
CHAPTER: Compliance

SECTION: Introduction to Employee Benefit Accounts

Section 730

Introduction to Employee Benefit Accounts

This section is intended to provide an overview of employee benefit plan administration, including the more important provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and those of the Internal Revenue Code (IRC). ERISA is a complex statute and many of its general rules have exceptions or rules of special application. Therefore, these materials should be considered as a general guide and not a definitive treatment of ERISA.

An employee benefit account administered by a trust department includes an employee benefit plan and a trust agreement created to administer the assets of the plan. The trust agreement may either be a part of the plan or a separate document. While there are a wide variety of employee benefit plans, only those commonly administered in a trust department are discussed in this section. These include defined benefit and defined contribution plans as well as individual retirement accounts (IRAs). Most qualified plans, which include all the plans discussed in this section with the exception of IRAs, are required under ERISA to hold the assets of the employee benefit plan in a trust.

Employee benefit plans as well as employee benefit trust administration are subject to a comprehensive scheme of federal law contained in ERISA, the Internal Revenue Code and the Pension Benefit Guaranty Corporation (PBGC). The U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) are the agencies responsible for regulations and interpretations issued pursuant to ERISA and the IRC. The PBGC insures the benefits of defined benefit plans to the extent provided in Title IV of ERISA.

ERISA consists of four major titles. Title I, "Protection of Employee Benefit Rights," has "parts" relating to reporting and disclosure, participation and vesting, funding and fiduciary responsibility. Title II, contains the Internal Revenue Code provisions of ERISA. These are primarily interpreted by the IRS and are substantially similar to Title I in terms of fiduciary responsibility. Title III contains provisions establishing interagency jurisdiction and mandating coordination and exchanges of information between the responsible supervisory agencies. Title IV, "Plan Termination Insurance," establishes the Pension Benefit Guaranty Corporation (PBGC), an insurance fund for defined benefit pension plans funded by premiums the plans are assessed on a yearly basis.

A trust and asset management examination of employee benefit accounts should focus on the prohibited transaction provisions of ERISA in Title I. ERISA §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. Certain transactions, otherwise prohibited, are exempted either by statute or by an administrative exemption granted by the DOL. A prohibited transaction violation usually generates a corresponding violation of the fiduciary responsibility provisions (exclusive benefit and/or prudence rules) of ERISA §404. Generally, the prohibited transaction violation is generally deemed to be the more concrete and significant of the two sets of violations. There is also a parallel set of violations involving §4975 of the IRC for most types of prohibited transactions. While IRC §4975 is similar to the provisions of ERISA regarding prohibited transactions, the two are not identical. If the prohibited transaction provisions of ERISA are violated, fiduciaries can be subject to substantial statutory penalties and surcharges. Therefore, it is especially important that a trust department have special expertise, policies and procedures in order to properly administer employee benefit accounts and IRAs.

All citations in this section are to ERISA unless otherwise noted.

Types of Benefits

The term “employee benefit plan,” which is defined in ERISA §3(3), refers to employee pension benefit plans and employee welfare benefit plans. An employee pension benefit plan is any plan, fund or program that is established or maintained by an employer or employee organization that provides retirement income to employees. Employee pension benefit plans can be either “qualified” or “nonqualified.” Qualified plans “qualify” for special tax treatment under the Internal Revenue Code. While many provisions of the IRC overlap provisions contained in ERISA, the IRC alone contains the tax qualification rules. Qualified plans, in turn, generally can be broken down into two categories: defined benefit plans and defined contribution plans. Nonqualified plans defer compensation or otherwise provide benefits payable at retirement or termination of employment but do not qualify for favorable tax treatment. Generally, nonqualified plans include executive or incentive compensation arrangements. Employee welfare benefit plans include plans that provide benefits such as medical, dental, life and disability insurance coverage. ERISA’s trust requirements generally apply to welfare benefit plans. However, a welfare plan is exempt from ERISA’s trust requirements if the assets of the plan consist solely of insurance contracts or policies.

Types of Qualified Employee Benefit Pension Plans

As mentioned above, qualified employee benefit pension plans may be classified into two primary categories: defined benefit plans and defined contribution plans. There are a wide variety of plans that fall under these broad categories. The one thing they have in common is that they must meet the strict standards set by the Internal Revenue Code in order to maintain their qualified status. For example, the IRC mandates that the plan document contain a number of requirements, such as provisions regarding nondiscrimination in eligibility for the plan and provisions to assure that executive and highly paid employees do not receive preferential treatment. Other requirements concern vesting, withdrawals, participant loans and distribution of benefits. IRC rules governing these matters are complex and are generally the concern of the plan sponsor, the plan administrator or the plan recordkeeper, however, many savings associations provide these services for plan sponsors and must perform them in compliance with various rules and regulations. Because tax laws and regulations are subject to frequent revisions, all products and services provided to plans must be constantly monitored to ensure that the tax-deductible status of the plan is maintained. Financial institutions providing products and services to employee benefit plans should have specialized expertise in this area.

A *defined benefit pension plan* guarantees a specific or determinable benefit to participants at normal retirement age and requires the sponsoring employer to contribute over a period of years whatever amounts are necessary to fund those benefits. For example, a defined benefit pension plan might provide a monthly benefit to each participant, payable at age 65, equal to \$25 multiplied by the participant’s number of years of service. In that example, a participant who had worked for 20 years would be entitled, at retirement, to a benefit equal to \$500 per month for life. Because a defined benefit plan promises a certain benefit to an employee at his or her retirement, the employer is responsible for contributing to the plan the amount of funds necessary to pay benefits when they are due. In these plans an actuary is retained to determine what dollar level of contribution is necessary from the employer. If the investments perform better than the actuary has assumed or if salaries do not increase as expected, the actual amount of contributions necessary from the employer is reduced. Conversely, if the investments do not perform as well as the actuary assumes or if employee salaries increase faster than assumed, the employer must increase its contributions to make up the difference.

The Pension Benefit Guaranty Corporation (PBGC) insures defined benefit pension plans to the extent provided in Title IV of ERISA. If the employer becomes insolvent prior to contributing sufficient amounts to fund accrued benefits under the plan, the PBGC will step in and pay participants’ pension benefits up to

certain levels. The plan sponsor pays premiums to the PBGC on a per participant per year basis for this coverage.

Defined benefit plans are more expensive to administer and operate than defined contribution plans. Due to the extra costs involved, defined benefit plans have fallen out of favor with plan sponsors and many have been terminated and replaced with defined contribution plans.

A ***cash balance plan*** is another form of defined benefit plan. It exhibits features of both defined benefit and defined contribution plans. The most recognizable feature of the cash balance plan is its use of a separate account for each participant, established upon the employee's becoming a member of the plan. The amounts an employer contributes to the plan are determined actuarially to ensure sufficient funds to provide for the benefits promised by the plan. The minimum funding standards apply to cash balance plans, as is the case with other types of defined benefit plans. Cash balance plans provide higher benefits for younger employees and lower benefits for older employees, in contrast to traditional defined benefit plans. This is because 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.

A ***defined contribution pension plan*** does not promise a specific benefit. Instead, the amount of an employee's benefit is based upon the amount contributed to the participant's account and the success of the plan's investment results. Each participant has an account under the plan and is entitled only to the amount in their account at retirement age. Contributions are made by the employer based on a formula established in the plan, such as a percentage of profits of the company, the salary of a participant or any number of other factors. Under some plans, the participant may also elect to make contributions to the plan out of his or her salary. This type of plan is not insured by the PBGC. Examples of these plans are: profit sharing plans, 401(k) plans, money purchase plans and target benefit plans.

A typical contribution formula under a ***profit sharing plan*** would provide that the employer would contribute to the plan each year an amount equal to a certain percentage of the company's profits and allocate the contribution, pro rata, according to the compensation paid to each participant for the year. Such plans are thought to foster productivity on the part of employees, as they will share in the profits of the company. Plan assets are often invested in employer securities. ERISA diversification requirements are not generally violated so long as the plan or trust instrument allows no more than 10 percent of the plan's assets to be invested in employer securities except as provided in ERISA §407(b). While these plans are called "profit sharing," there is no longer a requirement that the company has to make a profit to contribute to the plan. A profit sharing plan may provide benefits for employees, some or all of whom are owner-employees. Such a plan will be a qualified plan if it meets all the requirements contained in §§401(a) and 401(d) of the IRC. One of the §401(d) requirements is that contributions on behalf of owner-employees may be made only with respect to the earned income of the owner-employee that is derived from the trade or business with respect to which the plan is established.

A ***401(k) plan*** contains a cash or deferred arrangement (CODA). In these plans, an employee may make an election to have the employer make a contribution to the plan on the employee's behalf or pay an equivalent amount to the employee in cash. The amount contributed to the plan under the CODA on behalf of the employee is called an elective contribution. Subject to certain limitations, elective contributions are excluded from the employee's gross income for the year in which they are made and are not subject to taxation until distributed. Provisions contained in the Internal Revenue Code limit the total compensation contribution that a participant may make in any calendar year. The plan may provide for the employee to

make contributions as well, but again these contributions must comply with certain limitations established under the IRC.

State and local governments and tax-exempt organizations were prohibited until recently from maintaining 401(k) plans but certain plans, established before the law that prohibited them was enacted, were grandfathered. State or local governments with a plan established prior to May 6, 1986 or prior to July 2, 1986, in the case of tax-exempt organizations, were permitted to retain their 401(k) plans but not establish new ones. For years beginning after 1996, 401(k) plans, through a change in the tax law, were made available to tax-exempt organizations but remain unavailable to state and local governments, unless they have grandfathered plans.

In many of these plans, employees can choose to place their plan assets into several preselected investment vehicles. Many plans include employer stock as one of the investment options. Some plans that allow the employee to decide how to invest the funds in their plan account may operate in a way that reduces the fiduciary liability for both the sponsor and the trustee. However, in order to establish such a reduction in liability, the plan must be in full compliance with ERISA §404(c).

