

The services discussed below are commonly offered by the majority of trust departments and the duties described are typical. The duties associated with the various fiduciary capacities described vary from state to state. For this reason, they are described in general terms. In order to gain a more complete understanding of the scope of the duties and responsibilities of a given fiduciary capacity examiners should be familiar with applicable state statutes.

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

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**A. INTRODUCTION**

The field of employee benefits is one which applies to banks with or without trust departments. Employee benefit plans are vehicles for which the benefits promised by an employer are funded, administered, and provided to eligible employees or members. Individual Retirement Accounts (IRAs) established by individuals under certain provisions of the tax laws are also covered in this section.

Employee benefit plans represent a diverse field. Plans vary according to the types of benefits provided, the manner in which plan assets are administered, and the manner in which benefit amounts are provided to the employees/participants and their beneficiaries. Every bank offers various types of employee benefits to its employees and their beneficiaries. As such, portions of the material in this section of the manual are relevant to every bank supervised by the FDIC.

Bank trust departments may manage the bank's own employee benefit plan(s) for its own employees. The trust department may perform the same services for the bank's parent holding company and affiliates. In addition, the trust department may service employee benefit plans sponsored by outside corporations, unions, individuals, and government entities.

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**B. SCOPE OF BANK ACTIVITY**

A bank may serve in various capacities with respect to employee benefit plans. For example, a bank may be appointed trustee or co-trustee for a plan, or may accept an appointment as agent, custodian, depository, or recordkeeper for a plan, or fulfill a combination of these duties. In addition to the duties described above, a bank may also perform administrative functions for a plan. The duties of the bank with respect to an employee benefit account depend upon the governing plan documents and the written documents, including trust and agency agreements, between the bank and the sponsor of the employee benefit plan.

While banks provide various trust and agency services to employee benefit plans sponsored by non-affiliated corporations, unions, government entities and individuals, they often provide such services for own-bank or affiliated institution plans. Since a bank is not required to obtain trust powers in order to serve as trustee for its own-bank plans, many banks without trust departments will also be subject to ERISA and Department of Labor regulations. Therefore, the material covered in this section will be applicable to banks that do not operate a trust or fiduciary services department.

Moreover, banks often serve as trustee or custodian for retirement benefit plans established by individuals. The most common type of retirement plan established by individuals is the Individual Retirement Account (IRA). While retirement plans established by individuals are not subject to ERISA or Department of Labor regulations, they are, due to their tax-advantaged status, subject to various sections of the Internal Revenue Code and regulation by the Internal Revenue Service. This section also covers IRAs and other individual retirement plans, along with the applicable Internal Revenue Code and IRS regulations governing such plans.

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**C. TYPES OF BENEFITS**

One way of describing various types of employee benefit plans is to reference the types of benefits the plan provides. In general, there are two types of benefits: retirement and welfare.

Retirement plan benefits generally arise when an employee is qualified to retire and often provide benefits to the employee's spouse and dependents. Some retirement plans involve the deferral of income for periods extending to the termination of employment, or beyond. Such plans usually cover key members of management. Retirement plans involve a number of different types of plans and funding arrangements. Although trust departments are generally more active in the retirement benefits field, examiners need to be aware of the general requirements for welfare benefit plans as well.

The term welfare benefits is used to describe non-retirement benefits. Welfare benefits may involve health and life insurance, scholarships and education assistance, day care centers, apprentice programs, prepaid legal services, vacation and sick-leave programs, and all other non-retirement benefits.

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**D. TYPES OF PLANS**

A second, and more common way of generically describing various types of employee benefit plans involves the method used to determine how assets are contributed to the plan. In this regard, there are two main types of pension plans: defined benefit and defined contribution plans.

Most plans operated by private employers are offered, at least in part, because contributions to the plan are tax deductible to the plan sponsor. In order to be tax deductible, an employee benefit pension plan must meet certain minimum standards and have certain provisions required by the Internal Revenue Service (IRS). As the tax laws and regulations tend to change often, the specific requirements, eligibility, conditions, and thresholds also are subject to change.

**Types of Employee Benefit Pension Plans**

Plan Type	Benefit Basis	Examples of Plans	Risk Born By	Assets Available For Benefits	Admin Cost
Defined Benefit	Formula – (based on Salary & Longevity)	Pensions	Sponsor	All Plan Assets	HEAVY
	Cash Balance (based on “Pay Credit” and “Interest Credit”)	Pensions	Sponsor	Participant’s Vested Account Balance	Less costly than traditional defined benefit plan
Defined Contribution	Employee (+ Employer) Contributions	Profit-Sharing ESOP 401(k) 403(b) SEP-IRA Pensions	Employee	Participant’s Own Portion of Plan	Much Less
	Investment Choices				
	Investment Results				

**Defined Benefit Plans**

A defined benefit plan is one which establishes a formula to define what the participant (employee) is entitled to receive. The formula is usually based on longevity and/or income. Most traditional pension plans use this approach, which often provides greater benefits the longer the employee stays with the plan sponsor. Employees/participants are entitled to the percentage of the benefits established under the plan. This entitlement is termed "vesting."

***Defined Benefit Pension Plans***

In this approach, the benefit payment is defined. The participant is entitled to whatever amount the formula results in and has a claim against all of the plan's assets for payment of the vested benefit. The plan sponsor (employer or union) is responsible for ensuring that sufficient assets are in the plan to pay those defined benefits. The most common type of defined benefit plan is the traditional pension plan.

Pension plan benefits are generally paid out in the form of a life annuity beginning at the participant's normal retirement date. Other methods of paying benefits are installment payments and lump sum distributions, with options sometimes given to the

participant. The Pension Benefit Guarantee Corporation (PBGC) insures the benefits of private defined benefit plans to the extent provided in Title IV of ERISA.

In private plans, it is common for retirement benefits payable under the pension plan to be set in conjunction with Social Security benefits. Benefits calculated in this manner are said to be integrated with Social Security retirement benefits. IRS regulations governing the integration of Social Security benefits are complex and designed to prevent discrimination in favor of highly paid employees.

Defined benefit plans are more expensive to administer and operate than defined contribution plans. Defined benefit plans involve projecting a host of variables to estimate the amount of benefits payable upon retirement and the amount of assets that must be contributed today to fund those benefits in the future. Actuaries are required to perform the projections. Due to the extra costs involved, defined benefit plans have become less popular, with many defined benefit plans terminated and replaced by defined contribution plans.

### ***Cash Balance Plans***

Another form of defined benefit plan is the "cash balance" plan. Cash balance plans are similar to traditional defined benefit pension plans in that: (a) they guarantee a specific benefit upon retirement which is not dependent upon the plan's investment performance; (b) retirement benefits are payable as an annuity with surviving spouse protection; employers must follow minimum funding policies under ERISA, and basic plan benefits are guaranteed by the PBGC up to limits set by law.

In recent years, this type of plan has become increasingly popular. Most of these plans have emerged as conversions from overfunded traditional defined benefit pension plans. Following conversion, plan assets remain intact. And employers cannot remove overfunded assets unless the plan has been terminated and full benefits under the terminated plan have been funded. Despite this protection, some conversions by high profile employers have attracted media attention. The focus of much of the attention, and controversy, surrounds diminished benefits for employees with long years of service. Unless employers take explicit steps to protect older employees with long company service, conversions from traditional pension plans (whose benefits are largely determined by years of service and final average pay) into cash balance plans, may impact these employees negatively.

Cash balance plans differ from traditional defined benefit plans in that they define benefits in terms of a stated "account balance," as opposed to a specific monthly benefit for life under traditional defined benefit pension plans. In this form of plan, employers credit a participant's account each year with a "pay credit" (typically based on a percentage of compensation) plus an "interest credit" (either a fixed rate, or a rate which is linked to an index, such as the one-year treasury bill rate). When a participant retires under a cash balance plan, he or she is entitled to the balance of his or her vested benefit (similar to a defined contribution plan), which may be taken as an annuity or in a lump sum. This is opposed to retirements under traditional defined benefit pension plans, where retirees are entitled to monthly lifetime annuities based upon years of service and pay.

A transition device, called "wearaway," is sometimes offered to employees with long service when traditional defined benefit pension plans are converted to cash balance plans. Wearaway provides employees the option of receiving the greater of their frozen benefit under the phased-out pension plan formula, or their total benefit under the cash balance formula. Employees near early retirement age may accrue little or nothing for a prolonged period under a cash balance plan until the phased out plan benefit is worn away. This is because the value of the traditional pension plan benefit may be far greater than future accruals under the cash balance plan. Furthermore, beginning balances under the cash balance plan may be set lower than the present value of the phased-out plan's accrued benefit. This serves to worsen the wearaway effect. Some employers temper the adverse conversion impact on long service employees by: (a) "grandfathering" them under the older plan's benefit formula, (b) providing higher "pay credits," (c) setting their opening balances higher, or (d) permitting employees to choose between benefit formulas under the old or new plans.

Employer accruals under a typical cash balance plan remain relatively level, increasing only slightly toward the end of an employee's career. Employer accruals under a traditional defined benefit pension plan begin relatively low, but increase sharply as an employee approaches retirement. This tends to make cash balance plans less costly to fund and operate than traditional defined benefit pension plans. Unlike traditional pension plans, cash balance plans also typically eliminate early retirement options but permit participants to receive retirement benefits in a lump sum, which can be rolled over into an IRA or another employer's plan.

**Defined Contribution Plans**

A defined contribution plan is one which establishes a formula defining how much the plan sponsor will contribute to the plan. The formula may be based on the sponsor's profitability, on the amount of the participant's earnings, or on any number of other factors or combinations. In some plans, the sponsor determines the amount of contribution on a discretionary basis.

Profit sharing, employee stock ownership, thrift 401(k) and 403(b), Simplified Employee Pension (SEP)-IRA, Salary Reduction SEP (SARSEP), Savings Incentive Match Plan for Employees (SIMPLE), and other types of commonly encountered plans use the defined contribution approach. As with defined benefit plans, plan participants are entitled to their vested percentage of the benefits, as established under the plan.

In this approach, the contribution is defined; the benefit payment is not. The benefit amount is dependent on both the amount contributed and the success of the investment results. Under this approach, the participant is entitled only to the amount in his or her account, based on the varying amounts contributed and the investment return. The participant has a claim only on the assets of his or her account in the plan; there is no claim against all of the plan assets belonging to other plan participants. The PBGC does not insure the benefits of defined contribution plans.

In general, there are five basic types of plans or formulas for defined contribution plans: profit sharing, money purchase pension, target benefit, stock bonus, and employee stock ownership.

***Profit Sharing Plans***

A profit-sharing plan is a qualified defined contribution plan which is also an Individual account plan. These plans are subject to ERISA. Plan assets are often invested wholly in the employer's stock. ERISA diversification requirements are not generally violated so long as the plan or trust instrument allows no more than 10% of the plan's assets to be invested in employer securities, except as provided in Section 407(a) of ERISA. Such plans are believed to foster productivity on the part of employees who will own part of the company.

There are two types of profit-sharing plans: current or deferred plans. In a current profit-sharing plan, profits are paid directly to employees in cash, check, or stock as soon as profits are determined. Deferred profit-sharing plans are more common. Deferred profit-sharing plans are defined contribution plans operating under a written plan and qualified under the Internal Revenue Code (IRC) where the employer provides retirement benefits.

The employer's contribution to the plan each year can be either purely discretionary (nothing at all, if the employer wishes) or based on some type of predefined formula. If a formula is used, it typically relates the contribution to the employer's profits. The term profit sharing plan implies that an employer must have profits before any contributions are made to the plan. However, this requirement was eliminated under the Tax Reform Act of 1986. Contributions to profit sharing plans are not required to be based on an employer's profits according to Section 401(a)(27)(A) of the IRC.

The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants. In addition, the plan must provide a predetermined formula for distributing the fund accumulated under the plan after a fixed number of years; attainment of a stated age; or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

Generally, contributions are allocated to participants in proportion to their compensation with subsequent allocations reflecting future contributions adjusted by the investment experience of the plan. Plan benefits consist of the amount accumulated in each participant's account including: (1) employer contributions, (2) forfeitures from other employee's accounts, and (3) interest and capital gains. Many plans permit participants to borrow against their vested interest in the plan.

***Money Purchase Pension Plans***

A Money Purchase Pension Plan (MPPP) is a defined contribution plan which is also an Individual account plan. Employer contributions are usually determined based upon a percentage of compensation for specific Individuals. As with the profit-sharing

plan, benefits for each participant are derived from the amounts contributed to each Individual account. Unlike a profit-sharing plan, forfeitures are not added to participants' accounts but are used to reduce the employer's contributions.

Money purchase pension plans differ from profit sharing plans in a number of ways:

- MPPPs must state a definite formula or approach for employer contributions; contributions may not be determined annually by the employer;
- MPPPs are subject to minimum funding requirements of the IRC;
- MPPPs must provide for a life annuity as a distribution option;
- MPPPs have different deduction limitations under the IRC than profit sharing plans; and
- MPPPs distributions are not permitted before retirement age, death, disability, or termination of either the plan or employment.

### ***Target Benefit Plans***

Target benefit plans are intended to provide a target benefit to each participant upon retirement. Employer contributions to each participant's account are established through a defined benefit formula. The amount of the contribution is determined by an actuary. The plan does not guarantee that the target benefit will be paid at retirement; its only obligation is to pay whatever can be provided by the amount in the participant's account depending on the actual investment results achieved by the fund. A life annuity must be one distribution option for the employee.

Target benefit plans are hybrids of a money purchase plan and a defined benefit plan. Target benefit plans are Individual account plans because contributions are allocated to each participant's Individual account.

### ***Stock Bonus Plans***

Stock bonus plans are identical to profit sharing plans and are usually established to permit employees to share in the ownership of the business and/or to reward meritorious service. Contributions, as with profit sharing plans, are not necessarily based upon profits and the benefits are distributable in cash or stock of the employer.

Generally, the plan must allow the participant to demand that the benefit be distributed in employer securities. If employer stock is not traded on an established market, the employee must have the right to require the employer to repurchase the stock under a fair market value formula.

### ***Employee Stock Ownership Plans (ESOPs)***

The information presented under this section will apply to both ESOPs sponsored by the bank for its own employees, and ESOPs found in the bank's trust department which are sponsored by different employers. In addition to the material presented under this heading, examiners should also refer to the following:

ESOP Plans - Employer Securities Investments - Prudence; (2) ESOP Plans - Employer Securities Investments - Valuation; and (3) ESOPs Loans to Plans - Section 408 Statutory Exemption. The pertinent areas related to ESOPs are noted below:

- ESOPs, In General
- Leveraged ESOPs
- Advantages and Disadvantages of ESOPs

#### **ESOPs, In General**

An ESOP is an Individual account plan that is either a qualified stock bonus plan or a combination qualified stock bonus and qualified money purchase plan. ESOPs provide separate accounts for each participant. Benefits are based solely on amounts contributed to each Individual account including attributable income, expenses, gains and losses, and allocated forfeitures of other participants' accounts. ESOPs are defined in Section 407(d)(6) of ERISA, Department of Labor (DOL) ERISA Regulation 2550.407d-6, and Section 4975(e)(7) of the IRC. See Appendix E.

Congress has provided a number of tax incentives to encourage the formation and continuation of ESOPs. ESOPs operate primarily under IRS requirements but are also subject to certain ERISA provisions. Since tax incentives impact government revenues, the rules under which ESOPs operate are subject to change by Congress and implementing IRS regulations. Some ESOPs which reflect various statutory or regulatory approaches have special names: Tax Reform Act Stock Ownership Plans (TRASOPs), Payroll-deduction Stock Ownership Plans (PAYSOPs), etc.

Most ESOPs invest solely in the employer's stock. Since many companies are either closely-held or have a very limited market for their stock, valuing the stock can prove problematic and provide opportunities for abuse. The value of the employer's stock greatly impacts the employee's eventual benefits.

In reviewing the administration of an ESOP's investments, the examiner must be cognizant of the following facts pertaining to ESOPs. ESOPs:

- *Are not* exempt from ERISA's prudence and exclusive benefit rules; but
- *Are exempt* from ERISA's diversification rule; and
- *May be exempt* from prohibited transactions (purchases and sales of employer securities from the employer and/or parties in interest) *if* certain conditions are met. In general, refer to ERISA Section 408(e) and DOL ERISA Regulation 2550.408e. See Appendix E. Three main conditions for exemption require:
  - Not more than adequate consideration may be paid by the plan (see Definitions, ERISA 3(18));
  - No direct or indirect commissions may be paid; and
  - The investment meets the prudence requirement of Section 404(a) of ERISA.

As tax-qualified plans, ESOPs must follow applicable IRS requirements, in addition to ERISA provisions. Except as otherwise indicated below, IRS Regulation 54.4975-1 (see Appendix E) establishes most of the following operational requirements for ESOPs. An ESOP must:

- Be formally designated as an ESOP in the plan document.
- Be designed to invest primarily in qualifying employer securities. For leveraged ESOPs, investments are restricted to the employer's common stock or convertible preferred stock; stock rights, warrants, and options are not considered in the definition. For non-leveraged ESOPs, the definition also includes marketable bonds, debentures, notes, and similar marketable debt instruments of the employer.

The types of qualifying employer securities are covered by IRS Regulation 54.4975-12. DOL ERISA Regulation 2550.407d-5 defines the term qualifying. See Appendix E.

- Value employer securities in accordance with both IRS and ERISA requirements. The valuations affect purchases and sales of employer securities, market-value reporting on the Annual Report (Form 5500), allocations to participants' accounts, and distributions to participants.

ERISA Section 408(e)(1) and DOL ERISA Regulation 2550.408e require that transactions for employer securities involve no more than adequate consideration. This term is defined in ERISA Section 3(18).

Section (d)(5) of IRS Regulation 54.4975-11 requires certain steps when valuing employer securities by an ESOP. For securities traded on securities exchanges, the quoted prices may be used. If the stock is publicly traded, no appraisal is necessary. But if it is traded infrequently, an appraisal may still be needed. In general, employer securities which are not readily tradable on an established securities market must be valued by an independent appraiser.

- Valuations must be made in good faith and based on all relevant factors:
  - In any transaction between the ESOP and a disqualified person, the value of the securities must be determined as of the date of the transaction. In such transactions, an independent appraisal, by itself, does not automatically equal good faith.
  - For all other transactions, values must be determined as of the most recent valuation date under the plan. In such transactions, an independent appraisal will generally be deemed to be a good faith determination of value.
- Include a put option. IRC Section 401(a)(23) also states that, to be qualified, a stock bonus plan must include a put option for securities that are not publicly traded.

With a put option, an employee who is entitled to a distribution from an ESOP has the option of requiring the employer to repurchase employer securities from the employee's Individual account in the plan. If the securities are not readily tradable on an established market, the securities must be valued at a reasonable fair market value. Through this arrangement, the employee receives a cash distribution instead of an in-kind distribution of illiquid securities.

- Include a suspense account for which assets are added to and maintained.

In addition, an ESOP must (1) pass voting rights through to participants for those shares allocated to Individual accounts according to Security and Exchange Commission (SEC) Regulation 240.14c-7 and (2) meet stringent nondiscrimination tests as to employee participation according to IRS regulations.

ESOPs can acquire assets through: (1) an outright gift of cash or newly issued common stock to the plan, (2) a thrift arrangement under which employees contribute money (PAYSOPs), (3) a profit-sharing arrangement where the employer's annual contribution is a percentage of profits, or (4) a money purchase arrangement where a percentage of compensation is contributed each year irrespective of profits. Most ESOPs; however, obtain initial funding through loans and are termed leveraged ESOPs. Loans to ESOP plans must comply with IRS and Labor Department requirements. Refer to the Leveraged ESOPs caption below.

### Leveraged ESOPs

Since a majority of ESOPs are leveraged, the examiner needs to understand the concept of a leverage ESOP and the conditions that apply. A corporation creates an ESOP, alone or in addition to (sometimes referred to as piggyback) another qualified retirement plan. The ESOP applies for a loan. The lender is usually an independent third party, but it could be anyone, including a party in interest such as the plan sponsor or the bank.

A number of conditions apply to such loans when the loan is with or guaranteed by a party in interest. The ESOP loan should be primarily for the benefit of participants and beneficiaries. Demand loans are not permitted and the loan must be payable over a set period. Terms of the loan must be, at the time it is made, at least as favorable to the ESOP as those of a comparable loan negotiated at an arm's-length basis by independent parties. No more than a reasonable rate of interest may be charged. While the loan may be unsecured, most ESOP loans are secured. If collateral is given by the plan to a party in interest, it may consist only of qualifying employer securities.

Leveraged financing may operate in two different ways. In the first way, the company gives the lender a written guaranty promising that the ESOP will repay the loan and that, each year, the employer will contribute to the ESOP sufficient funds to permit the ESOP to make its annual repayment of the loan. In the second way, the company borrows money from a bank and lends the money to the ESOP under terms identical to those negotiated between the company and the bank (mirror loan). After one of the financing options is chosen, the ESOP takes the loan proceeds and purchases qualifying employer securities at a reasonable price. Purchases must meet the conditions of ERISA Section 408(e) to avoid violating prohibited transaction rules.

Company contributions to the ESOP, which are tax-deductible under IRC Section 404, are used to pay off the loan. The employer's entire plan contribution (used to pay back the loan) is deductible within the limits of the IRC. If the employer borrowed the money directly, only the interest paid on the loan, and not repayment of the principal, would be deductible. The payments release a proportionate amount of securities from the loan's collateral. The securities, which were held in a suspense account by the plan, can be allocated among the plan participants as portions of the loan are paid off.

### Advantages and Disadvantages of an ESOP

There are a number of factors that influence the decision to sponsor an ESOP. Many of the considerations are tax-oriented. The plan sponsor, participating employees, and other parties all derive various advantages and disadvantages from the operation of an ESOP.

#### *Employer Considerations*

The employer's advantages include the fact that ESOPs are believed to foster productivity on the part of employees who will own part of the company. An ESOP may also provide a means of raising capital internally without resorting to outside financing,

which may be more expensive. If leverage for the ESOP is necessary, the lender may offer a lower interest rate to the plan since interest received on the loan may be non-taxable to the lender (see Lenders to ESOPs). In addition, an ESOP may be used to convert a public company to a private one or to resist an unwanted takeover. An ESOP used for such a purpose is subject to, among other things, the fiduciary responsibility and prohibited transaction provisions of Title I of ERISA, Protection of Employee Benefit Rights.

Operating an ESOP also offers the employer a number of tax advantages. Tax deductions are available for stock or cash contributions to the plan, cash dividends paid to plan participants, and dividends used to repay the loan. Particularly noteworthy is that the employer's entire plan contribution (used to pay back the loan) is deductible within IRC Section 404 limits.

Disadvantages for the employer involve the dilution of ownership and/or control, and the difficulties and costs inherent in arriving at recurring fair market valuations for thinly-traded securities.

### *Employee Considerations*

The primary consideration for most employees is that contributions made by the employer and accumulated earnings are tax-deferred. In addition, taxes on stock appreciation, when the stock is distributed, may be deferred by rolling the distribution over into an Individual Retirement Account (IRA). The fact that ESOPs offer employees a stake in the employer corporation through stock ownership has meant, in some situations, that employees have been able to save their jobs by purchasing a company or production facility which was scheduled for closure.

One significant disadvantage is that the employee bears all investment risk. In addition, the employee's investment is concentrated in one company's stock performance and valuations for the employer stock may be difficult to achieve. If the outlook for the employer's industry or for the employer itself is poor, the employee's retirement benefits may be threatened. Ownership of marginal or poorly managed companies, or those in declining industries, is of little value to employees and no foundation for careful retirement planning. As with any defined contribution plan, the employee's benefits are not insured by the PBGC.

When employees own stock in the employer, they exercise a certain amount of control over the employer. However, their influence may be limited as most ESOPs do not own a majority of the company's stock. Only shares allocated to Individual accounts have voting rights. And, the allocation of stock to Individual employees' accounts is a slow process in leveraged ESOPs. Voting rights are fully passed through only in publicly traded companies; in non publicly traded companies, only certain issues are voted on by participants. In a number of instances where an ESOP was formed to permit employees to purchase a facility from the employer, the employees owned a majority of the stock but management controlled voting authority. In effect, the employees may have little or no say in how the company they own is managed or operated.

To qualify for tax credit under IRC Section 409, ESOPs are required to pass the following voting rights on to Individual accounts holding allocated shares. IRC Section 409(e)(2) requires plans holding registered employer securities to permit plan participants to direct the plan on how to vote allocated securities. Where plans hold non-registered securities, IRC Sections 409(e)(3) and (5) require plans to permit plan participants to direct the plan on how to vote allocated securities with respect to corporate matters, such as: mergers, consolidations, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets of a business, or similar transactions. IRC Section 409(e) is located in Appendix E.

### *Lenders to ESOPs*

Tax laws provide incentives for lenders to grant loans to ESOPs. Under IRC Section 133, 50% of the interest the lender earns from an ESOP loan is non-taxable income when certain conditions are met:

- The ESOP owns at least 50% of each class of the outstanding stock of the corporation issuing the stock (or 50% of all outstanding stock) immediately after the acquisition (there are some limited additional provisions for isolated situations);
- The term of the loan isn't for more than 15 years; and
- The participants can direct the plan how to vote the shares allocated to their Individual accounts and acquired with the exempt loan.

These loans carry normal credit risk to the lender; plan sponsors in weak financial condition may involve more than normal credit risk. If the employer is unable to make its contributions to the ESOP, the plan will be unable to repay the lender. If the lender exercises its rights as a secured lender (the employer stock collateral pledged by the ESOP and the employer guarantee), it may wind up owning and operating the company.

#### *Company Shareholder Considerations*

Generally, if an ESOP exists, shareholders of the employer have a ready market for their stock. In addition, if a shareholder sells his or her employer stock to the ESOP, any unrealized gain may be deferred. The shareholder may elect not to recognize the gain on the sale of stock to the ESOP if qualified replacement property is purchased within the replacement period. Refer to IRC Section 1042 regarding the Sales of Stock to Employee Stock Ownership Plans or Certain Cooperatives.

#### ***Thrift and Savings Plans***

A thrift or savings plan is a defined contribution plan which is also a type of Individual account plan. These plans are employer sponsored and employee participation is normally voluntary. The plans permit the employee to make contributions, usually established as a percentage of pay. Employers normally make matching or partially matching contributions.

In many thrift and savings plans, employees can direct their plan assets into several pre-selected investment vehicles. Many corporate plans include employer stock as one of the investment options for these plans. An advantage to a plan where the employee decides how to invest funds in his or her plan account is that there is a reduced fiduciary liability for both the plan sponsor and any bank trustee. Self-directed thrift plans must generally comply with the requirements of DOL ERISA Regulation 2550.404c-1. This is discussed further in subsection H.5.c.(6), Individual Account (Section 404(c)) Plans.

Most thrift and savings plans are tax-qualified. Section 401(k) of the IRC, which originally was added in 1978, permits employers to establish tax qualified cash or deferred profit sharing or stock bonus plans. Under such plans, taxes on amounts contributed by both the employer and the employee, as well as accumulated earnings are deferred. With a salary reduction-type arrangement, the employees receive less current cash income and pay correspondingly lower Federal income taxes. Essentially, what a salary reduction plan accomplishes is to permit employees to provide for their own retirement with pre-tax dollars, rather than after-tax dollars.

To qualify for the mentioned tax benefits, the IRS requires the plan document to cover a number of specific areas. Among these are nondiscrimination in eligibility for the plan, and provisions to assure that executives and highly-paid employees do not receive preferential treatment. Vesting, withdrawals, participant loans, distribution of benefits, and other requirements must be met. The IRS rules governing these matters are complex and are primarily a concern for the plan sponsor, not a bank fiduciary.

#### ***Welfare Benefit Plans***

The more common types of employee welfare benefit plans and the related benefits include:

- *Health Plans* which provide for hospital expenses, diagnostic X-ray and laboratory fees, surgical and medical fees, medicine and drugs, major medical insurance, accidental death and dismemberment, and life insurance benefits. Such plans may also provide for dental care, visual care, psychiatric care, and preventive medical examinations.
- *Disability Plans* which normally provide benefits during periods of inability to work because of physical incapacity from illness or injury.
- *Vacation and Holiday Plans* which provide cash benefits to cover time off for vacation purposes.
- *Apprenticeship, Educational, and Similar Plans* which provide funds for retraining Individuals in the event of termination of a job in a particular industry, provide an opportunity to expand skills to improve job performance, or take on new responsibilities within or outside of the company.
- *Multiple Employer Welfare Arrangements (MEWAs)* which permit a pooling of employer contributions to purchase health insurance for their employees at favorable rates. Problems can arise because some suppliers offer attractively priced but unfunded "insurance-like" products without complying with state insurance laws. These suppliers claim their products are employee benefit "plans" and are, therefore, preempted from state insurance laws by ERISA. In doing so, they attempt to avoid state regulation and insurance reserve requirements. The following rules apply: (1) when a MEWA is covered by

ERISA and fully insured (which rarely happens), state insurance laws may apply to the extent they provide specified levels of reserves and contributions to pay future benefits; (2) when a MEWA is covered by ERISA and not fully insured, any state insurance law "not inconsistent" with ERISA may also apply; (3) when a MEWA is not covered by ERISA, no preemption can be claimed. Refer to subsection L, Compliance with State Laws for additional comment on state law and MEWAs. [The term MEWA is defined for purposes of Title I of ERISA in Section 3(40)(A); section 514(b)(6) of ERISA addresses the issue of presumption with respect to MEWAs.]

Most single employer welfare plans are either insured plans or unfunded plans. The insured plans typically provide medical and/or life insurance. The unfunded benefit plans most common for single employers are vacation and sick leave plans. The establishment of a single trust, to which contributions are made and from which benefits are paid, normally involves multiple employer plans. Occasionally larger corporations may provide medical and life benefits on a self-insured basis. In these instances, a trust to which annual contributions are made may be established.

Since welfare benefits are normally included in group insurance programs, an examiner will infrequently encounter a trust department acting as trustee of a welfare benefit plan. However, trustee welfare benefit plans are subject to the various provisions of ERISA in the same manner as pension benefit plans. Thus, when encountered in trust departments there must be a plan and trust document which defines the manner of contribution, provides the basis for payment of benefits, and describes the manner in which such plan funds are to be invested.

## **Abandoned Plans**

The Abandoned Plan Program facilitates the termination of, and distribution of benefits from, individual account pension plans that have been abandoned by their sponsoring employers. The program was established pursuant to three final regulations and a related class exemption and is administered by Employee Benefits Security Administration national and regional offices.

Significant business events, such as bankruptcies, mergers, acquisitions, and other similar transactions affecting the status of an employer, too often result in employers, particularly small employers, abandoning their individual account pension plans (e.g., 401(k) plans). When this happens, custodians such as banks, insurers, mutual fund companies, etc. are left holding the assets of these abandoned plans but do not have the authority to terminate such plans and make benefit distributions – even in response to participant demands. In these situations, participants and beneficiaries have great difficulty accessing the benefits they have earned. In response, the Labor Department's Employee Benefits Security Administration (EBSA) has developed rules to facilitate a voluntary, safe and efficient process for winding up the affairs of abandoned individual account plans so that benefit distributions are made to participants and beneficiaries. Information about the program is available under the Abandoned Plan Program section of EBSA's Web site at <https://www.dol.gov/agencies/ebsa>.

## ***Overview of Regulations***

The regulations, 29 CFR Parts 2550 and 2578, establish standards for determining when a plan is abandoned, simplified procedures for winding up the plan and distributing benefits to participants and beneficiaries, and provide guidance on who may initiate and carry out the winding-up process.

## ***Plan Abandonment***

A plan generally will be considered abandoned if no contributions to or distributions from the plan have been made for a period of at least 12 consecutive months and, following reasonable efforts to locate the plan sponsor, it is determined that the sponsor no longer exists, cannot be located, or is unable to maintain the plan.

## ***Determinations of Abandonment***

Only a qualified termination administrator (QTA) may determine whether a plan is abandoned under the regulations. To be a QTA, an entity must hold the plan's assets and be eligible as a trustee or issuer of an individual retirement plan under the Internal Revenue Code (e.g., bank, trust company, mutual fund family, or insurance company).

***Termination and Winding-Up Process***

The regulations establish specific procedures that QTAs must follow, including:

- Notifying EBSA prior to, and after, terminating and winding up a plan.
- Locating and updating plan records.
- Calculating benefits payable to participants and beneficiaries.
- Notifying participants and beneficiaries of the termination, their rights and options.
- Distributing benefits to participants and beneficiaries.
- Filing a summary terminal report.

A QTA is not required to amend a plan to accommodate the termination.

The regulations include model notices that the QTA may use.

***Distribution Safe Harbor for Missing Participants***

The regulations establish a fiduciary safe harbor for distributions from terminating individual account plans (whether or not abandoned) on behalf of missing participants.

In most cases, the account of a missing participant will be transferred directly to an individual retirement plan. In some cases, accounts of \$1,000 or less may be distributed to a bank account or state unclaimed property fund on behalf of the missing participant.

***Fiduciary Liability***

QTAs that follow the regulations will be considered generally to have satisfied the prudence requirements of ERISA with respect to winding-up activities.

A QTA does not have an obligation to conduct an inquiry or review to determine whether or what breaches of fiduciary responsibility may have occurred with respect to a plan prior to becoming the QTA for such plan.

A QTA is not required to collect delinquent contributions on behalf of the plan, provided that the QTA informs EBSA of known delinquencies.

Since more than one entity may be holding assets of a plan, the regulations provide a safe harbor for other asset custodians who cooperate with the QTA.

***Annual Reporting Relief***

The regulations provide annual reporting relief, under which QTAs are not responsible for filing a Form 5500 Annual Report on behalf of an abandoned plan, either in the terminating year or any previous plan years; but the QTA must complete and file a summary terminal report at the end of the winding up process.

Instructions on how to file the terminal report will be available under the Abandoned Plan Program section of EBSA's Web site at [www.dol.gov/ebsa](http://www.dol.gov/ebsa).

***Class Exemption***

Accompanying the regulations is a class exemption, PTE 2006-06 (PDF), that provides conditional relief from ERISA's prohibited transaction restrictions.

The exemption would cover transactions where the QTA selects and pays itself:

- For services rendered prior to becoming a QTA.
- To provide services in connection with terminating and winding up an abandoned plan.
- For distributions from abandoned plans to IRAs or other accounts maintained by the QTA resulting from a participant's failure to provide direction.

### **Health Savings Accounts (HSAs)**

Health Savings Accounts (HSAs) were created on December 8, 2003 under Title XII of the Medicare Prescription Drug, Improvement and Modernization Act of 2003," (MPDIMA of 2003) and updated under Title III of the Tax Relief and Health Care Act of 2006 (TRHCA of 2006).

In general, HSAs are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents. Individuals with a high-deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish an HSA. However, individuals who may be claimed as a dependent on another person's tax return are not eligible to open an HSA. HSAs provide tax-favored treatment for current medical expenses as well as the ability to save on a tax-favored basis for future medical expenses. Within limits, contributions to an HSA made by or on behalf of an eligible individual are deductible by the individual. Where the establishment of an HSA is voluntary on the part of an employee, and the employer does not influence or limit the investment or use of HSA funds, the HSA constitute "employee welfare benefit plans" for purposes of Title I of ERISA. Individuals may make tax deductible contributions to the HSA even if they do not itemize deductions; the individual's employer can make contributions that are not taxed to either the employer or the employee; and, employers sponsoring cafeteria plans can allow employees to contribute untaxed salary through salary reduction. Individuals age 55 and older are also allowed to make additional catch-up contributions to their HSAs. Furthermore, certain credits on behalf of the individual by plan sponsors are permissible and not viewed as a prohibited transaction under ERISA or the Code. Amounts contributed to an HSA belong to the account holder and are portable. Earnings on HSAs are not taxable, and can grow tax-free through investment earnings. Unlike amounts in Flexible Spending Arrangements that are forfeited if not used by the end of the year, unused funds remain available for use in later years. Distributions from an HSA for qualified medical expenses are not includible in gross income. However, distributions from an HSA which are not used for qualified medical expenses are includible in gross income and subject to an additional 10 percent tax. The additional tax does not apply if the distribution is made after death, disability, or the individual attains the age of 65. After an individual has attained age 65 and becomes enrolled in Medicare benefits, contributions cannot be made to an HSA.

A high-deductible health plan is a health plan that, for 2007, has a deductible that is at least \$1,100 for self-only coverage or \$2,200 for family coverage and that has an out-of-pocket expense limit that is no more than \$5,500 in the case of self-only coverage, and \$11,000 in the case of family coverage. Out-of-pocket expenses include deductibles, co-payments, and other amounts (other than premiums) that the individual must pay for covered benefits under the plan. A plan is not a high-deductible health plan if substantially all of the coverage is for permitted coverage or coverage that may be provided by permitted insurance. A plan does not fail to be a high-deductible health plan by reason of failing to have a deductible for preventive care.

Permitted insurance is: (1) insurance if substantially all of the coverage provided under such insurance relates to (a) liabilities incurred under worker's compensation law, (b) tort liabilities, (c) liabilities relating to ownership or use of property (e.g., auto insurance), or (d) such other similar liabilities as the Secretary of Treasury may prescribe by regulations; (2) insurance for a specified disease or illness; and (3) insurance that provides a fixed payment for hospitalization.

Permitted coverage is coverage (whether provided through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.

Health flexible spending arrangement ("FSAs") and health reimbursement arrangements ("HRAs") are health plans that constitute other coverage under the HSA rules. An individual who is covered by a high-deductible health plan and a health FSA, or HRA, is generally not eligible to make contributions to an HSA. An individual is eligible to make contributions to an HSA if the health FSA or HRA is: (1) a limited purpose health FSA or HRA; (2) a suspended HRA; (3) a post-deductible health FSA or HRA; or (4) a retirement HRA.

***Tax Treatment of and Limits on Contributions***

Contributions to an HSA by or on behalf of an eligible individual are deductible (within limits) in determining adjusted gross income. In addition, employer contributions to HSAs (including salary reduction contributions made through a cafeteria plan) are excludable from gross income and wages for employment tax purposes. In the case of an employee, contributions to an HSA may be made by both the individual and the individual's employer. All contributions are aggregated for purposes of the maximum annual contribution limit. Contributions to Archer MSAs (medical savings accounts for self-employed individuals and employees of small employers with 50 or fewer employees) reduce the annual contribution limit for HSAs. The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high-deductible health plan, or (2) (for 2007) \$2,850 for self-only coverage and \$5,650 for family coverage. The annual contribution limit is the sum of the limits determined separately for each month, based on the individual's status and health plan coverage as of the first day of the month. The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of individuals and covered spouses who are age 55 or older, the HSA annual contribution limit is increased by catch-up contributions of \$700 in 2006, \$800 in 2007, \$900 in 2008, and \$1,000 in 2009 and thereafter. As in determining the general annual contribution limit, the increase in the annual contribution limit for individuals who have attained age 55 is also determined on a monthly basis. Contributions, including catch-up contributions, cannot be made once an individual is enrolled in Medicare. In the case of individuals who are married and either spouse has family coverage, both spouses are treated as having only the family coverage with the lowest annual deductible. The annual contribution limit (without regard to the catch-up contribution amounts) is divided equally between the spouses unless they agree on a different division (after reduction for amounts paid from any Archer MSA of the spouses). An excise tax applies to contributions in excess of the maximum contribution amount for the HSA. The excise tax generally is equal to six percent of the cumulative amount of excess contributions that are not distributed from the HSA. Amounts can be rolled over into an HSA from another HSA or from an Archer MSA.

***Comparable Contributions***

Section 306 of the TRHCA of 2006 requires employers to make available comparable contributions on behalf of all employees with comparable coverage during the same period. Contributions are considered comparable if they are either of the same amount or the same percentage of the deductible under the plan. If employer contributions do not satisfy the comparability rule during a period, then the employer is subject to an excise tax equal to 35 percent of the aggregate amount contributed by the employer to HSAs for that period. The comparability rule does not apply to contributions made through a cafeteria plan.

***Taxation of Distributions***

Distributions from an HSA for "qualified medical expenses" of the individual and his or her spouse or dependents are excludable from gross income. Qualified medical expenses include expenses for diagnosis, cure, mitigation, treatment, or prevention of disease. Qualified medical expenses do not include expenses for insurance other than for (1) long-term care insurance, (2) premiums for health coverage during any period of continuation coverage required by Federal law, (3) premiums for health care coverage while an individual is receiving unemployment compensation under Federal or State law, or (4) health insurance premiums for Medicare, other than premiums for Medigap policies. Qualified health insurance premiums include Medicare Part A and Part B premiums, Medicare HMO premiums, and the employee share of premiums for employer-sponsored health insurance. Distributions from an HSA that are not for qualified medical expenses are includible in gross income. Distributions includible in gross income also are subject to an additional 10 percent tax unless made after death, disability, or the individual attains the age of 65.

