

AN ERISA COMPLIANCE HANDBOOK FOR ASSET MANAGERS

Updated November 2019





TABLE OF CONTENTS

Introduction	3
Basics	
CHAPTER 1: When Does ERISA Apply?	4
CHAPTER 2: Fiduciary Duties	7
CHAPTER 3: Prohibited Transactions	9
Qualifications	
CHAPTER 4: QPAM Exemption	11
CHAPTER 5: Alternatives for Non-QPAMs	15
CHAPTER 6: Non-U.S. Assets	17
CHAPTER 7: Fidelity Bonds	18
Documentation	
CHAPTER 8: Client Intake and Subscriptions.....	21
CHAPTER 9: Investment Management Agreements	23
CHAPTER 10: Prime Brokerage and Derivatives	25
Client Relations	
CHAPTER 11: Reporting and Disclosure	27
CHAPTER 12: Gifts and Entertainment.....	31
Transactions	
CHAPTER 13: Trading Basics	34
CHAPTER 14: Affiliated Brokers	36
CHAPTER 15: Affiliated Underwriters	37
CHAPTER 16: Affiliated Funds	38
CHAPTER 17: Cross-Trades and Other Conflicts of Interest	39
CHAPTER 18: Foreign Exchange	41
CHAPTER 19: Asset-Backed and Mortgage-Backed Securities	42
CHAPTER 20: ERISA-Restricted Securities	43
CHAPTER 21: Corrections	45
Appendix	
Parties in Interest Diagram.....	48



Introduction

This is the 2019 revised and updated edition of Ropes & Gray’s ERISA Compliance Handbook for Asset Managers. Like the original Handbook, this new edition is intended to familiarize managers of U.S. private pension assets with the basic rules and requirements of ERISA and help them make the best use of their ERISA compliance resources.

One purpose of this Handbook is to serve as a reference guide for specific situations governed by special rules under ERISA. The objective is to provide a practical resource that can be taken off the shelf as circumstances create a need for information regarding compliance with ERISA. A further purpose of this Handbook is to encourage the adoption and implementation of robust ERISA compliance policies and procedures. To facilitate the adoption of appropriate policies, this Handbook includes “Sample Compliance Policy” language at the end of many chapters, set off in a separate text box. Of course, to be useful in reducing compliance risk, a manager’s policies and procedures should be carefully tailored to its business and operations and regularly reviewed to ensure they reflect current business needs. Legal counsel should be consulted when adopting or reviewing compliance policies and procedures.

The first Section of this Handbook, “Basics,” reviews basic rules governing fiduciary conduct under ERISA and discusses the methodology for determining when you are managing ERISA plan assets. The next two Sections, “Qualifications” and “Documentation,” address standard requirements for a manager that undertakes to manage ERISA plan assets and customary documentation a manager should have in place before accepting ERISA plan assets for management. The fourth Section, “Client Relations,” details reporting and disclosure requirements in connection with the relationship between a manager and its ERISA clients and explains rules that apply to gifts and entertainment provided between a manager and its ERISA clients. The fifth Section, “Transactions,” explains rules that apply to specific transactions and to transactions involving specific assets.

Although every effort has been made to reflect current guidance on key issues, new guidance appears on a regular basis. We advise the readers of this Handbook to continue to watch for developments in this area.

The following Ropes & Gray partners are responsible for creating and maintaining this Handbook:

Bill Jewett: +1 617 951 7070 | william.jewett@ropesgray.com

Josh Lichtenstein: +1 212 841 5788 | joshua.lichtenstein@ropesgray.com

If you have particular questions regarding the content in this Handbook, please contact any of the above or your usual Ropes & Gray advisor.

Communicating with Ropes & Gray LLP or a Ropes & Gray lawyer does not create a client-lawyer relationship. The ERISA Compliance Handbook is intended to be used for informational purposes only. It is not intended to be and should not be relied upon as legal advice with respect to any particular set of facts.

© 2019 Ropes & Gray LLP. All rights reserved.



Basics

CHAPTER 1

When Does ERISA Apply?

A threshold condition for an investment or an account to be subject to ERISA is whether a “benefit plan investor,” as defined in ERISA, is involved. “Benefit plan investors” include:

- Employee benefit plans subject to ERISA (and related trusts), such as pension plans, 401(k) plans and Taft-Hartley (multiemployer) plans, but not:
 - governmental plans and public retirement systems, or
 - non-U.S. plans and pension systems, or
 - church plans, unless a special election has been made to be subject to ERISA.
- IRAs and other plans that are not subject to ERISA but that are subject to section 4975 of the Internal Revenue Code (the “Code”).
- Entities such as collective funds, group trusts, or insurance company general or separate accounts that are deemed to hold plan assets by reason of investments in the entity by benefit plan investors, as described below.

A client account will be subject to ERISA if the client is a “benefit plan investor” that is subject to ERISA. However, if the only benefit plan investors in a client account are IRAs or other nonemployer-sponsored plans or accounts that are subject to the prohibited transaction rules under Section 4975 of the Code, but not to Title I of ERISA, then that client account will be subject to the prohibited transaction rules, but not to the additional requirements of ERISA.

As noted above, entities such as collective funds likewise can be subject to ERISA. If a “benefit plan investor” invests in any pooled investment vehicle, then, unless one or more of the exceptions described below apply, the underlying assets of the fund are deemed to be “plan assets” for purposes of ERISA, as though an undivided interest in each asset were held by the benefit plan investor. In that case, if any benefit plan investor is subject to ERISA, the fund itself becomes subject to ERISA, and the fund’s manager (or, as applicable, its general partner, managing member, trustee, adviser or similar entity) becomes an ERISA fiduciary with respect to the assets attributable to investors that are subject to ERISA.

A benefit plan investor’s investment in an entity will cause the assets of the entity to be treated as plan assets unless one or more of the following exceptions apply:

- Interests in the entity constitute a “publicly offered security”—generally, a freely transferable security that is part of a class of securities that is widely held and registered under Section 12(b) or (g) of the Securities Exchange Act. This exception effectively requires a U.S. listing, so publicly listed companies outside of the United States cannot rely on this exception.

Note: This can make it challenging for ERISA plans and IRAs to invest in non-U.S. exchange-traded funds, including UCITS.



- The entity is an investment company registered under the Investment Company Act of 1940 (e.g., a mutual fund, but not a Business Development Company).
- The entity is an “operating company” because it is primarily engaged, either directly or through majority-owned subsidiaries, in the production or sale of a product or service other than the investment of capital (e.g., the entity’s primary business is conducted through a majority-owned manufacturing company).
- The entity is not itself an operating company but qualifies as either a “venture capital operating company” (VCOC) or a “real estate operating company” (REOC). To qualify as a VCOC or REOC, the entity would need to invest primarily in operating companies (in the case of a VCOC) or managed real estate (in the case of a REOC), and would need to obtain and exercise management rights with respect to those investments.
- Less than 25% of the total value of each class of equity interests in the entity is held by benefit plan investors, in which case participation by benefit plan investors is treated as not “significant” and is disregarded for purposes of determining whether the entity holds plan assets. The Department of Labor has not issued guidance on what constitutes a separate “class” of equity for this purpose, so ERISA counsel should be consulted in any doubtful cases. Moreover, various technical rules apply in determining whether benefit plan investor participation is significant. Notably, for purposes of applying this 25% test, interests held by the manager or its affiliates are excluded from the calculation, unless the manager or affiliate is itself a benefit plan investor. The determination of who an affiliate is can be highly fact-dependent, so care should be given in applying this aspect of the 25% test.

The requirement to exclude capital of or under the control of the manager and its affiliates for purposes of the 25% test can create difficulty when a fund is structured as a master-feeder fund where multiple feeder vehicles all invest into the master fund and each vehicle is controlled by an affiliate of the manager. This type of structure is common if tax-exempt or non-U.S. investors and taxable U.S. investors are all permitted to invest in a strategy. If the manager has discretion to choose how the feeder vehicles are invested, then there is an argument that the feeder funds should be treated as being under the control of the master fund manager or its affiliate, which would require the master fund to calculate the 25% test based on the direct investments into the master fund and the benefit plan investor money invested into the feeder funds. In practice, this would cause many funds to be treated as being subject to ERISA despite those funds having sufficient third-party non-ERISA capital to pass the 25% test on an aggregated “look through” basis. To address this concern, many funds are structured as “hardwired” master-feeder funds where each feeder fund is required to invest only into the master fund. Please note that hardwiring is a market-based practice and there is no statutory or Department of Labor guidance on this topic, so funds normally try to adhere to market standards when structuring a hardwired fund. These market standards are constantly evolving based on commercial trends and developments under other laws, so ERISA counsel should be consulted before launching a new hardwired structure based on previous documents.



A client cannot elect in its investment management agreement or subscription documents to be subject to ERISA, although governmental pension systems and certain other investors that are not benefit plan investors frequently ask to be treated, for various purposes, as if they were subject to ERISA. A fund, likewise, cannot elect to be subject to ERISA—it either is or isn't, as a matter of law. It is not uncommon, however, for a manager to decide to operate a fund as though it were subject to ERISA, to ensure compliance in case the fund becomes subject to ERISA and to avoid the need for continual testing to see if participation of benefit plan investors at any given time is “significant.” It is also common for union-sponsored “Taft-Hartley” multiemployer plans to request that a manager act as an ERISA fiduciary when the plan invests into a fund that is not subject to ERISA. Care should be given in negotiating the language for any such acknowledgement, since a contractual agreement can bind a manager to an ERISA-like standard of care but cannot actually make a manager take on ERISA fiduciary status. In all cases where a manager elects by contract to take on ERISA-based fiduciary responsibilities with respect to a fund that is not expected actually to be subject to ERISA, it is advisable to limit these contractual undertakings to the standard of care, and not to agree to comply with ERISA's prohibited transaction rules or other requirements. In particular, it would be difficult for a manager to comply with a contractual version of the ERISA prohibited transaction rules when a fund is not subject to ERISA, because the prohibited transaction exemptions that apply under ERISA would not be available as a technical matter.

SAMPLE COMPLIANCE POLICY

ERISA Status

Responsibilities for accounts

Each person who participates in the management of a client account is responsible for knowing whether the client is an ERISA client and should be aware of the potential consequences for the person and the Firm. If you do not know whether a client is an ERISA client, please consult with the Chief Compliance Officer.

Responsibilities for funds

The Chief Compliance Officer is responsible for monitoring the level of investment by benefit plan investors in the funds or confirming the availability of one or more exceptions under the plan asset rules. Monitoring of benefit plan investor participation percentages should be done in connection with each new investment, redemption, or transfer of an interest in a fund.



