

Legal Alert: Pension Protection Act of 2006 – Investments, Insurance and Services

August 10, 2006

The [Pension Protection Act of 2006](#) includes a number of significant provisions that will change the way products and services are offered in the employee plan marketplace, particularly with respect to investments and investment services. A number of the principal changes are summarized below; other changes implicating these issues – for examples, those dealing with ESOPs – are described in our other summaries of the Act. Further information is provided by the [technical explanation](#) published by the staff of the Joint Committee on Taxation.

In general, the following amendments are incorporated in the fiduciary standard and/or prohibited transaction provisions of ERISA, with parallel changes, where applicable, to corresponding prohibited transaction provisions of section 4975 of the Internal Revenue Code (the “Code”).

Participant-Directed Plans

Investment Advice. A new statutory exemption – ERISA section 408(b)(14) – provides relief for the provision of investment advice to participants and beneficiaries of participant-directed plans. This new provision generally allows “*fiduciary advisers*” to render investment advice, including investment advice with respect to their own investment products, under an “eligible investment advice arrangement,” *i.e.*, an arrangement for providing investment advice (1) that is based on a *computer model* or (2) under which the fiduciaries’ *fees do not vary depending on the investment option selected*.

- The new legislation builds on the Labor Department’s interpretive position in the “SunAmerica letter,” ERISA Advisory Opinion 2001-09A (Dec. 14, 2001) – both codifying it in statutory form and amplifying its details in a number of respects.
- *Fiduciary advisers* are limited to (i) investment advisers registered under the Investment Advisers Act of 1940 or under the laws of the states in which the adviser maintains its principal office and place of business, (ii) banks or similar financial institutions or savings associations, but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities, (iii) insurance companies qualified to do business in at least one state, (iv) a broker or dealer registered under the Securities

Act of 1934, (v) affiliates of any of the foregoing, or (vi) employees, agents or registered representatives of any of the foregoing who satisfy applicable insurance, banking and securities laws relating to the provision of investment advice.

- Among the conditions on which the exemptive relief is conditioned are the following:
 - If the advice is based on a **computer model**, the model must satisfy certain standards and must be certified prior to use by an “eligible investment expert” satisfying requirements to be prescribed by the Labor Department. The eligible investment expert must be completely independent of any investment adviser and persons related to investment advisers. The computer model must be the exclusive basis of advice provided under the investment advice program, and all decisions must be solely at the direction of the participant/beneficiary.
 - The arrangement must be expressly **authorized by an independent plan fiduciary**, *i.e.*, a plan fiduciary other than the person offering the investment advice program and any person providing investment options under the plan, and any affiliates of either.
 - An independent qualified **independent auditor** must conduct a compliance audit of the arrangement annually for compliance with the standards and deliver a written report to the fiduciary authorizing the arrangement.
 - The adviser must provide certain **information** to participants/beneficiaries.
 - The adviser’s compensation must be **reasonable** and all investment transactions must be on **arm’s-length** terms.
- **Exemptive relief** generally covers the provision of the advice, the acquisition, holding or sale of securities or other property, and the direct or indirect receipt of fees or other compensation by the fiduciary adviser.

- ***Fiduciary relief*** is also provided, for ***plan sponsors or other fiduciaries*** (other than fiduciary advisers) with respect to investment advice provided to participants/beneficiaries.
 - They are generally deemed to have discharged their fiduciary duties if the advice is provided by a fiduciary adviser pursuant to an eligible investment advice arrangement requiring compliance by the fiduciary adviser with the statutory terms, and the terms of the eligible investment advice include a written acknowledgment that the fiduciary adviser is a fiduciary with respect to the provision of the advice.
 - Fiduciaries other than the fiduciary adviser have a continuing duty to select the fiduciary adviser prudently and to review the fiduciary adviser's performance periodically.
 - However, they have no duty to monitor the specific advice given by the fiduciary adviser to any particular recipient.
- ***Developers of computer models*** used in providing investment advice to participants and beneficiaries and ***marketers of computer programs and investment advice programs*** are treated as plan fiduciaries. The Labor Department can prescribe rules under which only one fiduciary adviser may elect to be treated as a plan fiduciary.
- Exemptive relief for computer-model-based investment advice arrangements does not extend to ***individual retirement accounts*** and certain other individual accounts that are subject to section 4975 of the Code. However, the legislation calls for the Labor Department to determine whether an adequate computer model exists for such accounts and, if so, to lift the restriction on exemptive relief or, if not, to fashion appropriate exemptive relief through the class exemption process.
- The legislation provides that the amendments to ERISA and section 4975 of the Code do not alter existing individual or class exemptions provided by statute or administrative action.
 - ***Effective date:*** Generally applies to advice provided after 2006. (A technical amendment to the effective date provision of the amendments to section 4975 of the Code may be necessary.)

