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Client Alert

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Recent U.S. DOL Prohibited Transaction Guidance

ADVISORY OPINION 2006-01A, PTCES 75-1 AND 84-24

The U.S. Department of Labor (the "DOL") recently issued final amendments to two Prohibited Transaction Class Exemptions ("PTCEs")–PTCE 75-1, which permits employee benefit plans to enter into certain transactions with registered broker-dealers, reporting dealers and banks that would be otherwise prohibited, and PTCE 84-24, which permits insurance agents or brokers and certain other service providers to receive sales commissions that would otherwise be prohibited in connection with a plan's purchase of insurance and annuity contracts and mutual fund shares. The DOL issued the amendments, which will permit plans to engage in covered transactions with a greater number of financial institutions, in response to increasing affiliations among financial institutions resulting from consolidation in the industry.

The DOL also recently issued an Advisory Opinion (DOL Adv. Op. 2006-01A, January 6, 2006) which found that an IRA owner's investment in a limited liability company ("LLC") resulted in a prohibited transaction under the Internal Revenue Code of 1986, as amended (the "Code") where the investment was part of an arrangement or understanding that the LLC would engage in a transaction with a party in interest. The DOL reached this conclusion notwithstanding that the LLC did not hold "plan assets" under the plan assets regulations issued under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

Amendments to PTCE 75-1

PTCE 75-1 provides for five prohibited transaction exemptions covering various securities transactions with registered broker-dealers, including certain principal transactions and extensions of credit. Certain of these exemptions also apply to reporting dealers and banks. The recent amendments affect only Part II (Principal Transactions) and Part V (Extensions of Credit). Previously, the literal language of the exemptions provided that neither of those Parts were available if the broker-dealer, reporting dealer or bank or any of their affiliates was a fiduciary with respect to any assets of the plan.[1] The recent amendments now extend the relief of these Parts to broker dealers, reporting dealers or banks that are fiduciaries to a plan, in general so long as the broker-dealer, reporting dealer or bank does not have discretionary authority or render investment advice with respect to the assets involved in the transaction.

As amended, Part II of PTCE 75-1 now provides an exemption from the prohibitions of Section 406(a) of ERISA for the purchase and sale of securities between a plan and a registered broker-dealer, a reporting dealer or a bank if:

- the broker-dealer, reporting dealer or bank customarily purchases and sells securities for its own account in the ordinary course of business;
- the transaction is at least as favorable to the plan as it would be in an arm's-length transaction with an unrelated party;

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[1] One commenter on the proposed amendments had encouraged the DOL to state that it was the DOL's intention when it originally granted the final exemption in 1975 to exclude from the exemption's coverage only fiduciaries with respect to the plan assets involved in the transaction. However, the DOL did not concur that this was its original intent.

- neither the broker-dealer, reporting dealer or bank (nor its affiliates) has or exercises any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction, or renders investment advice with respect to those assets; and

- the plan follows certain recordkeeping requirements.

The amendment to Part II also repositioned the provisions of the exemption that extend relief from both Sections 406(a) and 406(b) of ERISA to the purchase or sale by a plan of securities issued by a registered open-end investment company (mutual fund) from a party in interest. The amendment clarifies that mutual fund purchases and sales are permitted so long as the fiduciary who made the decision on behalf of the plan to enter into the transaction is not a principal underwriter for, or affiliated with the mutual fund. Previously, a literal reading of the exemption would not have covered a transaction in which a fiduciary of the plan was the principal underwriter for or affiliated with the mutual fund, regardless of whether the fiduciary was the decision maker with respect to the purchase or sale at issue. The DOL noted that it had received comments on the mutual fund rule that it needed more time to consider. However, the DOL decided to implement the changes to the mutual fund portion of the exemption pending any future guidance.

As amended, Part V of PTCE 75-1 now generally permits a registered broker-dealer that is a party in interest to a plan to extend credit to a plan in connection with the purchase or sale of securities if:

- neither broker-dealer nor its affiliates has, or exercises, any discretionary authority or control (except as a directed trustee) with respect to the investment of the plan assets involved in the transaction and the broker-dealer and its affiliates do not render investment advice with respect to those assets, unless no interest or other consideration is received by such broker-dealer or affiliate;

- the extension of credit is lawful under the Securities Exchange Act of 1934; and

- the plan follows certain recordkeeping requirements.

Part V is not applicable to reporting dealers or banks.