CHAPTER 2

Fiduciary Duties

A manager of ERISA plan assets is a fiduciary with respect to those assets and must satisfy ERISA's fiduciary standards, which are generally regarded as the highest fiduciary standards under U.S. law. This means that:

- The manager must act solely in the interest of the ERISA investor's participants and beneficiaries. For example, the manager cannot, acting in its fiduciary capacity, use plan assets to benefit its other clients, and cannot benefit its other clients at the expense of an ERISA investor or a fund holding plan assets.
- The manager must act prudently with respect to decisions affecting the plan—that is, 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. This is often referred to as a “prudent expert” standard.
- The manager must diversify the plan assets under its management so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.
- The manager must act in accordance with the documents and instruments governing the plan insofar as those documents are consistent with ERISA.

ERISA clients will typically make a formal appointment of the manager and require that the manager acknowledge in writing that it is a fiduciary, so that they will have properly delegated their fiduciary authority to an “investment manager” as defined in ERISA section 3(38) and so that the manager will be able to use the QPAM Exemption (see Chapter 4). Unless a named fiduciary has properly delegated its authority to the investment manager and continues to ensure that the delegation is appropriate, the named fiduciary will remain liable as a “co-fiduciary” for losses caused by the manager's breach of its fiduciary duties.

ERISA imposes a few other technical requirements on fiduciaries managing plan assets:

- The manager must be bonded under a fidelity bond in an amount determined according to the value of the assets of each plan with assets under management (and whether the plan holds employer securities). A manager should confirm that any fidelity bond obtained clearly covers third-party ERISA plans for which the manager is responsible (certain bonds only apply to the purchaser's own plans). See Chapter 7 for further details.
- An account or fund that holds plan assets may not indemnify the manager for any breach of the manager's fiduciary duties. A fiduciary may be indemnified or insured outside the plan, however, including by the plan sponsor.
- The manager must maintain the “indicia of ownership” of the assets being managed within the jurisdiction of the U.S. district courts, with certain exceptions. This means that if the fund intends to invest internationally, certain structural considerations may need to be taken into account. See Chapter 6 for further details.

“Prudence is process” is an old adage among ERISA practitioners. This means that the best way to demonstrate that a manager has acted in accordance with ERISA's fiduciary



standards is to establish compliance policies and procedures and to maintain robust documentation of how those policies and procedures were followed. Any policies or procedures should be reviewed on a periodic basis to ensure that they remain appropriate in light of changing market practices and conditions. Care should also be given to written communications regarding ERISA accounts, including emails.

SAMPLE COMPLIANCE POLICIES

Fiduciary Duties

Exclusive Benefit

The Firm's Compliance Department will review each ERISA account at least annually and more frequently as appropriate to determine whether investment decisions are being made without consideration of benefits to the portfolio manager or third parties.

Prudence

The Firm should communicate periodically with each ERISA client regarding the particular needs of the ERISA plan, such as liquidity requirements, and should retain all records of such communications. The Firm retains all internal written memoranda relating to investment analysis or recommendations and other records of meetings where particular investments are discussed, and other documentation relating to investment decisions. The Firm's Compliance Department will review each ERISA account at least annually (and more frequently, as appropriate) to determine whether investment decisions are being made with the care, skill, prudence and diligence that a prudent person acting in a like capacity and familiar with such matters would use under the circumstances in the conduct of an enterprise of a like character and with like aims.

Diversification

Client Intake will request an agreement from each ERISA client that the Firm is responsible for managing only a portion of the ERISA plan's assets and that the client will be solely responsible for overall diversification of the ERISA plan's assets. The Firm will document any specific guidelines regarding diversification of each ERISA account. For accounts that are highly concentrated in a particular security or industry, the Firm will document those weightings and discuss these findings with the portfolio manager.

Plan Documents

Client Intake will request copies of all relevant plan documents. The plan documents will be retained and reviewed at least annually (and more frequently, as appropriate) to determine whether the plan's portfolio is being invested in accordance with the plan documents. Client Intake will also request from each ERISA client a representation that the powers and duties of the Firm set forth in the investment management agreement are consistent with the governing plan documents. Each account will be reviewed at least annually (and more frequently, as appropriate) to determine whether investment decisions are being made in conformity with the client's investment objectives and any investment restrictions as stated in the client agreement.

Bonding

The Compliance Department will review the Firm's fidelity bond at the outset of each ERISA client engagement and annually to confirm adequacy of coverage. Where coverage is agreed to be provided under the bond of the ERISA client, the Compliance Department will review the bond to determine that the Firm is named as an insured and that the coverage is satisfactory.



CHAPTER 3

Prohibited Transactions

Rules governing “prohibited transactions” are set forth in Sections 406, 407 and 408 of ERISA and Section 4975 of the Code. The regulatory scheme surrounding prohibited transactions is based on (i) broad prohibitions coupled with (ii) conditional exemptions. Accordingly, many ordinary course arrangements are swept up in the prohibited transaction definitions, but are permitted under applicable exemptions that require satisfaction of a variety of conditions.

Most prohibited transactions are subject to penalty taxes—initially, 15% of the amount involved for each year that the transaction continues. This tax is imposed on the person dealing with the plan, which may be the manager or a third party on the other end of a trade. If the tax is imposed on another person, the manager might nevertheless be subject to liability by reason of indemnification or other contractual obligations. This tax regime requires self-reporting and payment. Failure to pay the required taxes and correct the prohibited transaction can result in an additional tax of 100% of the amount involved. Additionally, a fiduciary that is involved in a prohibited transaction is required under ERISA to take action to correct that prohibited transaction, which may involve disgorging fees or otherwise making payments to the plan to make it whole. Plans involved in non-exempt prohibited transactions are required to publicly disclose them on their annual reports (Form 5500).

Party-in-Interest Transactions

A fiduciary that manages ERISA assets may not—unless an exemption applies—use those assets to engage in a sale or exchange, leasing of property, loan or extension of credit, or furnishing of goods, services or facilities with any “party in interest” to an ERISA plan with an interest in those assets. A “party in interest” with respect to an ERISA plan includes any fiduciary of the plan, any person providing services to the plan, any employer whose employees are covered by the plan and any of certain affiliates. A chart showing the complete array of potential parties in interest can be found in the Appendix. Party-in-interest transactions are determined on a “strict liability” basis.

Self-Dealing Transactions

A fiduciary may not—again, unless an exemption applies—allow plan assets to be transferred to or used by or for the benefit of itself or any person (such as an affiliate) in which the fiduciary has an interest that could affect the exercise of its best judgment as a fiduciary. Moreover, a fiduciary may not, absent an exemption, stand on both sides of a transaction involving plan assets, whether acting for itself or for client accounts. This generally prohibits cross-trades, including most rebalancing and warehousing transactions. A fiduciary also may not receive payments from third parties in connection with a transaction involving plan assets, again, unless an applicable exemption is available. The determination of whether a transaction is a self-dealing prohibited transaction (other than a cross-trade) must be made based on the prevailing facts and circumstances. Under ERISA section 408(c)(2), a fiduciary will not be treated as having breached these prohibitions on self-dealing if it receives reasonable compensation for services rendered.



Employer Securities

It is prohibited for an ERISA plan to acquire “employer securities” or “employer real property” except in accordance with ERISA section 407(a). Employer securities are securities issued by an employer of employees covered by a plan or by an affiliate of the employer, and employer real property is real property (and related personal property) leased to such an employer or affiliate. ERISA section 407(a) prohibits a plan from acquiring employer securities that are not “qualifying employer securities,” defined to include stock and certain marketable obligations. Moreover, generally, even qualifying employer securities may not be acquired if, immediately after the acquisition, the aggregate fair market value of the employer securities held by the plan exceeds 10% of the fair market value of the plan’s assets. These prohibitions can be particularly challenging for union-sponsored Taft-Hartley multiemployer plans. ERISA clients may request assistance from managers in abiding by these restrictions, and managers may require clients to provide lists of restricted securities to assist with this compliance.

SAMPLE COMPLIANCE POLICY

Employer Securities

All Client Intake documents require ERISA clients to identify all employer securities and to state whether or not they are “qualifying employer securities.” The Firm will not invest more than 10% of the assets of any ERISA account or plan asset fund in identified employer securities. Client Intake will forward CUSIPs for all identified employer securities to Compliance for correlation with the appropriate account’s or fund’s compliance obligations matrix. Compliance and portfolio managers will be responsible for monitoring investments in such securities.



Qualifications

CHAPTER 4

QPAM Exemption

The QPAM Exemption (Prohibited Transaction Class Exemption 84-14) is a status-based class exemption that enables qualifying registered investment advisers, banks, savings and loan associations, and insurance companies to engage in a wide range of transactions with parties in interest. To be in a position to manage ERISA assets, it is generally helpful to qualify as a “qualified professional asset manager,” or QPAM, and to satisfy the other conditions for using the QPAM Exemption.

The QPAM Exemption prescribes two sets of rules: one establishing the requirements for becoming a QPAM, the other limiting the transactional settings in which the exemption will apply. This summary focuses on the requirements as they apply to registered investment advisers. In brief summary, the requirements are as follows:

1. The manager must meet tests for assets under management and shareholder equity.
2. The party in interest cannot have certain types of authority over the manager.
3. The plan must not make up more than 20% of the manager’s assets under management.
4. The manager must make the decision to enter into the transaction.
5. The party in interest cannot be the manager or a person “related” to the manager.
6. The terms of the transaction must be at arm’s length.
7. The manager and its affiliates must not have done certain disqualifying acts.

A more detailed discussion of each requirement follows below.

1. The manager must meet the definition of a “QPAM” at the time of the transaction or, in the case of a continuing transaction, at the time the transaction is entered into or renewed. This means that, at the relevant times, a manager that is a registered investment adviser:
 - Must have more than \$85,000,000 of total client assets under its management and control as of the last day of its most recent fiscal year. The timing of the test means that a new manager cannot qualify as a QPAM until after its first year closes.
 - Must have shareholders’ or partners’ equity, as shown in the most recent balance sheet prepared within the two years immediately preceding the transaction, in accordance with GAAP, in excess of \$1,000,000 or an unconditional guarantee by an affiliate with more than \$1,000,000 in equity of payment of all the manager’s liabilities.
 - Must have acknowledged in a written management agreement that it is a “fiduciary” with respect to the relevant ERISA clients.



2. At the time of a transaction (or when the transaction is entered into or renewed, in the case of a continuing transaction), neither the party in interest on the other side of the transaction nor any of its “affiliates” (defined below) can have the authority to:
 - Appoint or terminate the manager as a manager of the plan assets involved in the transaction (including, for example, by acquiring or redeeming an interest in a fund managed by the manager); or
 - Negotiate the terms of a management agreement with the manager (including renewals or modifications) on behalf of the ERISA client with respect to the assets involved in the transaction.