***Health Flexible Spending Arrangements and Health Reimbursement Arrangements***

Arrangements commonly used by employers to reimburse medical expenses of their employees include health flexible spending arrangements ("FSAs") and health reimbursement accounts ("HRAs"). Health FSAs are typically funded on a salary reduction basis. If the health FSA meets certain requirements, the compensation that is forgone is not includible in gross income and reimbursements for medical care from the health FSA are excludable from gross income and wages. Health FSAs are subject to the general requirements relating to cafeteria plans, including a requirement that a cafeteria plan generally may not provide deferred compensation. This requirement is referred to as the "use-it-or-lose-it-rule." Until May of 2005, this requirement was interpreted to mean that amounts available from a health FSA as of the end of a plan year must be forfeited by the employee. In May 2005, the Treasury Department issued a notice that allows a grace period not to exceed two and one half months immediately

following the end of the plan year during which unused amounts may be used. An individual participating in a health FSA that allows reimbursements during a grace period is generally not eligible to make contributions to the HSA until the first month following the end of the grace period even if the individual's health FSA has no unused benefits as of the end of the prior plan year. HRAs operate in a manner similar to health FSAs, in that they are an employer maintained arrangement that reimburses employees for medical expenses. Some of the rules applicable to HRAs and health FSAs are similar, e.g., the amounts in the arrangements can only be used to reimburse medical expenses and not for other purposes. Some of the rules are different. For example, HRAs cannot be funded on a salary reduction basis and the use-it-or lose-it rule does not apply. Rather, amounts remaining at the end of the year may be carried forward to be used to reimburse medical expenses in the next year. Reimbursements for insurance covering medical care expenses are allowable reimbursements under an HRA, but not under a health FSA. Subject to certain limited exceptions, health FSAs and HRAs constitute other coverage under the HSA rules.

### ***Rollovers from Health FSAs and HRAs into HSAs for a Limited Time***

Section 302 of the TRHCA of 2006 permits certain amounts in a health FSA or HRA to be distributed from the health FSA or HRA and contributed through a direct transfer to an HSA without violating the requirements for such arrangements. The amount that can be distributed from a health FSA or HRA and contributed to an HSA may not exceed an amount equal to the lesser of (1) the balance in the health FSA or HRA as of September 21, 2006 or (2) the balance in the health FSA or HRA as of the date of the distribution. Amounts contributed to an HSA under this section are excludable from gross income for tax purposes, are not taken into account in applying the maximum deduction limitation for other HSA contributions, and are not deductible. Contributions must be made directly to the HSA before January 1, 2012. The rollover is limited to one distribution with respect to each health FSA or HRA of the individual. This provision was designed to assist individuals in transferring from another type of health plan to a high-deductible health plan. If an individual for whom a contribution is made under the provision does not remain an eligible individual during the "testing period," the amount of the contribution is includible in gross income of the individual. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10 percent additional tax applies to the amount includible. A modified comparability rule applies with respect to contributions under the provision. If the employer makes available to any employee the ability to make contributions to the HSA from distributions from a health FSA or HRA under this section, all employees who are covered under a high-deductible plan of the employer must be allowed to make such distributions and contributions. The IRS issued guidance regarding rollovers from FSAs and HRAs into HSAs. See Internal Revenue Service Notice 2007-22.

### ***Certain FSA Coverage Treated as Disregarded Coverage***

Section 302 of the TRHCA of 2006 provides that, for taxable years beginning after December 31, 2006, coverage under a health flexible spending arrangement ("FSA") during the period immediately following the end of a plan year during which unused benefits may be paid or reimbursed to plan participants for qualified expenses is disregarded coverage. Such coverage is disregarded if (1) the balance in the health FSA at the end of the plan year is zero, or (2) the entire remaining balance in the health FSA at the end of the plan year is contributed to an HSA.

### ***Repeal of Annual Plan Deductible Limitation on HSA Contribution Limitation***

Section 303 of the TRHCA of 2006 modifies the limit on the annual deductible contributions that can be made to an HSA. The maximum deductible contribution is not limited to the annual deductible under the high-deductible health plan. The maximum aggregate annual contribution that can be made to an HSA in 2007 is \$2,850 for self-only coverage and \$5,650 family coverage.

### ***Indexing of Cost of Living Adjustments***

Section 304 of the TRHCA of 2006 provides that for adjustments made for any taxable year beginning after 2007, the Consumer Price Index for a calendar year will be determined as of the close of the 12-month period ending on March 31 of the calendar year for the purpose of making cost-of-living adjustments for the HSA dollar amounts that are indexed for inflation (contribution limits and high-deductible health plan requirements).

***Contribution for Months Preceding Month that Taxpayer is an Eligible Individual***

Section 305 of the TRHCA of 2006 allows individuals who become covered under a high-deductible plan in a month other than January to make the full deductible HSA contribution for the year. An individual who is an eligible individual during the last month of a taxable year is treated as having been an eligible individual during every month during the taxable year for purposes of computing the amount that may be contributed to the HSA for the year. For the months preceding the last month of the taxable year that the individual is treated as an eligible individual solely by reason of this section, the individual is treated as having been enrolled in the same high-deductible health plan in which the individual was enrolled during the last month of the taxable year. If an individual makes contributions permitted by section 305 but does not remain an eligible individual during the "testing period," the contributions preceding the month in which the individual was an eligible individual are includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The "testing period" is the period beginning with the last month of the taxable year and ending on the last day of the 12th month following such month. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax applies to the amount in question.

***Employer Comparable Contribution Requirements for Contributions Made to Non-highly Compensated Employees***

Section 306 of the TRHCA of 2006 provides an exception to the comparable contribution requirements which allows employers to make larger HSA contributions for non-highly compensated employees than for highly compensated employees. Highly compensated employees are defined as under section 414(q) and include any employee who was (1) a five-percent owner at any time during the year or the preceding year; or (2) for the preceding year, (A) had compensation from the employer in excess of \$100,000 (for 2007) and (B) if elected by the employer, was in the group consisting of the top 20 percent of employees when ranked based on compensation. The comparable contribution rules continue to apply to the contributions made to non-highly compensated employees so that the employer must make available comparable contributions on behalf of all non-highly compensated employees with comparable coverage during the same period.

***Rollovers from IRAs into HSAs***

Section 307 the TRHCA of 2006 permits a one-time contribution to an HSA of amounts distributed from an individual retirement arrangement ("IRA"). The contribution must be made in a direct trustee-to trustee transfer. Amounts distributed from an IRA under this section are not includible in income, and are not subject to the 10 percent tax on early distributions. The amount that can be distributed from the IRA and contributed to an HSA is limited to the maximum deductible contribution to the HSA computed on the basis of the type of coverage under the high-deductible health plan at the time of the contribution. The amount that can otherwise be contributed to the HSA for the year of the contribution from the IRA is reduced by the amount contributed from the IRA. No deduction is allowed for the amount contributed from an IRA to an HSA. Only one distribution and contribution may be made during the lifetime of the individual. However, if a distribution and contribution are made during a month in which an individual has self-only coverage as of the first day of the month, an additional distribution and contribution may be made during a subsequent month within the taxable year in which the individual has family coverage. The limit applies to the combination of both contributions. If the individual does not remain an eligible individual during the "testing period," the amount of the distribution and contribution is includible in gross income. An exception applies if the employee ceases to be an eligible individual by reason of death or disability. The amount is includible for the taxable year of the first day during the testing period that the individual is not an eligible individual. A 10-percent additional tax applies to the amount in question. Section 307 does not apply to simplified employee pensions ("SEPs") or to SIMPLE retirement accounts. The IRS issued guidance on this matter in the form of a Service Notice on March 5, 2007.

***DOL Guidance Regarding HSAs***

The DOL has issued guidance on several issues concerning HSA and the application of ERISA and the Internal Revenue Code to HSAs. In 2004, the DOL issued Field Assistance Bulletin 2004-01 which addressed the application of ERISA to HSAs established in connection with employment. DOL expanded on this guidance by issuing Q&As in Field Assistance Bulletin 2006-02. In addition, in 2004, DOL issued Advisory Opinion 2004-09A, which addresses the application of the prohibited transaction provision of IRC Section 4975 to certain contributions to HSAs.

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**E. SELF-EMPLOYED RETIREMENT (KEOGH OR HR-10) PLANS**

Self-employed Individuals are permitted to establish tax-qualified pension and profit sharing plans for themselves and their employees. A self-employed Individual is a sole proprietor or partner who works in his or her unincorporated business. Such arrangements are normally designated as Keogh or HR-10 plans, trusts, or accounts. Sometimes Keogh accounts are termed Self-Employed Retirement Plans (SERPs). Keogh plans are generally comparable to corporate-sponsored defined contribution plans that are Individual account plans.

There are specific provisions in the IRC covering Keogh accounts. Only self-employed Individuals may deduct contributions to a Keogh plan. Participants may be permitted to make nondeductible contributions to a plan in addition to employer contributions. Even though these employee contributions may not be deductible, the earnings on them and the contributions by the employer are tax deferred until the Individual begins retirement withdrawals. Retirement withdrawals may commence upon attainment of age 59 1/2 but must commence by the end of the calendar year in which the Individual attains age 70 1/2. The owner-employee may contribute up to 25% of the first \$150,000 of earned income or \$30,000, whichever is less. In addition, the IRC requires that contributions, in the same percentage of compensation as for the owner-employer, be made on behalf of common law employees with three or more years of service. Plan participants rarely direct their own investments.

In self-employed retirement plans, the *contribution* is defined but the benefit payment is not. Benefits are subject to both the amount contributed and the success of the investment results. Under this approach, the participant is entitled only to the amount in his or her account, based on the varying amounts contributed and the investment return. The participant has a claim only on the assets of his or her account in the plan; there is no claim against all of the plan assets belonging to other plan participants. The PBGC does not insure the benefits of defined contribution plans. IRS Publication 560, Retirement Plans for the Self-Employed, provides more detailed information on both defined benefit and defined contribution Keogh plans.

A bank may serve as a trustee or custodian for Keogh or HR-10 plans. As trustee, the bank's responsibilities may range from ministerial functions to the exercise of broad discretionary duties. As custodian, responsibilities are essentially ministerial in nature. In either case, the bank's responsibilities will be governed by the instrument and ERISA.

- Keogh accounts which cover only the owner-employer, and no other employees, are subject to compliance with the prohibited transaction provisions of ERISA Section 406 and the parallel IRC Section 4975 (refer to subsection H.7, Prohibited Transactions - ERISA Section 406).
- Keogh accounts which cover both the owner-employer and other employees are subject to ERISA Sections 404 and 406, covering fiduciary responsibility and prohibited transactions (refer to subsection H.7, Prohibited Transactions - ERISA Section 406).
- IRC Section 408(m) indicates that if self-directed and Individual account plans invest in collectibles, the investment will be treated as a distribution. Collectibles include: stamps, coins, artwork, gems, antiques, etc. An exception is made for U.S. American Eagle gold coins, which are permissible investments (refer to Appendix E).

A bank may accept non-deposit self-directed Keogh custodial accounts without trust powers under Section 333.101(b) of the FDIC's Rules and Regulations, if the appropriate state authority also permits such accounts to be accepted without trust powers. Despite the fact that trust powers are not needed, banks accepting such accounts must implement appropriate controls. Refer to Section 2, subsection O, Self-Directed IRAs and Keogh Accounts.

Examiners should also be aware that Keogh accounts may not normally be invested in Collective Investment Funds (CIFs) without violating Federal securities laws. There are a few approaches where collective investments are possible, but with many restrictions. Refer to Section 7, subsection D.1, Keogh Account Usage Of Collective Investment Funds. Under certain conditions, banks may offer beneficiaries of Keogh accounts reduced or no cost banking services, refer to Section 5, subsection H.9.c. Receipt of Services by IRAs and Keogh Plans.

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**F. INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)**

As tax laws change, the types of IRA and the conditions affecting their availability and operation change. An IRA is a personal savings plan that offers a person tax advantages to set aside money for retirement. Two advantages for the individual include that they may be able to deduct contributions to the IRA in whole or in part, and generally, earnings and gains are not taxed until retirement distributions commence. Tax qualification for IRAs is achieved pursuant to IRC Section 408.

In 2003 and 2004, an individual may contribute the lesser of \$3,000 (\$3,500 if the individual reached age 50 before 2004) or taxable compensation into an IRA. An individual and a non-working spouse (a one-income couple) are limited to \$6,000 per year in contributions (\$3,000 each to a Traditional IRA and a Spousal IRA). This limit increases to \$6,500 if one individual reached age 50 before 2004, or \$7,000 if both reached 50 before 2004. The amount contributed is deductible on the Individual's tax return. IRA contributions must end in the year the participant turns 70 1/2. (Note: Traditional IRAs are IRAs which are neither Roth IRAs nor SIMPLE IRAs.)

IRA deductibility for Federal income tax purposes is limited based on income tax filing status, the amount of earned income, and/or coverage of the participant or spouse by an employer-sponsored retirement plan(s). Even if Individuals cannot take a full deduction because of one of the limitations described above, they may still contribute up to the maximum amount permitted in the current year (refer to IRS Publication 590 for detailed information pertaining to IRA contributory and deductibility limits, these limits are subject to change). Retirement withdrawals may commence upon attainment of age 59 1/2, but must commence by the end of the calendar year in which the Individual attains age 70 1/2.

Under certain conditions, banks may offer beneficiaries of IRAs reduced or no cost banking services, refer to subsection H.9.c. Receipt of Services by IRAs and Keogh Plans.

IRS Publication 590, Individual Retirement Arrangements provides further information on IRAs.

**Operating/Filing Requirements**

The IRS requires all IRAs to operate under either one of two versions of IRS Form 5305, or under a written agreement which incorporates the provisions of either of the versions of this form. The two forms are identical except for the interchangeability of the terms trust and custodian throughout the forms. As custodian, responsibilities are essentially ministerial in nature.

The examiner should note:

- Under IRC Section 408(h) - bank custodians of IRAs are considered trustees, hence fiduciaries.
- Under IRC Section 408(i) - IRA trustees are required to report contributions, distributions, and other matters required by regulation (including the fair market value of assets) to the IRS and the IRA owner on an annual basis. As the value of some types of assets, such as limited partnerships, is not easily ascertainable, the administration of some IRA accounts can be problematic.

In a 2-24-93 letter to Partnership Valuations, Inc., Annapolis, Maryland, the IRS indicated that trustees of IRAs were responsible for ensuring that IRA assets are properly valued on an annual basis, including assets which are "hard to value". It also stated that IRA trustees could not evade evaluation responsibility by having the IRA owner sign a release, indemnification or other instrument. The IRS indicated that IRA contributions, distributions, and valuations should be reported on IRS Form 5498 (Individual Retirement Arrangement Information) to satisfy annual reporting requirements. A copy of the 2-23-93 IRS Interpretive Letter EP:R:9 - Valuation of IRA Assets to Partnership Valuations, Inc. is located in Appendix E. IRS Revenue Ruling 59-60 Valuation of Non-Traded Assets, in Appendix E also provides general guidance on valuing non-traded assets.

**Types of IRAs**

In addition to IRAs for Individuals, a number of different variations now exist and are highlighted below:

- *Rollover IRAs* enable an employee to transfer, tax-free, lump-sum distributions from a previous employer's tax-deferred retirement plan to a new IRA. Rollovers may also be used to transfer funds from one IRA account to another IRA account. The transfer permits the employee to continue tax-deferred earnings.

When a lump-sum distribution from an employee benefit plan is "rolled" into an IRA, the entire distribution from the previous plan must be transferred to one or more rollover IRAs. In addition, if the funds being transferred originate from either a lump-sum distribution or represent the movement from an existing IRA account to a new IRA account, the transfer must be done directly from the previous plan or IRA to the rollover IRA. If the transfer is done by a check to the employee, the employee must:

- Pay 20% of the total amount to the government for Federal income taxes, which is withheld from the initial disbursement;
  - Furnish the 20% that was withheld in order to avoid tax consequences since the entire amount of the initial distribution must be rolled into the new rollover IRA; and
  - Place the total amount of funds into the rollover IRA by the 60th day after the day the distribution is received.
- *Individual Retirement Annuity* is an IRA which is established by purchasing an annuity contract or an endowment contract from a life insurance company. The annuity must be issued to the IRA owner, and either the owner or their surviving beneficiaries may receive benefits from the IRA. The entire interest in the contract must be nonforfeitable, it must provide that the owner cannot transfer any portion of it to any person other than the issuer, it must (for contracts issued after 11-6-78) have flexible premiums to permit annuities to change as the owner's compensation changes, it must limit annual contributions to the maximum amount permitted under Traditional IRAs discussed above, and provide for refunded premiums to pay for future premiums or to buy additional benefits before the end of the calendar year after the year the refund is received, and it must begin distributions by April 1 of the year the owner reaches age 70 1/2. IRS Publication 590, Individual Retirement Arrangements, provides further basic information on IRAs.
- *Individual Retirement Bonds* are IRAs which were funded through the purchase of Individual retirement bonds issued by the Federal government. The program was suspended after 4-30-82. It had the following characteristics: the bonds paid interest only until they were cashed in by the owner; no interest was paid on the bonds after the owner reached 70 1/2 years of age; upon the owner's death, the bonds stopped paying interest at the earlier of 5 years after the date of death or the date on which the owner would have reached age 70 1/2; and the bonds could not be sold, discounted, or used as collateral or security. IRS Publication 590, Individual Retirement Arrangements, provides further basic information on IRAs.
- *Simplified Employee Pension (SEP)-IRA* is a pension plan where the employer establishes an IRA account for the benefit of each covered employee. Employer contributions are excluded from an employee's income. In any year where the employer's contribution is less than the normal IRA maximum for Individuals (refer to Traditional IRAs above), the employee may contribute the difference. SEP-IRAs are much simpler and involve less administrative cost for the employer than do other types of retirement plans. IRS Publication 560, Retirement Plans for the Self-employed, provides information on SEP-IRA plans.

The Economic Growth and Tax Relief Reconciliation Act of 2001 amended Sections 402 and 414 of the Internal Revenue Code, enabling individuals age 50 and over to make elective retirement plan deferrals (catch-up contributions) to 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEP), Section 403(b) arrangements, and Section 457 governmental plans effective for plan years beginning after December 31, 2001. Refer to Section Q. Catch-Up Contributions for additional details.

- *Salary Reduction Simplified Employee Pension Plan (SARSEP)* is a type of defined contribution employee benefit plan established under the Tax Reform Act (TRA) of 1986. SARSEPs are sometimes referred to as elective deferral arrangements or as salary reduction arrangements. SARSEPs operate with pretax employee contributions, thus reducing the employee's income tax liability.

New SARSEPs could be adopted by employers through December 31, 1996. Beginning January 1, 1997, SARSEPs were replaced by Savings Incentive Match Plans for Employees (SIMPLEs), and no new SARSEPs may be established. SARSEPs adopted prior to 1997 can be continued with additional contributions made to them.

SARSEPs were available to employers with 25 or fewer employees, and with at least 50% of eligible employees participating in the plan. Employees contribute a percentage of their salary, thus reducing current income and current income taxes. Income and capital gains earned by SARSEPs are tax deferred. The annual limit on salary contributions to a SARSEP is limited

(\$9,500 in 1996), with the limit indexed. In top heavy plans, the amount contributed for the highly compensated employees cannot be more than 125% of the average percentage of pay contributed by all non-highly compensated employees.

IRS Publication 560, Retirement Plans for the Self-Employed, also provides information on SARSEP plans.

- *Inherited Individual Retirement Accounts* are subject to special rules. The IRA is included in the estate of the decedent who owned it. Unless the inheriting beneficiary is the decedent's surviving spouse, the beneficiary cannot treat the IRA as their own. Only the surviving spouse can elect to: make contributions to the IRA, including rollover contributions; rollover the inherited IRA into another IRA; and to delay receipt of distributions until (the surviving spouse reaches) age 70 1/2. All other inheriting beneficiaries must take distributions from the IRA, which is dependent upon the IRA owner's election at the time the IRA was opened and minimum distribution requirements. IRS Publication 590, *Individual Retirement Arrangements*, provides further basic information on IRAs.
- *Roth Individual Retirement Accounts* were introduced in 1998. Except for some special rules which apply only to Roth IRAs, these Individual retirement accounts are subject to the same IRS rules as are traditional IRAs. IRS Publication 590, *Individual Retirement Accounts*, extensively discusses all types of IRAs, and it should be used as general guidance when reviewing IRAs. Some of the basic Roth IRA rules follow:

- A Roth IRA must be initially designated as a Roth IRA when it is established. Neither SEP-IRAs nor SIMPLE IRAs may be designated or operated as Roth IRAs.
- Contributions to Roth IRAs are not tax deductible and are not reported on the individual's tax return:

- Roth IRA contribution limit:

If contributions are made only to Roth IRAs, the contribution limit for 2003 for individuals under age 50 is generally the lesser of:

- \$3,000 (\$3,500 if the individual is 50 or older in 2003), or
- An individual's taxable compensation for the year.
- These \$3,000 and \$3,500 amounts do not increase in 2004.

- Contributions to both traditional and Roth IRAs for same year

If contributions are made to both a Roth IRA and a traditional IRA, the contribution limit for 2003 is the lesser of:

- \$3,000 (\$3,500 if the individual is 50 or older in 2003) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- An individual's taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

If an individual's modified adjusted gross income is above a certain amount, contribution limits may be reduced and must be computed. IRS Publication 590, *Individual Retirement Arrangements*, details how to calculate the reduced contribution limits.

- An individual can contribute to a Spousal Roth IRA, provided:

- The contributions satisfy the Spousal IRA limit (same as Traditional IRA Spousal Limit above),
  - A joint tax return is filed for the year, and
  - The couple's modified adjusted gross income is less than \$160,000.
- Contributions to Roth IRAs may continue even after the owner has reached 70 1/2 years of age, there is no age limit for contributions.
  - A contribution to one type of IRA may be "recharacterized" as a contribution to a different IRA, but it must be performed in a trustee-to-trustee transfer.

- Roth IRAs are not subject to any minimum distribution, and account balances can be left in the IRA as long as the owner lives.
- Traditional IRAs, SEP-IRAs, and SIMPLE IRAs can be converted to Roth IRAs if the owner has a "modified adjusted gross income" of not more than \$100,000 and (if married) files a joint return. Except for the one year waiting period, most rollover rules for traditional IRAs apply.
- A Traditional IRA may be converted to a Roth IRA. The conversion is treated as a rollover, regardless of the conversion method used. Most of the rules for rollovers apply to these rollovers. However, the 1-year waiting period does not apply. Although the conversion of a Traditional IRA is considered a rollover for Roth IRA purposes, it is treated as a taxable distribution from the Traditional IRA.
- Individuals who convert traditional IRAs to Roth IRAs, but who are ineligible to do so, are subject to a taxable distribution for the amount of the conversion, plus any additional taxes on early withdrawals. A Roth IRA conversion may be "re-characterized" by converting it back to a traditional IRA prior to the owner's tax return due date, including extensions.
- For tax years 1998 and 1999, IRA owners were permitted to convert an amount from a traditional IRA to a Roth IRA, transfer that amount back in a "re-characterization," and then reconvert it back to a Roth IRA in a "reconversion." After 1999, owners cannot convert and reconvert an amount during the same taxable year.
- Qualified distributions from Roth IRAs are not taxable, if they are made after a 5-year period beginning with the first taxable year for which a contribution was made, and the distribution is:
  - Made on or after the date the owner reaches age 59 ½,
  - Made because of the owner's disability,
  - At the owner's death, made to a beneficiary or the to the owner's estate, or
  - One that meets the traditional IRA "First" home requirements, up to a lifetime limit of \$10,000.
- Distributions of regular contributions are not taxable.
- If the owner of a Roth IRA dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her required "beginning date" (by April 1 of the year following the year in which the owner reaches age 70 ½ ).
- Beneficiaries:
  - Generally, upon the death of the owner, the entire interest in the Roth IRA must be distributed to a beneficiary by the end of the fifth year of the owner's death, unless the interest is payable to a designated beneficiary over his or her life expectancy.
  - A beneficiary of a Roth IRA may *aggregate an inherited Roth IRA with another Roth IRA*, if: (i) either the beneficiary inherited the other Roth IRA from the decedent, or was the spouse of the decedent, (ii) the beneficiary is the sole beneficiary of the Roth IRA, and (iii) the beneficiary elects to treat it as his or her own IRA.
  - If the sole beneficiary of a Roth IRA is the spouse, he or she can either delay distributions until the decedent would have reached age 70 ½ , or treat the IRA as his or her own.
- Excess contributions are subject to a 6% excise tax.
- Early withdrawals are subject to a 10% premature distribution tax in addition to other applicable taxes.
- Abusive Roth IRA Transactions - The Treasury Department issued Notice 2004-8 identifying and prohibiting certain abusive Roth IRA contribution transactions. The notice was effective on the date of issuance, December 31, 2003. The transactions in question are used to avoid Roth IRA contribution limitations and, in some instances, taxation as income or capital gains. These and similar types of transactions subject the IRA to possible disqualification and/or excise tax as prohibited transactions under the IRS Code.
- Deemed IRAs (Traditional IRA and/or Roth contributions to an individual retirement account within a qualified employer plan). The Economic Growth and Tax Relief Reconciliation Act of 2001 added IRC Section 408(q), creating "deemed IRAs" for plan years after 2002. Contributions to deemed IRAs may only be made on a voluntary basis by the employee and are not deductible from income. These contributions do not affect the dollar amount of employer based contributions under a qualified plan. Deemed IRAs must be maintained in a separate account or annuity under the plan, and are subject to IRA rules, not qualified plan rules. However, the plan may commingle deemed IRA assets with qualified employer plan assets for investment purposes. The IRS issued Revenue Procedure 200313 outlining amendment guidance for existing qualified employer plans. The revenue procedure also provides sample plan amendment language which allows qualified plans to

include deemed IRAs. For Deemed IRA purposes, the IRS has ruled that qualified employer plans include Section 401(a) defined benefit and defined contribution plans, Section 401(k) plans, Section 403(a) annuity plans and 403(b) plans, and Section 457 deferred compensation plans. They do not, however, include Savings Incentive Match Plans for Employees of Small Employers (SIMPLE) IRAs. Procedures for amending qualified employer plans are also provided in IRS Bulletin 2003-4.

- Group Trust Participation by Roth and Deemed IRAs - IRS Revenue Ruling 2004-67 extends the ability to participate in group trust investments described in Revenue Ruling 81-100 to Roth individual retirement accounts described in § 408A and deemed individual retirement accounts described in § 408(q). (Note: investing IRAs in common or collective funds is prohibited under Federal securities laws, refer to IRS Revenue Ruling 81-100 in Section 7.)
- Coverdell Education Savings Accounts (ESAs) - referred to as Education IRAs until July 26, 2001 - are not Individual Retirement Accounts or retirement arrangements of any kind. They are trust or custodial accounts established for the purpose of paying "qualified higher education expenses" (tuition, fees, books, supplies, equipment, and "contributions to a qualified state tuition program") of a designated beneficiary at an "eligible educational institution" (either an eligible postsecondary school - any college, university, vocational school, or other post secondary educational institution qualified to participate in student aid programs by the U.S. Department of Education; or an eligible elementary or secondary school - any public, private, or religious school that provides elementary or secondary education - kindergarten through grade 12 as determined under state law.)

Earnings on investments grow tax free until distributed. Upon distribution, if the withdrawals are less than the beneficiary's qualified higher education expenses, the withdrawals are tax free. Any portion of a withdrawal which is greater than the beneficiary's educational expenses is taxable to the beneficiary. Taxable distributions are subject to a 10% tax in addition to other applicable income taxes.

To be treated as an ESA, the account must be designated as such when it is established. Any Individual, including the designated beneficiary, can contribute to an ESA if the individual's modified adjusted gross income for the year is less than \$110,000 (\$220,000 for individuals filing joint returns). Contributions are not tax deductible. There is no limit on the number of ESAs which can be established for the same beneficiary, and there are no limits to the number of beneficiaries a contributor may contribute towards in the same year. However, total contributions for the same beneficiary in any tax year cannot exceed \$2,000. Contribution limits are gradually reduced if a contributor's modified adjusted gross income is between \$95,000 and \$110,000 (between \$190,000 and \$220,000 if filing a joint return). Excess contributions are subject to a 6% excise tax. No contributions may be made to an ESA in any tax year in which the beneficiary receives a contribution toward a "qualified state tuition program."

Education IRA Account requirements:

- The trustee or custodian must be a bank or an entity approved by the IRS.
- The document must provide that the trustee or the custodian can only accept a contribution that:
  - is in cash,
  - is made before the beneficiary reaches age 18 (no contributions can be made to an ESA after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary (not defined as of 2004), and
  - would not result in total contributions for the tax year (not including rollover contributions) being more than \$2,000.
- Money in the account cannot be invested in life insurance contracts.
- Money in the account cannot be combined with other property except in a "common trust fund or common investment fund." (Note: investing IRAs in common or collective funds is prohibited under Federal securities laws, refer to IRS Revenue Ruling 81-100 in Section 7.)
- Generally, the balance in the account must be distributed within 30 days after the beneficiary reaches age 30, or the death of the beneficiary. Assets distributed upon the death of a beneficiary must either be made to the beneficiary's estate, or to a beneficiary named by the designated beneficiary. However, distribution is not required if the Education IRA is transferred to a surviving spouse or other family member under age 30.

IRS Publication 970, Tax Benefits for Education provides information on Education IRAs.

**Bank Trustee and Custodial Responsibilities**

As trustee, the bank's responsibilities may range from ministerial functions to the exercise of broad discretionary duties. In most instances, IRAs found in trust departments are subject to the investment direction of the Individual or possibly an investment advisor. However, the trust department may be given full discretion in the investment selection process. As custodian, responsibilities are essentially ministerial in nature. The examiner should note that IRC Section 408(h) considers bank custodians of IRAs to be trustees, hence fiduciaries (refer to Appendix E).

Whether acting as trustee or custodian, the bank's responsibilities and duties will be controlled by provisions of the instrument under which the relationship is established. Examiners should perform a careful review of this instrument in order to ascertain the degree of responsibility assumed by the bank and conformity with the duties imposed upon the institution under the agreement.

- **Self-Directed Custodial IRAs - Own Bank Deposits**

The majority of IRAs serviced by banks are handled in the commercial department in a custodial capacity. These accounts are restricted to investments in own bank deposits. Unless state law provides to the contrary, trust powers for such accounts are not required, even if the account document indicates the bank is a trustee.

- **Self-Directed Custodial IRAs - Non Bank Deposits**

A bank may accept non-deposit self-directed custodial IRAs without trust powers under Section 333.101(b) of the FDIC's Rules and Regulations, if the appropriate state authority also permits such accounts to be accepted without trust powers. Despite the fact that trust powers are not needed, banks which accept such accounts must implement appropriate controls. Refer to Section 2, subsection O, Self-Directed IRAs and Keogh Accounts for additional information.

**Special Examination Application**

There are several provisions involving IRA accounts which examiners should be aware of:

- According to Advisory Opinion 93-33A issued by the PWBA Office of Regulations and Interpretations of the US Department of Labor on December 16, 1993, pursuant to Regulation 2510.3-2(d), the DOL does not have jurisdiction over IRAs which are not part of an employer sponsored pension plan falling under Title I of ERISA. Nevertheless, under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the DOL was given the authority to issue interpretations of section 4975 of the Internal Revenue Code (with certain exceptions, including sections 4975(a), (b), (c)(3), (d)(3), (e)(1), and (e)(7)) involving prohibited transactions of that section of the Code. Accordingly, employer sponsored IRAs are subject to ERISA and fall under DOL jurisdiction. Traditional or individual non-employer sponsored/non-employer-contributed IRAs are not subject to ERISA and fall under the supervision of the Secretary of the Treasury. They are, however, subject to DOL interpretations of section 4975 of the Code with regard to prohibited transactions under that section of the Code. (Refer also to subsection H.7, Prohibited Transaction - ERISA Section 406).

Several IRA-specific interpretations have been issued by the Labor Department, which has authority over ERISA and also to interpret IRC Section 4975. All of the Advisory Opinions (AOs) noted below deal with self-directed transactions.

- AOs 88-9 and 88-28 deal with investment in the fiduciary bank's stock (or that of its holding company). These AOs include guidance on purchases of treasury stock and stock issued in an Initial Public Offering (IPO).
- AO 88-18 deals with a loan from the IRA to a company where the grantor/customer has a substantial interest. Under the circumstances described, DOL concludes that a prohibited use of plan assets for the benefit of a disqualified person under Section 4975(c)(1)(D) or an act of self-dealing under Section 4975(c)(1)(E) is likely to result if the customer directs the IRA to lend funds to the company.
- AO 89-3 deals with the investment of IRA assets in the stock of the company which employs the grantor/customer. In this case, the stock was purchased directly from the employer company. Under the circumstances described, particularly that the employer had no involvement with the establishment or maintenance of the IRAs, the employer company is not a disqualified person under Section 4975(e)(2); therefore, no prohibited transaction under Section 4975(c)(1)(D) exists. The AO cautions that a prohibited transaction may occur under other provisions of Section 4975.

- SEP-IRAs are subject to ERISA Sections 404 and 406, covering fiduciary responsibility and prohibited transactions.
- IRS Forms 5305 (the governing IRA document) prohibit the Individual sponsoring an IRA from borrowing from the account or from pledging the account as collateral for a loan.

IRS Regulation 1.408-4 regarding the Treatment of Distributions from IRAs states that if the Individual establishing the account uses, directly or indirectly, any portion of the IRA as security for a loan, the amount used as collateral will be deemed a distribution for that tax year [IRS Regulations 1.408-1(c)(4) and 1.408-4(d)(2)]. The regulation requires the issuing of a W2-P to the borrower and to the IRS to report the distribution. If the distribution occurs prior to the Individual reaching age 59½, a premature distribution would take place, involving an IRS penalty equal to 10% of the pledged amount under IRS Regulation 1.408-1(c)(6).

- Section 408(m) of the IRC indicates that if an IRA invests in collectibles, the investment will be treated as a distribution. Collectibles include: stamps, coins, artwork, gems, antiques, etc. Both Section 408(m) and DOL Prohibited Transaction Class Exemption (PTE) 9155 provide an exception for U.S. American Eagle gold coins, which are permissible investments.
- Group Trust/Collective Investment Funds - Examiners should be aware that IRAs of all types may not invest in OCC Regulation 9.18 Collective Investment Funds (CIFs) without violating Federal securities laws. A number of lawsuits have resulted from IRAs being placed in CIFs, and there is one instance of the SEC taking enforcement action against an FDIC-supervised bank for having done so. There are a few approaches where IRAs may be collectively invested, with many restrictions. The investments are usually confined to mutual funds, but never to Regulation 9.18 CIFs. (Refer to IRS Revenue Ruling 81-100 in Section 7.

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## **G. SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES (SIMPLE)**

Savings Incentive Match Plans for Employees (SIMPLEs) plans are defined contribution employee benefit plans which replaced SARSEP plans effective January 1, 1997. SIMPLE plans permit small employers and their employees to make salary reduction contributions toward a simplified retirement arrangement. Employers may establish a SIMPLE IRA plan: (a) if they had 100 or fewer employees who received \$5,000 or more in compensation in the preceding year; and (b) they do not maintain another qualified plan, unless the other plan is for collective bargaining employees. These plans must be maintained on a calendar year basis, and may be established as either:

- part of a 401(k) plan (SIMPLE 401(k)), or by
- using SIMPLE IRAs (SIMPLE IRA plan).

Employer matching contributions - employers are required to match each employee's salary reduction contributions on a dollar-for-dollar basis up to 3% of the employee's compensation. This requirement does not apply if employers make non-elective contributions.

Non-elective contributions - employers may choose to make non-elective contributions of 2% of compensation on behalf of each eligible employee who will earn at least \$5,000 (or a lower employer designated amount) in the current calendar year. Employers opting for this contributory method must make non-elective contributions whether or not employees elect to make their own salary reduction contributions.

Employees earning at least \$5,000 during any 2 years preceding the current calendar year, and who are reasonably expected to do so in the current calendar year, are eligible to participate in a SIMPLE plan. Employees may elect to contribute up to \$8,000 for 2003 (increasing \$1,000 each tax year until it reaches \$10,000 in 2005). Salary reduction contributions under a SIMPLE IRA plan count toward the overall annual salary exclusion limit (\$12,000 for 2003) when employees participate in other employer plans with elective salary reductions or deferred compensation. Participants who are age 50 or over at the end of the calendar year may make catchup contributions. The catch-up contribution limit for 2003 is \$1,000; it increases by \$500 each year until it reaches \$2,500 in 2006. The limit is subject to cost-of-living increases thereafter.

The Economic Growth and Tax Relief Reconciliation Act of 2001 amended Sections 402 and 414 of the Internal Revenue Code, enabling individuals age 50 and over to make elective retirement plan deferrals (catch-up contributions) to 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEP), Section 403(b) arrangements, and Section 457 governmental plans effective for plan years beginning after December 31, 2001. Refer to Section Q. Catch-Up Contributions for additional details.

IRS Publication 560, Retirement Plans for the Self-Employed provides information on SIMPLE plans.

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## **H. COMPLIANCE WITH THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 (ERISA)**

ERISA is a very complicated law and the employee benefit area is constantly being impacted by changes in Federal tax laws. In addition, the Labor Department issues various regulations, interpretations, and opinions in response to changes in the industry and the need to clarify various requirements of ERISA. As a result, the material in this part is grouped according to the various requirements of ERISA.

Before reviewing the entire ERISA section of this manual, the examiner should initially review four parts of this section which may highlight plans, accounts, and/or circumstances, which in general, ERISA does not apply. The four sections include: (1) Accounts Covered/Not Covered by ERISA; (2) Fiduciaries Defined; (3) Exemptions from Prohibited Transactions; and (4) Compliance with State Laws.

### **Introduction**

The primary objective of ERISA is to protect the rights and interests of participants and their beneficiaries in the various plans and accounts described above. Plans and accounts which fall under ERISA are required to: contain certain data, be properly administered in an arm's-length manner, make disclosures to employees and beneficiaries, and comply with government reporting requirements.

Two government agencies are primarily responsible for administration and enforcement of ERISA. DOL is responsible for interpreting and enforcing fiduciary provisions of ERISA and also interprets those sections of the IRC dealing with fiduciary requirements for employee benefit plans. The IRS is responsible for IRAs, Keogh accounts that cover only the Individual/employer, and various tax-related provisions of the IRC.

ERISA also established the Pension Benefit Guaranty Corporation (PBGC), which insures participants' and beneficiaries' vested interests in defined benefit pension plans to a maximum monthly benefit as specified in Title IV of ERISA. PBGC also acts as trustee and receiver for pension plans voluntarily terminated by their sponsors, or involuntarily terminated because of the failure of the sponsor for financial or other reasons. All private defined benefit pension plans meeting certain requirements must, under ERISA, make required annual premium payments to the PBGC.

### *Important Notice*

Material in this section, dealing with ERISA, makes reference to various sections and interpretations of ERISA. Appendix E provides information covering four general types of reference material:

- ERISA Law and Internal Revenue Code Sections.
- Summaries of ERISA Regulations, Opinions, and Court Decisions, by ERISA Section.
- Implementing Labor and IRS Regulations.
- Interpretive Opinions, Technical Bulletins, Exemptions, etc.

### **Accounts Covered/Not Covered by ERISA - ERISA Section 401**

ERISA basically covers the administration and operation of all kinds of employee benefit plans. This includes pension plans, profit-sharing plans, 401(k) plans, ESOPs, IRAs, and Keogh Plans (HR-10 Accounts). Banks which sponsor these for their own employees or offer them to bank customers must comply with ERISA. Bank trust departments which administer the bank's own plan or the plans of others must also comply with ERISA. As a result, ERISA applies to all plans sponsored by banks and their holding companies, and will apply to most employee benefit plans the examiner will encounter in trust departments.

Described below are three frequently encountered employee benefit plans which are not subject to ERISA. ERISA does not apply to:

- *Government plans.* These include plans sponsored by Federal, State, and local government instrumentalities (Nonqualified deferred compensation plans offered by government agencies may also be referred to as 457 plans). As a result, plans for county or city employees, fire and police forces, economic development authorities, etc. are excluded from ERISA requirements. In 1986, a tax-deferred savings plan was established for Federal employees pursuant to the Federal Employees' Retirement System Act of 1986.
- *Church plans.* Plans sponsored by religious (church) organizations and their affiliated organizations.
- *Excess benefit plans that are unfunded.* In general, these plans cover a select group of highly compensated employees and provide benefits in addition to those provided under a tax-qualified plan. Excess benefit plans are funded solely out of the general assets of the employer. These plans are not tax-qualified nor protected in a trust from creditors of the plan sponsor. The reason these plans are not tax-qualified is that benefits provided under the plan are in excess of those permitted for tax-exemption under the IRC and coverage under the plan is limited to highly paid employees. (Examiner note: there is nothing illegitimate or inappropriate about this type of plan if established and administered properly.)

The above list is not all inclusive and the examiner should refer to ERISA Section 4(b) for a complete listing. The types of employee benefit plans that are exempt from ERISA are generally subject to State statutes.

### **Establishment of Plan - ERISA Section 402**

Every employee benefit plan shall be established and maintained pursuant to a written instrument. Such instrument shall provide for one or more named fiduciaries who jointly or severally shall have authority to control and manage the operation and administration of the plan. Every employee benefit plan shall:

- Name a Plan Administrator;
- Provide a procedure for establishing and carrying out a funding policy;
- Describe any procedures for the allocation of responsibilities for the operation and administration of the plan;
- Provide a procedure for amending such plan, and for identifying the persons with authority to amend the plan; and
- Specify the basis on which payments are made to and from the plan.