Black-Out Periods and Mapping. The Act makes three changes applicable to black-out periods:

- First, the new legislation provides a *general framework for the responsibility and liabilities of fiduciaries* of ERISA section 404(c) participant-directed plans with respect to black-out periods. The fiduciaries are responsible for the authorization and implementation of the black-out period but, if they meet the fiduciary standards of ERISA in doing so, they will not be responsible for investment losses during the black-out period. Within one year of enactment, the Labor Department is directed to issue guidance on how fiduciaries can satisfy these obligations, including safe harbors.
- Second, section 404(c) relief is provided when *plan investment choices are changed and mapped* to new investment options that are “reasonably similar” to those to which participant accounts were allocated prior to the change, provided that advance notice of the change is provided to participants and beneficiaries.
 - *Effective date:* Plan years beginning after 2007, except that collectively bargained plans maintained under collective bargaining agreements ratified before the date of enactment can generally defer compliance until plan years beginning in 2009 or, in certain circumstances, 2010.
- Finally, in a provision not limited to participant-directed plans, the Act expands the *one-participant plans exempt from the blackout notice provision* enacted in the Sarbanes-Oxley Act of 2002.

Default Options. Participant-directed plans will generally be allowed to allocate participant/beneficiary accounts for which directions are not received to default options in accordance with regulations to be issued by the Labor Department if advance notice satisfying certain standards has been provided to the participants/beneficiaries. If the requirements are satisfied, fiduciaries are generally relieved of liability under section 404(c) of ERISA in connection with these allocations.

- Regulations are to be issued by the Labor Department no later than six months after the date of enactment.
 - *Effective date:* Plan years beginning after 2006.

Plan Asset Rules

The new legislation significantly modifies the Labor Department's "plan asset" regulation, 29 C.F.R. § 2510.3-101. The plan asset regulation generally provides that if a plan covered by ERISA or section 4975 of the Code acquires an equity interest that is not publicly traded in an investment fund other than a registered mutual fund, the fund's underlying assets are treated as "plan assets" subject to the fiduciary provisions of ERISA and/or section 4975, unless "benefit plan investors" hold less than 25% of each equity interest in the entity or another exception applies.

- The legislation does not change the 25% limitation (although it precludes the Labor Department from lowering the percentage), but provides that, in contrast to the plan asset regulation as previously in effect, ***plans that are not subject to ERISA or section 4975 — generally, governmental plans, foreign plans and “non-electing” church plans — are not to be treated as “benefit plan investors” and are not to count towards the 25% limitation.*** This modification is expected to allow non-publicly traded investment funds, including hedge funds, to accept more ERISA plan money.
- The legislation also provides that an entity that is treated as holding plan assets is deemed to do so ***only in proportion to the equity interests in the entity held by the benefit plan investors.*** For example, if the underlying assets of Investment Fund A are treated as plan assets because 40% of its equity is held by benefit plan investors, and Investment Fund A acquires \$1,000,000 of an equity class of securities in Investment Fund B, only \$400,000 of the equity securities held by Investment Fund A is treated as being held by benefit plan investors and counted towards the 25% limitation in determining whether Investment Fund B's underlying assets are treated as plan assets.
 - ***Effective date:*** Transactions occurring after the date of enactment.