However, these restrictions *do not apply* if there are two or more plans in a fund and the assets of the investing plan, together with assets of other plans of the same employer and affiliates, account for less than 10% of the total assets of the fund. This means that a fund’s manager will generally have to inquire into who has investment authority over an ERISA investor’s assets only if the investor holds a 10% or more interest in the fund. For purposes of these rules, an “affiliate” of a party in interest includes, among others:

- any person directly or indirectly, through one or more intermediaries, controlling, controlled by or under common control with the party in interest;
- any corporation, partnership, trust or unincorporated enterprise of which the party in interest is an officer, director, or 10% or more partner;
- any director or employee who earns 10% or more of the wages paid by the party in interest or who has direct or indirect authority, responsibility or control regarding the custody, management or disposition of plan assets.

This condition—sometimes referred to as the “hire/fire” condition or the “power of appointment” condition—is generally the most challenging for managers to be certain they have satisfied. While in most cases they will know the identity of the authorized person responsible for placing a plan’s assets under their management, they will not necessarily know the identity of all of that person’s affiliates, particularly if the person is affiliated with a major financial institution. In certain situations, responsibility for compliance with this condition is contractually split between the manager and the counterparty, who may be in a better position than the manager to determine whether it has affiliates with “hire/fire” power over the assets being managed. In general, managers are most concerned with knowing the identities of any financial institutions (such as banks) that have hire/fire authority, but the broader net of affiliates may be important to certain funds, such as direct lending funds that may need to avoid lending to any affiliate of an entity with hire/fire authority.

3. The assets of the plan in question and all other plans of the same employer and its affiliates must represent no more than 20% of the total client assets managed by the manager. In this context, an employer’s “affiliate” means only a person directly or



indirectly, through one or more intermediaries, controlling, controlled by, or under common control with the employer. This limitation is designed to ensure that a QPAM is not so beholden to the plan whose assets are under management that it lacks independence. A manager will not be prohibited from acting as a QPAM with respect to plans that make up 20% or less (determined as described above) of a manager's assets, which means a manager may be able to act as a QPAM with respect to some clients but not others.

4. The terms of the transaction must be negotiated by or under the authority and general direction of the manager; the manager must make the decision to enter into the transaction; and the transaction must not be part of an agreement, arrangement or understanding designed to benefit the party in interest. This requirement means that a QPAM cannot serve merely to rubber-stamp a decision that has been made by others. However, the language that permits the transaction to be negotiated "under the authority and general direction" of the manager gives non-QPAM fiduciaries some room to involve themselves in the transaction, and accommodates agents and subadvisers.
5. The party in interest cannot be either the manager or a person or entity "related" to the manager. An entity is "related" to the manager if, as of the last day of its most recent calendar quarter:
 - The manager owns 10% or more of the entity;
 - A person controlling or controlled by the manager owns 20% or more of the entity;
 - The entity owns 10% or more of the manager; or
 - A person controlling or controlled by the entity owns 20% or more of the manager.

For purposes of these tests, interests held in a fiduciary capacity are not counted when applying the 10% or 20% test. In addition to these bright-line rules, ownership interests between 10% and 20% may also cause parties to be considered "related" if one party exercises control over the management or policies of the other by reason of its ownership interest.

6. The terms of the transaction must be at least as favorable to the fund as terms generally available in arm's length transactions between unrelated parties. This test is applied both at the time the transaction is entered into and at the time of any subsequent renewal or modification that requires consent of the manager.
7. Neither the manager, nor any "affiliate," nor any direct or indirect 5% owner of the manager, may be a person convicted of or released from prison with respect to a list of specified felonies or other major crimes within the 10 years preceding the transaction. This means that the bad acts of even certain remotely related parties can disqualify the QPAM from using the QPAM Exemption. The Department of Labor has granted a number of individual exemptions (i.e., exemptions available only to the applicant and specified others) permitting use of the QPAM Exemption in such situations, subject to certain additional conditions. Recent individual exemptions contain extensive lists of



additional conditions, and it is currently unclear whether the Department of Labor will continue to grant such individual exemptions in all cases. A plan fiduciary should confirm that all of the requirements are or will be met before transacting under the QPAM Exemption with fiduciaries relying on one of these individual exemptions.

The QPAM Exemption does not provide an exemption from the self-dealing prohibitions of Section 406(b) of ERISA. It also does not provide an exemption for securities lending or the acquisition of interests in mortgage pools or mortgage financing arrangements. These transactions must meet the requirements of separate class exemptions.

SAMPLE COMPLIANCE POLICY

QPAM Exemption

The Chief Compliance Officer will be responsible for determining on at least an annual basis that the Firm is a QPAM and for identifying any clients or circumstances with respect to which the QPAM Exemption is unavailable.

All Client Intake documents require ERISA clients to identify any parties who have (or whose affiliates in the financial services industry have) the power to appoint or terminate the Firm as manager over the ERISA client's assets managed by the Firm, or to negotiate the terms of an investment management agreement with the Firm with respect to such assets.



CHAPTER 5

Alternatives for Non-QPAMs

It is sometimes not possible for a manager to qualify as a QPAM, or a manager that is a QPAM may be unable to use the QPAM Exemption for certain accounts or transactions. For example, new managers may have a period of time before they meet the assets under management test, or may have ERISA clients that account for more than 20% of their assets under management. Managers in this situation may still manage investments under other exemptions.

Other Status-Based Exemptions

Apart from the QPAM Exemption, there are four additional status-based class exemptions, each of which covers a broad range of transactions. They are:

- PTE 90-1 – insurance company separate accounts
- PTE 91-38 – bank collective investment funds
- PTE 95-60 – insurance company general accounts
- PTE 96-23 – in-house asset managers

These exemptions are not covered by this Handbook. Managers that do not qualify as QPAMs, but may qualify for use of one of these alternative status-based exemptions, should contact counsel for advice.

Service Provider Exemption

A manager, whether or not it is a QPAM, can rely on the so-called Service Provider Exemption set forth in Section 408(b)(17) of ERISA and Code section 4975(d)(20) for a wide variety of transactions with parties in interest. The Service Provider Exemption applies only to transactions between a plan and a party in interest that is a service provider but not a fiduciary that exercises any discretionary authority or control with respect to the investment of the plan assets involved in the transaction or that renders investment advice (or an affiliate of such a fiduciary). The Service Provider Exemption applies to the following types of transactions: (1) the sale, exchange or lease of property between a plan and a party in interest; (2) lending or money or other extension of credit between a plan a party in interest; or (3) the transfer to, or use by or for the benefit of, a party in interest, of any assets of a plan.

The Service Provider Exemption will apply only if the plan receives no less, and pays no more, than “adequate consideration.” The definition of “adequate consideration” for a security for which there is a generally recognized market depends on whether such security is traded on a registered national securities exchange:

- Securities Traded on a National Securities Exchange. “Adequate consideration” means the price of the security prevailing on a national securities exchange that is registered under § 6 of the Securities Exchange Act of 1934, taking into account factors such as the size of the transaction and marketability of the security.



- Securities Not Traded on a National Securities Exchange. If the security is not traded on a national securities exchange but is still traded on a generally recognized market, “adequate consideration” means a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of the party in interest, taking into account factors such as the size of the transaction and marketability of the security.
- Assets Other than Securities for Which There Is a Generally Recognized Market. In the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset is determined in good faith by a fiduciary or fiduciaries in accordance with regulations prescribed by the Secretary. These regulations have not been promulgated.

Broker-dealer and bank counterparties may have varying levels of comfort relying on this exemption if another exemption is available because, in the absence of regulations, in some cases there is uncertainty about what counts as “adequate consideration.” Market practice is evolving in this regard, so it may be worthwhile to discuss the exemption with counterparties even if they have expressed discomfort with using it in the past.

Special-Purpose Exemptions

See the Section of this Handbook on “Transactions” for descriptions of commonly used special-purpose exemptions, most of which can be used whether or not the manager is a QPAM.



CHAPTER 6

Non-U.S. Assets

Generally, managers of plan assets subject to ERISA have an obligation under Section 404(b) of ERISA not to maintain the “indicia of ownership” of plan assets outside the jurisdiction of the district courts of the United States, subject to limited exceptions. The indicia of ownership rules may require, for example, a deed for non-U.S. real property, or subscription agreements and similar documentation for non-U.S. partnership interests, to be held in the manager’s U.S. offices.

Regulations provide several exceptions to this requirement that permit the indicia of ownership of non-U.S. securities and non-U.S. currencies to be held outside the United States. The simplest exception applies where the manager is a registered investment adviser that is organized in the United States and has its principal place of business in the United States and that has more than \$50 million in assets under management and \$750,000 in shareholder or partner equity. Another exception applies where indicia of ownership are physically held by (or are in transit to) a branch of a U.S. bank or a U.S.-registered broker or dealer with net worth in excess of \$750,000. A third exception applies where indicia of ownership are maintained by a U.S. bank in the custody of a non-U.S. bank and certain conditions are satisfied, including that the U.S. bank is liable to the ERISA plan to the same extent it would be if it retained the physical possession of the indicia of ownership within the United States.

A manager that is not organized in the United States or does not have its principal place of business in the United States will not be able to take advantage of the first exception described above. In order to maintain the indicia of ownership of non-U.S. securities and non-U.S. currencies outside the United States, such a manager would need to satisfy another exception, such as the exception that permits indicia of ownership to be maintained by a U.S. bank in the custody of a non-U.S. bank.

It is not clear how the exception that permits indicia of ownership to be maintained in the custody of a non-U.S. bank works for certain commonly traded types of securities, because the indicia of ownership rules have not kept pace with the way in which assets are held. In particular, questions have been raised about what constitutes the indicia of ownership for uncertificated securities and certain new forms in which securities are traded, such as A Shares traded on the Hong Kong, Shanghai and Shenzhen Stock Connect. There is no guidance addressing this question. Ideally, responsibility for satisfying these rules should be allocated to the ERISA client itself, together with its custodian and the custodian’s non-U.S. sub-custodial network, because they are in a better position than the non-U.S. manager to satisfy an applicable exception.



CHAPTER 7

Fidelity Bonds

Section 412 of ERISA requires that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan be covered by a fidelity bond. Personnel with discretionary authority to invest plan assets are treated as handling funds of the plan. Persons whose duties with respect to plan investments are essentially advisory are not treated as handling funds of the plan. The requirement will apply with respect to every client that is a retirement plan, a master trust, or a commingled fund if the plan, trust or fund is subject to Title I of ERISA.

