U.S. Department of Labor **Employee Benefits Security Administration**
Washington, D.C. 20210

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2005-09A
ERISA SEC.
408(b)(8)

Dear Mr. Myers:

This is in response to your request for an advisory opinion on behalf of Vanguard Fiduciary Trust Company (Vanguard) concerning the application of section 408(b)(8) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the parallel provisions under section 4975(d)(8) of the Internal Revenue Code of 1986, as amended (the Code),[1] to an in-kind investment in a bank collective investment fund, as made under the circumstances described herein.

Background

You represent that Vanguard is a trust company, based in Valley Forge, Pennsylvania, that is organized under the laws applicable to such entities under the Pennsylvania Banking Code. Vanguard is supervised by the Pennsylvania Department of Banking. Vanguard is a wholly-owned subsidiary of The Vanguard Group, Inc. (Vanguard Group).

The Vanguard Group manages assets through registered open-end investment companies, pursuant to the Investment Company Act of 1940 (i.e., mutual funds). Vanguard manages assets held in collective trust funds for employee benefit plans covered by ERISA. You state that many Vanguard Group mutual funds and Vanguard trust funds serve as investment options for participant-directed individual account plans, organized to comply with section 401(k) of the Code ("401(k) plans"), and as investments for other qualified retirement plans.

Vanguard structures stable value investment options, designed to allow investors to receive current interest income and preserve principal amounts, for many 401(k) plans either using a commingled trust, or as a separately managed account for a particular plan. You state that over 900 plans use the commingled trust structure, and

[1] Under Reorganization Plan No. 4 of 1978, effective December 31, 1978 [5 USC App. at 214 (2000 ed.)], the authority of the Secretary of the Treasury to issue interpretations regarding section 4975 of the Code has been transferred, with certain exceptions not here relevant, to the Secretary of Labor and the Secretary of the Treasury is bound by interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA should be read to refer also to the corresponding sections of the Code.

approximately 40 are using the stable value separate account structure (referred to collectively herein as "stable value portfolios").

The commingled trust structure uses a collective investment vehicle, the VRST Master Trust. Plans do not hold interests directly in the VRST Master Trust, but instead invest in one of seven "feeder" trusts – the Retirement Savings Trusts – that invest all of their assets in the VRST Master Trust. Investment management fees are imposed at the "feeder" trust level.

The commingled trusts used by Vanguard take the form of collective investment funds intended to qualify as group trusts, pursuant to Revenue Ruling 81-100, 1981-1 C.B. 326, and Revenue Ruling 2004-67, 2004-28 I.R.B., that are tax exempt under section 401 and 501(a) of the Code. Vanguard serves as trustee for such commingled trusts.

Plans pay fees to Vanguard only at the level of the stable value investment portfolio in which the plan directly invests. This is the level of the separately managed account or, with respect to the VRST Master Trust, the "feeder" trust level.

Vanguard's stable value portfolios (i.e., the commingled trusts or the separately managed accounts) currently invest in, among other things, a series of fixed-income commingled trusts, the Vanguard Targeted Return Trusts (the TRTs). The TRTs were established quarterly on a rolling basis, each with a 5-year term, and managed to a constantly decreasing duration to provide liquidity at the end of the 5-year term. At any one time, there would be 20 TRTs in existence with durations ranging from one quarter of a year to 5 years. Each quarter, one TRT would expire and a new one would be created. The stable value portfolios managed by Vanguard, including the VRST Master Trust, have invested in the various TRTs based on their available cash, other investments and liquidity needs. The VRST Master Trust holds the majority of the assets of each TRT.

You state that Vanguard created the TRTs as stable value portfolios with high-quality fixed income securities with fixed maturity dates. These securities were then backed by "wrap" contracts with insurance companies or banks to provide for certain disbursements to be made at the "book" value of the assets, rather than the market value. This structure is commonly referred to as a "synthetic" guaranteed investment contract arrangement.

You represent that for various reasons related to investment management strategies and cost efficiencies, Vanguard has begun to phase out the TRT program. As the existing TRTs mature, they are being replaced by investments in two commingled trusts of comparable aggregate duration – the Vanguard Intermediate-Term Bond Trust (ITBT), and the Vanguard Short-Term Bond Trust (STBT). These trusts (collectively, the Bond Trusts), like the TRTs, invest principally in high-quality fixed-income securities.

As a means of transitioning to the new investment management structure, and more quickly realizing the efficiencies and other benefits of managing assets through the Bond Trusts rather than the existing TRTs, Vanguard would like to transfer the assets of the TRTs in-kind to the Bond Trusts as soon as possible, and then terminate the TRTs.

Specifically, TRT securities would be allocated to the Bond Trusts based on the TRTs' average durations. Each TRT would receive in return interests in the applicable Bond Trust – i.e., the STBT or ITBT – that are equal in value to the value of the securities it transferred to the respective Bond Trust. The same business day, the TRT would distribute those Bond Trust interests to each stable value portfolio that holds interests in the TRT, in proportion to the portfolio's TRT interests, and then terminate. At the end of the business day, each stable value portfolio would hold Bond Trust interests equal in value to its former TRT interests.