A **money purchase pension plan** (MPPP) requires the employer to contribute a specific percentage of eligible employees' compensation each year which would make age and length of service of the participant irrelevant for both contribution and allocation purposes. The obligation to fund the plan makes a money purchase pension plan different from most profit sharing plans. In most profit sharing plans, there are generally no unfavorable consequences for the company if it fails to make a contribution. However, if the company maintains a money purchase pension plan, its failure to make a contribution can result in the imposition of a penalty tax. Forfeitures that occur because of employee turnover may reduce future contributions of the company or may be used to increase the benefits of remaining participants.

Target benefit plans are individual account plans that are a hybrid of a money purchase plan and a defined benefit plan and are intended to provide a "targeted" benefit upon retirement. It is like a defined benefit plan in that the employer contributions to each participant account are established through a defined benefit formula calculated by an actuary. It is like a typical defined contribution plan in that there are no guarantees that the targeted benefit will be paid at retirement. If the earnings of the fund differ from those assumed, this does not result in any increase or decrease in employer contributions; instead, it increases or decreases the benefits payable to the participant. Thus, a target benefit plan operates much like a money purchase pension plan. The difference is that in a money purchase pension plan, contributions for identically compensated employees are the same even though their ages differ; in a target benefit plan, age is one of the factors that determines the size of the contributions. Because older employees have less time in which to have their benefits funded, employer contributions on their behalf are greater, as a percentage of compensation, than for younger employees. Consequently, target benefit plans appeal to employers that desire to benefit older employees.

Another type of qualified pension plan is an **employee stock ownership plan (ESOP)**. An ESOP, although required to invest primarily in certain types of employer stock in accordance with IRC §409, is subject to most of the same Internal Revenue Code and ERISA requirements as other qualified defined contribution plans but there are some differences that subject a savings association that acts as a trustee for these plans to a greater degree of risk. The reasons for the increased risk are as follows:

- In addition to the Code requirements that apply to all qualified retirement plans, a series of special requirements apply to ESOPS under the IRC and ERISA.

- Anytime a trustee holds stock of the employer/plan sponsor, there is increased likelihood that the trustee will be drawn into a takeover battle in which the voting of shares held by the plan becomes an issue.
- An ESOP, by definition, is required to invest primarily in employer stock. This lack of diversification, though permitted under ERISA, exacerbates fiduciary liability issues in the event of a precipitous decline in the employer's stock price or the employer's insolvency.
- Where the ESOP holds stock of a private company or a sparsely traded public company, valuation issues frequently arise.
- Where the ESOP is leveraged, the existence of the stock purchase loan and the requirement of annual repayments can generate additional problems.

ESOPs are designed to invest "primarily" in "qualifying employer securities." Qualifying employer securities means publicly traded common stock of the employer. If the employer has no publicly traded common stock, the ESOP may invest in common stock with voting power and dividend rights that are equal to or greater than that of any class of the employer's common stock. The ESOP may invest in preferred stock under certain conditions. Employer securities that are not publicly traded, including preferred stock that is convertible into publicly traded common stock, must be valued by an independent appraiser upon purchase by the ESOP. The ESOP must value nonpublicly traded employer securities at least annually and upon special occurrences such as transactions with major shareholders. DOL regulations and case law have imposed a heavy burden on the fiduciary responsibility for determining the fair market value of the stock held by an ESOP. This burden includes the requirements of prudent investigation and strict independence from the employer. It is prudent for fiduciaries to rely on an independent appraiser to determine whether a purchase or sale of assets held by an ESOP is for adequate consideration.

A "leveraged" ESOP is an ESOP that borrows money from a bank or the employer and uses the proceeds of the loan to purchase employer stock. Often the employer will guarantee repayment of the loan. The ESOP holds the employer stock in a suspense account as the primary or sole asset of the ESOP. The employer is obligated to make annual contributions to the ESOP. The ESOP uses the annual employer contributions to make periodic principal and interest payments on the loan, pursuant to the loan agreement between the ESOP trustee and the lender. When the ESOP makes loan repayments, it allocates an equal portion of the employer stock from the suspense account to the accounts of ESOP participants. The IRC and ERISA permit qualified retirement plans other than ESOPs to borrow money. However, only ESOPs can borrow money using the credit or guarantees of the plan sponsor. To be exempt from the prohibited transaction provisions of ERISA, an ESOP loan must meet certain requirements that can be found at §408(e).

There are certain requirements that an ESOP must meet under IRC §409. The plan must allocate all employer securities transferred to it or purchased by it to the accounts of all the participants who are entitled to share in the allocation. Each participant is then given a nonforfeitable right to any of the employer securities that are allocated to his or her account. The plan may not distribute securities allocated to a participant's account before the end of the 84th month beginning after the month in which the security is allocated to the account unless certain specific conditions exist. Section 409(e) of the IRC contains requirements in regards to the proxy voting rights of the securities allocated to a participant's account. ESOPs, unlike other defined contribution plans, must pass through voting rights on allocated shares to the participants. The pass-through must be on all voting issues if the company is publicly held or if the ESOP acquired the allocated shares with the proceeds of a loan in connection with which the 50 percent interest exclusion was used. The pass-through is required only on important issues, such as a major corporate restructuring, if the company is not publicly held and the allocated shares are not affected by the 50 percent interest exclusion.

Welfare Benefit Plans

The most common types of employee welfare benefit plans are health, life insurance, disability, vacation and holiday, apprenticeship, educational or multiple employer welfare arrangements (MEWA) plans. Generally, ERISA §403(a) requires that all assets of an employee benefit plan be held in trust. This includes any assets of an employee welfare plan. However, ERISA's funding requirements are not applicable to welfare benefit plans and the IRC does not provide for tax-free accumulation to fund welfare benefit plans in the same manner as it does for pension plans. For this reason, most employers provide welfare benefits on a pay as you go basis rather than accumulating assets in a trust.

Rabbi Trusts

Some employers use a grantor trust (sometimes known as a "rabbi trust") to accumulate funds to pay employer-provided health benefits or to provide nonqualified deferred compensation benefits for management employees. The IRS has ruled that where the employer pays benefits from a rabbi trust, the employer can deduct its contributions for benefits and premiums in the year in which it pays such amounts to the recipient. This is also the year such amounts would have been taxable to the recipient but for the exclusions for employer-provided benefits. An employer ordinarily could not use a rabbi trust to satisfy ERISA's trust requirements because funds accumulated in a rabbi trust are treated as assets of the employer. Rabbi trust funds are subject to the claims of the employer's general creditors if the employer becomes insolvent or bankrupt. Both the DOL and the IRS have issued guidance with respect to rabbi trusts. For example, the DOL has issued an advisory opinion letter (94-31A, September 9, 1994) that indicates that an irrevocable grantor trust committed to pay retiree medical benefits are "plan assets" subject to ERISA's trust requirements. The Internal Revenue Service has issued guidance indicating that a rabbi trust holding stock in a parent company that is to be used to provide benefits for employees of a subsidiary company would generally not result in adverse tax consequences to the parent or the subsidiary but only if the trust assets are subject to the claims of creditors of both the parent company and the subsidiary (IRS Notice 2000-56).

VEBA

Examiners may also come across a voluntary employees' beneficiary association (VEBA). IRC §501(c)(9) establishes that a VEBA is a tax-exempt entity that is generally established by an employer or union to prefund health and other welfare benefits. Subject to significant limitations found in IRC §419, employer contributions to the VEBA are deductible by the employer and some funds accumulate tax-free.

Multiemployer Plans

Many companies maintain qualified retirement plans established under collective bargaining agreements. These plans are sometimes referred to as "Taft-Hartley" plans, so named in honor of the "Labor-Management Relations Act" (1947), which was sponsored by Sen. Robert A. Taft and Rep. Fred A. Hartley. Often a retirement plan negotiated by a union is set up on an industry-wide basis. These plans are very common in certain industries such as construction, transportation and mining. In multiemployer plans, two or more unrelated employers may participate in the plan under a collective bargaining agreement. There are separate requirements under ERISA that apply only to multiemployer plans. The main difference between these plans and other qualified plans is that a multiemployer plan is managed by a board of trustees composed of both union and employer representatives.

The PBGC has the authority to insure the benefits of a defined benefit multiemployer plan. This authority, which was established by federal courts, has been given despite the fact that a multiemployer plan usually combines the features of a defined benefit plan and a defined contribution plan.

Individual Retirement Accounts

An IRA is a tax-advantaged personal savings retirement plan that uses a trust or custodial account established in the United States. It can be used by employees and self-employed persons, even if they are covered by another plan, if all the conditions established in §408 of the Internal Revenue Code are met. The individual may also be able to deduct contributions to the IRA in whole or in part and the earnings and gains that accumulate within the IRA are not taxed until distributions commence. There are limitations on how much an individual may contribute to his or her IRA account. The limitation established at §408(a)(1) is \$2,000 annually. (Note: The Economic Growth and Tax Relief Reconciliation Act of 2001 has increased this limitation, Pub. L. No. 107-16, June 7, 2001). The IRA account may not be invested in life insurance contracts as established by §408(a)(3) or collectibles such as stamps, coins, artwork, gems, antiques etc. (§408(m)) (An exception is made for U.S. American Eagle gold coins). Another basic characteristic of an IRA is that the individual's interest in the account must not be forfeitable. Finally, there are minimum distribution rules that must be followed to avoid any penalties for insufficient distributions. The distribution rules are similar to the distribution requirements of qualified plans.

The trustee (or custodian) of an IRA must be a bank, thrift, insurance company, brokerage firm or other person who demonstrates to the IRS that he or she will administer the account in a manner consistent with the requirements of the law. (See IRC §408(a)). The trustee of an IRA may contract to perform purely ministerial duties, such as calculating benefits, collecting and applying contributions, processing claims, preparing reports and tax forms or it may be charged with broad investment discretionary duties. Except in the case of a rollover contribution, described below, the trustee or custodian may not accept contributions to the IRC account unless it is in cash.