A plan must be bonded for at least 10% of the amount of funds handled, subject to a maximum of \$500,000. If the plan holds employer securities, then a maximum of \$1,000,000 applies. An “employer security” is a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. Note that a plan is not considered to be holding employer securities for this purpose merely because the plan invests in a broadly diversified common or pooled investment vehicle that holds employer securities but that is independent of the employer and its affiliates. Thus, a manager’s purchase of an employer security for a broadly diversified plan asset fund in which an ERISA client holds an interest should not cause the relevant plan to be treated as holding employer securities for bonding purposes. However, if the manager purchases an employer security for an ERISA client’s separate account, the relevant ERISA plan would be treated as holding employer securities for bonding purposes.

With respect to situations where assets of more than one plan are held together, the rules state: “Where the funds or other property of several plans are commingled (if permitted by law) with each other or with other funds, [the bonding] arrangement shall allow recovery to be attributed proportionately to the amount for which each plan is required to be protected.” Thus, for example, in the case of a client that is a master trust, the manager should look through the master trust to determine the coverage required for each plan investing (directly or indirectly) through the master trust.

Examples

1. Manager manages a \$20 million separate account for a client that is a trust holding assets of one plan, with no employer securities. The bond required for this client is the lesser of (i) 10% of \$20 million (i.e., \$2 million) and (ii) \$500,000. Thus the bond required for this client is \$500,000.
2. Manager manages a \$20 million separate account for a client that is a master trust holding assets of two plans, Plan A (which makes up 20% of the trust) and Plan B (which makes up 80% of the trust), neither of which holds employer securities. The bond required for this client must cover separately the \$4 million that is attributable to Plan A and the \$16 million that is attributable to Plan B. The bond required for Plan A is the lesser of (i) 10% of \$4 million (i.e., \$400,000) and (ii) \$500,000, or \$400,000; the bond required for Plan B is the lesser of (i) 10% of \$16 million (i.e., \$1,600,000) and (ii) \$500,000, or \$500,000. Thus, the bond required for this client is \$400,000 plus \$500,000, or \$900,000.



The same reasoning applies to fidelity bonds for commingled funds that are subject to ERISA. That is, a manager should look through a commingled fund to determine the coverage required for each plan investing (directly or indirectly) in the commingled fund.

Examples

1. Manager manages an \$80 million commingled fund that has one ERISA investor, a trust holding assets of one plan, with no employer securities. This ERISA investor holds 25% of the fund. The bond required for this commingled fund is the lesser of (i) 10% of \$20 million (i.e., \$2 million) and (ii) \$500,000. Thus, the bond required for this commingled fund is \$500,000.
2. Manager manages an \$80 million commingled fund that has two ERISA investors, Plan A (which holds a 5% interest) and Plan B (which holds a 20% interest), neither of which holds employer securities. The bond required for this commingled fund must cover separately the \$4 million that is attributable to Plan A and the \$16 million that is attributable to Plan B. The bond required for Plan A is the lesser of (i) 10% of \$4 million (i.e., \$400,000) and (ii) \$500,000, or \$400,000; the bond required for Plan B is the lesser of (i) 10% of \$16 million (i.e., \$1,600,000) and (ii) \$500,000, or \$500,000. Thus the bond required for this commingled fund is \$400,000 plus \$500,000, or \$900,000.

If commingled funds and/or master trusts invest in other commingled funds and/or master trusts, the rules apply on a look-through basis in a manner analogous to the foregoing examples.

Managers should double-check their fidelity bond documentation to make sure the bond covers client assets, not just plans sponsored by the manager for its own employees.



SAMPLE COMPLIANCE POLICY

Fidelity Bonds

Separate Accounts

If the client is a single ERISA plan, the firm must determine whether the plan holds employer securities. Generally, the firm should obtain a bond equal to 10% of the plan assets managed by the firm subject to a \$1 million maximum for plans holding employer securities and a \$500,000 maximum for plans not holding employer securities.

- For new clients, information on whether the plan holds employer securities should be provided as part of the intake process.
- For existing clients, the firm should review the most recently filed Form 5500 for the plan to determine whether the plan held employer securities during the plan year for which the form was filed (unless the firm is itself holding employer securities for the plan). If the Form 5500 review shows that the plan did not hold employer securities, the firm should contact the client asking for confirmation, stating that the firm will assume the plan does not hold employer securities unless the client provides different information.

If the client is a master trust holding assets of more than one ERISA plan, the firm should contact the client to determine (i) how many plans hold interests in the master trust, (ii) what percentages of the master trust each plan holds, and (iii) whether the underlying plans hold employer securities.

- For new clients, this information should be provided as part of the intake process.
- For existing clients, the firm should contact the client to obtain this information, stating that the firm will assume that only a single plan holds an interest in the master trust and that no employer securities are held unless the client provides different information.

For each underlying plan, the firm should generally obtain a \$1 million bond if the plan holds employer securities; otherwise, the firm should obtain a \$500,000 bond. However, the firm should determine whether any underlying plan's interest in the separate account is less than \$5 million (\$10 million if the plan holds employer securities). If so, the firm may limit the bond for such a plan to 10% of the plan's interest in the separate account.

Commingled Funds

For commingled funds that are subject to ERISA, the firm should determine the dollar value of the portion of the fund attributable to each ERISA client. The firm can then determine the proper amount of the fidelity bond to be obtained with respect to each ERISA client by treating such ERISA client's investment in the fund as if it were a separate account and following the procedures outlined above. However, the firm should not treat an ERISA client (or an underlying plan) as holding employer securities merely because the fund in which the ERISA client invests holds employer securities.

Updates

All determinations made and client information obtained for compliance with this policy should be updated on an annual basis.



Documentation

CHAPTER 8

Client Intake and Subscriptions

Individual Clients

It is standard practice to require new clients to complete forms designed to determine their ERISA status and document any particular requirements that may apply to their account, including information necessary to avoid prohibited transactions and/or ensure the availability of needed exemptions.

Fund Investors

It is also standard practice to require all investors in a fund to complete a subscription agreement that includes a questionnaire designed to determine the investor's ERISA status. In addition, each ERISA investor will generally be required to represent that (i) it is aware of and has taken into consideration its fiduciary duties, including the diversification requirements of Section 404(a)(1)(C) of ERISA; (ii) it has concluded that its proposed investment in the fund is a prudent one; and (iii) the terms of the investment (including the incentive fee and any restrictions on withdrawal) are in accordance with all requirements applicable to the investor under its governing instruments and ERISA. ERISA investors will generally also be required to acknowledge and agree that, for so long as the fund is not deemed to hold plan assets, the general partner or managing member will not be a "fiduciary" and that the investor is not relying on the general partner or managing member to provide any kind of investment advice with respect to the investor's purchase of fund interests.

Systems Coding and Review

Despite a lack of guidance from the Department of Labor on requirements for compliance and trading systems coding, proper compliance system and trading system coding is one of the most important steps in avoiding ERISA compliance problems, including prohibited transactions. Whenever a new ERISA account is established, the manager should ensure that the account is coded as subject to ERISA, and that appropriate restrictions, such as blocks on cross-trading, limitations on employer securities, and restrictions on trading with parties that have "hire/fire" authority over the account (including their affiliates) have been properly entered into the system. It is also advisable for the manager to verify that all of the restrictions are working properly on a periodic basis, or any time that the trading or compliance systems are updated or changed.



SAMPLE COMPLIANCE POLICY

Client Information

All separate account clients have completed intake forms indicating whether they are benefit plan investors. Each Client Intake form should be reviewed by external counsel to confirm ERISA status and identify any special issues.

All investors in the funds have completed subscription agreements indicating whether they are benefit plan investors and, if so, the extent to which their invested assets are plan assets. The subscription agreements further require the investor to notify the Firm of any changes. Each new subscription agreement should be reviewed by external counsel to ascertain whether the responses to the ERISA section of the subscription agreement appear on their face to be appropriate.

Each ERISA Client will be coded as subject to ERISA and/or Section 4975 of the code in the Firm's trade management and compliance systems, and all appropriate restrictions related to the account will be coded and subject to review by a supervisor. All ERISA-related coding will be checked on a periodic basis.



CHAPTER 9

Investment Management Agreements

Investment management agreements (IMAs) with ERISA clients generally will contain certain provisions to accommodate the client’s ERISA-related needs and to avoid imposing unnecessary burdens on the manager. A summary of relevant provisions is provided below.

The appointing fiduciary should expressly appoint the manager as an investment manager, as defined in Section 3(38) of ERISA. The appointing fiduciary should represent that it is a “named fiduciary” under ERISA. The appointing fiduciary should also represent that the appointment of the manager is consistent with the plan’s documents.

The manager should acknowledge that it is a “fiduciary” under ERISA with respect to the plan assets that it is managing.

The investor will generally represent that all actions contemplated under the IMA are consistent with the plan’s documents and that the investor will notify the manager if any plan provision changes in a way that would make that representation untrue. The manager may agree to act in accordance with the plan documents.

The manager may represent that it is qualified to act as a QPAM. The QPAM Exemption does not require a manager to agree that it will act in accordance with the requirements of the Exemption or that each transaction will be exempt by application of the Exemption, but managers commonly do so agree.

The manager may undertake to vote proxies in accordance with its fiduciary duties under ERISA, unless the IMA specifically identifies another party as responsible for voting the proxies or reserves the right to the named fiduciary of the investing plan.

The manager generally should avoid having discretionary authority to value assets on which a management fee or performance fee is based. The manager also generally should not have the ability to increase its fees by allocating assets to a particular investment strategy.

The manager may agree to diversify the account in accordance with ERISA, but the manager would normally not make any commitment with respect to the overall investment strategy of the plan. Some managers seek to disclaim the duty of diversification, particularly with very targeted investment strategies.

A U.S.-based manager may agree to comply with the “indicia of ownership” requirements under ERISA. A non-U.S. manager generally should consult with counsel with regard to these requirements and any related contractual undertakings.

With respect to any client-directed brokerage arrangement, the investor generally will be required to represent that the direction of its account to a specified broker and the brokerage commission rate (i) are in the best interest of the account; (ii) are for the exclusive purpose of providing benefits to participants and beneficiaries of the plan; and (iii) are not, and will not cause the account to be engaged in, a prohibited transaction. The investor will generally also represent that it has determined, and will monitor the



account to ensure, that the directed broker is capable of providing best execution for the account's brokerage transactions and that the commission rates that have been negotiated are reasonable in relation to the value of the brokerage and other services received.