Service Providers

Broad exemptive relief from the prohibitions against transactions with parties in interest/disqualified persons for ***non-fiduciary service providers and their affiliates***, generally allows them to engage in property sales and leases, loans, transactions involving the transfer of plan assets and certain other transactions with plans to which they provide services, subject to an "adequate consideration" standard.

- This exemption may functionally supersede some of the existing prohibited transaction class exemptions issued by the Labor Department for transactions with service providers.
- Provision of services by the service provider is not within the scope of the new exemption, but remains exempt under existing section 408(b)(2) subject to a “reasonable compensation” standard.
 - **Effective date:** Transactions occurring after the date of enactment.

Insurance Products

Annuity Distributions. The Act modifies in two respects the rules for using annuity contracts to distribute benefits from retirement plans.

- The Labor Department is directed to issue a regulation within one year after enactment of the new legislation clarifying that the *selection of an annuity contract as an optional form of benefit under a defined contribution plan is not subject to the “safest available annuity” rule* set forth in Interpretive Bulletin (“IB”) 95-1, 29 C.F.R. § 2509.95-1, but is subject to all otherwise applicable fiduciary standards. IB 95-1 generally provides that fiduciaries distributing commercial annuities to participants and beneficiaries in satisfaction of benefit obligations must choose the safest annuity available without regard to cost, “unless under the circumstances it would be in the interests of participants and beneficiaries to do otherwise.”
 - **Effective date:** Effective on the date of enactment.
- As part of the significant transformation of the funding requirements for single-employer defined benefit plans, the Act *constrains the purchase of annuities* from commercial insurers during periods *when plans are “at-risk”* under those new rules. These rules are discussed in our summary of the Act’s provisions dealing with Defined Benefit Plans.

Qualified Long-Term Care Coverage. The new legislation makes certain changes—which are for the most part liberalizing—to the treatment of qualified long-term care insurance contracts that are part of, or attached as riders to, life insurance and annuity contracts. The provisions of the new legislation include the following:

- **Qualified long-term care insurance contracts**, as defined in section 7702B(b) of the Code, can be part of, or attached as riders to, *both* life insurance contracts and annuity contracts. Under prior law, there was no provision allowing qualified long-term care insurance to part of, or attached as riders to, annuity contracts.
 - **Effective date:** Applies to contracts issued after 1996 with respect to taxable years beginning after 2009.

- Under section 72(e), as amended by the new legislation, charges for qualified long-term care insurance contracts that are part of, or attached as riders to, life insurance and annuity contracts, if subtracted from the cash value of the base contract, are not includible in income. Under prior law, such charges were treated as taxable distributions. Thus, **qualified long-term care insurance can be paid for out of the cash value of life insurance and annuity contracts on a before-tax basis**. However, the **investment in the contract** is reduced (but not below zero) by the amount of such charges, resulting in the potential for current taxation of a larger portion of subsequent distributions from the contract.
 - **Effective date:** Applies to contracts issued after 1996 with respect to taxable years beginning after 2009.

- If charges for qualified long-term care insurance contracts that are part of, or attached as riders to, life insurance contracts designed to satisfy the **guideline premium limitation** of section 7702(c) are imposed against the base life insurance contract's cash value and are not includible in income, such charges reduce the premiums paid under section 7702(f)(1), for purposes of the guideline premium limitation. This subsequently allows additional premiums equal to the amount of such charges to be paid into the life insurance contract without violating the guideline premium limitation.
 - **Effective date:** Applies to contracts issued after 1996 with respect to taxable years beginning after 2009.

- In addition, charges for qualified long-term care insurance contracts that are part of, or attached as riders to, life insurance contracts or annuity contracts cannot be deducted under section 213(a) if subtracted from the cash value of the base contract.
 - **Effective date:** Applies to contracts issued after 1996 with respect to taxable years beginning after 2009.