A savings association may act as a trustee or custodian of individual retirement accounts without obtaining trust powers from the OTS if it is permitted to do so under state law. However, under 12 CFR §550.580 - 620, there are certain conditions that a savings association must meet in regards to these IRA accounts. A savings association must observe principles of sound fiduciary administration as they relate to recordkeeping and segregation of assets. The savings association may either invest the assets of the IRA account in its deposits, obligations or securities or in any investment that the IRA customer chooses. Such self-directed IRA accounts are permitted to be serviced by savings associations without trust powers from the OTS if the institution does not exercise any investment discretion with regards to the IRA account assets or directly or indirectly provide any investment advice with regards to the accounts.

An IRA, even though the assets may be held within a trust, is not considered to be a "qualified" plan subject to the discrimination, vesting and other IRC §401 rules set out for qualified plans. IRA accounts are, however, subject to the prohibited transactions provisions of ERISA Section 406 and the parallel IRC §4975 provisions. IRAs are not subject to the fiduciary responsibility provisions of ERISA Section 404 covering prudence, diversification etc. There are certain prohibited transaction class exemptions that, provided all the conditions contained within the class exemption are met, allow IRA accounts to overcome violations of the prohibited transaction provisions. An example is PTE 91-55 that permits purchases and sales by IRAs of American Eagle bullion coins. Another example is PTE 93-33 that allows banks to provide IRA holders or their family members with services or products at either reduced cost or no cost. The services or product, such as free checking or a safety deposit box, must be the same as those offered by the bank in the ordinary course of its business to customers who do not maintain IRAs at the bank. In these cases, a prohibited transaction will not occur when an IRA holder, who is a fiduciary with respect to the IRA, uses IRA assets to obtain services from the bank. Under PTE 93-1, banks can offer cash or other premiums as incentives for opening IRAs or for making additional IRA contributions. The value of the premium on deposits up to \$5,000 is limited to \$10 and on deposits in excess of \$5,000 is limited to \$20.

A rollover IRA is a tax-free transfer of cash, securities, shares or other property from a qualified retirement plan (or an IRA) to another qualified retirement plan or to an individual retirement account. A rollover is generally paid directly to an eligible retirement plan (or IRA) from another retirement plan (or IRA) without the individual being involved at all. The means of transfer may be by wire transfer or by check made payable to the trustee of the accepting retirement plan. If a check is made out to the individual then, in most cases, a distribution has occurred not a rollover. There are no dollar limits on the amount that may be transferred in a rollover. Rollovers from one IRA account into another give IRA participants the flexibility to shift investments. To make the rollover tax-free, certain requirements must be met. The first requirement is that the amount distributed to the individual from the old account must be transferred to the new account not later than 60 days after receipt. The second is that, if property other than cash is received from the old account, that same property must be transferred to the new account.

Roth IRAs

In 1998, a new type of IRA was created, the Roth IRA. The major difference between a Roth IRA and the old type of IRA is that in a Roth IRA, contributions are not deductible but distributions may be income tax free. Another difference is that contributions to a Roth IRA may be made after an individual attains age 70 ½ and the minimum distribution rules do not apply during the individual's lifetime. An individual may also be eligible to roll over all or part of an IRA to a Roth IRA or convert an IRA into a Roth IRA. The Internal Revenue Code lays out all the provisions regarding Roth IRAs in §408A. The IRS has issued two model forms for use by financial institutions to offer Roth IRAs (Form 5305-RA and Form 5305-R).

Education IRAs

Along with Roth IRAs, in 1998, another type of IRA came into existence - the education IRA. An education IRA is a trust or custodial account created in the United States exclusively for the purpose of paying the qualified higher education expenses of an individual who is the trust's designated beneficiary. The account must be designated as an education IRA at the time it is created or organized. Although contributions to an education IRA are not deductible, distributions may be income tax free. The requirements of an education IRA are found in the Internal Revenue Code at §530.

Simplified Employee Pension Plans

A simplified employee pension plan (SEP) is an individual retirement account established for an employee to which the employer makes tax-deductible contributions. Certain IRC requirements (in §408(k)) must be met in order for these arrangements to work like qualified employee benefit plans but without the complexity and burden of many of the qualified plan rules.

Any employer, such as C and S corporations, partnerships and sole proprietorships may establish a SEP. To begin a SEP, the employer must execute a written instrument that includes the name of the employer, the participation requirements, the allocation formula and the signature of a responsible official. The SEP may use a model SEP (IRS Form 5305-SEP), a master or prototype plan for which a favorable opinion letter has been issued or an individually designed plan. All employees, including part-time employees, not excluded under one of the statutory exclusions in §408(k) must participate in the SEP. The SEP may not discriminate in favor of highly compensated employees. The assets of a SEP may be managed by a financial institution (any entity eligible to be an IRA custodian) although the employee may be permitted to direct the investment of his or her account. If the participant does not have an IRA, the employer must establish one for the participant. Employees, under a SEP are immediately vested in the assets of their IRA.

Savings Incentive Match Plans for Employees

A small business owner that wants to institute a retirement plan for his or her employees but does not want the complexity associated with a qualified plan may choose to institute a **savings incentive match plan for employees** (SIMPLE). A SIMPLE allows employees to make elective contributions and requires employers to make matching or nonelective contributions. The requirements for a SIMPLE can be found at §408(p). The SIMPLE may be structured as either a SIMPLE IRA plan or a SIMPLE 401(k) plan. SIMPLE plans are generally not subject to the nondiscrimination rules applicable to qualified retirement plans. Under a SIMPLE IRA, each employee may choose whether to have the employer make payments as contributions under the SIMPLE IRA plan or to receive these payments directly in cash. Contributions under a SIMPLE IRA may only be made to a SIMPLE IRA and not to any other type of IRA. Employers, including self-employed individuals, who employed 100 or fewer employees, may adopt a SIMPLE IRA. Each employee who received at least \$5,000 in compensation from their employer during any two preceding calendar years and who is reasonably expected to receive at least \$5,000 in compensation during the calendar year must be eligible to participate in the SIMPLE IRA plan for the calendar year. All contributions placed in the SIMPLE IRA are immediately vested. An employee may make elective contributions of up to \$6,000 a year, adjusted for inflation, to a SIMPLE IRA (Note: these limitations have been increased by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, June 7, 2001). An employer must make either a matching contribution or a nonelective contribution. A dollar for dollar match of the employee's elective contribution of up to three percent of the employee's compensation for the entire calendar year is required or an employer may elect to make a nonelective contribution of two percent of compensation for each eligible employee regardless of whether the employee makes any elective contribution. Generally, an employer must permit an employee to select the financial institution for the SIMPLE IRA to which the employer will make all contributions on behalf of the employee. However, under certain conditions specified in §408(p)(7), an employer may require that all contributions on behalf of all eligible employees under the SIMPLE IRA plan be made to SIMPLE IRAs at a particular financial institution. A SIMPLE 401(k) is a 401(k) plan that meets the requirements established in IRC §401(k)(11) and all of the requirements of a qualified plan.

Master and Prototype Plans

A **Master Plan** is a form of a qualified plan established by a sponsoring organization, such as a bank or savings association. The plan is preapproved by the IRS and made available for adoption by employer/customers. Under a master plan, the sponsoring organization establishes a single funding medium (i.e. trust or custodial account) for joint use by all adopting employers. The plan consists of three parts: 1) a basic plan document, which is identical for all the employers that adopt the plan; 2) an adoption agreement, which generally contains options that an employer may select that relate to eligibility, vesting, contribution or benefit levels; and 3) a trust agreement under which all participating plan investments are held. Only a financial institution may establish and maintain a master plan. The financial institution, as the sponsoring organization, files the plan document form, the adoption agreement and the trust agreement with the IRS and asks for an opinion that the master plan is acceptable to the Service for a qualified plan and meets all the latest IRS 401(a) requirements.

A **prototype plan** is basically the same thing as a master plan except that the sponsoring organization establishes a separate funding medium for each adopting employer. Prototype plans are much more prevalent in the employee benefit world. In addition to financial institutions, law and accounting firms can sponsor a prototype plan.

A master or prototype plan may be either standardized or nonstandardized. A standardized plan is completely preapproved by the IRS. In these situations, an employer that adopts a standardized defined contribution plan and does not then or has never maintained another qualified plan covering any of the same participants, may rely on the sponsoring organization's IRS opinion letter and does not need a separate determination letter. A nonstandardized plan gives an adopting employer certain choices but very little flexibility as to plan design. The IRS preapproves nonstandardized plans but an adopting employer must apply for approval of its individual plan adoption with the IRS.

ERISA - Introduction

ERISA is a very complicated law and subject to constant change by way of legislation and by the issuance of various advisory opinions, prohibited transaction exemptions and regulations. The primary objective of ERISA is to protect the rights and interests of employee benefit plan participants and their beneficiaries. There are very specific standards in ERISA regarding how plans are to be administered and also regarding the investment of plan assets. There are also various reporting requirements to both the DOL and the IRS as well as disclosure requirements as they relate to the plan sponsor, plan participants and beneficiaries. Failure to properly follow the various rules and regulations issued by the DOL and the IRS may subject a savings association to civil money penalties for mismanagement. Before accepting any employee benefit account it is important that a savings association have special expertise and systems as well as adequate policies and procedures that are appropriate for the various types of employee benefit accounts.

Two governmental agencies are primarily responsible for the administration and enforcement of ERISA. The DOL is responsible for interpreting and enforcing the fiduciary provisions of ERISA. The IRS is responsible for the provisions found in Title II of ERISA and in the Internal Revenue Code under §401(a) that relate to maintaining the qualified status of a plan.

