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

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The Pension Protection Act of 2006 (PPA) provides changes and exemptions to the fiduciary duty provisions under the Employee Retirement Income Security Act of 1974 (ERISA) and the prohibited transaction rules under both ERISA and the Internal Revenue Code of 1986. These provisions include new rules on participant-level investment advice, relief on prohibited transaction issues, changes in the ERISA bond requirements, and liberalization of the plan asset rules that impact hedge funds and other alternative pension investments.

Plan Participant-level Investment Advice
The PPA permits an adviser/fiduciary to provide participant-level investment advice for an additional fee within a participant-directed plan (e.g., a 401(k) plan) under an “eligible investment advice arrangement.” This exemption allows an adviser to provide fiduciary advice regarding investment funds and products that provide the adviser, directly or indirectly, with additional compensation. However, the practical application of this provision may be limited because advice here is limited to nondiscretionary advice, which contrasts with many discretionary products coming into the marketplace.

Eligible Investment Advice Arrangements. Eligible investment advice arrangements can be structured as either 1) fee neutral (i.e., the adviser’s total compensation does not vary based on the advice given) or 2) based on a computer model. Under the fee-neutral approach the adviser’s aggregate fee is not affected by the investment allocation of the account.

In recently issued Field Assistance Bulletin No. 2007-01, the Department of Labor (DOL) clarifies that the required fee leveling has to occur at the advice-giver level without regard to varying compensation earned by the advice-giver’s affiliates.

Alternatively, arrangements based on advice generated by a computer model allow compensation to vary based on the advice given. The computer model must be certified by an “eligible investment expert” (i.e., someone unaffiliated with the adviser who meets DOL requirements), apply generally accepted investment theories, use relevant participant information (e.g., age, retirement status, model disclosure forms are available from DOL.

Relief for Plan Sponsors. The PPA also offers relief to plan sponsors that make an “eligible investment advice arrangement” available to plan participants regarding fiduciary liability exposure. Specifically, plan sponsors have no obligation to provide investment advice to plan participants, but once they do, they must act prudently. The PPA provides that a plan sponsor will not violate this standard of care if the adviser is prudently selected and periodically reviewed. Most importantly, the PPA provides that periodic monitoring does not require the monitoring of any specific investment advice given to any particular participant. However, what is left unanswered is what a plan fiduciary is supposed to monitor and how.

IRA and other tax-qualified accounts. The PPA requires the DOL to determine the feasibility of using a computer-model investment-advice program for IRAs, Archer MSAs, health savings accounts, and Coverdell education accounts in the future. In the meantime, advisers may run different advice programs for their 401(k) and IRA markets.

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

Block Trades
The PPA provides an exemption from the prohibited transaction rules of ERISA and the Code for the purchase or sale from a nonfiduciary party of a “block trade” (i.e., a trade of at least 10,000 shares or with a market value of at least $200,000) that is allocated across two or more unrelated client accounts. But because this provision does not apply to transactions between a plan and a fiduciary, its utility is limited.

Effective date. This exemption applies to transactions conducted after August 17, 2006, the date of enactment.
The PPA seems to codify and develop the “blind transaction doctrine” as provided for in ERISA’s original legislative history and the DOL’s Liquidnet Letter (DOL AO 2004-04A, May 2004). Specifically, the PPA provides a prohibited transaction exemption for securities and other transactions (as determined by the DOL) executed through an electronic communications network (ECN), an alternative trading system (ATS), or a similar trading venue that is subject to federal or foreign regulatory oversight. To qualify for the exemption, a number of conditions must be met. It is not clear whether this provision applies to national securities exchanges as well. If so, this would represent an expansion of the blind transaction doctrine, as provided for in ERISA’s legislative history, which applies to transactions executed through an exchange where the parties do not know each other’s identity.

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Effective date. This exemption applies to transactions conducted after August 17, 2006.

Increase in Maximum Bond Amount
The PPA increases ERISA’s maximum bond amount from $500,000 to $1 million for plans that hold “employer securities.” ERISA generally requires most fiduciaries with discretionary authority over plan assets and persons who “handle” plan assets to be bonded. Broker–dealers should check with their risk management groups to see if they can take advantage of this potential reduction in coverage costs.

Effective date. This relief applies to plan years beginning after August 17, 2006.

Codification of the “Blind Transaction Doctrine” and the Liquidnet Letter
The PPA seems to codify and expand both the “blind transaction doctrine” as provided for in ERISA’s legislative history and the DOL’s Liquidnet Letter (DOL AO 2004-04A, May 2004). Specifically, the PPA provides a prohibited transaction exemption for securities and other transactions (as determined by the DOL) executed through an electronic communications network (ECN), an alternative trading system (ATS), or a similar trading venue that is subject to federal or foreign regulatory oversight. To qualify for the exemption, a number of conditions must be met. It is not clear whether this provision applies to national securities exchanges as well. If so, this would represent an expansion of the blind transaction doctrine, as provided for in ERISA’s legislative history, which applies to transactions executed through an exchange where the parties do not know each other’s identity.