If referenced in the IMA, any "soft dollars" arrangement must comply with the safe harbor standards under Section 28(e) of the Securities Exchange Act of 1934.

The manager generally will agree to be bonded as required under ERISA, unless the investor agrees to cover this obligation.

The manager may not be indemnified out of plan assets for any breach of its fiduciary duties. Therefore, the indemnification provisions of the IMA should permit indemnification only to the extent permitted by applicable law, including ERISA.

The manager generally will not agree to avoid or monitor transactions in employer securities unless the investor provides a list of such employer securities and/or guidelines for handling such securities.

SAMPLE COMPLIANCE POLICY

Investment Management Agreements

The Firm maintains a standard form of investment management agreement for ERISA clients that has been reviewed by outside counsel for compliance with ERISA. All client agreements can be accessed through Client Intake. The Firm will have outside counsel comment on any alternative terms or conditions. Any comments will be retained with the client files.



CHAPTER 10

Prime Brokerage and Derivatives

Managers of plan asset funds often will enter into so-called prime brokerage arrangements that cover a suite of services in addition to execution of trades. Other services may include margin loans, foreign exchange transactions, and securities lending, and the prime broker may in some cases act as counterparty in swap transactions.

Special considerations arise from the prime broker's holding and use of assets pledged as collateral in connection with certain transactions. Similar considerations arise in connection with ISDA agreements governing swap transactions and GMRA's governing repurchase transactions. Two recurrent questions that arise in connection with these arrangements are whether the collateral held by the broker or counterparty remains subject to ERISA in the hands of the broker or counterparty and what permits the broker or counterparty to exercise certain agreed rights over assets in the account, such as offset and closeout rights.

The Department of Labor has addressed these issues in limited contexts in a manner that has given practitioners comfort that assets pledged as collateral do not retain their plan asset character in the hands of the counterparty. Specifically, the Department has stated that when assets are held by a futures commission merchant (FCM) to fund a plan's margin account, the assets in the account are not plan assets; rather, when a plan engages in a futures transaction, "its assets are the rights embodied in the futures contract as evidenced by a written confirmation and outlined in its agreement with its FCM. . . ." Similarly, the Department has stated that when assets being used for cleared swaps are held in a margin account, the assets in the account are not plan assets; rather, when a plan engages in cleared swaps, "its assets are the rights embodied in the swap contract as evidenced by the written agreement" between the plan and its clearing member.

The Department of Labor has also opined that the exercise of closeout rights over amounts in an ERISA account can be treated as exempt under the QPAM Exemption, if the rights have been spelled out in detail in the agreement. Specifically, the Department has stated in the cleared swaps context that the QPAM Exemption provides relief for such transactions as "subsidiary transactions" if the agreement governing the swap clearing services contains enough specifics of such subsidiary transactions that the potential outcomes are reasonably foreseeable by the QPAM when negotiating and entering into the agreement.

In view of the foregoing considerations, managers entering into prime brokerage and derivatives agreements on behalf of ERISA accounts will typically need to consider the following:

1. The agreement will usually require that the manager represent that it is a QPAM and represent that the QPAM Exemption is available for transactions under the agreement. Sometimes this representation is made on the basis of assumed conditions agreed by the parties.



2. In the case of a prime brokerage agreement, the prime broker is a service provider to the ERISA customer, so its compensation needs to be reasonable and it needs to give the customer a full fee disclosure to satisfy the exemption under ERISA for reasonable compensation paid for necessary services. (See Chapter 11.)
3. Generally, a prime broker will ask for assurances that the ERISA customer does not and will not treat any assets pledged as collateral as “plan assets.” The DOL guidance on analogous situations described above is generally sufficient for managers to be comfortable operating in this way, but it is more appropriate to word this provision as an agreement or acknowledgment between the parties rather than as a representation regarding the legal status of the assets. These assurances are also often made by the prime broker to the ERISA customer.
4. A prime broker may also ask for assurances that certain uses of the ERISA customer’s assets are exempt from the prohibited transaction restrictions. Again, the DOL guidance on analogous situations described above is often sufficient for managers to be comfortable with their ability to use the QPAM Exemption to cover such transactions, as subsidiary transactions.

It is common for ISDAs to contain more or less elaborate ERISA-related termination events, disclosure obligations, and representations. It is generally advisable for a manager to have ERISA counsel review these sections, perhaps after discussing with counsel what an appropriate “standard” set of ERISA provisions should include and exclude. Attention should also be paid to the form of derivative documentation being used and whether all requirements of any applicable exemptions have been met.



Client Relations

CHAPTER 11

Reporting and Disclosure

Managers of ERISA accounts have certain disclosure obligations and certain responsibilities to assist the underlying ERISA plans with their annual reporting obligations. For example, ERISA plans must report annually on the assets held in plan asset funds in which they invest; accordingly, the manager of such a fund should be ready to disclose the fund's holdings.

The most significant disclosure and reporting obligations relate to compensation received by service providers, including asset managers. The details are set out below.

Compensation Reporting

Most ERISA plans must file a public report (Form 5500, Schedule C) showing all compensation received by service providers to the plan, including managers of funds in which the plan's assets are invested. Service providers to ERISA plans must provide information needed to comply with the plan's reporting obligations. This requirement applies to all investment funds (other than funds that are treated as operating companies, such as VCOCs and REOCs) in which an ERISA plan holds an interest, whether or not assets of the fund are deemed to be "plan assets"—including mutual funds as well as non-registered funds.

ERISA plans generally must report the following compensation-related information:

- The identity of any person receiving \$5,000 or more for services;
- Any relationship between such person and the plan sponsor or other parties in interest to the plan;
- One or more codes describing the services; and
- The amount of any compensation paid directly.

If a service provider received *indirect compensation*—that is, amounts paid by someone other than the plan in connection with services provided to the plan—the plan must report the amount of indirect compensation paid, or a formula for calculating it, unless a special exception described below applies. Additional information must be reported for certain service providers that may be exposed to conflicts of interest, including investment managers. For this class of service providers, each source paying \$1,000 or more in indirect compensation must be disclosed, except as described below.

Under a special exception for so-called *eligible indirect compensation*, no amount needs to be reported for a recipient of indirect compensation (such as a fund manager) if (i) the compensation consists of fees or expense reimbursements reflected in the value of the investment, finder's fees, soft dollar revenue, float revenue, brokerage commissions or other transaction-based fees for transactions or services involving the plan, and (ii) the



plan receives written disclosure of:

- The existence of the indirect compensation;
- The services provided for the compensation;
- The amount or an estimate of the compensation, or a formula used to determine the amount; and
- The identity of the parties paying and receiving the compensation.

Managers who want to avoid extensive and detailed public disclosure of fee-related information will generally try to make sure that ERISA plans receive a written disclosure satisfying these requirements. The disclosure can be set forth in existing documents (e.g., an offering memorandum) as long as ERISA investors are told which parts of the documents are intended to satisfy the requirements. If an investment manager receives *only* eligible indirect compensation in connection with plan investments, all the plan has to report is the identity and EIN or address of the person providing the plan administrator with the written disclosure. The person providing the disclosure need not be the investment manager.

The consequences of noncompliance with the obligation to provide information necessary to complete Schedule C can be severe. A service relationship with an ERISA plan will be a per se prohibited transaction unless the service provider supplies this information in a timely manner.

Compensation Disclosure

Certain service providers are obligated to make an up-front disclosure relating to their compensation. The service provider fee disclosure rules apply to a “covered service provider,” which means a service provider that enters into a contract with a plan or a plan-asset fund to provide fiduciary, registered investment advisory, recordkeeping or certain other services (e.g., accounting, custodial and consulting services), and reasonably expects to receive at least \$1,000 in compensation for the services provided.

All covered service providers must disclose to the contracting plan fiduciary in writing:

- The services to be provided;
- Whether the covered service provider will act as a fiduciary or investment adviser registered under the Investment Advisers Act of 1940 or state law;
- All compensation reasonably expected to be received, including:
 - Direct compensation;
 - Indirect compensation, with a description of the arrangement between the payer and the covered service provider or its affiliates or subcontractors;
 - Compensation paid among the covered service provider and its affiliates or



subcontractors, if charged on a transaction basis (e.g., commissions, soft dollars, finder's fees or other similar incentive compensation paid based on business placed or retained) or charged directly against the investment and reflected in the value of the investment (e.g., Rule 12b-1 fees), together with a description of the services for which such compensation is paid, and the identities of the payer and recipient;

- Compensation that the covered service provider would receive in connection with the termination of the contract and how prepaid amounts would be calculated and refunded upon termination.

If a fund is used as a designated investment alternative under a participant-directed individual account plan, the plan administrator will have an obligation to make annual disclosures to participants relating to fees charged by the fund. For this reason, the following must also be disclosed by the covered service provider, if applicable, on a regular basis:

- Total annual operating expenses for an investment where the return is not fixed, and any ongoing expenses (e.g., wrap fees, mortality and expense fees);
- Total annual operating expenses expressed as a percentage and calculated in accordance with the participant-level fee disclosure rules that apply to plan administrators; and
- Any other information about the designated investment alternative that is required for the plan fiduciary to comply with the participant-level fee disclosure rules and that is within the control of, or reasonably available to, the covered service provider.

If a covered service provider acts as a fiduciary with respect to the plan or investment entity that holds plan assets, the following disclosures must be made with respect to each investment product that holds plan assets and in which the plan has a direct equity investment:

- Compensation charged against the investment (e.g., commissions, sales loads, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, account fees and purchase fees) that is not included in the annual operating expenses of the investment; and
- Annual operating expenses for an investment where the return is not fixed, and any ongoing expenses (e.g., wrap fees, mortality and expense fees).

Generally, initial disclosures must be provided reasonably in advance of the date the contract or arrangement is entered into, renewed or extended. Information changes must be disclosed as soon as practicable, but not later than 60 days from the date the service provider knows of the change, except that changes to investment-related information are to be reported at least annually. Certain plans may also request to receive updated disclosure every year. Compensation information requested by a plan fiduciary for



purposes of complying with reporting and disclosure requirements under ERISA must be provided reasonably in advance of the date on which the plan fiduciary or administrator states that it needs the information. There are special timing rules for disclosure with respect to investments that are later determined to hold plan assets or investments that later become designated investment alternatives.

There is no required format for written disclosures, and disclosures may be made through one or more documents. However, the regulations contain a “guide” that service providers are encouraged by the Department to use when making initial disclosures to plan fiduciaries.

Covered service providers are protected if errors or omissions are made in good faith and the service provider acted with reasonable diligence, as long as the error or omission is corrected within 30 days after discovery. Covered service providers must comply with a plan fiduciary’s request to correct an error or omission. Failure to comply will in some cases require the fiduciary to terminate the service contract.