ERISA applies to all defined benefit and defined contribution plans which are sponsored by private entities. It will apply to most plans reviewed during examinations. ERISA does not apply to certain plans sponsored by federal, state and local government instrumentalities. These plans are generally known as "457" plans. ERISA also does not apply to plans sponsored by religious organizations and their affiliates, which are commonly known as "church" plans. Nonqualified plans, which are used to provide benefits to management and other highly compensated employees (and not the rank and file), are also exempt from most of the requirements of ERISA. The most common types of nonqualified plans are supplemental executive retirement plans (SERPs), Top Hat plans, rabbi trusts and secular trusts. One of the most significant disadvantages of a nonqualified plan is that, in order to avoid current taxation to the employee, the employer's obligation to pay benefits under the plan - including amounts attributable to employee compensation deferrals - must remain no more than an unfounded promise to pay amounts in the future. If a nonqualified plan were to be formally funded, the plan would become subject to, and in violation of ERISA and the participating employees would immediately recognize income on the nonqualified plan benefits. To remain unfounded for tax purposes, nonqualified plan benefits must be paid from the employer's general assets. However, most employers that maintain nonqualified plans have established an "informal" funding arrangement with respect to the plan.

ERISA Section 402 - Establishment of a Plan

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

- 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 the 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 §402.

ERISA Section 403 - Trustee Requirements

ERISA §403 requires that one or more trustees must hold all assets of employee benefit plans in trust. There is no requirement that an institution or other corporate fiduciary be used, as individuals may serve as plan trustees under ERISA. An exception to this requirement is where the assets of the plan consist of insurance contracts or policies.

Trusted plans are those most frequently encountered and a trust agreement, as distinguished from the governing plan, establishes the trustee's duties and responsibilities. The trustee, under ERISA, has the exclusive authority and discretion to manage and control the assets of the plan unless certain exceptions apply. One such exception is where the plan expressly provides that the trustee is subject to the direction of the named fiduciary as long as the directions are made in accordance with the terms of the plan and are not contrary to ERISA. Another exception is where the authority to manage, acquire or dispose of the assets of the plan is delegated to one or more investment manager(s).

Other typical trust agreement provisions relate to: irrevocability and nondiversion of trust assets; 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.

ERISA Section 404 - Fiduciary Responsibilities

ERISA's fiduciary provisions are intended to subject plan fiduciaries to a uniform federal fiduciary standard essentially based on common law principles. Under ERISA a fiduciary has five basic duties:

1. To act solely in the interests of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries and to defray reasonable expenses of administering the plan (§404(a)(1)(A)). This duty is in essence a restatement of the common law requirement of fiduciary loyalty, which is sometimes referred to as the "duty of loyalty." In accordance with the duty of loyalty, a fiduciary is forbidden from acting in its own personal interest, or in the interest of a third party, or in any way contrary to the best interests of the plan and its participants. Examples of situations where a fiduciary was found to have violated ERISA's duty of loyalty include:
 - investing plan assets in a manner that indirectly favored the trustee;
 - churning a plan's assets so as to increase its fees;
 - making loans on favorable terms from plan assets to third persons;

- failing to attempt to collect on loans to itself; and
 - permitting the diversion of plan assets to a union.
2. To act “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 and with like aims” (§404(a)(1)(B)). This requirement contains the duty of prudence. Over the years the “prudent man” standard has evolved into a “prudent expert” standard. This is not to say that a fiduciary is required to be an expert in all facets (or in any) of the administration and management of a plan. However, it does mean that if the fiduciary is not an expert in any facet, it must seek the advice or retain the services, of one who is an expert. The DOL (29 C.F.R. 2550.404a-1), has stated that the requirements under this section will be met if the fiduciary has given appropriate consideration to those facts and circumstances that the fiduciary knows or should know are relevant to the particular investment. This basically means that the fiduciary must determine that the particular investment is reasonably designed to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain associated with the investment. The DOL in its regulations has also listed several factors that should be taken into consideration as they relate to the portfolio of the plan. The factors are: 1) the composition of the portfolio with regard to diversification; 2) the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and 3) the projected return of the portfolio relative to the funding objectives of the plan.

Courts have relied on a number of factors in order to determine whether an investment is prudent. Some factors are as follows: 1) the success of the investment (objective or comparison based); 2) expert testimony that the investment scheme was low risk; 3) the fiduciary is experienced and knowledgeable regarding the subject matter of the investment and has a proven track record; 4) the fiduciary thoroughly investigated the subject matter of the investment; 5) the fiduciary considered alternative investments; 6) the particular investment strategy was within industry standards; 7) the fiduciary provided a thorough and well-reasoned rationale for its actions; and 8) divestiture would cause a large loss to the plan.

3. To diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so (§404(a)(1)(C)).
4. To act in accordance with the documents and instruments governing the plan, insofar as they are consistent with the provisions of ERISA (§404(a)(1)(D)). Under this requirement, a fiduciary must not only be familiar and comply with the terms of the governing instrument but it must also determine whether any directives given by an authorized party are permissible under the overall fiduciary responsibility provisions of ERISA.

An example of a fiduciary breach under this provision would be where a plan fiduciary invested in equity securities in amounts that exceeded limitations prescribed by the plan guidelines. The phrase “documents and other instruments governing the plan” generally would include any statements of investment policy or guidelines adopted by the plan sponsor, its investment committee or other named fiduciary.

5. To refrain from engaging in prohibited transactions (see ERISA Section 406 - Prohibited Transactions).

In addition to the requirements found in §404(a), §404(b) requires that indicia of ownership (security certificates, etc) of plan assets must be maintained within the jurisdiction of United States Courts. DOL Regulation 29 C.F.R. §2550.404(b)-1 lists some specific exceptions. Generally speaking, plans may invest in foreign property if they either bring the actual indicia of ownership (e.g. stock certificate, bond, property title or currency) back to the United States or arrange for such indicia of ownership to be maintained by certain entities that are subject to the jurisdiction of U.S. district courts.

Section 404(c)

ERISA §404(c) provides that if a participant in an individual account plan (typically a 401(k) plan) exercises control over the assets in his or her account, the participant will not be considered a plan fiduciary and trustees and other fiduciaries of the plan will be relieved from liability for any loss resulting from the participant's exercise of control, if all of the conditions stated in §404(c) are met. ERISA does not require that retirement plans and fiduciaries comply with the requirements of §404(c). Noncompliance only means that fiduciaries (trustee and plan sponsor) remain liable for damages resulting from participants' investment choices. There are extensive regulations contained at 29 C.F.R. §2550.404c-1 that gives guidance on how a plan can meet each of the three main components of §404(c). These components are as follows:

- Plan participants must have the opportunity to give investment instruction 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 no less than once a quarter. 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. Special provisions are given for investments in stock of the employer/sponsor.
- Plan participants must have the opportunity to exercise control by investing their accounts among 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. 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, 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.
- Plan participants must be given sufficient information to make informed investment decisions. This involves specific disclosures about the plan itself, as well as each authorized investment alternatives within the plan with respect to participants or beneficiaries of a plan.

When a plan sponsor, trustee or other fiduciary gives "investment advice" to plan participants, it will lose the protection gained through compliance with §404(c), and become exposed to fiduciary liability resulting from participants' investment decisions. The DOL has issued an interpretive bulletin (DOL Interp. Bull. 96-1) that provides guidance about what is "investment education" as opposed to "investment advice." The bulletin indicates generally that the primary difference between investment "education" and "advice" lies in how closely each addresses the individual participant's situation and makes specific recommendations. The bulletin provides four "safe harbor" categories of investment education information that may be given orally, in writing or over the internet.

ERISA Section 405 - Liability For Breach of Cofiduciary

In addition to any liability that a fiduciary may have for its own acts, a fiduciary may be held liable for a breach of duty committed by another fiduciary:

- If the fiduciary knowingly participates in or undertakes to conceal a breach by another fiduciary [§405(a)(1)];
- If the fiduciary enables another fiduciary to commit a breach by his failure to discharge his responsibilities prudently [§405(a)(2)]; or
- If the fiduciary has knowledge of a breach and fails to make reasonable efforts to remedy it [§405(a)(3)].

Fiduciaries that have limited functions do not insulate themselves from breaches by other fiduciaries. Failure to adequately monitor the conduct of another fiduciary may be deemed imprudent and cause cofiduciary liability. Resignation by the fiduciary as a protest against the breach is not sufficient to eliminate the liability; action must be taken to remedy the breach.

ERISA allows for allocation of specific responsibilities, obligations or duties among trustees and other fiduciaries in §405(b) and (c). The allocation of responsibilities requires specific authorization in the plan document. If the trust is one where a fiduciary is subject to the directions of an investment manager, the fiduciary will not be responsible for the investment manager's acts or omission; if, the investment manager is properly appointed in accordance with provisions of the plan, is a "qualified" investment manager and acknowledges its fiduciary status in writing. The trustee should insist that all "directions" be in writing or in a format other than oral.

Some plans include provisions authorizing each plan participant, at his or her election, to direct the investment of funds allocated to their account. In these cases, §404(c) affords protection to plan fiduciaries, including the trustee, if all the conditions set forth in DOL regulation 2550.404c-1 are met.

ERISA Section 406 - Prohibited Transactions

ERISA §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 provides that a trustee or other fiduciary that causes a plan to engage in a prohibited transaction with a party in interest is personally liable for any loss the plan suffers from a violation and it must disgorge any profits earned as a result of the violation. The DOL also may impose a 20 percent excise tax on any amount received from a fiduciary because of its violation of the prohibited transaction rules. Finally, ERISA empowers courts to grant injunctive relief to stop prohibited transactions from going forward and imposes criminal penalties for willful violations. The IRC imposes a two-tiered penalty tax structure on parties in interest. Any party in interest who participates in a prohibited transaction is subject to: 1) a 10 percent penalty tax on the amount involved in the transaction and 2) a 100 percent penalty tax on the amount involved, if the prohibited transaction is not corrected before the earlier of the date the IRS assesses the 5 percent penalty tax, or mails a notice of deficiency with respect to the tax.

