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Client Advisory

New Pension Law Changes ERISA Fiduciary Rules and Related Provisions of Tax Code

August 17, 2006

Today, President Bush signed H.R. 4, the Pension Protection Act of 2006 (the "Act"). The Act makes significant changes to many provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and the Internal Revenue Code of 1986, as amended (the "Code"), such as strengthening funding rules, adding certain notice requirements, encouraging automatic enrollment in certain plans, clarifying rules for cash balance plans and changing some of the fiduciary and prohibited transactions rules of ERISA and Section 4975 of the Code. This Client Advisory will focus on Section VI of the Act which:

(1) changes the "25% test" for determining whether an entity is deemed to hold "plan assets";

(2) adds a number of statutory prohibited transaction exemptions;

(3) adds a correction period during which certain prohibited transactions could be corrected without incurring the Code Section 4975 excise tax; and

(4) changes the ERISA bonding rules.

Except where otherwise noted, each of these provisions will become effective on August 18, 2006.

Executive Summary

25% Test Changes

The most significant change to the fiduciary rules in the Act is in the method of calculating the "25% test" to determine if an entity holds "plan assets." Under the revised test, governmental plans, foreign plans and certain church plans do not count against the "25% test." In addition, if an investment fund which is considered to hold "plan assets" invests in an entity, only the portion of the assets of the investing fund attributable to "benefit plan investors" counts against that entity's "25% test" (as opposed to 100% under prior law).

These changes make it considerably easier to satisfy the 25% test. Many funds that could not satisfy the "25% test" in the past, and either decided to use another exemption to "plan asset" status, such as the Venture Capital Operating Company (VCOC) or the Real Estate Operating Company (REOC) exemptions, or decided to operate as a "plan asset" fund, may now be able to operate within the new "25% test."

New Prohibited Transaction Statutory Exemptions and Correction Period

The Act incorporates a number of new statutory prohibited transaction exemptions for (i) transactions with service providers which are not fiduciaries, (ii) block trading, (iii) transactions through electronic communication networks, alternative trading systems or similar execution systems or trading venues, (iv) foreign exchange transactions, (v) cross trading, and (vi) providing investment advice. In particular, the exemption for transactions with service providers which are not fiduciaries is very broad, and may exempt many inadvertent prohibited transactions. The Act also provides for a 14 day cure period to allow prohibited transactions to be corrected by a fiduciary or party in interest if certain requirements are satisfied, thereby avoiding the imposition of excise taxes under Code Section 4975.

Bonding Rules

The Act also relieves registered broker-dealers which are required by a self-regulatory agency (such as NASD) to be bonded from having to obtain an ERISA fidelity bond for future plan years. However, for plan years starting after December 31, 2007, the Act increases the bonding requirements (from $500,000 to $1 million) with respect to plans holding "employer securities."

Each of these changes is discussed in greater detail below.

25% Test Changes

Prior Law

In 1986, the U.S. Department of Labor (the "DOL") promulgated a regulation, 29 C.F.R. Section 2510.3-101 (the "Plan Asset Regulation"), describing what constitutes the assets of a plan with respect to the plan's investment in an entity for purposes of certain provisions of ERISA, including the fiduciary responsibility and prohibited transaction provisions of Title I of ERISA and the related prohibited transaction provisions under Section 4975 of the Code. Under the Plan Asset Regulation, if a plan invests in an "equity interest" of an entity that is neither a "publicly offered security" nor a security issued by a registered investment company, the plan's assets include both the equity interest and an undivided interest in each of the entity's underlying assets, unless it is established that the entity is an "operating company" or that equity participation in the entity by "Benefit Plan Investors" (as defined below) is not "significant."

Under the Plan Asset Regulation, equity participation in an entity by Benefit Plan Investors (as defined below) is "significant" on any date if, immediately after the most recent acquisition of any equity interest in the entity, 25% or more of the value of any class of equity interests in the entity is held by Benefit Plan Investors. The term "Benefit Plan Investor"" is defined in the Plan Asset Regulation as:

- any employee benefit plan (as defined in Section 3(3) of ERISA), whether or not it is subject to the provisions of Title I of ERISA;
- any plan described in Section 4975(e)(1) of the Code; and
- any entity whose underlying assets include plan assets by reason of the investment in the entity by such employee benefit plan and/or plan (such as an entity where benefit plan investors own at least 25% or more of any class of equity interest).

