) CONFORMING AMENDMENTS.—
(A) Subparagraph (B) of section 404(a)(3) is amended by striking the last sentence thereof.
(B) Clause (i) of section 4972(c)(6)(B) is amended by striking ''(within the meaning of section 404(a))'' and inserting ''(within the meaning of section 404(a) and as adjusted under section 404(a)(12))''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after December 31, 2001.

Sec. 617. Option To Treat Elective Deferrals As After-Tax Roth Contributions.
(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 (relating to deferred compensation, etc.) is

amended by inserting after section 402 the following new section:
‘‘ SEC. 402A. OPTIONAL TREATMENT OF ELECTIVE DEFERRALS AS ROTH CONTRIBUTIONS.
‘‘ (a) GENERAL RULE.—If an applicable retirement plan includes a qualified Roth contribution program—
‘‘ (1) any designated Roth contribution made by an employee pursuant to the program shall be treated as an elective deferral for purposes of this chapter, except that such contribution shall not be excludable from gross income, and
‘‘ (2) such plan (and any arrangement which is part of such plan) shall not be treated as failing to meet any requirement of this chapter solely by reason of including such program.
‘‘ (b) QUALIFIED ROTH CONTRIBUTION PROGRAM.—For purposes of this section—
‘‘ (1) IN GENERAL.—The term ‘qualified Roth contribution program’ means a program under which an employee may elect to make designated Roth contributions in lieu of all or a portion of elective deferrals the employee is otherwise eligible to make under the applicable retirement plan.
‘‘ (2) SEPARATE ACCOUNTING REQUIRED.—A program shall not be treated as a qualified Roth contribution program unless the applicable retirement plan—
‘‘ (A) establishes separate accounts (‘designated Roth accounts’) for the designated Roth contributions of each employee and any earnings properly allocable to the contributions, and
‘‘ (B) maintains separate recordkeeping with respect to each account.
‘‘ (c) DEFINITIONS AND RULES RELATING TO DESIGNATED ROTH CONTRIBUTIONS.—For purposes of this section—
‘‘ (1) DESIGNATED ROTH CONTRIBUTION.—The term ‘designated Roth contribution’ means any elective deferral which—
‘‘ (A) is excludable from gross income of an employee without regard to this section, and
‘‘ (B) the employee designates (at such time and in such manner as the Secretary may prescribe) as not being so excludable.
‘‘ (2) DESIGNATION LIMITS.—The amount of elective deferrals which an employee may designate under paragraph (1) shall not exceed the excess (if any) of—
‘‘ (A) the maximum amount of elective deferrals excludable from gross income of the employee for the taxable year (without regard to this section), over ‘‘(B) the aggregate amount of elective deferrals of the employee for the taxable year which the employee does not designate under paragraph (1).
‘‘ (3) ROLLOVER CONTRIBUTIONS.—
‘‘ (A) IN GENERAL.—A rollover contribution of any payment or distribution from a designated Roth account which is otherwise allowable under this chapter may be made only if the contribution is to—
‘‘ (i) another designated Roth account of the individual from whose account the payment or distribution was made, or
‘‘ (ii) a Roth IRA of such individual.
‘‘ (B) COORDINATION WITH LIMIT.—Any rollover contribution to a designated Roth account under subparagraph (A) shall not be taken into account for purposes of paragraph (1).
‘‘ (d) DISTRIBUTION RULES.—For purposes of this title—
‘‘ (1) EXCLUSION.—Any qualified distribution from a designated Roth account shall not be includible in gross income.
‘‘ (2) QUALIFIED DISTRIBUTION.—For purposes of this subsection—
‘‘ (A) IN GENERAL.—The term ‘qualified distribution’ has the meaning given such term by section 408A(d)(2)(A) (without regard to clause (iv) thereof).
‘‘ (B) DISTRIBUTIONS WITHIN NONEXCLUSION PERIOD.—
A payment or distribution from a designated Roth account shall not be treated as a qualified distribution if such payment or distribution is made within the 5-taxable-year period beginning with the earlier of—
‘‘ (i) the first taxable year for which the individual made a designated Roth contribution to any designated Roth account established for such individual under the same applicable retirement plan, or
‘‘ (ii) if a rollover contribution was made to such designated Roth account from a designated Roth account previously established for such individual under another applicable retirement plan, the first taxable year for which the individual made a designated Roth contribution to such previously established account.
‘‘ (C) DISTRIBUTIONS OF EXCESS DEFERRALS AND CONTRIBUTIONS
AND EARNINGS THEREON.—The term ‘qualified distribution’ shall not include any distribution of any excess deferral under section 402(g)(2) or any excess contribution under section 401(k)(8), and any income on the excess deferral or contribution.
‘‘ (3) TREATMENT OF DISTRIBUTIONS OF CERTAIN EXCESS DEFERRALS.—Notwithstanding section 72, if any excess deferral under section 402(g)(2) attributable to a designated Roth contribution is not distributed on or before the 1st April 15 following the close of the taxable year in which such excess deferral is made, the amount of such excess deferral shall—
‘‘ (A) not be treated as investment in the contract, and
‘‘ (B) be included in gross income for the taxable year in which such excess is distributed.
‘‘ (4) AGGREGATION RULES.—Section 72 shall be applied separately with respect to distributions and

payments from a designated Roth account and other distributions and payments from the plan.
'' (e) OTHER DEFINITIONS.—For purposes of this section—
'' (1) APPLICABLE RETIREMENT PLAN.—The term 'applicable retirement plan' means—
'' (A) an employees' trust described in section 401(a) which is exempt from tax under section 501(a), and
'' (B) a plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b).
'' (2) ELECTIVE DEFERRAL.—The term 'elective deferral' means any elective deferral described in subparagraph (A) or (C) of section 402(g)(3).''.
(b) EXCESS DEFERRALS.—Section 402(g) (relating to limitation on exclusion for elective deferrals) is amended—
(1) by adding at the end of paragraph (1)(A) (as added by section 201(c)(1)) the following new sentence: ''The preceding sentence shall not apply the portion of such excess as does not exceed the designated Roth contributions of the individual for the taxable year.''; and
(2) by inserting ''(or would be included but for the last sentence thereof)'' after ''paragraph (1)'' in paragraph (2)(A).
(c) ROLLOVERS.—Subparagraph (B) of section 402(c)(8) is amended by adding at the end the following:
'' If any portion of an eligible rollover distribution is attributable to payments or distributions from a designated Roth account (as defined in section 402A), an eligible retirement plan with respect to such portion shall include only another designated Roth account and a Roth IRA.''.
(d) REPORTING REQUIREMENTS.—
(1) W–2 INFORMATION.—Section 6051(a)(8) is amended by inserting '', including the amount of designated Roth contributions (as defined in section 402A)'' before the comma at the end.
(2) INFORMATION.—Section 6047 is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:
'' (f) DESIGNATED ROTH CONTRIBUTIONS.—The Secretary shall require the plan administrator of each applicable retirement plan (as defined in section 402A) to make such returns and reports regarding designated Roth contributions (as defined in section 402A) to the Secretary, participants and beneficiaries of the plan, and such other persons as the Secretary may prescribe.''.
(e) CONFORMING AMENDMENTS.—
(1) Section 408A(e) is amended by adding after the first sentence the following new sentence: ''Such term includes a rollover contribution described in section 402A(c)(3)(A).''.
(2) The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by inserting after the item relating to section 402 the following new item: ''Sec. 402A. Optional treatment of elective deferrals as Roth contributions.''.
(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2005.

Sec. 618. Nonrefundable Credit To Certain Individuals For Elective Deferrals And IRA Contributions.
(a) IN GENERAL.—Subpart A of part IV of subchapter A of chapter 1 (relating to nonrefundable personal credits) is amended by inserting after section 25A the following new section:
'' SEC. 25B. ELECTIVE DEFERRALS AND IRA CONTRIBUTIONS BY CERTAIN INDIVIDUALS.
'' (a) ALLOWANCE OF CREDIT.—In the case of an eligible individual, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the applicable percentage of so much of the qualified retirement savings contributions of the eligible individual for the taxable year as do not exceed $2,000.
'' (b) APPLICABLE PERCENTAGE.—For purposes of this section, the applicable percentage is the percentage determined in accordance with the following table:

Adjusted Gross Income						
Joint return		Head of a household		All other cases		Applicable percentage
Over	Not over	Over	Not over	Over	Not over	
	$30,000		$22,500		$15,000	50
$30,000	$32,500	$22,500	$24,375	$15,000	$16,250	20
$32,500	$50,000	$24,375	$37,500	$16,250	$25,000	10
$50,000		$37,500		$25,000		0

'' (c) ELIGIBLE INDIVIDUAL.—For purposes of this section—
'' (1) IN GENERAL.—The term 'eligible individual' means any individual if such individual has attained the age of 18 as of the close of the taxable year.
'' (2) DEPENDENTS AND FULL-TIME STUDENTS NOT ELIGIBLE.—
The term 'eligible individual' shall not include—
'' (A) any individual with respect to whom a deduction under section 151 is allowed to another taxpayer for a

taxable year beginning in the calendar year in which such individual's taxable year begins, and ''(B) any individual who is a student (as defined in section 151(c)(4)).
'' (d) QUALIFIED RETIREMENT SAVINGS CONTRIBUTIONS.—For purposes of this section—
'' (1) IN GENERAL.—The term 'qualified retirement savings contributions' means, with respect to any taxable year, the sum of—
'' (A) the amount of the qualified retirement contributions (as defined in section 219(e)) made by the eligible individual,
'' (B) the amount of— ''(i) any elective deferrals (as defined in section 402(g)(3)) of such individual, and ''(ii) any elective deferral of compensation by such individual under an eligible deferred compensation plan (as defined in section 457(b)) of an eligible employer described in section 457(e)(1)(A), and ''(C) the amount of voluntary employee contributions by such individual to any qualified retirement plan (as defined in section 4974(c)).
'' (2) REDUCTION FOR CERTAIN DISTRIBUTIONS.—
'' (A) IN GENERAL.—The qualified retirement savings contributions determined under paragraph (1) shall be reduced (but not below zero) by the sum of— ''(i) any distribution from a qualified retirement plan (as defined in section 4974(c)), or from an eligible deferred compensation plan (as defined in section 457(b)), received by the individual during the testing period which is includible in gross income, and ''(ii) any distribution from a Roth IRA or a Roth account received by the individual during the testing period which is not a qualified rollover contribution (as defined in section 408A(e)) to a Roth IRA or a rollover under section 402(c)(8)(B) to a Roth account.
'' (B) TESTING PERIOD.—For purposes of subparagraph (A), the testing period, with respect to a taxable year, is the period which includes—
'' (i) such taxable year, ''(ii) the 2 preceding taxable years, and ''(iii) the period after such taxable year and before the due date (including extensions) for filing the return of tax for such taxable year.
'' (C) EXCEPTED DISTRIBUTIONS.—There shall not be taken into account under subparagraph (A)—
'' (i) any distribution referred to in section 72(p), 401(k)(8), 401(m)(6), 402(g)(2), 404(k), or 408(d)(4), and
'' (ii) any distribution to which section 408A(d)(3) applies.
'' (D) TREATMENT OF DISTRIBUTIONS RECEIVED BY
SPOUSE OF INDIVIDUAL.—For purposes of determining distributions received by an individual under subparagraph (A) for any taxable year, any distribution received by the spouse of such individual shall be treated as received by such individual if such individual and spouse file a joint return for such taxable year and for the taxable year during which the spouse receives the distribution.
'' (e) ADJUSTED GROSS INCOME.—For purposes of this section, adjusted gross income shall be determined without regard to sections 911, 931, and 933.
'' (f) INVESTMENT IN THE CONTRACT.—Notwithstanding any other provision of law, a qualified retirement savings contribution shall not fail to be included in determining the investment in the contract for purposes of section 72 by reason of the credit under this section.
'' (g) TERMINATION.—This section shall not apply to taxable years beginning after December 31, 2006.''.
(b) CREDIT ALLOWED AGAINST REGULAR TAX AND ALTERNATIVE MINIMUM TAX.—
(1) IN GENERAL.—Section 25B, as added by subsection (a), is amended by inserting after subsection (f) the following new subsection:
'' (g) LIMITATION BASED ON AMOUNT OF TAX.—The credit allowed under subsection (a) for the taxable year shall not exceed the excess of—
'' (1) the sum of the regular tax liability (as defined in section 26(b)) plus the tax imposed by section 55, over
'' (2) the sum of the credits allowable under this subpart (other than this section and section 23) and section 27 for the taxable year.''.
(2) CONFORMING AMENDMENTS.—
(A) Section 24(b)(3)(B), as amended by sections 201(b) and 203(d), is amended by striking ''section 23'' and inserting ''sections 23 and 25B''.
(B) Section 25(e)(1)(C), as amended by section 201(b), is amended by inserting ''25B,'' after ''24,''.
(C) Section 26(a)(1), as amended by sections 201(b) and 203, is amended by striking ''and 24'' and inserting'' , 24, and 25B''.
(D) Section 904(h), as amended by sections 201(b) and 203, is amended by striking ''and 24'' and inserting '', 24, and 25B''.
(E) Section 1400C(d), as amended by sections 201(b) and 203, is amended by striking ''and 24'' and inserting '', 24, and 25B''.
(c) CONFORMING AMENDMENT.—The table of sections for subpart A of part IV of subchapter A of chapter 1, as amended by section 432, is amended by inserting after the item relating to section 25A the following new item:'' Sec. 25B. Elective deferrals and IRA contributions by certain individuals.''.
(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2001.

Sec. 619. Credit For Pension Plan Startup Costs Of Small Employers.

(a) IN GENERAL.—Subpart D of part IV of subchapter A of chapter 1 (relating to business related credits) is amended by adding at the end the following new section:

‘‘ SEC. 45E. SMALL EMPLOYER PENSION PLAN STARTUP COSTS.

‘‘ (a) GENERAL RULE.—For purposes of section 38, in the case of an eligible employer, the small employer pension plan startup cost credit determined under this section for any taxable year is an amount equal to 50 percent of the qualified startup costs paid or incurred by the taxpayer during the taxable year.

‘‘ (b) DOLLAR LIMITATION.—The amount of the credit determined under this section for any taxable year shall not exceed—

‘‘ (1) $500 for the first credit year and each of the 2 taxable years immediately following the first credit year, and

‘‘ (2) zero for any other taxable year.

‘‘ (c) ELIGIBLE EMPLOYER.—For purposes of this section—

‘‘ (1) IN GENERAL.—The term ‘eligible employer’ has the meaning given such term by section 408(p)(2)(C)(i).

‘‘ (2) REQUIREMENT FOR NEW QUALIFIED EMPLOYER PLANS.—

Such term shall not include an employer if, during the 3-taxable year period immediately preceding the 1st taxable year for which the credit under this section is otherwise allowable for a qualified employer plan of the employer, the employer or any member of any controlled group including the employer (or any predecessor of either) established or maintained a qualified employer plan with respect to which contributions were made, or benefits were accrued, for substantially the same employees as are in the qualified employer plan.

‘‘ (d) OTHER DEFINITIONS.—For purposes of this section—

‘‘ (1) QUALIFIED STARTUP COSTS.—

‘‘ (A) IN GENERAL.—The term ‘qualified startup costs’ means any ordinary and necessary expenses of an eligible employer which are paid or incurred in connection with—

‘‘ (i) the establishment or administration of an eligible employer plan, or

‘‘ (ii) the retirement-related education of employees with respect to such plan.

‘‘ (B) PLAN MUST HAVE AT LEAST 1 PARTICIPANT.—Such term shall not include any expense in connection with a plan that does not have at least 1 employee eligible to participate who is not a highly compensated employee.

‘‘ (2) ELIGIBLE EMPLOYER PLAN.—The term ‘eligible employer plan’ means a qualified employer plan within the meaning of section 4972(d).

‘‘ (3) FIRST CREDIT YEAR.—The term ‘first credit year’ means—

‘‘ (A) the taxable year which includes the date that the eligible employer plan to which such costs relate becomes effective, or

‘‘ (B) at the election of the eligible employer, the taxable year preceding the taxable year referred to in subparagraph (A).

‘‘ (e) SPECIAL RULES.—For purposes of this section—

‘‘ (1) AGGREGATION RULES.—All persons treated as a single employer under subsection (a) or (b) of section 52, or subsection (n) or (o) of section 414, shall be treated as one person. All eligible employer plans shall be treated as 1 eligible employer plan.

‘‘ (2) DISALLOWANCE OF DEDUCTION.—No deduction shall be allowed for that portion of the qualified startup costs paid or incurred for the taxable year which is equal to the credit determined under subsection (a).

‘‘ (3) ELECTION NOT TO CLAIM CREDIT.—This section shall not apply to a taxpayer for any taxable year if such taxpayer elects to have this section not apply for such taxable year.’’.

(b) CREDIT ALLOWED AS PART OF GENERAL BUSINESS CREDIT.—

Section 38(b) (defining current year business credit) is amended by striking ‘‘plus’’ at the end of paragraph (12), by striking the period at the end of paragraph (13) and inserting ‘‘, plus’’, and by adding at the end the following new paragraph: ‘‘(14) in the case of an eligible employer (as defined in section 45E(c)), the small employer pension plan startup cost credit determined under section 45E(a).’’.