Party in Interest Defined

ERISA §3(14) defines “party in interest.” In general, a party in interest will include the following:

- The plan sponsor, its directors, officers and employees.
- 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. ERISA §3(15) defines the term “relative” as a spouse, ancestor, lineal descendant or spouse of a lineal descendant. [See also IRC §4975(e)(2)].

A savings association normally serves in one or more of the party in interest positions. For its own plans, the savings association is the plan sponsor and therefore a fiduciary and may also be a service provider. For outside plans, the savings association may serve as a trustee (fiduciary) or other service provider role. A savings association acting as a custodian is generally not a fiduciary but is a party in interest under ERISA.

Fiduciary Defined

For the most part, the definition of a fiduciary under ERISA in §3(31) is a functional definition. Therefore, a person is a fiduciary to the extent he or she:

- Exercises any discretionary authority or discretionary control respecting management of an employee benefit 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 plan assets or has any authority or responsibility to do so; and
- Has any discretionary authority or discretionary responsibility in the administration of a plan.

The Department of Labor has issued several sets of regulations in a question and answer format over the years that relate to the definition of fiduciary. Examiners should refer to §2509.75-5 and 2509.75-8. In particular, examiners should refer to §2509.75-8, D-3, which states that the position of “trustee” is considered to be a “fiduciary” position.

Prohibited Transactions with Parties in Interest - 406(a)

ERISA §406(a) 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:

- Sale, exchange or leasing of any property [see ERISA §406(a)(1)(A) and IRC §4975(c)(1)(A)];
- Lending of money or other extension of credit [see ERISA §406(a)(1)(B) and IRC §4975(c)(1)(B)];
- Furnishing of goods, services or facilities [see ERISA §406(a)(1)(C) and IRC §4975(c)(1)(C)];
- 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 ERISA §406(a)(1)(D) and IRC §4975(c)(1)(D)]; and

- Acquiring of plan sponsor's securities or real property. Special exemptions are included in ERISA §407, with different provisions for different types of plans [see ERISA §406(a)(1)(E)] [no parallel IRC provision, but see IRC rules for ESOPs].

Prohibited Transactions with Fiduciaries - 406(b)

ERISA §406(b) 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 §406(b)(1) and IRC §4975(c)(1)(E)].
- Acting on behalf of a party whose interests are adverse to the interests of the plan, its participants or beneficiaries in any transaction involving the plan [see ERISA §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 §406(b)(3) and IRC §4975(c)(1)(F)].

ERISA Sections 407 - Investment in Employer Securities and Real Property

ERISA §407 was intended to address Congress' concern that a number of employee benefit plans incurred major losses because they had placed large amounts of assets in employer securities or employer real property. Under ERISA §407, plans may not acquire or hold employer securities or employer real property unless they are "qualifying employer securities" or "qualifying employer real property." Additionally, plans may not acquire employer securities or employer real property if, immediately after the acquisition, the aggregate fair market value of the investment exceeds a statutory limit of 10 percent of the fair market value of all the assets of the plan. The 10 percent limitation of Section 407 does not apply to "eligible individual account plans," which include most 401(k) plans and profit sharing plans [see ERISA §407(b)(1)].

Under DOL §2550.407a-2, "acquisitions" of employer securities and employer real property that are subject to the 10 percent limitation include acquisition by purchase, exchange of plan assets, exercise of warrants or rights or foreclosures of collateral for a defaulted loan. Acquisition of securities as a result of a stock dividend or stock split are not counted towards the 10 percent limitation. In addition, any acquisition or sale of employer securities or employer real property between a plan and a party in interest must meet the conditions of §408(e), which provides that the acquisition, sale or lease be for adequate consideration and that no commission be charged [see also DOL §2550.408e].

An acquisition of employer securities or employer real property that does not meet the requirements of §407 is a prohibited transaction in violation of §406(a)(1)(E) and 406(a)(2).

ERISA §407 defines "qualifying employer securities" as stock, certain interests in publicly traded partnerships, and certain bonds, debentures, notes, certificates or other evidence of indebtedness of the employer or an affiliate. "Qualifying employer real property" is defined in ERISA §407(d)(4).

ERISA Section 408 - Exemptions From Prohibited Transactions

Statutory Exemptions - Certain exemptions from the prohibited transaction provisions are included in §408 of ERISA. A number of these statutory exemptions are applicable to the trust and asset management activities of savings associations. These exemptions are discussed below. Failure to comply with the various

conditions of these statutory exemptions would mean that the transaction is a prohibited transaction in violation of ERISA §406.

Plan Loan Statutory Exemption

Any loans made by the plan to parties-in-interest who are participants or beneficiaries of the plan are exempted from the prohibited transaction rules if such loans:

- are made in accordance with specific plan provisions;
- are available to all participants on a reasonably equivalent basis;
- are not made available to highly compensated employees in an amount greater than the amount made available to other employees;
- have a reasonable rate of return; and
- are adequately secured.

DOL regulations (29 C.F.R. §2550.408b-1) further explain each condition of the exemption. The tax treatment of participant loans made from qualified employer plans to plan participants is contained in the Internal Revenue Code at §72(p). The IRS issued final regulations on July 31, 2000 at 65 FR 46588, which make substantial changes to the treatment of employee benefit plan loans.

When the trust department is acting as trustee or recordkeeper for an employee benefit plan, it may be responsible, on behalf of the plan, for complying with Regulation Z disclosures in connection with employee benefit plan loans to plan participants. An employee benefit plan is deemed to be a creditor for Truth in Lending purposes if it regularly extends consumer credit that is payable in more than four installments, or for which the payment of a finance charge is or may be required and if it is the party shown as the payee on the face of the note evidencing the loan. Truth in Lending requires a plan fiduciary as a creditor to make disclosures to the borrowing participant with respect to certain credit information, including: 1) interest rates; 2) finance charges; 3) amounts financed; 4) payment schedules; 5) demand features; 6) prepayment penalties; 7) late payment fees; and 8) security interest descriptions and charges. The plan must disclose other relevant credit information so that the borrowing participant can compare credit terms from different sources. Regulation Z contains extensive guidance as to which fees are considered finance charges, the calculation of finance charges and requirements applicable to open-end credit and closed-end credit. Most, if not all, plan loans will be deemed to be closed-end credit and subject to the Truth in Lending requirements applicable to such credit. A loan over \$25,000, not secured by real property or the borrower's principal dwelling is exempted from Truth in Lending requirements. Thus, larger plan loans may be excluded from complying with the disclosure requirements.

The Services Statutory Exemption

ERISA §406(a)(1)(C) prohibits a party in interest from providing services to an employee benefit plan. Congress provided two statutory exemptions, ERISA §408(b)(2) for necessary services and §408(b)(6), for what are termed "ancillary services" by banks and financial institutions.

ERISA §408(b)(2) [see also IRC §4975(d)(2)] permits a plan to receive office space, 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 that is reasonable; and no more than reasonable compensation may be paid by the plan [see ERISA §2550.408b-2 for important guidance on

the scope of this exemption]. The exemption provides relief only from the prohibitions of ERISA §406(a), and not from §406(b).

ERISA §408(b)(6) permits financial institutions to receive reasonable compensation for the provision of ancillary services, provided the institution has adopted internal safeguards to ensure provision of such services consistent with sound banking and financial practices and specific guidelines are adopted on the extent to which the services will be provided. This exemption, §408(b)(6) provides relief from ERISA §406(a) as well as 406(b)(1) and 406(b)(2) (but not ERISA §406(b)(3)); therefore, it may provide an exemption in cases that would not be covered by ERISA §408(b)(2) [see §2550.408b-6 and 2550.408c-2 (compensation for services)].

Collective Investment Funds (CIFs)

The investment of employee benefit plans in a CIF operated by a party in interest of the plan is a prohibited transaction. ERISA §408(b)(8) [See also IRC §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, is specifically authorized by the plan or trust agreement or by an independent fiduciary and if the bank receives no more than reasonable compensation. Section 408(b)(8) provides relief from §§406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2).

Deposits, Interest-Bearing Statutory Exemption

ERISA §408(b)(4) provides a statutory exemption for the investment of plan assets in bank deposits that 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 §§406(a)(1), 406(b)(1) and 406(b)(2) but not from §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. The authorization must identify the bank by name. See §2550.408b-4.

Employee Stock Ownership Plans (ESOPs) - Loans To Plans Statutory Exemption

Examiners may encounter ESOPs sponsored by a savings association or its holding company or ESOPs sponsored by outside organizations for which the savings association 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 potential for abuse due to the possible involvement of insiders and the stock's potential lack of marketability. The guarantee of the loan by a party in interest is a prohibited transaction.

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

The exemption requires the loan to the plan to be:

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

A loan that is exempt under §408(b)(3) must be nonrecourse against the plan and the plan may give as collateral only qualifying employer securities (as defined under §407) that were acquired with the exempt loan or that were used as collateral on a prior exempt loan repaid with the proceeds of the current exempt loan.

Prohibited Transaction Exemptions - Class and Individual Exemptions

ERISA §408(a) provides authority for the DOL to issue both class and individual exemptions. These exemptions are in addition to the exemptions provided by ERISA. While class exemptions are applicable to any party that meets the conditions, individual exemptions provide relief only for the party (ies) that requested it. The DOL has issued more than 35 class exemptions and hundreds of individual exemptions.

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

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

Class Exemptions

A number of prohibited transactions not specifically covered in ERISA statutory exemptions are particularly relevant to financial institutions such as savings associations. These prohibited transactions, in many cases, have been addressed in class exemptions. Some of these class exemptions are discussed below.

Collective Investment Funds - PTE 91-38

The DOL has issued a class exemption, Prohibited Transaction Exemption 91-38 (PTE 91-38) which provides relief from ERISA §§406(a), 406(b)(2) and 407(a) for: (i) transactions between parties in interest with respect to a plan invested in a CIF and the bank that maintains the CIF, 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);
- The CIF is a specialized fund that invests substantially all of its assets in short-term obligations (one year or less); or
- 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.