For purposes of this determination, the value of equity interests held by a person (other than a Benefit Plan Investor) that has discretionary authority or control with respect to the assets of the entity or that provides investment advice for a fee (direct or indirect) with respect to such assets (or any affiliate of any such person) is disregarded.

Pension Protection Act of 2006

Section 611(f) of the Act adds a new definition of "plan assets" to Section 3 of ERISA which is designed to overrule the Plan Asset Regulation. The Act defines "Benefit Plan Investor" as:

- any employee benefit plan subject to the fiduciary rules of ERISA;
- any plan to which Section 4975 of the Code applies (most significantly, IRAs and Keogh plans); and
- any entity whose underlying assets include plan assets by reason of a plan's investment in such entity (such as where benefit plan investors (as defined in the Act) own 25% or more of any class of equity interests in the entity).

This definition excludes employee benefit plans which are not subject to the fiduciary rules of ERISA, such as governmental plans, foreign plans, and certain church plans. *The Act does not change the class by class nature of the test, so the test is still done on a class by class basis* (an earlier version of this legislation, which did not pass, changed the test so that it was no longer done on a class by class basis).

This change makes governmental plans, foreign plans and church plans which are not subject to ERISA ("Non-ERISA Plans") attractive investors for hedge fund managers. Historically, every $1 received by a non-ERISA Plan would reduce the amount of money that the manager could take in from ERISA investors by $1, assuming the manager wanted to stay below the 25% threshold. Under the Act, each $1 received from a Non-ERISA Plan not only does not decrease the amount of ERISA money

the manager can accept, it actually increases the amount of ERISA money the manager can accept from ERISA plans by $0.25, because it increases the denominator of the fraction.

Also of considerable importance, the Act provides that "[a]n entity shall be considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors." Under the Plan Asset Regulation, the 25% test was a binary test in that if an entity was below the 25% threshold it held 0% plan assets and if it was at or above 25% threshold it was treated as holding 100% plan assets. Under the Act, if an entity is below the 25% threshold it still holds 0% plan assets, but if it is above the 25% threshold, now it only holds that percentage of plan assets.

For example, consider a fund-of-funds in which benefit plan investors own 30% of the fund-of-funds — if the fund-of-funds invested $100 million in an underlying fund, the Plan Asset Regulation would require that the entire $100 million be counted as a benefit plan investor for purposes of the underlying fund's own 25% test. Under the Act, however, only $30 million counts as coming from a benefit plan investor and $70 million counts as coming from a non-benefit plan investor (which means that increasing the denominator by $100 million "covers" $25 million of the $30 million represented by "benefit plan investors") .

These two changes, taken together, permit many funds that were unlikely to satisfy the 25% test under the Plan Asset Regulation to satisfy the new 25% test in the Act. Consequently, many fund managers operating funds satisfying other exemptions under the Plan Asset Regulation, such as VCOCs and REOCs, may consider examining whether they can operate under the revised 25% test. If they are confident that they can do so, then they may wish to revise their fund documentation to use the revised 25% test in lieu of continuing to satisfy the VCOC and REOC exemptions.
Similarly, "plan asset" funds may also be able to operate within the revised 25% test, and may wish to consider whether they can satisfy the revised 25% test. If so, then they may wish to revise their fund documents accordingly.

Prohibited Transaction Exemption for Service Providers

The Act includes a broad statutory prohibited transaction exemption covering transactions between a plan and a person that is a party in interest[1] other than a fiduciary (or an affiliate of a fiduciary) with respect to the assets used in the transaction, solely by reason of providing services or being affiliated with a service provider or both, provided that, in connection with the transaction the plan receives no less than, nor pays any more than, "adequate consideration."
For this purpose, "adequate consideration" means:

- in the case of a security for which there is a generally recognized market and taking into account factors such as the size of the transaction and marketability of the security—
- the price prevailing on a registered national securities exchange; or
- if the security is not traded on such a registered national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and the party in interest; and
- in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a fiduciary or fiduciaries in accordance with regulations to be issued by the Department of Labor.

This exemption, however, does not cover (i) self-dealing prohibited transactions, and (ii) prohibited transactions furnishing goods, services or facilities between the plan and a party in interest. For transactions regarding furnishing services or facilities, the service provider exemption in Section 408(b)(2) and (c)(2) of ERISA may provide an exemption.