Examiners should note that the plan sponsor is generally responsible for ensuring that the plan meets the requirements of ERISA Section 402.

### **Trustee Requirements - ERISA Section 403**

Section 403 of ERISA requires that all assets of employee benefit plans must be held in trust by one or more trustees. There is no requirement that a bank or other corporate fiduciary be used. Individuals may serve as plan trustees under ERISA.

Trusteed plans are those most frequently encountered and a trust agreement, as distinguished from the governing plan, establishes the trustee's duties and responsibilities. Principal among these, the trustee holds title to and takes possession of account assets. The trustee is also responsible for safekeeping and asset management, to the extent this is not delegated to others. Other typical trust agreement provisions relate to irrevocability and non-diversion of trust assets, as well as investment powers of the trustee, payment of legal and other fees, periodic reports by the trustee, records and accounts to be maintained, payment of benefits, and the rights and duties of a trustee in case of amendments to or termination of the plan.

### **Fiduciary Responsibilities - ERISA Section 404**

ERISA codifies traditional fiduciary responsibilities into a single nationwide standard. The primary section of the ERISA which deals with fiduciary responsibilities is Section 404. The standards enunciated by Section 404 amount to an itemization of how a fiduciary *should* act.

***Fiduciary Defined***

For the most part, the definition of a fiduciary under ERISA is a functional definition. Therefore, a person is a fiduciary to the extent he:

- Exercises any discretionary authority or discretionary control respecting management of such plan, or exercises any authority or control respecting management or disposition of its assets;
- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or
- Possesses any discretionary authority or discretionary responsibility in the administration of such plan.

See Section 3(21)(A) of ERISA.

Certain entities with respect to a plan are automatically fiduciaries: trustees, named fiduciaries, plan administrators and investment managers. This includes the management of the plan sponsor. For a bank's own employee benefit plan, this would typically mean the bank's board of directors, senior management, and any plan committee. Employees (if any) of a plan who exercise discretionary authority or responsibility in the administration of a plan become fiduciaries with respect to such plan. In addition, banks sometimes provide plan administration services, especially for the bank's own plan, and, as a result, are fiduciaries with respect to such plans.

Every qualified plan must have at least one named fiduciary person designated as the one responsible for operating the plan. This person may be the trustee, the plan administrator, the employer/plan sponsor, or the investment advisor. Fiduciaries generally do not include accountants, attorneys, insurance agents, insurance companies, consultants, or actuaries unless they exercise control over the plan in some fashion.

The examiner should remember that DOL has ruled that a bank serving solely as custodian is not a fiduciary according to Advisory Opinion 77-45.

***Requirements***

**Exclusive Benefit** - ERISA Section 404(a)(1)(A): The overall thrust of ERISA is that the plan must be operated solely for participants and beneficiaries of the plan. Section 404(a)(1)(A) expands on this underlying theme by stating that the plan must be operated for the exclusive purpose of providing benefits and defraying reasonable administration expenses. Any violations of ERISA's self-dealing or conflict of interest provisions (Section 406 prohibited transactions) would also normally involve a violation of Section 404 addressing the exclusive benefit provisions.

**Prudent Man Rule** - ERISA Section 404(a)(1)(B): This section of ERISA requires that fiduciaries act prudently. Prudence is normally associated with asset management, but this section also applies to all of a fiduciary's duties for a plan. ERISA Section 404(a)(1)(B) states that fiduciaries must manage the plan:

With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.

The wording of the prudence requirement under ERISA includes an implication that a trust department may be held to a higher standard of prudence than Individual fiduciaries. The text of ERISA refers to a fiduciary acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims. A fiduciary which holds itself out as having a certain expertise (such as a trust department marketing and charging fees for its services and expertise) is to be held to a higher standard of prudence than merely a prudent Individual.

Section 404(a)(1)(B) of ERISA discusses investment duties of the fiduciary which somewhat mirror the Prudent Investor approach. This approach differs from the traditional Prudent Man Rule in two major aspects:

- No category of investment is deemed inherently imprudent by its very nature.

- Prudence is evaluated by looking at the entire investment portfolio. The Prudent Man Rule approach looks at Individual investments, ignoring all investments with gains and focusing only on those with losses.

Prudence is generally viewed by evaluating the decision-making process, not necessarily the results. Therefore, investment decisions tend to be viewed as of the date of the transactions, not on the basis of what happened after an investment was made. Also see related discussions of the Prudent Man Rule and the Uniform Prudent Investor Act in Section 3 - Asset Management and in Appendix C - Fiduciary Law.

Examiners should be aware that a plan's exemptions under Sections 407 and 408 from prohibited transactions under Section 406 of ERISA, do not release the fiduciary's duty under Section 404 regarding prudence. The fact that a bank has plan and statutory authority to invest up to x percent of its assets in employer securities does not mean it can make an investment if, to do so, would be imprudent. This is true even if the only investment that can be made under the plan is restricted to employer securities.

Appropriate Consideration of Investment Decisions - DOL ERISA Regulation 2550.404a-1(b): The Labor Department has provided guidance on the actions a fiduciary must take in order to demonstrate it was prudent. DOL ERISA Regulation 2550.404a-1(b) addressing Investment Duties provides the fiduciary must exercise appropriate consideration when making investment decisions including:

- Determining that the investment or investment course of action is reasonably designed as part of the portfolio (or the portion of the plan's portfolio for which the fiduciary has investment duties) to further the purposes of the plan, taking into account the risk of loss and the opportunity for gain associated with the investment or investment course of action; and
- Considering the portfolio's or portion of the portfolio's: (1) diversification, (2) liquidity and current return relative to plan cash flow and needs, and (3) projected return relative to plan funding requirements.

The regulation points out that contemplation of an investment decision must include the above considerations, but that it is not necessarily limited to only the itemized points. The regulation does not explicitly state that the appropriate consideration must be in writing; however, documentation is the only logical way a bank could demonstrate prudent actions at a later date. Examiners, therefore, should expect to see reasonable written documentation of investment decisions for ERISA plans, although failure to have appropriate documentation is not a violation. Examiners should remember that a bank is not responsible for reviewing the prudence of investment decisions made by outside investment managers to whom investment responsibility has been properly delegated by the plan administrator or other authorized party.

Diversification of Investments - Section 404(a)(1)(C): Section 404(a)(1)(C) of ERISA requires that plan investments be diversified in order to minimize the risk of large losses. Prior DOL rulings indicate an appropriate benchmark of one-third (33%) of the total portfolio of assets should be used in evaluating whether an investment is diversified. The 25% banking statutory standard to determine concentrations of credit does not apply to ERISA accounts.

While ERISA requires that plan assets be diversified, and failure to do so is a violation, there are a number of specific instances where the diversification standard does not apply, including the following:

- Individual account plans where the participant directs his or her own investments. See the discussion on Section 404(c) plans.
- Insured bank, thrift, and credit union deposits which comply with the statutory exemptive provisions of ERISA Section 408(b)(4) and DOL ERISA Regulation 2550.408b-4.
- Bank, thrift, and credit union deposits which are in excess of the amounts covered by Federal insurance, if the institution's assets are diversified, and if the transaction also complies with the statutory exemptive provisions of ERISA Section 408(b)(4) and DOL ERISA Regulation 2550.408b-4. Also refer to DOL Advisory Opinion 77-46 in Appendix E.
- Mutual funds, collective investment funds, Real Estate Investment Trusts (REITs), and annuities, as these investments are not considered single investments. Refer to DOL Advisory Opinions 75-93, 80-13, 7830, and 75-79, respectively.

Adherence to Plan Document - ERISA Section 404(a)(1)(D): Section 402(a)(1) of ERISA requires that every employee benefit plan shall be governed by a written plan instrument. Failure to follow this governing plan document is normally a violation of ERISA Section 404(a)(1)(D).

If the trustee's actions comply with the plan or trust agreement but would violate ERISA, the plan or agreement may not be followed. In such instances, ERISA takes precedence over the governing documents.

Indicia of Ownership of Plan Assets - ERISA Section 404(b): In order to facilitate oversight and enforcement by appropriate agencies, ERISA Section 404(b) requires that documents evidencing ownership of plan assets must be maintained within the jurisdiction of United States (U.S.) courts. These documents (securities, certificates, etc.) are termed indicia of ownership. A number of specific exceptions to holding plan assets which are foreign securities outside the U.S. are outlined primarily in DOL ERISA Regulation 2550.404b-1 and, under certain circumstances, the accompanying Preamble. Listed below are some of the exceptions provided by the regulation. Each of the exceptions is subject to specific conditions.

- American Depository Receipts (ADRs). ADRs that enable a person to demand delivery of a foreign security constitutes the indicia of ownership of the foreign security. This exception is specifically noted in the Preamble to DOL ERISA Regulation 2550.404b-1.
- Assets that are under the management and control of a U.S. regulated bank, insurance company, or investment adviser, which is organized under the laws of a State or of the U.S. In addition, the plan fiduciary's principal place of business must be in the U.S. and certain minimum financial conditions must be satisfied.
- Foreign securities which are in the physical possession of, or in transit to, a U.S.-based bank or registered broker or dealer and certain other conditions are met.
- Contributions made on behalf of plan participants who are Canadian citizens or residents may be maintained in Canada if required by Canadian tax or other laws.
- Foreign Currency maintained outside the U.S. solely as an incident to the purchase, sale, or maintenance of securities by a U.S. plan.
- Assets which are maintained by a registered broker or dealer in SEC designated satisfactory control locations if certain other conditions are met. The SEC regulation covering designation of satisfactory control locations is Rule 15c3-3 [17 C.F.R. 240.15c3-3].

The DOL's indicia of ownership rules also address any securities (other than those issued by Individuals) the principal trading market for which is outside the jurisdiction of the U.S. District courts. SEC Rule 17f-5(c) provides fiduciary standards for Eligible Foreign Custodians. These standards concern whether: (1) the Eligible Foreign Custodian has the requisite financial strength to provide reasonable care for the foreign assets, (2) the Custodian has adequate ~~reputation and~~ standing, and (3) the mutual fund will have jurisdiction over and be able to enforce judgments against the Custodian.

The FDIC has been advised that an **eligible foreign custodian** as defined in SEC Rule 17f-5 of the Investment Company Act of 1940 [17 C.F.R. 270.17f5], may fulfill the requirements of a satisfactory control location. An eligible foreign custodian under the revised rule is any one of the following:

An entity that is incorporated or organized under the laws of a country other than the United States **and** which is a Qualified Foreign Bank **or** which is a majority-owned direct or indirect subsidiary of a U.S. Bank or bank-holding company.

Under the revised rule: (1) A Qualified Foreign Bank is a bank or trust company, organized under the laws of a country other than the United States, and which is regulated by that country's government or an agency of the country's government. (2) U.S. Bank is: (i) a national bank; (ii) a Federal Reserve member bank; (iii) a state chartered bank or trust company which is supervised by state or federal authority; or (iv) a receiver, conservator, or other liquidating agent of any of these institutions. (3) Foreign Assets consist of investments for which the primary market is outside the United States, and any cash and cash equivalents reasonably necessary to effect transactions in those investments.

### ***Special Examination Applications of Fiduciary Responsibility Provisions***

A number of areas not specifically covered in the ERISA statute are particularly relevant to banks and trust departments. Many areas are noted because of frequent inquiries by examiners and bankers, while other areas have been subject to criticism in examination reports. The special application of a number of issues regarding ERISA plans are commented on below, grouped alphabetically by topic.

(1) Contributions, In-Kind	H.5.c.(1)
(2) Derivatives	H.5.c(2)
(3) Economically Targeted Investments (ETIs) (Social/Ethical Investing) Section 3, F.3.e and	H.5.c(3)
(4) ESOP Plans – Employer Securities Investments – Prudence	H.5.c(4)
(5) ESOP Plans – Employer Securities Investments – Valuation	H.5.c(5)
(6) Individual Account (Section 404(c)) Plans	H.5.c(6)
(7) Loans – Documentation	H.5.c(7)
(8) Own-Bank/Holding Company Stock Investments	H.5.c(8)
(9) Proxy Voting and Corporate Governance	H.5.c(9)
(10) Directed Trustees	H.5.c(10)

### 1. Contributions, In-Kind

Instead of making a cash contribution to an employee benefit plan, some plan sponsors have attempted to make a contribution of non-cash assets, usually termed an in-kind contribution. DOL Interpretive Bulletin 94-3 explains that it is a prohibited transaction for the sponsor to make in-kind contributions in satisfaction of an obligation to contribute to defined benefit plans and certain defined contribution and welfare benefit plans. Refer to subsection H.7.f.(2), Contributions, In-Kind for additional information regarding in-kind contributions and the associated prohibited transaction under ERISA Section 406.

Independent of the application of the prohibited transaction provision, Interpretive Bulletin 94-3 also states that a fiduciary has a duty to review in-kind contributions when such contributions are permissible. The bulletin indicates that automatic acceptance of an in-kind contribution may violate ERISA Sections 404(a)(1)(A) addressing the exclusive benefit rule, 404(a)(1)(B) addressing the Prudent Investor Rule, and/or 404(a)(1) (C) regarding the lack of diversification. If accepting an in-kind contribution results in ERISA violations of 404(a)(1)(A), (B), and/or (C); the fiduciaries of the plan would be liable for any losses resulting from such a breach of fiduciary responsibility, even if the contribution in-kind does not constitute a prohibited transaction under ERISA Section 406.

### 2. Derivatives

Derivative investments are not automatically contrary to ERISA's provisions. It should, however, be considered imprudent and an apparent violation of ERISA Section 404(a)(1)(B) if an employee benefit plan invests in derivatives without: (1) understanding the investment vehicle, (2) realizing that the investment involves derivatives, either directly or through a pooled investment vehicle which uses derivatives; (3) adequately evaluating the market, legal, credit and operational risks associated with investments in derivatives; (4) obtaining timely and accurate market prices for investments in derivatives; and (5) adequately monitoring investments in derivatives. For a further discussion of derivatives, associated risks, and considerations in evaluating prudence, refer to subsection F.2.C of Section 3 of this Manual. In addition, refer to the Labor Department letter issued to the Office of the Comptroller of the Currency regarding Investments in Derivatives dated March 21, 1996 (refer to Appendix E).

One of the problems associated with derivatives is the inability to properly price and value the investment, both at acquisition and during the period that the investment is held. Often, derivatives are overvalued at book value, rather than

the lower market value. Failure to value such investments at a fair market value for employee benefit plans may have two further consequences on:

- Fees - If the plan's fees are based on its asset size, as is common, the overvaluation of derivatives will cause the plan to pay unwarranted fees.
- Reports - The overvaluation of the derivatives will normally result in a parallel failure to accurately report the plan in regulatory filings, particularly the Form 5500 annual report. In such cases, an appropriate violation for inaccurate reporting should be cited.

### 3. Economically Targeted Investments (ETIs or Social Investing)

Social investing is an investment approach whereby the investor attempts to inject non-investment criteria into the investment process. Normally, the investment manager desires to either promote or endorse a non-investment criteria or attempts to criticize or avoid certain criteria (for example, promotes environmentally friendly firms and avoids tobacco firms). The screening process may deal with Individual companies, or entire countries and industries. Many times, a potential investment is reviewed through multiple filters or screens to determine whether the non-investment goals can be met.

In 1994, the Labor Department issued Interpretive Bulletin 94-1 dealing with ETIs. The bulletin indicates that an ETI philosophy is not, in and of itself, imprudent. The Interpretive Bulletin states that ETIs are subject to the same standards as any other plan investment in that the investment must be: (1) prudent, (2) authorized by the plan, and (3) considered in light of other available investment alternatives. In accordance with the standard of care (Section 227) and duty of loyalty (Section 170) in the Prudent Investor Rule, an ETI would not be prudent if it would be expected to provide a plan with a lower rate of return than available alternative investments with commensurate degrees of risk, or if the ETI is riskier than alternative available investments with commensurate rates of return. Refer to Section 3 of this Manual for additional comment.

### 4. ESOP Plans - Employer Securities Investments – Prudence

Some ESOPs are sponsored by companies which are encountering difficulties (for example, banks with low capital) or are in declining industries. While the ESOP plan document may restrict plan investments to employer stock, the prudence of such an investment may be open to question. This is especially true if the employer eventually fails, the plan's employer stock become worthless, and hindsight is used.

A number of court challenges have been brought against bank trustees who followed the plan document and continued purchasing employer stock, even as the employer trended toward eventual failure. The actual failure of the employer is not necessarily required for a challenge merely the loss of a major portion of the stock's value. The fact that the trustee followed the plan document which authorized no other investment vehicle, has not always been a sufficient defense for the trustee. In addition, the price paid by the plan for the employer stock may be called into question.

Court decisions have reportedly differed, in some cases deciding for the trustee and in other cases deciding for the plan participants. A sampling of court cases appears in Appendix E. The court decisions provide guidance for how such investment transactions may be evaluated. When an ESOP invests in employer securities, the examiner should:

- Determine if the trustee (bank, directors, officers, plan committee, etc.) is following the plan document(s) [Reference: Statewide Bancorp ESOP court case].
- Determine if the plan requires investment in the employer securities or if the language is permissive.

If the plan requires investment in employer securities, the trustee must comply unless "compliance would be impossible or illegal" or a court approves a deviation.

If investment language is permissive, prudence is required in the acquisition and retention of the securities. A fiduciary is presumed to have complied with ERISA unless the facts and circumstances would defeat or substantially impair the plan's purpose. If trustees are also directors or officers of the employer (likely in own-bank plans), they must show that

they acted impartially in investigating available investment alternatives -- particularly if the employer is experiencing financial difficulty.

In evaluating a fiduciary's prudence when an ESOP's investment language is permissive, the examiner should evaluate the reasonableness of the fiduciary's actions based on whether the action:

- Complies with the provisions of the plan;
- Complies with the goals of the plan; and
- Conflicts with the substantive or procedural requirements of ERISA, or the regulations thereunder.

[References: U.S. Supreme Court Case, *Firestone Tire and Rubber Co. v. Bruch*, 489 U.S. 101 (1989); and *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995).]

Evaluate, based on the facts presented, if the trustee administered its investment responsibilities prudently in either continuing or discontinuing the purchase of the employer stock.

In those situations where the value of the securities and/or the financial stability of the employer is declining, and in the examiner's judgment the trustee is acting imprudently, the examiner should criticize the administration of the account and cite the apparent violation(s) of the applicable ERISA section(s) [primarily ERISA Section 404(a)(1)(B)].

#### 5. ESOP Plans - Employer Securities Investments – Valuation

Many of the ESOPs that FDIC examiners will encounter are sponsored by small banks and small companies in small towns. The stock of such entities is typically closely held and not listed or traded on securities exchanges or NASDAQ. Brokers usually do not make a market for the stock and it is thinly traded in the local area. The question of fair and proper valuation of such stock is critical to any ESOP plan.

The valuation of employer stock is covered in both IRS and DOL regulations applicable to ESOPs. The standard established in DOL regulations requires that no more than adequate compensation may be paid. IRS regulations expand on this somewhat by providing that an independent appraiser must be used to establish a fair price. The IRS stresses that the mere presence of a written appraisal does not necessarily mean that the appraisal arrived at a fair valuation. Refer to subsection D.2.e., Employee Stock Ownership Plans (ESOPs) regarding valuing employer securities in accordance with both IRS and ERISA requirements.

Both the DOL and IRS indicate that no one method of valuation is acceptable or unacceptable in every situation. Examiners must use judgment in assessing if adequate consideration for the transaction was provided. In general; however, book value by itself is not considered a sufficient independent basis for valuation.

Despite the guidelines above, a number of abuses or potential abuses have occurred in ESOPs, including those sponsored by banks and bank holding companies. The abuses often involve insiders of the employer, who set unrealistically high values for the employer stock. In some instances, the inflated prices help maintain a market for the employer's stock. In other cases, the insiders sell their stock to the ESOP at the inflated price. The FDIC has referred a number of these plans to the Labor Department for apparent ERISA violations involving the pricing of the employer securities.

Failure to value employer securities at a fair market value for the plan itself will normally result in an apparent violation of ERISA 404(a)(1)(B). In addition, failure to value employer securities at fair market value will result in a parallel failure to accurately report the plan assets in regulatory filings, particularly the Form 5500 annual report. In such cases, ERISA Section 103(b)(3)(A) should be cited for inaccurate reporting (refer to DOL ERISA Regulation 2520.103-1(a)(1) and -1(b)(2)(i) for additional guidance).

#### 6. Individual Account (Section 404(c)) Plans

Section 404(c) of ERISA provides limited relief from certain fiduciary responsibilities and duties for plans which permit participants to self-direct their plan investments. Plans such as 401(k) and 403(b) are Individual account plans. Under

Section 404(c), plan participants who direct their own investments are not considered to be fiduciaries, provided that the conditions set forth in DOL Regulations under Section 404(c) are met.

Plan sponsors can limit their fiduciary liability if the plan operates in conformance with DOL ERISA Regulation 2550.404c-1. Compliance with the regulation is optional, but if a plan does not comply with the regulation, the relief provided by Section 404(c) is not available. The regulation is generally for transactions beginning with the first day of the second plan year beginning on or after October 13, 1992. Transactions occurring before that date are subject only to the general requirements of Section 404(c) of ERISA, without regard to the specifics of regulation.

Compliance with the regulation generally imposes requirements on the plan, not the participants. The Individual account plan must permit participants with the ability to:

- Choose from a broad range of investment alternatives. At least three investment alternatives must be provided, each of which is diversified and has materially different risk and return characteristics [see 2550.404c-1(b)(3)(i)(B)].

In practice, the three alternatives will generally consist of the following types of investment vehicles: (1) a no-risk investment [for example, money market mutual fund, Short-Term Investment Fund (STIF), or Guaranteed Investment Contract (GIC)]; (2) a stock investment; and (3) a fixed-income investment. Employer stock may be a choice but special requirements apply to this investment.

- Give investment instructions with a frequency appropriate to the market volatility of the investment alternatives. Plan participants must be able to make changes to at least three of the investment vehicles not less than once a quarter [see 2550.404c-1(b)(2)(ii)(C)(1)].

If an investment vehicle permits investment changes more often than quarterly, the participant must have the ability to immediately roll the proceeds into another plan investment vehicle that is a low risk, liquid investment choice [see 2550.404c-1(b)(2)(ii)(C)(2)]. Special provisions are given for investments in stock of the employer/sponsor.

- Diversify investments within and among investment alternatives. [refer to DOL regulation 2550.404c-1(b)(3)(i)(C)].
- Obtain sufficient information to make informed investment decisions. This involves specific disclosures about the plan itself, as well as each authorized investment alternative within the plan with respect to participants or beneficiaries of a plan. [see 2550.404c-1(b)(2)(i)(B)(1) and (2)].

The Labor Department has released special guidance on this requirement to provide investment information and education to plan participants [see Interpretive Bulletin 96-1]. Examiners should be aware that this guidance applies primarily to plan sponsors, not to bank trustees who service outside accounts. It will, however, apply to banks and bank holding companies who sponsor Individual account plans for their own employees. The bulletin will also apply in those instances where banks provide such investment information and/or education to outside plan sponsors.

Special provisions are given for investments in stock of the employer/sponsor [see 2550.404c-1(b)(2)(ii)(C)(3)].

Under Section 404(c) of ERISA and the implementing regulation, the plan sponsor and fiduciaries have no obligation to provide investment advice to plan participants and beneficiaries. However, the plan sponsor and fiduciaries do have an obligation (see requirements above) to provide sufficient information on which the participants can make informed and intelligent decisions.

## 7. Loans - Documentation

The FDIC has made a number of ERISA referrals to the Labor Department regarding loans made by plans where the loans lacked key or common documentation. Examiners applied normal underwriting or documentation standards that examiners would expect to find if the loan had been made by the bank itself. Granting of loans in the absence of such key documentation was cited as an apparent violation of the ERISA prudence standards. Examples of the documentation deficiencies reported include nonexistent corporate borrowing authority, missing financial information, unsupported repayment capacity, and inadequate lien filings. For each referral, Labor Department investigators determined that either such documentation deficiencies did not represent a violation of ERISA, or the matter did not qualify for further

investigation. As a result, examiners should not cite apparent violations of ERISA Section 404(a)(1)(B) regarding prudence for such documentation exceptions.

#### 8. Own-Bank/Holding Company Stock Investments

One common inquiry from examiners involves discretionary investments of an outside account's assets in the stock of the fiduciary bank or its holding company. In a 1980 letter to the OCC, the Labor Department stated that a discretionary investment in own-bank or own-holding company stock was an imprudent act. DOL commented that such a discretionary investment burdens our imagination to envision a situation in which a trustee with investment discretion could make an objective decision, solely on the basis of the prudence standard, regarding the purchase or sale of its own stock.

In a number of situations DOL has indicated that self-directed or nondiscretionary purchases, sales, and retention of own-bank and own holding company stock are permitted. Specific guidance was given for self-directed IRA purchases and initial public offerings of savings bank stock upon conversion from a mutual to a stock institution [see DOL Advisory Opinions 88-9, 88-28, and 92-23 in Appendix E].

#### 9. Proxy Voting and Corporate Governance

In Interpretive Bulletin 94-2, the Labor Department has stated that the voting of proxies is a fiduciary responsibility under the prudence requirements of ERISA. Trustees have the duty to execute proxies unless they receive proper instructions from the named fiduciary. The absence of explicit proxy voting instructions in a plan document or trust agreement does not relieve the fiduciary of the duty to vote the proxies. If the investment management responsibility has been properly delegated to an investment manager by a named fiduciary, the investment manager has authority to execute proxies unless the right to vote proxies (in whole or in part) has been reserved by the plan to the trustee or named fiduciary. The fiduciary is responsible not only for voting all proxies which it receives, but also for ensuring that it receives all proxies to which a plan is entitled. Records must be kept of proxy voting.

The fiduciary duties of prudence and loyalty to participants and beneficiaries require trustees and investment managers to vote on every proposal that might affect the value of a plan's investment. In voting proxies, the fiduciary may consider only those factors that affect the value of a plan's investment. The impact on the plan participants and beneficiaries of the subject being voted upon may not be considered. This is especially relevant in cases of leveraged buyouts or unfriendly takeovers, where the jobs of the participants may be in jeopardy.

The Labor Department has also stated that an activist stance in shareholder rights is not automatically imprudent. A plan may undertake activities intended to monitor or influence the management of corporations in which the plan owns stock. Circumstances where this may occur are in closely-held companies, or stock intended to be held as a long-term investment. Actions might be undertaken for such concerns as mergers and acquisitions, capitalization and debt levels, executive compensation, and long-term business plans.

#### 10. Directed Trustees

While a plan trustee is always a fiduciary under ERISA 3(21), not all trustees have the same level of control or authority over the management of a plan's assets. A directed trustee is a plan trustee who is, by the terms of the plan, subject to the direction of a named fiduciary who is not a trustee. Section 403(a) of ERISA recognizes that such trustees have limited authority and discretion, and, therefore, limits the fiduciary liability of directed trustees provided that the directions being carried out for named fiduciaries are proper, in accordance with the terms of the plan, and not contrary to ERISA. On December 17, 2004, DOL issued Field Assistance Bulletin 2004-03, Fiduciary Responsibilities Of Directed Trustees, which provides, in the context of publicly traded securities, guidance regarding the fiduciary duties of directed trustees and factors to be considered in determining whether the directions of a named fiduciary are "proper." See FAB 2004-03 for a complete discussion.

**Co-Fiduciary Liability - ERISA Section 405**

ERISA Section 405(a) provides that, in general, a fiduciary is liable for the actions of another fiduciary that breaches fiduciary responsibilities if it:

- Participates knowingly in an act or omission of the other fiduciary.
- Undertakes knowingly to conceal an act or omission of the other fiduciary.
- Enables the other fiduciary to breach its duties by a failure to comply with Section 404(a)(1) [Prudence] in the administration of its specific fiduciary responsibilities.
- Possesses knowledge of a breach by the other fiduciary and does not make reasonable efforts under the circumstances to remedy the act.

Examiners must be careful in citing violations of this section as a fiduciary is not automatically liable for the misconduct of a co-fiduciary. The fiduciary is required to know that: (1) a co-fiduciary exists, (2) the other fiduciary participated in the act in question, and (3) the action was a breach of fiduciary duty.

Fiduciaries with limited required duties (for example, when fiduciary responsibilities are properly allocated or delegated), do not insulate themselves from breaches in other areas by other plan fiduciaries. On one hand, a fiduciary may become liable if it merely knows of a breach of fiduciary duty by another fiduciary and does nothing to remedy the problem. On the other hand, failing to adequately monitor the conduct of another fiduciary may be an imprudent act and cause co-fiduciary liability to be incurred.

One of the remedies often proposed by a fiduciary who learns of a co-fiduciary's misconduct is to offer resignation of the fiduciary appointment, thereby attempting to insulate itself from the co-fiduciary's misconduct. However, mere resignation by the fiduciary as a protest against the breach is not sufficient. Action must be taken to rectify the breach of fiduciary responsibilities.

A successor trustee is not responsible for breaches of fiduciary responsibilities by predecessor trustees. However, it cannot ignore any misconduct by a previous trustee. The successor trustee has a duty to correct prior improper investments upon assuming responsibilities.

***Allocation and Delegation of Fiduciary Responsibility***

Each plan document must designate a named fiduciary as defined in Section 402(a)(2) of ERISA. While this is often a plan committee, it may also be Individuals identified by name or position. The named fiduciary is primarily responsible for managing the plan and for selecting and monitoring any outside trustees, investment managers, and other fiduciaries.

The allocation of responsibilities usually requires specific authorization in the plan document. If properly implemented, allocation procedures can protect named fiduciaries. In addition, proper allocation procedures may permit one fiduciary to insulate itself from the actions of another fiduciary, despite the co-fiduciary liability provisions of ERISA Section 405. Refer to ERISA Section 405(c)(2).

Sections 402, 403, and 405 of ERISA contain various overlapping provisions dealing with the allocation and delegation of duties and responsibilities among fiduciaries. Two significant provisions note that a named fiduciary:

- May allocate either trustee responsibilities (authority and discretion to manage and control plan assets) and/or non-trustee responsibilities (fiduciary duties that do not involve asset management) to entities, groups, Individuals, etc., other than those referenced in the plan document as named fiduciaries.
- May not allocate *trustee* responsibilities (non-trustee fiduciary responsibilities are permissible) among themselves, as named fiduciaries are jointly and severally liable for such responsibilities.

Trustee responsibilities normally lie with the named fiduciary. However, if the plan states a non-trustee named fiduciary may appoint outside trustees:

- The named fiduciaries are insulated from the actions of the outside trustee. But, the named fiduciaries must monitor the outside trustee's actions.

- The outside trustee is obligated to follow the proper directions of the named fiduciary. Proper directions are those which follow the plan document and do not violate ERISA. [References: ERISA Sections 402(c) (3), 403(a)(1), and 405(c)(3)].

ERISA also permits the named fiduciary to delegate authority to one or more qualified investment managers. A qualified investment manager is: (1) a bank, (2) an investment manager registered with the SEC under the Investment Advisors Act of 1940, or (3) an insurance company which is qualified under the laws of more than one state to perform services, and which has acknowledged in writing its fiduciary status with the plan. If responsibilities are delegated to a qualified investment manager:

- Named fiduciaries are insulated from the actions of the investment manager as long as:
  - The investment manager was prudently chosen and retained.
  - The investment manager does not violate the fiduciary responsibilities of ERISA Section 404(a)(1).
  - The named fiduciary monitors the performance of the investment manager. This may occur by formal periodic review, day-to-day contact and evaluation, or other appropriate means.
- Trustees are not responsible for the actions of a properly-appointed investment manager, even when the trustee is subject to direction from the investment manager.

[References: ERISA Sections 3(38), 402(c)(3), 403(a)(1), 403(a)(2), and 405(c)(2)(A)(iii)]

Where the plan permits, named fiduciaries may allocate responsibility for non-trustee fiduciary responsibilities among themselves. If the named fiduciary delegates non-trustee responsibilities, they are not liable for such other person(s) who carry out these responsibilities, provided that:

- The plan's provisions regarding establishment, implementation, and continuation of the allocation are appropriate and properly followed.
- The non-trustee fiduciary is prudently chosen and retained.

[References: ERISA Sections 403(a)(2), 405(c)(1)(A), 405(c)(1)(B), 405(c)(2), and 405(c)(3)].

### ***Directed Accounts***

One aspect of employee benefit account administration that merits special examiner attention relates to directed accounts. ERISA provides statutory protection from liability for trustees who follow the directions of an investment manager as defined in Section 3(38), or of a plan participant, who is properly authorized in the plan instrument(s) to instruct the trustee in the investment of plan funds.

For example, many plans permit the sponsor (employer) or the plan administrative body (Individual, plan committee, etc.) to appoint investment managers who are authorized to direct the trustee in the selection of trust investments. Where a duly qualified investment manager has been appointed, Section 405(c) of ERISA affords the trustee substantive protections in following the investment manager's directions.

Some plans include provisions authorizing each plan participant, at his or her election, to direct investment of funds allocated to their account. In these cases Section 404(c) affords protection to plan fiduciaries, including the trustee, if the conditions set forth in DOL Regulation 2550.404c-1 are met. However, it is not uncommon for the plan document(s) to permit the employer, plan administrator, or plan administrative committee to instruct the trustee to retain or dispose of specific trust assets at their option. Other plans specifically require that the employer or the plan administrative body direct all investments. Thus, examiners will frequently find it necessary to determine whether investment selection by an outside party is merely allowed, or is required by terms of the plan and trust instruments.

The trustee should insist that all directions received from a participant, investment manager, employer, or plan administrative body relative to investment purchases or sales be in writing, whether or not the plan/trust instruments require such documentation. Where the plan documents require that investment instructions, or any other instructions, from outside parties to the trustee be in writing, a trustee's failure to obtain such documentation would constitute a violation of

Section 404(a)(1)(D) of ERISA.

As a result of the statutory protections afforded directed trustees under ERISA, many trust managers have taken the position that as long as they faithfully follow the instructions of an outside party who is duly authorized to select investments, the bank is fully protected. This is not the situation in all instances. Where the trustee follows instructions of an outside fiduciary which violate the prohibited transaction provisions of Section 406, or the limitation provision relative to holdings of employer securities or real property of Section 407 of ERISA, the trustee would be equally liable with the co-fiduciary. In instances where the employer or plan administrative body instructing the trustee failed to: (1) adhere to the prudence standards prescribed in Section 404(a)(1)(B), (2) diversify plan investments as required by Section 404(a)(1)(C), or (3) act in accord with the documents and instruments governing the plan as prescribed by Section 404(a)(1)(D) of ERISA, the trustee would be exposed to liability as a co-fiduciary under Section 405 of ERISA in accepting and acting upon such instructions.

## **Prohibited Transactions – ERISA Section 406**

### ***Introduction***

ERISA prohibits a fiduciary of an employee benefit plan from causing the plan to engage in certain transactions with a "party in interest". Generally, all transactions with parties in interest are prohibited, even if done on an arm's length basis. Certain transactions with parties in interest are exempted from the prohibition, either by statute or by an administrative exemption granted by the U.S. Department of Labor (DOL).

ERISA Section 406, the primary section dealing with prohibited transactions, is divided into two parts. The first part prohibits fiduciaries of plans from causing the plan to engage in transactions with parties in interest. The second part sets forth additional prohibitions on transactions between a plan and a fiduciary of the plan. ERISA Section 407 contains special provisions covering securities and real estate of the employer sponsoring the plan. ERISA Section 408 provides the statutory exemptions for certain prohibited transactions and authorizes the issuance of administrative exemptions by the DOL. All three of these sections are very pertinent to bank trust departments and own-bank plans. Examiners need to be aware of provisions that may appear in more than one section of the law, as well as covered in various exemptions.

A prohibited transaction violation usually generates a corresponding violation of the fiduciary responsibility provisions (exclusive benefit and/or prudence rules) of ERISA Section 404. In drafting Report of Examination comments, the examiner should bear in mind that the prohibited transaction violation is generally deemed to be the more concrete and significant of the two sets of violations.

Examiners should note that there is a parallel set of violations involving Section 4975 of the IRC for most types of prohibited transactions. While IRC Section 4975 is similar to the provisions of ERISA regarding prohibited transactions, the two are not identical. Where applicable, both sets of violations should be cited. Refer to subsection M, Compliance with the Internal Revenue Code for coverage of these provisions. Where possible, a cross reference to IRC Section 4975 is given.

### ***ERISA Insiders - Party in Interest Defined***

Section 3(14) of ERISA provides a definition of a party in interest. Definitions applicable to bank insiders from banking laws and regulations do not apply. Reference is made to the text of ERISA definitions and the summary of interpretations for a more complete description.

In general, a party in interest will include the following:

- The plan sponsor and its directors and officers.
- Fiduciaries, legal counsel, and employees of the plan. Fiduciaries include plan administrators, investment managers and trustees of the plan.
- Service providers and their directors, officers, and employees.

Certain subsidiaries, affiliates, and controlling shareholders of parties in interest are themselves considered parties in interest, as well as relatives of certain parties in interest. Section 3(15) defines the term relative as a spouse, ancestor, lineal descendant, or spouse of a lineal descendant [also see IRC 4975(e)(2)].

A bank normally serves in one or more of the primary party in interest positions. For own-bank plans, the bank is the plan sponsor and therefore a fiduciary, and also may also be a service provider. For outside plans, the bank may serve as fiduciary and service provider. Examiners should note that a bank serving as a mere custodian is generally not a fiduciary (As explained in subsection H.7.c., the definition of fiduciary is a functional one.), but is a party in interest under ERISA.

The chart below is a summary of the major party in interest provisions. For each of the primary party in interest positions, the chart indicates if the organization/Individuals, directors and officers, owners, and affiliates are considered to be a party in interest. Reference is made to the appropriate section(s) of ERISA. For further details, consult the definition of a party in interest and ERISA Section 3(14) in Appendix E [Also see IRC 4975(e)(2)].

### ERISA INSIDERS

							50+ % Affiliates	50+ % Affiliates
		Organizations or Individuals	Directors Officers	50+ % Owners	10+ % Owners	Relatives	Organizations	DOE & 10%+ Owners
Type of Insider	Sections	3(21)(A)	3(14)(H)	3(14)(E)	3(14)(H) and 3(14)(I)	3(14)(F) and 3(15)	3(14)(G)	3(14)(H) And 3(14)(I)
Fiduciaries	3(14)(A)	X	X			X	X	X
Plan Sponsor	3(14)(C)	X	X	X	X	X	X	
Employee Unions	3(14)(D)	X	X	X	X		X	
Service Providers	3(14)(B)	X	X			X	X	X

Owners include: Corporations, Partnerships, Joint Ventures, Trusts, and Estates

### Prohibited Transactions With Parties in Interest

Section 406(a) of ERISA prohibits a fiduciary from causing an ERISA plan to engage in five general types of transactions between the plan and parties in interest, if the fiduciary knows or should know that the transaction constitutes a direct or indirect:

- Selling, exchanging, or leasing of any property [see Section 406(a)(1)(A) and IRC 4975(c)(1)(A)].
- Lending of money or other extensions of credit [see Section 406(a)(1)(B) and IRC 4975(c)(1)(B)]. Exceptions exist for own-bank deposits, overdrafts, repurchase agreements, securities lending, and loans to plan participants. See Special Examination Applications below.
- Furnishing goods, services, or facilities [see Section 406(a)(1)(C) and IRC 4975(c)(1)(C)]. Much of this prohibition is negated by the ancillary service exemptions in Section 408.
- Transferring of plan assets to a party in interest, or use of plan assets by (or for the benefit of) a party in interest [see Section 406(a)(1)(D) and IRC 4975(c)(1)(D)].

- Acquiring or holding of sponsor employer securities or employer real property. Special exemptions are included in Section 407, with different provisions for different types of plans [see Section 406(a)(1)(E)]. There is no parallel IRC provision, but see subsection H.5.c.(5) for special IRC rules for ESOPs.

Transactions are prohibited even when done on an arm's-length basis. ERISA Section 408 and related DOL Regulation 25 50.408 contain a number of statutory exemptions for transactions covered by Section 406. In addition, the DOL has issued a number of official interpretations and class exemptions for transactions covered by Section 406.

### ***Prohibited Transactions With Fiduciaries***

Section 406(b) of ERISA prohibits three general types of self-dealing transactions between ERISA plans and fiduciaries, even if done on an arm's-length basis. The fiduciary is prohibited from:

- Dealing with a plan's assets in its own interest or for its own benefit [see ERISA Section 406(b)(1) and IRC Section 4975(c)(1)(E)].
- In any transaction involving the plan, acting on behalf of a party whose interests are adverse to the interests of the plan, its participants or beneficiaries [see ERISA Section 406(b)(2)][no parallel IRC provision].
- Receiving any consideration for itself from any party dealing with the plan in connection with a transaction involving assets of the plan [see ERISA Section 406(b)(3) and IRC Section 4975(c)(1)(F)].

As is the case with Section 406(a), there are statutory exemptions, as well as DOL interpretations and transaction class exemptions, that cover certain transactions covered by Section 406(b).