- **Exchanges** of life insurance contracts, endowment contracts, annuity contracts and qualified long-term care insurance contracts for qualified long-term care insurance contracts are eligible to be treated as tax-free exchanges under section 1035(a). Qualified long-term care insurance contracts that are part of, or attached as riders, to life insurance and annuity contracts do not disqualify such life insurance and annuity contracts from eligibility for such tax-free exchanges.
 - **Effective date:** Applies to exchanges occurring after 2009.
- Charges for qualified long-term care insurance contracts against the cash value of the base contract are subject to **new information reporting requirements** specific to long-term care insurance.
 - **Effective date:** Applies to charges made after 2009.
- The proxy “tax” under section 848 of the Code for life insurance company **deferred acquisition costs** (“DAC”) (*i.e.*, the disallowance as a current deduction, and the capitalization and amortization over 10 years, of a portion of an insurance company’s general expenses based on the amount of premiums it collects) is the highest rate, namely, 7.7% of premiums, for life insurance and annuity contracts with qualified long-term care insurance contracts attached. Lower rates of 2.05% and 1.75% continue to apply to annuity contracts and group life insurance contracts, respectively, without long-term care insurance contracts attached.
 - **Effective date:** Applies for taxable years beginning after 2009.

Corporate-Owned Life Insurance (“COLI”). In recent years, a number of states have amended their insurance laws governing COLI to amplify notice and consent requirements and/or to limit the ability of the employer to retain the policy after the insured leaves employment. The Act models those substantive state insurance changes.

- The **death proceeds** under a policy owned by, and directly or indirectly payable to, an employer (engaged in a trade or business, and certain related persons) of an insured U.S. citizen or resident, less the premiums and other consideration paid for the contract, will be **taxable** unless both (i) a notice and consent requirement is met and (ii) one of four exceptions applies. On the face of the statute, this new rule would appear not to apply to life insurance owned by a VEBA.

- The ***notice and consent requirement*** is met if, prior to policy issuance, insured employees (including officers and directors) receive written notification that they are proposed to be insured and the maximum face amount for which the employee could be insured at issuance, are advised that the employer (or certain related entities) will be the policy beneficiary, and provide written consent to being insured and to the continuation of coverage after employment.
- The four ***exceptions*** apply if (i) ***at any time during the 12 months preceding death***, the insured was an employee, officer, director or section 414(q) highly compensated employee (under the qualified plan nondiscrimination rules) of the employer (including certain related entities), (ii) ***at the time the policy was issued***, the insured was a director, section 414(q) highly compensated employee, or section 105(h)(5) highly compensated individual (under the nondiscrimination rule for self-insured medical plans, modified to include the highest paid 35% of employees) of the employer (again including certain related entities), (iii) to the extent ***proceeds are paid to a family member*** of the insured, a policy ***beneficiary*** other than the employer designated by the insured, a ***trust*** established for the benefit of such family member or designated beneficiary, or the insured's ***estate***, or (iv) to the extent the proceeds are used to ***purchase an equity, capital or profits interest*** in the employer (including certain related entities) from such family member, designated beneficiary, trust or estate.
- The Act creates a new ***information reporting*** requirement for owners of one or more employer-owned life insurance policies issued after the date of enactment.
 - ***Effective date***: Life insurance contracts issued or materially modified after the date of enactment. Neither a section 1035 exchange nor (as to pre-Act insureds) the addition of insureds under a master contract vitiates grandfathering. A material increase in the death benefit or other material change in general causes the policy to be treated as newly issued, although the Joint Committee staff explanation suggests that grandfathering will not be lost due to death benefit changes resulting on a nondiscretionary basis from the operation of section 7702 or the terms of the policy, administrative changes in the policy, changes from general to separate account, or changes resulting from the exercise of a contractual option or right existing at policy issuance.

Life Insurance Owned by Exempt Organizations. The Act imposes a *temporary reporting requirement* with respect to the acquisition of interests in life insurance, annuity and endowment contracts by exempt organizations under certain circumstances.