CHAPTER 12

Gifts and Entertainment

ERISA prohibits a plan fiduciary from receiving consideration for his or her personal account from any party dealing with the plan in connection with a transaction involving assets of the plan. However, the Department of Labor's Enforcement Manual treats the receipt of gifts, gratuities, meals, entertainment or other consideration with an aggregate annual value of less than \$250 as insubstantial and not as a violation of ERISA's prohibited transaction rules. The implication is that exceeding the \$250 threshold could result in a prohibited transaction that would be subject to enforcement. Some financial firms have ERISA-specific gifts and entertainment policies based on the Department of Labor's enforcement approach, and such policies generally are advisable and appropriate where a firm regularly deals with ERISA investors.

The Enforcement Manual sets out an exception for reimbursement of educational expenses associated with a plan representative's attendance at a conference, as long as a plan fiduciary has reasonably determined in writing, in advance and without regard to whether the expenses would be reimbursed, that (i) the plan's payment of the expenses was prudent and consistent with a written plan policy or provision designed to prevent abuse, (ii) the conference had a reasonable relationship to the duties of the attending plan representative, and (iii) the expenses were reasonable in light of the benefits afforded and unlikely to compromise the plan representative's ability to carry out his or her ERISA duties. Some financial services providers offer reimbursement to ERISA plan representatives for conference expenses using a form intended to ensure that a plan fiduciary has made the required determinations. Based on the Enforcement Manual, many institutions require fiduciaries to obtain prior clearance before accepting any gifts or entertainment from clients or vendors or giving any gifts to ERISA fiduciaries (i.e., the investment committee of a plan client). Where prior clearance is not possible, it is common to require prompt reporting to the compliance department of gifts and entertainment.

ERISA imposes Form 5500 reporting requirements on ERISA plan administrators with respect to gifts, meals and similar items exceeding a certain amount in value, and some firms have more restrictive ERISA-specific gifts and entertainment policies intended to help plans avoid having to report such items. In particular, all non-monetary compensation must be reported unless it is of "insubstantial value." The "insubstantial value" exception applies when (a) the value of the item is tax deductible for federal income tax purposes for the provider and would not be taxable income to the recipient, (b) each gift item is valued at less than \$50 and (c) the aggregate annual value of all items received from a single source is less than \$100. Gifts of less than \$10 in value do not count toward the \$100 threshold; however, if the \$100 threshold is exceeded, the value of all gifts must be reported. Items received by one person from multiple employees of the same entity must be treated as a single source, and their value must be consolidated for purposes of calculating the \$100 threshold. By contrast, the value of items received from one person by multiple employees of the same entity should be separately determined for each employee. The requirement that gifts or other items be tax deductible by the provider and not taxable income to the recipient imposes additional restrictions on what



is considered to be of insubstantial value. Business meals are deductible if the provider is present and the meal is not “lavish or extravagant under the circumstances.” However, business gifts are only tax deductible up to an aggregate annual limit of \$25 per recipient.

Examples

1. An investment manager receives two gifts and two meals in connection with services provided to a plan, with values of \$6 and \$8 (gifts) and \$40 and \$49 (meals). The \$6 and \$8 gifts do not count towards the \$100 threshold. Since only the \$40 and \$49 meals are used in calculating the amount to be disclosed, the \$100 limit is not exceeded (\$89 is less than \$100), and none of the items must be reported.
2. An investment manager receives three gifts and two meals valued at \$6, \$8 and \$11 (gifts) and \$40 and \$49 (meals). The \$6 and \$8 gifts do not count towards the \$100 threshold. However, the aggregate value of the three items valued at more than \$10 – the \$11, \$40 and \$49 items – reaches the \$100 threshold, so the value of all five items (\$114) must be reported.

SAMPLE COMPLIANCE POLICY A

Gifts and Entertainment

The Firm and its employees may not provide any person who is a fiduciary of an ERISA plan gifts, entertainment or other consideration with an aggregate annual value of \$250 or more. Cash gifts and gifts of \$50 or more in value are not allowed.



SAMPLE COMPLIANCE POLICY B

Gifts and Entertainment

All employees that are ERISA fiduciaries are required to notify the Chief Compliance Officer in advance of giving or accepting any gifts or entertainment in connection with their services for an ERISA account and to seek preapproval of such gifts or entertainment. If advance notice is not practicable, then an employee who is an ERISA fiduciary must notify the Chief Compliance Officer as soon as reasonably practicable following the giving or receipt of such gifts or entertainment. For the avoidance of doubt, all gifts and entertainment given or received by an ERISA Fiduciary are subject to this paragraph, including de minimis items.

Employees are prohibited from giving or accepting gifts, entertainment or similar items in connection with any services provided by the Firm to a client that is a pension plan subject to Form 5500 Schedule C reporting obligations unless the following three conditions are all met: (i) the item is tax deductible for federal income tax purposes for the provider and would not be taxable income to the recipient; (ii) the item is valued at less than \$50; and (iii) items received from any one person during a calendar year are valued at less than \$100. Note that a gift otherwise permissible under these limits may be impermissible as a result of federal income tax rules on tax deductibility of business gifts and meals. For example, business meals are deductible as long as the provider is present and the meal is not lavish or extravagant under the circumstances, while business gifts are only tax deductible up to an aggregate annual limit of \$25 per recipient.

Gifts and entertainment received from multiple employees of a single entity will be treated as coming from a single source when calculating whether the \$100 limit applies. However, in applying the limit to an occasional gift received by multiple employees from a single person, the amount received by each employee may be separately determined in applying the \$100 limit.

Employees may give or accept occasional gifts or entertainment of less than \$10 in value without the gift counting toward the \$100 limit. Employees may also give or accept promotional gifts of little intrinsic value that display a company logo (for example, pens with the company name).

If a vendor or service provider provides services to the Firm relating to its pension plan clients and its non-pension plan clients, a pro rata share of the value of any item received by the Firm should be counted towards the \$50 and \$100 limits. For example, it would be permissible for the Firm to accept a holiday gift basket from a broker worth \$75 if 90% of the business the broker has with the Firm is non-pension plan business.

Compliance with the limits set forth in this policy is designed to prevent pension plan clients of the Firm from having to comply with certain Form 5500 Schedule C reporting obligations. Employees should be aware that even if these limits are followed, the provision or acceptance of gifts or entertainment of any value by the Firm in connection with the services it provides to pension plan clients may nonetheless violate ERISA and may give rise to civil liabilities and criminal penalties. Consultation with your supervisor or the Compliance Department before providing or accepting any gift or entertainment in connection with services provided to pension plan clients is advised.



Transactions

CHAPTER 13

Trading Basics

Many ordinary-course securities transactions that may involve parties in interest are not regarded by the Department of Labor as prohibited transactions. Certain transactions that would be prohibited absent an exemption can be covered by readily available exemptions even if the manager does not have the benefit of a status-based exemption, such as the QPAM Exemption.

Trades on Exchanges

Transactions executed on a national exchange are generally “blind” transactions, where neither party knows the identity of the other party. Blind transactions are not regarded as prohibited transactions and therefore do not require an exemption, even if it should turn out that the other party to the transaction is a party in interest.

Alternative Trading Systems

Transactions executed through certain alternative trading systems are designed to be blind transactions. The Department of Labor has stated that blind transactions executed through alternative trading systems are not prohibited transactions. However, the Department cautioned that fiduciaries using an alternative trading system for a blind transaction must be careful to make sure that the transaction is truly blind.

There is a statutory exemption covering transactions placed through an electronic communication network or similar system, even if the transactions are not truly blind. Transactions may be placed for an ERISA plan through an electronic communication network or similar system if:

- The network or system is subject to federal regulation and oversight;
- The identities of the parties are not taken into account in the execution of trades;
- Rules are in place to match purchases and sales at the best price available;
- Price and compensation are at least as favorable to the ERISA plan as in an arm’s length transaction; and
- A plan fiduciary is notified at least 30 days in advance of the first use of the network or system.

Under the exemption, electronic networks or similar systems may be used even with a party in interest to the ERISA plan that has an ownership interest in the network or system, as long as the network or system has been authorized for the plan’s use by the plan sponsor or another independent fiduciary.



Principal Transactions

Even if a manager does not have the benefit of a status-based exemption such as the QPAM Exemption, PTE 75-1, Part II permits principal trades of securities to be executed with a party in interest. The conditions for using this exemption are as follows:

- The other party to the purchase or sale must be a registered broker that customarily purchases and sells securities for its own account in the ordinary course of business; and
- The other party to the purchase or sale must not have or exercise any discretionary authority or control (except as a directed trustee) or render investment advice with respect to the investment of the plan assets involved.

The exemption is also available for purchases or sales of U.S. government or agency securities with either (a) a reporting dealer who makes primary markets in U.S. government or agency securities and reports daily to the Federal Reserve, or (b) a bank supervised by the United States or a state. The dealer or bank must customarily purchase and sell such securities for its own account in the ordinary course of business.

Margin and Short Sales

Trading on margin and short sales involve an extension of credit by a broker that is a party in interest by reason of providing services. That extension of credit is a prohibited transaction in need of an exemption. Typically, coverage would be available under a general-purpose exemption, e.g., the QPAM Exemption or the Service Provider Exemption. However, if a general-purpose exemption is not available, there is a special-purpose exemption in PTCE 75-1, Part V, for extensions of credit in connection with securities transactions. In order for this exemption to apply, the following conditions must be satisfied:

- The extension of credit must be permissible under the securities laws;
- If the party in interest is a fiduciary, the fiduciary must receive no interest or other consideration; and
- The plan must maintain records for six years that are sufficient to demonstrate compliance with the terms of the exemption.



CHAPTER 14

Affiliated Brokers

A fiduciary's selection of itself or an affiliate as a broker to place trades would generally be a prohibited transaction, because the fiduciary would be using its authority to cause an additional fee to be paid to itself or the affiliated broker-dealer. However, a commonly used class exemption, PTE 86-128, provides a conditional exemption covering use of an affiliated broker, as long as the trades are not excessive in either amount or frequency.

The conditions of the exemption, as applied to separately managed accounts, are as follows:

- A plan fiduciary must provide advance written authorization, which must be terminable at will without penalty;
- The authorizing fiduciary must be provided, within three months before the authorization, with any reasonably available information necessary to determine whether to give the authorization, including a copy of PTE 86-128, a form for termination of the authorization and a description of the broker's placement practices;
- The trading fiduciary must furnish the authorizing fiduciary a confirmation slip within 10 days of each trade; or, alternatively, the trading fiduciary may provide, within 45 days of quarter-end, a quarterly report describing each trade, the total of all charges paid by the plan, and the amount of these charges retained by the fiduciary or affiliate and the amount paid to other persons for execution or other services;
- The trading fiduciary must provide, within 45 days of each year-end, a report including the same information a quarterly report would contain, plus a description of any material changes in brokerage practices during the year and the annualized portfolio turnover ratio for the plan.