### ***Prohibited Transaction Liabilities of Non-Fiduciary Parties In Interest***

As explained above, ERISA Section 406 prohibits fiduciaries from causing a plan to engage in a prohibited transaction. In *Harris Trust and Savings Bank v. Salomon Smith Barney, Inc.*, No. 99-579, 120 S.Ct. 2180, (June 12, 2000), the U.S. Supreme Court held that non-fiduciary parties in interest who participate in prohibited transactions also may be held liable under ERISA.

Salomon Smith Barney, Inc. (Salomon) provided broker-dealer services to the Ameritech Pension Trust (APT). Salomon acted on a non-discretionary basis, subject to the direction of APT's investment manager. Solomon accordingly was considered a party in interest, but not a fiduciary, of APT. APT's trustee, Harris Trust and Savings Bank, sued Salomon when certain motel interests sold by Salomon to APT were discovered to be nearly worthless. Solomon had provided financing for two motel chains and, in exchange, received a percentage of the net cash flow generated by the motels and a share of any increase in the property value. Solomon sold these interests to APT. Both motels went bankrupt shortly after being sold to APT.

The action was brought under ERISA Section 502(a)(3), which authorizes civil actions to obtain "appropriate equitable relief" to redress violations of ERISA, and sought rescission of the transaction, restitution and disgorgement of profits. Salomon moved for summary judgment, noting that ERISA Section 406 applies only to fiduciaries, and asserting that "absent a substantive provision of ERISA expressly imposing a duty upon a non-fiduciary party in interest, the non-fiduciary party may not be held liable under ERISA Section 502(a)(3)."

The Supreme Court rejected Salomon's position. It stated that ERISA Section 502(a)(3) "itself imposes certain duties, and therefore...liability under that provision does not depend on whether ERISA's substantive provisions impose a specific duty on the party being sued." Actions under ERISA Section 502(a)(3), the Supreme Court found, are not limited to specific defendants, but are limited by the requirement that relief sought be "appropriate equitable relief."

Utilizing a similar analysis, several other courts have found that entities that are neither parties in interest nor fiduciaries may be sued under ERISA Section 502(a)(3) for participation in a prohibited transaction. See *LeBlanc v. Cahill*, 153 F.3d 134 (4th Cir. 1998); *Reich v. Compton*, 57 F.3d 270 (3d Cir. 1995).

## *Special Examination Applications of Prohibited Transaction Provisions*

A number of areas not specifically covered in the ERISA statute are particularly relevant to banks and trust departments. Many of the topics have been the subject of inquiries by examiners and bankers and subject to criticism in examination reports. In some cases, banks have been subject to Labor Department lawsuits or investigations, plan or beneficiary reimbursements, and/or penalty payments. The topics most relevant to examiners are noted below and grouped alphabetically by topic.

Brokers Executing Securities Transactions	H.7.f.(1)
Contributions, In-Kind	H.7.f.(2)
Float Management	H.7.f.(3)
Foreign Exchange	H.7.f.(4)
Loans to Common Borrowers - General	H.7.f.(5)
Loans to Common Borrowers - Lending Limits	H.7.f.(6)
Loans - Takeout Financing	H.7.f.(7)
Loans - Own-Bank Origination and Servicing	H.7.f.(8)
Mortgages (Residential), Investment in	H.7.f.(9)
Mutual Funds, Conversion from Collective Investment Funds	H.7.f.(10)
Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised	H.7.f.(11)
Investment of Own Bank EB Funds in Proprietary Mutual Funds	H.7.f.(12)
Mutual Funds, Receipt of 12b-1 Fees	H.7.f.(13)
Overdrafts	H.7.f.(14)
Qualified Professional Asset Managers - Transactions With Investment Managers	H.7.f.(15)
Repurchase Agreements	H.7.f.(16)
Securities Lending	H.7.f.(17)
Securities Issued - Proceeds Used to Reduce Debt at a Party in Interest	H.7.f.(18)
Soft Dollars	H.7.f.(19)
Sweep Fees	H.7.f.(20)

### Brokers Executing Securities Transactions

Prohibited Transaction Class Exemption (PTE) 86-128 is designed more for securities brokers who execute transactions for ERISA plans than it is for banks and trust departments. However, there are several portions which are very applicable to trust

departments. In general, PTE 86-128 permits fiduciaries to execute securities transactions for ERISA accounts. The PTE states to what extent the fiduciaries may charge and retain commissions on the transactions.

PTE 86-128 is based on the ancillary services statutory exemption of ERISA Section 408(b)(2). The PTE provides relief only from the prohibited transaction provisions of ERISA Section 406(b), which involves plan transactions with a fiduciary. Direct and indirect sales (or other underlying transactions) under ERISA Section 406(a) between an ERISA plan and a party in interest are not covered.

There are a number of other exclusions from the PTE that are relevant to trust departments. Custodians, non-discretionary trustees, and trustees of self-directed plans are excluded from the general definition of trustee. In addition, it explicitly does not exempt churning of account assets, inter-trust transactions where the bank has discretion on both sides of a transaction, and transactions of IRAs.

PTE 86-128 deals with securities transactions which occur in several different scenarios:

- **Non-Profit Basis** - Under the PTE, any fiduciary (including trustees, plan administrators, and plan sponsors) may execute securities transactions for Individual ERISA plans if *all* profits earned in connection with the transaction are credited back to the plan. This is termed a recapture. Both direct and reasonable indirect costs (including overhead) of executing the transaction may be retained. The nonprofit approach would apply to both discretionary and non-discretionary trust department accounts.
- **Profit Fees Charged** - The PTE permits broker-dealers to execute securities transactions for ERISA accounts and charge commissions to make a profit. Ordinarily, a broker providing services to an ERISA plan is a party in interest, and the plan is prohibited from having any transactions with such an insider.

This portion of the PTE covers fiduciaries who are not trustees, plan administrators, and plan sponsors. As such, it would cover bank-affiliated securities brokers, custodians, non-discretionary trustees, and trustees of self-directed plans.

- **Collective Investment Funds (CIFs)** - For CIFs with ERISA accounts, the recapture method is authorized. Alternatively, commissions from CIF transactions may be retained if:
  - The employer-bank's ERISA plan(s) amounts to no more than 20% of the CIF, and
  - The total commissions from all CIFs containing the employer-bank's ERISA plan(s) amount to no more than 5% of all brokerage commissions received by the bank during the calendar year.

These provisions seem primarily aimed at preventing abuses by the bank of its own-bank ERISA plan(s) invested in the bank's CIFs. The conditions are intended to prevent undue commissions from being paid by the bank's plan(s) to a bank-affiliated broker through the medium of the CIF transactions.

- **Inter-Account Transactions** - These transactions (agency cross transactions), where the buyer and seller of a security use the same broker, are permitted, if certain conditions are met. Inter-trust account transactions, where the bank has discretion over both accounts, are not included in this part of the PTE.

PTE 86-128 also sets conditions for Individual plans pertaining to: (1) Information, (2) Non-discretionary Status, (3) Authorization, (4) Disclosure and Approval, (5) Confirmations, and (6) Summary Reports. Refer to the PTE 86-128 for further details.

### Contributions, In-Kind

Instead of making a cash contribution to an employee benefit plan, some plan sponsors have attempted to make a contribution of non-cash assets, usually termed an in-kind contribution. Based on a Supreme Court case, the Labor Department released Interpretive Bulletin 94-3, which indicates that a prohibited transaction exists when the plan sponsor makes such a contribution to defined benefit and certain defined contribution and welfare benefit plans.

An in-kind contribution to a defined *benefit* plan by a plan sponsor constitutes a prohibited transaction in violation of ERISA Section 406(a)(1)(A) and a violation of IRC Section 4975(c)(1)(A). The transaction constitutes a prohibited transaction because

such a contribution would be credited to the plan's funding standard account. Such an in-kind contribution is considered a prohibited transaction even if the value of the contribution exceeds the funding obligation for the plan year, as it would be credited against future funding obligations.

An in-kind contribution to a *defined contribution plan* or a *welfare plan* is considered a prohibited transaction if it reduces an obligation of the plan sponsor to make a contribution measured in terms of cash amounts. As an example, the Interpretive Bulletin states that an in-kind contribution to a profit sharing plan, the terms of which require the employer to make annual contributions of a specified percentage of profits, would be considered a prohibited transaction, even if the terms of the plan permit an in-kind contribution. On the other hand, an in-kind contribution to a plan which is funded solely at the employer's discretion would not constitute a prohibited transaction.

Interpretive Bulletin 94-3 also provides details about a fiduciary's duty to review in-kind contributions. This is covered in the material for Section 404 of ERISA dealing with fiduciary responsibilities in subsection H.5.c.(1), Contributions, In-Kind.

### Float Management

When employee benefit funds are distributed from a trust account, funds are transferred from the trust account to a general Demand Deposit Account (DDA) for the trust department. This DDA is normally with the commercial side of the bank. Until the checks are returned and paid, the bank earns the float from the demand deposit balance.

In Advisory Opinion 93-24A and a follow-up interpretation to the American Bankers Association, DOL indicates that a violation of ERISA Section 406(b)(1), and possibly 406(b)(3), may occur. The DOL asserted that this would be the case regardless of whether the funds are technically considered plan assets after they were transferred from the trust. On November 5, 2002, the DOL issued Field Assistance Bulletin 2002-3, Disclosure and other Obligations Relating to "Float," in which DOL discusses the factors that a fiduciary must consider in assessing the reasonableness of an agreement wherein a service provider retains float and the disclosure requirements for service providers under such an arrangement.

The statutory ancillary services exemption of ERISA 408(b)(6) does not include the float earned by the fiduciary bank from a DDA to the extent that it is reasonably possible to earn a return on such funds. Retention of float would be permissible; however, if it was a part of the trust department's overall compensation from the plan and if appropriate disclosures regarding the use of float were provided to the plan.

### Foreign Exchange

The Pension Protection Act of 2006 (PDF) added a statutory exemption for foreign exchange transactions. See Section H.9.1 for details concerning the exemption contained in ERISA Section 408(b)(18). Prior to the enactment of the statutory exemption, DOL issued several PTEs covering certain foreign exchange transactions.

Prohibited Transaction Class Exemption 94-20 (PTE 94-20) permits banks and broker-dealers to effect foreign currency exchanges and foreign currency options transactions for employee benefit plans for which the banks or broker-dealers are parties in interest. To qualify for PTE 94-20, the transactions may be performed only for non-discretionary accounts or upon the direction of an independent fiduciary. In addition, the terms of the transaction must be the same afforded on an arm's-length basis, written policies must be maintained, written confirmations (with specified contents) must be provided, and appropriate records retained for six years. PTE 94-20 is effective for transactions incurred on June 18, 1991, and later. Provisions are also included for transactions prior to that date. The full text of PTE 94-20 can be found in Appendix E.

Under the Labor Department's Prohibited Transaction Class Exemption 98-54 (PTE 98-54), [located in Appendix E], the following foreign exchange transactions between employee benefit plans and banks or broker-dealers (which are trustees, custodians, fiduciaries or other parties in interest with respect to the plans), are permitted pursuant to standing instructions:

- conversions of interest, dividends or other securities distributions into U.S. dollars, or into other currencies, in an amount equivalent to no more than \$300,000 U.S. dollars. Note: As stated in footnote 4 of PTE 98-54, although the Department of Labor believes that the \$300,000 threshold is appropriate for large plans that purchase and sell foreign securities, the

Department notes that such dollar limitations may not be appropriate for smaller plans (e.g., plans with aggregate plan assets of less than \$50 million), and

- the purchase or sale of foreign currencies in an amount equivalent to no more than \$300,000 U.S. dollars, in connection with the purchase or sale of foreign securities.

The exemption contains both retroactive conditions for transactions prior to January 12, 1999, and prospective conditions for transactions occurring after that date. Prospective conditions include the following: (1) arm's-length terms; (2) no discretionary authority or control or investment advice by the bank or broker-dealer with respect to the plan assets involved in the transaction; (3) deadlines for trades following the receipt of good funds, and daily establishment of an exchange rate for the trades; (4) advance written authorization by an independent fiduciary; (5) written policies and procedures for handling foreign exchange transactions for plans; (6) written confirmations; (7) compliance with certain recordkeeping procedures.

#### Loans to Common Borrowers – General

In a number of banks, examiners have found that employee benefit plans sponsored or administered by the bank have invested plan assets in loans to the same borrowers as the bank itself. This would appear to violate ERISA Section 406(b)(2) in that the plan's interests are, directly or indirectly, in conflict with the bank's interests as lender to the same party.

Examiners should review the performance and credit quality of such loans, applying normal loan examination standards. Where loans are delinquent, appropriate comments should be made and the examiner should also review the procedures used to monitor loan performance. Examiners should also sample the status of loans made by the commercial loan department to the same borrowers. When both loans are delinquent, examiners should provide details of both sets of loans and also review adequacy of procedures to protect the plan's interests. In several instances, examiners have noted favoritism given to the loans made by the bank over those made by the plan.

Examiners should be aware that, like any investment, loans of this nature may represent a violation of the diversification and prudence requirements of ERISA Section 404(a)(1). The bank must also be able to demonstrate that it exercised the appropriate consideration of DOL ERISA Regulation 2550.404a-1 regarding investment duties for investing plan assets in a loan where the plan's interests conflict with that of the bank.

#### Loans to Common Borrowers - Lending Limits

FDIC examiners have encountered a number of instances where a bank used an employee benefit plan to circumvent state legal lending limits. When the amount of a loan (or credit line) exceeds the bank's legal lending limit, either a separate loan is made by an employee benefit plan or the employee benefit plan participates in the bank's loan. This is clearly a conflict of interest and self-dealing, irrespective of the credit quality of the borrower.

The primary ERISA violation in such cases is Section 406(b)(1) in that the transaction would primarily have taken place to enable the bank to make the loan or keep a customer relationship, which would otherwise have violated state law. Section 404(a)(1)(A), which requires that the plan be operated exclusively for the benefit of plan participants and beneficiaries, would coexist with the Section 406(b)(1) violation. The bank is also likely to be in violation of ERISA Section 406(b)(2). The bank's interests as a lender to the same borrower as the plan would, directly or indirectly, be in conflict with the interests of the plan.

Examiners should be aware that, like any investment, loans of this nature may represent a violation of the diversification and prudence requirements of ERISA Section 404(a)(1). The bank must also be able to demonstrate that it exercised the appropriate consideration of DOL ERISA Regulation 2550.404a-1(b)(2) regarding investment duties for investing plan assets in a loan where the plan's interests conflict with that of the bank.

#### Loans - Takeout Financing

In a number of instances, a bank has granted construction loans in conjunction with ERISA employee benefit plans. The bank will provide the short-term construction loan and the employee benefit plan will fund the long-term financing for the same construction project. This type of arrangement is a prohibited transaction in violation of ERISA Section 406(b)(1) and 406(b)(2)

because the plan is providing the financing to pay off the bank's loan. In addition, the construction loan was most likely granted with the knowledge that the ERISA plan would provide the permanent financing.

#### Loans - Own-Bank Origination and Servicing

Employee benefit plans may invest in loans if authorized by plan documents. A trust department may utilize the experience and facilities of the bank's loan department to originate and service loans for employee benefit accounts. Such arrangements are not prohibited transactions so long as the bank either charges no fee or charges no more than its direct costs of performing these services for the plan. Indirect costs may not be charged to the plan.

When the bank acts as a loan originator, great care must be taken to ensure that all of the loan documents are either (1) in the plan's name, or (2) in the name of the bank as trustee or agent of the plan. If the loan documents are in the bank's name, there is a presumption that the loan was made by the bank and sold to the plan, which would be a prohibited transaction in violation of ERISA Section 406(a)(1).

When the bank acts as a loan originator and the borrower pays certain fees to obtain the loan (such as a loan origination fee), all of these fees must flow back to the plan, and not be retained by the bank. If the bank retained such fees, it would be a prohibited transaction in violation of ERISA Section 406(b)(3).

#### Mortgages (Residential), Investment in

Prohibited Transaction Class Exemption (PTE) 82-87 (as amended by PTE 88-59), permits employee benefit plans to participate in transactions related to residential mortgage financing, including commitments for the provision of mortgage financing, receipt of commitment fees, the making or purchase of loans or participation interests, and the sale, exchange or transfer prior to the maturity date of mortgage loans or participations in mortgage loans. The PTE applies to mortgage loans on single or multiple residential dwelling units, such as detached houses, townhouses, and condominiums.

The exemption is necessary in the case of plans that engage in mortgage financing transactions with parties in interest. The exemption provides relief only from ERISA Section 406(a), and not ERISA Section 406(b).

General conditions exist for relief under the PTE, including

- mortgage loans acquired must be "recognized mortgage loans" or participation interests in such loans. "Recognized mortgage loans" are defined as either residential mortgages eligible for purchase by FNMA, GNMA, FHLMC, or Federal Housing Administration insured GNMA tandem project residential mortgage loans.
- loans must be made for the purchase of a residential dwelling unit(s).
- mortgage loans must be originated by an independent established mortgage lender.
- the price paid or received by the plan must be at least as favorable as available in a similar transaction involving unrelated parties.
- certain Individuals may not be fiduciaries with respect to the plan's decision to engage in the transaction, including developers and builders of the units, lenders, and existing owners of the mortgage or participation interests.
- the decision to engage in the mortgage financing transaction must be made by an independent qualified real estate manager. This is a financial institution or business organization that advises institutional investors in similar investments and which acknowledges in writing that it will make relevant decisions in the capacity as a fiduciary.
- the plan must maintain records for the duration of any loan made pursuant to the exemption sufficient to demonstrate compliance with the exemption.

The PTE also contains specific conditions applicable to commitments to purchase either a mortgage loan or a participation interest, and for the purchase of participation interests.

#### Mutual Funds, Conversion from Collective Investment Funds (CIFs)

In a 1994 letter to the OCC's trust examination section (see Appendix E), the Labor Department indicated that a transaction involving a CIF used by ERISA accounts which converted into a proprietary mutual fund would represent a prohibited transaction

under ERISA Sections 406(a) and 406(b). The opinion letter specifically notes that PTE 77-4 [located in Appendix E] covers the acquisition and sale of mutual funds for cash, but it does not provide relief for conversion transactions. The Labor Department took the position that a prohibited transaction occurs because the bank, as an ERISA plan fiduciary, is involved in the following:

- Transferring plan assets to itself (by imposition of mutual fund fees) in violation of ERISA Section 406(a)(1)(D).  
  
ERISA applies because, as either investment advisor or custodian of a mutual fund, the bank (or an affiliate) gains financially through increased fee income. Fee income is increased by investing ERISA plan assets in an investment vehicle where the bank/affiliate's investment advisor or custodian fees are dependent on the amount of assets invested in the mutual fund.
- Dealing with itself (or an affiliate) on both sides of the conversion transaction, in violation of ERISA Sections:
  - 406(b)(1), dealing with itself, which constitutes self-dealing;
  - 406(b)(2), by serving on both sides of the transaction; and/or
  - 406(b)(3), by receiving fees based on the transaction.

In 1997, the Labor Department issued Prohibited Transaction Exemption 97-41 (PTE 97-41) [which is located in Appendix E], providing relief from the prohibitions of ERISA Sections 406(a), 406(b)(1) and 406(b)(2) for conversions of CIFs into mutual funds, and the investment of employee benefit plans in the converted funds. Note that no exemption is provided from the prohibition of ERISA Section 406(b)(3). PTE 97-41 permits employee benefit plans to: (a) purchase shares of a mutual fund advised by a bank or investment adviser which is also a fiduciary to the plan, (b) in exchange for assets transferred in-kind from the CIF, (c) when the plan's assets are completely withdrawn from the CIF. These transactions are also subject to in-kind asset transfer requirements of SEC Rule 17(a)-7, issued under the Investment Company Act of 1940 [17 C.F.R. 270.17(a)-7]. PTE 97-41 is retroactive from October 1, 1988.

PTE 97-41 requirements for the in-kind transfer of plan assets and purchase of mutual fund shares are virtually identical for retroactive exemptions of previous transactions (occurring between October 1, 1988 and August 8, 1997), and later transactions. In both cases, the transfer and purchase must be in connection with a complete withdrawal of an employee benefit plan's assets from a CIF. Conversions occurring after August 8, 1997 must meet the following conditions:

- No sales commissions or other fees are paid by the employee benefit plan in connection with the purchase of mutual fund shares.
- All transferred assets are securities for which market quotations are readily available, or cash.
- The transferred assets constitute the employee benefit plan's pro rata portion of all assets that were held by the CIF immediately prior to the transfer.
- The employee benefit plan receives mutual fund shares that have a total net asset value equal to the value of the plan's transferred assets on the date of the transfer, in accordance with SEC Rule 17a-7.
- An independent fiduciary with respect to the employee benefit plan receives advance written notice of the in-kind transfer and purchase of assets, and full written disclosure of information concerning the mutual funds, including:
  - A current prospectus for each mutual fund to which the CIF assets may be transferred;
  - Fees to be paid by an employee benefit plan and the mutual funds to the Bank or Plan Adviser;
  - Reasons why the Bank or Plan Adviser considers the transfer and purchase to be appropriate for the employee benefit plan;
  - Limitations with respect to plan assets which may be invested in shares of the mutual funds, and, if so, the nature of such limitations;
  - The identity of all securities to be valued in accordance with SEC Rule 17a-7(b)(4); and
  - The identity of fixed-income securities to be allocated on the basis of each employee benefit plan's pro rata share of the aggregate value of such securities.
- An independent fiduciary must give prior written approval for each purchase of mutual fund shares in exchange for the employee benefit plan's assets transferred from the CIF.
- An independent fiduciary of each employee benefit plan is provided, in writing:

- Within 30 days of purchase--(i) The identity of each transferred security that was valued in accordance with Rule 17a-7(b)(4); (ii) The current market price, as of the date of the in-kind transfer, of each such security; and (iii) The identity of each pricing service or market-maker consulted in determining the current market price of such securities.
- Within 105 days following each purchase--(i) The number of CIF units held by the plan immediately before the in-kind transfer, the related per unit value, and the total dollar amount of such CIF units; and (ii) The number of shares in the mutual funds held by the plan immediately *following* the purchase, the related per share net asset value, and the total dollar amount of such shares.
- With respect to each of the mutual funds which an employee benefit plan continues to hold shares acquired in connection with the in-kind transfer, the Bank or Plan Adviser must provide the independent fiduciary--(i) A prospectus of such fund annually; and (ii) Upon request, a description of all fees paid by the fund to the Bank or Plan Adviser.
- The combined total of all plan fees received by the Bank or Plan Adviser must not be in excess of "reasonable compensation" within the meaning of section 408(b)(2) of the Act.
- All dealings in connection with the in-kind transfer and purchase between the employee benefit plan and a mutual fund must be on a basis no less favorable to the employee benefit plan than dealings between the mutual fund and other shareholders.

As noted above, the PTE does not provide relief for prohibited transactions in violation of ERISA Section 406(b)(3). However, the PTE provides that a transaction that complies with the exemption is deemed to satisfy certain conditions under PTE 77-4 (which does provide such relief), and therefore may qualify under that exemption if the additional conditions are met. PTE 77-4 provides relief for ERISA Section 406(a) and 406(b), including 406(b)(3). Accordingly, a bank that complies with PTE 97-41 may receive investment management and advisory fees with respect to the plan's assets invested in the fund if it complies with the additional requirements of PTE 77-4.

Another type of CIF conversion, involving liquidation-to-cash of a CIF's assets, with simultaneous rollover of the cash proceeds into a mutual fund, is not considered an ERISA prohibited transaction. Further, employee benefit CIFs are permitted by the IRS to convert into a mutual fund using the liquidation-to-cash method without being subject to capital gains taxes.

Examiners should consider conversions of ERISA CIFs into proprietary mutual funds which fall outside the requirements of PTE 97-41, or the liquidation-to-cash method, to be a prohibited transaction.

A bank electing to convert a CIF through an in-kind transfer of assets which does not meet the conditions of PTE 97-41 may seek an Individual prohibited transaction exemption from the DOL. See e.g., Allfirst Bank, 64 FR 57129; Pacific Income Advisors, 63 FR 60408; Society National Bank, 61 FR 44081. [See 29 C.F.R. 2570.30 -.52 Individual and Class Prohibited Transaction Exemption Requests, which replaced ERISA Procedure 75-1, for information about the requirements for requesting exemptions.]

The DOL staff has indicated its primary concerns involve (i) the proper valuation of the CIF and mutual fund assets, and (ii) various fees and commissions which may be levied, together with the disclosure.

Some bank counsel have suggested that PTE 84-24 regarding Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance and Investment Companies, and Investment Company Principal Underwriters, may provide an alternative approach to PTE 77-4. The Labor Department staff has verbally indicated that this is an unsatisfactory approach.

## Mutual Funds, Investment in Proprietary (Own-Bank or Affiliated) and Advised

A bank that exercises its discretionary authority to cause an employee benefit plan to invest in the bank's proprietary mutual funds or in mutual funds advised by a bank's trust department would be engaging in a prohibited transaction under ERISA Sections 406(b)(1) and 406(b)(3). The bank (and its holding company or an affiliate) receives a management fee from the mutual fund based on the amount of assets advised. The placement of plan assets in the mutual fund thus generates direct or indirect compensation for the bank and represents a conflict of interest prohibited by ERISA Section 406(b).

Prohibited Transaction Class Exemption 77-4 (PTE 77-4) permits employee benefit plans to invest in mutual funds which are proprietary to or advised by a bank that is a fiduciary to such plans. If certain requirements are satisfied, PTE 77-4 exempts fiduciaries from the prohibitions of ERISA Sections 406(a) and 406(b). In general, PTE 77-4 applies differently to discretionary and non-discretionary accounts as follows:

- Applicability to Discretionary ERISA Accounts
  - An independent fiduciary must approve purchases and sales of the proprietary mutual fund for the account. The approval must be:
    - Indicated in writing prior to each Individual purchase or sale of the fund,
    - Indicated in writing prior to the commencement of a specified purchase program, or
    - Set forth in the plan documents or in the investment management agreement between the plan and the fiduciary/investment advisor.
  - No sales commission load is paid in connection with the purchase.
  - No redemption fee is paid, unless the fee is:
    - Paid only to the mutual fund, and
    - Disclosed in the prospectus both at the time of the purchase and at the time of the sale.
  - No investment management/advisory fee is paid to the mutual fund for the entire period of the investment, subject to specific limitations.
  - The independent fiduciary receives mutual fund prospectuses, written disclosures of investment advisory and other fees charged, notification of any fee changes, and analyses of the advantages of the affiliated arrangement.
- Applicability to Non-Discretionary ERISA Accounts

PTE 77-4 also applies to non-discretionary transactions. Only the three conditions above involving fees would apply in all cases. The final condition above covering prospectuses would be satisfied if the party making investment decisions receives the specified information noted above.

PTE 77-4 was released in 1977 and was not intended specifically for bank-related or bank-affiliated mutual fund investments. The PTE was intended for mutual funds operated by insurance companies and securities brokers. Nonetheless, it is the primary guidance available at this time to evaluate similar arrangements in banks and trust companies.

The Labor Department has released two Advisory Opinions (AO) applying PTE 77-4 to banking-related situations. AO 93-13A provides guidance on how PTE 77-4 applies to affiliated mutual funds and AO 93-26A provides guidance on how the PTE applies to the use of affiliated mutual funds by IRA and Keogh accounts.

#### Investment of Own Bank Employee Benefit Plans In Proprietary Mutual Funds

As discussed in the Collective Investment Fund Conversion section above, the Labor Department's Prohibited Transaction Exemption 97-41 (PTE 97-41), [located in Appendix E], provides relief from ERISA Section 406 violations for conversions of CIFs into mutual funds, and the investment of employee benefit plans in the converted funds. However, it does not provide a specific exemption for the investment of a bank's own employee benefit plans in mutual funds which are sponsored, advised, or underwritten by the fiduciary bank, or any of its affiliates.

Prohibited Transaction Exemption 77-3 (PTE 77-3), [located in Appendix E] provides relief from ERISA Sections 406 and 407(a) for transactions involving the purchase or sale of shares of registered open-end investment companies by plans covering employees of the mutual fund, its investment advisor, its principal underwriter and affiliates of such entities.

The exemption is conditioned on the following:

- the plan may not pay plan-level advisory fees to an investment advisor, principal underwriter or affiliated person.
- the plan may not pay a redemption fee in connection with the sale by the plan to the mutual fund of shares unless the redemption fee is paid only to the mutual fund and the existence of the fee is disclosed.
- the plan may not pay a sales commission in connection with the purchase or sale of shares.

- all dealings between the plan, the mutual fund, the investment advisor or principal underwriter and any affiliate must be on a basis no less favorable to the plan than dealings with other shareholders of the fund.

PTE 77-3 was not initially intended to cover banks. Nonetheless, it, together with Department of Labor Advisory Opinion 98-06A (AO 98-06A), [located in Appendix E], applies to bank sponsored plans. The AO 98-06A addresses investment in kind by own-bank plans in funds advised by the bank. The AO provides that relief is available not only for cash purchases of mutual fund shares, but also for transactions involving the exchange of securities held on behalf of a plan for shares of the mutual fund. The AO further provides that PTE 77-3 requires the same methodology as PTE 97-41 for valuing the assets of the plan and determining the number of shares of the fund received by the plan. The AO clarifies that PTE 77-3 would not provide relief for a prohibited transaction arising in connection with terminating a CIF, permitting certain plans to withdraw from a CIF that is not terminating, or transferring any plan assets held by a CIF.

The July 30, 1998 opinion, issued in response to an inquiry by Federated Investors, provides the following cautionary notes:

- "...a plan fiduciary considering the in-kind acquisition of shares of a mutual fund advised by the bank in exchange for assets of the bank's in-house plan must insure that the fiduciary's or the bank's interest in attracting and retaining investors in the mutual fund does not conflict with the interests of the plan or its participants and beneficiaries in the selection of appropriate investment vehicles."
- "If the decision by the plan fiduciary to enter into the transaction is not "solely in the interest" of the plan's participants and beneficiaries, e.g., if the decision is motivated by the intent to generate seed money that facilitates the marketing of the mutual fund, then the plan fiduciary would be liable for any loss resulting from such breach of fiduciary responsibility, even if the acquisition of mutual fund shares was exempt by reason of PTE 77-3."

At least two companies, New York Life Insurance Company and First Union Corporation, have been sued for breach of fiduciary duty by in-house plan participants in connection with the investment of in-house plans in proprietary mutual funds.

#### Mutual Funds, Receipt of 12b-1 Fees

Under SEC Rule 12b-1, mutual funds are permitted to pay, from the assets of the mutual fund itself, certain distribution costs. These payments may take the form of commission-like payments to organizations which generate large numbers of transactions in the mutual fund. Not all mutual funds have 12b-1 arrangements.

ERISA Section 406(b)(3) prohibits a fiduciary bank from receiving any direct or indirect compensation for itself from a plan's investment in a mutual fund, including the receipt of 12b-1 fees. In addition, a bank with discretionary authority to invest in a mutual fund which pays the bank a 12b-1 fee would violate ERISA Section 406(b)(1) because it is involved in a conflict of interest. The Department of Labor has issued several advisory opinions clarifying the circumstances in which receipt of 12b-1 fees constitutes a violation of ERISA Sections 406(b)(1) and (3).

The Department of Labor issued Advisory Opinion 93-13A on the receipt by a fiduciary of 12b-1 fees from mutual funds involving bank proprietary mutual funds. In Footnote 4 to AO 93-13A, the DOL was unable to conclude that PTE 77-4 would be available for plan purchases and sales of mutual fund shares if a 12b-1 fee is paid to the fiduciary or its affiliate. This means that the purchase of a proprietary mutual fund would be a prohibited transaction if a 12b-1 fee was paid to a fiduciary or affiliate.

The Department of Labor has also issued Advisory Opinions involving discretionary and non-discretionary accounts which invest in mutual funds which pay 12b-1 fees to fiduciaries. These opinions are discussed below. DOL Advisory Opinion 97-15A to Frost National Bank, commonly referred to as Frost and Advisory Opinion 97-16A to the Aetna Life Insurance and Annuity Company, commonly referred to as Aetna appear in Appendix E. The Department of Labor also issued an interpretive letter to the American Bankers Association on 8-20-97, summarizing the issues addressed by these advisory opinions.

An analysis of ERISA and corresponding exemptions and interpretations, leads to two potential interpretations, one for discretionary accounts and the other for self-directed and non-discretionary accounts:

- Discretionary Accounts - As a general rule, ERISA Section 406(b)(3) prohibits a fiduciary from using the control, authority, or responsibility that makes it a fiduciary, to cause such fiduciary to receive any direct or indirect compensation for itself

from a plan transaction, including the receipt of 12b-1 fees. A bank with discretionary authority to invest in a mutual fund which pays the bank a 12b-1 fee would appear to violate ERISA Section 406(b)(1) because it is involved in a conflict of interest that causes itself to receive additional compensation.

Advisory Opinion letter AO 97-15A - Frost National Bank:

- The general prohibition with respect to discretionary authority was tempered in AO 97-15A to Frost National Bank on 5-22-97. The DOL indicated that advising plan assets invested in mutual funds which pay additional fees to the advising fiduciary would generally violate the prohibitions of Sections 406(b)(1) and (b)(3). The DOL indicated, however, that a fiduciary would not violate these sections by receiving 12b-1 fees from a mutual fund if the fiduciary used the fees to offset, on a dollar-for-dollar basis, a plan's obligation to pay the fiduciary for its services.
  - The DOL further stated that fiduciaries which do not advise or exercise authority or control to cause a plan to invest in a mutual fund, would not violate these sections merely by the receipt of a fee or other compensation from a mutual fund in connection with a plan's investment. See AO 2003-09A, ABN AMRO Trust Services Company. It cautioned, however, that if a fiduciary retains authority to delete or substitute mutual funds which it makes available to plans, the fiduciary in fact may, depending upon the circumstances, exercise discretionary authority or control to cause the payment of fees to itself. If the fees were used to offset the plan's liability to the trustee, however, the fiduciary would not violate Sections 406(b)(1) and (b)(3).
  - Finally, DOL's Frost opinion noted that with respect to the standards of fiduciary conduct stated in ERISA Section 404(a)(1), the plan fiduciary must assure that the compensation paid directly or indirectly by the plan to its administrator is reasonable, taking into account the trustee services provided to the plan in addition to any other fees or compensation received by the plan administrator in connection with the investment of plan assets. DOL emphasized that the responsible plan fiduciaries must obtain sufficient information regarding any fees or other compensation that the plan administrator receives with respect to the plan's investments in each mutual fund to make an informed decision as to whether the plan administrator's compensation for services is no more than reasonable. In addition, DOL required that plan fiduciaries monitor the actions taken by the plan administrator in the performance of its duties, to assure, among other things, that any fee offsets to which the Plan is entitled are correctly calculated and applied.
- Self-Directed and Non-Discretionary Accounts - It is possible that DOL may exempt such transactions if the use of the mutual funds generating the 12b-1 fees is specifically authorized in the plan and if a fiduciary's receipt of the 12b-1 fees is disclosed in the mutual fund's prospectus and by the plan.

Advisory Opinion letter AO 97-16A - Aetna Life Insurance and Annuity Company:

- While the DOL has not adopted a Prohibited Transaction Exemption on this matter, it did release AO 97-16A on 5-22-97 to the Aetna Life Insurance and Annuity Company. The opinion addresses the acceptance of fees by non-discretionary administrative and record keeping service providers.
- In application, the letter indicated the mere receipt of a fee or other compensation from a mutual fund in connection with a plan's investment would not in and of itself violate section 406(b)(1) or (b)(3) if a service provider did not advise or otherwise exercise authority or control to cause a plan to invest in a mutual fund.
- In a cautionary note, the DOL stated that service providers retaining authority to delete or substitute mutual funds made available to plans might, depending upon the circumstances, be deemed to exercise discretionary authority or control to cause the payment of fees to themselves. Once again, the DOL took the position that if the fees were used to offset the plan's liability to the trustee, the fiduciary would not violate Sections 406(b)(1) and (b)(3).

Consequently, examiners should not cite the receipt of 12b-1 fees by self-directed or non-discretionary accounts as an ERISA violation or recommend them for referral to the Department of Labor.

Advisory Opinion letter AO 2003-09A - ABN AMRO Trust Services Company:

- A trustee that provides bundled services to plans, but not investment discretion, may keep 12b-1 fees from affiliated mutual funds as long as a fiduciary, who is independent of the trustee and its affiliates, elects to include the particular fund as one of the allowed investment elections.
- If the trustee, however, provides investment advice within the meaning of regulation 29 CFR 2510.3-21(c), the trustee will cause a violation of 406(b)(1).

Except as noted in the following paragraph, a violation of general fiduciary duties (ERISA Section 406(b)(3)) resulting from the receipt of 12b-1 fees by a fiduciary from a mutual fund can be cured if the fiduciary rebates the 12b-1 fees back to the trust accounts that generated the transactions. Where the bank has retained 12b-1 fees without the authorizations or directions noted above, examiners should recommend that the fees be returned to the accounts that generated them.

Financial institutions that operate proprietary mutual funds may attempt to resolve the ERISA conflict of interest and self-dealing concerns that result when a proprietary mutual fund collects 12b-1 fees from trust accounts that the institution administers in a discretionary capacity by rebating or waiving such fees for trust account shareholders. The proprietary fund, however, collects 12b-1 fees from non-trust account shareholders. The SEC has indicated that the waiving or rebating of 12b-1 fees for some shareholders, but not others, may violate the proprietary mutual fund's obligation to treat all shareholders impartially. See 1986 no-action letter to Southeastern Growth Fund, Inc. If the bank is using this no-action letter as a defense for not rebating the 12b-1 fees, a general criticism of the matter should be presented in the examination report together with a request for a legal opinion. Furthermore, acceptance of 12b-1 fees on discretionary employee benefit accounts invested in such funds would violate ERISA Section 406(b)(3) as noted above.

### Overdrafts and Interest-Free Loans

An overdraft in an ERISA plan's deposit account may be a transaction prohibited by ERISA Section 406(a)(1)(B), as overdrafts represent the lending of funds from a depository institution to an ERISA plan. The depository institution is a party in interest either because it is a fiduciary (own-bank deposits) or a provider of services to the plan.

The Department of Labor has recognized that most overdrafts are of a temporary nature and not abusive. Overdrafts may occur as the result of securities transactions or check clearings. As a result, the DOL provided relief in Prohibited Transaction Class Exemption 80-26 (PTE 80-26) [located in Appendix E] from the prohibitions of ERISA Sections 406(a)(1)(B), 406(a)(1)(D) and 406(b)(2), for interest free loans and other extensions of credit from parties in interest to employee benefit plans. The PTE is effective January 1, 1975. The exemption covers loans or other extensions of credit used for the payment of ordinary operating expenses of the plan, or for a period of no more than three days for a purpose incidental to the ordinary operation of the plan.

The exemption requires the following:

- no interest or other fee may be charged to the plan and no discount for payment in cash is relinquished by the plan.
- the loan or extension of credit must be unsecured.
- the loan or extension of credit may not be made, directly or indirectly, by an employee benefit plan.

The Department of Labor also issued PTE 2000-14, as a temporary amendment to PTE 80-26 (both of which are located in Appendix E). The purpose of the temporary amendment was to permit parties in interest to make interest free loans to plans, enabling them to continue to operate in the event they experienced an inability to liquidate or access assets, or to access data caused by Y2K problems. The amendment was effective from November 1, 1999 until December 31, 2000. Loans extended under this exemption were to be repaid no later than December 31, 2000.

In addition to the guidance discussed above, the Department of Labor issued an advisory opinion on February 10, 2003, that discusses the provision of overdraft protection services in connection with securities and other financial market transactions. In AO 2003-02A, the Department of Labor opined that, under certain circumstances, the extension of an overdraft to a plan in connection with the settlement of a securities or other financial market transaction would satisfy the requirements for the exemptions provided in ERISA Sections 408(b)(2) and 408(b)(6).

### Qualified Professional Asset Managers (QPAMs) - Transactions With Investment Managers

PTE 84-14 (PDF) (80KB PDF file - PDF Help) permits various parties in interest with respect to employee benefit plans to engage in transactions with investment funds in which plans are invested if the investment fund is managed by a "qualified professional asset manager" (QPAM). Investment funds are accounts subject to the discretionary authority of the QPAM, including accounts maintained by an insurance company and trusts maintained by a bank. PTE 84-14, therefore would apply to certain transactions between a bank with discretionary investment authority over an ERISA plan and parties in interest for such a plan, provided the

bank meets the definition of a QPAM given below. The exemption permits banks and other parties in interest to avoid costly ERISA compliance reviews for investment transactions under consideration. PTE 84-14 became effective December 21, 1982.

A bank that has the power to manage, acquire or dispose of the assets of a plan qualifies as a QPAM if it has equity capital in excess of \$1,000,000 as of the last day of its most recent fiscal year, and acknowledges in writing that it is a fiduciary with respect to each plan that has retained it as a QPAM. Savings and loan associations, insurance companies, and investment advisors that meet certain qualifying conditions may also be QPAMs. With respect to bank trust departments, Individual ERISA plans and Collective Investment Funds would usually satisfy the definition of an investment fund.