The principal advantage of liquidating the TRTs through in-kind exchanges of securities for interests in the Bond Trusts, as opposed to liquidations for cash on the open market, would be to avoid transaction costs. The total transaction cost estimates are in the range of $5.4 million as existing TRTs have securities with an estimated market value of approximately $3.4 billion. In addition, Vanguard seeks to avoid the possibility of the Bond Trusts not acquiring the same securities on the open market that are sold by the TRTs.

You represent that the trust documents for the TRTs and the Bond Trusts provide the necessary authority for Vanguard to cause the TRTs to make an in-kind investment in the Bond Trusts. You state that the TRTs, by their terms, permit investment in a collective investment fund maintained by the trustee of the TRTs (i.e., Vanguard), where the fund invests principally in securities of the type in which the TRT is permitted to invest. Specifically, Article 6.1(a) of each TRT gives the trustee the authority, in its sole discretion, "to invest and reinvest the Trust in such investments and other property, without restrictions to investments authorized for fiduciaries, as the Trustee determines in accordance with the Trust's investment objective as set forth in Article 1.2 …, including, without limitation, (i) any other collective investment trust maintained by the Trustee…"

Your represent further that the trust documents for the Bond Trusts permit investment by any common, collective or commingled trust fund or group trust that consists solely of the assets of pension, profit-sharing and other qualified plans, and/or other types of retirement plans or vehicles holding retirement plan assets. Under Article 1.02 of the STBT and Article 2.2 of the ITBT, an investment in units of the respective Trust may be made in the form of cash, or in the form of other property acceptable to the trustee.

For purposes of the in-kind investments by the TRTs in the Bond Trusts, you state that the assets being transferred would be valued in a consistent manner by both the investing and receiving trusts, using independent pricing sources.

Specifically, for valuing fixed-income securities, Vanguard uses the same pricing services for both the TRTs and the Bond Trusts. Where none of the pricing services used makes a value available for a particular security, or where there has been a significant change in value of the security from the previous price used (i.e., greater than 1%), Vanguard will obtain quotations from three (3) different independent brokers, and will use the lowest of the three available quotes. You state that pricing services and broker quotations are not used for short-term instruments maturing within 60 days. Thus, pursuant to the trust document's valuation provisions, these instruments would be valued at cost (plus or minus any amortized discount or premium). All valuations would be made as of 3:00 p.m. Eastern Time on the valuation date.

Vanguard serves as trustee of both the TRTs and the Bond Trusts – all of which, as bank collective investment funds, are deemed to hold "plan assets" subject to ERISA pursuant to the Department's regulations (see 29 CFR §2510.3-101(h)(1)(ii)). For this reason, you state that Vanguard would find itself acting in a discretionary role on both sides of any transaction between the TRTs and the Bond Trusts. Thus, the in-kind investment by the TRTs in the Bond Trusts could be viewed as a sale by the TRTs of their securities to the Bond Trusts, with Vanguard, in its capacity as trustee, acting in the role of both the buyer and the seller.

Advisory Opinion Requested

You request an opinion as to whether a purchase of interests in a collective investment fund through an in-kind investment of securities would be exempt from the prohibited transaction provisions of section 406 of ERISA by reason of the statutory exemption contained in section 408(b)(8) of ERISA.

Relevant Provisions of ERISA and Analysis

Section 406(a)(1) of ERISA provides, in part, that a fiduciary with respect to a plan shall not cause the plan to engage in certain direct or indirect transactions with a party in interest, including sales or exchanges of property between the plan and a party in interest (section 406(a)(1)(A)), and transfers to or use by or for the benefit of a party in interest of any assets of the plan (section 406(a)(1)(D)).

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(2) of ERISA provides that a fiduciary shall not in his or her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or

represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.

Section 3(21) of ERISA defines a "fiduciary" of a plan to include a person who exercises any discretionary authority or control respecting management or disposition of its assets; or who renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of the plan, or has any authority or responsibility to do so.

Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary and a person providing services to a plan.

The Department's regulation at 29 CFR §2510.3-101 defines what are considered to be "plan assets" when a plan invests in another entity. The regulation provides, at 29 CFR §2510.3-101(h)(1)(ii), that when a plan acquires an interest in a common or collective trust fund of a bank, its assets include its investment as well as an undivided interest in each of the fund's underlying assets.

As you have acknowledged, Vanguard is a fiduciary under section 3(21) of ERISA with respect to ERISA-covered plans for which it serves as trustee. Pursuant to the Department's regulations defining "plan assets" (as noted above), Vanguard is also a fiduciary for ERISA-covered plans that invest in the TRTs, either through separately managed accounts or commingled trusts, by reason of its discretionary authority and control over such assets. You indicate that Vanguard receives investment management fees from plans that invest in such accounts or trusts invested in the TRTs, at either the separate account or "feeder" trust level, as applicable.

Therefore, unless an exemption applies, you are concerned that Vanguard would violate sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1), and 406(b)(2) of ERISA if, as a fiduciary of ERISA-covered plans, it caused "plan assets" invested in the TRTs to be invested in the Bond Trusts.