(c) CONFORMING AMENDMENTS.—

(1) Section 39(d) is amended by adding at the end the following new paragraph:

‘‘ (10) NO CARRYBACK OF SMALL EMPLOYER PENSION PLAN STARTUP COST CREDIT BEFORE JANUARY 1, 2002.—No portion of the unused business credit for any taxable year which is attributable to the small employer pension plan startup cost credit determined under section 45E may be carried back to a taxable year beginning before January 1, 2002.’’.

(2) Subsection (c) of section 196 is amended by striking ‘‘and’’ at the end of paragraph (8), by striking the period at the end of paragraph (9) and inserting ‘‘, and’’, and by adding at the end the following new paragraph:‘‘ (10) the small employer pension plan startup cost credit determined under section 45E(a).’’.

(3) The table of sections for subpart D of part IV of subchapter A of chapter 1 is amended by adding at the end the following new item:‘‘ Sec. 45E. Small employer pension plan startup costs.’’.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to qualified employer plans established after such

date.

Sec. 620. Elimination Of User Fee For Requests To IRS Regarding Pension Plans.

(a) ELIMINATION OF CERTAIN USER FEES.—The Secretary of the Treasury or the Secretary's delegate shall not require payment of user fees under the program established under section 10511 of the Revenue Act of 1987 for requests to the Internal Revenue Service for determination letters with respect to the qualified status of a pension benefit plan maintained solely by one or more eligible employers or any trust which is part of the plan. The preceding sentence shall not apply to any request—
(1) made after the later of—
(A) the fifth plan year the pension benefit plan is in existence; or
(B) the end of any remedial amendment period with respect to the plan beginning within the first 5 plan years; or
(2) made by the sponsor of any prototype or similar plan which the sponsor intends to market to participating employers.
(b) PENSION BENEFIT PLAN.—For purposes of this section, the term ''pension benefit plan'' means a pension, profit-sharing, stock bonus, annuity, or employee stock ownership plan.
(c) ELIGIBLE EMPLOYER.—For purposes of this section, the term ''eligible employer'' means an eligible employer (as defined in section 408(p)(2)(C)(i)(I) of the Internal Revenue Code of 1986) which has at least one employee who is not a highly compensated employee (as defined in section 414(q)) and is participating in the plan. The determination of whether an employer is an eligible employer under this section shall be made as of the date of the request described in subsection (a).
(d) DETERMINATION OF AVERAGE FEES CHARGED.—For purposes of any determination of average fees charged, any request to which subsection (a) applies shall not be taken into account.
(e) EFFECTIVE DATE.—The provisions of this section shall apply with respect to requests made after December 31, 2001.

Sec. 621. Treatment Of Nonresident Aliens Engaged In International Transportation Services.

(a) EXCLUSION FROM INCOME SOURCING RULES.—The second sentence of section 861(a)(3) (relating to gross income from sources within the United States) is amended by striking ''except for purposes of sections 79 and 105 and subchapter D,''.
(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to remuneration for services performed in plan years beginning after December 31, 2001.

Subtitle C—Enhancing Fairness for Women

Sec. 631. Catch-Up Contributions For Individuals Age 50 Or Over.

(a) IN GENERAL.—Section 414 (relating to definitions and special rules) is amended by adding at the end the following new subsection:
'' (v) CATCH-UP CONTRIBUTIONS FOR INDIVIDUALS AGE 50 OR OVER.—
'' (1) IN GENERAL.—An applicable employer plan shall not be treated as failing to meet any requirement of this title solely because the plan permits an eligible participant to make additional elective deferrals in any plan year.
'' (2) LIMITATION ON AMOUNT OF ADDITIONAL DEFERRALS.—
'' (A) IN GENERAL.—A plan shall not permit additional elective deferrals under paragraph (1) for any year in an amount greater than the lesser of—
'' (i) the applicable dollar amount, or
'' (ii) the excess (if any) of— ''(I) the participant's compensation (as defined in section 415(c)(3)) for the year, over ''(II) any other elective deferrals of the participant for such year which are made without regard to this subsection.
'' (B) APPLICABLE DOLLAR AMOUNT.—For purposes of this paragraph—
'' (i) In the case of an applicable employer plan other than a plan described in section 401(k)(11) or 408(p), the applicable dollar amount shall be determined in accordance with the following table:
'' For taxable years beginning in: The applicable dollar amount is:
2002 .... $1,000
2003 .... $2,000
2004 .... $3,000
2005 .... $4,000
2006 and thereafter .... $5,000.
'' (ii) In the case of an applicable employer plan described in section 401(k)(11) or 408(p), the applicable dollar amount shall be determined in accordance with the following table:
'' For taxable years beginning in: The applicable dollar amount is:
2002 .... $500
2003 .... $1,000

2004 .... $1,500
2005 .... $2,000
2006 and thereafter .... $2,500.
‘‘ (C) COST-OF-LIVING ADJUSTMENT.—In the case of a year beginning after December 31, 2006, the Secretary shall adjust annually the $5,000 amount in subparagraph (B)(i) and the $2,500 amount in subparagraph (B)(ii) for increases in the cost-of-living at the same time and in the same manner as adjustments under section 415(d); except that the base period taken into account shall be the calendar quarter beginning July 1, 2005, and any increase under this subparagraph which is not a multiple of $500 shall be rounded to the next lower multiple of $500.’’.
‘‘ (3) TREATMENT OF CONTRIBUTIONS.—In the case of any contribution to a plan under paragraph (1)—
‘‘ (A) such contribution shall not, with respect to the year in which the contribution is made—
‘‘ (i) be subject to any otherwise applicable limitation contained in section 402(g), 402(h), 403(b), 404(a), 404(h), 408(k), 408(p), 415, or 457, or ‘‘(ii) be taken into account in applying such limitations to other contributions or benefits under such plan or any other such plan, and
‘‘ (B) except as provided in paragraph (4), such plan shall not be treated as failing to meet the requirements of section 401(a)(4), 401(a)(26), 401(k)(3), 401(k)(11), 401(k)(12), 403(b)(12), 408(k), 408(p), 408B, 410(b), or 416 by reason of the making of (or the right to make) such contribution.
‘‘ (4) APPLICATION OF NONDISCRIMINATION RULES.—
‘‘ (A) IN GENERAL.—An applicable employer plan shall be treated as failing to meet the nondiscrimination requirements under section 401(a)(4) with respect to benefits, rights, and features unless the plan allows all eligible participants to make the same election with respect to the additional elective deferrals under this subsection.
‘‘ (B) AGGREGATION.—For purposes of subparagraph (A), all plans maintained by employers who are treated as a single employer under subsection (b), (c), (m), or (o) of section 414 shall be treated as 1 plan.
‘‘ (5) ELIGIBLE PARTICIPANT.—For purposes of this subsection, the term ‘eligible participant’ means, with respect to any plan year, a participant in a plan—
‘‘ (A) who has attained the age of 50 before the close of the plan year, and
‘‘ (B) with respect to whom no other elective deferrals may (without regard to this subsection) be made to the plan for the plan year by reason of the application of any limitation or other restriction described in paragraph (3) or comparable limitation or restriction contained in the terms of the plan.
‘‘ (6) OTHER DEFINITIONS AND RULES.—For purposes of this subsection—
‘‘ (A) APPLICABLE EMPLOYER PLAN.—The term ‘applicable employer plan’ means—
‘‘ (i) an employees’ trust described in section 401(a) which is exempt from tax under section 501(a),
‘‘ (ii) a plan under which amounts are contributed by an individual’s employer for an annuity contract described in section 403(b), ‘‘(iii) an eligible deferred compensation plan under section 457 of an eligible employer described in section 457(e)(1)(A), and ‘‘(iv) an arrangement meeting the requirements of section 408 (k) or (p).
‘‘ (B) ELECTIVE DEFERRAL.—The term ‘elective deferral’ has the meaning given such term by subsection (u)(2)(C).
‘‘ (C) EXCEPTION FOR SECTION 457 PLANS.—This subsection shall not apply to an applicable employer plan described in subparagraph (A)(iii) for any year to which section 457(b)(3) applies.’’.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply to contributions in taxable years beginning after December 31, 2001.

Sec. 632. Equitable Treatment For Contributions Of Employees To Defined Contribution Plans.
(a) EQUITABLE TREATMENT.—
(1) IN GENERAL.—Subparagraph (B) of section 415(c)(1) (relating to limitation for defined contribution plans) is amended by striking ‘‘25 percent’’ and inserting ‘‘100 percent’’.
(2) APPLICATION TO SECTION 403(b).—Section 403(b) is amended—
(A) by striking ‘‘the exclusion allowance for such taxable year’’ in paragraph (1) and inserting ‘‘the applicable limit under section 415’’,
(B) by striking paragraph (2), and
(C) by inserting ‘‘or any amount received by a former employee after the fifth taxable year following the taxable year in which such employee was terminated’’ before the period at the end of the second sentence of paragraph (3).
(3) CONFORMING AMENDMENTS.—
(A) Subsection (f) of section 72 is amended by striking ‘‘section 403(b)(2)(D)(iii))’’ and inserting ‘‘section 403(b)(2)(D)(iii), as in effect before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001’’.
(B) Section 404(a)(10)(B) is amended by striking ‘‘, the exclusion allowance under section 403(b)(2),’’.
(C) Section 415(a)(2) is amended by striking ‘‘, and the amount of the contribution for such portion shall reduce the exclusion allowance as provided in section 403(b)(2)’’.
(D) Section 415(c)(3) is amended by adding at the end the following new subparagraph:‘‘ (E) ANNUITY

CONTRACTS.—In the case of an annuity contract described in section 403(b), the term ‘participant's compensation’ means the participant's includible compensation determined under section 403(b)(3).’’.
(E) Section 415(c) is amended by striking paragraph (4).
(F) Section 415(c)(7) is amended to read as follows: ‘‘(7) CERTAIN CONTRIBUTIONS BY CHURCH PLANS NOT TREATED AS EXCEEDING LIMIT.—
‘‘ (A) IN GENERAL.—Notwithstanding any other provision of this subsection, at the election of a participant who is an employee of a church or a convention or association of churches, including an organization described in section 414(e)(3)(B)(ii), contributions and other additions for an annuity contract or retirement income account described in section 403(b) with respect to such participant, when expressed as an annual addition to such participant's account, shall be treated as not exceeding the limitation of paragraph (1) if such annual addition is not in excess of $10,000.
‘‘ (B) $40,000 AGGREGATE LIMITATION.—The total amount of additions with respect to any participant which may be taken into account for purposes of this subparagraph for all years may not exceed $40,000.
‘‘ (C) ANNUAL ADDITION.—For purposes of this paragraph, the term ‘annual addition’ has the meaning given such term by paragraph (2).’’.
(G) Subparagraph (B) of section 402(g)(7) (as redesignated by section 611(c)(3)) is amended by inserting before the period at the end the following: ‘‘(as in effect before the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001’’.
(H) Section 664(g) is amended—
(i) in paragraph (3)(E) by striking ‘‘limitations under section 415(c)’’ and inserting ‘‘applicable limitation under paragraph (7)’’, and
(ii) by adding at the end the following new paragraph:
‘‘ (7) APPLICABLE LIMITATION.—
‘‘ (A) IN GENERAL.—For purposes of paragraph (3)(E), the applicable limitation under this paragraph with respect to a participant is an amount equal to the lesser of—‘‘(i) $30,000, or ‘‘(ii) 25 percent of the participant's compensation (as defined in section 415(c)(3)).
‘‘ (B) COST-OF-LIVING ADJUSTMENT.—The Secretary shall adjust annually the $30,000 amount under subparagraph (A)(i) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter beginning October 1, 1993, and any increase under this subparagraph which is not a multiple of $5,000 shall be rounded to the next lowest multiple of $5,000.’’.
(4) EFFECTIVE DATE.—The amendments made by this subsection shall apply to years beginning after December 31, 2001.
(b) SPECIAL RULES FOR SECTIONS 403(b) AND 408.—
(1) IN GENERAL.—Subsection (k) of section 415 is amended by adding at the end the following new paragraph:
‘‘ (4) SPECIAL RULES FOR SECTIONS 403(b) AND 408.—For purposes of this section, any annuity contract described in section 403(b) for the benefit of a participant shall be treated as a defined contribution plan maintained by each employer with respect to which the participant has the control required under subsection (b) or (c) of section 414 (as modified by subsection (h)). For purposes of this section, any contribution by an employer to a simplified employee pension plan for an individual for a taxable year shall be treated as an employer contribution to a defined contribution plan for such individual for such year.’’.
(2) EFFECTIVE DATE.—
(A) IN GENERAL.—The amendment made by paragraph (1) shall apply to limitation years beginning after December 31, 1999.
(B) EXCLUSION ALLOWANCE.—Effective for limitation years beginning in 2000, in the case of any annuity contract described in section 403(b) of the Internal Revenue Code of 1986, the amount of the contribution disqualified by reason of section 415(g) of such Code shall reduce the exclusion allowance as provided in section 403(b)(2) of such Code.
(3) ELECTION TO MODIFY SECTION 403(b) EXCLUSION ALLOWANCE TO CONFORM TO SECTION 415 MODIFICATION.—In the case of taxable years beginning after December 31, 1999, and before January 1, 2002, a plan may disregard the requirement in the regulations regarding the exclusion allowance under section 403(b)(2) of the Internal Revenue Code of 1986 that contributions to a defined benefit pension plan be treated as previously excluded amounts for purposes of the exclusion allowance.
(c) DEFERRED COMPENSATION PLANS OF STATE AND LOCAL GOVERNMENTS AND TAX-EXEMPT ORGANIZATIONS.—
(1) IN GENERAL.—Subparagraph (B) of section 457(b)(2) (relating to salary limitation on eligible deferred compensation plans) is amended by striking ‘‘331/3 percent’’ and inserting ‘‘100 percent’’.
(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to years beginning after December 31, 2001.

Sec. 633. Faster Vesting Of Certain Employer Matching Contributions.

(a) IN GENERAL.—Section 411(a) (relating to minimum vesting standards) is amended—

(1) in paragraph (2), by striking ''A plan'' and inserting ''Except as provided in paragraph (12), a plan''; and
(2) by adding at the end the following: ''(12) FASTER VESTING FOR MATCHING CONTRIBUTIONS.—In the case of matching contributions (as defined in section 401(m)(4)(A)), paragraph (2) shall be applied—'' (A) by substituting '3 years' for '5 years' in subparagraph (A), and ''(B) by substituting the following table for the table contained in subparagraph (B):

The nonforfeitable ''Years of service:	percentage is:
2	20
3	40
4	60
5	80
6	100.''.

(b) AMENDMENT OF ERISA.—Section 203(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(a)) is amended—
(1) in paragraph (2), by striking ''A plan'' and inserting ''Except as provided in paragraph (4), a plan'', and
(2) by adding at the end the following:
'' (4) In the case of matching contributions (as defined in section 401(m)(4)(A) of the Internal Revenue Code of 1986), paragraph (2) shall be applied—
'' (A) by substituting '3 years' for '5 years' in subparagraph (A), and ''(B) by substituting the following table for the table contained in subparagraph (B):

The nonforfeitable''Years of service:	percentage is:
2	20
3	40
4	60
5	80
6	100.''.

(c) EFFECTIVE DATES.—
(1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to contributions for plan years beginning after December 31, 2001.
(2) COLLECTIVE BARGAINING AGREEMENTS.—In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified by the date of the enactment of this Act, the amendments made by this section shall not apply to contributions on behalf of employees covered by any such agreement for plan years beginning before the earlier of—
(A) the later of—
(i) the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after such date of the enactment); or (ii) January 1, 2002; or
(B) January 1, 2006.
(3) SERVICE REQUIRED.—With respect to any plan, the amendments made by this section shall not apply to any employee before the date that such employee has 1 hour of service under such plan in any plan year to which the amendments made by this section apply.

Sec. 634. Modification To Minimum Distribution Rules.

The Secretary of the Treasury shall modify the life expectancy tables under the regulations relating to minimum distribution requirements under sections 401(a)(9), 408(a)(6) and (b)(3), 403(b)(10), and 457(d)(2) of the Internal Revenue Code to reflect current life expectancy.

Sec. 635. Clarification Of Tax Treatment Of Division Of Section 457 Plan Benefits Upon Divorce.

(a) IN GENERAL.—Section 414(p)(11) (relating to application of rules to governmental and church plans) is amended—
(1) by inserting ''or an eligible deferred compensation plan (within the meaning of section 457(b))'' after ''subsection (e))''; and
(2) in the heading, by striking ''GOVERNMENTAL AND CHURCH PLANS'' and inserting ''CERTAIN OTHER PLANS''.
(b) WAIVER OF CERTAIN DISTRIBUTION REQUIREMENTS.—Paragraph (10) of section 414(p) is amended by striking ''and section 409(d)'' and inserting ''section 409(d), and section 457(d)''.
(c) TAX TREATMENT OF PAYMENTS FROM A SECTION 457 PLAN.— Subsection (p) of section 414 is amended by redesignating paragraph (12) as paragraph (13) and inserting after paragraph (11) the following new paragraph:
'' (12) TAX TREATMENT OF PAYMENTS FROM A SECTION 457 PLAN.—If a distribution or payment from an eligible deferred compensation plan described in section 457(b) is made pursuant to a qualified domestic relations order, rules similar to the rules of section 402(e)(1)(A) shall apply to such distribution or payment.''.
(d) EFFECTIVE DATE.—The amendment made by this section shall apply to transfers, distributions, and payments made after December 31, 2001.