This is an extremely broad exemption that could exempt many potential inadvertent prohibited transactions. One of the strongest objections to the entire prohibited transaction regime has been that it was overly broad because it included service providers as "parties in interest" and thereby prohibited any transactions with those service providers and many of their affiliates, even in situations where the service provider had no fiduciary authority over the plan. As a result of the

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[1] Section 406 of ERISA prohibits certain transactions between a plan and a "party in interest" and Section 4975 of the Code applies an excise tax on prohibited transactions between a plan and a "disqualified person." The definitions of "party in interest" and "disqualified person" are very similar and, for simplicity's sake, throughout this Client Advisory when the term "party in interest" is used it refers to both a "party in interest" under ERISA and a "disqualified person" under Section 4975 of the Code.

inclusion of service providers within the prohibited transaction regime, many large financial institutions assumed that they were likely service providers to virtually every significant plan because, as a practical matter, they were likely to provide some level of services to such a plan (e.g., as a broker-dealer, trustee, record keeper, etc.). These financial institutions often refused to engage in any transaction with a plan, unless the plan (or its fiduciary) had an applicable prohibited transaction exemption, such as the "QPAM" exemption.

This exemption may solve many of those problems, although it does not exempt transactions with service providers who are fiduciaries with respect to the assets used in the transaction. Consequently, some of these issues will still exist with respect to persons who are fiduciaries with respect to a plan as a whole (e.g., trustees, certain investment advisors, etc.), even if those persons are not directly controlling the assets involved in the transaction.

Prohibited Transaction Exemption for Block Trading

The Act adds a statutory prohibited transaction exemption for block trading. The new exemption covers any transaction involving the purchase or sale of securities or other property, between a plan and a party in interest (other than a fiduciary) with respect to a plan if:

- the transaction is a trade of at least 10,000 shares or has a market value of at least $200,000;
- the trade is allocated across two or more unrelated client accounts of a fiduciary;
- at the time of the transaction, the interest of the plan (together with interests of other related plans), does not exceed 10% of the aggregate size of the block trade;
- the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction; and
- the compensation associated with the purchase and sale is not greater than the compensation associated with an arm's length transaction with an unrelated party.

Prohibited Transaction Exemption for Electronic Communications Networks

The Act adds a new prohibited transaction exemption which exempts from the prohibited transaction rules of ERISA and the Code any transaction involving the purchase or sale of securities or other property between a plan and a party in interest if:

- the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue (the "Trading System") subject to regulation and oversight by (i) the applicable federal regulating agency, or (ii) a foreign regulatory entity approved by the Secretary of Labor;
- either:
  - The transaction is effected pursuant to rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the Securities and Exchange Commission or other relevant governmental authority; or
  - Neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades;
- the price and compensation associated with the purchase and sale are not greater than the price and compensation associated with an arm's length transaction with an unrelated party;
- if the party in interest has an ownership interest in the Trading System, then the plan sponsor or other independent fiduciary has authorized the use of the Trading System for the transaction; and
- not less than 30 days prior to the initial transaction to be executed through the Trading System, a plan fiduciary is provided written or electronic notice of the intent to execute the transaction through the Trading System.

Prohibited Transaction Exemption for Foreign Exchange Transactions

Among the prohibited transaction exemptions included in the Act is one covering foreign exchange transactions between a plan and a bank or a broker-dealer, where the bank or broker-dealer (or their affiliate) is a trustee, custodian, fiduciary, or other party in interest, but only if the following conditions are satisfied:

- the transaction is in connection with the purchase, holding, or sale of securities or other investment assets (i.e., the foreign exchange transaction is not done solely to hold foreign currency);
- the terms of the transaction are not less favorable to the plan than (i) the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties, or (ii) the terms afforded by the bank or broker-dealer (or their affiliates) in comparable arm's-length foreign exchange transactions involving unrelated parties;
- the exchange rate used by such bank or broker-dealer (or their affiliate) does not deviate by more or less than 3% from the interbank bid and asked rates for transactions of comparable size and maturity at the time of the transaction as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency; and
- the bank or broker-dealer (or their affiliates) does not have investment discretion, or provide investment advice, with respect to the transaction.

This exemption covers transactions in which the foreign exchange transactions are connected with the purchase, holding or sale of securities or other investment assets and therefore, as a practical matter, it should cover transactions done on the spot market in connection with the purchase, holding or sale of such securities or other investment assets. It would appear that this exemption could also cover transactions dealing with currency futures or foreign currency options, provided those transactions are in connection with the purchase, holding or sale of securities or other investment assets (e.g., a hedge on a foreign currency entered into to avoid taking currency risk on a security being held which trades in that currency).