Section 408(b)(8) of ERISA exempts, in pertinent part, any transaction between a plan and a common or collective trust fund maintained by a party in interest which is a bank or trust company supervised by a state or federal agency, if the following conditions are met:

(1) the transaction is a sale or purchase of an interest in the fund,

(2) the bank or trust company receives not more than reasonable compensation, and

(3) such transaction is expressly permitted by the instrument under which the plan is maintained, or by a fiduciary (other than the bank or trust company or an affiliate) who has authority to manage and control the assets of the plan.

You represent that the TRTs and Bond Trusts are collective trust funds maintained by Vanguard, a trust company supervised by the Pennsylvania Department of Banking. The transactions at issue would be purchases of interests in the Bond Trusts, and would be authorized by the applicable trust documents relating to each TRT and Bond Trust. Vanguard would not be paid any separate fees by the Bond Trusts for the assets invested therein by the TRTs. You state that Vanguard's existing fee arrangements with plans would remain unaffected by the proposed transactions and it would not receive more than reasonable compensation as a result of the transactions.

With respect to the conditions of ERISA section 408(b)(8), although the statutory provisions do not define the term "reasonable compensation" for purposes of the exemption, the ERISA Conference Committee Report (as issued by Congress in 1974) provides that:

> "[t]o be allowed, no more than reasonable compensation may be paid by the plan in the purchase (or sale) and no more than reasonable compensation may be paid by the plan for investment management by the pooled fund."

[See H.R. Rep. No. 93-1280, 93rd Cong., 2nd Sess., at 316 (1974)]

Thus, Congress anticipated that the term "reasonable compensation" would apply to the purchase or sale of an interest in a collective investment fund by a plan and to amounts to be paid by the plan for investment management of such assets.

In addition, with respect to covered transactions, the ERISA Conference Committee Report does not appear to distinguish cash from in-kind assets, nor does it specify a particular form of investment, with regard to any purchase or sale of interests or units in a common or collective investment trust fund, or pooled investment fund, maintained by a party in interest which is a bank or trust company. Furthermore, at the end of the relevant section discussing the provisions of ERISA section 408(b)(8), Congress expressed the view that, under the general fiduciary rules of ERISA, a bank "…cannot use pooled funds as a place to dump unwanted investments which were initially made on its own (or another's behalf)." *Id*.

In this regard, by noting the possibility of a bank placing investments it previously had made into a collective investment fund, Congress appears to have anticipated in-kind investments being made into such a fund as a "purchase" covered by the statutory exemption.

Accordingly, it is the opinion of the Department that the statutory exemption provided under section 408(b)(8) of ERISA would permit an in-kind exchange of securities owned by a plan or fund holding "plan assets" for units or interests in a collective investment fund maintained by a bank or trust company, provided that the conditions necessary for relief as stated therein are met.[2] However, please note that the issue of whether all of the conditions of section 408(b)(8) will be met is a factual determination upon which the Department cannot opine. Therefore, the appropriate plan fiduciaries, including Vanguard, must determine, based on the particular facts and circumstances, whether the conditions of section 408(b)(8) will be met for the proposed in-kind exchanges.

In particular, the Department notes that the exemption provided in section 408(b)(8) is available for the proposed in-kind exchanges only if the valuation method used by Vanguard in connection with each transaction results in a plan paying no more than reasonable compensation for its investment. In our view, a plan would pay more than reasonable compensation in any in-kind exchange in which the value of assets transferred to a fund would be more than the value of the fund units or interests the plan received.

Therefore, the Department cautions Vanguard to ensure that appropriate procedures and safeguards are in place to guarantee uniform pricing of both the relevant "plan assets" in each TRT to be transferred to each Bond Trust and the Bond Trust's units to be received by each plan's stable value portfolio investment. As described herein, such investments would include the Retirement Savings Trusts that are "feeder" trusts for the VRST Master Trust, as managed by Vanguard on the date of the transactions.

Finally, the Department is providing no opinion herein as to Vanguard's current or future stable value investment strategies, or courses of action to implement to such strategies (including methods for saving transaction costs or avoiding market impact).

Section 404(a)(1) of ERISA provides, in pertinent part, that fiduciaries shall discharge their duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person 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. Among other things, a fiduciary must give appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment

[2] See Adv. Op. 96-15A (Aug. 7, 1996), wherein the Department took the position that section 408(b)(8) of ERISA provides relief from sections 406(a)(1)(A), 406(a)(1)(D), 406(b)(1) and 406(b)(2) for the purchase or sale by a bank or trust company, as fiduciary of ERISA-covered plans, of interests in a collective fund so long as the conditions of the statutory exemption are met, including that the transaction be expressly permitted by the plan or an authorized independent fiduciary.

or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties.[3]

This letter constitutes an advisory opinion under ERISA Procedure 76-1, 41 Fed. Reg. 36281 (1976). Accordingly, this letter is issued subject to the provisions of that procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Louis J. Campagna
Chief, Division of Fiduciary Interpretations
Office of Regulations and Interpretations

[3] The Department notes that regulation §2550.404a-1 defines appropriate considerations for an investment course of action by fiduciaries in such matters.