Sec. 636. Provisions Relating To Hardship Distributions.
(a) SAFE HARBOR RELIEF.—
(1) IN GENERAL.—The Secretary of the Treasury shall revise the regulations relating to hardship distributions under section 401(k)(2)(B)(i)(IV) of the Internal Revenue Code of 1986 to provide that the period an employee is prohibited from making elective and employee contributions in order for a distribution to be deemed necessary to satisfy financial need shall be equal to 6 months.
(2) EFFECTIVE DATE.—The revised regulations under this subsection shall apply to years beginning after December 31, 2001.
(b) HARDSHIP DISTRIBUTIONS NOT TREATED AS ELIGIBLE ROLLOVER DISTRIBUTIONS.—
(1) MODIFICATION OF DEFINITION OF ELIGIBLE ROLLOVER.—
Subparagraph (C) of section 402(c)(4) (relating to eligible rollover distribution) is amended to read as follows:''
(C) any distribution which is made upon hardship of the employee.''.
(2) EFFECTIVE DATE.—The amendment made by this subsection shall apply to distributions made after December 31, 2001.

Sec. 637. Waiver Of Tax On Nondeductible Contributions For Domestic Or Similar Workers.
(a) IN GENERAL.—Section 4972(c)(6) (relating to exceptions to nondeductible contributions), as amended by section 616, is amended by striking ''and'' at the end of subparagraph (A), by striking the period and inserting '', or'' at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph: ''(C) so much of the contributions to a simple retirement account (within the meaning of section 408(p)) or a simple plan (within the meaning of section 401(k)(11)) which are not deductible when contributed solely because such contributions are not made in connection with a trade or business of the employer.''.
(b) EXCLUSION OF CERTAIN CONTRIBUTIONS.—Section 4972(c)(6), as amended by subsection (a), is amended by adding at the end the following new sentence: ''Subparagraph (C) shall not apply to contributions made on behalf of the employer or a member of the employer's family (as defined in section 447(e)(1)).''.
(c) NO INFERENCE.—Nothing in the amendments made by this section shall be construed to infer the proper treatment of nondeductible contributions under the laws in effect before such amendments.
(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2001.

Subtitle D—Increasing Portability for Participants

Sec. 641. Rollovers Allowed Among Various Types Of Plans.
(a) ROLLOVERS FROM AND TO SECTION 457 PLANS.—
(1) ROLLOVERS FROM SECTION 457 PLANS.—
(A) IN GENERAL.—Section 457(e) (relating to other definitions and special rules) is amended by adding at the end the following:
'' (16) ROLLOVER AMOUNTS.—
'' (A) GENERAL RULE.—In the case of an eligible deferred compensation plan established and maintained by an employer described in subsection (e)(1)(A), if— ''(i) any portion of the balance to the credit of an employee in such plan is paid to such employee in an eligible rollover distribution (within the meaning of section 402(c)(4)), ''(ii) the employee transfers any portion of the property such employee receives in such distribution to an eligible retirement plan described in section 402(c)(8)(B), and ''(iii) in the case of a distribution of property other than money, the amount so transferred consists of the property distributed,
then such distribution (to the extent so transferred) shall not be includible in gross income for the taxable year in which paid.
'' (B) CERTAIN RULES MADE APPLICABLE.—The rules of paragraphs (2) through (7) and (9) of section 402(c) and section 402(f) shall apply for purposes of subparagraph (A).
'' (C) REPORTING.—Rollovers under this paragraph shall be reported to the Secretary in the same manner as rollovers from qualified retirement plans (as defined in section 4974(c)).''.
(B) DEFERRAL LIMIT DETERMINED WITHOUT REGARD TO ROLLOVER AMOUNTS.—Section 457(b)(2) (defining eligible deferred compensation plan) is amended by inserting ''(other than rollover amounts)'' after ''taxable year''.
(C) DIRECT ROLLOVER.—Paragraph (1) of section 457(d) is amended by striking ''and'' at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting '', and'', and by inserting after subparagraph (B) the following: ''(C) in the case of a plan maintained by an employer described in subsection (e)(1)(A), the plan meets requirements similar to the requirements of section 401(a)(31). Any amount transferred in a direct trustee-to-trustee transfer in accordance with section 401(a)(31) shall not be includible in gross income for the taxable year of transfer.''.
(D) WITHHOLDING.—
(i) Paragraph (12) of section 3401(a) is amended by adding at the end the following:'' (E) under or to an eligible deferred compensation plan which, at the time of such payment, is a plan described in section 457(b)

which is maintained by an eligible employer described in section 457(e)(1)(A), or''.
(ii) Paragraph (3) of section 3405(c) is amended to read as follows: ''(3) ELIGIBLE ROLLOVER DISTRIBUTION.—For purposes of this subsection, the term 'eligible rollover distribution' has the meaning given such term by section 402(f)(2)(A).''.
(iii) LIABILITY FOR WITHHOLDING.—Subparagraph (B) of section 3405(d)(2) is amended by striking ''or'' at the end of clause (ii), by striking the period at the end of clause (iii) and inserting '', or'', and by adding at the end the following: ''(iv) section 457(b) and which is maintained by an eligible employer described in section 457(e)(1)(A).''.
(2) ROLLOVERS TO SECTION 457 PLANS.—
(A) IN GENERAL.—Section 402(c)(8)(B) (defining eligible retirement plan) is amended by striking ''and'' at the end of clause (iii), by striking the period at the end of clause (iv) and inserting '', and'', and by inserting after clause (iv) the following new clause: ''(v) an eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A).''.
(B) SEPARATE ACCOUNTING.—Section 402(c) is amended by adding at the end the following new paragraph:'' (10) SEPARATE ACCOUNTING.—Unless a plan described in clause (v) of paragraph (8)(B) agrees to separately account for amounts rolled into such plan from eligible retirement plans not described in such clause, the plan described in such clause may not accept transfers or rollovers from such retirement plans.''.
(C) 10 PERCENT ADDITIONAL TAX.—Subsection (t) of section 72 (relating to 10-percent additional tax on early distributions from qualified retirement plans) is amended by adding at the end the following new paragraph:'' (9) SPECIAL RULE FOR ROLLOVERS TO SECTION 457 PLANS.—
For purposes of this subsection, a distribution from an eligible deferred compensation plan (as defined in section 457(b)) of an eligible employer described in section 457(e)(1)(A) shall be treated as a distribution from a qualified retirement plan described in 4974(c)(1) to the extent that such distribution is attributable to an amount transferred to an eligible deferred compensation plan from a qualified retirement plan (as defined in section 4974(c)).''.
(b) ALLOWANCE OF ROLLOVERS FROM AND TO 403(b) PLANS.—
(1) ROLLOVERS FROM SECTION 403(b) PLANS.—Section 403(b)(8)(A)(ii) (relating to rollover amounts) is amended by striking ''such distribution'' and all that follows and inserting ''such distribution to an eligible retirement plan described in section 402(c)(8)(B), and''.
(2) ROLLOVERS TO SECTION 403(b) PLANS.—Section 402(c)(8)(B) (defining eligible retirement plan), as amended by subsection (a), is amended by striking ''and'' at the end of clause (iv), by striking the period at the end of clause (v) and inserting '', and'', and by inserting after clause (v) the following new clause:'' (vi) an annuity contract described in section 403(b).''.
(c) EXPANDED EXPLANATION TO RECIPIENTS OF ROLLOVER DISTRIBUTIONS.—
Paragraph (1) of section 402(f) (relating to written explanation to recipients of distributions eligible for rollover treatment) is amended by striking ''and'' at the end of subparagraph (C), by striking the period at the end of subparagraph (D) and inserting '', and'', and by adding at the end the following new subparagraph:
'' (E) of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making such distribution.''.
(d) SPOUSAL ROLLOVERS.—Section 402(c)(9) (relating to rollover where spouse receives distribution after death of employee) is amended by striking ''; except that'' and all that follows up to the end period.
(e) CONFORMING AMENDMENTS.—
(1) Section 72(o)(4) is amended by striking ''and 408(d)(3)'' and inserting ''403(b)(8), 408(d)(3), and 457(e)(16)''.
(2) Section 219(d)(2) is amended by striking ''or 408(d)(3)'' and inserting ''408(d)(3), or 457(e)(16)''.
(3) Section 401(a)(31)(B) is amended by striking ''and 403(a)(4)'' and inserting '', 403(a)(4), 403(b)(8), and 457(e)(16)''.
(4) Subparagraph (A) of section 402(f)(2) is amended by striking ''or paragraph (4) of section 403(a)'' and inserting '', paragraph (4) of section 403(a), subparagraph (A) of section 403(b)(8), or subparagraph (A) of section 457(e)(16)''.
(5) Paragraph (1) of section 402(f) is amended by striking ''from an eligible retirement plan''.
(6) Subparagraphs (A) and (B) of section 402(f)(1) are amended by striking ''another eligible retirement plan'' and inserting ''an eligible retirement plan''.
(7) Subparagraph (B) of section 403(b)(8) is amended to read as follows:'' (B) CERTAIN RULES MADE APPLICABLE.—The rules of paragraphs (2) through (7) and (9) of section 402(c) and section 402(f) shall apply for purposes of subparagraph (A), except that section 402(f) shall be applied to the payor in lieu of the plan administrator.''.
(8) Section 408(a)(1) is amended by striking ''or 403(b)(8),'' and inserting ''403(b)(8), or 457(e)(16)''.
(9) Subparagraphs (A) and (B) of section 415(b)(2) are each amended by striking ''and 408(d)(3)'' and inserting ''403(b)(8), 408(d)(3), and 457(e)(16)''.

(10) Section 415(c)(2) is amended by striking ''and 408(d)(3)'' and inserting ''408(d)(3), and 457(e)(16)''.
(11) Section 4973(b)(1)(A) is amended by striking ''or 408(d)(3)'' and inserting ''408(d)(3), or 457(e)(16)''.
(f) EFFECTIVE DATE; SPECIAL RULE.—
(1) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 2001.
(2) REASONABLE NOTICE.—No penalty shall be imposed on a plan for the failure to provide the information required by the amendment made by subsection (c) with respect to any distribution made before the date that is 90 days after the date on which the Secretary of the Treasury issues a safe harbor rollover notice after the date of the enactment of this Act, if the administrator of such plan makes a reasonable attempt to comply with such requirement.
(3) SPECIAL RULE.—Notwithstanding any other provision of law, subsections (h)(3) and (h)(5) of section 1122 of the Tax Reform Act of 1986 shall not apply to any distribution from an eligible retirement plan (as defined in clause (iii) or (iv) of section 402(c)(8)(B) of the Internal Revenue Code of 1986) on behalf of an individual if there was a rollover to such plan on behalf of such individual which is permitted solely by reason of any amendment made by this section.

Sec. 642. Rollovers Of IRAs Into Workplace Retirement Plans.

(a) IN GENERAL.—Subparagraph (A) of section 408(d)(3) (relating to rollover amounts) is amended by adding ''or'' at the end of clause (i), by striking clauses (ii) and (iii), and by adding at the end the following:'' (ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to this paragraph).For purposes of clause (ii), the term 'eligible retirement plan' means an eligible retirement plan described in clause (iii), (iv), (v), or (vi) of section 402(c)(8)(B).''.
(b) CONFORMING AMENDMENTS.—
(1) Paragraph (1) of section 403(b) is amended by striking ''section 408(d)(3)(A)(iii)'' and inserting ''section 408(d)(3)(A)(ii)''.
(2) Clause (i) of section 408(d)(3)(D) is amended by striking ''(i), (ii), or (iii)'' and inserting ''(i) or (ii)''.
(3) Subparagraph (G) of section 408(d)(3) is amended to read as follows:'' (G) SIMPLE RETIREMENT ACCOUNTS.—In the case of any payment or distribution out of a simple retirement account (as defined in subsection (p)) to which section 72(t)(6) applies, this paragraph shall not apply unless such payment or distribution is paid into another simple retirement account.''.
(c) EFFECTIVE DATE; SPECIAL RULE.—
(1) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 2001.
(2) SPECIAL RULE.—Notwithstanding any other provision of law, subsections (h)(3) and (h)(5) of section 1122 of the Tax Reform Act of 1986 shall not apply to any distribution from an eligible retirement plan (as defined in clause (iii) or (iv) of section 402(c)(8)(B) of the Internal Revenue Code of 1986) on behalf of an individual if there was a rollover to such plan on behalf of such individual which is permitted solely by reason of the amendments made by this section.

Sec. 643. Rollovers Of After-Tax Contributions.

(a) ROLLOVERS FROM EXEMPT TRUSTS.—Paragraph (2) of section 402(c) (relating to maximum amount which may be rolled over) is amended by adding at the end the following: ''The preceding sentence shall not apply to such distribution to the extent—'' (A) such portion is transferred in a direct trustee-to-trustee transfer to a qualified trust which is part of a plan which is a defined contribution plan and which agrees to separately account for amounts so transferred, including separately accounting for the portion of such distribution which is includible in gross income and the portion of such distribution which is not so includible, or'' (B) such portion is transferred to an eligible retirement plan described in clause (i) or (ii) of paragraph (8)(B).''.
(b) OPTIONAL DIRECT TRANSFER OF ELIGIBLE ROLLOVER DISTRIBUTIONS.—
Subparagraph (B) of section 401(a)(31) (relating to limitation) is amended by adding at the end the following: ''The preceding sentence shall not apply to such distribution if the plan to which such distribution is transferred — ''(i) agrees to separately account for amounts so transferred, including separately accounting for the portion of such distribution which is includible in gross income and the portion of such distribution which is not so includible, or ''(ii) is an eligible retirement plan described in clause (i) or (ii) of section 402(c)(8)(B).''.
(c) RULES FOR APPLYING SECTION 72 TO IRAS.—Paragraph (3) of section 408(d) (relating to special rules for applying section 72) is amended by inserting at the end the following:
'' (H) APPLICATION OF SECTION 72.—
'' (i) IN GENERAL.—If—''(I) a distribution is made from an individual retirement plan, and ''(II) a rollover contribution is made to an eligible retirement plan described in section 402(c)(8)(B)(iii), (iv), (v), or (vi) with respect to all or part of such distribution, then, notwithstanding paragraph (2), the rules of clause (ii) shall apply

for purposes of applying section 72.
'' (ii) APPLICABLE RULES.—In the case of a distribution described in clause (i)—''(I) section 72 shall be applied separately to such distribution, ''(II) notwithstanding the pro rata allocation of income on, and investment in, the contract to distributions under section 72, the portion of such distribution rolled over to an eligible retirement plan described in clause (i) shall be treated as from income on the contract (to the extent of the aggregate income on the contract from all individual retirement plans of the distributee), and
'' (III) appropriate adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent taxable years.''.
(d) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after December 31, 2001.

Sec. 644. Hardship Exception To 60-Day Rule.

(a) EXEMPT TRUSTS.—Paragraph (3) of section 402(c) (relating to transfer must be made within 60 days of receipt) is amended to read as follows:
'' (3) TRANSFER MUST BE MADE WITHIN 60 DAYS OF RECEIPT.—
'' (A) IN GENERAL.—Except as provided in subparagraph (B), paragraph (1) shall not apply to any transfer of a distribution made after the 60th day following the day on which the distributee received the property distributed.
'' (B) HARDSHIP EXCEPTION.—The Secretary may waive the 60-day requirement under subparagraph (A) where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.''.
(b) IRAS.—Paragraph (3) of section 408(d) (relating to rollover contributions), as amended by section 643, is amended by adding after subparagraph (H) the following new subparagraph:
'' (I) WAIVER OF 60-DAY REQUIREMENT.—The Secretary may waive the 60-day requirement under subparagraphs (A) and (D) where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 2001.

Sec. 645. Treatment Of Forms Of Distribution.