The exemption is not available if the fiduciary is a plan administrator or an employer whose employees are covered by the plan, unless the fiduciary returns or credits to the plan all profits earned in connection with the trades. In such a case, however, arguably the exemption is not needed because the fiduciary is not using its authority to cause an additional fee to be paid to itself or an affiliate.

The exemption is available for plan asset funds, with some modifications to the conditions. Specifically, fiduciaries of plans investing in the fund must give advance authorization, and if they do not agree to the arrangement, they must be permitted to terminate their investment in the fund without penalty before an affiliated broker is used.

The exemption is also available for IRAs and other plans that do not cover employees, in which case the authorization and reporting conditions listed above do not need to be satisfied.

Special conditions apply if the plan in question covers employees of the fiduciary placing trades.



CHAPTER 15

Affiliated Underwriters

A manager of ERISA plan assets may seek to purchase publicly offered securities during the existence of an underwriting or selling syndicate that includes the manager or an affiliate of the manager. The Department of Labor has long considered it a prohibited transaction for a manager to purchase a security in this circumstance either from the manager itself or from its affiliate. Even a purchase from another member of the selling syndicate might be a prohibited transaction, the Department has stated, because “it is generally in the interests of the members of an underwriting syndicate that all shares being offered by the syndicate are sold.”

However, a class exemption, PTE 75-1, Part III, is available for purchases from a member of the selling syndicate other than the manager or its affiliate. The exemption has a variety of technical conditions not addressed here, but a key condition is that the exemption is not available if the manager or its affiliate is a “manager” of the selling syndicate. For this purpose, a “manager” is any member of the syndicate who is authorized to act on behalf of the members of the syndicate or who receives compensation from the members of the syndicate for services as a manager of the syndicate. In some cases, members of a syndicate may be called “managers” but not possess this authority. In these cases, the availability of the exemption may be unclear. The Department has issued multiple individual exemptions that cover a broader range of affiliated underwriter transactions than PTE 75-1.

Some take the view that if the affiliated underwriter does not receive compensation from the members of the syndicate for its services in selling securities, there should be no prohibited transaction. The implication of this view is that if the affiliated underwriter renounces a portion of its selling concession corresponding to the portion of the securities purchased by the manager for its ERISA accounts, the conditions of the class exemption should not have to be satisfied. It is worth noting that renouncing selling concessions in this manner is a condition of certain individual exemptions allowing purchases of this kind on generally more relaxed terms than those of the class exemption. A manager that wants broad flexibility to purchase securities during the existence of an underwriting syndicate that includes an affiliate of the manager should consider applying for an



individual exemption of this kind.

CHAPTER 16

Affiliated Funds

A fiduciary with respect to ERISA plan assets that considers it appropriate to invest those assets in a fund managed by the fiduciary or an affiliate faces the prospect of a prohibited transaction by reason of using its fiduciary authority to cause the plan to pay it or its affiliate an additional fee for services. Fortunately, one of the earliest prohibited transaction exemptions, PTE 77-4, provides a road map to carry out such investments safely, at least for investments in mutual funds. Under the exemption:

- No sales commission can be charged.
- No redemption fees can be charged, except fully disclosed redemption fees paid only to the fund.
- The plan cannot be charged double advisory or management fees; either the plan must not pay a plan-level fee with respect to the assets invested in the mutual fund, or the plan must receive a credit against its plan-level fee for its pro rata share of advisory fees paid by the fund.
- A plan fiduciary independent of the manager must be given a prospectus and detailed written disclosure of all fees, stating the reasons why the manager considers the investment appropriate for the plan and whether there are any limitations on the manager with respect to which plan assets may be invested in the mutual fund.
- The independent plan fiduciary must consent to the investment and to any changes in fees.

This exemption is not available for affiliated investments other than investments in affiliated mutual funds. Investments in affiliated bank collective trusts can be covered under a statutory exemption at Section 408(b)(8), which actually offers broader relief than PTE 77-4. However, investments in other types of affiliated funds have no express exemption.

With respect to investments in other types of affiliated funds, some practitioners take the view that satisfaction of the conditions of PTE 77-4 should be sufficient to ensure that there is no prohibited transaction in need of exemption. The argument is that if these conditions are satisfied, the fiduciary is not using its authority to cause the plan to pay an additional fee to itself or an affiliate.

The DOL has called attention to the fact that an investment in an affiliated fund could give rise to an independent prohibited transaction, without exemption, if the fiduciary is using the investment to serve its own purposes or those of an affiliate. In particular, the DOL has expressed concerns about the use of ERISA plan assets to seed a new fund. Because such separate issues can easily arise in connection with investments of this kind, it is advisable to consult ERISA counsel before entering into a new arrangement, even one



that satisfies the terms of PTE 77-4.

CHAPTER 17

Cross-Trades and Other Conflicts of Interest

Because of the conflict of interest restrictions in Section 406(b)(2) of ERISA, the Department of Labor takes the view that a manager can enter into cross-trades, i.e., trades between an ERISA account and another account managed by the same manager, only if an explicit exemption is available. Cross-trades typically must be avoided, because of the difficulty of using available exemptions. Arranging a cross-trade through a broker, or through two cooperating brokers, is likewise not permitted. As a result, many managers prohibit entering into buy and sell transactions involving the same security on the same day through the same broker where an ERISA account is involved. For certain low-trading volume securities, certain managers extend this prohibition on same security trades to a longer period than a single day. In addition, it is important for managers to avoid any prearrangement of buy and sell orders for the same security when an ERISA account is involved.

However, two exemptions are available, each subject to several conditions. The exemptions each require managers to provide fiduciaries of participating ERISA plans with written policies governing the manager's cross-trading program. In addition, under a long-standing "blind trade" doctrine, an ERISA account may generally enter into a securities transaction without concern over potential cross-trades where the account is not aware of the identity of the counterparty to the transaction.

Cross-trades may be covered by a statutory exemption at Section 408(b)(19) of ERISA. The exemption covers only securities for which market quotations are readily available. Generally, the exemption requires the manager (i) to develop policies and procedures to govern cross-trades, (ii) to obtain the consent of clients to participate in the cross-trading program, after providing full disclosure, (iii) to carry out any cross-trades in accordance with its policies and procedures, and (iv) to provide quarterly reports and carry out an annual compliance review.

Certain "passive" cross-trades may be carried out under a special-purpose class exemption even if the general statutory exemption for cross-trading is not available. PTE 2002-12 provides an exemption for cross-trades involving index and model-driven funds or portfolio restructurings for large accounts. However, PTE 2002-12 covers only trades involving equity securities that are widely held and actively traded and for which market quotations are readily available from independent sources and fixed-income securities for which market quotations are readily available from independent sources. Generally, PTE 2002-12 requires the manager (i) to adopt and follow written procedures for its cross-trading program, (ii) to provide advance written notice to investors in funds participating in the cross-trading program, (iii) to adhere to certain pricing and timing requirements, and (iv) to satisfy certain recordkeeping and annual notice requirements.

Please note that the prohibition on cross-trading applies only to plans or accounts subject



to ERISA, and not to IRAs or similar plans or accounts that are not subject to ERISA.

Similar conflicts of interest may arise where a manager is acting on behalf of multiple accounts (one or more of which is an ERISA account) that hold different securities issued by the same company. In these cases, care must be given when exercising any security holder's rights with respect to one account's holdings where there may be adversity of interest with another account. A common example would be where an ERISA account holds senior debt and another account holds junior debt of the same issuer and the ERISA account must determine whether to exercise its rights to preserve the value of its own securities, thereby lowering the value of the junior debt held by the other account. In these cases, a manager may take steps to insulate the decision-making process on behalf of different accounts, including potentially hiring an independent fiduciary. These types of conflict situations can be challenging and costly to address when they arise, so managers may want to include formulaic rules for addressing certain conflicts under their formative documents. This approach may also be beneficial for managers of funds of funds or secondaries funds who may face these types of conflicts as the funds they hold interests in wind down.



CHAPTER 18

Foreign Exchange

Foreign exchange transactions are principal trades with a third party, typically a bank or a broker-dealer, that may well be a party in interest to the ERISA investor engaging in the trade. Accordingly, an exemption is typically required for such transactions. The QPAM Exemption is the exemption most often used, and it is increasingly expected by counterparties to be the exemption relied upon. However, the Service Provider Exemption may also be available to cover foreign exchange transactions.

There is also a special-purpose statutory exemption at ERISA Section 408(b)(18) covering foreign exchange trades. However, the statutory exemption covers only trades in connection with the purchase, holding or sale of securities or other investment assets, and therefore does not cover speculative trades or other trades unrelated to investment holdings. The conditions for the exemption are as follows:

- At the time the transaction is entered into, the terms must be not less favorable to the plan than the terms generally available in comparable arm’s length transactions between unrelated parties, or the terms afforded by the bank or broker dealer.
- The exchange rate must not deviate by more than 3% from the interbank bid and asked rates for transactions of comparable size and maturity as displayed by an independent reporting service.
- The counterparty must not have investment discretion or provide investment advice with respect to the transaction.

Additional special-purpose exemptions are available for standing instruction trades and for trades not relating to existing investment holdings. However, these exemptions are rarely used.

A question that arises with some regularity is whether an asset manager can aggregate and net foreign exchange trades using an internal system or third-party service, before submitting the net trades to its foreign exchange counterparty. As a general matter, such netting procedures, while attractive economically and generally advantageous for clients, raise concerns about impermissible cross-trading. However, the ERISA analysis of such netting procedures is highly fact-dependent and should be discussed with ERISA counsel.



CHAPTER 19

Asset-Backed and Mortgage-Backed Securities

Dealings in ABS and MBS for ERISA accounts may involve some complexity, depending on the nature of the securities. Generally, offering materials for the securities should be reviewed to determine the nature of the securities, whether ERISA investors are permitted to invest in a specific security, and if so, what exemptions may be needed to acquire and hold the securities.

The simplest case is presented by securities that are treated as debt instruments with no substantial equity features. For such securities, the QPAM Exemption (or another status-based exemption) or the Service Provider Exemption will likely be needed to cover the extension of credit to the issuer (which may be a party in interest) and the purchase of the security from the underwriter (which, likewise, may be a party in interest).