The DOL had previously issued two prohibited transaction class exemptions covering foreign exchange transactions, PTCE 94-20 and PTCE 98-54. The exemption included in the Act incorporates some of the conditions from those exemptions, but removes (i) the "direction" requirement in PTCE 94-20, which required an independent plan fiduciary to direct the bank, broker-dealer or their affiliate to effect the currency transaction at a specified amount of currency at a specific exchange rate, (ii) the limited time frame and de minimis limits ($300,000) in PTCE 98-54, and (iii) the various documentation and recordkeeping requirements in both exemptions.

Prohibited Transaction Exemption for Cross Trading

The Act exempts from certain of the prohibited transaction rules, any transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager, if:

- the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security;
- the security in issue is one for which market quotations are readily available;
- the transaction is effected at the independent current market price of the security (within the meaning of 17 C.F.R. Section 270.17a-7(b));
- no brokerage commission, fee (other than customary transfer fees), or other remuneration is paid in connection with the transaction;
- a fiduciary (other than the investment manager and its affiliates) for each plan participating in the transaction authorizes in advance (the "CT Authorization") the investment manager to engage in cross trades at the investment manager's discretion, after such fiduciary has received disclosure regarding the conditions under which cross trades may take place (the "CT Disclosure"), including the written policies and procedures of the investment manager;
- the CT Authorization and the CT Disclosure must be separate from any other agreement or disclosure involving the asset management relationship;
- each plan participating in the transaction has assets of at least $100 million or is invested in a master trust, comprising plans of related employers, holding at least $100 million in assets;
- the investment manager provides the plan fiduciary with quarterly reports detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including (i) the identity of each security bought or sold, (ii) the number of shares or units traded, (iii) the parties involved in the cross trade, and (iv) the trade price and the method used to establish the trade price;

- the investment manager does not base its fee schedule on the plan's consent to cross trading, and no other service (other than investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;
- the investment manager has adopted, and cross trades are effected in accordance with, written cross trading policies and procedures that are fair and equitable to all accounts participating in the cross trading program, and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross trading program;
- the investment manager has designated an individual responsible for periodically reviewing such purchases and sales to ensure compliance with the written policies and procedures, and following such review, the individual shall issue an annual written report, no later than 90 days following the period to which it relates, signed under penalty of perjury, to the plan fiduciary who authorized the cross trading describing the steps performed during the course of the review, the level of compliance, and any specific instances of non-compliance; and
- the written report must also notify the plan fiduciary of the plan's right to terminate participation in the investment manager's cross trading program at any time.

This exemption is of limited value to hedge funds and other collective investment vehicles because (i) each investing plan must have $100 million in assets (or be part of a master trust with $100 million in assets) and (ii) the plan investors cannot be pressured in any way to permit cross trading, so if a single plan investor has less than $100 million in assets or refuses to permit cross trading, then the investment manager may not engage in cross trading with that fund. Also, cross trading can only be engaged in with respect to securities for which market quotations are readily available, so a fund of funds will not be able to engage in a cross trade with another fund controlled by the same manager to transfer underlying fund interests among different fund of funds controlled by that manager.

The DOL had previously issued an exemption, PTCE 86-128 that permitted cross trades, but only provided a significant number of conditions (some of which are in the statutory exemption in the Act) were satisfied, and also provided the investment manager did not have discretion with respect to both sides of the transaction. The cross trading exemption in the Act is far broader than that provided in PTCE 86-128.

Prohibited Transaction Exemption For Provision of Investment Advice to Participants

The Act's prohibited transaction exemption for providing investment advice is designed to cover advice (i) provided under flat fee arrangements (i.e., arrangements where the advisor receives a flat fee irrespective of which alternative investments are selected) or (ii) generated using an appropriate computer model. This prohibited transaction exemption has many conditions that must be satisfied, which are discussed in detail below.

This new exemption is effective January 1, 2007 and provides that, so long as the transaction is effected under an "Eligible Investment Advice Arrangement," and the various conditions of the exemption are satisfied, each of the following is exempted from the prohibited transaction rules:

- the provision of investment advice to plan participants and beneficiaries with respect to a security or other property available as an investment under the plan;
- the acquisition, holding, or sale of a security or other property available as an investment under the plan pursuant to investment advice; and
- the receipt of fees or other compensation by the person providing the investment advice (the "Fiduciary Adviser"), provided that person is:
  - a registered investment adviser;
  - a trust department of a bank or similar financial institution;
  - an insurance company;
  - a registered broker or dealer; or
  - an affiliate, employee, agent, or registered representative of any such person.