(a) PLAN TRANSFERS.—
(1) AMENDMENT OF INTERNAL REVENUE CODE.—Paragraph (6) of section 411(d) (relating to accrued benefit not to be decreased by amendment) is amended by adding at the end the following:
'' (D) PLAN TRANSFERS.—
'' (i) IN GENERAL.—A defined contribution plan (in this subparagraph referred to as the 'transferee plan') shall not be treated as failing to meet the requirements of this subsection merely because the transferee plan does not provide some or all of the forms of distribution previously available under another defined contribution plan (in this subparagraph referred to as the 'transferor plan') to the extent that—''(I) the forms of distribution previously available under the transferor plan applied to the account of a participant or beneficiary under the transferor plan that was transferred from the transferor plan to the transferee plan pursuant to a direct transfer rather than pursuant to a distribution from the transferor plan, ''(II) the terms of both the transferor plan and the transferee plan authorize the transfer described in subclause (I), ''(III) the transfer described in subclause (I) was made pursuant to a voluntary election by the participant or beneficiary whose account was transferred to the transferee plan, ''(IV) the election described in subclause (III) was made after the participant or beneficiary received a notice describing the consequences of making the election, and ''(V) the transferee plan allows the participant or beneficiary described in subclause (III) to receive any distribution to which the participant or beneficiary is entitled under the transferee plan in the form of a single sum distribution.
'' (ii) SPECIAL RULE FOR MERGERS, ETC.—Clause (i) shall apply to plan mergers and other transactions having the effect of a direct transfer, including consolidations of benefits attributable to different employers within a multiple employer plan.
'' (E) ELIMINATION OF FORM OF DISTRIBUTION.—Except to the extent provided in regulations, a defined contribution plan shall not be treated as failing to meet the requirements of this section merely because of the elimination of a form of distribution previously available thereunder. This subparagraph shall not apply to the elimination of a form of distribution with respect to any participant unless—'' (i) a single sum payment is available to such participant at the same time or times as the form of distribution being eliminated, and ''(ii) such single sum payment is based on the same or greater portion of the participant's account as the form of distribution being eliminated.''.
(2) AMENDMENT OF ERISA.—Section 204(g) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1054(g)) is amended by adding at the end the following: ''(4)(A) A defined contribution plan (in this subparagraph referred to as the 'transferee plan') shall not be treated as failing to meet the requirements of this subsection merely because the transferee plan does not provide some or all of the forms of distribution

previously available under another defined contribution plan (in this subparagraph referred to as the 'transferor plan') to the extent that—
'' (i) the forms of distribution previously available under the transferor plan applied to the account of a participant or beneficiary under the transferor plan that was transferred from the transferor plan to the transferee plan pursuant to a direct transfer rather than pursuant to a distribution from the transferor plan;
'' (ii) the terms of both the transferor plan and the transferee plan authorize the transfer described in clause (i);
'' (iii) the transfer described in clause (i) was made pursuant to a voluntary election by the participant or beneficiary whose account was transferred to the transferee plan;
'' (iv) the election described in clause (iii) was made after the participant or beneficiary received a notice describing the consequences of making the election; and
'' (v) the transferee plan allows the participant or beneficiary described in clause (iii) to receive any distribution to which the participant or beneficiary is entitled under the transferee plan in the form of a single sum distribution.
'' (B) Subparagraph (A) shall apply to plan mergers and other transactions having the effect of a direct transfer, including consolidations of benefits attributable to different employers within a multiple employer plan. ''(5) Except to the extent provided in regulations promulgated by the Secretary of the Treasury, a defined contribution plan shall not be treated as failing to meet the requirements of this subsection merely because of the elimination of a form of distribution previously available thereunder. This paragraph shall not apply to the elimination of a form of distribution with respect to any participant unless—'' (A) a single sum payment is available to such participant at the same time or times as the form of distribution being eliminated; and ''(B) such single sum payment is based on the same or greater portion of the participant's account as the form of distribution being eliminated.''.
(3) EFFECTIVE DATE.—The amendments made by this subsection shall apply to years beginning after December 31, 2001.
(b) REGULATIONS.—
(1) AMENDMENT OF INTERNAL REVENUE CODE.—Paragraph (6)(B) of section 411(d) (relating to accrued benefit not to be decreased by amendment) is amended by inserting after the second sentence the following: ''The Secretary shall by regulations provide that this subparagraph shall not apply to any
plan amendment which reduces or eliminates benefits or subsidies which create significant burdens or complexities for the plan and plan participants, unless such amendment adversely affects the rights of any participant in a more than de minimis manner.''.
(2) AMENDMENT OF ERISA.—Section 204(g)(2) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1054(g)(2)) is amended by inserting after the second sentence the following: ''The Secretary of the Treasury shall by regulations provide that this paragraph shall not apply to any plan amendment which reduces or eliminates benefits or subsidies which create significant burdens or complexities for the plan and plan participants, unless such amendment adversely affects the rights of any participant in a more than de minimis manner.''.
(3) SECRETARY DIRECTED.—Not later than December 31, 2003, the Secretary of the Treasury is directed to issue regulations under section 411(d)(6) of the Internal Revenue Code of 1986 and section 204(g) of the Employee Retirement Income Security Act of 1974, including the regulations required by the amendment made by this subsection. Such regulations shall apply to plan years beginning after December 31, 2003, or such earlier date as is specified by the Secretary of the Treasury.

Sec. 646. Rationalization Of Restrictions On Distributions.

(a) MODIFICATION OF SAME DESK EXCEPTION.—
(1) SECTION 401(k).—
(A) Section 401(k)(2)(B)(i)(I) (relating to qualified cash or deferred arrangements) is amended by striking ''separation from service'' and inserting ''severance from employment''.
(B) Subparagraph (A) of section 401(k)(10) (relating to distributions upon termination of plan or disposition of assets or subsidiary) is amended to read as follows: ''(A) IN GENERAL.—An event described in this subparagraph is the termination of the plan without establishment or maintenance of another defined contribution plan (other than an employee stock ownership plan as defined in section 4975(e)(7)).''.
(C) Section 401(k)(10) is amended— (i) in subparagraph (B)— (I) by striking ''An event'' in clause (i) and inserting ''A termination''; and (II) by striking ''the event'' in clause (i) and inserting ''the termination''; (ii) by striking subparagraph (C); and (iii) by striking ''OR DISPOSITION OF ASSETS OR SUBSIDIARY'' in the heading.
(2) SECTION 403(b).—
(A) Paragraphs (7)(A)(ii) and (11)(A) of section 403(b) are each amended by striking ''separates from service'' and inserting ''has a severance from employment''.
(B) The heading for paragraph (11) of section 403(b) is amended by striking ''SEPARATION FROM SERVICE'' and inserting ''SEVERANCE FROM EMPLOYMENT''.
(3) SECTION 457.—Clause (ii) of section 457(d)(1)(A) is amended by striking ''is separated from service'' and

inserting ''has a severance from employment''.
(b) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 2001.

Sec. 647. Purchase Of Service Credit In Governmental Defined Benefit Plans.
(a) SECTION 403(b) PLANS.—Subsection (b) of section 403 is amended by adding at the end the following new paragraph: ''(13) TRUSTEE-TO-TRUSTEE TRANSFERS TO PURCHASE PERMISSIVE SERVICE CREDIT.—No amount shall be includible in gross income by reason of a direct trustee-to-trustee transfer to a defined benefit governmental plan (as defined in section 414(d)) if such transfer is— ''(A) for the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under such plan, or ''(B) a repayment to which section 415 does not apply by reason of subsection (k)(3) thereof.''.
(b) SECTION 457 PLANS.—Subsection (e) of section 457, as amended by section 641, is amended by adding after paragraph (16) the following new paragraph: ''(17) TRUSTEE-TO-TRUSTEE TRANSFERS TO PURCHASE PERMISSIVE SERVICE CREDIT.—No amount shall be includible in gross income by reason of a direct trustee-to-trustee transfer to a defined benefit governmental plan (as defined in section 414(d)) if such transfer is— ''(A) for the purchase of permissive service credit (as defined in section 415(n)(3)(A)) under such plan, or ''(B) a repayment to which section 415 does not apply by reason of subsection (k)(3) thereof.''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to trustee-to-trustee transfers after December 31, 2001.

Sec. 648. Employers May Disregard Rollovers For Purposes Of Cash-Out Amounts.
(a) QUALIFIED PLANS.—
(1) AMENDMENT OF INTERNAL REVENUE CODE.—Section 411(a)(11) (relating to restrictions on certain mandatory distributions) is amended by adding at the end the following: ''(D) SPECIAL RULE FOR ROLLOVER CONTRIBUTIONS.— A plan shall not fail to meet the requirements of this paragraph if, under the terms of the plan, the present value of the nonforfeitable accrued benefit is determined without regard to that portion of such benefit which is attributable to rollover contributions (and earnings allocable thereto). For purposes of this subparagraph, the term 'rollover contributions' means any rollover contribution under sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3)(A)(ii), and 457(e)(16).''.
(2) AMENDMENT OF ERISA.—Section 203(e) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(c)) is amended by adding at the end the following: ''(4) A plan shall not fail to meet the requirements of this subsection if, under the terms of the plan, the present value of the nonforfeitable accrued benefit is determined without regard to that portion of such benefit which is attributable to rollover contributions (and earnings allocable thereto). For purposes of this subparagraph, the term 'rollover contributions' means any rollover contribution under sections 402(c), 403(a)(4), 403(b)(8), 408(d)(3)(A)(ii), and 457(e)(16) of the Internal Revenue Code of 1986.''.
(b) ELIGIBLE DEFERRED COMPENSATION PLANS.—Clause (i) of section 457(e)(9)(A) is amended by striking ''such amount'' and inserting ''the portion of such amount which is not attributable to rollover contributions (as defined in section 411(a)(11)(D))''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions after December 31, 2001.

Sec. 649. Minimum Distribution And Inclusion Requirements For Section 457 Plans.
(a) MINIMUM DISTRIBUTION REQUIREMENTS.—Paragraph (2) of section 457(d) (relating to distribution requirements) is amended to read as follows:
'' (2) MINIMUM DISTRIBUTION REQUIREMENTS.—A plan meets the minimum distribution requirements of this paragraph if such plan meets the requirements of section 401(a)(9).''.
(b) INCLUSION IN GROSS INCOME.—
(1) YEAR OF INCLUSION.—Subsection (a) of section 457 (relating to year of inclusion in gross income) is amended to read as follows:
'' (a) YEAR OF INCLUSION IN GROSS INCOME.—
'' (1) IN GENERAL.—Any amount of compensation deferred under an eligible deferred compensation plan, and any income attributable to the amounts so deferred, shall be includible in gross income only for the taxable year in which such compensation or other income—
'' (A) is paid to the participant or other beneficiary, in the case of a plan of an eligible employer described in subsection (e)(1)(A), and ''(B) is paid or otherwise made available to the participant or other beneficiary, in the case of a plan of an eligible employer described in subsection (e)(1)(B).
'' (2) SPECIAL RULE FOR ROLLOVER AMOUNTS.—To the extent provided in section 72(t)(9), section 72(t) shall apply to any amount includible in gross income under this subsection.''.
(2) CONFORMING AMENDMENTS.—
(A) So much of paragraph (9) of section 457(e) as precedes subparagraph (A) is amended to read as follows:
''(9) BENEFITS OF TAX EXEMPT ORGANIZATION PLANS NOT TREATED AS MADE AVAILABLE BY

REASON OF CERTAIN ELECTIONS, ETC.—In the case of an eligible deferred compensation plan of an employer described in subsection (e)(1)(B)—''.
(B) Section 457(d) is amended by adding at the end the following new paragraph:
'' (3) SPECIAL RULE FOR GOVERNMENT PLAN.—An eligible deferred compensation plan of an employer described in subsection (e)(1)(A) shall not be treated as failing to meet the requirements of this subsection solely by reason of making a distribution described in subsection (e)(9)(A).''.
(c) EFFECTIVE DATE.—The amendments made by subsections (a) and (b) shall apply to distributions after December 31, 2001.

Subtitle E—Strengthening Pension Security and Enforcement

Part I—General Provisions

Sec. 651. Repeal Of 160 Percent Of Current Liability Funding Limit.
(a) AMENDMENTS TO INTERNAL REVENUE CODE.—Section 412(c)(7) (relating to full-funding limitation) is amended—
(1) by striking ''the applicable percentage'' in subparagraph (A)(i)(I) and inserting ''in the case of plan years beginning before January 1, 2004, the applicable percentage''; and
(2) by amending subparagraph (F) to read as follows: ''(F) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A)(i)(I), the applicable percentage shall be determined in accordance with the following table:
'' In the case of any plan year ....The applicable
beginning in— ....percentage is—
2002 165
2003 .... 170.''.
(b) AMENDMENT OF ERISA.—Section 302(c)(7) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1082(c)(7)) is amended—
(1) by striking ''the applicable percentage'' in subparagraph (A)(i)(I) and inserting ''in the case of plan years beginning before January 1, 2004, the applicable percentage'', and (2) by amending subparagraph (F) to read as follows:
'' (F) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A)(i)(I), the applicable percentage shall be determined in accordance with the following table:
'' In the case of any plan year ....The applicable
beginning in calendar year— ....percentage is—
2002 165
2003 .... 170.''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after December 31, 2001.

Sec. 652. Maximum Contribution Deduction Rules Modified And Applied To All Defined Benefit Plans.
(a) IN GENERAL.—Subparagraph (D) of section 404(a)(1) (relating to special rule in case of certain plans) is amended to read as follows:
'' (D) SPECIAL RULE IN CASE OF CERTAIN PLANS.—
'' (i) IN GENERAL.—In the case of any defined benefit plan, except as provided in regulations, the maximum amount deductible under the limitations of this paragraph shall not be less than the unfunded current liability determined under section 412(l).
'' (ii) PLANS WITH 100 OR LESS PARTICIPANTS.—For purposes of this subparagraph, in the case of a plan which has 100 or less participants for the plan year, unfunded current liability shall not include the liability attributable to benefit increases for highly compensated employees (as defined in section 414(q)) resulting from a plan amendment which is made or becomes effective, whichever is later, within the last 2 years.
'' (iii) RULE FOR DETERMINING NUMBER OF PARTICIPANTS.—
For purposes of determining the number of plan participants, all defined benefit plans maintained by the same employer (or any member of such employer's controlled group (within the meaning of section 412(l)(8)(C))) shall be treated as one plan, but only employees of such member or employer shall be taken into account.
'' (iv) PLANS MAINTAINED BY PROFESSIONAL SERVICE EMPLOYERS.—In the case of a plan which, subject to section 4041 of the Employee Retirement Income Security Act of 1974, terminates during the plan year, clause (i) shall be applied by substituting for unfunded current liability the amount required to make the plan sufficient for benefit liabilities (within the meaning of section 4041(d) of such Act).''.
(b) CONFORMING AMENDMENT.—Paragraph (6) of section 4972(c), as amended by sections 616 and 637, is amended—
(1) by striking subparagraph (A) and redesignating subparagraphs (B) and (C) as subparagraphs (A) and (B), respectively,

(2) by striking the first sentence following subparagraph (B) (as so redesignated),
(3) by striking ‘‘subparagraph (B)’’ in the next to last sentence and inserting ‘‘subparagraph (A)’’, and
(4) by striking ‘‘Subparagraph (C)’’ in the last sentence and inserting ‘‘Subparagraph (B)’’.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after December 31, 2001.

Sec. 653. Excise Tax Relief For Sound Pension Funding.
(a) IN GENERAL.—Subsection (c) of section 4972 (relating to nondeductible contributions) is amended by adding at the end the following new paragraph:
‘‘ (7) DEFINED BENEFIT PLAN EXCEPTION.—In determining the amount of nondeductible contributions for any taxable year, an employer may elect for such year not to take into account any contributions to a defined benefit plan except to the extent that such contributions exceed the full-funding limitation (as defined in section 412(c)(7), determined without regard to subparagraph (A)(i)(I) thereof). For purposes of this paragraph, the deductible limits under section 404(a)(7) shall first be applied to amounts contributed to defined contribution plans and then to amounts described in this paragraph. If an employer makes an election under this paragraph for a taxable year, paragraph (6) shall not apply to such employer for such taxable year.’’.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply to years beginning after December 31, 2001.

Sec. 654. Treatment Of Multi-employer Plans Under Section 415.
(a) COMPENSATION LIMIT.—
(1) IN GENERAL.—Paragraph (11) of section 415(b) (relating to limitation for defined benefit plans) is amended to read as follows:
‘‘ (11) SPECIAL LIMITATION RULE FOR GOVERNMENTAL AND MULTIEMPLOYER PLANS.—In the case of a governmental plan (as defined in section 414(d)) or a multi-employer plan (as defined in section 414(f)), subparagraph (B) of paragraph (1) shall not apply.’’.
(2) CONFORMING AMENDMENT.—Section 415(b)(7) (relating to benefits under certain collectively bargained plans) is amended by inserting ‘‘(other than a multi-employer plan)’’ after ‘‘defined benefit plan’’ in the matter preceding subparagraph (A).
(b) COMBINING AND AGGREGATION OF PLANS.—
(1) COMBINING OF PLANS.—Subsection (f) of section 415 (relating to combining of plans) is amended by adding at the end the following:
‘‘ (3) EXCEPTION FOR MULTIEMPLOYER PLANS.—Notwithstanding paragraph (1) and subsection (g), a multi-employer plan (as defined in section 414(f)) shall not be combined or aggregated—
‘‘ (A) with any other plan which is not a multi-employer plan for purposes of applying subsection (b)(1)(B) to such other plan, or
‘‘ (B) with any other multi-employer plan for purposes of applying the limitations established in this section.’’.
(2) CONFORMING AMENDMENT FOR AGGREGATION OF PLANS.—Subsection (g) of section 415 (relating to aggregation of plans) is amended by striking ‘‘The Secretary’’ and inserting ‘‘Except as provided in subsection (f)(3), the Secretary’’.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after December 31, 2001.