Brokers Executing Securities Transactions - PTE 86-128

This exemption permits fiduciaries to effect or execute securities transactions for employee benefit plan accounts and to charge reasonable compensation for doing so. The PTE also permits a fiduciary to act and to

charge reasonable compensation for acting in an agency cross transaction as agent for both the plan and one or more other parties to the transaction, except where the fiduciary has discretionary authority on both sides of the transaction.

The effecting or executing securities transactions for a plan by a party in interest would generally fall within the statutory exemption of §408(b)(2), which permits payment of reasonable compensation for services provided. However, §408(b)(2) provides relief only from the transactions prohibited by §406(a). PTE 86-128 was granted to provide relief from the prohibited transaction provisions of §406(b), involving transactions between a plan and a fiduciary.

Certain limitations apply to the relief provided under the exemption. Trustees (except nondiscretionary trustees), administrators and sponsoring employers are not covered, unless they return or credit all profits earned in connection with the securities transaction to the plan. The exemption also does not apply in the case of transactions that are deemed excessive under the circumstances, either in amount or frequency.

The PTE requires satisfaction of conditions including advance written authorization by an independent plan fiduciary, disclosure of information and confirmation of transactions. The conditions are not required in the case of certain IRAs or Keogh Plans.

Special conditions exist for agency cross transactions, which are securities transactions in which the same person acts as agent for both seller and buyer for the purchase or sale of a security. The transaction must be a purchase or sale, without consideration, other than cash payment for a security for which a market quotation is readily available. The price must be at or in between the independent ask and bid prices for the security. Expanded disclosure must be provided with respect to these transactions, including a statement that the person effecting or executing the transaction will have a potentially conflicting division of loyalty and responsibility. These conditions are not required if the person effecting or executing the transaction does not render investment advice to any plan for a fee with respect to the transaction, is not otherwise a fiduciary with investment discretion over the plan assets involved in the transaction and does not have authority over any person who is or proposes to be a fiduciary with respect to such assets.

Special rules also exist for persons, including banks, engaging in a transaction on behalf of a collective investment fund (CIF) in which plan assets are invested. The special rules require, among other things, that a plan fiduciary be provided with certain disclosures and thereafter authorize the transaction. If the special rules are met, several of the conditions of the exemption are waived and, in certain cases, sponsoring employers may rely on the exemption.

Foreign Exchange - PTE 94-20

Prohibited Transaction Class Exemption 94-20 (PTE 94-20) permits banks and broker-dealers to effect foreign currency exchanges and foreign currency option transactions for employee benefit plans for which the banks or broker-dealers are parties in interest. The transactions may be performed only for nondiscretionary accounts and must be directed by an independent fiduciary. Additionally, the transactions must be on terms not less favorable to the plan than the terms generally available in comparable arm's-length transactions between unrelated parties. Other conditions apply regarding written policies and procedures, written confirmations (with specified contents) and appropriate records retained for six years. PTE 94-20 is effective for transactions incurred on or after June 18, 1991. Provisions also are included for transactions prior to that date.

A related class exemption is PTE 98-54 which exempts certain foreign exchange transactions between employee benefit plans and banks or broker-dealers that are parties in interest with respect to the plan upon standing instructions from an independent fiduciary. The permitted transactions are as follows:

- Income item conversions, which are conversions of interest, dividends and other securities distributions into U.S. dollars or other currencies, in an amount equivalent to no more than \$300,000 U.S. dollars; and
- *De minimis* purchase or sale transactions, which are purchases or sales of foreign currencies in an amount equal to no more than \$300,000 in 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, 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; and (7) compliance with certain recordkeeping procedures.

Investment in Residential Mortgages - PTE 88-59

Prohibited Transaction Class Exemption 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 of mortgage loans or participation interests prior to the maturity date. 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 §406(a), and not ERISA §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.

- 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.

Conversion from Collective Investment Funds (CIFs) to Mutual Funds - PTE 97-41

In 1997, the DOL issued Prohibited Transaction Class Exemption 97-41 (PTE 97-41) which provided relief from ERISA §§406(a), 406(b)(1) and 406(b)(2) for the transfer in-kind of plan assets from a CIF to a mutual fund, where the investment advisor or custodian of the mutual fund also serves as a fiduciary of the plan, provided the transfer represents a complete withdrawal of the plan's investment in the CIF. These transactions are also subject to in-kind asset transfer requirements of Securities Exchange Commission Rule 17(a)-7, issued under the Investment Company Act of 1940 [17 C.F.R. 270.17(a)-7]. PTE 97-41 was effective August 8, 1997 and contains provisions for retroactive relief from October 1, 1988 to August 8, 1997.

PTE 97-41 contains several conditions for prospective relief, including the following:

- No sales commissions or other fees may be paid by the plan in connection with purchase of the shares;
- All transferred assets must be securities for which market quotations are readily available, or cash;
- The transferred assets must represent the plan's pro rata share of all the assets of the CIF, except that special rules apply in the case of fixed-income securities;
- The plan must receive mutual fund shares of equal value to the assets transferred from the CIF;
- An independent fiduciary of the plan must receive advance notice of the transaction and certain disclosures, as well as written confirmations of the transactions;
- The independent fiduciary must provide written approval prior to the transaction;
- The investment advisor must receive no more than reasonable compensation for services to the plan and to the fund; and
- All dealings between the plan and the fund must be on terms no less favorable than transactions involving the fund and other shareholders.

As noted above, the PTE does not provide relief for prohibited transactions in violation of ERISA §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 §§406(a) and 406(b), including 406(b)(3). Accordingly, a bank that complies with PTE 97-41 may receive an investment management and advisory fee for services rendered to the fund, with respect to the plan's assets invested in the fund if it complies with the additional requirements of PTE 77-4.

Proprietary Mutual Funds - PTE 77-4

PTE 77-4 covers the purchase or sale by a plan of shares of a registered open-end investment company when the investment adviser of the company is also a fiduciary (or an affiliate thereof) with respect to the plan and is not an employer of employees covered by the plan.

The payment of sales commissions in connection with purchases or sales of mutual fund shares covered by the exemption is prohibited. In addition, the plan may not pay “double” investment advisory or investment management fees with respect to the plan assets invested in the mutual fund shares. To satisfy this condition, the plan either must not pay a plan-level investment advisory or management fee with respect to those assets or must receive a credit against its plan-level fee for its pro rata share of investment advisory fees paid by the mutual fund.

The exemption also contains various disclosure and approval requirements. An independent fiduciary must receive a current prospectus of the mutual fund, as well as full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan and the mutual fund. On the basis of this information, the independent fiduciary must approve the purchases and sales of the mutual fund shares consistent with its fiduciary responsibilities under ERISA. The approval can be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan. If there is any change in any of the rates of fees that were disclosed to the independent fiduciary, the fiduciary must be notified of the change and approve in writing the continued purchase, sale and holding of the mutual fund shares.

PTE 77-4 provides relief from the prohibitions of ERISA §§406(a) and 406(b). The DOL has released two Advisory Opinions (AO) applying PTE 77-4 to banking-related situations. AO 93-12A, dated April 27, 1993 (and also AO 93-13A, dated April 27, 1993) states that the proprietary mutual fund may pay a bank or an affiliate of the bank for secondary services provided to the mutual fund without a waiver or credit for a plan’s pro rata share of such fees. Secondary services are defined as acting as a transfer agent or providing custodial, administrative or accounting services. The secondary services fee may be charged as a flat fee, be based on a percentage of fund assets, a function of the number of accounts or on the volume of transactions. Secondary service fees are separately ascertainable from investment advisory fees. The DOL has indicated that PTE 77-4 does not specifically condition exemptive relief on the crediting of fees to plans for services paid by the investment company other than investment advisory services. AO 93-26A provides guidance on how the PTE applies to the use of affiliated mutual funds by IRA and Keogh accounts.

A Thrift’s own Employee Benefit Plans Invested in Proprietary Mutual Funds - PTE 77-3

PTE 77-3 provides relief for the acquisition or sale of shares of a registered open-end investment company by an “in-house” employee benefit plan, that is, a plan covering only employees of the mutual fund, the fund’s investment adviser, the fund’s principal underwriter, or an affiliate of such persons.

The plan may not pay any investment management, investment advisory or similar fee to the fund adviser, underwriter or affiliate, except in the form of investment advisory fees paid by the fund under a proper investment advisory agreement. The plan also may not pay a sales commission in acquiring or selling the fund shares, and may only be charged a redemption fee under certain conditions. Any other dealings with the plan, such as exchanging shares of one fund for a related fund, must be on a basis no less favorable to the plan than such dealings with other fund shareholders.

Overdrafts - PTE 80-26

An overdraft in an employee benefit plan’s account may be a prohibited transaction in violation of ERISA §406(a)(1)(B), as overdrafts represent the lending of funds from a party in interest (financial institution) to a plan. The financial institution would be a party in interest either because it is a fiduciary (trustee) or a provider of services to the plan.

The DOL has recognized that most overdrafts are of a temporary nature and not abusive. Overdrafts may occur as the result of failed securities transactions or problems with check clearings. As a result, the DOL provided relief in Prohibited Transaction Class Exemption 80-26 (PTE 80-26) from the restrictions of ERISA §§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.

Other conditions to the exemption are as follows:

- 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; and
- the loan or extension of credit may not be made, directly or indirectly, by an employee benefit plan.

Qualified Professional Asset Managers (QPAMs) - PTE 84-14

Prohibited Transaction Class Exemption 84-14 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 savings association. The exemption permits savings associations and other parties in interest to avoid costly ERISA compliance reviews for investment transactions under consideration. PTE 84-14 is effective December 21, 1982.

A savings association 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.