The exemption deals with different types of scenarios and, depending on the type of scenario, provides relief from Section 406(a) prohibited transactions with parties in interest, Sections 406(b)(1) and (2) prohibited transactions with fiduciaries, and Section 407(a) restrictions on investments in employer real estate. No relief is provided by the PTE from ERISA Section 406(b)(3), involving a fiduciary earning fees or profiting from the transactions it places. In addition, the exemption specifically excludes securities lending (PTE 81-06) [refer to subsection H.7.e.(17), Securities Lending], investments in residential mortgages (PTE 82-87) [refer to subsection H.7.e.(9), Mortgages (Residential), Investment In], and investments in mortgage pools (PTE 83-1).

The QPAM TE (PDF) provides a safe harbor for a number of situations which may occur after a particular transaction first occurs. For instance, a loan may be made to an outside person or organization who later becomes a party in interest [relief provided]. In another situation, a plan purchases an office building from an unrelated party, but among the building's tenants is an office of an affiliate of a plan sponsor [relief provided if percentage tests met]. In another instance, a bank QPAM hires an outside investment manager for its expertise with a particular type of asset, with the bank retaining a potential veto power over transactions [no relief provided]. The Preamble for the PTE gives more than 20 examples of when, how, and if the PTE applies.

If certain general conditions of the PTE 84-14 are satisfied, many types of transactions are exempted if other specific conditions are satisfied.

- General Conditions - Although PTE 84-14 addresses seven general conditions, two of the most important conditions are noted below.
  - The plan in question, when combined with the assets of other plans established or maintained by the same employer or by the same employee organization, does not represent more than 20% of all discretionary assets managed by the QPAM for the client at the time of the transaction (not just employee benefit accounts).
  - At the time of a transaction, the party in interest (or its affiliate) did not possess, and during the immediately preceding year did not exercise the authority to:
    - Appoint or terminate the QPAM as a plan asset manager, or
    - Negotiate a management agreement for a plan with the QPAM. This includes renewals or modifications to existing agreements.
- Transactions With Employers - A QPAM may have the following types of transactions with employers or with any person who is a party in interest by virtue of a relationship with an employer whose ERISA plans are invested in the investment fund:
  - Selling, leasing, or servicing of goods, or the furnishing of services to an investment fund managed by a QPAM by a party in interest if the transaction meets five requirements:
    - The transaction must be necessary for the administration or management of the investment fund;
    - The transaction takes place in the ordinary course of business engaged in by the party in interest with the public;
    - Effective as of August 23, 2005, the revenue received from the investment fund by a party in interest does not exceed 1% of the party in interest's gross annual receipts; and
    - The requirements of Sections I(c) through I(g) of the General Exemption are satisfied.
  - Leasing commercial or office space by an investment fund managed by a QPAM to a party in interest with respect to a plan having an interest in the investment fund if the transaction meets six requirements:

- No more than 10% of the investment fund's assets are invested in the employer's securities and real estate;
  - No commissions or fees are paid by the investment fund to the QPAM or employer (or their affiliates);
  - The space leased must be adaptable to more than one use;
  - The leased space must represent no more than 15% of the building; and
  - For a plan that is not an individual account plan, the aggregate fair market value of employer real estate and employer securities held by the investment funds of the QPAM does not exceed 10% of the fair market value of the assets of the plan held those investment funds; and
  - The requirements of Sections I(c) through I(g) of the General Exemption are satisfied.
- Leases to the QPAM - This section permits the investment fund to lease to the bank various office or commercial space in which the investment fund has invested, if the following general requirements are satisfied:
    - No commissions or fees are paid by the investment fund to the QPAM-bank or its affiliates;
    - The space leased is adaptable to more than one use;
    - The leased space is not more than the greater of 7,500 square feet or 1% of the building; and
    - The transaction takes place on an arm's length basis.
  - Transactions Involving Places of Public Accommodation - Effective as of August 23, 2005, the restrictions of Sections 406(a)(1)(A) through (E) and 406(b)(1) and (2), along with the corresponding taxes imposed by Code Section 4975(a) and (b) do not apply to the furnishing of services and facilities (and goods incidental thereto) by a place of public accommodation owned by an investment fund managed by a QPAM to a party in interest if the services and facilities (and incidental goods) are furnished on a comparable basis to the general public.

On August 23, 2005, the Department of Labor's Employee Benefits Security Administration adopted amendments to PTE 84-14 (PDF). The amendments provide for the following:

- Eliminates the "one year look-back rule" where the exemption was not available if a party in interest had exercised the power to appoint the QPAM within one year preceding a transaction;
- Clarifies that the power to appoint the QPAM provision of the PTE applies only with respect to the assets involved in a transaction, as opposed to a plan's other assets;
- Makes the exemption available to a party in interest investing in a commingled investment fund, notwithstanding that the party in interest has the authority to redeem or acquire units of the fund on behalf of the plan, if the plan's interest in the fund represents less than 10% of the investment fund's total assets;
- Amends the definition of affiliate as it applies to sections I(a) and Part II, to delete those partnerships in which the person has less than a 10% interest, and to only include highly compensated employees as defined in IRC 4975(e)(2)(H);
- Amends the determination of when a party in interest is related to a QPAM to those instances where:
  - The QPAM or the party in interest owns a 10% or greater interest in the other entity; or
  - A person controlling, or controlled, by the QPAM or the party in interest owns a 20% interest in the other entity; or
  - A person controlling, or controlled, by the QPAM or the party in interest owns less than a 20% interest in the other entity, but nevertheless exercises control over the management or policies of the other party by reason of its ownership interest.
- States that determinations of whether the QPAM is "related" to a party in interest for the purposes of Section I(d) may be made as of the last day of the most recent calendar quarter;
- States that shares held in a fiduciary capacity need not be considered in applying percentage limitations;
- Raises the threshold for client assets from \$50 million to \$85 million for registered investment advisors (RIAs) to meet the definition of QPAM. Client assets are determined as of the last day of the RIA's fiscal year. Similarly, the minimum shareholders' and partners' equity for RIAs was increased from \$750,000 to \$1 million;
- Requires that a QPAM must be independent of an employer with respect to a plan whose assets are managed by the QPAM, i.e. an employer cannot be a QPAM for its own plan(s).

**Repurchase Agreements**

Since a repurchase agreement is generally considered to represent a loan, a repurchase agreement between a party in interest and the fiduciary bank would normally be a prohibited transaction under ERISA Section 406(a)(1)(B). The DOL issued Prohibited Transaction Class Exemption 81-8 (PTE 81-8) (as amended 50 FR 14043, April 9, 1985) which provides relief from the restrictions of ERISA Section 406(a)(1)(B). Repurchase Agreements are also discussed in subsection F.14. of Section 3, Asset Management. The FDIC adopted the FFIEC Supervisory Policy on Repurchase Agreements of Depository Institutions with Securities Brokers and Others on November 12, 1985. The policy statement is located in Appendix C.

PTE 81-8 addresses a number of short-term investments including repurchase agreements. The restrictions of ERISA Section 406(a)(1)(A), (B), and (D) do not apply to the investment of employee benefit plan assets which involves the acquisition, holding, sale, exchange or redemption by or on behalf of the plan of banker's acceptances, commercial paper, repurchase agreements, certificates of deposit and, as of 1985, securities of certain banks.

Conditions applicable to repurchase agreements in which the seller of the underlying securities is a bank, broker-dealer, or a dealer who makes primary markets in securities of the United States or any agency thereof or in bankers acceptances include:

- the repurchase agreement must be embodied in a written agreement the terms of which are at least as favorable to the plan as an arm's-length transaction between unrelated parties.
- the plan must receive interest at a rate no less than in a comparable transaction with an unrelated party.
- the repurchase agreement must have a duration of one year or less.
- the plan must receive securities, banker's acceptances, commercial paper or certificates of deposit with a market value of not less than 100 percent of the purchase price paid by the plan.
- upon expiration of the repurchase agreement and the return of the securities or other instrument to the bank, the seller must transfer to the plan an amount equal to the purchase price plus appropriate interest.
- neither the seller nor an affiliate may have discretionary authority with respect to the plan assets invested in the transaction, or may render investment advice with respect to those assets.
- the underlying securities or other instruments must be of a type that could be acquired by the plan without violating the restrictions of the prohibited transaction rules and such securities may not be restricted securities within the meaning of Rule 144 of the Securities Act of 1933.
- certain measures must be agreed to such that, during the term of the agreement, the plan always holds securities or other instruments with a market value equal to the purchase price paid by the plan.
- the seller must furnish the plan with specified financial statements.

**Securities Lending**

The lending of securities from employee benefit plans is a fairly common practice. When the lending is fully collateralized, there is little risk and the plan earns additional income from the lending of the securities. Generally, this activity takes place with the fiduciary bank, a securities broker, and/or one of their affiliates providing services to the plan. In such cases, a prohibited transaction in violation of ERISA Section 406(a) would exist because the fiduciary bank and/or service providers are considered parties in interest by definition. Securities lending is also discussed in subsection F.15 of Section 3, Asset Management. The FDIC adopted the FFIEC Supervisory Policy on Securities Lending on July 22, 1997. The policy statement is located in Appendix C.

Prohibited Transaction Class Exemption 81-6 (PTE 81-6) (as amended 52 FR 18754, May 19, 1987) permits securities lending with parties in interest if certain conditions are satisfied. In addition, Prohibited Transaction Class Exemption 82-63 (PTE 82-63) permits the fiduciary bank to charge a reasonable fee for securities lending services. A fiduciary bank may instead use the statutory exemption under Section 408(b)(6) of ERISA to receive a fee for these services.

PTE 81-6 provides relief from ERISA Sections 406(a)(1)(A) - (D). Conditions include:

- neither the borrower nor an affiliate has discretionary authority or control with respect to the investment of the plan assets involved in the transaction, or renders investment advice with respect to those assets;

- the plan must receive as collateral either cash, securities issued by the U.S. Government, or its agencies or instrumentalities, or irrevocable bank letters of credit;
- collateral must be provided equal to 100 percent of the market value of the securities lent, and if on any day the market value of the collateral is less than 100 percent of the market value of the securities lent, the borrower must deliver additional collateral such that the total collateral equals 100 percent of the market value of the securities lent;
- the borrower must provide the plan with certain financial statements prior to the loan;
- the loan must be made pursuant to a written loan agreement with arm's length terms;
- the plan must receive reasonable fees for the loan of the securities, or the opportunity to invest cash collateral, and also must retain all income from the securities that were lent under certain circumstances, rebates to the borrower are permitted;
- the plan must be able to terminate the loan at any time, at which time the borrower shall deliver to the plan certificates for such securities or the plan may apply the collateral to the purchase of equivalent securities.

#### Securities Issued - Proceeds Used to Reduce Debt at a Party in Interest

If a fiduciary uses its discretionary authority to cause an employee benefit plan to purchase securities, the proceeds of which will be used to repay a debt owed by the issuer to a party in interest or a plan fiduciary that is a bank or a bank affiliate, such a transaction would violate ERISA Section 406(a). Violations of ERISA Sections 406(b)(1) and (2) are also possible.

Prohibited Transaction Class Exemption 80-83(PTE 80-83) permits the purchase of such securities in several different situations. Generally, the price paid by the plan for such securities may not be greater than the offering price described in an effective registration statement under the Securities Act of 1933 or an offering circular required under applicable federal law, and the plan must comply with certain recordkeeping procedures. In addition, when a fiduciary bank's loan is to be repaid with the proceeds of a securities issue, the PTE includes the following additional requirements that must be satisfied:

- with some exceptions, the securities generally must be purchased prior to the end of the first full business day after the securities are offered to the public;
- the securities must be offered by the issuer pursuant to an underwriting agreement under which the underwriters have generally committed to purchasing all of the securities being offered;
- the issuer must have been in continuous operation for at least three years;
- the amount of securities purchased by the plan may not exceed three percent of the total offering;
- the price to be paid by the plan may not exceed three percent of the fair market value of the plan's assets which are subject to the management and control of such fiduciary;
- the total amount of securities in any single offering purchased by the fiduciary of the plan, combined with all other securities purchased by the fiduciary on behalf of all other employee benefit plans may not exceed 10 percent of the offering.

#### Soft Dollars

The term soft dollars refers to the practice whereby the investment manager of a discretionary account pays more than the absolute minimum commission in placing securities transactions with a broker. In return, the investment manager receives research services paid for by the excess commissions. Section 28(e) of the Securities Exchange Act of 1934 permits this practice and authorizes a safe harbor if bona fide research services are provided. In addition to the statutory provision of Section 28(e), the SEC has issued additional guidance governing "soft dollar" arrangements. See Securities Exchange Act Release No. 34-23170 and Release No. 34-54165.

For discretionary accounts, Technical Bulletin 86-1, indicates that soft dollar transactions which meet the safe harbor of Section 28(e) do not represent a prohibited transaction under ERISA. However, those that do not fall within the safe harbor would represent a violation of ERISA Sections 406(a)(1)(D), 406(b)(1), and 406(b)(3).

For non-discretionary accounts, the safe harbor is not available. A non-discretionary account cannot justify paying higher brokerage commissions in order to receive investment research which won't benefit the account. The same violations would apply as noted in the preceding paragraph, in such instances.

**Sweep Fees**

Banks acting as trustees or investment managers to employee benefit plans may agree to provide "sweep services" to such plans. Sweep services involve investing excess uninvested cash of a plan in either a deposit account or other short-term investment vehicle. Depending on how the arrangement is structured, provision of sweep services may involve one or more prohibited transactions under ERISA Section 406. In some cases, the statutory exemptions of ERISA Section 408 may provide a safe harbor.

The primary guidance regarding sweep fees is contained in two DOL opinions, AO 88-2A and AO 86-FRB, the Plotkin Letter. The two overriding variables applicable to sweep fees are whether fees are earned by the bank from the transaction and whether the bank has discretion to make the sweep transaction. The key is whether the bank is exercising its fiduciary authority or control to cause a plan to pay an additional fee. The examiner needs to identify the variables present at the bank under examination.

The general rule is that a bank which has authority to decide when a sweep transaction should be performed and which levies a separate fee for this service, is in violation of ERISA Sections 406(b)(1), (2) and (3). Section 406(b)(1) [Also see IRC 4975(c)(1)(E)] is applicable because the bank is exercising its discretionary authority to cause the plan to pay an extra fee. Section 406(b)(2) is applicable because the bank is charging a fee for the sweep transaction which is adverse to the interest of the plan or the plan's participants or beneficiaries. Section 406(b)(3) [Also see IRC 4975(c)(1)(F)] is applicable because the extra fee is being paid to the bank. Mere authorization by an independent fiduciary does not preempt a violation.

Whether a bank may provide sweep services involves a number of interrelated areas. Four primary areas or questions to consider include the following: (1) Are any extra fees charged for sweep services? (2) Does the bank have discretion over the plan's investments? (3) What is the bank's discretion over when sweeps will occur and how much will be swept? and (4) What type of investment vehicle is used?

For all types of ERISA accounts, the bank may:

- Provide sweep services if no fee is charged [Plotkin Letter].
- Provide investment services, including sweep services, under a single fee arrangement which is calculated as a percentage of the market value of the total assets under management [Plotkin Letter].
- Charge direct expenses properly and actually incurred in the performance of such services [Plotkin Letter].
- Provide sweep services where a for-profit fee is charged, if a fiduciary independent of the bank (such as the plan sponsor, plan administrator, or outside investment manager) [See AO 88-2]:
  - Authorizes either Individual sweep transactions or authorizes a standard procedure as to when and how sweeps will occur;
  - Is provided adequate disclosures of pertinent matters such as the fees, sweep intervals, and sweep levels;
  - Authorizes the investment vehicle(s);
  - Is permitted to terminate the sweep arrangement at any time without penalty; and
  - Receives notice from the bank, not less than 30 days prior, of any change in sweep fees.
- The independent fiduciary must be provided with sufficient information so that it can adequately exercise its responsibility to monitor the sweep arrangement [AO 88-2].
- For-profit fees may be based on a percentage of the income paid by the sweep investment vehicle [Plotkin Letter] or on a percentage of the amount swept.

Normally, uninvested cash is swept to high-quality and highly liquid money market investment vehicles. Examples of these vehicles include the following (list is not all-inclusive):

- Own-bank and other-institution deposits.
- Trust collective investment funds (such as a Short-Term Investment Fund).
- Mutual funds which are:
  - Independent of the bank or its parent,

- Bank or holding company related mutual funds (such as proprietary funds - refer to subsection H.7.f.(11), Mutual Funds, Investment in Proprietary (Own Bank or Affiliated) and Advised), and
- Advised by the bank's investment advisor (refer to subsection H.7.f.(11), Mutual Funds, Investment in Proprietary (Own Bank or Affiliated) and Advised).
- Repurchase agreements (refer to subsection H.7.f.(16), Repurchase Agreements).
- Commercial paper (refer to PTE 81-8).

Even with this guidance; however, trust department management may contend that sweep fees are permissible. One type of defense which may be raised by management involves the statutory exemptions under ERISA Section 408. These exemptions are addressed in the Plotkin letter. Sections 408(b)(4) Deposits and 408(b)(8) Collective Investment Funds provide authority to utilize own-bank investment vehicles, but do not preempt sweep fee violations of Section 406(b) (see the conditions listed for the use of those section 408 exemption categories in Section 408(b)(4)(A) and (B) and 408(b)(8)(A) and (C)). The same can be said for the ancillary services provisions of Sections 408(b)(2) and (6), particularly with investment vehicles such as repurchase agreements and commercial paper. In addition, the Plotkin letter discusses the applicability of the statutory exemptions under Section 408(b)(6) regarding ancillary services and under Section 408(b)(8) regarding collective trust funds for sweep service arrangements maintained by a bank.

#### Release of Claims and Extensions of Credit in Connection with Litigation

On December 31, 2003, the Department of Labor issued PTE 2003-39 (PDF) (72KB PDF file - PDF Help), "Release of Claims and Extensions of Credit in Connection with Litigation." The exemption provides relief from Sections 406(a)(1)(A), (B), and (D) of ERISA, and the taxes imposed by Sections 4975(c)(1)(A), (B), and (D) of the Internal Revenue Code for the following transactions:

- The release by the plan, or a plan fiduciary, of a legal or equitable claim against a party in interest in exchange for consideration, given by, or on behalf of, a party in interest to the plan in partial or complete settlement of the plan's or the fiduciary's claim; or
- An extension of credit by a plan to a party in interest in connection with a settlement where the party in interest agrees to repay, over time, an amount owed to the plan for the settlement of a legal or equitable claim.

The exemption is subject to the following conditions:

- There must be a genuine controversy involving the plan. A genuine controversy is deemed to exist when a court has certified a case as a class-action;
- The fiduciary that authorizes the settlement has no relationship to, or interest in, any of the parties involved in the litigation, other than the plan, that might affect the exercise of such fiduciary's best judgment;
- The settlement is reasonable in light of the plan's likelihood of full recovery, the risks and costs of litigation, and the value of the claims foregone;
- The terms and conditions of the transaction are no less favorable to the plan than comparable arms-length terms and conditions that would have been agreed to by unrelated parties under similar circumstances;
- The transaction is not part of an agreement, arrangement, or understanding designed to benefit a party in interest;
- Any extension of credit by the plan to a party in interest in connection with the settlement is on terms that are reasonable, taking into consideration the creditworthiness of the party in interest and the time value of money; and
- The transaction does not involve matters covered by PTE 76-1, which relates to delinquent employer contributions to multiemployer and multiple employer collectively bargained plans.

In addition to the conditions above, transactions entered into after January 30, 2004 are subject to several additional conditions:

- Where the litigation has not been certified as a class action, an attorney(s) of the plan, having no relationship to any of the parties other than the plan, determines that there is a genuine controversy involving the plan;
- All terms of the settlement are specifically described in a written settlement agreement or consent decree;
- Assets other than cash may be received by the plan from a party in interest in connection with the settlement only if:
  - Necessary to rescind a transaction that is the subject of the litigation; or

- Such assets are securities having a generally recognized market, per ERISA 3(18)(A), and which can be objectively valued. A settlement will not, however, fail to meet this requirement solely because it involves the contribution of additional qualifying employer securities in settlement of a dispute involving such qualifying employer securities.
- To the extent that assets other than cash are received by the plan for the release of claims, such assets must be specifically described in the written settlement and valued at their fair market value in accordance with Section 5 of the VFC. The valuation methodology, including the appropriate date, must be set forth in the written settlement agreement;
- Nothing precludes the exemption from applying to a settlement that includes a written agreement to:
  - Make future contributions;
  - Adopt amendments to the plan; or
  - Provide additional employee benefits
- The fiduciary acting on behalf of the plan acknowledges in writing that it is a fiduciary with respect to the settlement of the litigation on behalf of the plan.

Finally, the PTE requires the maintenance and retention of certain records demonstrating compliance with the conditions of the PTE for a period six years.

### **Investment in Employer Securities and Real Property - ERISA Section 407 and 408(e)**

When Congress considered various provisions for ERISA, it reviewed employee benefit plan losses and abuses. Congress found that a number of plans incurred major losses because they had placed large amounts of their assets in employer securities and/or real property. However, Congress also realized that some investment in employer securities and real property could be beneficial when not done to excess.

In general, ERISA Section 407(a)(2) provides that no employee benefit plan may invest more than 10% of its assets, valued at market at the time of the transaction, in employer securities and real property. In determining the 10% maximum, both employer securities and employer real property are added together. Since certain types of employee benefit plans are designed to invest *exclusively* in employer securities (ESOPs, etc.), certain exceptions to the general limitations were included in the law.

An important exception to the 10% limitation is embodied in ERISA Section 407(b)(1). This section provides that the *10% limitation does not apply to eligible Individual plans* (generally, defined contribution plans) as defined in ERISA Section 407(d)(3). Therefore, the *10% limitation usually only applies to defined benefit plans*.

For any investment in employer securities or real property, ERISA Section 407 establishes three tests. The securities and/or real property must be: (1) *qualifying*, (2) within statutory limits which differ according to the type of plan, and (3) meet certain fiduciary standards of ERISA Section 404. The acquisition or sale of such securities and/or real property must also meet the conditions of ERISA Section 408(e). Acquiring, holding, or selling employer securities and/or real estate which do not qualify as such, exceed the limitations of Section 407, or do not meet the conditions of Section 408(e) result in a violation of ERISA Section 406(a)(1)(E) and/or Section 406(a)(2).

Examiners should also take special note that there is a parallel set of violations involving Section 4975 of the IRC for most types of prohibited transactions. Both sets of violations should be cited whenever applicable. Refer to subsection M, Compliance with the Internal Revenue Code for coverage of these provisions.

### ***Qualifying Employer Securities***

ERISA Section 407(d)(5) defines the term qualifying employer security to include stock and other marketable obligations of the employer. In addition, Section 407(d)(1) provides that securities issued by affiliates of the employer are also included in the term "employer security." The term affiliate is itself defined in Section 407(d)(7). The IRS definition for the term qualifying employer security" is found in IRS Regulation 54.4975-12.

For employer stock held in plans, *other than eligible Individual account plans*, ERISA Section 407(f) imposes the following percentage limitations (*which should not be confused with the maximum 10% limitation of employee benefit plan assets discussed under H.8 above*):

- no more than 25% of the aggregate amount of the same class of stock (issued and outstanding at the time of acquisition) is held by the plan, and
- at least 50% of that amount is held by persons independent of the issuer.

However, ERISA Section 407(f) also provided temporary exemptive relief from the limitations until 1-1-93, provided: (1) the stock was held since 12-17-87, or (2) the stock was acquired after 12-17-87 (under a contract legally binding as of 12-17-87) and was continuously held following its acquisition.

ERISA Section 407(e) defines marketable obligations to include debt obligations (bonds, debentures, and notes), certificates, or other evidence of indebtedness. The same section requires that the debt obligations must be acquired for no more than the value which is established independent of the issuer and meets one of the market price categories listed in ERISA Section 407(e)(i)(A), (B), or (C). The acquisition of debentures convertible into stock is deemed to be the acquisition of a debenture, not stock.

### ***Qualifying Employer Real Property***

ERISA Section 407(d)(2) states that employer real property includes land and buildings (and related personal property) leased to an employer or to an affiliate of the employer. Section 407(d)(4)(C) permits all of the property to be leased to the employer or its affiliate. The term affiliate is defined in Section 407(d)(7).

Real property must satisfy three requirements to be considered *qualifying* employer real property:

- There must be at least two pieces of real property. A single parcel of land, or a single building or lease can never be considered qualifying [ERISA Section 407(d)(4)(A)].
- The real property (consisting of at least two parcels) must be geographically dispersed. This is decided on a fact and circumstance basis [ERISA Section 407(d)(4)(A)].
- Each piece of real property and its improvements, must be adaptable to more than one use. This is also decided on a fact and circumstance basis [ERISA Section 407(d)(4)(B)].

DOL ERISA Regulation 2550.407a-1 refers to applicable requirements in ERISA Sections 406 and 407 concerning the acquisition and holding of employer securities and employer real property.

### ***Statutory Limitations***

#### **Defined Benefit Plans**

Defined benefit plans and most money purchase plans may invest no more than 10% of their assets, in aggregate, in employer securities and employer real property. Total plan assets are calculated net of plan debt (including any debt to acquire the securities or real property). [See DOL ERISA Regulation 2550.407a-2(c)]

#### **Individual Account Plans**

The statutory limit of 10 percent does not apply to "eligible Individual account plans." Eligible Individual account plans are profit-sharing and employee stock ownership plans (ESOPs), as well as stock bonus, thrift and savings plans, that explicitly provide for the acquisition and holding of qualifying employer securities or qualifying employer real property. [See ERISA Section 407(d)(3)(A)] Generally, these plans are intended to invest wholly or largely in employer securities. Section 407(d)(3)(B) requires that such plans must *explicitly authorize* the holding of employer securities and/or real property in excess of the Section 407(d)(3)(A) 10% general limitation.

Plans offering participant-directed investments (such as 401(k) and 403(b) plans) may provide for investment in employer securities, so long as certain requirements are observed [see DOL ERISA Regulation 2550.404c-1 and subsection H.5.c.(6),

Individual Account (Section 404(c)) Plans]. The regulation contains specific requirements when employer securities are offered as an investment alternative to participants. Generally, fiduciaries are provided with limited relief from ERISA fiduciary responsibility liability if plans meet certain conditions and participants direct their own investments [see 2550.404c-1(d)(2)].

### ***Acquisition of Employer Securities and/or Real Property***

ERISA Section 408(e) and DOL Regulation 2550.408e indicate that the acquisition or sale of employer securities and/or real property must be for adequate consideration and that the plan may pay no fee or commission. Adequate consideration refers to the price paid for the securities and/or real property. For a parallel discussion, refer to the discussion of valuing employer securities for ESOP plans in subsection H.5.c.(5), ESOP Plans - Employer Securities Investments - Valuation.

The 10% limitation is viewed at the time of the acquisition; subsequent upward movements in market prices do not create violations. DOL ERISA Regulation 2550.407a-2(b) indicates that acquisitions include contributions to the plan, outright purchases, exchanges of assets, or foreclosures of collateral for a defaulted loan. The exercise of warrants resulting in the acquisition of an employer's common stock is considered a transaction subject to Section 407; however, employer stock acquired as a result of a stock dividend or stock split should *not* be included when determining whether the 10% maximum has been breached.

### ***Fiduciary Standards***

Even if all of the above conditions are met, a fiduciary making decisions to invest in employer securities/real property must ensure that the exclusive benefit and prudence rules of ERISA Section 404(a)(1) are met. Refer to a parallel discussion of the prudence of ESOP investments in employer securities in subsection H.5.c.(5), ESOP Plans - Employer Securities Investments - Valuation.

## **Exemptions From Prohibited Transactions - ERISA Section 408**

Certain exemptions from the prohibited transaction provisions are included in Section 408 of ERISA. A number of these statutory exemptions are discussed below. Failure to comply with the various conditions of these statutory exemptions means that the transaction is a prohibited transaction in violation of ERISA Section 406.

Examiners should note that there is a parallel set of prohibitions in Section 4975 of the Internal Revenue Code for most types of prohibited transactions described in ERISA Section 406. IRC Section 4975(d), however, contains a number of exemptions from the prohibited transactions detailed in Section 4975. Although similar, ERISA Section 406 and IRC Section 4975 are not identical.

In addition to violations of ERISA Section 406, examiners should also cite violations of IRC Section 4975 if applicable. Refer to subsection M, Compliance with the Internal Revenue Code for coverage of these provisions.

### ***Exemptions and Opinions***

#### **Class and Individual Exemptions**

ERISA Section 408(a) authorizes the DOL to issue both class and Individual exemptions. These exemptions are in addition to the exemptions provided by ERISA Section 408. While class exemptions are applicable to any party that meets the conditions, Individual exemptions provide relief only for the party(ies) requesting the exemption. The DOL has issued more than 35 class exemptions and hundreds of Individual exemptions. A number of the Prohibited Transaction Exemptions most relevant to banks and trust departments are cited throughout this manual and appear in Appendix E.

Before an exemption may be granted, ERISA requires that the DOL find that the exemption is:

- administratively feasible;
- in the interests of the plan and its participants and beneficiaries;
- protective of the rights of plan participants and beneficiaries.

A bank requesting an exemption from the DOL must supply the information required by DOL ERISA Regulation 2570.30 - .52. Regulation 2570.30 - .52 replaced ERISA Procedure 75-1, which is cited in many of the rulings dated prior to 1990. A publication, *Exemption Procedures Under Federal Pension Law*, explains how to obtain ERISA exemptions and is available from the Division of Public Affairs, Pension and Welfare Benefits Administration, U.S. Department of Labor, 200 Constitution Avenue, NW, Washington D.C. 20210; phone (202) 219-8921; web site: [www.dol.gov](http://www.dol.gov).

#### Advisory Opinions

The DOL also is authorized to answer inquiries regarding ERISA-related matters in the form of information letters and advisory opinions. A bank submitting such an inquiry must supply the information outlined in ERISA Procedure 76-1.

#### ***Ancillary Services Statutory Exemption***

ERISA Section 406(a)(1)(C) prohibits a party in interest from providing services to an employee benefit plan. Congress provided two statutory exemptions, ERISA Sections 408(b)(2) for necessary services, and 408(b)(6), for what are termed "ancillary services" by banks and financial institutions. No exemptions, however, are provided from the fiduciary responsibility or co-fiduciary liability sections of ERISA Sections 404 and 405, respectively.

ERISA Section 408(b)(2) [see also IRC Section 4975(d)(2)] permits a plan to receive office space, or legal, accounting or other services from a party in interest. The office space or service must be necessary for the establishment or operation of the plan; it must be furnished under a contract or arrangement which is reasonable; and no more than reasonable compensation may be paid by the plan [see DOL ERISA Regulations 2550.408b-2 for important guidance on the scope of this exemption]. The exemption provides relief only from the prohibitions of ERISA Section 406(a), and not from Section 406(b).

ERISA Section 408(b)(6) permits fiduciary banks to receive reasonable compensation for the provision of ancillary services, provided the bank has adopted internal safeguards to ensure that the provision of such services is consistent with sound banking and financial practices, and provided that specific guidelines are adopted addressing the extent to which the services will be provided. Examples of services that could be provided include securities lending, loan origination and servicing, EDP services and use of own-bank demand deposits. Section 408(b)(6) provides an exemption from ERISA Sections 406(a) as well as 406(b)(1) and 406(b)(2) (but not ERISA Section 406(b)(3)); therefore, it may provide an exemption in cases that would not be covered by ERISA Section 408(b)(2) [see DOL ERISA Regulation 2550.408b-6; see also DOL ERISA Regulation 2550.408c-2].

Refer to ERISA Section 408(b)(4) and related DOL Regulation 2550.408(b)(4) concerning exemptions governing the use of own-bank interest-bearing deposits, PTE 81-6 and PTE 82-63 concerning requirements governing securities lending and AO 92-24A addressing float management (a component of reasonable compensation) for demand deposits.

#### ***Receipt of Services by IRAs and Keogh Plans Exemption***

The DOL's Prohibited Transaction Class Exemption 93-33 (PTE 93-33) permits banks to provide certain banking services at reduced or no cost to Individuals for whose benefit IRAs or Keogh plans are established, and their family members. PTE 93-33 provides relief from ERISA Section 406(a)(1)(D) and 406(b), and from the sanctions resulting from application of IRC Section 4975, including the loss of exemption of an IRA. PTE 93-33 amended and superseded Prohibited Transaction Class Exemption 93-2.

The exemption allows banks to take deposit balances of IRAs and Keoghs into account when determining eligibility for reduced fees for services. While the term "services" is not defined, the services must be of the type the bank could offer consistent with applicable federal and state banking law, and must be provided by the bank or an affiliate in the ordinary course of the bank's business to customers who qualify for reduced or no cost banking services but who do not maintain IRAs or Keoghs with the bank. Services may include incidental products of a *de minimis* value provided by third parties.

Other conditions of the exemption include:

- for the purpose of determining eligibility to receive services at reduced or no cost, the deposit balance required by the bank for the IRA or Keogh must be equal to the lowest balance required for any other type of account which qualifies for the reduced or no cost services.
- the rate of return on the IRA or Keogh plan must be no less favorable than the rate of return on an identical investment that could have been made by a customer of the bank who does not receive reduced or low cost services.

PTE 93-33 was amended on April 21, 1994 to permit banks to include securities investments (except investments offered solely to IRAs and Keoghs) in determining eligibility for reduced fees.

The DOL more recently issued Prohibited Transaction Class Exemption 97-11 (PTE 97-11) which provides a similar exemption to broker dealers.

### ***Collective Investment Funds (CIFs) Statutory Exemption***

The investment of employee benefit plans in a CIF operated by a party in interest of the plan is a prohibited transaction. ERISA Section 408(b)(8) [see also IRC Section 4975(d)(8)] provides a statutory exemption for any transaction between a plan and a bank's CIF, if the investment is a sale or purchase of an interest in the fund, specifically authorized in the governing plan or by an independent fiduciary, and if the bank receives no more than reasonable compensation. Section 408(b)(8) provides relief from ERISA Sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2).

The DOL has issued a class exemption, Prohibited Transaction Class Exemption 91-38 (PTE 91-38) which provides relief from ERISA Sections 406(a), 406(b)(2) and 407(a) for (i) transactions between parties in interest with respect to a plan, and a CIF that is maintained by the bank and in which an employee benefit plan is invested, and (ii) acquisitions of employer securities or employer real property by the CIF, provided that the party in interest is not the bank that maintains the CIF or any other CIF maintained by the bank or an affiliate. The transaction must meet one of the following criteria:

- The plan, along with all other employee benefit plans maintained by the same employer, may not hold more than 10 percent of the total of all interests in the CIF. (For transactions occurring between October 23, 1980 and June 30, 1990, the plans could not hold more than 5 percent of the total of all interests); or
- The CIF is a specialized fund that invests substantially all of its assets in short-term obligations (one year or less).

The PTE requires that the terms of the transaction be not less favorable than terms generally available in an arm's length transaction between unrelated parties and that the bank adhere to certain recordkeeping procedures.

The PTE covers other transactions under additional conditions:

- transactions between employers participating in a multiple employer plan and CIFs;
- acquisitions, sales, or holding of employer securities and employer real property by CIFs that do not meet the conditions of the general exemption;
- certain transactions with persons who are parties in interest with respect to a plan solely by virtue of being providers of services;
- the furnishing of certain goods to or leasing of real property by a CIF from a party in interest of a plan participating in the CIF;
- provision of services to a CIF in which a plan has an interest by the bank maintaining the CIF in connection with the management of real property owned by the CIF;
- provision of services, facilities and any goods incidental to such services and facilities by a place of public accommodation owned by a bank sponsored CIF to a party in interest with respect to a plan which has an interest in the CIF;
- excess holding of qualifying employer securities or qualifying employer real property (other than through a CIF).

Refer to Section 7, Collective Investment Funds for a general discussion of Collective Investment Funds.

***Deposits, Interest-Bearing Statutory Exemption***

ERISA Section 408(b)(4) provides a statutory exemption for the investment of plan assets in bank deposits which bear a reasonable interest rate, where the bank is a fiduciary or other party in interest of the plan. The exemption provides relief from ERISA Sections 406(a)(1), 406(b)(1) and 406(b)(2) but not from ERISA Section 406(b)(3).

The exemption may be utilized with respect to own-bank plans, or, for other plans if the transaction is authorized by the plan or an independent fiduciary. Own-bank deposits, when used as investments for plans covering a bank's employees must bear a reasonable rate of interest.

Investment in own-bank interest-bearing deposits by outside plans must satisfy the following requirements [also see IRC 4975(d)(4)(B)]:

- Use of the deposits must be expressly authorized by the plan or an independent fiduciary.
- The deposits must bear a reasonable rate of interest.
- The express authorization must identify the bank by name. [See Labor Regulation 2550.408b-4]

***Employee Stock Ownership Plans (ESOPs) - Loans to Plans Statutory Exemption***

Bank examiners may encounter ESOPs sponsored by a bank or its holding company, or ESOPs sponsored by outside organizations for which the bank serves as trustee or plan administrator. In most ESOPs, the purchase of employer securities is financed through loans guaranteed by one or more parties in interest, known as "leveraging." Leveraged ESOPs involve the potential for abuse due to the possible involvement of insiders and the stock's potential lack of marketability. Moreover, the guarantee of a loan to an ESOP by a party in interest is a prohibited transaction.

ERISA Section 408(b)(3) [see also IRC Section 4975(d)(3)] provides an exemption from the prohibited transaction provisions of ERISA Sections 406(a), 406(b)(1) and 406(b)(2) for loans to an ESOP that are guaranteed by a party in interest [see also DOL ERISA Regulation 2550.408b-3] and loans which are issued by a bank that is a party in interest.

The exemption requires a loan to a plan to be:

- primarily for the benefit of the participants and beneficiaries of the plan (see DOL ERISA Regulation 2550.408b-3(c) for the tests to determine whether a loan is made primarily for the benefit of the participants and beneficiaries [also see IRC Section 4975(d)(3)(A)]); and
- charged a reasonable interest rate (see DOL ERISA Regulation 2550.408b-3(g)).

When an ESOP purchases employer securities with the proceeds of a loan from an insider or a party in interest, the price paid for the securities must be a fair market price established by persons who are not parties in interest. An independent appraisal is often required by IRS Regulations. *This is an area where abuse of ESOPs has often been noted.* When an ESOP purchases employer securities at prices in excess of their fair market value, the question arises whether the transaction was primarily for the benefit of the participants and beneficiaries of the plan. Refer to the discussion in subsection H.5.c.(5), ESOP Plans - Employer Securities Investments - Valuation.

A loan that is exempt under Section 408(b)(3) must be non-recourse against the plan, and the plan may pledge as collateral only qualifying employer securities (as defined under ERISA Section 407) acquired with the proceeds of the exempt loan or pledged as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan.

ESOPs are further described in subsection D.2.e., Employee Stock Ownership Plans (ESOPs).

***Loans to Plan Participants Statutory Exemption***

Most employee benefit retirement plans (pension, profit-sharing, 401(k), etc.) permit the plan to make loans to its own plan participants. Four sets of overlapping conditions, all of which must be complied with, must be satisfied when a plan engages in this type of activity. The four conditions are:

- ERISA statutory and regulatory requirements,
- Plan authorization and conditions,
- IRS statutory and regulatory requirements, and:
- Consumer protection laws.

Under the terms of some trust or agency agreements, a bank may neither be responsible for administering participant loan programs, nor for participant loan record keeping. Often, the plan administrator is responsible for participant loan programs. In situations where a bank is the plan's trustee, but: (1) it is not responsible under the terms of its appointment for administering a participant loan program, and (2) it does not have access to loan documentation, or other information which would reasonably permit it to determine that either the program or the participant loans are in compliance with applicable IRS regulations, it should not be cited for violations pertaining to the operation of the participant loan program.

#### ERISA Requirements for Loans to Plan Participants

Section 408(b)(1) of ERISA permits loans to plan participants, even though participants are parties in interest and may also be fiduciaries of the plan. Loans must meet four requirements including the following:

- Originated in accordance with specific plan provisions [see Section 408(b)(1)(C) and IRC 4975(d)(1)(C)]. Labor Department Regulation 2550.408b-1(d)(2) requires that certain features of the participant loan program be included in the plan document or other official documents of the plan (such as the Summary Plan Description). Required features of a participant loan program include:
  - Identification of loan program administrator(s);
  - Procedures for loan applications;
  - Basis for loan approvals or denials;
  - Limits (if any) on amounts/types of loans;
  - Determination of what constitutes a reasonable rate of interest;"
  - Types of acceptable collateral; and
  - Events constituting default, and steps that will be taken in the event of default.

#### Examiner Note:

- A defaulted loan is taxable in the year of default. A 1099-R must be issued (to the borrower and the IRS) to report the distribution. Refer to IRS requirements dealing with when default occurs (refer to subsection H.9.g.(3), IRS Statutory and Regulatory Requirements for Loans to Plan Participants).
- If defaulted loans are present, check the IRS/DOL Annual Return/Report (Form 5500) for the plan

This section of the DOL regulation was effective for participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989.