Sec. 655. Protection Of Investment Of Employee Contributions To 401(K) Plans.
(a) IN GENERAL.—Section 1524(b) of the Taxpayer Relief Act of 1997 is amended to read as follows:
‘‘ (b) EFFECTIVE DATE.—
‘‘ (1) IN GENERAL.—Except as provided in paragraph (2), the amendments made by this section shall apply to elective deferrals for plan years beginning after December 31, 1998.
‘‘ (2) NONAPPLICATION TO PREVIOUSLY ACQUIRED PROPERTY.—
The amendments made by this section shall not apply to any elective deferral which is invested in assets consisting of qualifying employer securities, qualifying employer real property, or both, if such assets were acquired before January 1, 1999.’’.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply as if included in the provision of the Taxpayer Relief Act of 1997 to which it relates.

Sec. 656. Prohibited Allocations Of Stock In S Corporation ESOP.
(a) IN GENERAL.—Section 409 (relating to qualifications for tax credit employee stock ownership plans) is amended by redesignating subsection (p) as subsection (q) and by inserting after subsection (o) the following new subsection:
‘‘ (p) PROHIBITED ALLOCATIONS OF SECURITIES IN AN S CORPORATION.—
‘‘ (1) IN GENERAL.—An employee stock ownership plan holding employer securities consisting of stock in an S corporation shall provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any

plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person.
'' (2) FAILURE TO MEET REQUIREMENTS.—
'' (A) IN GENERAL.—If a plan fails to meet the requirements of paragraph (1), the plan shall be treated as having distributed to any disqualified person the amount allocated to the account of such person in violation of paragraph (1) at the time of such allocation.
'' (B) CROSS REFERENCE.—
'' For excise tax relating to violations of paragraph (1) and ownership of synthetic equity, see section 4979A.
'' (3) NONALLOCATION YEAR.—For purposes of this subsection—
'' (A) IN GENERAL.—The term 'nonallocation year' means any plan year of an employee stock ownership plan if, at any time during such plan year— ''(i) such plan holds employer securities consisting of stock in an S corporation, and ''(ii) disqualified persons own at least 50 percent of the number of shares of stock in the S corporation.
'' (B) ATTRIBUTION RULES.—For purposes of subparagraph (A)—
'' (i) IN GENERAL.—The rules of section 318(a) shall apply for purposes of determining ownership, except that — ''(I) in applying paragraph (1) thereof, the members of an individual's family shall include members of the family described in paragraph (4)(D), and ''(II) paragraph (4) thereof shall not apply.
'' (ii) DEEMED-OWNED SHARES.—Notwithstanding the employee trust exception in section 318(a)(2)(B)(i), an individual shall be treated as owning deemed-owned shares of the individual. Solely for purposes of applying paragraph (5), this subparagraph shall be applied after the attribution rules of paragraph (5) have been applied.
'' (4) DISQUALIFIED PERSON.—For purposes of this subsection—
'' (A) IN GENERAL.—The term 'disqualified person' means any person if— ''(i) the aggregate number of deemed-owned shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned shares of stock in the S corporation, or ''(ii) in the case of a person not described in clause (i), the number of deemed-owned shares of such person is at least 10 percent of the number of deemed-owned shares of stock in such corporation.
'' (B) TREATMENT OF FAMILY MEMBERS.—In the case of a disqualified person described in subparagraph (A)(i), any member of such person's family with deemed-owned shares shall be treated as a disqualified person if not otherwise treated as a disqualified person under subparagraph (A).
'' (C) DEEMED-OWNED SHARES.—
'' (i) IN GENERAL.—The term 'deemed-owned shares' means, with respect to any person— ''(I) the stock in the S corporation constituting employer securities of an employee stock ownership plan which is allocated to such person under the plan, and ''(II) such person's share of the stock in such corporation which is held by such plan but which is not allocated under the plan to participants.
'' (ii) PERSON'S SHARE OF UNALLOCATED STOCK.—
For purposes of clause (i)(II), a person's share of unallocated S corporation stock held by such plan is the amount of the unallocated stock which would be allocated to such person if the unallocated stock were allocated to all participants in the same proportions as the most recent stock allocation under the plan.
'' (D) MEMBER OF FAMILY.—For purposes of this paragraph, the term 'member of the family' means, with respect to any individual— ''(i) the spouse of the individual, ''(ii) an ancestor or lineal descendant of the individual or the individual's spouse, ''(iii) a brother or sister of the individual or the individual's spouse and any lineal descendant of the brother or sister, and ''(iv) the spouse of any individual described in clause (ii) or (iii). A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance shall not be treated as such individual's spouse for purposes of this subparagraph.
'' (5) TREATMENT OF SYNTHETIC EQUITY.—For purposes of paragraphs (3) and (4), in the case of a person who owns synthetic equity in the S corporation, except to the extent provided in regulations, the shares of stock in such corporation on which such synthetic equity is based shall be treated as outstanding stock in such corporation and deemed-owned shares of such person if such treatment of synthetic equity of 1 or more such persons results in— ''(A) the treatment of any person as a disqualified person, or ''(B) the treatment of any year as a nonallocation year. For purposes of this paragraph, synthetic equity shall be treated as owned by a person in the same manner as stock is treated as owned by a person under the rules of paragraphs (2) and (3) of section 318(a). If, without regard to this paragraph, a person is treated as a disqualified person or a year is treated as a nonallocation year, this paragraph shall not be construed
to result in the person or year not being so treated.
'' (6) DEFINITIONS.—For purposes of this subsection—
'' (A) EMPLOYEE STOCK OWNERSHIP PLAN.—The term 'employee stock ownership plan' has the meaning given such term by section 4975(e)(7).
'' (B) EMPLOYER SECURITIES.—The term 'employer security' has the meaning given such term by section 409(l).
'' (C) SYNTHETIC EQUITY.—The term 'synthetic equity' means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also

includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.
'' (7) REGULATIONS AND GUIDANCE.—
'' (A) IN GENERAL.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection.
'' (B) AVOIDANCE OR EVASION.—The Secretary may, by regulation or other guidance of general applicability, provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of this subsection.''.
(b) COORDINATION WITH SECTION 4975(e)(7).—The last sentence of section 4975(e)(7) (defining employee stock ownership plan) is amended by inserting '', section 409(p),'' after ''409(n)''.
(c) EXCISE TAX.—
(1) APPLICATION OF TAX.—Subsection (a) of section 4979A (relating to tax on certain prohibited allocations of employer securities) is amended—
(A) by striking ''or'' at the end of paragraph (1), and (B) by striking all that follows paragraph (2) and inserting the following: ''(3) there is any allocation of employer securities which violates the provisions of section 409(p), or a nonallocation year described in subsection (e)(2)(C) with respect to an employee stock ownership plan, or ''(4) any synthetic equity is owned by a disqualified person in any nonallocation year, there is hereby imposed a tax on such allocation or ownership equal to 50 percent of the amount involved.''.
(2) LIABILITY.—Section 4979A(c) (defining liability for tax) is amended to read as follows:
'' (c) LIABILITY FOR TAX.—The tax imposed by this section shall be paid—'' (1) in the case of an allocation referred to in paragraph (1) or (2) of subsection (a), by— ''(A) the employer sponsoring such plan, or ''(B) the eligible worker-owned cooperative, which made the written statement described in section 664(g)(1)(E) or in section 1042(b)(3)(B) (as the case may be), and'' (2) in the case of an allocation or ownership referred to in paragraph (3) or (4) of subsection (a), by the S corporation the stock in which was so allocated or owned.''.
(3) DEFINITIONS.—Section 4979A(e) (relating to definitions) is amended to read as follows:
'' (e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—'' (1) DEFINITIONS.—Except as provided in paragraph (2), terms used in this section have the same respective meanings as when used in sections 409 and 4978.'' (2) SPECIAL RULES RELATING TO TAX IMPOSED BY REASON OF PARAGRAPH (3) OR (4) OF SUBSECTION (a).—
'' (A) PROHIBITED ALLOCATIONS.—The amount involved with respect to any tax imposed by reason of subsection (a)(3) is the amount allocated to the account of any person in violation of section 409(p)(1).
'' (B) SYNTHETIC EQUITY.—The amount involved with respect to any tax imposed by reason of subsection (a)(4) is the value of the shares on which the synthetic equity is based.
'' (C) SPECIAL RULE DURING FIRST NONALLOCATION YEAR.—For purposes of subparagraph (A), the amount involved for the first nonallocation year of any employee stock ownership plan shall be determined by taking into account the total value of all the deemed-owned shares of all disqualified persons with respect to such plan.
'' (D) STATUTE OF LIMITATIONS.—The statutory period for the assessment of any tax imposed by this section by reason of paragraph (3) or (4) of subsection (a) shall not expire before the date which is 3 years from the later of—'' (i) the allocation or ownership referred to in such paragraph giving rise to such tax, or ''(ii) the date on which the Secretary is notified of such allocation or ownership.''.
(d) EFFECTIVE DATES.—
(1) IN GENERAL.—The amendments made by this section shall apply to plan years beginning after December 31, 2004.
(2) EXCEPTION FOR CERTAIN PLANS.—In the case of any— (A) employee stock ownership plan established after March 14, 2001, or (B) employee stock ownership plan established on or before such date if employer securities held by the plan consist of stock in a corporation with respect to which an election under section 1362(a) of the Internal Revenue Code of 1986 is not in effect on such date, the amendments made by this section shall apply to plan years ending after March 14, 2001.

Sec. 657. Automatic Rollovers Of Certain Mandatory Distributions.
(a) DIRECT TRANSFERS OF MANDATORY DISTRIBUTIONS.—
(1) IN GENERAL.—Section 401(a)(31) (relating to optional direct transfer of eligible rollover distributions), as amended by section 643, is amended by redesignating subparagraphs (B), (C), and (D) as subparagraphs (C), (D), and (E), respectively, and by inserting after subparagraph (A) the following new subparagraph:
'' (B) CERTAIN MANDATORY DISTRIBUTIONS.—
'' (i) IN GENERAL.—In case of a trust which is part of an eligible plan, such trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that if— ''(I) a distribution described in clause (ii) in excess of $1,000 is made, and ''(II) the distributee does not make an election under subparagraph (A) and does not elect to receive the distribution directly, the plan administrator shall make such transfer to an individual retirement plan of a designated trustee or issuer and shall notify the distributee in writing (either separately or as part of the notice under section 402(f)) that the distribution may be transferred

to another individual retirement plan.
“ (ii) ELIGIBLE PLAN.—For purposes of clause (i), the term ‘eligible plan’ means a plan which provides that any nonforfeitable accrued benefit for which the present value (as determined under section 411(a)(11)) does not exceed $5,000 shall be immediately distributed to the participant.’’.
(2) CONFORMING AMENDMENTS.—
(A) The heading of section 401(a)(31) is amended by striking ‘‘OPTIONAL DIRECT’’ and inserting ‘‘DIRECT’’.
(B) Section 401(a)(31)(C), as redesignated by paragraph (1), is amended by striking ‘‘Subparagraph (A)’’ and inserting ‘‘Subparagraphs (A) and (B)’’.
(b) NOTICE REQUIREMENT.—Subparagraph (A) of section 402(f)(1) is amended by inserting before the comma at the end the following: ‘‘and that the automatic distribution by direct transfer applies to certain distributions in accordance with section 401(a)(31)(B)’’.
(c) FIDUCIARY RULES.—
(1) IN GENERAL.—Section 404(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1104(c)) is amended by adding at the end the following new paragraph: ‘‘(3) In the case of a pension plan which makes a transfer to an individual retirement account or annuity of a designated trustee or issuer under section 401(a)(31)(B) of the Internal Revenue Code of 1986, the participant or beneficiary shall, for purposes of paragraph (1), be treated as exercising control over the assets in the account or annuity upon— ‘‘(A) the earlier of the earlier of— ‘‘(i) a rollover of all or a portion of the amount to another individual retirement account or annuity; or ‘‘(ii) one year after the transfer is made; or ‘‘(B) if the transfer is made in a manner consistent with guidance provided by the Secretary.’’.
(2) REGULATIONS.—
(A) AUTOMATIC ROLLOVER SAFE HARBOR.—Not later than 3 years after the date of enactment of this Act, the Secretary of Labor shall prescribe regulations providing for safe harbors under which the designation of an institution and investment of funds in accordance with section 401(a)(31)(B) of the Internal Revenue Code of 1986 is deemed to satisfy the fiduciary requirements of section 404(a) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1104(a)).
(B) USE OF LOW-COST INDIVIDUAL RETIREMENT PLANS.—
The Secretary of the Treasury and the Secretary of Labor may provide, and shall give consideration to providing, special relief with respect to the use of low-cost individual retirement plans for purposes of transfers under section 401(a)(31)(B) of the Internal Revenue Code of 1986 and for other uses that promote the preservation of assets for retirement income purposes.
(d) EFFECTIVE DATE.—The amendments made by this section shall apply to distributions made after final regulations implementing subsection (c)(2)(A) are prescribed.

Sec. 658. Clarification Of Treatment Of Contributions To Multi-employer Plan.
(a) NOT CONSIDERED METHOD OF ACCOUNTING.—For purposes of section 446 of the Internal Revenue Code of 1986, a determination under section 404(a)(6) of such Code regarding the taxable year with respect to which a contribution to a multi-employer pension plan is deemed made shall not be treated as a method of accounting of the taxpayer. No deduction shall be allowed for any taxable year for any contribution to a multi-employer pension plan with respect to which a deduction was previously allowed.
(b) REGULATIONS.—The Secretary of the Treasury shall promulgate such regulations as necessary to clarify that a taxpayer shall not be allowed an aggregate amount of deductions for contributions to a multi-employer pension plan which exceeds the amount of such contributions made or deemed made under section 404(a)(6) of the Internal Revenue Code of 1986 to such plan.
(c) EFFECTIVE DATE.—Subsection (a), and any regulations promulgated under subsection (b), shall be effective for years ending after the date of the enactment of this Act.

PART II—TREATMENT OF PLAN AMENDMENTS REDUCING FUTURE BENEFIT ACCRUALS

Sec. 659. Excise Tax On Failure To Provide Notice By Defined Benefit Plans Significantly Reducing Future Benefit Accruals.
(a) AMENDMENT OF INTERNAL REVENUE CODE.—
(1) IN GENERAL.—Chapter 43 (relating to qualified pension, etc., plans) is amended by adding at the end the following new section:
“ SEC. 4980F. FAILURE OF APPLICABLE PLANS REDUCING BENEFIT ACCRUALS TO SATISFY NOTICE REQUIREMENTS.
“ (a) IMPOSITION OF TAX.—There is hereby imposed a tax on the failure of any applicable pension plan to meet the requirements of subsection (e) with respect to any applicable individual.
“ (b) AMOUNT OF TAX.—
“ (1) IN GENERAL.—The amount of the tax imposed by subsection (a) on any failure with respect to any applicable individual shall be $100 for each day in the noncompliance period with respect to such failure.
“ (2) NONCOMPLIANCE PERIOD.—For purposes of this section, the term ‘noncompliance period’ means,