The general exemption of PTE 84-14 applies to ERISA §406(a)(1)(A)-(D) and contains a number of conditions summarized as follows:

- At the time of the transaction, the party in interest may not have, and during the immediately preceding one year may not have exercised, authority over the appointment or termination of the QPAM or the terms of management agreement with the QPAM.
- The terms of the transaction must be negotiated by or under the authority of the QPAM on behalf of the investment fund.
- The party in interest dealing with the investment fund may not be the QPAM or a person related to the QPAM.
- The transaction may not be entered into with any party in interest with respect to a plan, where the assets of the plan (combined with the assets of other plans sponsored by the same employer) managed by the QPAM represent more than 20 percent of the total assets managed by the QPAM at the time of the transaction.
- The terms of the transaction must be at least as favorable to the plan as generally available in an arm’s-length transaction between unrelated parties.

- Neither the QPAM nor a 5 percent owner of the QPAM may be a person who, within the 10 years immediately preceding the transaction, has been convicted or released from imprisonment (whichever is later) as a result of certain felonies.

The exemption does not apply to securities lending (see PTE 81-6); investment in mortgage pools (PTE see 83-1) and investment in mortgage financing (see PTE 88-59).

In addition to the general exemption, PTE 84-14 provides a specific exemption from the restrictions of ERISA §§406(a), 406(b)(1) and 407(a) for the provision of goods or services by a party in interest that is a sponsoring employer to an investment fund managed by a QPAM or for the leasing of space by the fund to a party in interest that is a sponsoring employer. A specific exemption from the restrictions of ERISA §§406(a)(1)(A)-(D) and 406(b)(1)-(2) also is provided for the leasing of space to a QPAM, an affiliate of the QPAM or a person with the authority to appoint, terminate or negotiate the terms of an agreement on behalf of a plan with a QPAM by an investment fund managed by the QPAM. Finally, there is a limited exemption for places of public accommodation. The specific exemptions have conditions and also must meet certain conditions of the general exemption.

Receipt of Services by IRAs and Keogh Plans - PTE 93-33

The DOL's Prohibited Transaction Class Exemption 93-33 permits savings associations to provide certain banking services at reduced or no cost to individuals, and their family members, for whose benefit the IRAs or Keogh plans were established. PTE 93-33 provides relief from ERISA §§406(a)(1)(D) and 406(b), and from the sanctions resulting from application of IRC §4975, including the loss of exemption of an IRA. PTE 93-33 amended and superseded Prohibited Transaction Class Exemption 93-2. The exemption allows savings associations 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 thrift could offer consistent with applicable federal and state banking law, and must be provided by the thrift or an affiliate in the ordinary course of business to customers who qualify for reduced or no cost banking services but who do not maintain IRAs or Keoghs with the institution. 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 savings association 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 savings association who does not receive reduced or low cost services.

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

Securities Lending - PTE 81-6

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, securities lending takes place with a financial institution that is acting as a trustee or investment

manager for the plan and a securities broker or one of their affiliates is providing services to the plan. In such cases, a prohibited transaction in violation of ERISA §406(a) exists because the financial institution or securities broker or the affiliate of either are parties in interest with respect to the plan. 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 financial institution to charge a reasonable fee for securities lending services. Conditions of the exemption 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 (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; and
- the loan must be able to be terminated by the plan 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.

Advisory Opinions

The DOL also is authorized to answer inquiries regarding ERISA, and does so, in the form of information letters and advisory opinions. When an inquiry is submitted, the institution must supply the information outlined in ERISA Procedure 76-1.

Mutual Funds, Receipt of 12b-1 Fees

Under SEC Rule 12b-1, mutual funds are permitted to pay certain distribution costs from the assets of the mutual fund itself. These payments may take the form of commission-like payments to organizations that generate large numbers of transactions in the mutual fund. Not all mutual funds have 12b-1 arrangements. There are compliance issues regarding the payment of 12b-1 (or shareholder servicing, sub transfer agent and shelf space) fees to the thrift, its operating subsidiaries, service corporations or affiliates from both proprietary mutual funds and third-party (nonproprietary) mutual funds.

ERISA §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 acting as trustee is prohibited under ERISA §406(b)(1) from dealing with assets of a plan in a way that would benefit itself. The receipt of 12b-1 fees would seem to come within this prohibition.

Proprietary Mutual Funds

An examiner may find a situation where a thrift or its affiliate is receiving 12b-1 fees from a proprietary mutual fund. First, the examiner should determine if all of the conditions of PTE 77-4 are being met. PTE 77-4 provides relief from the prohibitions of ERISA §406(a) and 406(b) when employee benefit plan assets for which the thrift is a trustee or other fiduciary are being invested in a proprietary mutual fund. There are two DOL Advisory Opinion Letters (AOs) that apply PTE 77-4 to other mutual fund fee sharing arrangements. AO 93-12A, dated April 27, 1993 (and also AO 93-13A, dated April 27, 1993) states that the proprietary mutual fund may pay a bank or an affiliate of the bank for secondary services provided to the mutual fund without a waiver or credit for a plan's pro rata share of such fees. Secondary services are defined as acting as a transfer agent or providing custodial, administrative or accounting services. The secondary services fee may be charged as a flat fee, be based on a percentage of fund assets, a function of the number of accounts or on the volume of transactions. Secondary service fees are separately ascertainable from investment advisory fees. The DOL has indicated that PTE 77-4 does not specifically condition exemptive relief on the crediting to plans, of fees the bank receives from the mutual fund for services rendered to the fund, other than investment advisory services.

So, the DOL has addressed investment advisory fees through PTE 77-4 and secondary services fees through AO 93-12A (and 13A) but has not directly addressed the receipt of 12b-1 fees received by a bank or thrift from a proprietary mutual fund.

In Advisory Opinion 93-12A, dated April 27, 1993, the DOL indicated that at the time PTE 77-4 was granted, the use of a portion of the assets of a registered investment company (mutual fund) to pay distribution expenses (12b-1 fee) was not generally permitted by the SEC. Accordingly, the payment of fees pursuant to a distribution plan adopted in accordance with Rule 12b-1 under the Investment Company Act was not specifically considered by the Department as part of its determination to grant PTE 77-4. (See footnote #4 to DOL Advisory Opinion Letter 93-12A, April 27, 1993). The DOL has gone on to say that it does not believe that the payment of a 12b-1 fee by a fund to a plan fiduciary or its affiliate can be functionally distinguished in many instances from the payment of a commission by the plan in connection with the acquisition or sale of shares in a mutual fund. If an examiner determines that payments of 12b-1 fees from proprietary mutual funds are being received by the thrift or its affiliate, he or she should ascertain whether an opinion of counsel has been obtained, that shows that current law and circumstances permit such payment and distinguishes the fees being received from commissions. The examiner should also determine whether there is a written agreement between the fund and the thrift or its affiliate that is receiving the 12b-1 fees, which describes the services that are being provided by the thrift to the fund.

Nonproprietary Mutual Funds

The DOL has addressed the question of receipt of 12b-1 fees (shareholder services fees, sub transfer agent fee and/or shelf space) in two advisory opinion letters and one information letter.

The first main advisory opinion letter is 97-15A, dated May 22, 1997 (Frost National Bank opinion letter). Frost presented two situations to the DOL. One was where it was acting in a discretionary capacity. In this situation, Frost was making recommendations to plan sponsors regarding the advisability of investing in the various mutual funds that Frost offered as part of its 401(k) product. In the other situation, Frost was acting as a trustee to 401(k) plans but was not making any recommendations concerning the selection of, or continued investment in, particular mutual funds. The selection of the mutual funds to offer to participants was made, in all cases, by the plan sponsor after reviewing the funds Frost had available as part of its 401(k) product.

Frost asked whether its receipt of fees from the mutual funds would violate ERISA §406(b)(1) or (b)(3). The DOL in its opinion indicated that since Frost is a trustee in both discretionary and nondiscretionary situations, it is a fiduciary. In fact, the opinion states, "...the position of trustee of a plan, by its very nature, requires the person who holds it to perform one or more of the functions described in ERISA §3(21)(A)." Footnote #6 which follows this statement is as follows:

Section 403(a) of ERISA establishes that, in general, a trustee of a plan must have exclusive authority and discretion to manage and control the plan's assets. Under §403(a)(1), when the plan expressly so provides, the trustee may be subject to the proper directions of a named fiduciary which are made in accordance with the terms of the plan and not contrary to ERISA. Nevertheless, a directed trustee has residual fiduciary responsibility for determining whether a given direction is proper and whether following the direction would result in a violation of ERISA. Accordingly, it is the view of the Department that a directed trustee necessarily will perform fiduciary functions.

The DOL concluded that when Frost is acting in a discretionary capacity, i.e. advising the plan sponsor regarding the various mutual funds in its 401(k) product menu and receives 12b-1 fees from the mutual funds the plan participants are invested in, then Frost is in violation of ERISA §406(b)(1). However, the DOL said that Frost could extinguish its prohibited transaction violations by disclosing to the plan the extent to which it may receive fees from the various mutual funds. In addition, Frost would have to offset on a dollar per dollar basis any fees it receives from the mutual funds against any fees that the plans owe to Frost. Any fees that Frost receives from the mutual funds that exceeds the plan's liabilities to Frost, will go to the plan.

When Frost is directed by the plan or the plan participants, there is no violation of either ERISA §406(b)(1) or §406(b)(3) whether Frost offsets the fees from the mutual fund against the plan's trustee fee or not. But, since Frost reserved the right to add or remove mutual fund families from its 401(k) product, there is a violation of §§406(b)(1) & 406(b)(3). Frost extinguishes its prohibited transaction violations by off-setting dollar for dollar the fees it receives from the mutual funds against the plan's fees owed to Frost or Frost could choose to credit directly to the plan, the fees received from the mutual funds.