- Available to participants and beneficiaries on a reasonably equivalent basis [refer to Section 408(b)(1)(A) and (B), and IRC 4975(d)(1)(A) and (B)]. Department of Labor ERISA Regulation 2550.408b-1(b) and (c) states that loans must be available on a non-discriminatory basis to all eligible plan participants and beneficiaries, regardless of race, color, religion, age, sex, or national origin. In addition, the minimum loan amount set in the plan document may not exceed \$1,000. The plan can set a maximum dollar amount and/or a maximum percentage of a participant's vested interest in the plan which may be borrowed.
- Charge a reasonable rate of interest [see Section 408(b)(1)(D) and IRC 4975(d)(1)(D)]. Reasonable is explained in DOL ERISA Regulation 2550.408b-1(e) as a rate commensurate to the rates charged by persons lending money for loans under similar circumstances.
- Provide adequate security or collateral [see Section 408(b)(1)(E) and IRC 4975(d)(1)(E)]. If a loan is secured by a participant's vested interest in a plan, the maximum loan amount is based on 50% of the vested interest. Anything in excess requires additional collateral. See DOL ERISA Regulation 2550.408b-1(f).

Labor Department Regulation 2550.408b-1 addressing Loans to Plan Participants and Beneficiaries, explains the meaning and implementation of the statutory provisions. Except as noted in the plan provisions above, the regulation was effective for loans granted or renewed beginning October 19, 1989.

## Plan Authorization and Conditions for Loans to Plan Participants

As noted above, ERISA Section 408(b)(1)(C) permits ERISA plans to make loans to plan participants and beneficiaries only if authorized by the plan document or some other related official document. Granting loans that do not comply with the plan's conditions would result in a violation of ERISA Section 404(a)(1)(D).

## IRS Statutory and Regulatory Requirements for Loans to Plan Participants

A loan made by an ERISA plan is considered taxable income (distribution) to the plan participant unless it meets a number of IRS provisions. In addition, if a participant or beneficiary assigns or pledges any portion of his or her interest in a plan as security for a loan, the portion of the Individual's interest assigned or pledged is treated as a distribution from the plan to the Individual, refer to IRS Regulation 401(a)-13. If any taxable distributions occur, the plan participants must receive a year-end Form W2-P and appropriate notification must be provided to the IRS and state tax authority.

The IRS participant loan requirements are governed by Section 72(p) of the Internal Revenue Code. Section 72(p) was added in 1982 and its provisions have been amended numerous times since the establishment of this section. Two different standards apply to participant loans:

- Loans used to *acquire* the principal residence of the participant must be repaid by normal retirement age, as defined by the plan [see IRC Section 72(p)(2)(B)].

Previous tax law provisions permitted these loans to be used to acquire, build, or substantially renovate the principal residence of the participant or dependent family member. However, these provisions were revoked in 1986.

- For all other loans dated August 13, 1982, or later, there are specific limitations on the term, maturity, renewals, repayment, principal amounts, and amounts of any new loans. Failure to comply with the following requirements results in the loan being treated as a taxable distribution.
  - The loan agreement must provide that the term not exceed five years.
  - Principal of the loan must be repaid in not less than quarterly installments [see IRC Section 72(p)(2)(C)].
  - Extensions, renewals, and rollovers are prohibited. A taxable distribution results if these transactions occur.
  - The maximum amount eligible for a tax-free loan is based on the participant's vested interest in the plan:

Participant's Vested Interest	Tax-Free Loan Limit
\$ 10,000 or less	Full Vested Amount
\$ 10,000 - Under \$ 20,000	\$ 10,000
\$ 20,000 - Under \$ 100,000	50% of Vested Amount
\$ 100,000 and more	\$ 50,000

- The maximum amount of any new loan is reduced by the excess (if any) of the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date on which the new loan was made over the outstanding balance of loans from the plan on the date the loan was made. The effect is to reduce the \$50,000 maximum limit for a participant loan by the amount paid on any outstanding loan during the one-year period immediately preceding the making of the new loan.

Default occurs at the time of failure to make the payments. The employee benefit plan may permit a grace period which can be no longer than the last day of the calendar quarter following the calendar quarter in which the missed payment was due. If default occurs:

- The amount of the deemed distribution is the entire outstanding balance of the loan at the time of such failure to make payments.
- The participant will be taxed on the amount of the deemed distribution, unless the participant's account includes after-tax contributions, in which case all or a part may not be taxable.
- The 10% premature distribution tax will apply to the amount of the deemed distribution if the participant has not reached age 59 1/2.
- A Form 1099R needs to be issued to the participant and the IRS (and, if applicable, to the state tax department).

The Internal Revenue Service amended Section 72(p) effective July 31, 2000, by adding Section 72(p)-1. This new section provides question and answer guidance, together with examples, on how participant loans which are deemed distributions are to be accounted for by employee benefit plans. Section 72(p)-1 appears in Appendix E.

The IRC also requires spousal consent when a participant's accrued benefit is used to secure a participant loan from the plan. IRC Section 417(a)(4) prohibits the use of accrued benefits to secure participant loans unless: (1) written spousal consent is obtained within 90 days preceding the date on which the loan is to be secured, and (2) the plan provides for spousal consent. IRC Section 417 appears in Appendix E.

#### Consumer Protection Laws and Loans to Plan Participants

Participant loans are viewed as consumer credit: credit extended for personal, family or household purposes. Since participant loans are consumer loans, consumer protection laws apply to participant loans originated by an employee benefit plan's participant loan program in the same manner as they apply to a corporate fiduciary's own consumer loans. Although less frequently the case, Individual trust accounts originating loans may meet the definition of a creditor for consumer protection purposes. In such cases, the loans extended by Individual trust accounts must also satisfy the requirements of applicable consumer protection laws. Business purpose loans, on the other hand, are generally exempted from the requirements of consumer protection laws.

Trust examiners are not expected to have the technical expertise to conduct consumer compliance reviews, nor are they expected to conduct consumer compliance examinations while performing a trust examination. Trust examiners may review previous Compliance Examination reports, as well as internal/external audit reports, to ascertain whether the institution has demonstrated adequate compliance with consumer protection laws and regulations. Where deemed necessary, trust examiners may discuss the advisability of performing a consumer compliance examination with field supervisors.

#### ***Provision of Investment Advice to Participants and Beneficiaries***

The Pension Protection Act (PDF) added new sections 408(b)(14) and 408(g) to ERISA. The new sections provide relief for any transaction in connection with the provision of investment advice to a participant directed individual account. The relief covers the advice itself; the acquisition, sale, or holding of a security or other property in connection with the advice; and the receipt, direct or indirect, of fees or other compensation by the fiduciary or an affiliate in connection with the advice.

In order to qualify for the statutory exemption in 408(b)(14) the provision of investment advice must comply with the requirements detailed in Section 408(g). Section 408(g) requires that the investment advice be provided by a "fiduciary adviser" under an "eligible investment advice arrangement." An "eligible investment advice arrangement" is defined as a nondiscretionary investment advisory arrangement where either:

- Direct or indirect compensation received by the fiduciary adviser does not vary depending on the nature of the advice, i.e. a flat or level fee arrangement; or
- Advice is provided exclusively on the basis of a computer model meeting certain specified requirements.

The DOL in Field Assistance Bulletin (FAB) 2007-01 stated that the level fee requirement applies only to the fiduciary adviser, and not to an affiliate of the fiduciary adviser, unless the affiliate is also a fiduciary adviser to the plan.

A "fiduciary adviser" is a:

- A bank or similar institution, but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or state banking authorities;
- A registered investment adviser;
- An insurance company qualified to do business under the laws of a State;
- A registered broker-dealer;
- Affiliates of the above; and
- An employee, agent, or registered representative of the above.

When an individual acts as an employee, agent, or registered representative of an entity that provides investment advice - both the individual and the entity are considered fiduciary advisers. See FAB 2007-01.

In addition the following general requirements apply:

- The fiduciary adviser must provide appropriate disclosures, including those required by Federal securities laws;
- Any sale, acquisition, or holding must be at the sole direction of the recipient of the advice;
- Compensation received by the fiduciary adviser or an affiliate must be reasonable; and
- Terms must be at least as favorable as in an arm's-length transaction.

If a computer model is used, the model must:

- Apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time;
- Take into account relevant information about the participant, such as age, life expectancy, risk tolerance, assets, sources or income, etc;
- Use prescribed objective criteria to provide advice to participants;
- Not be biased in favor of investments offered by the fiduciary adviser or its affiliates; and
- Take into account all the investment options under the plan and may not be inappropriately weighted towards any investment option

An "eligible investment expert" must certify that the computer model meets the specific requirements prior to the first use and at the time of each material modification of the model. The DOL may establish qualifications for an "eligible investment expert."

The "eligible investment advice arrangement" must be audited annually by an independent auditor. The independent auditor must:

- Have appropriate technical training or experience and proficiency;
- Must represent in writing that he/she has the required training and expertise; and
- Issue a written report of its findings to each fiduciary that has authorized participation in the arrangement.

Section 408(g)(6) requires the following disclosures:

- The role of any party that has a material affiliation or contractual relationship with the financial adviser in the development of the investment advice program or in the selection of investment options available under the plan;
- Past performance and historical rates of return of the investment options available;
- All fees or other compensation, including payments by third-parties, that the fiduciary adviser or its affiliates will receive;
- Any material affiliation or contractual relationship of the fiduciary adviser or its affiliates in any security or other property;
- When and how any participant information will be used;
- Types of services provided by the fiduciary adviser in connection with the provision of investment advice; and
- The participant may arrange separately for the provision of advice by another adviser that has no material affiliation with, and receives no fees or other compensation in connections with, a security or other property

Disclosures must be clear and conspicuous and calculated to be understood by the average plan participant. The DOL and the SEC will develop a model disclosure form. Fiduciary advisers are required to:

- Ensure that all disclosure materials are accurate;
- Provide disclosure to recipients of advice at no charge, at least annually; and
- Provide disclosures to recipients of any material changes to the disclosures at no charge and at a time reasonably contemporaneous with such changes.

Fiduciary advisers must keep for a period of at least six years the records necessary to determine whether they have complied with the requirements for the exemption. If, however, the records are lost or destroyed due to circumstances beyond their control, a prohibited transaction will not be deemed to have occurred solely on account of the records having been lost or destroyed.

#### Responsibilities of Plan Sponsors

Plan sponsors and other authorizing fiduciaries have a fiduciary responsibility for the prudent selection and periodic review of a fiduciary adviser. Plan sponsors and other authorizing fiduciaries, however, are not responsible for monitoring the specific investment advice of a fiduciary adviser. The Pension Protection Act does provide limited relief from fiduciary liability for plan sponsors entering into an "eligible investment advice arrangement" if 1) the terms of the arrangement require the fiduciary adviser to comply with the requirements of ERISA Section 408(b)(14) and 2) the fiduciary adviser acknowledges acting as a plan fiduciary.

On February 2, 2007, the DOL issued Field Assistance Bulletin (FAB) 2007-01 in which DOL provided guidance regarding processes and criteria for selecting and monitoring an investment adviser. In FAB 2007-01 the DOL opined that the selection of an investment adviser should be based on an objective process designed to obtain the information necessary to assess the qualifications of the adviser, the quality of services, and the reasonableness of fees. The process must avoid self-dealing, conflicts of interest, and other improper influence. Selection criteria should include:

- Experience and qualifications, including required registrations and licenses;
- Willingness of an adviser to assume fiduciary status; and
- Extent to which advice will be based upon generally accepted investment theories

Monitoring criteria should include the periodic review of:

- Changes in the information made to select the adviser;
- Compliance with contractual provisions;
- Utilization of investment advice in comparison with its cost; and
- Participant comments and complaints

Note that while plan sponsors and authorizing fiduciaries are not normally required to monitor the specific investment advice given by the fiduciary adviser, they may have to review specific advice in response to comments or complaints by plan participants.

#### Prior DOL Guidance Concerning the Provision of Investment Advice

In FAB 2007-01, the DOL reiterated that prior guidance regarding the provision of investment advice remains valid. Prior guidance issued by DOL includes Interpretive Bulletin 96-1 and Advisory Opinion 2001-09A, the SunAmerica Letter. In addition, certain guidance relating to the receipt of fees by fiduciaries would be applicable to situations where a fiduciary adviser receives fees. For example, the Frost and Country Bank advisory opinions, AO97-15A and AO2005-10A, respectively, apply to the receipt of fees by fiduciary advisers. Therefore, plan sponsors could opt to provide investment advice or education under prior DOL exemptions or guidance.

***Block Trades***

The Pension Protection Act added new Section 408(b)(15) to ERISA, which provides an exemption for block trades of stock between a plan and a non-fiduciary party in interest. Section 408(b)(15) defines a block trade as any trade of at least 10,000 shares or with a market value of at least \$200,000 which will be allocated across two or more unrelated client accounts of a fiduciary. The interest of a plan, or group of plans sponsored by the same employer, can not be greater than 10% of the aggregate size of the block trade. The terms of the transaction must be at least as favorable to the plan as in an arm's-length transaction. The compensation associated with a block trade can not exceed the compensation associated with an arm's-length transaction with an unrelated party.

***Alternate Execution Systems***

The Pension Protection Act added new Section 408(b)(16) to ERISA which provides an exemption for 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 if certain requirements are satisfied.

The execution system must be subject to regulation by the applicable regulatory agency or by a foreign regulatory agency. The execution system must either:

- Be designed to match purchases and sales at the best price available through the system in accordance with SEC rules or those of another relevant government authority; or
- Neither the execution system nor the parties to the transaction may take into account the identity of the parties in the execution of trades.

The price and compensation associated with the purchase or sale cannot be greater than in an arm's-length transaction with an unrelated party. If the party in interest has an ownership interest in the system, advance authorization by the plan sponsor or other independent fiduciary is required. A plan fiduciary must be provided with 30 days prior notice before using the system.

***Service Providers and Their Affiliates***

The Pension Protection Act (PDF) added Section 408(b)(17) to ERISA. Section 408(b)(17) provides an exemption for the transactions described in Section 406(a)(1)(A), (B), and (D), (e.g. the sale, exchange, or leasing of property; the lending of money or other extension of credit; or the transfer of plan assets to, or use by or for the benefit of a party in interest), if the transactions are between the plan and a non-fiduciary party in interest that provides services to a plan or is related to a service provider to a plan. Such transactions are exempt only if the plan receives no less, or pays no more, than adequate consideration.

Adequate consideration means:

- in the case of a security for which there is a generally recognized market -
  - the price of the security prevailing on a national securities exchange which is registered under Section 6 of the Securities Exchange Act of 1934, taking into account factors such as the size of the transaction and marketability of the security, or
  - if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of the party in interest, taking into account factors such as the size of the transaction and marketability of the security, and
- 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 prescribed by the Secretary.

***Foreign Exchange Transactions***

The Pension Protection Act (PDF) added Section 408(b)(18) to ERISA. Section 408(b)(18) exempts any foreign exchange transaction between a bank or a broker-dealer (or an affiliate of either) and a plan for which the bank or broker-dealer is a trustee, custodian, fiduciary, or other party in interest if the following requirements are satisfied:

- The bank or broker-dealer does not have investment discretion or provide investment advice with respect to the transaction;
- The transaction is in connection with the purchase, holding, or sale of securities or other investment assets, i.e. it can not be a stand-alone transaction;
- The terms are no less favorable than an arm's-length transaction between unrelated parties; and
- The exchange rate cannot deviate by more than 3% from interbank bid and ask rates for transactions of comparable size and maturity, as displayed by an independent service that reports exchange rates.

***Cross-Trading***

The Pension Protection Act (PDF) added Section 408(b)(19) to ERISA. Section 408(b)(19) provides an exemption from ERISA Sections 406(a)(1)(A) and 406(b)(2) for transactions involving the purchase or sale of a security between a plan and any other account managed by the same investment manager if the following requirements are satisfied:

- 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 readily available;
- The transaction is effected at the independent current market price of the security (within the meaning of SEC Rule 270.17a-7(b));
- No brokerage commission, fee (except for customary transfer fees, which are disclosed), or other remuneration is paid in connection with the transaction;
- Cross-trading must be authorized in advance by a plan fiduciary other than the investment manager and the plan fiduciary must receive disclosures detailing the conditions under which cross-trades will occur. The authorization and disclosures must be in writing in a document separate the other written agreements between the parties. In addition, the investment manager must provide authorizing plan fiduciaries a copy of the investment manager's written policies and procedures governing cross-trading;
- Each plan participating in the transaction has assets of at least \$100 million. If the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust must have assets of at least \$100 million;
- The investment manager provides to the plan fiduciary who authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during the quarter, including the following information, as applicable: (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) 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 the 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; and
- The investment manager has designated an individual responsible for periodically reviewing such purchases and sales to ensure compliance with the investment manager's written policies and procedures, and following the review, the responsible individual must issue an annual written report no later than 90 days following the period to which it relates and signed under penalty of perjury to the plan fiduciary who authorized cross trading describing the steps performed during the course of the review, the level of compliance, and any specific instances of non- compliance. The written report must also indicate to the authorizing fiduciary that the plan has the right to terminate its participation in the cross-trading program at any time.

On February 9, 2007, the Department of Labor issued Interim Final Rule 2550.408b-19, which describes the general requirements for and the content of an investment manager's written cross-trading policies and procedures. The interim final rule requires that cross-trading policies:

- Must be fair and equitable to all accounts and reasonably designed to ensure compliance with Section 408(b)(14);
- Clear and concise and written so as to be understood by the average plan fiduciary; and
- Sufficiently detailed so as to facilitate the periodic review of the cross-trading program by the compliance officer.

The interim rule specifically requires that cross-trading policies include:

- A description for determining whether a cross-trade benefits the parties to the transaction;
- A description of how the investment manager will determine that cross-trades are effected at the "independent market price";
- A description of how the investment manager will ensure compliance with the \$100 million minimum asset size requirement;
- A description of how the investment manager will mitigate potential conflicts of interests involving the parties to a cross-trade;
- A requirement that the investment manager allocate cross-trades among accounts in an objective and equitable manner, including a description of allocation methods and how they are chosen;
- The identity of the compliance officer, including a description of the compliance officer's qualifications; and
- A description of the scope of the review to be conducted by the compliance officer.

### ***Inadvertent Prohibited Transactions***

The Pension Protection Act (PDF) added Section 408(b)(20) to ERISA. Section 408(b)(20) provides limited exemptive relief for transactions with parties in interest that are corrected within 14 days of discovery, or when date when the transaction should have reasonably been discovered, if:

- The transaction is the acquisition, holding, or disposition of securities or commodities;
- The transaction is not a transaction between a plan and plan sponsor that involves employer securities or employer real estate; and
- The fiduciary or other party in interest did not know, nor reasonably should have known, that the transaction was prohibited.

Under Section 408(b)(20) means:

- To undo the transaction to the extent possible and in any case to make good to the plan or affected account and losses from the transaction; and
- To restore to the plan or affected account any profits made through the use of assets of the plan.

### ***Exculpatory and Indemnification Provisions - ERISA Section 410(a)***

An exculpatory clause is a provision in a plan document or trust instrument that attempts to exculpate, or excuse, persons from certain actions. Sometimes these are called an immunity provision. These clauses may attempt to relieve trustees from liabilities from certain described actions and permit a trustee to adhere to a lesser standard than otherwise required by applicable law. Section 410(a) of ERISA states that any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty ... shall be void as against public policy. The only exception is to recognize that fiduciaries may allocate and delegate responsibilities under ERISA Section 405 (refer to subsection H.6, Co-Fiduciary Liability - ERISA Section 405).

An indemnification agreement is one where one person or organization agrees to protect another against loss. In Interpretive Bulletin 75-4, the Labor Department permits indemnification agreements which leave the fiduciary fully responsible and liable for its actions, but allows another party to satisfy any liability incurred by the fiduciary in the same manner as fiduciary liability insurance (see below). The plan itself may not provide this indemnification; if it does, it is as ineffective as an exculpatory clause.

### ***Fiduciary Liability Insurance - ERISA Section 410(b)***

Section 410(b) of ERISA permits, but does not require, fiduciaries to be covered by fiduciary liability insurance. This type of coverage would protect the plan against errors or omissions of fiduciaries. The insurance may be purchased by the plan, out of plan assets, or by other interested parties. Coverage might be for the fiduciary or the plan sponsor/employer.

If the plan purchases the insurance coverage, the policy must be payable to the plan. The policy must also provide that the insurance company may take recourse (seek reimbursement) against the fiduciaries in the event of a breach of fiduciary liability. If the plan purchases the coverage, a party in interest (such as a fiduciary) may not be the beneficiary of the policy. If the insurance is purchased by a party other than the plan, the recourse provision is not required.

Individual fiduciaries may also purchase fiduciary liability insurance which would protect them against personal fiduciary liability. Such protection is often purchased by banks to protect their directors, officers, and employees. Reference is made to the insurance coverage in Section 10 of this Manual.

### ***Bonding Requirements - ERISA Section 412***

Section 412(a) of ERISA requires that, in general, each fiduciary or other person who is responsible for plan assets must be bonded. Bonding protects the plan against fraud or dishonesty. Corporate fiduciaries with \$1,000,000 or more in capital are exempted from these provisions. Section 611(b) of the Pension Protection Act of 2006 (PDF) added an exemption for broker/dealers registered under the Securities Exchange Act of 1934 and subject to the fidelity bonding requirement of a self-regulatory organization. As a result, the bonding requirements effectively apply to bank directors and officers who serve as individual fiduciaries. The amount of the bond is 10% of the assets handled, with a minimum of \$1,000 and a maximum of \$500,000. If, however, a plan holds employer securities, then the maximum bond is \$1,000,000. See Section 622(a) of the Pension Protection Act of 2006 (PDF). However, if a plan holds Administrators, officers, and employees of unfunded plans are exempt from the bonding requirements.

The bond may have no deductible and must name the plan as the insured party. A pledge of assets, even if U.S. Government securities, is not an acceptable substitute for the bonding coverage. Bankers blanket bond policies normally do not provide this fiduciary bonding coverage. There is no requirement for errors and omissions insurance.

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## **I. DISCLOSURES TO EMPLOYEES AND BENEFICIARIES**

In enacting ERISA in 1974, Congress found that there was a dearth of information available to the average plan participant. In most cases, participants had no legal right to such information. As a result, ERISA requires several participant disclosures to inform participants of their rights and obligations under a plan. Two of the most common are described below.

A table located in subsection J.2. provides an overview of the major ERISA reporting and disclosure requirements.

- **Summary Plan Description**

Section 102(a)(1) of ERISA governs the Summary Plan Description (SPD). This is a plain-language summary of the plan. The SPD is provided to all plan participants and is required to be sufficiently accurate so as to inform participants of their rights and duties under the plan. The SPD must be written in a manner calculated to be understood by that plan's average plan participant. If a substantial portion of the plan participants speak a language other than English, the SPD must contain a prominent notice in that other language stating how to obtain assistance.

SPDs must be prepared for all pension and welfare plans covered by Title I of ERISA. The requirement applies to plans with fewer than 100 participants, as well as to large plans. Preparation and distribution of the SPD is normally the responsibility of the plan administrator, not the bank fiduciary. Only in the event that the bank is responsible for preparing, distributing, or filing the SPD does it need to have copies of the disclosures. Nonetheless, if the bank has a copy, it may provide a good summary of the plan's various provisions.

While there is no specified format for the SPD, the requirements for the content of the SPD, explained in Department of Labor Regulation 2520.102-3, have as their objective supplying the plan participant with a full picture of how the plan operates and whom to contact with questions or complaints. In general, the SPD should include:

- Plan Identification. This includes the name and address of the sponsor, the plan's tax identification number (EIN), and the type of plan.

- Plan Administrator/Trustee. This identifies (name, address, telephone) the person(s) or organization operating the plan for the plan sponsor, as well as the plan's trustee(s).
- Plan Information. Eligibility qualifications to join the plan must be provided, as well as a description of circumstances that would lead to disqualification, ineligibility, forfeiture, loss, or suspension of benefits.
- Pension Benefit Guaranty Corporation (PBGC) Coverage. A statement must indicate whether plan benefits are guaranteed by PBGC and, if not, why not.
- Participant Rights. A statement must be included in the SPD which indicates which rights a participant or beneficiary has under ERISA and the plan. DOL regulations provide a model statement which may be used.
- Benefit Claims. A procedure for claiming benefits must be included in the SPD.

In general, plan participants must be provided an SPD at least once every five years. If no changes are made to a plan, an SPD must be distributed at least every ten years. If major changes to a plan are made, a summary of the changes or an updated SPD must be distributed within seven months after the end of the plan's fiscal year in which changes occur. Changes need not be sent to retirees and their beneficiaries if the changes do not affect them.

The summary plan description was also previously filed with the Labor Department under Section 104(a) of ERISA four months after the plan became subject to the Act. Whenever material changes were made in the plan, a summary of the changes, or an updated SPD, was filed with the Labor Department within seven months after the end of the (plan's) fiscal year in which the changes occurred.

Effective August 5, 1997, with the passage of the Taxpayer Relief Act of 1997, plan administrators were no longer required to file SPDs, summary material modifications (SMMs) or updated SPDs with the Labor Department. Under the new law, plan administrators must furnish copies of SPDs and other plan documents to the department upon request. In addition, new civil penalties of up to \$100 per day (not to exceed \$1,000 per request) may be assessed against administrators who fail to furnish the requested information to the department within 30 days.

- Summary Annual Report

Section 104(b) of ERISA requires each plan to furnish a Summary Annual Report (SAR) to its participants *and* beneficiaries. The SAR is intended to provide interested parties with a concise summary of the plan's financial position and operating results. The requirement applies to plans with fewer than 100 participants, as well as to large plans.

DOL has issued two report formats, one for pension plans and another for welfare benefit plans. See Labor Regulation 2520.104b-10. Both contain basic plan descriptions and explain how the plan is funded, but the plan administrator may omit any part of the model SAR that doesn't apply to a particular plan.

For non-insurance funded plans, the model pension SAR provides for a valuation of plan assets at the beginning and end of the plan year, amounts of administrative expenses and benefit disbursements, and information about transactions with parties in interest. The model welfare benefit SAR provides information about relevant insurance policies and, if assets are invested outside insurance funding vehicles, financial information similar to that in the pension SAR. Both contain a notice that the participant is entitled to more details, and how to obtain the additional information.

SARs must be distributed to applicable participants two months after the Annual Report (Form 5500) is filed. The Form 5500 is normally filed seven months after the plan's fiscal year-end, so SARs are due to be distributed nine months after the plan year-end. Any extension in filing Form 5500 automatically extends the distribution date for the SPD. SARs are not filed with the government.

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## J. REPORTING TO GOVERNMENT AGENCIES

Under Title I of the Employee Retirement Income Security Act (ERISA), Title IV of ERISA, and the Internal Revenue Code, pension and other employee benefit plans are generally required to file returns/reports annually concerning, among other things, a plan's financial condition and operations. Many of these reporting requirements are satisfied by filing the IRS/DOL/PBGC Form

5500. Private pension plans must also file a reports with the PBGC. The two reports most often encountered by examiners are summarized below. For a summary of ERISA reporting requirements refer to subsection J.2.

### **Annual Return/Report of Employee Benefit Plan (Form 5500)**

Section 103(a)(1)(A) of ERISA requires an annual report to be prepared for each ERISA plan. ERISA Section 104(a)(1) requires the annual report to be filed with the government. The annual report is a combined IRS-DOL-PBGC filing using the Form 5500. Although Form 5500 is an IRS form, it is not a tax form and the information disclosed on Form 5500 is public information. Information on Individual Form 5500 filings can be obtained from the freeERISA web site: <https://freeerisa.benefitspro.com/>. Registration is required to use the site, which is available without charge. Users can access Form 5500 filings either by providing the filer's name or the filer's Employee Identification Number (EIN).

Not every employee benefit account file sampled will contain a Form 5500, since it is the administrator and sponsor of an employee benefit plan who are required to report. However, the bank as trustee may be responsible for the preparation and filing of the report. In such cases, a copy of the form should be retained in the trustee's files and available for review by examiners. Although the examiner's responsibilities do not include validating the accuracy of Form 5500, examiners should criticize the account if transactions that took place during the year are not reflected on the Form 5500, or if such transactions are not reported accurately. Limited penalties may be applicable for false statements of fact or knowingly concealing information. See DOL ERISA Regulation 2520.103-1(a)(1) and -1(b)(2)(i), and ERISA Section 103(b)(3).

Form 5500, along with instructions for its preparation, is available on the Internet at: <https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/reporting-and-filing/form-5500>.

Form 5500: This is the annual report form that pension benefit plans, welfare benefit plans, Direct Filing Entities (DFEs) and fringe benefit plans must file. The Form 5500, Annual Return/Report for Employee Benefit Plans was substantially revised for the 1999 reporting year. Beginning with the 1999 reporting year, one Form 5500 will be used for all filers. Prior to 1999, there were several alternative Form 5500s, such as the 5500-C and 5500-R. For the 1999 filing year and thereafter, Form 5500 consists of a relatively simple main form containing basic identifying information and a checklist that guides filers to more detailed schedules that must be filed according to the filer's specific type of plan. Form 5500 contains **12** Individual schedules. Each schedule focuses on a particular subject area and/or filing requirement. Filers must complete only those schedules applicable to the filer's specific type of plan. Refer to the Profile of Form 5500 Components table for a summary of the type of information collected for each schedule and a description of the changes made to each schedule.

The revised Form 5500 was structured to streamline annual reporting requirements for plans using simple tax qualification structures and financial operations. Generally, welfare plans will complete fewer items than pension plans, and small plans (those with fewer than 100 participants) will complete fewer items than large plans. (Note: In determining whether a plan has 100 or more participants at the beginning of its plan year, *all* participants in the plan are counted, not just vested participants.)

Many plans with only one participant can continue to file Form 5500EZ.

Who Must File: Generally, unless exempted, a return/report must be filed every year for every pension benefit plan, welfare benefit plan, fringe benefit plan, and Direct Filing Entity (see below).

Pension benefit plans required to file include both defined benefit plans and defined contribution plans. A return/report is due whether or not the plan is qualified and even if benefits no longer accrue, contributions were not made this plan year, or contributions are no longer made. The following are among the pension benefit plans for which a return/report must be filed:

- Profit-sharing, stock bonus, money purchase, 401(k) plans, etc.
- Annuity arrangements under Code section 403(b)(1).
- Custodial accounts established under Code section 403(b)(7) for regulated investment company stock.
- Individual retirement accounts (IRAs) established by an employer under Code section 408(c).
- Pension benefit plans maintained outside the United States primarily for nonresident aliens if the employer who maintains the plan is:

- a domestic employer, or
  - a foreign employer with income derived from sources within the United States if contributions to the plan are deducted on its U.S. income tax return.
- Church pension plans electing coverage under Code section 410(d).
  - Pension benefit plans that cover residents of Puerto Rico, the U.S. Virgin Islands, Guam, Wake Island, or American Samoa.
  - Plans that satisfy the Actual Deferral Percentage requirements of Code section 401(k)(3)(A)(ii) by adopting the SIMPLE provisions of section 401(k)(11).

The following pension benefit plans are **not** required to file Form 5500:

- An unfunded excess benefit plan.
- An annuity or custody account arrangement under Code section 403(b)(1) or (7) not established or maintained by an employer as described in 29 CFR 2510.3-2(f).
- A Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) that involves SIMPLE IRAs under Code section 408(p).
- A simplified employee pension (SEP) or a salary reduction SEP described in Code section 408(k) that conforms to the alternative method of compliance in 29 CFR 2520.104-48 or 2520.104-49.
- A church plan not electing coverage under Code section 410(d).
- A pension plan that is a qualified foreign plan within the meaning of Code section 404A(e) that does not qualify for the treatment provided in Code section 402(e)(5).
- An unfunded pension plan for a select group of management or highly compensated employees that meets the requirements of 29 CFR 2520.104-23, including timely filing of a registration statement with the DOL.
- An unfunded dues financed pension plan that meets the alternative method of compliance provided by 29 CFR 2520.104-27.
- An Individual retirement account or annuity not considered a pension plan under 29 CFR 2510.3-2(d).
- A governmental plan.

Welfare benefit plans provide benefits such as medical, dental, life insurance, apprenticeship and training, scholarship funds, severance pay, disability, etc. All welfare benefit plans covered by ERISA, except the following, are required to file Form 5500:

- A welfare benefit plan that covered fewer than 100 participants as of the beginning of the plan year and is unfunded, fully insured, or a combination of insured and unfunded.
- A welfare benefit plan that is maintained outside the United States primarily for persons substantially all of whom are nonresident aliens.
- A governmental plan.
- An unfunded or insured welfare plan for a select group of management or highly compensated employees which meets the requirements of 29 CFR 2520.104-24.
- An employee benefit plan maintained only to comply with workers' compensation, unemployment compensation, or disability insurance laws.
- A welfare benefit plan that participates in a group insurance arrangement that files a Form 5500 on behalf of the welfare benefit plan as specified in 29 CFR 2520.103-2.
- An apprenticeship or training plan meeting all of the conditions specified in 29 CFR 2520.104-22.
- An unfunded dues financed welfare benefit plan exempted by 29 CFR 2520.104-26.
- A church plan under ERISA section 3(33).
- A welfare benefit plan solely for:
  - an Individual or an Individual and his or her spouse, who wholly owns a trade or business, whether incorporated or unincorporated; or
  - partners or the partners and the partners' spouses in a partnership.

Plans must file Form 5500 by the last day of the 7th calendar month after the end of the plan year (not to exceed 12 months in length).

***Direct Filing Entities (DFEs)***

The term direct filing entity includes common/collective trusts (CCTs), pooled separate accounts (PSAs), group insurance arrangements (GIAs), master trust investment accounts (MTIAs) and 103-12 investment entities (103-12 IEs) for which a form 5500 is properly filed. Only one Form 5500 should be filed for each DFE year for all plans participating in the DFE. The DFE Form 5500, including all required schedules and attachments, must report information for the DFE year (not to exceed 12 months in length) that ends with or within the participating plan's year. The DFE Form 5500 filing is an integral part of the annual report of each participating plan and the plan administrator may be subject to penalties for failing to file a complete annual report unless both the DFE Form 5500 and the plan's Form 5500 are properly filed.

For reporting purposes, common/collective trust (CCT) and pooled separate account (PSA) are, respectively: (1) a trust maintained by a bank, trust company, or similar institution or (2) an account maintained by an insurance carrier, which are regulated, supervised, and subject to periodic examination by a state or Federal agency in the case of a CCT, or by a state agency in the case of a PSA, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or controlled group of corporations.

A master trust investment account (usually referred to as a master trust) is a trust for which a regulated financial institution serves as trustee or custodian (regardless of whether such institution exercises discretionary authority or control with respect to the management of assets held in trust), and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. The assets of a master trust are considered for reporting purposes to be held in one or more investment accounts (MTIAs). An MTIA may consist of a pool of assets or a single asset. Each pool of assets held in a master trust must be treated as a separate MTIA if each plan that has an interest in the pool has the same fractional interest in each asset in the pool as its fractional interest in the pool, and if each such plan may not dispose of its interest in any asset in the pool without disposing of its interest in the pool. A master trust may also contain assets that are not held in such a pool. Each such asset must be treated as a separate MTIA.

DOL Regulation 2520.103-12 provides an alternative method of reporting for plans that invest in an entity (other than an MTIA, CCT, or PSA), whose underlying assets include plan assets within the meaning of 29 CFR 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans. Such an entity that correctly files a Form 5500 constitutes a 103-12 Investment Entity (103-12 IE).

A group insurance arrangement (GIA), for reporting purposes, provides benefits to the employees of two or more unaffiliated employers (not in connection with a multiemployer plan or a collectively-bargained multi-employer plan), fully insures one or more welfare plans of each participating employer, uses a trust or other entity as the holder of the insurance contracts, and uses a trust as the conduit for payment of premiums to the insurance company.

Schedule D, DFE/Participating Plan Information, is a new schedule added to Form 5500 to standardize the format of DFE reporting requirements. DOL's goal is to ensure adequate reporting of the approximately \$2 trillion in plan assets held in PSAs, CCTs, MTIAs and 103-12 IEs.

DFEs, other than GIAs, must file Form 5500 no later than 9 ½ months after the end of the DFE year. A Form 5500 filed for a DFE must report information for the DFE year (not to exceed 12 months in length) that ends with or within the participating plans year. GIAs must file by the last day of the 7th calendar month after the end of the plan year (not to exceed 12 months in length) that began in 1999. A 1999 Transition Rule permits DFEs with a fiscal year ending in 1999 to file 1999 DFE Form 5500s on or before October 16, 2000. Under a separate 1999 Transition Rule, the new requirements that large plans report their percentage interests in the assets of CCTs and PSAs on their Schedule H if the CCT or PSA chooses not to file as a DFE was deferred until returns/reports for plan years beginning in 2000.

**Filing Requirements**

The Form 5500 schedules that a plan must file are generally determined by the type of plan, pension, welfare, DFE or Fringe Benefit, and, for pension and welfare plans, whether it is a small or a large plan (i.e. whether the plan has fewer than 100 participants). The Quick Reference Chart summarizes which schedules are required for each type of plan. Three schedules that examiners should be aware of are detailed below.

- *Schedule A: Insurance Information* - This schedule must be attached if any benefits under a defined benefit, defined contribution, or welfare benefit plan are provided by an insurance company, insurance service, or other similar organization. This includes investments with insurance companies such as Guaranteed Investment Contracts (GICs).
- *Schedule B: Actuarial Information* - The employer or plan administrator of a defined benefit plan that is subject to minimum funding standards (see IRC Section 412 and Part 3 Title I of ERISA) must file this attachment. An enrolled actuary must sign Schedule B. See Income Tax Regulation Section 301.6059-1(d) for qualifications of an enrolled actuary. The form summarizes the actuarial assumptions used to calculate the participant's defined benefit.

Schedule B includes the amount of a defined benefit plan's unfunded vested liability; the number of plan participants; transactions with insiders; and limited partnership valuations, as well as similarly difficult to value assets.

For the bank's own employee pension plans, the unfunded vested liability represents a contingent liability of the bank. See Bank Sponsored Employee Benefit Plans in subsection K.3, Unfunded Vested Liability regarding the examination treatment of unfunded vested pension liabilities.

- *Schedule C: Service Provider and Trustee Information* - All persons receiving, directly or indirectly, \$5,000 or more in compensation for all services rendered to the plan during the plan year must be described on this attachment. Examples of service providers include, but are not limited to: accountants, lawyers, brokers, custodians, trustees, and actuaries.

Form 5500EZ: In general, this form is intended for one participant pension plans.

Profile Of Form 5500 Components

**Source:** In Brief: 1999 Form 5500, U.S. Department of Labor – PWBA

## Profile of Form 5500 Components

Form Component	Type of Information Collection	Description
<b>Form 5500</b>	Overview information on type of annual return/report, type of plan, and schedules attached.	Basic information identifying the filer with checklist for attached schedules.
<b>Schedule A</b>	Information on contracts with insurance companies for plans and certain DFEs.	Revised by adding questions to collect better data on type and value of insurance contracts.
<b>Schedule B</b>	Actuarial information on defined benefit pension plans.	Minor revisions to update for 1999 requirements.
<b>Schedule C</b>	Information on service providers for large plans and certain DFEs.	Limited to 40 highest paid service providers, eliminated list of trustees, and limited termination notice to accountants and enrolled actuaries.
<b>Schedule D</b>	Information on participation in certain pooled investment/insurance arrangements (CCTs, PSAs, MTIAs, 103-12 IEs and GIAs).	New standardized form for reporting information about Direct Filing Entities (DFEs) and participating plans.
<b>Schedule E</b>	Information on ESOP plans.	No material revisions.

<b>Schedule G</b>	Information on nonexempt transactions and loans, leases and fixed income investments in default/uncollectible for large plans and certain DFEs.	Streamlining current schedules of loans, leases, fixed income obligations in default/uncollectible and nonexempt transactions. (Note: Schedules of assets and reportable (5%) transactions are required to be filed, but not on computer scannable forms.)
<b>Schedule H</b>	Financial statements and related information for large plans and DFEs.	New schedule streamlining large plan financial questions on current Form 5500 and consolidating them into a separate schedule.
<b>Schedule I</b>	Financial statements and related information for small plans.	New schedule streamlining small plan financial questions on current Form 5500-C/R and consolidating them into a separate schedule.
<b>Schedule P</b>	Tax exempt pension trust filers to start IRS statute of limitations.	No material revisions.
<b>Schedule R</b>	Information on pension plans including plan distributions and funding requirements.	New schedule revising pension plan questions on current Form 5500 and Form 5500-C/R and consolidating them into a single schedule.
<b>Schedule T</b>	Information on pension plan tax qualification requirements.	New schedule revising tax qualification questions on current Form 5500 and Form 5500-C/R and consolidating them into a separate schedule that can be filed in accordance with the 3-year testing cycle under Rev. Proc. 93-42.
<b>Schedule SSA</b>	Information required by Social Security Administration for pension plans on separated participants with rights to future benefits.	No material revisions.

**Quick Reference Chart For Filing the New Form 5500<sup>1</sup>**

	<b>Large Pension Plan</b>	<b>Small Pension Plan</b>	<b>Large Welfare Plan</b>	<b>Small Welfare Plan</b>	<b>DFE<sup>2</sup></b>

<sup>1</sup> Source: In Brief: 1999 Form 5500, U.S. Department of Labor - PWBA. This chart provides only general guidance. Not all rules and requirements are reflected. Refer to specific Form 5500 instructions and regulations for complete information.