with respect to any failure, the period beginning on the date the failure first occurs and ending on the date the notice to which the failure relates is provided or the failure is otherwise corrected.
‘‘ (c) LIMITATIONS ON AMOUNT OF TAX.—
‘‘ (1) TAX NOT TO APPLY WHERE FAILURE NOT DISCOVERED AND REASONABLE DILIGENCE EXERCISED.—No tax shall be imposed by subsection (a) on any failure during any period for which it is established to the satisfaction of the Secretary that any person subject to liability for the tax under subsection (d) did not know that the failure existed and exercised reasonable diligence to meet the requirements of subsection (e).
‘‘ (2) TAX NOT TO APPLY TO FAILURES CORRECTED WITHIN 30 DAYS.—No tax shall be imposed by subsection (a) on any failure if— ‘‘(A) any person subject to liability for the tax under subsection (d) exercised reasonable diligence to meet the requirements of subsection (e), and ‘‘(B) such person provides the notice described in subsection (e) during the 30-day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that such failure existed.
‘‘ (3) OVERALL LIMITATION FOR UNINTENTIONAL FAILURES.—
‘‘ (A) IN GENERAL.—If the person subject to liability for tax under subsection (d) exercised reasonable diligence to meet the requirements of subsection (e), the tax imposed by subsection (a) for failures during the taxable year of the employer (or, in the case of a multi-employer plan, the taxable year of the trust forming part of the plan) shall not exceed $500,000. For purposes of the preceding sentence, all multi-employer plans of which the same trust forms a part shall be treated as 1 plan.
‘‘ (B) TAXABLE YEARS IN THE CASE OF CERTAIN CONTROLLED GROUPS.—For purposes of this paragraph, if all persons who are treated as a single employer for purposes of this section do not have the same taxable year, the taxable years taken into account shall be determined under principles similar to the principles of section 1561.
‘‘ (4) WAIVER BY SECRETARY.—In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary may waive part or all of the tax imposed by subsection (a) to the extent that the payment of such tax would be excessive or otherwise inequitable relative to the failure involved.
‘‘ (d) LIABILITY FOR TAX.—The following shall be liable for the tax imposed by subsection (a):
‘‘ (1) In the case of a plan other than a multi-employer plan, the employer. ‘‘(2) In the case of a multi-employer plan, the plan.
‘‘ (e) NOTICE REQUIREMENTS FOR PLANS SIGNIFICANTLY REDUCING BENEFIT ACCRUALS.—
‘‘ (1) IN GENERAL.—If an applicable pension plan is amended to provide for a significant reduction in the rate of future benefit accrual, the plan administrator shall provide written notice to each applicable individual (and to each employee organization representing applicable individuals).
‘‘ (2) NOTICE.—The notice required by paragraph (1) shall be written in a manner calculated to be understood by the average plan participant and shall provide sufficient information (as determined in accordance with regulations prescribed by the Secretary) to allow applicable individuals to understand
the effect of the plan amendment. The Secretary may provide a simplified form of notice for, or exempt from any notice requirement, a plan—
‘‘ (A) which has fewer than 100 participants who have accrued a benefit under the plan, or ‘‘(B) which offers participants the option to choose between the new benefit formula and the old benefit formula.
‘‘ (3) TIMING OF NOTICE.—Except as provided in regulations, the notice required by paragraph (1) shall be provided within a reasonable time before the effective date of the plan amendment.
‘‘ (4) DESIGNEES.—Any notice under paragraph (1) may be provided to a person designated, in writing, by the person to which it would otherwise be provided.
‘‘ (5) NOTICE BEFORE ADOPTION OF AMENDMENT.—A plan shall not be treated as failing to meet the requirements of paragraph (1) merely because notice is provided before the adoption of the plan amendment if no material modification of the amendment occurs before the amendment is adopted.
‘‘ (f) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—
‘‘ (1) APPLICABLE INDIVIDUAL.—The term ‘applicable individual’ means, with respect to any plan amendment—‘‘(A) each participant in the plan, and ‘‘(B) any beneficiary who is an alternate payee (within the meaning of section 414(p)(8)) under an applicable qualified domestic relations order (within the meaning of section 414(p)(1)(A)), whose rate of future benefit accrual under the plan may reasonably be expected to be significantly reduced by such plan amendment.
‘‘ (2) APPLICABLE PENSION PLAN.—The term ‘applicable pension plan’ means—
‘‘ (A) any defined benefit plan, or ‘‘(B) an individual account plan which is subject to the funding standards of section 412. Such term shall not include a governmental plan (within the meaning of section 414(d)) or a church plan (within the meaning of section 414(e)) with respect to which the election provided by section 410(d) has not been made.
‘‘ (3) EARLY RETIREMENT.—A plan amendment which eliminates or significantly reduces any early retirement benefit or retirement-type subsidy (within the meaning of section 411(d)(6)(B)(i)) shall be treated as having the effect of significantly reducing the rate of future benefit accrual.
‘‘ (g) NEW TECHNOLOGIES.—The Secretary may by regulations allow any notice under subsection (e) to be

provided by using new technologies.''.
(2) CLERICAL AMENDMENT.—The table of sections for chapter 43 is amended by adding at the end the following new item:
'' Sec. 4980F. Failure of applicable plans reducing benefit accruals to satisfy notice requirements.''.
(b) AMENDMENT OF ERISA.—Subsection (h) of section 204 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1054) is amended to read as follows:
'' (h)(1) An applicable pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual unless the plan administrator provides the notice described in paragraph (2) to each applicable individual (and to each employee organization representing applicable individuals).
'' (2) The notice required by paragraph (1) shall be written in a manner calculated to be understood by the average plan participant and shall provide sufficient information (as determined in accordance with regulations prescribed by the Secretary of the Treasury) to allow applicable individuals to understand the effect of the plan amendment. The Secretary of the Treasury may provide a simplified form of notice for, or exempt from any notice requirement, a plan—''(A) which has fewer than 100 participants who have accrued a benefit under the plan, or ''(B) which offers participants the option to choose between the new benefit formula and the old benefit formula.
'' (3) Except as provided in regulations prescribed by the Secretary of the Treasury, the notice required by paragraph (1) shall be provided within a reasonable time before the effective date of the plan amendment. ''(4) Any notice under paragraph (1) may be provided to a person designated, in writing, by the person to which it would otherwise be provided.
'' (5) A plan shall not be treated as failing to meet the requirements of paragraph (1) merely because notice is provided before the adoption of the plan amendment if no material modification of the amendment occurs before the amendment is adopted.
'' (6)(A) In the case of any egregious failure to meet any requirement of this subsection with respect to any plan amendment, the provisions of the applicable pension plan shall be applied as if such plan amendment entitled all applicable individuals to the greater of—''(i) the benefits to which they would have been entitled without regard to such amendment, or ''(ii) the benefits under the plan with regard to such amendment.
'' (B) For purposes of subparagraph (A), there is an egregious failure to meet the requirements of this subsection if such failure is within the control of the plan sponsor and is—'' (i) an intentional failure (including any failure to promptly provide the required notice or information after the plan administrator discovers an unintentional failure to meet the requirements of this subsection),'' (ii) a failure to provide most of the individuals with most of the information they are entitled to receive under this subsection, or'' (iii) a failure which is determined to be egregious under regulations prescribed by the Secretary of the Treasury.
'' (7) The Secretary of the Treasury may by regulations allow any notice under this subsection to be provided by using new technologies.
'' (8) For purposes of this subsection—
'' (A) The term 'applicable individual' means, with respect to any plan amendment—'' (i) each participant in the plan; and'' (ii) any beneficiary who is an alternate payee (within the meaning of section 206(d)(3)(K)) under an applicable qualified domestic relations order (within the meaning of section 206(d)(3)(B)(i)), whose rate of future benefit accrual under the plan may reasonably be expected to be significantly reduced by such plan amendment.
'' (B) The term 'applicable pension plan' means—'' (i) any defined benefit plan; or'' (ii) an individual account plan which is subject to the funding standards of section 412 of the Internal Revenue Code of 1986.
'' (9) For purposes of this subsection, a plan amendment which eliminates or significantly reduces any early retirement benefit or retirement-type subsidy (within the meaning of subsection (g)(2)(A)) shall be treated as having the effect of significantly reducing the rate of future benefit accrual.''.
(c) EFFECTIVE DATES.—
(1) IN GENERAL.—The amendments made by this section shall apply to plan amendments taking effect on or after the date of the enactment of this Act.
(2) TRANSITION.—Until such time as the Secretary of the Treasury issues regulations under sections 4980F(e)(2) and (3) of the Internal Revenue Code of 1986, and section 204(h) of the Employee Retirement Income Security Act of 1974, as added by the amendments made by this section, a plan shall be treated as meeting the requirements of such sections if it makes a good faith effort to comply with such requirements.
(3) SPECIAL NOTICE RULE.—
(A) IN GENERAL.—The period for providing any notice required by the amendments made by this section shall not end before the date which is 3 months after the date of the enactment of this Act.
(B) REASONABLE NOTICE.—The amendments made by this section shall not apply to any plan amendment taking effect on or after the date of the enactment of this Act if, before April 25, 2001, notice was provided to participants and beneficiaries adversely affected by the plan amendment (or their representatives) which was reasonably expected to notify them of the nature and effective date of the
plan amendment.

Subtitle F—Reducing Regulatory Burdens

Sec. 661. Modification Of Timing Of Plan Valuations.

(a) IN GENERAL.—Paragraph (9) of section 412(c) (relating to annual valuation) is amended to read as follows:
'' (9) ANNUAL VALUATION.—
'' (A) IN GENERAL.—For purposes of this section, a determination of experience gains and losses and a valuation of the plan's liability shall be made not less frequently than once every year, except that such determination shall be made more frequently to the extent required in particular cases under regulations prescribed by the Secretary.
'' (B) VALUATION DATE.—
'' (i) CURRENT YEAR.—Except as provided in clause (ii), the valuation referred to in subparagraph (A) shall be made as of a date within the plan year to which the valuation refers or within one month prior to the beginning of such year.
'' (ii) USE OF PRIOR YEAR VALUATION.—The valuation referred to in subparagraph (A) may be made as of a date within the plan year prior to the year to which the valuation refers if, as of such date, the value of the assets of the plan are not less than 125 percent of the plan's current liability (as defined in paragraph (7)(B)).
'' (iii) ADJUSTMENTS.—Information under clause (ii) shall, in accordance with regulations, be actuarially adjusted to reflect significant differences in participants.''.
(b) AMENDMENT OF ERISA.—Paragraph (9) of section 302(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1053(c)) is amended—
(1) by inserting ''(A)'' after ''(9)'', and
(2) by adding at the end the following:
'' (B)(i) Except as provided in clause (ii), the valuation referred to in subparagraph (A) shall be made as of a date within the plan year to which the valuation refers or within one month prior to the beginning of such year.'' (ii) The valuation referred to in subparagraph (A) may be made as of a date within the plan year prior to the year to which the valuation refers if, as of such date, the value of the assets of the plan are not less than 125 percent of the plan's current liability (as defined in paragraph (7)(B)).'' (iii) Information under clause (ii) shall, in accordance with regulations, be actuarially adjusted to reflect significant differences in participants.''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to plan years beginning after December 31, 2001.

Sec. 662. ESOP Dividends May Be Reinvested Without Loss Of Dividend Deduction.

(a) IN GENERAL.—Section 404(k)(2)(A) (defining applicable dividends) is amended by striking ''or'' at the end of clause (ii), by redesignating clause (iii) as clause (iv), and by inserting after clause (ii) the following new clause: ''(iii) is, at the election of such participants or their beneficiaries— ''(I) payable as provided in clause (i) or (ii), or ''(II) paid to the plan and reinvested in qualifying employer securities, or''.
(b) STANDARDS FOR DISALLOWANCE.—Section 404(k)(5)(A) (relating to disallowance of deduction) is amended by inserting ''avoidance or'' before ''evasion''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2001.

Sec. 663. Repeal Of Transition Rule Relating To Certain Highly Compensated Employees.

(a) IN GENERAL.—Paragraph (4) of section 1114(c) of the Tax Reform Act of 1986 is hereby repealed.
(b) EFFECTIVE DATE.—The repeal made by subsection (a) shall apply to plan years beginning after December 31, 2001.

Sec. 664. Employees Of Tax-Exempt Entities.

(a) IN GENERAL.—The Secretary of the Treasury shall modify Treasury Regulations section 1.410(b)–6(g) to provide that employees of an organization described in section 403(b)(1)(A)(i) of the Internal Revenue Code of 1986 who are eligible to make contributions under section 403(b) of such Code pursuant to a salary reduction agreement may be treated as excludable with respect to a plan under section 401(k) or (m) of such Code that is provided under the same general arrangement as a plan under such section 401(k), if— (1) no employee of an organization described in section 403(b)(1)(A)(i) of such Code is eligible to participate in such section 401(k) plan or section 401(m) plan; and (2) 95 percent of the employees who are not employees of an organization described in section 403(b)(1)(A)(i) of such Code are eligible to participate in such plan under such section 401(k) or (m).
(b) EFFECTIVE DATE.—The modification required by subsection (a) shall apply as of the same date set forth in section 1426(b) of the Small Business Job Protection Act of 1996.

Sec. 665. Clarification Of Treatment Of Employer-Provided Retirement Advice.

(a) IN GENERAL.—Subsection (a) of section 132 (relating to exclusion from gross income) is amended by

striking ‘‘or’’ at the end of paragraph (5), by striking the period at the end of paragraph (6) and inserting ‘‘, or’’, and by adding at the end the following new paragraph:
‘‘ (7) qualified retirement planning services.’’.
(b) QUALIFIED RETIREMENT PLANNING SERVICES DEFINED.—Section 132 is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following:
‘‘ (m) QUALIFIED RETIREMENT PLANNING SERVICES.—
‘‘ (1) IN GENERAL.—For purposes of this section, the term ‘qualified retirement planning services’ means any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan.
‘‘ (2) NONDISCRIMINATION RULE.—Subsection (a)(7) shall apply in the case of highly compensated employees only if such services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer’s qualified employer plan.
‘‘ (3) QUALIFIED EMPLOYER PLAN.—For purposes of this subsection, the term ‘qualified employer plan’ means a plan, contract, pension, or account described in section 219(g)(5).’’.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to years beginning after December 31, 2001.

Sec. 666. Repeal Of The Multiple Use Test.

(a) IN GENERAL.—Paragraph (9) of section 401(m) is amended to read as follows:
‘‘ (9) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection and subsection (k), including regulations permitting appropriate aggregation of plans and contributions.’’.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply to years beginning after December 31, 2001.

TAX RELIEF and HEALTH CARE ACT of 2006

Title III: Health Savings Accounts

Health Opportunity Patient Empowerment Act of 2006

SEC. 301. SHORT TITLE.

This title may be cited as the `Health Opportunity Patient Empowerment Act of 2006'.

SEC. 302. FSA AND HRA TERMINATIONS TO FUND HSAs.

(a) In General- Section 106 (relating to contributions by employer to accident and health plans) is amended by adding at the end the following new subsection:
`(e) FSA and HRA Terminations to Fund HSAs-
`(1) IN GENERAL- A plan shall not fail to be treated as a health flexible spending arrangement or health reimbursement arrangement under this section or section 105 merely because such plan provides for a qualified HSA distribution.
`(2) QUALIFIED HSA DISTRIBUTION- The term `qualified HSA distribution' means a distribution from a health flexible spending arrangement or health reimbursement arrangement to the extent that such distribution--
`(A) does not exceed the lesser of the balance in such arrangement on September 21, 2006, or as of the date of such distribution, and
`(B) is contributed by the employer directly to the health savings account of the employee before January 1, 2012.
Such term shall not include more than 1 distribution with respect to any arrangement.
`(3) ADDITIONAL TAX FOR FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE-
`(A) IN GENERAL- If, at any time during the testing period, the employee is not an eligible individual, then the amount of the qualified HSA distribution--
`(i) shall be includible in the gross income of the employee for the taxable year in which occurs the first month in the testing period for which such employee is not an eligible individual, and
`(ii) the tax imposed by this chapter for such taxable year on the employee shall be increased by 10 percent of the amount which is so includible.
`(B) EXCEPTION FOR DISABILITY OR DEATH- Clauses (i) and (ii) of subparagraph (A) shall not apply if the employee ceases to be an eligible individual by reason of the death of the employee or the employee becoming disabled (within the meaning of section 72(m)(7)).
`(4) DEFINITIONS AND SPECIAL RULES- For purposes of this subsection--
`(A) TESTING PERIOD- The term `testing period' means the period beginning with the month in which the qualified HSA distribution is contributed to the health savings account and ending on the last day of the 12th month following such month.
`(B) ELIGIBLE INDIVIDUAL- The term `eligible individual' has the meaning given such term by section 223(c)(1).
`(C) TREATMENT AS ROLLOVER CONTRIBUTION- A qualified HSA distribution shall be treated as a rollover contribution described in section 223(f)(5).
`(5) TAX TREATMENT RELATING TO DISTRIBUTIONS- For purposes of this title--
`(A) IN GENERAL- A qualified HSA distribution shall be treated as a payment described in subsection (d).
`(B) COMPARABILITY EXCISE TAX-
`(i) IN GENERAL- Except as provided in clause (ii), section 4980G shall not apply to qualified HSA distributions.
`(ii) FAILURE TO OFFER TO ALL EMPLOYEES- In the case of a qualified HSA distribution to any employee, the failure to offer such distribution to any eligible individual covered under a high deductible health plan of the employer shall (notwithstanding section 4980G(d)) be treated for purposes of section 4980G as a failure to

meet the requirements of section 4980G(b).'.
(b) Certain FSA Coverage Disregarded Coverage- Subparagraph (B) of section 223(c)(1) (relating to certain coverage disregarded) is amended by striking `and' at the end of clause (i), by striking the period at the end of clause (ii) and inserting `, and', and by inserting after clause (ii) the following new clause:
`(iii) for taxable years beginning after December 31, 2006, coverage under a health flexible spending arrangement during any period immediately following the end of a plan year of such arrangement during which unused benefits or contributions remaining at the end of such plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during such period if--
`(I) the balance in such arrangement at the end of such plan year is zero, or
`(II) the individual is making a qualified HSA distribution (as defined in section 106(e)) in an amount equal to the remaining balance in such arrangement as of the end of such plan year, in accordance with rules prescribed by the Secretary.'.
(c) Application of Section-
(1) SUBSECTION (a)- The amendment made by subsection (a) shall apply to distributions on or after the date of the enactment of this Act.
(2) SUBSECTION (b)- The amendment made by subsection (b) shall take effect on the date of the enactment of this Act.

SEC. 303. REPEAL OF ANNUAL DEDUCTIBLE LIMITATION ON HSA CONTRIBUTIONS.

(a) IN GENERAL.—Paragraph (2) of section 223(b) (relating to monthly limitation) is amended—
(1) in subparagraph (A) by striking ''the lesser of—'' and all that follows and inserting ''$2,250.'', and (2) in subparagraph (B) by striking ''the lesser of—'' and all that follows and inserting ''$4,500.''.
(b) CONFORMING AMENDMENT.—Section 223(d)(1)(A)(ii)(I) is amended by striking ''subsection (b)(2)(B)(ii)'' and inserting ''subsection (b)(2)(B)''.
(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

SEC. 304. MODIFICATION OF COST-OF-LIVING ADJUSTMENT.