In the Frost letter, the DOL also noted that the general standards of fiduciary conduct stated in ERISA §404(a)(1) require the plan fiduciary to determine that the compensation paid directly or indirectly by the plan to its trustee is reasonable, taking into account the services provided to the plan as well as any other fees or compensation received by the trustee in connection with the investment of plan assets. The DOL emphasized that plan fiduciaries must obtain sufficient information regarding any fees or other compensation that the trustee receives with respect to the plan's investments in each mutual fund to make an informed decision as to whether the trustee's compensation for services is no more than reasonable. In addition, plan fiduciaries are required to periodically monitor the actions taken by the trustee 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.

The situation in the next advisory opinion letter on 12b-1 fees was very different. In 97-16A, dated May 22, 1997 (the Aetna letter) the DOL looked at whether a nonfiduciary, such as a recordkeeper could retain 12b-1 fees received from third-party mutual funds without an offset. In all situations that Aetna presented to the DOL, the plan participants were making the selection of which mutual fund to invest in and the plan sponsor was choosing which mutual funds (from those available in Aetna's 401(k) product) would be made available to the plan participants in their 401(k) program.

The first question that the DOL faced was whether Aetna was a fiduciary. The DOL referred to Interpretive Bulletin (IB) 75-8 that provides guidance concerning what types of functions will make a person a fiduciary with respect to a plan. Based on the information provided in the IB, the DOL stated that the question of whether Aetna is a fiduciary within the meaning of 3(21)(A) of ERISA is inherently factual and depends on the particular actions or functions that Aetna performs on behalf of the plans. The DOL found that since Aetna was not a trustee or administrator of the plan and provided only administrative and recordkeeping services, it was not a fiduciary. However, the DOL was concerned with the fact that Aetna retained the right to delete or substitute mutual funds in its 401(k) product list. The DOL determined that normally this would make Aetna a fiduciary, however, since Aetna provided advance notice of any mutual fund changes in its product list, including any changes in the fees received and afforded the plan sponsor a reasonable period of time within which to decide whether to accept or reject the change and, in the event of a rejection to secure a new service provider; Aetna would not become a fiduciary solely as a result of deleting or substituting mutual funds, provided that the actual decision to accept or reject the change is made by the plan.

The DOL closed its advisory opinion letter by reiterating the general fiduciary concerns it expressed in the Frost letter.

In an informational letter dated August 20, 1997 and addressed to Judith McCormick, Senior Trust Counsel of the American Bankers Association, the DOL indicated that if a fiduciary, such as a directed trustee, that retained the right to add or delete mutual funds from its 401(k) product menu and did not want to offset dollar for dollar any 12b-1 or other fees it received from mutual funds would have to follow the conditions as laid out in the Aetna advisory opinion letter.

Float Management

In advisory opinion letter 93-24A, dated September 13, 1993 the DOL addressed the question of whether a bank acting as an agent or trustee for employee benefit plans can earn interest for its own account from the “float” when a benefit check is written to a participant until the check is presented for payment. The question was asked by a nondeposit trust company that maintained a disbursement account at a national bank. The trust company and the bank had a retail repurchase agreement that allowed the trust company to earn (for its own benefit, not that of the plan) interest on the funds held in the disbursement account until they were released when checks were cashed.

The question asked of the DOL was whether this practice was a violation of §406(b)(3) of ERISA. The trust company contended that once a check is written to a participant, the corresponding amounts in the disbursement account were no longer plan assets.

The DOL first asked the question of whether the trust company was a fiduciary. The DOL looked to §3(21)(A) of ERISA, which defines a fiduciary, in part, as one who exercises any discretionary authority with respect to the assets of a plan. The DOL then went on to look at 29 C.F.R. 2509.75-8 which states that persons serving as plan trustees will be fiduciaries due to the very nature of their position. Then the DOL stated:

Accordingly, it is the view of the Department that, based on the facts described above, where a fiduciary (e.g. Trust Company) exercises discretion with regard to plan assets, its receipt of income from the “float” on benefit checks under a repurchase agreement with a national bank in connection with the investment of such plan assets would result in a transaction described in ERISA §406(b)(1).

Although asked, the DOL declined to address the question of whether the trust company had also violated ERISA §406(b)(3).

The DOL then addressed the subject of float in an informational letter addressed to Judith McCormick, Federal Counsel of the American Bankers Association dated August 11, 1994. In the letter, the DOL indicated that if a bank acting as trustee openly negotiated with the plan sponsor to retain earnings on the float as part of its overall compensation, the bank's use of the float would not violate the prohibited transaction rules. The DOL suggested that to avoid problems, banks should, as part of their fee negotiations, provide full and fair disclosure regarding the use of float on outstanding benefit checks.

Sweep Fees

Savings associations 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 into 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 §406. In some cases, the statutory exemptions of ERISA §408 may provide a safe harbor.

The primary guidance regarding sweep services is contained in DOL Advisory Opinion, AO 88-02A and a DOL information letter issued to Robert S. Plotkin, dated August 1, 1986 (the Plotkin Letter). The general rule established under these letters is that a bank, which has the authority to decide whether a sweep transaction should be performed and which levies a separate fee for this service is in violation of ERISA §406(b). Section 406(b)(1) [see also 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 that is adverse to the interest of the plan or the plan's participants and beneficiaries.

The DOL letters clarify that a bank may provide sweep services under the following circumstances:

- If no fee is charged (other than direct expenses properly and actually incurred in the performance of services). [Plotkin Letter].
- If investment services, including sweep services, are provided under a single fee arrangement that is calculated as a percentage of the market value of the total assets under management. [Plotkin Letter].
- If a for-profit fee is charged, provided that a fiduciary independent of the bank (such as the plan sponsor, plan administrator, or outside investment manager) (i) authorizes either individual sweep transactions or authorizes a standard procedure as to when and how sweeps will occur in order to eliminate any discretion on the part of the bank; (ii) authorizes the investment vehicle(s); (iii) is permitted to terminate the sweep arrangement at any time without penalty; and (iv) receives notice from the bank not less than 30 days prior to any change in sweep fees.

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.

The DOL's 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 Section 28(e) would represent a violation of ERISA §§406(a)(1)(D), 406(b)(1) and 406(b)(3).

ERISA - Miscellaneous Provisions (Sections 409, 410, 411 and 412)

Section 409 states that any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations or duties imposed upon fiduciaries shall be liable to make good to such plan any losses to the plan resulting from each breach, shall restore to the plan any profits of a fiduciary which have been made through use of plan assets and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of the fiduciary.

Some employee benefit plans contain exculpatory clauses or indemnification agreements in the plan document or trust instrument. These clauses attempt to relieve the trustee from liabilities from certain described actions. They may attempt to permit a trustee to adhere to a lesser standard than required by law. Section 410(a) of ERISA states that "any provisions 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 that fiduciaries may allocate and delegate responsibilities under §405). DOL Interpretive Bulletin 75-4 permits indemnification agreements that leave the fiduciary fully responsible and liable for its actions, but allow another party to satisfy any liability incurred by the fiduciary (i.e. liability insurance). At least one court has ruled on indemnification language. In the case of Reich v. NationsBank of Georgia, 2138 N.D. Ga. 1993, which is also known as the "Polaroid" case, a federal district court held that common law trust principles invalidate indemnification agreements that tend to induce a breach of the fiduciary's trust. The court went on to say that the indemnification provision contained in the ESOP agreement (which was at issue in the case) "creates a financial incentive for the trustee to breach its fiduciary obligations under ERISA" because, if the trustee exercised independent judgment it would be left unprotected against charges of negligence, bad faith or willful misconduct.

Section 410(b) of ERISA permits plans to purchase insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of an act or omission. The policy must be payable to the plan and provide that the insurance company may take recourse against the fiduciary for breaches of fiduciary responsibility. Individual fiduciaries may also purchase insurance that would protect them against personal liability.

Section 411 prohibits any person convicted of or imprisoned as a result of a conviction of certain specific crimes (such as embezzlement, bribery or extortion, etc.) to serve in any capacity with regard to an employee benefit plan during or for the period of five years after such conviction or after the end of such imprisonment.

Finally, ERISA §412 requires that, in general, each fiduciary or other person who handles funds or other property of the plan 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. The amount of the bond is 10 percent of the assets handled, with a minimum of \$1,000 and a maximum of \$500,000.

Referrals to the Department of Labor

The Federal Financial Institutions Examination Council (FFIEC) and the Department of Labor have signed an agreement (Interagency Referral Agreement for ERISA Violations) under which significant possible violations of ERISA are to be referred to the DOL by OTS and the other federal regulatory agencies. Generally, referrals are to be made for possible violations relating to fiduciary duties (§404) and prohibited

transactions (§406). In addition, the violations must affect transactions of \$100,000 or more and must pose a threat to plan assets, participants or beneficiaries.

- The DOL forwards any referrals to be investigated to its appropriate regional office for review. The written notification to the DOL is to include the following: 1) the name of the financial institution; 2) the name of the plan; and 3) a brief description of the nature of the possible violation and any corrective action requested by the OTS and/or initiated by the OTS.

In order to provide for the orderly processing of any such possible referrals and to assure national uniformity, potential referrals should be forwarded to the Examination Policy section of OTS in Washington, D.C., for review prior to making the referral.

Participant Recordkeeping

While many institutions perform participant recordkeeping services in-house for individual account defined contribution employee benefit plans as part of their product or service to employee benefit plan customers, some institutions have assigned these responsibilities to recordkeeping specialists that may be affiliates, third parties or, in the largest trust institutions, to separate departments. With the increasingly complex regulatory requirements in processing and reporting of plan transactions, many savings associations have used these specialists to receive and process transactions, value the assets held by the plan (whether daily, monthly, quarterly, semiannually or annually), perform participant recordkeeping for loans, regulatory and participant reporting, do compliance testing and to update the plans with recent regulatory changes. It is important for the examiner to review the servicing agreements between the parties, to assess the technical expertise of these service providers and to evaluate the controls used to mitigate the heightened legal and operational risks associated with this function. The sufficiency of the savings association's oversight of the service provider should also be assessed.