<sup>2</sup> DFE (Direct Filing Entity) includes: bank common and collective trusts (CCTs) and insurance company pooled separate accounts (PSAs) (29 CFR 2520.103-3 and 103-4) that choose to file information on behalf of their participating plans; master trust investment accounts (MTIAs)

Schedule A (Insurance Information)	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts. <sup>5</sup>	Must complete if plan has insurance contracts.	Must complete if plan has insurance contracts.	Must complete if MTIA, 103-12 IE or GIA has insurance contracts.
Schedule B (Actuarial Information)	Must complete if defined benefit plan and subject to minimum funding standards.	Must complete if defined benefit plan and subject to minimum funding standards.	Not required.	Not required.	Not required.
Schedule C (Service Provider Information)	Must complete if service provider was paid \$5,000 or more and/or an accountant or actuary was terminated.	Not required.	Must complete if service provider was paid \$5,000 or more and/or an accountant or actuary was terminated.	Not required.	MTIAs, GIAs and 103-12 IEs must complete Part I if service provider was paid \$5,000 or more. GIAs and 103-12 IEs must complete Part II if accountant was terminated.
Schedule D (DFE/Participating Plan Information)	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	103-12 IE.	Must complete Part I if plan participates in a CCT, PSA, MTIA, or 103-12 IE.	All DFEs must complete Part II, and DFEs that invest in CCT, PSA, or 103-12 IE must also complete Part I.
Schedule E (ESOP Information)	Must complete if ESOP.	Must complete if ESOP.	Not required.	Not required.	Not required.

(29 CFR 2520.103-1(e); investment entities filing under 29 CFR 2520.103-12 (103-12 IEs); and group insurance arrangements (GIAs) filing under 29 CFR 2520.103-2 and 104-43.

Schedule G (Financial Schedules)	Must complete if Schedule H, lines 4b, 4c, or 4d are Yes. <sup>3, 5</sup>	Not required.	Must complete if Schedule H, lines 4b, 4c, or 4d are Yes. <sup>3, 4</sup>	Not required.	MTIAs, GIAs and 103-12 IEs must complete if Schedule H, lines 4b, 4c, or 4d are Yes. <sup>3</sup>
Schedule H (Large Plan and DFE Financial Information)	Must complete. <sup>5</sup>	Not required.	Must complete. <sup>4</sup>	Not required.	All DFEs must complete Parts I, II & III, MTIAs, 103-12 IEs, and GIAs must also complete Part IV.
Schedule I (Small Plan Financial Information)	Not required.	Must complete.	Not required.	Must complete. <sup>4</sup>	Not required.
Schedule P (Annual Return of Fiduciary)	Must file to start running of statute of limitations under Code section 6501(a). <sup>5</sup>	Must file to start running of statute of limitations under Code section 6501(a).	Not required.	Not required.	Not required.

<sup>3</sup> Schedules of assets and reportable (5%) transactions also must be filed with the Form 5500 if Schedule H, lines 4i or 4j are Yes, but use of scannable form not required.

<sup>4</sup> Unfunded, fully insured and combination unfunded/insured welfare plans covering fewer than 100 participants at the beginning of the plan year that meet the requirements of 29 CFR 2520.104-20 are exempt from filing an annual report. Such a plan with 100 or more participants must file an annual report, but is exempt under 29 CFR 2520.104-44 from the accountant's report requirement and completing Schedule H, but MUST complete Schedule G, Part III, to report any nonexempt transactions.

<sup>5</sup> Not required for certain plans eligible for limited pension plan reporting.

Schedule R (Retirement Plan Information)	Must complete unless plan is neither a defined benefit plan nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year. <sup>5</sup>	Must complete unless plan is neither a defined benefit plan nor subject to Code section 412 or ERISA section 302 and no benefits were distributed during the plan year.	Not required.	Not required.	Not required.
Schedule SSA (Statement Identifying Separated Participants With Deferred Vested Benefits)	Must complete if plan had separated participants with deferred vested benefits to report. <sup>5</sup>	Must complete if plan had separated participants with deferred vested benefits to report.	Not required.	Not required.	Not required.
Schedule T (Qualified Pension Plan Information)	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year. <sup>5</sup>	Must complete if qualified plan unless permitted to rely on coverage testing information for prior year.	Not required.	Not required.	Not required.
Accountant's Report	Must attach. <sup>5</sup>	Not required.	Must attach. <sup>4</sup>	Not required.	Must attach for a GIA or 103-12 IE.

### **Pension Benefit Guarantee Corp (PBGC) Annual Premium Filing (Form PBGC-1)**

The Pension Benefit Guaranty Corporation (PBGC) was established as a federal corporation under The Employee Retirement Income Security Act of 1974. The PBGC is responsible for providing pension benefits to participants and beneficiaries of covered plans when plan sponsors can no longer fund the plan, generally in the case of bankruptcy. The agency insures only private-sector defined benefit plans. Public sector and religious organization pension plans are not covered; neither does the agency insure defined contribution plans of any kind. As of December 2006, the PBGC was the guarantor of pension benefits for more than 44

million American active workers and retirees participating in more than 30,000 private-sector defined benefit pension plans. The two major categories of plans covered by the agency are single-employer and multi-employer pension plans. Multi-employer plans are generally collectively bargained/union plans which are funded by one or more companies in a common industry. As of September 30, 2006, the single-employer program accounted for virtually all of the PBGC's deficit. It held total assets in these plans of \$61 billion, and was responsible for a present value of future benefits estimate of \$80 billion. PBGC's liabilities are not backed by the full faith and credit of the federal government, nor does it receive any funds from tax revenues. Rather, the PBGC is self-funding, deriving its revenue from premiums on covered plans paid by plan sponsors, assets acquired from terminated plans, recoveries from terminated sponsors, and earnings from invested assets.

Under the single-employer program, PBGC pays monthly retirement benefits up to a guaranteed maximum. The guaranteed maximum payment for a single life annuity in plans terminating in 2007 is: \$4,125.00 a month at age 65, \$3,258.75 a month at age 62, and \$1,856.251 a month at age 55. Benefit increases and new benefits are only partially covered if plan amendments covering the increases were adopted less than five years as of the date a plan terminated. Under the multiemployer Program, the agency provides financial assistance in the form of loans to plans facing insolvency. As a requirement for financial assistance, plans must discontinue benefits in excess of the PBGC's guaranteed level.

### Annual Premium Filing (Form PBGC-1)

**Form PBGC-1:** This form is filed on an annual basis by all defined benefit plans and is not dependent on the size of the plan. Large plans, plans with 500 or more participants, must file an estimated flat premium form.

**Form 1-ES:** This form discloses the number of participants and the estimated amount of premium payment due the PBGC. If an employer wants to terminate the plan, the PBGC must be notified in advance and must approve any distributions of plan assets to participants. PBGC forms are available on the Internet through PBGC's home page at <http://www.pbgc.gov/>.

### ERISA Reporting & Disclosure

	Sent To		Defined Benefit Pension		Defined Contribution Retirement (P/S – 401(k) - ESOP		Welfare Benefit	
Participant (#)			100 +	< 100		100 +	< 100	
<b>Recurring Requirements</b>								
PBGC-1 (Premium Pmt)	PBGC		7 months after plan fiscal year-end	Same		N/A	N/A	
Summary Annual Report (SAR)	Participants		9 months after plan fiscal year-end	Same		Same	Same	
Annual Report (Forms 5500)	IRS		7 months after plan fiscal year-end (9 ½ months for DFEs other than GIAs	Same		Same	Same	
<b>Exception Reports</b>								
Reportable Event Notice	PBGC		For some, file notice within 30 days of occurring; for other, report on Form 5500	Same		N/A	N/A	

Termination Intent Notice	PBGC		10 Days Before Proposed Termination	Same		N/A	N/A		N/A	N/A
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## K. BANK SPONSORED EMPLOYEE BENEFIT PLANS

### ERISA Applicability

The following summary gives the major provisions of ERISA applicable to banks sponsoring pension or profit-sharing plans for their own employees. Review of these major points should enable the examiner to determine whether a bank is in substantial compliance with ERISA. Some of the summary points represent a consolidation of many sections but, where practicable, citations are given indicating which sections of ERISA may be applicable.

### Form of Plan

Employee pension benefit plans are to be in writing [ERISA Section 402(a)(1)] and, with certain exceptions, must meet ERISA's minimum participation and vesting standards. [See also ERISA Section 402(b), refer to subsection H.3, Establishment of Plan - ERISA Section 402].

### Operation of Plan

- At least one trustee must be appointed to operate the plan [ERISA Section 403(a), refer to subsection H.4, Trustee Requirements - ERISA Section 403]. The trustee need not be a bank. Usually, directors, officers, or employees of the plan sponsor (employer) are named as Individual trustees.

In general, ERISA requires that all assets of employee benefit plans be held in trust. Exemptions exist for fully insured plans and regulations provide that welfare plans under which benefits are paid directly from the general assets of the employer (unfunded plans) are exempt from the trust requirements. Insured plans are those where the funding agency is an insurance company. Contributions are paid to the insurer which in turn pays all benefits to eligible participants based upon instructions from the plan's retirement or administrative committee. These plans range from fully guaranteed retirement benefits to immediate participation guarantee contracts in which the basic guarantee is limited to providing lifetime annuities for those employees who have actually retired.

- A trust agreement detailing the responsibilities and duties of the trustee should be in writing [ERISA Section 403(a)]. The trust agreement may be included with the plan as an all-inclusive document, but normally this is not the case. Trust agreements are not necessary if the plan's assets are solely insurance policies or annuity contracts issued by insurance companies [ERISA Section 403(b)].
- The plan must be operated solely in the interests of the plan participants and beneficiaries. In practice, this means that the plan must operate according to the plan documents and fiduciary principles, with diversified investments made prudently [ERISA Section 404, refer to subsection H.5.b., Requirements]. ERISA prohibits transactions involving conflicts of interest (ERISA Section 406(a)) and self-dealing (ERISA Section 406(b)). Refer to subsection H.7., Prohibited Transactions - ERISA Section 406.

### Trust Powers

If a bank sponsors an employee benefit plan for its own employees, it may name Individuals as trustees. This is commonly done in smaller institutions, where one or more directors and/or officers are named as Individual trustees. Where the bank itself is named as trustee for its own employee benefit plan (and does not serve in any fiduciary capacity for any other institution, parent company, affiliate, or Individual), it is not required to have trust powers unless trust powers are required by state law for such purposes. In such cases the FDIC does not view the bank as operating a trust department, and does not require the bank to apply for Corporation consent to serve as its own trustee. These plans are typically reviewed at safety and soundness examinations, and no trust report is prepared. Any apparent violations of ERISA are scheduled in the safety and soundness report. Referrals of violations (if any) to the Department of Labor are prepared according to instructions found in Appendix A. Refer to subsection B. of Section 10 of this Manual for further discussion of situations which may require FDIC consent to exercise trust powers under Part 333 of FDIC's Rules and Regulations.

## Unfunded Vested Liability

For the bank's own employee defined benefit pension plans, the unfunded vested liability represents a contingent liability of the bank. The unfunded vested liability figure from Form 5500 Schedule B should be noted on the optional own-bank employee benefit account page in the Trust examination report. If the bank contemplates terminating its pension plan or if the bank itself is in such a position that it may be closed, the amount of the unfunded vested liability should be shown as a contingent liability in the trust examination report and carried forward to any concurrent safety and soundness examination report.

## Capital Treatment for ESOPs

In issue number 89-10, the Emerging Issues Task Force (EITF) of the Financial Standards Accounting Board (FASB) reached a consensus that ESOP debt should be reflected on the plan sponsor's balance sheet if the ESOP has no other sources of funds except contributions from the sponsor, dividends on the sponsor's stock, or proceeds from sales of the stock with which to service the debt.

When a bank sponsors a leveraged ESOP which invests in bank stock, there is no immediate increase in regulatory capital for the bank. While the number of shares issued has increased because of the purchase by the ESOP, this increase is offset by the corresponding liability incurred by the bank in guaranteeing the ESOP loan. As the loan is paid down, a commensurate decrease in the ESOP-guarantee liability occurs, providing an increase in bank capital.

The FASB EITF indicated that the consensus reached in issue number 89-10 did not address the push down of ESOP debt to a subsidiary's balance sheet in the situation where the participants are employees of the subsidiary. Security Exchange Commission (SEC) Staff Accounting Bulletin Topic 5.J provides that holding company debt should be pushed down to a subsidiary if the subsidiary will: (1) assume the holding company's debt, (2) retire all or part of the holding company's debt with the proceeds from a debt or equity offering, or (3) guarantee or pledge its assets as collateral for the holding company's debt.

When a bank sponsors a leveraged ESOP which invests in the stock of its own holding company, a case-by-case determination must be made as to the proper Report of Condition treatment of the impact on the bank's capital. A number of issues are involved, including whether the bank or the holding company guarantees the ESOP's debt, sources of funds to repay the debt, etc.

## Fees - Permissibility vs. Prohibited Transactions

Banks are permitted to charge servicing fees to their own plans and to plans administered on behalf of their holding company. Labor Department Advisory Opinion 79-49 provides that the provision of services by a fiduciary to its own employee benefit plans is not a prohibited transaction under ERISA Section 406(a). This falls under the service provider exemption of ERISA Section 408(b)(2). However, this exemption applies only if the fiduciary does not charge the plan a fee in excess of its direct expenses. If a fee in excess of direct expenses is charged, the transaction would violate ERISA.

Under Section 23B of the Federal Reserve Act, a holding company must be charged for services performed on its behalf by an affiliated bank (unless the bank would also, in good faith, waive fees for comparable transactions with nonaffiliated plans). Therefore, banks acting as custodian, trustee, or any other fiduciary capacity for employee benefit plans sponsored by their holding company, should charge the holding company for performing these services.

Banks which service holding company plans, or their own plans, should be guided by the ERISA requirement that servicing fees may not exceed their direct servicing expenses. The Labor Department has previously taken the position that banks which charge their own plan fees which exceed their "direct expenses," are in violation of ERISA Sections 406(b)(1) and 404(a)(1)(B), and DOL Regulation 2550.408b-2(e)(1). Banks which do so are also subject to a penalty under ERISA Section 502(1), which is equal to 20 percent of any amount recoverable for the violation or breach of duty. Banks should also be aware that the DOL has taken the position that charging fees which are charged other trust customers is not considered a reimbursement of expenses. This is predicated on the concept that fees are formulated on a cost plus profit basis.

In reviewing own bank and holding company plans, examiners should determine whether management: (1) is aware of these requirements, and (2) can reasonably demonstrate that fees charged the plans are no more than "direct expenses." Also refer to a 1995 FDIC Legal Opinion on this matter located in Appendix C.

**Assignment or Alienation of Plan Benefits**

Examiners may encounter instances (either in trust department accounts, the bank's own employee benefit plan, or on the commercial side of the bank) where a participant has assigned their plan benefits as collateral for a loan. According to ERISA Section 206(d)(1) and IRC Section 401(a)(13), a plan will not be considered a qualified trust unless it provides that benefits under the plan may not be assigned or alienated. If a plan is disqualified, it may be required to forfeit favorable tax treatment. In addition, if a commercial lender originates a loan accepting an assignment of an employee benefit account, the lender may have difficulty securing the collateral if the borrower defaults.

There are three exceptions to the general rule prohibiting assignment and alienation of plan benefits. The three exceptions are discussed below.

- A plan may provide that once a participant begins receiving benefits under the plan, the participant may assign or alienate the right to future benefit payments if the assignment or alienation:
  - Is voluntary and revocable,
  - Does not in aggregate exceed 10% of any benefit payment, and
  - Is not for the purpose of defraying plan administration costs.
- A plan may provide for loans from the plan to a participant or a beneficiary to be secured by the participant's accrued nonforfeitable benefit provided that certain circumstances are met.
- A plan will not fail to satisfy the requirements of Section 401(a)(13) if payments are made to an alternate payee under a Qualified Domestic Relations Order (QDRO).

**In-Kind Contributions**

DOL Interpretive Bulletin 94-3 indicates that a prohibited transaction exists when the plan sponsor makes "in-kind" contributions to defined benefit plans and certain defined contribution and welfare benefit plans. Exceptions are noted for certain defined contribution and welfare benefit plans if the contribution would not reduce a present or future obligation of the plan sponsor to make cash contributions. Refer to subsections H.5.c.(1), Contributions, In-Kind and H.7.f.(5), Loans to Common Borrowers - General.

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**L. COMPLIANCE WITH STATE LAWS**

Section 514(a) of ERISA explicitly provides that, with certain exceptions, state laws dealing with employee benefit plans subject to ERISA are superseded by ERISA. From a practical standpoint, this means that only ERISA statutory, regulatory, and interpretive statements on a given issue apply to plans subject to ERISA. Even where FDIC requirements or state laws or regulations provide for a stricter standard, they do not apply to ERISA plans. ERISA further states in Section 514(b), that nothing shall be construed to exempt or relieve any person (or bank) from any law of any state which regulates insurance, banking, or securities. Refer to AO 94-41 for further discussion.

**Escheat Provisions**

When the plan document specifies the disposition of undeliverable benefits, those procedures control the trustee's actions. However, most plans will not address escheat guidelines. Thus, DOL concludes that ERISA preempts state escheat laws to the extent they apply to employee benefit plan payments when escheating is not addressed in state banking laws. In states where escheating is not addressed in state banking law, and the bank (as trustee or plan sponsor) remits unclaimed property to the state, an apparent violation of ERISA Section 404(a) would exist. Section 404(a) requires the trustee to hold and conserve plan assets for the exclusive purpose of providing benefits and defraying reasonable plan expenses. In states where escheat provisions are addressed in state banking law, examiners should not cite an apparent ERISA violation. However, the examiner should ensure that the bank is in compliance with state escheat laws. Refer to AO 94-41.

**Special Treatment for Multiple Employer Welfare Arrangements (MEWAs)**

The term Multiple Employee Welfare Arrangement (MEWA) is defined in Section 3(40)(A) of ERISA. A special provision exists for MEWA plans which are fully insured. In 1983, Congress added Section 514(b)(6) to ERISA to explicitly disclose that State insurance regulations apply to fully insured MEWA plans. Fully insured MEWA plans and unfunded MEWA plans are relatively rare (refer to subsection D.2.g., Welfare benefit Plans for further details).

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**M. COMPLIANCE WITH THE INTERNAL REVENUE CODE**

A prohibited transaction cited under ERISA Section 406 represents, in almost every instance, a parallel violation of Section 4975 of the Internal Revenue Code (IRC). Whenever examiners cite a violation of ERISA Section 406, the corresponding violation of IRC Section 4975 should also be noted. The result is that a prohibited transaction under ERISA creates tax penalties levied by the IRS.

There are some differences between ERISA and IRC provisions. Different terminology is used, such as the party in interest of ERISA is a disqualified person in IRC. The two definitions can differ in unusual situations. As a result, examiners should note that a few ERISA prohibited transactions may not result in tax penalties under IRC Section 4975. Section 4975 of IRC, titled Tax on Prohibited Transactions appears in Appendix E.

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**N. REFERRALS OF ERISA VIOLATIONS TO THE DEPARTMENT OF LABOR (DOL)**

The federal financial institution agencies entered into an agreement with the DOL to refer violations of ERISA, meeting certain specific criteria, to that agency. The Labor Department in turn is obligated by law to refer certain matters to the Internal Revenue Service. A copy of the Interagency Agreement is located in Appendix E. The referral agreement covers only apparent violations cited in FDIC examination reports. Apparent violations cited in State examination reports are not forwarded by the FDIC to the Labor Department.

In compliance with the interagency agreement, the Corporation may forward the following types of apparent violations to the Labor Department:

- Where the federal financial institution does not serve as plan administrator or plan sponsor, as those terms are defined in ERISA Section 3(16), possible violations of:
  - Title I, Part 4, Section 404, relating to fiduciary duties (including transactions directed by named fiduciaries or qualified investment managers), except where the transaction amounts, individually or in combination with other questionable transactions, constitute less than \$100,000;
  - Title I, Part 4, Sections 406 and 407(a), relating to prohibited transactions, except where the threat of loss to the plan participants is de minimis;
  - Title I, Part 4, Section 411, relating to prohibition against certain persons holding certain positions;
  - Title I, Part 4, Section 412, relating to the bonding requirements as applicable to the financial institution itself.
- Where the financial institution, in respect to a plan, also serves as plan administrator or plan sponsor, the agencies shall provide written notification of possible violations of the ERISA sections listed above, plus written notification of possible violations of Title I, Part 1 of ERISA relating to reporting and disclosure.

Examiners may cite ERISA violations of a bank's own employee benefit plan(s) in the safety and soundness examination report if the bank does not operate a trust department. Employee benefit plans operated by the bank are subject to review and examination by FDIC examiners. A substantial number of ERISA violations referred to the Labor Department come from other than trust examination reports.

A separate page in the trust examination report, ERISA Employee Benefit Account - Recommendation for Referral to Labor Department, is used to provide relevant information about the employee benefit plan(s) affected and to facilitate the referral of

the violation(s) to the Labor Department. This page should also be used if ERISA violations warranting referral are scheduled in the safety and soundness examination report. This separate page, when used, is either submitted as part of the Confidential Section of the examination report, or submitted separately to the Regional Office along with the report of examination. Instructions for completing the ERISA referral schedule can be found in Appendix A.

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## O. ACCOUNT DOCUMENTATION AND IRS DETERMINATION LETTERS

### Account Documentation in General

As with other types of trusts and agencies serviced by the trust department, corporate sponsored employee benefit accounts should be fully documented. At a minimum, the department should have on file properly executed copies of the:

- Governing plan document together with all subsequent amendments.
- Trust instrument or agency agreement, if separate from the plan document, together with all subsequent amendments.

Even if the department services accounts only in an agency capacity, such as a custodian, it is still desirable that copies of the governing plan document and agency agreement be on file. Retaining such documentation enables bank personnel to assure that responsibilities are executed in accordance with plan or agreement provisions.

- Certified resolution(s) of the sponsoring firm's board of directors adopting the plan, trust agreement, and subsequent amendments to either.
- Documents evidencing the appointment of other parties authorized, in accord with plan provisions, to direct the trustee to:
  - Make benefit payments (normally, the plan administrator), and/or
  - Select trust investments (normally, an outside investment manager) [see ERISA Section 405].
- Internal Revenue Service determination letter if the:
  - Bank is acting as plan administrator, or
  - Account is invested in a CIF restricted to employee benefit accounts operating under Revenue Ruling 81-100.

### IRS Letter of Determination

If requested, the IRS will review a plan and make a determination as to whether it meets the various standards to make it eligible for tax deductions. The opinion letter issued by the IRS is called a Letter of Determination. While there is no requirement imposed by ERISA or the IRS to obtain a Letter of Determination, it is prudent for the plan sponsor to do so. Failure to obtain a letter, however, is not a violation.

*Letters of Determination* are usually obtained for new plans and for amendments to existing plans. Each amendment to an existing plan does not normally trigger a request for a new Letter of Determination. A number of minor changes will occur before a new Letter of Determination is required. On the other hand, if a major change occurs, the plan sponsor will often seek a new Letter from the IRS.

A *sample Determination Letter* appears in Appendix E. For further information, consult IRS Publication 794. Relevant information from this publication appears in Appendix E.

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**P. VOLUNTARY CORRECTION PROGRAMS****Employee Benefit Plan Voluntary Correction Programs**

The Internal Revenue Service, US Department of Labor, and Pension Benefit Guaranty Corporation have adopted voluntary correction programs which permit employee benefit plan sponsors and other plan officials to correct certain categories of errors and misfilings with either no, or reduced, penalties, while preserving the plan's tax qualification.

***Internal Revenue Service***

The IRS retirement plan correction program (Employee Plans Compliance Resolution System, covered under Revenue Procedure 2003-44), helps employer sponsors protect participant benefits and keep their plans within the requirements of the Internal Revenue Code. This revenue procedure combined and revised a series of previous IRS remedial programs for correcting plan qualification defects. The program covers qualified retirement plans, Section 403(b) arrangements, SEPs, and SIMPLE IRAs, for a variety of plan qualification failures and violations, including: operational failures, for failure to comply with terms of plan documents; plan document failures, in which retirement plan provisions violate IRS qualification requirements; demographic failures, in which IRS nondiscrimination requirements are not met in the plan document; and the diversion or misuse of plan assets.

**Self Correction Program**

Under the Self Correction Program certain plan errors can be corrected without IRS involvement. No notification of IRS is required, no fees or penalties are assessed, and the plan and its participants retain tax benefits.

**Voluntary Correction Program**

The Voluntary Correction Program may be used for plan errors which not eligible for self-correction. Errors are corrected and the tax benefits of the plan are preserved for plan participants with IRS assistance.

**IRS Plan Audits**

Errors corrected under either the Self Correction or Voluntary Correction programs are not treated as errors when the IRS audits these plans. For other errors found during IRS examinations, the Audit Closing Agreement Program permits their correction and tax benefit preservation at fees which are lower than would be incurred if the plan had not participated in the Voluntary Correction Programs.

***U.S. Department of Labor***

The Employee Benefits Security Administration has two voluntary self-correction programs for plan administrators who need help in meeting ERISA requirements: the Delinquent Filer Voluntary Compliance Program promotes, through the assessment of reduced civil penalties, plan administrator compliance with annual reporting obligations under Title I of the Employee Retirement Income Security Act of 1974; the Voluntary Fiduciary Compliance Program allows plan participants and beneficiaries and certain other persons engaging prohibited transactions under the Employee Retirement Income Security Act of 1974 to self-correct the violations, and avoid potential civil actions by the DOL.

**Delinquent Filer Voluntary Compliance Program**

The Delinquent Filer Voluntary Compliance Program assists plan administrators who have filed Form 5500 late, or not filed it at all, to comply with the filing requirements and pay reduced civil penalties. The IRS has agreed to provide penalty relief under the Code for delinquent Form 5500 Annual Returns/Reports filed for Title I plans where the conditions of this program have been satisfied.

**Voluntary Fiduciary Correction Program**

The Voluntary Fiduciary Correction Program (PTE 2002-51 (PDF) and PTE 2002-51 Amendment (PDF)) affords plan sponsors and officials the opportunity to self-correct 15 specific transactions, involving delinquent participant contributions and other violations, prohibited under ERISA. The DOL also relieves these individuals from the payment of excise taxes associated with the transactions covered under the class exemption.

***Pension Benefit Guaranty Corporation***

PBGC provides incentives to self-correct late filings, or other errors involving missed premium deadlines and underpaid premiums.

**Underpaid Premium Correction Program**

Voluntarily self-corrected underpayments made before PBGC sends a notice of premium delinquency or a premium audit, reduces the monthly penalty rate by 80 percent (from 5 percent to 1 percent of the unpaid premium). Premium penalties may be waived for reasonable cause or in other appropriate circumstances.

**Participant Notice Voluntary Correction Program**

Missed or improperly prepared reports or notices are assessed lower penalties where the failure is quickly corrected or involves a small plan. Information penalties are waived for reasonable cause or in other appropriate circumstances. Self-correction is considered a mitigating factor for plans participating in this program.

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**Q. CATCH-UP CONTRIBUTIONS**

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended IRC Sections 402 and 414, creating a new category of elective retirement plan contributions, referred to as "catch-up" contributions. It also added IRC Section 414(v) which, effective for plan years beginning after December 31, 2001, permits individuals age 50 or older to make additional pre-tax salary deferrals ("catch-up" contributions) to certain eligible plans: 401(k) plans, SIMPLE IRA plans, simplified employee pensions (SEPs), Section 403(b) arrangements, and Section 457 governmental plans. Eligible plans must be amended to permit catch-up contributions. Final regulations implementing "catch-up" contribution rules were issued under IRS Revenue Bulletin 2003-37.

Catch-up contributions are elective retirement plan salary deferrals which would otherwise exceed plan imposed limitations. Catch-up contributions are also exempted from certain IRC statutory limits (IRC 401(a)(30), 401(k)(11), 402(h), 402A(c)(2), 403(b), 404(h), 408(k), 408(p), 415, and 457). Employers are not required to match catch-up contributions, and may incorporate plan language explicitly omitting catch-up contributions from existing employer-matching salary deferral programs. The IRC also does not require employers to provide for catch-up contributions in any of its plans. However, if an employer permits catch-up contributions in any one of its eligible plans, it must "universally" permit them in each of the eligible plans it sponsors. This "universality" provision ensures employers may not favor one category of employee vs. another (non-union vs. unionized, etc.). A temporary exclusion for collectively bargained plans is permitted, but only until the expiration of existing union agreements. Thereafter, all plans must be treated "universally." Although plan participants may elect to make "catch-up" contributions to a multiple number of eligible employer sponsored plans, the aggregate of their catch-up deferrals may not exceed annual statutory limits.

Under the IRC, deferrals are not considered "catch-up" contributions until the end of the plan's year. This is so because it cannot be determined until the end of a plan year whether or not the elective deferral will exceed plan limits. Further, although the catch-up limit is applied on a calendar year basis, the implementing regulations provide guidance on how the contributions may be calculated for retirement plans operating on a fiscal year basis.

Catch-up limits for all eligible plans except SIMPLE 401(k) and IRA plans:

Tax Year	Catch-up Limit*
2002	\$1,000
2003	\$2,000
2004	\$3,000
2005	\$4,000
2006	\$5,000

Catch-up limits for SIMPLE 401(k) and IRA plans:

Tax Year	Catch-up Limit*
2002	\$500
2003	\$1,000
2004	\$1,500
2005	\$2,000
2006	\$2,500

\* For taxable years beginning after 2006, catch-up limits will be adjusted for inflation in increments of \$500.

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## R. PENSION PROTECTION ACT OF 2006

### Pension Protection Act of 2006 (PDF)

### Pension Protection Act of 2006 (Revised)

#### *Background*

The Pension Protection Act of 2006 (PPA) was signed into law on August 17, 2006. The PPA is widely considered landmark legislation which is responsible for the most comprehensive changes to the Internal Revenue Code of 1986 (Code) and Employee Retirement Income Security Act of 1974 (ERISA) relating to all types of retirement plans since the enactment of ERISA in 1974. Although the PPA's primary purpose was to enact retirement plan reforms, its passage also addressed non-retirement issues. Titles I through XI of the PPA deal specifically with retirement plan issues, while the remainder of the Act, Titles XII through XIV, relate to non-retirement matters. The trust manual review of PPA reforms and changes will concentrate on the retirement plan components of the PPA.

Among the numerous retirement plan changes enacted, the PPA established new minimum funding standards for single-employer and multi-employer defined benefit pension plans; it extended interest rate rules for the funding standard account, requiring the use of a rate based on long-term investment grade corporate bonds rather than 30-year Treasury securities; it amended the interest rate calculation for lump sum distributions; it requires fully-funded single-employer plans to pay variable-rate premiums to the Pension Benefit Guaranty Corporation; it provides alternative funding rules for commercial passenger airline defined benefit plans, and establishes basic requirements relating to funding notices provided by defined benefit plans; it permits fiduciary advisers to give investment advice to participants or beneficiaries under specified conditions; it establishes rules governing the

treatment of defined benefit pension plans which fail to comply with age discrimination prohibitions; and it increases deduction limits for single-employer and multi-employer plans. The PPA also permits annuity contracts and life insurance contracts to include long-term care insurance provisions; it mandates defined contribution plans holding publicly traded securities to provide employees with: (a) the opportunity to divest employer securities; and (b) at least three investment options other than employer securities; under certain conditions, it permits employers to automatically enroll employees in defined benefit plans; it establishes rules governing the division of pension benefits between divorced parties; it authorizes the Secretary of the Treasury to establish or change the Employee Plans Compliance Resolution System and any other employee plans correction system or policies; and it prohibits a reduction of unemployment compensation resulting from pension rollovers. It also makes permanent some rules from the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) which were scheduled to expire in 2010. These include maximum contributions to IRAs and 401(k)s, and "catch up" contributions for individuals 50 and older. It also ensures the permanency of Roth IRAs and Roth 401(k)s, increased IRA rollover ability, mandatory cash outs of de-minimis account balances, hardship distributions from 401(k) and 403(b) plans, and Section 529 college savings plans.

In other areas unrelated to retirement plans, the PPA amends the Internal Revenue Code relating to the treatment of certain transactions involving charitable contributions, tax-exempt organizations, and supporting organizations; it amends the EGTRRA to permanently extend qualified tuition program provisions; and contains provisions dealing with mining, trade, tariff, and import duty issues.

Although the PPA modifies both the Code and ERISA, the discussion below is generally confined to the changes in ERISA.

### ***Title I - Reform of Funding Rules for Single-Employer Defined Benefit Pension Plans***

#### **Subtitle A - Amendments to the Employee Retirement Income Security Act of 1974**

- **Section 101 Minimum Funding Standards**

Alters minimum funding rules for single-employer defined benefit pension plans and identifies plan sponsors liable for maintaining pension funding; it also permits funding waivers for plan sponsors under "hardship" circumstances. Under the new funding requirements, plan sponsors are required to make annual contributions equal the minimum funding calculation for plan years beginning after 2007 unless they qualify for hardship relief.

- **Section 102 Funding Rules for Single Employer Defined Benefit Pension Plans**

Outlines the new funding standards and required contributions. It also identifies a new category of plan ("at risk"), and provides special rules for protecting assets of such plans. Minimum required contributions to single-employer defined benefit pension plans after 2007 should be sufficient to permit the plan to achieve its "target normal cost" (the present value of benefits expected to accrue during the plan year).

- **Section 103 Benefit Limitations Under Single Employer Plans**

Bans plan amendments from taking effect during any plan year in which a plan's "funding target attainment percentage" is less than 80 percent for the plan year.

- **Section 104 Special Rules for Multiple-Employer Plans of Certain Cooperatives**

Delays the imposition of revised interest rate calculations for cooperative multi-employer plans until the earlier of 2017 or the date on which a plan ceases to be a cooperative multi-employer plan.

- **Section 105 Temporary Relief for Certain PBGC Settlement Plans**

Delays the imposition revised interest rate calculations until 2014 for plans which were covered under a PBGC settlement on or before July 26, 2005.

- **Section 106 Special Rules for Plans of Certain Government Contractors**

Delays the imposition revised interest rate calculations for certain eligible government contractors until the earliest of the plan year for which the plan ceases to be an eligible government contractor plan, the effective date of the Cost Accounting Standards Pension Harmonization Rule, or 2011.

- Section 107 Technical and Conforming Amendments

Provides technical changes to ERISA to conform these laws to PPA changes.

#### Subtitle B - Amendments to the Internal Revenue Code of 1986

- Section 111 Minimum Funding Standards

Provides conforming changes to the minimum funding standard.

- Section 112 Funding Rules for Single Employer Defined Benefit Pension Plans

Provides conforming changes to single employer defined benefit plan funding rules.

- Section 113 Benefit Limitations Under Single Employer Plans

Provides conforming changes to single employer plan benefit limitations.

- Section 114 Technical and Conforming Amendments

Provides technical and conforming changes to the Code.

- Section 115 Modification of Transition Rule to Pension Funding Requirements

Provides conforming changes to modify pension funding transition rules.

- Section 116 Restrictions on Funding of Nonqualified Deferred Compensation Plans by Employers Maintaining Underfunded or Terminated Single Employer Plans

Provides conforming changes to restrict the funding of nonqualified deferred compensation plans by employers maintaining underfunded or terminated single-employer plans.

### ***Title II - Funding Rules for Multi-Employer Defined Benefit Plans***

#### Subtitle A - Amendments to the Employee Retirement Income Security Act of 1974

- Section 201 Funding Rules for Multi-Employer Defined Benefit Plans

Creates minimum funding rules for multi-employer defined benefit plans effective for plan years after 2007. It defines how plan assets are to be valued and what constitutes a fully funded plan. These new rules modify amortization periods, reducing the amortization of past service liability and changes in actuarial assumptions resulting from gain and loss experience, from 30 to 15 years. The rules also require actuaries to provide their "best estimate of anticipated experience under the plan," and to periodically review, and change, interest rate assumptions which are not within permissible ranges.

- Section 202 Additional Funding Rules for Multi-Employer Plans in Endangered or Critical Status

Mandates the use of additional funding rules for multi-employer defined benefit plans which fall under "endangered" or "critical" definitions. Plans falling under the "endangered" status definition are required to comply with a "funding improvement plan," plans considered to be "critical" must conform to a "rehabilitation plan." Plan actuaries are required to

certify whether or not a plan is "endangered" or "critical" by the 90th day of each plan year. Plans less than 80% funded are considered to be "endangered" or "seriously endangered;" plans less than 65% funded are considered to be "critical." "Endangered" and "seriously endangered" plans must develop funding improvement plans that will increase the plan's funding percentage over 10 or 15 years, respectively. "Critical" plans must adopt rehabilitation plans that will increase the plan's funding percentage within 10 years. Actuaries must also certify whether or not such plans meet progress requirements under their funding improvement or rehabilitation plans. An actuary's failure to certify the status of a plan (whether or not it is in "endangered" or "critical" status) by the 90th day of each plan year to the Secretary of the Treasury and the plan sponsor is treated as a failure to file the annual report.

- **Section 203 Measures to Forestall Insolvency of Multi-Employer Plans**

Strengthens insolvency protection rules covering multi-employer plans. This provision lengthens the insolvency testing period from 3 to 5 years for plans whose asset value is not at least equal to three times the value of anticipated benefit payments.

- **Section 204 Withdrawal Liability Reforms**

Modifies rules on employers withdrawing from multi-employer pension plans. Employers are subject to withdrawal liability for unfunded vested benefits. This section repeals the limitation on the withdrawal liability of insolvent employers, and updates rules relating withdrawal liability based on the employer's net worth.

- **Section 205 Prohibition on Retaliation Against Employers Exercising their Rights to Petition the Federal Government**

Updates Section 510 ERISA, making it "unlawful for the plan sponsor or any other person to discriminate against any contributing employer for exercising rights under this Act or for giving information or testifying in any inquiry or proceeding relating to this Act before Congress."

- **Section 206 Special Rule for Certain Benefits Funded Under an Agreement Approved by the Pension Benefit Guaranty Corporation**

Provides special waivers to changes made by sections 201, 202, 211, and 212 of the PPA for benefit increases under plan amendments adopted prior to June 30, 2005, if the multi-employer plan is operating in compliance with an agreement approved by the Pension Benefit Guaranty Corporation prior to that date.

#### Subtitle B - Amendments to the Internal Revenue Code of 1986

- **Section 211 Funding Rules for Multi-Employer Defined Benefit Plans**

Provides conforming changes to multi-employer funding rules.

- **Section 212 Additional Funding Rules for Multi-Employer Plans in Endangered or Critical Status**

Provides conforming funding rule changes to multi-employer plans which are "endangered" or "critical."

- **Section 213 Measures to Forestall Insolvency of Multi-Employer Plans**

Provides conforming changes to forestall insolvency of multi-employer plans.

- **Section 214 Exemption from Excise Taxes for Certain Multi-Employer Pension Plans**

Provides exemptions from excise taxes imposed under section 4971 of the Internal Revenue Code of 1986 with respect to accumulated funding deficiencies of certain multi-employer plans.

**Subtitle C - Sunset of Additional Funding Rules**

- **Section 221 Sunset of Additional Funding Rules**

Requires the Secretaries of Labor and the Treasury, and the Executive Director of the PBGC to conduct a study of the effect of the amendments made by this subtitle on the operation and funding status of multi-employer plans, and to report the results of the study, including any recommendations for legislation, to Congress by December 31, 2011.

***Title III - Interest Rate Assumptions***

- **Section 301 Extension of Replacement of 30-year Treasury Rates**

Provides for the extension of the substitution of long-term corporate bond interest rates for the 30-year U.S. Treasury bond rate for plan funding and PBGC premiums until 2007.

- **Section 302 Interest Rate Assumption for Determination of Lump Sum Distributions**

Changes the method for calculating lump sum payments to participants or beneficiaries, and requires plans to use specified interest and mortality assumptions.

- **Section 303 Interest Rate Assumption for Applying Benefit Limitations to Lump Sum Distributions**

Specifies interest rates which must be used to calculate benefit limitations on lump sum distributions. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

***Title IV - PBGC Guarantee and Related Provisions***

- **Section 401 PBGC Premiums**

Single-employer plans which have unfunded vested benefits must pay PBGC a variable rate premium. This section extends the temporary variable rate premium methodology which was set to expire for the 2005 plan year to 2007, and makes permanent the plan termination premiums enacted by the Deficit Reduction Act of 2005.

- **Section 402 Special Funding Rules for Certain Plans Maintained by Commercial Airlines**

Enacts special alternate funding rules designed to provide financial relief for eligible commercial airline retirement plans.

- **Section 403 Limitation on PBGC Guarantee of Shutdown and Other Benefits**

Limits PBGC liability in cases where plan amendments trigger "shutdown" or other "unpredictable contingent event" increased benefits by permitting the PBGC to phase in the increased benefits over a five-year period.

- **Section 404 Rules Relating to Bankruptcy of Employer**

Treats an employer's bankruptcy date as the plan's termination date for use in determining PBGC benefit liabilities.

- **Section 405 PBGC Premiums for Small Plans**

Permits employers with 25 or fewer employees to pay a reduced variable rate premium for each participant equal to \$5 per plan participant.

- **Section 406 Authorization for PBGC to Pay Interest on Premium Overpayment Refunds**

Authorizes the PBGC pay interest on premium overpayments which are refunded.

- Section 407 Rules for Substantial Owner Benefits in Terminated Plans

This section applies "majority owner" (50% or more owner) rules for "substantial owner" (10% to 49% owner) rules when calculating PBGC benefit limitations. The section also modifies the asset allocation rules relating to "majority owners."