Paragraph (1) of section 223(g) (relating to cost-of living adjustment) is amended by adding at the end the following new flush sentence:
''In the case of adjustments made for any taxable year beginning after 2007, section 1(f)(4) shall be applied for purposes of this paragraph by substituting 'March 31' for 'August 31', and the Secretary shall publish the adjusted amounts under subsections (b)(2) and (c)(2)(A) for taxable years beginning in any calendar year no later than June 1 of the preceding calendar year.''.

SEC. 305. CONTRIBUTION LIMITATION NOT REDUCED FOR PART-YEAR COVERAGE.

(a) INCREASE IN LIMIT FOR INDIVIDUALS BECOMING ELIGIBLE INDIVIDUALS AFTER BEGINNING OF THE YEAR.—Subsection (b) of section 223 (relating to limitations) is amended by adding at the end the following new paragraph:
''(8) INCREASE IN LIMIT FOR INDIVIDUALS BECOMING ELIGIBLE INDIVIDUALS AFTER THE BEGINNING OF THE YEAR.—
''(A) IN GENERAL.—For purposes of computing the limitation under paragraph (1) for any taxable year, an individual who is an eligible individual during the last month of such taxable year shall be treated—
''(i) as having been an eligible individual during each of the months in such taxable year, and
''(ii) as having been enrolled, during each of the months such individual is treated as an eligible individual solely by reason of clause (i), in the same high deductible health plan in which the individual was enrolled for the last month of such taxable year.
''(B) FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE.—
''(i) IN GENERAL.—If, at any time during the testing period, the individual is not an eligible individual, then —''(I) gross income of the individual for the taxable year in which occurs the first month in the testing period for which such individual is not an eligible individual is increased by the aggregate amount of all contributions to the health savings account of the individual which could not have been made but for subparagraph (A), and
''(II) the tax imposed by this chapter for any taxable year on the individual shall be increased by 10 percent of the amount of such in crease.
''(ii) EXCEPTION FOR DISABILITY OR DEATH.—Subclauses (I) and (II) of clause (i) shall not apply if the individual ceased to be an eligible individual by reason of the
death of the individual or the individual becoming disabled (within the meaning of section 72(m)(7)).
''(iii) TESTING PERIOD.—The term'testing period' means the period beginning with the last month of the taxable year referred to in subparagraph (A) and ending
on the last day of the 12th month following such month.''.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

SEC. 306. EXCEPTION TO REQUIREMENT FOR EMPLOYERS TO MAKE COMPARABLE HEALTH SAVINGS ACCOUNT CONTRIBUTIONS.

(a) IN GENERAL.—Section 4980G (relating to failure of employer to make comparable health savings account contributions) is amended by adding at the end the following new subsection:
''(d) EXCEPTION.—For purposes of applying section 4980E to a contribution to a health savings account of an employee who is not a highly compensated employee
(as defined in section 414(q)), highly compensated employees shall not be treated as comparable participating employees.''.
(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 2006.

SEC. 307. ONE-TIME DISTRIBUTION FROM INDIVIDUAL RETIREMENT PLANS TO FUND HSAs.

(a) IN GENERAL.—Subsection (d) of section 408 (relating to taxability of beneficiary of employees' trust) is amended by adding at the end the following new para
graph:
''(9) DISTRIBUTION FOR HEALTH SAVINGS ACCOUNT FUNDING.—
''(A) IN GENERAL.—In the case of an individual who is an eligible individual (as defined in section 223(c)) and who elects the application of this paragraph for a taxable year, gross income of the individual for the taxable year does not include a qualified HSA funding distribution to the extent such distribution is otherwise includible in gross income.
''(B) QUALIFIED HSA FUNDING DISTRIBUTION.—For purposes of this paragraph, the term 'qualified HSA funding distribution' means a distribution from an individual retirement plan (other than a plan described in subsection (k) or (p)) of the employee to the extent that such distribution is contributed to the health savings account of the individual in a direct trustee-to-trustee transfer.
''(C) LIMITATIONS.—''(i) MAXIMUM DOLLAR LIMITATION.—The amount excluded from gross income by subparagraph (A) shall not exceed the excess of—
''(I) the annual limitation under section 223(b) computed on the basis of the type of coverage under the high deductible health plan covering the individual at the time of the qualified HSA funding distribution, over
''(II) in the case of a distribution described in clause (ii)(II), the amount of the earlier qualified HSA funding distribution.
''(ii) ONE-TIME TRANSFER.—
''(I) IN GENERAL.—Except as provided in subclause (II), an individual may make an election under subparagraph (A) only for one qualified HSA funding distribution during
the lifetime of the individual. Such an election, once made, shall be irrevocable.
''(II) CONVERSION FROM SELF ONLY TO FAMILY COVERAGE.—If a qualified HSA funding distribution is made during a month in a taxable year during which an individual has self-only coverage under a high deductible health plan as of the first day of the month, the individual may elect to make an additional qualified HSA
funding distribution during a subsequent month in such taxable year during which the individual has family coverage under a high deductible health plan as of the first day of the subsequent month.
''(D) FAILURE TO MAINTAIN HIGH DEDUCTIBLE HEALTH PLAN COVERAGE.—
''(i) IN GENERAL.—If, at any time during the testing period, the individual is not an eligible individual, then the aggregate amount of all contributions to the health savings account of the individual made under subparagraph (A)—
''(I) shall be includible in the gross income of the individual for the taxable year in which occurs the first month in the testing period for which such individual is not an eligible individual, and
''(II) the tax imposed by this chapter for any taxable year on the individual shall be increased by 10 percent of the amount which is so includible.
''(ii) EXCEPTION FOR DISABILITY OR DEATH.—Subclauses (I) and (II) of clause (i) shall not apply if the individual ceased to be an eligible individual by reason of the
death of the individual or the individual becoming disabled (within the meaning of section 72(m)(7)).
''(iii) TESTING PERIOD.—The term'testing period' means the period beginning with the month in which the qualified HSA funding distribution is contributed to a
health savings account and ending on the last day of the 12th month following such month.
''(E) APPLICATION OF SECTION 72.—Not withstanding section 72, in determining the extent to which an amount is treated as otherwise includible in gross income for purposes of sub-paragraph (A), the aggregate amount distributed from an individual retirement plan shall be treated as includible in gross income to the extent that such amount does not exceed the aggregate amount which would have been so includible if all

amounts from all individual retirement plans were distributed. Proper adjustments shall be made in applying section 72 to other distributions in such taxable year and subsequent taxable years.''.

(b) COORDINATION WITH LIMITATION ON CONTRIBUTIONS TO HSAS.—Section 223(b)(4) (relating to coordination with other contributions) is amended by striking ''and'' at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting'', and'', and by inserting after subparagraph (B) the following new subparagraph:

''(C) the aggregate amount contributed to health savings accounts of such individual for such taxable year under section 408(d)(9) (and such amount shall not be allowed as a deduction under subsection (a)).''.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2006.

MEDICARE PRESCRIPTION DRUG, IMPROVEMENT, and MODERNIZATION ACT of 2003

TITLE XII—TAX INCENTIVES FOR HEALTH AND RETIREMENT SECURITY

SEC. 1201. HEALTH SAVINGS ACCOUNTS.

(a) IN GENERAL.—Part VII of subchapter B of chapter 1 of the Internal Revenue Code of 1986 (relating to additional itemized deductions for individuals) is amended by redesignating section 223 as section 224 and by inserting after section 222 the following new section:
'' SEC. 223. HEALTH SAVINGS ACCOUNTS.
'' (a) DEDUCTION ALLOWED.—In the case of an individual who is an eligible individual for any month during the taxable year, there shall be allowed as a deduction for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to a health savings account of such individual.
'' (b) LIMITATIONS.—
'' (1) IN GENERAL.—The amount allowable as a deduction under subsection (a) to an individual for the taxable year shall not exceed the sum of the monthly limitations for months during such taxable year that the individual is an eligible individual.
'' (2) MONTHLY LIMITATION.—The monthly limitation for any month is 1/12 of—
'' (A) in the case of an eligible individual who has self only coverage under a high deductible health plan as of the first day of such month, the lesser of—
'' (i) the annual deductible under such coverage, or
'' (ii) $2,250, or
'' (B) in the case of an eligible individual who has family coverage under a high deductible health plan as of the first day of such month, the lesser of—
'' (i) the annual deductible under such coverage, or
'' (ii) $4,500.
'' (3) ADDITIONAL CONTRIBUTIONS FOR INDIVIDUALS 55 OR OLDER.—
'' (A) IN GENERAL.—In the case of an individual who has attained age 55 before the close of the taxable year, the applicable limitation under subparagraphs (A) and (B) of paragraph (2) shall be increased by the additional contribution amount.
'' (B) ADDITIONAL CONTRIBUTION AMOUNT.—For purposes of this section, the additional contribution amount is the amount determined in accordance with the following table:

'' For taxable years beginning in:	The additional contribution amount is:
2004	$500
2005	$600
2006	$700
2007	$800
2008	$900
2009 and thereafter	$1,000.

'' (4) COORDINATION WITH OTHER CONTRIBUTIONS.—The limitation which would (but for this paragraph) apply under this subsection to an individual for any taxable year shall be reduced (but not below zero) by the sum of—
'' (A) the aggregate amount paid for such taxable year to Archer MSAs of such individual, and
'' (B) the aggregate amount contributed to health savings accounts of such individual which is excludable from the taxpayer's gross income for such taxable year
under section 106(d) (and such amount shall not be allowed as a deduction under subsection (a)).
Subparagraph (A) shall not apply with respect to any individual
to whom paragraph (5) applies.
'' (5) SPECIAL RULE FOR MARRIED INDIVIDUALS.—In the case of individuals who are married to each other, if either spouse has family coverage—

‘‘ (A) both spouses shall be treated as having only such family coverage (and if such spouses each have family coverage under different plans, as having the family coverage with the lowest annual deductible), and
‘‘ (B) the limitation under paragraph (1) (after the application of subparagraph (A) and without regard to any additional contribution amount under paragraph (3))—
‘‘ (i) shall be reduced by the aggregate amount paid to Archer MSAs of such spouses for the taxable year, and
‘‘ (ii) after such reduction, shall be divided equally between them unless they agree on a different division.
‘‘ (6) DENIAL OF DEDUCTION TO DEPENDENTS.—No deduction shall be allowed under this section to any individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which such individual’s taxable year begins.
‘‘ (7) MEDICARE ELIGIBLE INDIVIDUALS.—The limitation under this subsection for any month with respect to an individual shall be zero for the first month such individual is entitled to benefits under title XVIII of the Social Security Act and for each month thereafter.
‘‘ (c) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—
‘‘ (1) ELIGIBLE INDIVIDUAL.—
‘‘ (A) IN GENERAL.—The term ‘eligible individual’ means, with respect to any month, any individual if—
‘‘ (i) such individual is covered under a high deductible health plan as of the 1st day of such month, and
‘‘ (ii) such individual is not, while covered under a high deductible health plan, covered under any health plan—
‘‘ (I) which is not a high deductible health plan, and
‘‘ (II) which provides coverage for any benefit which is covered under the high deductible health plan.
‘‘ (B) CERTAIN COVERAGE DISREGARDED.—Subparagraph (A)(ii) shall be applied without regard to—
‘‘ (i) coverage for any benefit provided by permitted insurance, and
‘‘ (ii) coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.
‘‘ (2) HIGH DEDUCTIBLE HEALTH PLAN.—
‘‘ (A) IN GENERAL.—The term ‘high deductible health plan’ means a health plan—
‘‘ (i) which has an annual deductible which is not less than—
‘‘ (I) $1,000 for self-only coverage, and
‘‘ (II) twice the dollar amount in subclause (I) for family coverage, and
‘‘ (ii) the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered
benefits does not exceed—
‘‘ (I) $5,000 for self-only coverage, and
‘‘ (II) twice the dollar amount in subclause (I) for family coverage.
‘‘ (B) EXCLUSION OF CERTAIN PLANS.—Such term does not include a health plan if substantially all of its coverage is coverage described in paragraph (1)(B).
‘‘ (C) SAFE HARBOR FOR ABSENCE OF PREVENTIVE CARE DEDUCTIBLE.—A plan shall not fail to be treated as a high deductible health plan by reason of failing to have a deductible for preventive care (within the meaning of section 1871 of the Social Security Act, except as otherwise provided
by the Secretary).
‘‘ (D) SPECIAL RULES FOR NETWORK PLANS.—In the case of a plan using a network of providers—
‘‘ (i) ANNUAL OUT-OF-POCKET LIMITATION.—Such plan shall not fail to be treated as a high deductible health plan by reason of having an out-of-pocket limitation for services provided outside of such network which exceeds the applicable limitation under subparagraph (A)(ii).
‘‘ (ii) ANNUAL DEDUCTIBLE.—Such plan’s annual deductible for services provided outside of such network shall not be taken into account for purposes of subsection (b)(2).
‘‘ (3) PERMITTED INSURANCE.—The term ‘permitted insurance’ means—
‘‘ (A) insurance if substantially all of the coverage provided under such insurance relates to—
‘‘ (i) liabilities incurred under workers’ compensation laws,
‘‘ (ii) tort liabilities,
‘‘ (iii) liabilities relating to ownership or use of property, or
‘‘ (iv) such other similar liabilities as the Secretary may specify by regulations,
‘‘ (B) insurance for a specified disease or illness, and
‘‘ (C) insurance paying a fixed amount per day (or other period) of hospitalization.
‘‘ (4) FAMILY COVERAGE.—The term ‘family coverage’ means any coverage other than self-only coverage.
‘‘ (5) ARCHER MSA.—The term ‘Archer MSA’ has the meaning given such term in section 220(d).
‘‘ (d) HEALTH SAVINGS ACCOUNT.—For purposes of this section—
‘‘ (1) IN GENERAL.—The term ‘health savings account’ means a trust created or organized in the United States as a health savings account exclusively for the purpose of paying the qualified medical expenses of the account beneficiary, but only if the written governing instrument creating the trust meets the following requirements:
‘‘ (A) Except in the case of a rollover contribution described in subsection (f)(5) or section 220(f)(5), no contribution will be accepted—

‘‘ (i) unless it is in cash, or
‘‘ (ii) to the extent such contribution, when added to previous contributions to the trust for the calendar year, exceeds the sum of—
‘‘ (I) the dollar amount in effect under subsection (b)(2)(B)(ii), and
‘‘ (II) the dollar amount in effect under subsection (b)(3)(B).
‘‘ (B) The trustee is a bank (as defined in section 408(n)), an insurance company (as defined in section 816), or another person who demonstrates to the satisfaction of the Secretary that the manner in which such person will administer the trust will be consistent with the requirements of this section.
‘‘ (C) No part of the trust assets will be invested in life insurance contracts.
‘‘ (D) The assets of the trust will not be commingled with other property except in a common trust fund or common investment fund.
‘‘ (E) The interest of an individual in the balance in his account is nonforfeitable.
‘‘ (2) QUALIFIED MEDICAL EXPENSES.—
‘‘ (A) IN GENERAL.—The term ‘qualified medical expenses’ means, with respect to an account beneficiary, amounts paid by such beneficiary for medical care (as defined in section 213(d) for such individual, the spouse of such individual, and any dependent (as defined in section 152) of such individual, but only to the extent such amounts are not compensated for by insurance or otherwise.
‘‘ (B) HEALTH INSURANCE MAY NOT BE PURCHASED FROM ACCOUNT.—Subparagraph (A) shall not apply to any payment
for insurance.
‘‘ (C) EXCEPTIONS.—Subparagraph (B) shall not apply to any expense for coverage under—
‘‘ (i) a health plan during any period of continuation coverage required under any Federal law,
‘‘ (ii) a qualified long-term care insurance contract (as defined in section 7702B(b)),
‘‘ (iii) a health plan during a period in which the individual is receiving unemployment compensation under any Federal or State law, or
‘‘ (iv) in the case of an account beneficiary who has attained the age specified in section 1811 of the Social Security Act, any health insurance other than
a medicare supplemental policy (as defined in section 1882 of the Social Security Act).
‘‘ (3) ACCOUNT BENEFICIARY.—The term ‘account beneficiary’ means the individual on whose behalf the health savings account was established.
‘‘ (4) CERTAIN RULES TO APPLY.—Rules similar to the following rules shall apply for purposes of this section:
‘‘ (A) Section 219(d)(2) (relating to no deduction for rollovers).
‘‘ (B) Section 219(f)(3) (relating to time when contributions deemed made).
‘‘ (C) Except as provided in section 106(d), section 219(f)(5) (relating to employer payments).
‘‘ (D) Section 408(g) (relating to community property laws).
‘‘ (E) Section 408(h) (relating to custodial accounts).
‘‘ (e) TAX TREATMENT OF ACCOUNTS.—
‘‘ (1) IN GENERAL.—A health savings account is exempt from taxation under this subtitle unless such account has ceased to be a health savings account. Notwithstanding the preceding sentence, any such account is subject to the taxes imposed by section 511 (relating to imposition of tax on unrelated business
income of charitable, etc. organizations).
‘‘ (2) ACCOUNT TERMINATIONS.—Rules similar to the rules of paragraphs (2) and (4) of section 408(e) shall apply to health savings accounts, and any amount treated as distributed under such rules shall be treated as not used to pay qualified medical expenses.
‘‘ (f) TAX TREATMENT OF DISTRIBUTIONS.—
‘‘ (1) AMOUNTS USED FOR QUALIFIED MEDICAL EXPENSES.—
Any amount paid or distributed out of a health savings account which is used exclusively to pay qualified medical expenses of any account beneficiary shall not be includible in gross income.
‘‘ (2) INCLUSION OF AMOUNTS NOT USED FOR QUALIFIED MEDICAL EXPENSES.—Any amount paid or distributed out of a health savings account which is not used exclusively to pay the qualified medical expenses of the account beneficiary shall be included in the gross income of such beneficiary.
‘‘ (3) EXCESS CONTRIBUTIONS RETURNED BEFORE DUE DATE OF RETURN.—
‘‘ (A) IN GENERAL.—If any excess contribution is contributed for a taxable year to any health savings account of an individual, paragraph (2) shall not apply to distributions from the health savings accounts of such individual (to the extent such distributions do not exceed the aggregate excess contributions to all such accounts of such individual for such year) if—
‘‘ (i) such distribution is received by the individual on or before the last day prescribed by law (including extensions of time) for filing such individual’s return
for such taxable year, and
‘‘ (ii) such distribution is accompanied by the amount of net income attributable to such excess contribution.
Any net income described in clause (ii) shall be included in the gross income of the individual for the taxable