The Act provides that a person who develops or markets the computer model or the investment advice program becomes an ERISA fiduciary, although it provides that the DOL may prescribe rules under which only one such person may elect to be treated as an ERISA fiduciary with respect to the plan.

The exemption only applies to defined contribution plans which provide for investment direction by participants and beneficiaries ("401(k) Plans"), and, to a certain extent IRAs, HSAs, Archer MSAs, and Coverdell Education Savings Accounts ("Individual Accounts").

Under the Act, an "Eligible Investment Advice Arrangement" is an arrangement which either (a) provides that any fees (including commission or other compensation) received by the fiduciary adviser in connection with such arrangement (and the transactions effected thereunder) do not vary depending on the basis of any investment option selected (a "Flat Fee Arrangement"), or (b) uses an appropriate computer model (a "Computer Model Arrangement"). In order for a Computer Model Arrangement to qualify for the exemption, the following conditions must be satisfied:

- the model must apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- the model must utilize (i) relevant information about the participant (such as age, life expectancy, retirement age, risk tolerance, other assets or sources of income, and preferences as to certain types of investments) and (ii) prescribed objective criteria to provide asset allocation portfolios comprised of investment options available under the plan;
- the model must operate in a manner that is not biased in favor of investments offered by the fiduciary adviser or its affiliates;
- the model must take into account all investment options under the plan in specifying how a participant's account balance should be invested and may not be inappropriately weighted with respect to any investment option;
- the model must be pre-certified by an independent "eligible investment expert" (the determination of who qualifies as such an expert is expected to be defined in regulations issued by the DOL), that such model meets these requirements (material changes would require recertification prior to implementation of such changes); and
- all advice must be provided under the computer model, and all transactions must occur at the direction of the participant or the beneficiary (although a participant or beneficiary may request alternative or additional advice provided such request is not solicited by a person connected with the arrangement).

The Computer Model Arrangement is only available for 401(k) Plans and is not yet available for Individual Accounts. The Act requires the DOL to determine (in consultation with the Department of the Treasury) whether there is any computer model investment advice program that can be used by Individual Accounts, which can otherwise meet the statutory requirements.

Regardless of whether it is a Flat Fee Arrangement or a Computer Model Arrangement, in order to qualify as an Eligible Investment Advice Arrangement, any arrangement must meet the following requirements:

- it must be expressly authorized by a plan fiduciary other than the person offering the Arrangement;
- a qualified independent auditor must (1) annually audit the Arrangement and certify in writing that the Arrangement has been operated in compliance with the Act, and (2) must issue an annual report to the plan fiduciary authorizing the Arrangement which sets forth specific findings regarding the Arrangement's compliance;
- prior to the provision of any advice under the Arrangement, at least annually thereafter, and upon the request of the participant or beneficiary, a plan fiduciary must disclose (and update for material changes) the following in writing to the participant or beneficiary:
  - the role of any party materially affiliated with the financial adviser in the development of the Arrangement and the selection of the investment options thereunder,
  - the past performance and historical rates of return of the investment options available under the plan,
  - all of the fees or other compensation that the fiduciary adviser (and its affiliates) will receive in connection with the provision of the advice and the transactions effected as a result of the advice,

- any material affiliation or contractual relationship of the fiduciary adviser or affiliates thereof in the security or other property which is part of the Arrangement,
- the manner and circumstances under which any participant or beneficiary information provided under the arrangement will be used or disclosed,
- the types of services provided by the fiduciary adviser,
- that the adviser is acting as a fiduciary in connection with the Arrangement, and
- that the participant or beneficiary is free to separately arrange for the provision of advice by an unaffiliated adviser;

- the information provided must (i) be written in a clear and conspicuous manner and in a manner calculated to be understood by the average plan participant and (ii) be sufficiently accurate and comprehensive to reasonably apprise such participants and beneficiaries of the information required to be disclosed (the Act requires the DOL to issue a model form for disclosure of fees and other compensation);
- The fiduciary adviser must also make all disclosures required under applicable securities laws in connection with the sale, acquisition, or holding of any security or other property;
- any sale, acquisition or holding of any security or other property in connection with the Arrangement must occur solely at the direction of the participant or beneficiary;
- the compensation received by the fiduciary adviser in connection with the Arrangement must be reasonable;
- the terms of any sale, acquisition or holding of any security or other property in connection with the Arrangement must be at least as favorable to the plan as an arm's length transaction would be; and
- the fiduciary adviser must maintain evidence of compliance with the Act for a period of six years following the provision of advice under the Arrangement.