Liberalization and Clarification of the So-called 25-percent Exception to the DOL Plan Assets Regulation
The PPA liberalizes the method for calculating significant benefit plan investor (BPI) participation in private investment funds by limiting the definition of BPI to only 1) plans subject to the fiduciary provisions of ERISA, 2) plans subject to the Code’s prohibited transaction rules, and 3) entities (such as private investment funds) deemed to hold plan assets under the DOL regulations. Thus, governmental, foreign, and certain church plans no longer are included in the calculation. This provision also clarifies that in the context of a fund of funds, master-
feeder, or other situations in which one private investment fund invests in another, the investing fund only holds plan assets to the extent of its BPI investors. Thus, from a practical standpoint, the use of multiple feeder funds to separate the ERISA/Code plan investors from other non-ERISA/Code plan investors no longer may be necessary.

The 25-percent exception, however, is still set at 25 percent—not the 50-percent limit lobbied for—of any class of equity interest after the most recent acquisition, after disregarding interests held by individuals who exercise discretionary authority over the investment fund’s assets or provide the investment fund with investment advice for a fee. Regardless, this provision does provide welcome changes. Specifically, limiting BPIs to ERISA plans and plans subject to the Code’s prohibited transaction rules should free up substantial capacity in many funds operating close to the 25-percent limit. Moreover, clarifying that a fund holding plan assets only holds plan assets to the extent of its BPI investors should help fund advisers streamline fund structures and avoid unnecessary feeder funds or other structures used to control BPI interests. However, lines of communication between the underlying fund and funds investing in it will have to be established to ensure that the underlying fund can accurately track its percentage, which could change upon the acquisitions and redemptions of interests in it or in the funds investing in it.

Finally, because the PPA does not codify the DOL plan assets regulation in its entirety, the DOL has authority to make additional changes to the definition of plan assets.

**Effective date.** These changes apply to transactions conducted after August 17, 2006.

### Active Cross Trades for Large Plans

The PPA contains a long-awaited prohibited transaction exemption under ERISA and the Code for active cross trades. “Cross trade” means the trading of securities between a “large plan” and another account managed by the same adviser that meets the definition of an “investment manager” under ERISA or the Code.

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

**Effective date.** This exemption applies to transactions discovered, or which reasonably should have been discovered, after August 17, 2006.

### Relief for Foreign Exchange Transactions

The PPA provides an exemption from the prohibited transaction rules for foreign exchange (FX) transactions between a plan and a bank or a broker-dealer that is a trustee, custodian, fiduciary, or other party in interest. To qualify for the exemption, 1) the FX transaction must be in connection with the purchase, holding, or sale of securities or other investment assets; 2) the terms must be no less favorable to the plan than the terms available in a comparable arm’s-length FX transaction; 3) the exchange rate used does not deviate by more then 3 percent from the interbank bid and asked rates for transactions of comparable size and maturity; and 4) the bank or broker-dealer does not have investment discretion or provide investment advice for the transaction.

**Effective date.** This exemption applies to transactions conducted after August 17, 2006.
As noted above, the PPA, as adopted, contains a number of items that require either clarification through technical corrections or regulations from the DOL. It also is causing many financial service providers to reevaluate their policies and procedures in this area.

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Endnotes

1. The conditions are: 1) the price and commission of the transaction is no greater than that associated with an arm's-length transaction; 2) either a) the transaction is done under rules designed to match purchases and sales at the best price available or b) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades; 3) if the party in interest has an ownership interest in the execution system, an independent plan fiduciary authorizes the transaction; and 4) a plan fiduciary is provided written or electronic notice about the use of such trading system at least 30 day before such transactions begin.

2. Adequate consideration is defined to mean 1) in the case of a security for which there is a generally recognized market, either a) the prevailing price on a national securities exchange or b) if not traded on a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by current bid and asked prices quoted by persons independent of both the security issuer and the party in interest claiming the exemption, and 2) in the case of assets other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a plan fiduciary according to forthcoming DOL regulations.

3. This long list of conditions follows: 1) the transaction is a purchase or sale for no consideration other than cash payment against prompt delivery of a security for which market quotations are available; 2) the transaction is effected at the independent current market price of the security; 3) no brokerage commission, fee except certain customary transfer fees, or other remuneration is paid in connection with the transaction; 4) a plan fiduciary independent of the investment manager authorizes in advance and in writing the ability of the investment manager to conduct such cross trades; 5) the investment manager provides the plan fiduciary written disclosure of the conditions under which cross trades can occur; 6) the investment manager provides the plan quarterly reports detailing all cross trades executed in the quarter; 7) the investment manager does not condition its fees on the use of cross trades or charge a higher fee where the plan fiduciary refuses to permit cross trades under this exemption; 8) the investment manager has adopted certain written policies and procedures that provide for the allocation of cross trades among participating accounts in an objective manner; and 9) the investment manager designates an individual responsible for periodically reviewing cross trades to ensure that they are conducted in conformity with the manager's policies and procedures and to certify, under penalty of perjury, to the plan fiduciary, such person's findings and conclusions.