year in which it is received.
‘‘ (B) EXCESS CONTRIBUTION.—For purposes of subparagraph (A), the term ‘excess contribution’ means any contribution (other than a rollover contribution described in paragraph (5) or section 220(f)(5)) which is neither excludable from gross income under section 106(d) nor deductible under this section.
‘‘ (4) ADDITIONAL TAX ON DISTRIBUTIONS NOT USED FOR QUALIFIED MEDICAL EXPENSES.—
‘‘ (A) IN GENERAL.—The tax imposed by this chapter on the account beneficiary for any taxable year in which there is a payment or distribution from a health savings account of such beneficiary which is includible in gross income under paragraph (2) shall be increased by 10 percent of the amount which is so includible.
‘‘ (B) EXCEPTION FOR DISABILITY OR DEATH.—Subparagraph (A) shall not apply if the payment or distribution is made after the account beneficiary becomes disabled within the meaning of section 72(m)(7) or dies.
‘‘ (C) EXCEPTION FOR DISTRIBUTIONS AFTER MEDICARE ELIGIBILITY.—Subparagraph (A) shall not apply to any payment or distribution after the date on which the account beneficiary attains the age specified in section 1811 of the Social Security Act.
‘‘ (5) ROLLOVER CONTRIBUTION.—An amount is described in this paragraph as a rollover contribution if it meets the requirements of subparagraphs (A) and (B).
‘‘ (A) IN GENERAL.—Paragraph (2) shall not apply to any amount paid or distributed from a health savings account to the account beneficiary to the extent the amount received is paid into a health savings account for the benefit of such beneficiary not later than the 60th day after the day on which the beneficiary receives the payment or distribution.
‘‘ (B) LIMITATION.—This paragraph shall not apply to any amount described in subparagraph (A) received by an individual from a health savings account if, at any time during the 1-year period ending on the day of such receipt, such individual received any other amount described in subparagraph (A) from a health savings account which was not includible in the individual’s gross income because of the application of this paragraph.
‘‘ (6) COORDINATION WITH MEDICAL EXPENSE DEDUCTION.—
For purposes of determining the amount of the deduction under section 213, any payment or distribution out of a health savings account for qualified medical expenses shall not be treated as an expense paid for medical care.
‘‘ (7) TRANSFER OF ACCOUNT INCIDENT TO DIVORCE.—The transfer of an individual’s interest in a health savings account to an individual’s spouse or former spouse under a divorce or separation instrument described in subparagraph (A) of section 71(b)(2) shall not be considered a taxable transfer made by such individual notwithstanding any other provision of this subtitle, and such interest shall, after such transfer, be treated as a health savings account with respect to which such spouse is the account beneficiary.
‘‘ (8) TREATMENT AFTER DEATH OF ACCOUNT BENEFICIARY.—
‘‘ (A) TREATMENT IF DESIGNATED BENEFICIARY IS SPOUSE.—If the account beneficiary’s surviving spouse acquires such beneficiary’s interest in a health savings account by reason of being the designated beneficiary of such account at the death of the account beneficiary, such health savings account shall be treated as if the spouse were the account beneficiary.
‘‘ (B) OTHER CASES.—
‘‘ (i) IN GENERAL.—If, by reason of the death of the account beneficiary, any person acquires the account beneficiary’s interest in a health savings account in a case to which subparagraph (A) does not apply—
‘‘ (I) such account shall cease to be a health savings account as of the date of death, and
‘‘ (II) an amount equal to the fair market value of the assets in such account on such date shall be includible if such person is not the estate of such beneficiary, in such person’s gross income for the taxable year which includes such date, or if such person is the estate of such beneficiary, in such beneficiary’s gross income for the last taxable year of such beneficiary.
‘‘ (ii) SPECIAL RULES.—
‘‘ (I) REDUCTION OF INCLUSION FOR PREDEATH EXPENSES.—The amount includible in gross income under clause (i) by any person (other than the
estate) shall be reduced by the amount of qualified medical expenses which were incurred by the decedent before the date of the decedent’s death and paid by such person within 1 year after such date.
‘‘ (II) DEDUCTION FOR ESTATE TAXES.—An appropriate deduction shall be allowed under section 691(c) to any person (other than the decedent
or the decedent’s spouse) with respect to amounts included in gross income under clause (i) by such person.
‘‘ (g) COST-OF-LIVING ADJUSTMENT.—
‘‘ (1) IN GENERAL.—Each dollar amount in subsections (b)(2) and (c)(2)(A) shall be increased by an amount equal to—
‘‘ (A) such dollar amount, multiplied by
‘‘ (B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which such taxable year begins determined by substituting for ‘calendar year 1992’ in subparagraph (B) thereof—
‘‘ (i) except as provided in clause (ii), ‘calendar year 1997’, and
‘‘ (ii) in the case of each dollar amount in subsection (c)(2)(A), ‘calendar year 2003’.

'' (2) ROUNDING.—If any increase under paragraph (1) is not a multiple of $50, such increase shall be rounded to the nearest multiple of $50.
'' (h) REPORTS.—The Secretary may require—
'' (1) the trustee of a health savings account to make such reports regarding such account to the Secretary and to the account beneficiary with respect to contributions, distributions, the return of excess contributions, and such other matters as the Secretary determines appropriate, and
'' (2) any person who provides an individual with a high deductible health plan to make such reports to the Secretary and to the account beneficiary with respect to such plan as the Secretary determines appropriate.
The reports required by this subsection shall be filed at such time and in such manner and furnished to such individuals at such time and in such manner as may be required by the Secretary.''.

(b) DEDUCTION ALLOWED WHETHER OR NOT INDIVIDUAL ITEMIZES OTHER DEDUCTIONS.—
Subsection (a) of section 62 of such Code is amended by inserting after paragraph (18) the following new paragraph:
'' (19) HEALTH SAVINGS ACCOUNTS.—The deduction allowed by section 223.''.

(c) ROLLOVERS FROM ARCHER MSAS PERMITTED.—Subparagraph(A) of section 220(f)(5) of such Code (relating to rollover contribution) is amended by inserting ''or a health savings account (as defined in section 223(d))'' after ''paid into an Archer MSA''.

(d) EXCLUSIONS FOR EMPLOYER CONTRIBUTIONS TO HEALTH SAVINGS ACCOUNTS.—
(1) EXCLUSION FROM INCOME TAX.—Section 106 of such Code (relating to contributions by employer to accident and health plans) is amended by adding at the end the following new subsection:
'' (d) CONTRIBUTIONS TO HEALTH SAVINGS ACCOUNTS.—
'' (1) IN GENERAL.—In the case of an employee who is an eligible individual (as defined in section 223(c)(1)), amounts contributed by such employee's employer to any health savings account (as defined in section 223(d)) of such employee shall be treated as employer-provided coverage for medical expenses
under an accident or health plan to the extent such amounts do not exceed the limitation under section 223(b) (determined without regard to this subsection) which is applicable to such employee for such taxable year.
'' (2) SPECIAL RULES.—Rules similar to the rules of paragraphs (2), (3), (4), and (5) of subsection (b) shall apply for purposes of this subsection.
'' (3) CROSS REFERENCE.—
'' For penalty on failure by employer to make comparable contributions to the health savings accounts of comparable employees, see section 4980G.''.
(2) EXCLUSION FROM EMPLOYMENT TAXES.—
(A) RAILROAD RETIREMENT TAX.—Subsection (e) of section 3231 of such Code is amended by adding at the end the following new paragraph:
'' (11) HEALTH SAVINGS ACCOUNT CONTRIBUTIONS.—The term ' compensation' shall not include any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(d).''.
(B) UNEMPLOYMENT TAX.—Subsection (b) of section 3306 of such Code is amended by striking ''or'' at the end of paragraph (16), by striking the period at the end of paragraph (17) and inserting ''; or'', and by inserting after paragraph (17) the following new paragraph:
'' (18) any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(d).''.
(C) WITHHOLDING TAX.—Subsection (a) of section 3401 of such Code is amended by striking ''or'' at the end of paragraph (20), by striking the period at the end of paragraph (21) and inserting ''; or'', and by inserting after paragraph (21) the following new paragraph:
'' (22) any payment made to or for the benefit of an employee if at the time of such payment it is reasonable to believe that the employee will be able to exclude such payment from income under section 106(d).''.
(3) EMPLOYER CONTRIBUTIONS REQUIRED TO BE SHOWN ON W–2.—Subsection (a) of section 6051 of such Code is amended by striking ''and'' at the end of paragraph (10), by striking the period at the end of paragraph (11) and inserting '', and'', and by inserting after paragraph (11) the following new paragraph:
'' (12) the amount contributed to any health savings account (as defined in section 223(d)) of such employee or such employee's spouse.''.
(4) PENALTY FOR FAILURE OF EMPLOYER TO MAKE COMPARABLE HEALTH SAVINGS ACCOUNT CONTRIBUTIONS.—
(A) IN GENERAL.—Chapter 43 of such Code is amended by adding after section 4980F the following new section:
'' SEC. 4980G. FAILURE OF EMPLOYER TO MAKE COMPARABLE HEALTH SAVINGS ACCOUNT CONTRIBUTIONS.
'' (a) GENERAL RULE.—In the case of an employer who makes a contribution to the health savings account

of any employee during a calendar year, there is hereby imposed a tax on the failure of such employer to meet the requirements of subsection (b) for such calendar year.
'' (b) RULES AND REQUIREMENTS.—Rules and requirements similar to the rules and requirements of section 4980E shall apply for purposes of this section.
'' (c) REGULATIONS.—The Secretary shall issue regulations to carry out the purposes of this section, including regulations providing special rules for employers who make contributions to Archer MSAs and health savings accounts during the calendar year.''. (B) CLERICAL AMENDMENT.—The table of sections for chapter 43 of such Code is amended by adding after the item relating to section 4980F the following new item:
'' Sec. 4980G. Failure of employer to make comparable health savings account contributions.''.

(e) TAX ON EXCESS CONTRIBUTIONS.—Section 4973 of such Code (relating to tax on excess contributions to certain tax-favored accounts and annuities) is amended—
(1) by striking ''or'' at the end of subsection (a)(3), by inserting ''or'' at the end of subsection (a)(4), and by inserting after subsection (a)(4) the following new paragraph:
'' (5) a health savings account (within the meaning of section 223(d)),'', and
(2) by adding at the end the following new subsection:
'' (g) EXCESS CONTRIBUTIONS TO HEALTH SAVINGS ACCOUNTS.— For purposes of this section, in the case of health savings accounts
(within the meaning of section 223(d)), the term 'excess contributions' means the sum of—
'' (1) the aggregate amount contributed for the taxable year to the accounts (other than a rollover contribution described in section 220(f)(5) or 223(f)(5)) which is neither excludable from gross income under section 106(d) nor allowable as a deduction under section 223 for such year, and
'' (2) the amount determined under this subsection for the preceding taxable year, reduced by the sum of—
'' (A) the distributions out of the accounts which were included in gross income under section 223(f)(2), and
'' (B) the excess (if any) of—
'' (i) the maximum amount allowable as a deduction under section 223(b) (determined without regard to section 106(d)) for the taxable year, over
'' (ii) the amount contributed to the accounts for the taxable year.For purposes of this subsection, any contribution which is distributed out of the health savings account in a distribution to which section 223(f)(3) applies shall be treated as an amount not contributed.''.

(f) TAX ON PROHIBITED TRANSACTIONS.—
(1) Section 4975 of such Code (relating to tax on prohibited transactions) is amended by adding at the end of subsection (c) the following new paragraph:
'' (6) SPECIAL RULE FOR HEALTH SAVINGS ACCOUNTS.—An individual for whose benefit a health savings account (within the meaning of section 223(d)) is established shall be exempt from the tax imposed by this section with respect to any transaction concerning such account (which would otherwise be taxable under this section) if, with respect to such transaction, the account ceases to be a health savings account by reason of the application of section 223(e)(2) to such account.''.
(2) Paragraph (1) of section 4975(e) of such Code is amended by redesignating subparagraphs (E) and (F) as subparagraphs (F) and (G), respectively, and by inserting after subparagraph (D) the following new subparagraph:
'' (E) a health savings account described in section 223(d),''.

(g) FAILURE TO PROVIDE REPORTS ON HEALTH SAVINGS ACCOUNTS.—Paragraph (2) of section 6693(a) of such Code (relating to reports) is amended by redesignating subparagraphs (C) and (D) as subparagraphs (D) and (E), respectively, and by inserting after subparagraph (B) the following new subparagraph:'' (C) section 223(h) (relating to health savings accounts),''.

(h) EXCEPTION FROM CAPITALIZATION OF POLICY ACQUISITION EXPENSES.—Subparagraph (B) of section 848(e)(1) of such Code (defining specified insurance contract) is amended by striking ''and'' at the end of clause (iii), by striking the period at the end of clause (iv) and inserting '', and'', and by adding at the end the following new clause:
'' (v) any contract which is a health savings account (as defined in section 223(d)).''.

(i) HEALTH SAVINGS ACCOUNTS MAY BE OFFERED UNDER CAFETERIA PLANS.—Paragraph (2) of section 125(d) (relating to cafeteria
plan defined) is amended by adding at the end the following new subparagraph:
'' (D) EXCEPTION FOR HEALTH SAVINGS ACCOUNTS.— Subparagraph (A) shall not apply to a plan to the extent of amounts which a covered employee may elect to have the employer pay as contributions to a health savings account established on behalf of the employee.''.

(j) CLERICAL AMENDMENT.—The table of sections for part VII of subchapter B of chapter 1 of such Code is

amended by striking the last item and inserting the following:
'' Sec. 223. Health savings accounts.
'' Sec. 224. Cross reference.''.

(k) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 2003.

SEC. 1202. EXCLUSION FROM GROSS INCOME OF CERTAIN FEDERAL SUBSIDIES FOR PRESCRIPTION DRUG PLANS.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after section 139 the following new section:
'' SEC. 139A. FEDERAL SUBSIDIES FOR PRESCRIPTION DRUG PLANS.
'' Gross income shall not include any special subsidy payment received under section 1860D–22 of the Social Security Act. This section shall not be taken into account for purposes of determining whether any deduction is allowable with respect to any cost taken into account in determining such payment.''.

(b) ALTERNATIVE MINIMUM TAX RELIEF.—Section 56(g)(4)(B) of such Code is amended by inserting ''or 139A'' after ''section 114''.

(c) CONFORMING AMENDMENT.—The table of sections for part III of subchapter B of chapter 1 of such Code is amended by inserting after the item relating to section 139 the following new item:
'' Sec. 139A. Federal subsidies for prescription drug plans.''.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years ending after the date of the enactment of this Act.

SEC. 1203. EXCEPTION TO INFORMATION REPORTING REQUIREMENTS RELATED TO CERTAIN HEALTH ARRANGEMENTS.

(a) IN GENERAL.—Section 6041 of the Internal Revenue Code of 1986 (relating to information at source) is amended by adding at the end the following new subsection:

'' (f) SECTION DOES NOT APPLY TO CERTAIN HEALTH ARRANGEMENTS.—
This section shall not apply to any payment for medical care (as defined in section 213(d)) made under—
'' (1) a flexible spending arrangement (as defined in section 106(c)(2)), or
'' (2) a health reimbursement arrangement which is treated as employer-provided coverage under an accident or health plan for purposes of section 106.''.

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to payments made after December 31, 2002.

Approved December 8, 2003.