- Section 408 Acceleration of PBGC Computation of Benefits Attributable to Recoveries from Employers

Modifies the calculation by which the PBGC shares recoveries from the employer with participants.

- Section 409 Treatment of Certain Plans Where Cessation or Change in Membership of a Controlled Group

This section permits the use of a plan's interest rate to be used in the determination of benefit liabilities where certain changes occur in the plan's membership.

- Section 410 Missing Participants

This section requires the PBGC to expand the scope of its missing participant program, which is currently limited to terminating single employer defined benefit plans. Future coverage would include terminating single employer defined contribution plans, and terminating defined benefit and defined contribution multi-employer plans.

- Section 411 Director of the Pension Benefit Guaranty Corporation

This section changes the PBGC Director's position to a presidential appointment subject to Senate confirmation.

- Section 412 Inclusion of Information in the PBGC Annual Report

This section requires the PBGC to amend its annual report to detail specific parameters and values, and to make specific comparisons in a summary of its Pension Insurance Modeling System microsimulation model.

### ***Title V - Disclosure***

- Section 501 Defined Benefit Plan Funding Notice

This section expands the coverage of summary annual report (SAR) requirements to include single employer plans, and expands SAR content to add specific participant disclosures.

- Section 502 Access to Multi-Employer Pension Plan Information

This section requires multi-employer plan administrators to provide specific actuarial and financial information, including an estimation of potential withdrawal liabilities for those obligated to contribute to the plan, upon the written request of participants, beneficiaries, unions, and contributing employers.

- Section 503 Additional Annual Reporting Requirements

Expands information covered by the annual Form 5500 report of defined benefit plans. Additional information is required for plans whose liabilities consist of liabilities under 2 or more plans from any preceding year, as well as additional statistical information for multi-employer plans.

- Section 504 Electronic Display of Annual Report Information

This section requires the DOL to provide annual Form 5500 report information in electronic form within 90 days after receiving it. Employers (with intranet websites) must also provide this data on their intranet websites.

- **Section 505 Section 4010 Filings with the PBGC**

This section amends the filing requirements of Section 4010(b) of ERISA, substituting a percentage trigger (less than 80% of the plan's funding target) in place of a plan's asset value trigger (\$50 million). Plans failing to attain 80% of their funding target at the end of their preceding year must provide the PBGC a non-public report containing actuarial data, potential termination liabilities, and employer financial data.

- **Section 506 Disclosure of Termination Information to Plan Participants**

Requires plans terminating under "distress" or involuntary termination proceedings to provide participants with copies of previously confidential information provided to the PBGC.

- **Section 507 Notice of Freedom to Divest Employer Securities**

Amends Section 101(m) of ERISA by requiring plan administrators to notify participants of their right to divest employer securities 30 days before the first date on which they are eligible to do so. The notification must also explain the importance of diversifying retirement assets.

- **Section 508 Periodic Pension Benefit Statements**

This section directs single and multi-employer plans to regularly furnish benefit statements to participants. Defined benefit plans must furnish the information every three years or upon request. Defined contribution plans must furnish the information annually, unless the plan provides for participant investment direction, in which case it must provide the information quarterly. Failure to provide the information is subject to penalty. Refer also to US Department of Labor Field Assistance Bulletin 2006-03.

- **Section 509 Notice to Participants or Beneficiaries of Blackout Periods**

This section eliminates the requirement that one-person and partner-only plans provide "blackout notices" of periods during which participants are not permitted to self-direct investments.

### ***Title VI - Investment Advice, Prohibited Transactions, and Fiduciary Rules***

The Pension Protection Act of 2006 (PPA) added a number of key exemptions to existing Internal Revenue Code (Code) and Employee Retirement Income Security Act (ERISA) prohibited transaction rules. The new exemptions permit plans and fiduciaries, under specified conditions and requirements: to provide investment advice for a fee; to engage in block trades with previously disqualified persons; to engage in "blind" securities transactions between a plan and a party-in-interest using electronic networks; to enter into transactions with party-in-interest plan service providers; to engage in foreign exchange transactions with trustees and other parties-in-interest; to engage in cross trading with other accounts managed by the same adviser; to correct securities and commodities transactions which inadvertently violated nonfiduciary prohibited transaction rules; and to invest participant directed assets in default investment arrangements.

#### **Subtitle A - Investment Advice**

- **Section 601 Exemption for Fiduciary Advisers**

Section 601 of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions under ERISA Section 408(b)(14), and Section 4975(d)(17) of the IRC of 1986. Under specific conditions, investment advice for a fee previously prohibited to certain parties-in-interest may be provided to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan, and to beneficiaries of IRAs, HSAs, Archer MSAs, and Coverdell education savings accounts. If the requirements under the provision are met, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice; (2) an investment transaction (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. The

exemptions apply in connection with investment advice provided by a fiduciary adviser under an "eligible investment advice arrangement." An eligible investment advice arrangement is an arrangement (1) meeting certain requirements (discussed below) and (2) which either (a) provides that any fees (including any commission or compensation) received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected, or (b) uses a computer model under an investment advice program as described below in connection with the provision of investment advice to a participant or beneficiary. In the case of an eligible investment advice arrangement with respect to a defined contribution plan, the arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan, or (3) any affiliate of (1) or (2). Although employers and plan fiduciaries retain fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary advisers, they are not under the duty to monitor the specific investment advice given by a fiduciary adviser. Moreover, the exemption also provides that fiduciary responsibility provisions of ERISA do not preclude the use of plan assets to pay for reasonable expenses in providing investment advice. Refer also to US Department of Labor Field Assistance Bulletin 2007-01.

- **Fiduciary Adviser**

A "fiduciary adviser" is defined as a person who is a fiduciary of the plan by reason of the provision of investment advice to a participant or beneficiary and who is also: (1) registered as an investment adviser under the Investment Advisers Act of 1940 or under State laws; (2) a bank, a similar financial institution supervised by the United States or a State, or a savings association (as defined under the Federal Deposit Insurance Act), but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities; (3) an insurance company qualified to do business under State law; (4) registered as a broker or dealer under the Securities Exchange Act of 1934; (5) an affiliate of any of the preceding; or (6) an employee, agent or registered representative of any of the preceding who satisfies the requirements of applicable insurance, banking and securities laws relating to the provision of advice. A person who develops the computer model or markets the investment advice program or computer model is treated as a person who is a plan fiduciary by reason of the provision of investment advice and is treated as a fiduciary adviser, except that the Secretary may prescribe rules under which only one fiduciary adviser may elect treatment as a plan fiduciary. "Affiliate" means an affiliated person as defined under section 2(a)(3) of the Investment Company Act of 1940.

- **Eligible Investment Advice Arrangement Requirements:**

- **Investment Advice Program Using Computer Model**

Arrangements providing investment advice pursuant to a computer model (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, (2) use relevant information about the participant or beneficiary, (3) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan, (4) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person, and (5) take into account all the investment options under the plan in specifying how a participant's or beneficiary's account should be invested without inappropriate weighting of any investment option. An eligible investment expert must certify, before the model is used and in accordance with rules prescribed by the Secretary of Labor, that the model meets these requirements. The certification must be renewed if there are material changes to the model as determined under regulations. In addition, if a computer model is used, the only investment advice that may be provided is the advice generated by the computer model, and any investment transaction pursuant the advice must occur solely at the direction of the participant or beneficiary. This requirement does not preclude the participant or beneficiary from requesting other investment advice, but only if the request has not been solicited by any person connected with carrying out the investment advice arrangement.

- **Audit Requirements**

With respect to a defined contribution plans, an annual audit of the arrangement for compliance with applicable requirements must be conducted by an independent auditor (unrelated to the person offering investment advice or any person providing investment options under the plan) who has appropriate technical training or experience and proficiency and who so represents in writing. The auditor must issue a report of the audit results to the fiduciary

that authorized use of the arrangement. In the case of an eligible investment advice arrangement with respect to IRAs, an audit is required at such times and in such manner as prescribed by the Secretary of Labor.

- **Notice Requirements**

Before providing investment advice, a fiduciary adviser must provide written notice (which may be in electronic form) containing various information to the recipient of the advice, including information relating to: (1) the role of any related party in the development of the investment advice program or the selection of investment options under the plan; (2) past performance and rates of return for each investment option offered under the plan; (3) any fees or other compensation to be received by the fiduciary adviser or affiliate; (4) any material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction; (5) the manner and under what circumstances any participant or beneficiary information will be used or disclosed; (6) the types of services provided by the fiduciary adviser in connection with the provision of investment advice; (7) the adviser's status as a fiduciary of the plan in connection with the provision of the advice; and (8) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. This information must be maintained in accurate form and must be provided to the recipient of the investment advice, without charge, on an annual basis, on request, or in the case of any material change. Any notification must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and sufficiently accurate and comprehensive so as to reasonably apprise participants and beneficiaries of the required information. The Secretary is directed to issue a model form for the disclosure of fees and other compensation as required by the provision. The fiduciary adviser must maintain for at least six years any records necessary for determining whether the requirements for the prohibited transaction exemption were met. A prohibited transaction will not be considered to have occurred solely because records were lost or destroyed before the end of six years due to circumstances beyond the adviser's control.

- **Other Requirements**

In order for the exemption to apply, the following additional requirements must be satisfied: (1) the fiduciary adviser must provide disclosures applicable under securities laws; (2) an investment transaction must occur solely at the direction of the recipient of the advice; (3) compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable; and (4) the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

#### Subtitle B - Prohibited Transactions

- **Section 611(a) Exemption for Block Trading**

Section 611(a) of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions under ERISA Section 408(b)(15), and Section 4975(d)(18) of the IRC of 1986. The exemptions provide statutory relief for a purchase or sale of securities or other property (as determined by the Secretary of Labor) between a plan and a disqualified person (other than a fiduciary) involving a block trade if: (1) the transaction involves a block trade; (2) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor) does not exceed 10 percent of the aggregate size of the block trade; (3) the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction with an unrelated party; and (4) the compensation associated with the transaction is no greater than the compensation associated with an arm's length transaction with an unrelated party. For purposes of the provision, a block trade is defined as any trade of at least 10,000 shares or with a market value of at least \$200,000 that will be allocated across two or more unrelated client accounts of a fiduciary. Examples of property other than securities that the Secretary of labor may apply the exemption to include futures contracts and currency.

A "disqualified person" is defined in ERISA Section 3(14) (under "party-in-interest") and in IRC Section 4975(e)(2) as:

- Any fiduciary (including, but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan
- A person providing services to such plan

- An employer any of whose employees are covered by such plan
- An employee organization any of whose members are covered by such plan
- An owner, direct or indirect, of 50 percent or more of -
  - The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation.
  - The capital interest or the profits interest of a partnership, or
  - The beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);
- A relative (as defined in paragraph (15)) of any individual described in subparagraph (A), (B), (C), or (E);
- A corporation, partnership, or trust or estate of which (or in which) 50 percent or more of -
  - The combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,
  - The capital interest or profits interest of such partnership, or
  - The beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);
- An employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or
- A 10 percent or more (directly or indirectly in capital or profits) partner or joint venturer of a person described in subparagraph (B), (C), (D), (E), or (G).

A "fiduciary" is defined in ERISA Section 3(21) and in IRC Section 4975(e)(3) as any person who: (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

- **Section 611(c) Exemption for Electronic Communications Network**

Section 611(c) of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions under ERISA Section 408(b)(16), and Section 4975(d)(19) of the IRC of 1986. Present law does not provide a statutory prohibited transaction exemption for transactions made through an electronic communication network, but such transactions may be permitted if the parties are not known to each other (a "blind" transaction). Section 611(c) provides prohibited transaction exemptions for transactions involving the purchase or sale of securities (or other property as determined under regulations, including futures contracts and currency) 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 that is subject to regulation and oversight by: (a) the applicable Federal regulating entity, or (b) a foreign regulatory entity, as the Secretary may determine under regulations;
- either: (a) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades, or (b) the transaction is effected under rules designed to match purchases and sales at the best price available through the execution system in accordance with rules of the SEC or other relevant governmental authority;
- the price and compensation associated with the purchase and sale are not greater than an arm's length transaction with an unrelated party;
- if the disqualified person has an ownership interest in the system or venue, the system or venue has been authorized by the plan sponsor or other independent fiduciary for this type of transaction; and
- not less than 30 days before the first transaction of this type, a plan fiduciary is provided written notice of the execution of the transaction through the system or venue.

- **Section 611(d) Exemption for Party-In-Interest Service Providers**

Section 611(d) of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions from ERISA Sections 406(b)(1)(A),(B), and (D), under ERISA Section 408(b)(17), and Section 4975(d)(20) of the IRC of 1986. The exemptions provide statutory relief for transactions involving the sale of property, loans, and transfers or use of plan assets between a plan and a party in interest (individuals or entities treated under ERISA as a "**party in interest**" solely by reason of providing the services in question, or solely by having certain relationships with a service provider). The exemption is conditioned by the plan receiving no less, nor paying more, than "adequate consideration" for the services provided. The term "adequate consideration" (ERISA Section 3(18)) includes, (a) in the case of a security for which there is a generally recognized market, the price of the security prevailing on a national securities exchange registered under the Securities Exchange Act of 1934, or, if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any disqualified person, and (b) in the case of an asset other than a security, the fair market value of the asset as determined in good faith by a fiduciary or named fiduciaries in accordance with regulations. The exemption does not apply to a fiduciary or affiliate having or exercising investment discretion or investment advice over plan assets.

- Section 611(e) Exemption for Foreign Exchange Transactions

Section 611(e) of Title VI of the Pension Protection Act of 2006 provides foreign exchange prohibited transaction exemptions from ERISA Section 406 under ERISA Section 408(b)(18), and Section 4975(d)(21) of the IRC of 1986. Present law does not provide a statutory prohibited transaction exemption for foreign exchange transactions. Section 611(e) provides a prohibited transaction exemption under ERISA and the Code for foreign exchange transactions between a bank, broker-dealer (or an affiliate of either), and a plan in connection with the sale, purchase, or holding of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets) if:

- at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than terms generally available in comparable arm's length foreign exchange transactions between unrelated parties, or terms afforded by the bank, broker-dealer (or any affiliate thereof), in comparable arm's-length foreign exchange transactions involving unrelated parties;
- the exchange rate used for a particular foreign exchange transaction does not deviate by more than three percent from the interbank bid and asked rates (at the time of the transaction for transactions of comparable size and maturity) as reported by independent foreign currency exchange services; and
- the bank, broker-dealer (and any affiliate of either), does not have investment discretion or provide investment advice with respect to the transaction.

- Section 611(g) Exemption for Cross Trading

Section 611(g) of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions from ERISA Sections 406(b)(1)(A), and 406(b)(2), under ERISA Section 408(b)(19), and Section 4975(d)(22) of the IRC of 1986. The provision provides prohibited transaction exemptions under ERISA and the Code for transactions involving the purchase and sale of a security between a plan (generally a plan whose assets aggregate \$100 million or greater) and any other account managed by the same investment manager if the following requirements are met:

- 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 readily available);
- the transaction is effected at the independent current market price of the security;
- no brokerage commission fee (except for customary transfer fees which must be disclosed) or other remuneration is paid in connection with the transaction;
- a fiduciary (other than the investment manager engaging in the cross trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document separate from any other written agreement) the investment manager to engage in cross trades at the investment manager's discretion, after the fiduciary has received disclosure: (a) regarding the conditions under which cross trades may take place (in a disclosure separate from any other agreement or disclosure involving the asset management relationship), (b) which includes the investment manager's written policies and procedures;

- each plan participating in the transaction has assets of at least \$100,000,000, except that, if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust has assets of at least \$100,000,000;
- the investment manager provides to the plan fiduciary who has authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information as applicable: (a) the identity of each security bought or sold, (b) the number of shares or units traded, (c) the parties involved in the cross trade, and (d) 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 the 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, including (a) a description of the manager's pricing policies and procedures, and (b) the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and
- the investment manager has designated an individual responsible for (a) periodically reviewing purchases and sales to ensure compliance with the written policies and procedures and, (b) following such review, the individual must 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, (i) describing the steps performed during the course of the review, (ii) the level of compliance, and (iii) any specific instances of noncompliance. 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.

The Secretary of Labor, after consultation with the Securities and Exchange Commission, is directed to issue regulations regarding the content of policies and procedures required to be adopted by an investment manager under the requirements for the exemption within 180 days from date of enactment (August 17, 2006).

Refer also to US Department of Labor Cross Trading Statutory Exemption.

- **Section 612 Exemption for Certain Corrected Party-in-Interest Transactions Involving Securities and Commodities**

Section 612 of Title VI of the Pension Protection Act of 2006 provides prohibited transaction exemptions from ERISA Section 406(a) under ERISA Section 408(b)(20), and Section 4975(d)(23) of the IRC of 1986. ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person (referred to as a "party in interest" under ERISA). For purposes of these rules, the "amount involved" generally means the greater of (1) the amount of money and the fair market value of the other property given, or (2) the amount of money and the fair market value of other property received by the plan. The terms "correction" and "correct" mean, with respect to a prohibited transaction, undoing the transaction to the extent possible (but in any case placing the plan in a financial position not worse than the position in which it would be if the disqualified person were acting under the highest fiduciary standards). For purposes of the prohibited transaction rules of the Code and ERISA, a transaction involving the sale of securities is considered to occur when the transaction is settled (the actual change in ownership of the securities). Under current practice, securities transactions are commonly settled 3 days after the agreement to sell is made. Present law does not provide a statutory prohibited transaction exemption that is based solely on correction of the transaction. Section 612 provides a prohibited transaction exemption under ERISA and the Code for a transaction in connection with the acquisition, holding, or disposition of any security or commodity if the transaction is corrected within a certain period, generally within 14 days of the date the disqualified person (or other person knowingly participating in the transaction) discovers, or reasonably should have discovered, the transaction was a prohibited transaction. For this purpose, the term "correct" means, with respect to a transaction:

- to undo the transaction to the extent possible and in any case to make good to the plan or affected account any losses resulting from the transaction; and
- to restore to the plan or affected account any profits made through the use of assets of the plan.

If the exemption applies, no excise tax may be assessed with the transaction, any tax assessed may be abated, and any tax collected may be credited or refunded as a tax overpayment. The exemption does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of an employer security or the acquisition, sale, or lease of employer real property. In addition, in the case of a disqualified person (or other person knowingly participating in

the transaction), the exemption does not apply if, at the time of the transaction, the person knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.

#### Subtitle C - Fiduciary and Other Rule

- Section 621 Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participant or Beneficiary to Direct Investments

This section removes a plan fiduciary's protection during blackout periods when participants cannot self-direct investments unless the blackout period relates to a qualified change in investment options.

- Section 622 Increase in Maximum Bond Amount

This section increases fiduciary bonding requirements from \$500,000 to \$1 million for plans which hold employer securities.

- Section 623 Increase in Penalties for Coercive Interference with Exercise of ERISA Rights

This section increases penalties for coercive interference with ERISA rights a \$100,000 fine and three years in prison.

- Section 624 Default Investments Where Plan Participants Fail to Exercise Investment Options

Section 624 of Title VI of the Pension Protection Act of 2006 expands protections to fiduciaries of plans that provide for participant investment direction where a participant fails to affirmatively elect an investment option under the plan. It adds a new subsection to the fiduciary duties standards of ERISA (Section 404(c)(5)), which treats participants as exercising investment control over their account assets if the assets are invested in a default arrangement in accordance with Department of Labor regulations. On October 24, 2007 the DOL issued a final rule which would add subsection 2550.404c-5 (PDF) to 29 CFR Part 2550. The regulation provides guidance on the appropriateness of investments designated as default investments under the default investment arrangement, including guidance regarding mixes of default investments and asset classes which the Secretary of Labor considers consistent with long-term capital appreciation or long-term capital preservation, and the designation of other default investments. The proposed rule requires notification of a participant's rights and obligations under the arrangement. Plan administrators are required to give each participant notice of their rights and obligations under the arrangement within a reasonable period before the plan year begins. The notice must include an explanation of a participant's right to exercise investment control over the participant's assets in the plan. The participant must have a reasonable period of time, after receipt of the notice and before the assets are first invested, to make an investment election. The notice must also explain how the participant's assets will be invested in the absence of any investment election.

- Section 625 Clarification of Fiduciary Rule

Requires the Secretary of Labor to issue regulations by August 2007 which clarify the selection of an annuity contract as an optional form of distribution to a participant or beneficiary from individual account plans.

#### ***Title VII - Benefit Accrual Standards***

- Section 701 Benefit Accrual Standard

This section enacts rules for testing defined benefit plans which are converted to hybrid plans for age discrimination under the Code, ERISA, and the Age Discrimination in Employment Act (ADEA). "Wearaway" of participant benefits at conversion is prohibited. ("Wearaway" is a transitional device offered employees with long service when traditional defined benefit pension plans are converted to cash balance plans. In the past, "wearaway" has provided employees the option of receiving the greater of their frozen benefit under the phased out pension plan, or their total benefit under a cash balance plan. Employees near early retirement age may accrue little or nothing for a prolonged period under a cash balance plan until the phased out plan benefit is worn away. This is because the value of the traditional pension plan benefit may be greater than future accruals under cash balance plans.) Age discrimination prohibitions will not be treated as violated upon conversion if a participant's accrued benefit is equal to or greater than that of any "similarly situated younger individual."

Benefit accrual standards apply to plan conversion amendments beginning June 29, 2005. IRS Revenue Ruling Notice 2007–6 provides transitional guidance on the requirements of sections 411(a)(13) and 411(b)(5) of the Code as added by Section 701(b) of the Pension Protection Act of 2006. Refer also to IRS Revenue Ruling Notice 2007-06.

- Section 702 Regulations Relating to Mergers and Acquisitions

This section requires the Secretary of the Treasury to issue regulations for the application of this title "in cases where the conversion of a plan to an applicable defined benefit plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar transaction."

### ***Title VIII - Pension Related Revenue Provisions***

#### **Subtitle A - Deduction Limitations**

- Section 801 Increase in Deduction Limit for Single Employer Plans

Increases the maximum deductible amount for single employer plan contributions equal to the cost of benefits accrued plus the amount needed to meet the funding target. Employers may also contribute a cushion for the plan year equal to 50% of the funding target plus "the amount by which the funding target for the plan year would increase if the plan were to take into account ...increases in compensation which are expected to occur in succeeding plan years."

- Section 802 Deduction Limits for Multi-Employer Plans

Increases the maximum deductible amount for multi-employer plan contributions equal to "the excess (if any) of 140 percent of the current liability of the plan...over the value of the plan's assets."

- Section 803 Updating Deduction Rules for Combination of Plans

Raises the combined maximum deduction limit for employers sponsoring both defined benefit and defined contribution plans.

#### **Subtitle B - Certain Pension Provisions Made Permanent**

- Section 811 Pensions and Individual Retirement Arrangement Provisions of EGTRRA of 2001 Made Permanent

Makes permanent the pension and IRA changes brought about by subtitles A through F of Title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001. These include increased IRA, Defined Benefit Plan, and Defined Contribution Plan limits; Catch-up contributions for individuals age 50 and over; automatic rollovers of certain distributions into IRAs; and deemed IRAs under qualified employer plans, among others. Refer also to US Department of Labor Auto IRA Rollover Safe Harbor Rule 2550.404a-2.

- Section 812 Saver's Credit

Makes the Saver's Credit under Section 25B of the Internal Revenue Code of 1986 permanent.

#### **Subtitle C - Improvements in Portability, Distribution and Contribution Rules**

- Section 821 Clarifications Regarding Purchase of Permissive Service Credit

Amends the Code to permit participants of state and local retirement plans to purchase of service credits from prior government employers. It also allows trustee to trustee transfers from 403(b) or 457(e) plans to purchase service credits.

- Section 822 Allow Rollover of After-Tax Amounts in Annuity Contracts

Permits an individual to roll over after-tax amounts in 403(b) annuity contracts to a qualified plan.

- **Section 823 Clarification of Minimum Distribution Rules for Governmental Plans**

Requires the Treasury to issue regulations providing governmental plans relief from minimum distribution (age 70 1/2) rules.

- **Section 824 Allow Direct Rollovers from Retirement Plans to Roth IRAs**

Beginning in 2007, this section permits individuals with adjusted gross income under \$100,000 to roll over money from qualified defined benefit and defined contribution plans, 403(b) annuity, or 457 plan to a Roth IRA. This eliminates the previous requirement of first rolling money into a traditional IRA, before performing a second rollover into a Roth IRA. The money rolled over remains includible in gross income and subject to tax, but it is exempt from the 10% early withdrawal penalty.

- **Section 825 Eligibility for Participation in Retirement Plans**

This section permits individuals who received distributions from a section 457(b) plan of the Code prior to the amendments of the Small Business Job Protection Act of 1996 to participate in an eligible deferred compensation plan under section 457.

- **Section 826 Modifications of Rules Governing Hardships and Unforeseen Financial Emergencies**

This section directs the Secretary of the Treasury to issue regulations to modify the hardship regulations which permit a hardship or unforeseeable financial emergency distribution from section 401(k), section 403(b), and section 457(b) plans. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

- **Section 827 Penalty-Free Withdrawals from Retirement Plans for Individuals Called to Active Duty for at Least 179 Days**

This section amends Code section 72(t) to eliminate the 10% early withdrawal penalty for "qualified reservist distributions" (for reservists called to active duty for more than 179 days between September 11, 2001 and December 31, 2007). The distribution must be made from elective deferrals under a 401(k) or 403(b) plan, or from a traditional or Roth IRA during the active duty period. The distribution may be contributed into an IRA outside the maximum contribution limits within two years after the active duty ends.

- **Section 828 Waiver of 10 Percent Early Withdrawal Penalty Tax on Certain Distributions of Pension Plans for Public Safety Employees**

This section amends Code section 72(t) to eliminate the 10% premature distribution penalty for public safety employees (police, firefighter or EMT) in governmental defined benefit plans who retire after age 50. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

- **Section 829 Allow Rollovers by Non-spouse Beneficiaries of Certain Retirement Plan Distributions**

This section amends the Code to permit non-spouse beneficiaries to roll over distributions from qualified retirement plans, section 403(b) and 457(b) governmental plans to an IRA. The IRA is an "inherited" individual retirement account, subject to minimum distribution rules applicable to IRA beneficiaries, rather than the five-year rule for distributions from a qualified plan. Refer also to IRS Pension Protection Act Changes Notice 2007-7, and DOL Amendments to Safe Harbor for Distributions From Terminated Individual Account Plans and Termination of Abandoned Individual Account Plans.

- **Section 830 Direct Payment of Tax Refunds to Individual Retirement Plans**

This section requires the IRS to permit taxpayers to direct deposit tax refunds into the taxpayer's IRA.

- **Section 831 Allowance of Additional IRA Payments in Certain Bankruptcy Cases**

This section permits individuals aged 50 and over who worked for a bankrupt employer "subject to an indictment or conviction resulting from business transactions related to such case," and whose employer had a least a 50% match in the form of employer stock in its 401(k) plan, to make additional IRA catch-up contributions of up to three times the otherwise applicable amount. The contributions can be made for years 2007, 2008, and 2009.

- Section 832 Determination of Average Compensation for Section 415 Limits

This section modifies the compensation test under section 415(b)(3) of the Code to permit compensation earned while working for the employer, not only while a plan participant to be counted towards defined benefit plan benefit limits.

- Section 833 Inflation Indexing of Gross Income Limitations on Certain Retirement Savings Incentives

This section provides for indexing adjusted gross income levels for the Saver's Credit by modifying section 25B of the Code to index gross income limits for claiming the Saver's Credit. It also amends sections 219(g) and 408A(c)(3) of the Code to provide inflation adjustments (in \$1,000 increments) to the income limits for determining eligibility for traditional IRA and Roth IRA, respectively.

#### Subtitle D - Health and Medical Benefits

- Section 841 Use of Excess Pension Assets for Future Retiree Health Benefits and Collectively Bargained Retiree Health Benefits

This section lowers the required "excess assets" threshold (from 125% to 120%) to permit the transfer of assets from single employer defined benefit plans to retiree medical accounts covered by the same plan to defray liabilities of future retiree medical costs. During the transfer period, the defined benefit plan must be kept at the minimum funding level.

- Section 842 Transfer of Excess Pension Assets to Multi-Employer Health Plan

This section applies the right of single employer plans to transfer "excess assets" to a health plan to multi-employer pension plans. An identical 120% "excess assets" threshold is needed to permit the transfer. During the transfer period, the defined benefit plan must be kept at the minimum funding level.

- Section 843 Allowance of Reserve for Medical Benefits of Plans Sponsored by Bona Fide Associations

This section amends 419A(c) of the Code to permit a plan maintained by "bona fide associations" (as defined in section 2791(d)(3) of the Public Health Service Act) to add reserves to the plan of up to 35% of qualified direct annual costs for medical benefits (other than post-retirement medical benefits).

- Section 844 Treatment of Annuity and Life Insurance Contracts with a Long-Term Care Insurance Feature

This section permits annuity contracts to offer long-term care (LTC) contracts, and provides special tax treatment for the LTC component of contract. Among these is the ability to use the cash value of the contract to pay for the LTC benefit.

- Section 845 Distributions from Governmental Retirement Plans for Health and Long-Term Care Insurance for Public Safety Officers

This section amends section 402 of the Code to allow eligible retired "public safety officers" (as defined by section 1204(9)(A) of the Omnibus Crime Control and Safe Streets Act of 1968) to elect to exclude up to \$3,000 of their retirement benefits from federal gross income if it is applied toward the cost of health insurance or long term care insurance premiums. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

#### Subtitle E - United States Tax Court Modernization

- Section 851 Cost-of-Living Adjustments for Tax Court Judicial Survivor Annuities

This section conforms the method used to adjust annuities paid to survivors of Tax Court judges to the method used to adjust the cost-of-living increases paid under the Civil Service Retirement System.

- Section 852 Cost of Life Insurance Coverage for Tax Court Judges Age 65 or Over

This section directs the Tax Court to pay increases in employee premiums under the Federal Employee Group Life Insurance program on behalf of Tax Court judges age 65 or over.

- Section 853 Participation of Tax Court Judges in the Thrift Savings Plan

This section permits Tax Court judges to participate in the Federal Thrift Savings Plan.

- Section 854 Annuities to Surviving Spouses and Dependent Children of Special Trial Judges of the Tax Court

This section permits special trial judges of the Tax Court to participate in the Tax Court judges survival annuity plan.

- Section 855 Jurisdiction of Tax Court Over Collection Due Process Cases

This section transfers the jurisdiction for the review of taxpayer tax liability from the District Courts to the Tax Court.

- Section 856 Provisions for Recall

This section permits the Chief Judge to recall retired special trial judges to active service for up to 90 days annually.

- Section 857 Authority for Special Trial Judges to Hear and Decide Certain Employment Status Cases

This section authorizes the Tax Court to permit special trial judges to render employment decisions under section 7436(c) of the Code.

- Section 858 Confirmation of Authority of Tax Court to Apply Doctrine of Equitable Recoupment

This section confirms the statutory held by the Tax Court to apply equitable recoupment under Section 6214(b) of the Code "to same extent that it is available in civil tax cases before the district courts of the United States and the United States Court of Federal Claims."

- Section 859 Tax Court Filing Fee in All Cases Commenced by Filing Petition

This section confirms that the Tax Court is authorized under Section 7451 of the Code to impose a filing fee for tax court petitions.

- Section 860 Expanded Use of Tax Court Practice Fee for Pro Se Taxpayers

This section authorizes the Tax Court to use fees to provide services which assist pro se taxpayers appearing before the Court.

#### Subtitle F - Other Provisions

- Section 861 Extension to All Governmental Plans of Current Moratorium on Application of Certain Nondiscrimination Rules Applicable to State and Local Plans

This section extends the moratorium on the IRS disqualifying state and local governmental plans on the basis of violating nondiscrimination rules using by as a comparison the nondiscriminatory provisions of federal plans.

- Section 862 Elimination of Aggregate Limit for Usage of Excess Funds from Black Lung Disability Trusts

This section eliminates the limit on transfers coal employers are permitted to make from black lung disability trusts to pay for accident and health benefits or premiums.

- Section 863 Treatment of Death Benefits from Corporate-Owned Life Insurance

This section requires proceeds from corporate owned life insurance to be treated as income unless the insured was an employee within 12 months of death, or the insured was a "highly compensated employee" (employees owning more than 5%, directors, and employees in the top 35% salary category). The sole exception involves proceeds paid to an insured's beneficiary and which are used to buy back an equity interest owned at the time of death.

- Section 864 Treatment of Test Room Supervisors and Proctors who Assist in the Administration of College Entrance and Placement Exams

This section amends Section 530 of the Revenue Reconciliation Act of 1978 to treat test room supervisors and proctors who assist in the administration of college entrance examinations as independent contractors.

- Section 865 Grandfather Rule for Church Plans Which Self-Annuitize

This section allows qualified church plans (under section 401(a) of the Code) which self-annuitize distributions to avoid minimum distribution violations if the plans otherwise comply with the requirements of section 403(b)(9) of the Code.

- Section 866 Exemption for Income from Leveraged Real Estate Held by Church Plans

This section exempts church annuity plans from the imposition of unrelated business income tax on leveraged real estate investments.

- Section 867 Church Plan Rule

This section eliminates the maximum benefit that participants can receive from defined benefit plans under the Code for non-highly compensated employees covered by church plans.

- Section 868 Gratuitous Transfer for Benefits of Employees

This section specifies that the value used under section 664(g)(3) of the Code when allocating gratuitous transfers to an ESOP is to be equal to the "fair market value of securities ... allocated..."

### ***Title IX - Increase in Pension Plan Diversification and Participation***

- Section 901 Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets

Amends Section 401(a) of the Code by requiring qualified pension, profit-sharing, and stock bonus plans which invest in "publicly traded employer securities" to offer plan participants at least 3 investment options, other than employer securities, to "direct the proceeds from the divestment of employer securities...each of which is diversified and has materially different risk and return characteristics." Participants must be given the opportunity to divest and reinvest employer securities at least quarterly. Existing plans may phase in diversification of employer securities over a three-year period. However, participants aged 55 or over who have completed at least 3 years of service are exempted from the three-year phase in period. The new diversification requirements are not applicable to ESOPs which do not provide for elective, employee, or matching contributions, nor do they apply to "one participant retirement plans."

- Section 902 Increasing Participation Through Automatic Contribution Arrangements

Amends Section 401(k) of the code to provide for "qualified automatic contribution arrangements" designed to automatically enroll employees in a retirement plan unless they affirmatively elect not to participate in the plan. At a minimum, these plans

must provide for (a) automatic deferral of compensation, (b) nonelective contributions and a two-year vesting period, and (c) an annual notice of participant rights. Investments in these plans qualify for fiduciary relief under a Department of Labor Rule (Section 2550.404c-5 (PDF)). The proposed rule provides fiduciary relief for investments in "qualified default investment alternatives" in the absence of the participant's investment direction.

- **Section 903 Treatment of Eligible Combined Defined Benefit Plans and Qualified Cash or Deferred Arrangements**

Adds section 414(x) to the Code creating new "Combined Defined Benefit Plans" for employers with 500 or fewer employees. The combined plan is governed under one document which provides for both a defined benefit plan, and a deferred contribution plan with an automatic enrollment feature. Assets of the plans are held in a single trust, but must be identifiable and allocated to each of the defined benefit and defined contribution portions of the plan.

- **Section 904 Faster Vesting of Employer Nonelective Contributions**

Amends Section 411(a) of the Code to accelerate the vesting period on employer contributions to defined contribution plans. Plans must either provide for 100 percent vesting after an employee attains three years of service, or incremental vesting within a two to six year period as defined. In the case of stock ownership plans which had loans outstanding as of September 26, 2005, these changes do apply before the earlier of the date on which the loan is fully repaid, or the date on which the loan was scheduled to be fully repaid. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

- **Section 905 Distributions During Working Retirement**

Amends sections 401(a) of the Code and 3(2)(A) of ERISA to permit in-service distributions from defined benefit plans to individuals age 62 and over. While this amendment permits defined benefit plans to do so, it does not require them provide this form of benefit.

- **Section 906 Treatment of Certain Pension Plans of Indian Tribal Governments**

Amends Sections 414(d) of the Code and 3(32) of ERISA to treat plans maintained by Indian tribal governments as governmental plans. It also applies the special benefit limitations under Code Section 415(b)(2)(H), the pick up contributions under Code Section 414(h), and the special benefit limitations under Code Section 415(b)(10), each of which is applicable to police and firefighters of a state or political subdivision, to such plans.

### ***Title X - Spousal Pension Protection***

- **Section 1001 Regulations on Time and Order of Issuance of Domestic Relations Orders**

This section requires the Secretary of Labor to issue regulations under Sections 414(p) of the Code and 206(d)(3) of ERISA. The regulations will clarify that a domestic relations order "shall not fail to be treated as a qualified domestic relations order solely because (A) the order is issued after, or revises, another domestic relations order or qualified domestic relations order; or (B) of the time at which it is issued..."

The DOL published an Interim Final Rule Relating to Time and Order of Issuance of Domestic Relations Orders on March 6, 2007, it is effective April 7, 2007. The rule provides guidance on the timing and order of domestic relations orders under section 206(d)(3) of ERISA.

- **Section 1002 Entitlement of Divorced Spouses to Railroad Retirement Annuities Independent of Actual Entitlement of Employee**

This section makes the entitlement to railroad retirement annuities of a divorced spouse independent to that of the employee.

- **Section 1003 Extension of Tier II Railroad Retirement Benefits to Surviving Former Spouses Pursuant to Divorce Agreements**

This section ensures that a surviving spouse's railroad retirement benefit annuity, which is received pursuant to a "divorce decree, annulment, or legal separation or the terms of any court-approved property settlement incident to any such court decree, shall not be terminated upon the death of the...(retired employee)...unless such termination is otherwise required by the terms of such court decree."

- Section 1004 Requirement for Additional Survivor Annuity Option

This section modifies Section 417(a)(1)(A) of the Code to require plans which offer a "qualified optional survivor annuity" to provide as an option a joint and survivor benefit which is equal to at least 75% of the joint benefit.

### ***Title XI - Administrative Provisions***

- Section 1101 Employee Plans Compliance Resolution System

This section requires the Secretary of the Treasury to update and improve the "Employee Plans Compliance Resolution System."

- Section 1102 Notice and Consent Period Regarding Distributions

This section revises the consent period for joint and survivor notices from 90 days to 180 days. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

- Section 1103 Reporting Simplification

This section requires the Secretary of the Treasury to eliminate the annual Form 5500 reporting requirements for one person plans holding less than \$250,000 in assets, and requires the Secretaries of Labor and Treasury to simplify annual reporting requirements for plans with fewer than 25 participants.

- Section 1104 Voluntary Early Retirement Incentive and Employment Retention Plans Maintained by Local Educational Agencies and Other Entities

This section amends Sections 457(e)(11) of the Code, 4(l)(1) of the Age Discrimination in Employment Act of 1967 (ADEA), and 3(2)(B) of ERISA to treat payments made from certain voluntary early retirement incentive plans (VERIPs), employment retention plans of educational agencies, and nongovernmental VERIPs "as a bona fide severance pay plan ...payments or supplements to the extent such payments or supplements could otherwise have been provided under such defined benefit plan." The effect of the changes is to defer taxation of the payments.

- Section 1105 No Reduction in Unemployment Compensation as a Result of Pension Rollovers

Amends Section 3304(a) of the Code relating to State unemployment laws. The amendment states "Compensation shall not be reduced under paragraph (15) for any pension, retirement or retired pay, annuity, or similar payment which is not includible in gross income of the individual for the taxable year in which paid because it was part of a rollover distribution." The effect of the change is to prohibit the reduction of unemployment benefits on the basis of pension distributions which were rolled over.

- Section 1106 Revocation of Election Relating to Treatment as Multi-Employer Plan

This section permits certain pre-ERISA plans to elect to be treated as multi-employer plans.

- Section 1107 Provisions Relating to Plan Amendments

This section insulates plans from violating plan amendment requirements with respect to any amendments made to comply with the provisions of the Pension Protection Act of 2006.

***Title XII - Provisions Relating to Exempt Organizations***

- Section 1201 Tax-Free Distributions from Individual Retirement Plans for Charitable Purposes

This section amends Section 408(d) of ERISA by adding subsection (8), which provides that distributions from an IRA after an individual attains the age of 70 1/2 made directly by a trustee to organizations described in Section 170(b)(1)(A) of the Code is excluded from gross income. The exclusion is only available to the extent that the distribution would otherwise have been includible in gross income, and only if the contribution would otherwise qualify for a charitable contribution deduction under Section 170 of the Code. This provision expires on December 31, 2007 and, therefore, the exclusions are only available for plan years 2006 and 2007 (unless extended by Congress). The exclusions may not exceed \$100,000 in either year. Refer also to IRS Pension Protection Act Changes Notice 2007-7.

No other sections under this title pertain to employee benefit plans.

***Title XIII - Other Provisions***

- Section 1304 Qualified Tuition Programs

This section makes tax deferred "529" tuition programs permanent.

No other sections under this title pertain to employee benefit plans.

***Title XIV - Tariff Provisions***

No sections under this title pertain to employee benefit plans.