Another straightforward case involves securities that are treated as equity (typically called “certificates”) for purposes of ERISA but that either are “publicly offered securities” or are issued by an issuer the assets of which are not treated as plan assets because less than 25% of each class of equity interest is held by benefit plan investors. The latter case may be somewhat rare, as it is not typical for the issuer of such securities to monitor benefit plan investor participation. In these cases, again, the QPAM Exemption or the Service Provider Exemption will be needed to cover the purchase of the security from the underwriter, which may be a party in interest.

A third case not raising significant concerns involves certificates issued by Fannie Mae, Freddie Mac or Ginnie Mae. The assets underlying these securities are specifically exempted from being treated as plan assets.

Complexities arise in the case of securities that are treated as equity and that are issued by an issuer the assets of which may be treated as plan assets. One consideration is whether the underlying asset pools will be operated in accordance with the fiduciary requirements of ERISA. Typically, little or no discretion is exercised at the level of pool operations, so this is often considered not to be a serious concern. A more important consideration is whether the operation of the asset pool could give rise to a prohibited transaction, given that the parties involved are often related to each other and may be parties in interest to investing ERISA plans. However, many ABS and MBS are issued pursuant to so-called Underwriters Exemptions, which are administrative exemptions with nearly identical terms under which many of the major ABS and MBS sponsors enjoy protection against common prohibited transactions relating to the operation of the underlying asset pool. A manager that is purchasing ABS and MBS equity for an ERISA account should in most cases confirm that an Underwriters Exemption is available, and should make sure that the securities have investment grade ratings at the time of purchase, as that is a condition for the continued protection of the Underwriters Exemptions.

The structuring and issuance of ABS and MBS are beyond the scope of this Handbook. Managers seeking to engage in these activities for ERISA accounts should contact their legal advisers.



CHAPTER 20

ERISA-Restricted Securities

Certain securities, by their terms, are prohibited for purchase or holding by or transfer to benefit plan investors, and are appropriately described as “ERISA-restricted.” Such restrictions are often imposed in connection with the issuance of securities by a special purpose vehicle or trust where the security is thought to have significant equity features. Generally, issuers may impose ERISA restrictions out of a concern that the purchase or holding of the security by ERISA plans may subject the issuer and its affiliates to the fiduciary and prohibited transaction requirements of ERISA. Blanket ERISA restrictions are most often seen in fixed-income securities, particularly with respect to certain types of loan participation notes.

Risks associated with ERISA-restricted securities came to the forefront in early 2014, when the Department of Labor and the Securities and Exchange Commission fined an asset manager \$21 million for purchasing and holding ERISA-restricted securities on behalf of certain ERISA clients. This enforcement action was unprecedented and caused managers to review, and, in certain cases, amend their normal practices for researching and purchasing certain types of securities. Many managers have, with assistance of counsel, developed lists of types of securities that must be reviewed for ERISA restrictions.

Typically, securities that might be ERISA-restricted are accompanied by offering documents, such as a prospectus or supplemental prospectus, offering memorandum or private placement memorandum. It is typically within these offering documents that one can find provisions restricting the purchase or holding of a security by benefit plan investors. Offering materials that impose restrictions of this kind may state that purchasers and transferees of the securities are “deemed” to represent that they are not benefit plan investors. Such materials may also recite remedies that purportedly may be exercised by the issuer in its discretion in the event of a breach of the deemed representation—for example, nullifying the purchase or transfer as “void *ab initio*” or requiring that the securities be transferred to a transferee of the issuer’s choice within a specified period of time. These provisions can be complicated and are uncertain in their legal effect, and in some cases may contradict other portions of the offering document.

In an effort to streamline the purchase and sale of these securities on the secondary market, certain financial reporting services (e.g., Bloomberg) provide access to codes designating whether securities are restricted or permitted for purchase by benefit plan investors. Prior to the SEC’s and DOL’s enforcement action, some managers relied conclusively on these designations in purchasing securities. Unfortunately, the designations are at times incorrect. Accordingly, it is best practice for the manager or its counsel to review the applicable offering documents without relying solely on financial reporting services.

Certain securities that are commonly ERISA-restricted include the equity and lower-ranked tranches of CLOs, debt issued by special purpose vehicles that are not owned by the guarantor, UCITS and other non-U.S. exchange-traded funds, low exercise price warrants and certain non-U.S. issued debt. Offering documents should be carefully reviewed prior



to purchasing securities of types that are commonly found to be ERISA-restricted. If after review it is unclear whether the security is ERISA-restricted, it is advisable to contact ERISA counsel for assistance. Counsel should also be contacted if it is discovered that ERISA-restricted securities are being held or have been held on behalf of an ERISA client.

SAMPLE COMPLIANCE POLICY

Prohibition on purchase of ERISA-restricted securities on behalf of ERISA accounts

When contemplating the purchase for an ERISA account of securities of a type designated by the Chief Compliance Officer as potentially ERISA-restricted, the portfolio manager will ensure that the applicable offering documents are reviewed to determine that the security is not prohibited from purchase or holding by the ERISA account. If it is determined that a security is ERISA-restricted, the portfolio manager will not purchase such security on behalf of the ERISA client.

If it is determined that the Firm has purchased and currently holds an ERISA-restricted security on behalf of an ERISA client, the Firm will promptly notify the ERISA client of this fact.



CHAPTER 21

Corrections

There are generally two methods for correcting transactions that violate ERISA. For certain violations of the prohibited transaction rules, the statute provides 14 days to correct the transaction. For breaches of fiduciary duty, including certain prohibited transactions, the Department of Labor has adopted a Voluntary Fiduciary Correction Program. This chapter explains which transactions may be corrected by these means and how to correct those transactions.

Correcting a Prohibited Transaction

A fiduciary that has executed a nonexempt prohibited transaction involving the acquisition, holding or disposition of any security or commodity (each as defined below) may correct the transaction within 14 days of the date on which it discovers, or reasonably should have discovered, that the transaction was prohibited under ERISA. Since the 14-day period begins when the fiduciary “reasonably should have discovered” the violation, it is advisable to set up a monitoring system to detect prohibited transactions.

To correct a transaction, the fiduciary generally must (i) undo the transaction to the extent possible, (ii) make good to the plan any losses resulting from the transaction and (iii) restore to the plan any profits made through the use of assets of the plan.

The 14-day correction period is not available if, at the time the transaction occurred, the fiduciary knew, or reasonably should have known, that the transaction was prohibited under ERISA. The correction period is also not available for transactions between a plan and a plan sponsor or its affiliates that involve the acquisition or sale of an employer security, or the acquisition, sale, or lease of employer real property.

For purposes of this correction rule, a “security” means any (i) share of stock in a corporation; (ii) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (iii) note, bond, debenture or other evidence of indebtedness; (iv) interest rate, currency or equity notional principal contract; (v) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and any position not described above, or hedge, with respect to such a security.

For purposes of this correction rule, a “commodity” means (i) any commodity that is actively traded; (ii) any notional principal contract with respect to any actively traded commodity; (iii) any evidence of an interest in, or a derivative instrument in, any commodity described in (i) or (ii), including any option, forward contract, futures contract, short position and any similar instrument in such a commodity; and (iv) any position or hedge with respect to such a commodity.

Correcting a Breach of Fiduciary Duty

A fiduciary that has breached a fiduciary duty to a plan may, in certain cases, voluntarily



correct the transaction through the Voluntary Fiduciary Correction Program (VFCP). Generally, the program requires that the fiduciary (i) identify any violations and determine whether they are covered by the VFCP; (ii) undo the transaction, if possible; (iii) calculate and restore any losses, profits, or supplemental benefits to the plan and participants; and (iv) submit an application to the Department of Labor. Once the fiduciary satisfies the terms of the program, the Department will issue a no-action letter for the transaction in question. Pursuant to the no-action letter, the Department will not initiate a civil investigation regarding the fiduciary's responsibility for the transaction, or assess civil penalties on the correction amount paid to the plan or its participants. However, the Department may investigate to verify the facts set forth in the application and to confirm that the transaction was corrected.

The following transactions, among others, may be corrected through the VFCP:

- **PURCHASE OF AN ASSET BY A PLAN FROM A PARTY IN INTEREST**—Correction is available if a plan purchased an asset with cash from a party in interest, in a transaction to which no prohibited transaction exemption applies.
- **SALE OF AN ASSET BY A PLAN TO A PARTY IN INTEREST**—Correction is available if a plan sold an asset for cash to a party in interest, in a transaction to which no prohibited transaction exemption applies.
- **PURCHASE OF AN ASSET BY A PLAN AT A PRICE MORE THAN FAIR MARKET VALUE**—Correction is available if a plan acquired an asset from a person who is not a party in interest without determining the asset's fair market value, and as a result the plan paid more than it should have for the asset.
- **SALE OF AN ASSET BY A PLAN AT A PRICE LESS THAN FAIR MARKET VALUE**—Correction is available if a plan sold an asset to a person who is not a party in interest without determining the asset's fair market value, and as a result the plan received less than it should have from the sale.

A fiduciary cannot participate in the VFCP if the fiduciary or the plan is under investigation, unless the plan notifies the Department of Labor. A fiduciary or plan is under investigation if it has received a notice that (i) the Department is conducting an investigation of the fiduciary in connection with an act or transaction directly related to the plan; (ii) any governmental agency is conducting a criminal investigation of the fiduciary in connection with an act or transaction directly related to the plan; (iii) the Pension Benefit Guaranty Corporation, any state attorney general, or any state insurance commissioner is conducting an investigation or examination of the fiduciary in connection with an act or transaction directly related to the plan; (iv) the Department is conducting an investigation of the plan; or (v) the IRS is conducting an Employee Plans examination of the plan. The VFCP also cannot be used if the Department has conducted an investigation that resulted in the transaction's referral to the IRS. Finally, the VFCP is not available if the application contains evidence of potential criminal violations.



After identifying and correcting a breach, the fiduciary must file an application with the Department of Labor. If the fiduciary has a representative submit the application, the application must include a signed statement that the representative is authorized to represent the fiduciary. Plan assets may not be used for any fees paid to a representative for preparing and submitting the application. The application must include specified documentation relevant to the breach. The Department may request additional documentation in writing from the fiduciary or authorized representative. The fiduciary must maintain copies of the application and any subsequent correspondence with the Department for six years after the filing date.

The Department of Labor will maintain the confidentiality of any documents submitted under the VFCP, to the extent permitted by law. However, the Department has an obligation to make certain referrals to the IRS, and to refer to other agencies evidence of criminality and other information for law enforcement purposes.



Appendix

Parties in Interest ERISA Section 3(14)

Subsections of 3(14)

A
B
C
D
E
F
G
H
I