- An information return must be filed with the IRS by an “*applicable exempt organization*” that makes a “*reportable acquisition*.”
- A “*reportable acquisition*” is an acquisition of a direct or indirect interest in an “*applicable insurance contract*.”
- An “*applicable insurance contract*” is a life insurance, annuity or endowment insurance contract with respect to which *both the exempt organization and another person have directly or indirectly held an interest* (not necessarily at the same time) if the acquisition is part of a *structured transaction involving a pool* of such contracts.
- “*Applicable exempt organizations*” generally include section 501(c)(3) organizations, governments or political subdivisions of governments and Indian tribal governments.
- ***Exceptions to the Reporting Requirement:***
 - If each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an *insurable interest* in the insured independent of any interest in the exempt organization in the contract.
 - If the sole interest in the contract of the applicable exempt organization or each person other than the applicable exempt organization is as a *named beneficiary* of the contract.
 - If the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a *beneficiary of a trust* holding an interest in the contract, but only if the person’s designation as a beneficiary was made without consideration and solely on a *gratuitous* basis, or (2) as a trustee who holds an interest in the contract in a *fiduciary* capacity solely *for the benefit of applicable exempt organizations* or of persons otherwise meeting one of the first two exceptions.

- *Penalties* apply for failure to file the information return.
- *Effective dates:* The reporting requirement applies to reportable acquisitions occurring during the two-year period beginning on the date of enactment.
- The Treasury Secretary is required to undertake a *study* of the use of “applicable insurance contracts” by tax-exempt organizations to share the benefits of the exempt organizations’ insurable interests with investors and whether such activities are consistent with the tax-exempt status of the exempt organizations. No later than 30 months after the date of enactment, the Treasury Secretary is to *report* on this study to the Senate Finance and House Ways and Means Committees.

Investment Transactions

The Act includes five other new statutory prohibited transaction exemptions authorizing a range of industry developments for transacting and processing investment activity. Each of these exemptions is subject to conditions, including, but not limited to, those noted below.

- *Block Trades.* A prohibited transaction exemption generally allowing plan fiduciaries to effect large block trades on behalf of multiple plans.
 - No plan (or group of plans sponsored by the same employer) can exceed **10%** of the aggregate size of the block trade.
 - The block trade must involve at least **10,000 shares** or a market value of at least **\$200,000**.
 - The *terms of the transaction*, including the price, must be at least as favorable to the plan as an arm’s-length transaction.
 - The *compensation* associated with the transaction cannot exceed arm’s-length compensation.
 - *Effective date:* Transactions occurring after the date of enactment.
- *Alternative execution systems.* A prohibited transaction exemption generally allowing purchases and sales of securities through *electronic trading networks, alternative trading systems or similar execution systems or trading venues*.

- The execution system must be ***subject to regulation*** by the applicable federal regulating entity or a foreign regulatory entity determined by the Secretary of Labor.
 - Either (i) the execution system must be designed to match purchases and sales at the ***best price available*** through the system in accordance with SEC rules or those of another relevant governmental authority, or (ii) neither the execution system nor the parties to the transaction ***may take into account the identity of the parties*** in the execution of trades.
 - The ***price and compensation*** associated with the purchase and sale cannot be greater than in an arm's-length transaction with an unrelated party.
 - If the party in interest has an ownership interest in the system, ***advance authorization*** by the plan sponsor or other independent fiduciary is necessary.
 - Not less than 30 days prior to the initial transaction through the execution system, a plan fiduciary must be provided written or electronic ***notice*** of the execution of such transaction through the system.
 - ***Effective date:*** Transactions occurring after the date of enactment.
- ***Foreign Exchange Transactions.*** A prohibited transaction exemption generally allowing certain foreign exchange transactions between plans and banks or broker-dealers.
- The foreign exchange transaction must be ***in connection with the purchase, holding or sale of securities or other investment assets*** and cannot be a stand-alone transaction in foreign currencies.
 - The terms of the transaction must be no less favorable to the plan than the terms of a comparable ***arm's-length*** foreign exchange transaction involving unrelated parties (either arm's-length terms that are generally available or terms that are offered by the bank, broker-dealer or an affiliate).