The Act provides that so long as the fiduciary adviser is prudently selected and subject to appropriate periodic review, the plan sponsor and other plan fiduciaries are not subject to fiduciary liability solely by reason of the investment advice provided by the fiduciary adviser under the Arrangement. The Act further provides that nothing precludes the use of plan assets to pay for the reasonable expenses involved in providing investment advice.

Correction Period

The Act exempts any transaction between the plan on the one hand and a plan fiduciary or party in interest on the other hand, involving the acquisition, holding, or disposition of any security or commodity that would otherwise be prohibited by ERISA and the Code, provided the following conditions are satisfied:

- the transaction is corrected during the 14-day period beginning on the date on which the fiduciary or party in interest discovers, or reasonably should have discovered, that the transaction would otherwise constitute a prohibited transaction;
- in order to correct the prohibited transaction (1) the transaction must be undone to the extent possible, and in any case the plan or any affected account must be made good for any losses resulting from the transaction, and (2) the fiduciary or party in interest must restore to the plan or affected account any profits made through the use of assets of the plan;
- the ability to correct a transaction is not available for a transaction between the plan and a plan sponsor that involves either (1) the acquisition or sale of an employer security (e.g., stock or debt of the plan sponsor or its affiliate), or (2) the acquisition, sale or lease of employer real property; and
- the ability to correct a transaction does not apply if the fiduciary or other party in interest knowingly participated in the original transaction (e.g., if such person knew or should have known that the transaction was prohibited).

If a transaction is appropriately corrected then no excise tax is due with respect to the original prohibited transaction or the correction thereof. The correction provisions of the Act apply to any transaction that a fiduciary or other party in interest discovers, or reasonably should have discovered, constitutes a prohibited transaction after the date of enactment (even if the prohibited transaction occurred before enactment).

Code Section 4975 imposes an excise tax of 15% per year (in some cases rising to 100%) of the "amount involved" (e.g., the purchase price) on counterparties or fiduciaries who engage in a prohibited transaction until that prohibited transaction is

corrected. The addition of a correction period is a very important change because a significant concern of persons engaging in transactions with ERISA plans is that they may discover years later that they have engaged in a prohibited transaction and then discover that they owe significant Code Section 4975 excise taxes as a result of the prohibited transaction.   For example, if a plan were to purchase $100 of securities from a party in interest in a per se nonexempt prohibited transaction, and 4 years later they were to discover that a prohibited transaction had occurred, at that time they would owe $60 (15% x 4 x $100) in excise taxes. The correction period is meant to handle this precise situation and to remove some of the prohibited transaction risk inherent in dealing with an ERISA plan or a plan subject to Code Section 4975. The transaction would still need to be corrected (e.g., rescinded), so the correction period does not remove all of the prohibited transaction risk.

Changes in Bonding Requirements

The Act provides that the bond required under ERISA Section 412 for fiduciaries and others who handle plan assets (the "ERISA Bond") is not required of any entity which is registered as a broker or a dealer under Section 15(b) of the Securities Exchange Act of 1934, if the broker or dealer is subject to the fidelity bond requirement of a self-regulatory organization (such as NASD). While earlier versions of this provision also exempted registered investment advisors from the bonding requirement, that provision did not survive the legislative process and is not part of the Act.

The provision providing bonding relief for broker-dealers becomes effective for plan years beginning after the date of enactment. Therefore, an ERISA Bond held by a broker-dealer which satisfied the exemption requirements in the Act would need to be retained until each investing plan's current plan year expires.

The Act also includes another provision increasing the maximum bond amount from $500,000 to $1 million for plans that hold employer securities. This provision is problematic for fund managers because (i) they may not necessarily know whether their investing plans hold any employer securities and (ii) they may, in the ordinary course of managing their funds, acquire publicly traded employer securities which could cause them and every other fiduciary of the investing plan to suddenly need a $1 million bond.

The provision increasing the maximum bond amount is effective for plan years beginning after December 31, 2007.

We Can Help

Please contact one of the following Katten Muchin Rosenman LLP attorneys or your relationship partner if you wish to discuss the changes to ERISA's fiduciary rules made by the Act:

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