Acknowledging that there may have been some confusion regarding the scope of the exemptions as originally drafted, the DOL has determined that these amendments to PTCE 75-1 are retroactively effective to January 1, 1975.

Amendments to PTCE 84-24

PTCE 84-24 generally provides an exemption for a plan's payment of sales commissions to insurance agents or brokers, pension consultants or investment company principal underwriters in connection with the plan's purchase of insurance or annuity contracts and investment company securities. PTCE 84-24 also covers other transactions not discussed here.

PTCE 84-24 previously did not cover transactions where the insurance agent or broker, pension consultant or investment company principal underwriter or its affiliate was a fiduciary with respect to any assets of the plan. Similar to the amendment to PTCE 75-1, the recent amendments to PTCE 84-24 now extend the exemption's relief to transactions where the insurance agent or broker, pension consultant or investment company principal underwriter or its affiliate is a fiduciary of the plan, so long as such entity does not have any discretionary authority or control over the plan assets involved in the transaction other than as a nondiscretionary trustee.

The amendment also clarifies that a party is permitted to use the exemption notwithstanding its affiliation with a nondiscretionary trustee, including a directed trustee that performs such services with respect to the plan assets involved in the transaction.

As amended, transactions covered by PTCE 84-24 must meet the following conditions:

- the transaction must be effected in the ordinary course of business;

- the transaction must be on terms at least as favorable to the plan as an arm's length transaction with an unrelated party;

- the combined total of all fees, commissions and other consideration received in connection with the transaction must not be in excess of "reasonable compensation;"

- the agent, broker, pension consultant or investment company principal underwriter or its affiliates cannot be a trustee (other than a non-discretionary trustee) or a fiduciary who is expressly authorized in writing to manage, acquire or dispose of the assets of the plan involved in the transaction on a discretionary basis; and

- the agent, broker, pension consultant or investment company principal underwriter must provide an independent fiduciary of the plan with certain disclosures regarding the transaction and the independent fiduciary must acknowledge in writing the receipt of this information and approve the transaction.

These amendments to PTCE 84-24 are effective as of February 3, 2006.

DOL Advisory Opinion 2006-1

In Advisory Opinion 2006-1, the DOL reiterated its position that under certain circumstances, a transaction by an entity in which a plan has invested but **does not hold "plan assets"** can still be a prohibited transaction.

Factual Background. This Advisory Opinion request was made on behalf of Salon Services and Supplies Inc. (the "S Company"), a Washington state S corporation 68% owned by Miles and Sydney Berry. Mr. Berry proposed to create a limited liability corporation ("LLC") that would purchase land, build a warehouse and lease the property to the S Company. The proposed investors in the LLC were Berry's IRA (with a 49% interest in the LLC) and certain others. The S company was a disqualified person[2] with respect to Berry's IRA. The requester also represented that the LLC would not contain plan assets because it would qualify as a Real Estate Operating Company ("REOC") as defined in the DOL's plan assets regulations (29 C.F.R. § 2510.3-101).

DOL Findings. Section 4975(c)(1)(A) of the Code provides that a fiduciary must not cause a plan to engage in the direct or in indirect sale or exchange, or leasing of any property between a plan and a disqualified person. The DOL found that the leasing of property between the LLC and the S Company would be a prohibited transaction with respect to Berry's IRA despite the fact that the LLC, as a REOC, did not hold "plan assets."

The determinative factor in the DOL's finding was the parties' understanding in advance that the LLC would engage in a transaction with the S Company following the IRA's investment in the LLC. The DOL noted that a transaction between a party in interest and a corporation in which a plan has invested generally does not give rise to a prohibited transaction. Prior DOL guidance (most notably Interpretive Bulletin 75-2, 29 C.F.R. § 2509.75-2(c)) has made clear that a prohibited transaction does occur, however, when a plan invests in a corporation as part of an "arrangement or understanding" under which it is expected that the corporation will engage in a transaction with a party in interest.

Again relying on its Interpretive Bulletin 75-2, the DOL also explained that it considers it a violation of ERISA for a fiduciary to make an investment in a corporation for purposes of avoiding the application of ERISA's fiduciary provisions. It noted, therefore, that the proposed transaction would have to be referred to the Internal Revenue Service for a ruling as to whether it would consider the transaction a violation of the exclusive benefit rule of the Code (the Code's analogue to ERISA's fiduciary provisions).

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