- The exchange rate cannot deviate by *more than 3%* from the interbank bid and asked rates for transactions of comparable size and maturity at the time of the transaction, as displayed on an independent service that reports rates of exchange in the foreign currency market for the currency in question.
 - The exemption is available for banks and broker-dealers serving as plan fiduciaries, but only if they do not have investment discretion or provide investment advice with respect to the transaction at issue.
 - **Effective date:** Transactions occurring after the date of enactment.
- **Cross-Trading.** An exemption generally allowing an investment manager to effect cash purchases and sales of securities for which market quotations are readily available, between large plans and another account under management by the investment manager, subject to certain conditions. This exemption is more liberal than the Labor Department’s relief under Prohibited Transaction Class Exemption 2002-12 (67 Fed. Reg. 6614; Feb. 12, 2002) in this area, which is limited to index- and model-driven funds.
- The exemption is available for plans (or master trusts of plans of related employers) with at least **\$100,000,000** in assets.
 - The transaction must be a purchase or sale, for no consideration other than a **cash payment against prompt delivery** of a security for which market quotations are readily available.
 - The transaction must be **priced on the basis of SEC Rule 17a-7(b)** under the Investment Company Act of 1940, as amended.
 - **No brokerage, commission or fees** (other than “customary transfer fees”) may be charged for the transaction.
 - Cross-trading must be **authorized in advance** by a plan fiduciary other than the investment manager, and the plan fiduciary must receive quarterly reports detailing cross-trading activities.
 - The investment manager cannot base its fee schedule or other services on a plan’s consent to cross trading, but the investment

manager can pass on to a consenting plan investment opportunities and cost savings available through cross-trades.

- The investment manager must adopt **written policies and procedures** that are fair and equitable to all accounts and that must include a description of policies and procedures for pricing and for allocating cross-trades among accounts. The investment manager must designate an individual to periodically monitor compliance with its policies and procedures.
 - The Labor Department is directed to issue **regulations**, after consultation with the SEC, within 180 days after the date of enactment regarding the content of investment managers' cross-trading policies and procedures.
 - **Effective date:** Transactions occurring after the date of enactment.
- **Inadvertent Prohibited Transactions.** Limited exemptive relief for inadvertent transactions with parties in interest/disqualified persons **that are corrected within 14 days of discovery**.
- The exemption only applies to the acquisition, holding or disposition of securities and commodities.
 - The exemption does not apply to transactions between a plan and a plan sponsor involving employer securities or employer real property.
 - The exemption is unavailable if a fiduciary or other party in interest (or any other person knowingly participating in the transaction) knew (or reasonably should have known) that the transaction would, in the absence of the exemption, constitute a transaction prohibited by section 406(a) of ERISA or section 4975 of the Code.
 - **Effective date:** Transactions discovered, or which reasonably should have been discovered, after the date of enactment.

Bonding

- The *maximum amount* of the bond required of persons who handle plan funds is increased from \$500,000 to \$1,000,000. (Subject to the \$1,000,000 cap, section 412(a) of ERISA requires such persons to be bonded for 10% of the amount of funds handled.)
 - *Effective date:* Plan years beginning after 2007.
- *Broker-dealers* registered under the Securities Exchange Act of 1934 that are subject to fidelity bond requirements of a self-regulatory organization are exempt from the bonding requirements of section 412.
 - *Effective date:* Plan years beginning after the date of enactment.

Coercive Interference

- *Criminal penalties are increased* under section 511 for coercive interference with rights protected by ERISA, from a fine of \$10,000 or a prison term of one year or both, to a fine of \$100,000 or a prison term of 10 years or both.
 - *Effective date:* Violations occurring on and after the date of enactment.

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Please contact any of the following members of our Employee Benefits and Executive Compensation practice if you have any questions regarding this development:

George H. Bostick	202.383.0127	george.bostick@sablaw.com
Daniel M. Buchner	202.383.0869	daniel.buchner@sablaw.com
Adam B. Cohen	202.383.0167	adam.cohen@sablaw.com
Thomas A. Gick	202.383.0191	tom.gick@sablaw.com
Ian A. Herbert	202.383.0644	ian.herbert@sablaw.com
Alice Murtos	404.853.8410	alice.murtos@sablaw.com
Robert J. Neis	404.853.8270	robert.neis@sablaw.com
W. Mark Smith	202.383.0221	mark.smith@sablaw.com
William J. Walderman	202.383.0243	william.walderman@sablaw.com
Carol A. Weiser	202.383.0728	carol.weiser@sablaw.com