

DEPARTMENT OF LABOR**Office of Pension and Welfare Benefit Programs**

[Application No. D-3970]

Proposed Class Exemption To Replace PTE 79-1 and PTE 84-46 for Certain Transactions Involving Employee Benefit Plans and Securities Broker-Dealers**AGENCY:** Office of Pension and Welfare Benefit Programs, Labor.**ACTION:** Proposed class exemption, and proposed revocation of existing class exemptions.

SUMMARY: This document contains a notice of pendency before the Department of a proposed class exemption and of a proposed revocation of existing class exemptions. If adopted, the proposed class exemption would replace Prohibited Transaction Exemption (PTE) 79-1, which permits broker-dealers (or their affiliates) who serve as fiduciaries of employee benefit plans to exercise discretionary authority to effect or execute securities brokerage transactions on behalf of their plan clients without violating section 406 of the Employee Retirement Income Security Act of 1974 (ERISA), and PTE 84-46, which provides similar relief in the case of life insurance company pooled separate accounts that recapture brokerage profits generated by securities transactions effected by affiliates of the insurance company. The exemption and proposed revocation would affect those with an interest in the investments of employee benefit plans. The proposed exemption would provide conditional relief that differs, in some respects, from that provided by PTE 79-1 and PTE 84-46.

DATES: Written comments and requests for a public hearing should be received by the Department before March 25, 1985. The replacement exemption would be effective 30 days following publication of the final grant notice in the *Federal Register*.

ADDRESSES: All written comments and requests for a hearing (preferably 3 copies) should be sent to: Office of Regulations and Interpretations, Office of Pension and Welfare Benefit Programs, Room C-4526, 200 Constitution Ave. NW, Washington, DC 20210. Attn: Brokerage Exemption Revisions. The application for exemption, as well as all comments and requests for a public hearing, will be available for public inspection in the Public Documents Room, Office of Pension and Welfare Benefits Programs, U.S. Department of Labor, Room N-4677, 200 Constitution Ave. NW, Washington, DC 20210.

FOR FURTHER INFORMATION CONTACT:

E. F. Williams, Office of Regulations and Interpretations, Room C-4526, Washington, D.C. 20210, (202) 523-8194 (this is not a toll-free number).

SUPPLEMENTARY INFORMATION: Notice is hereby given of the pendency before the Department of a proposed class exemption that would replace PTE 79-1¹ and PTE 84-46,² which are class exemptions from the restrictions of section 406 of ERISA and from the taxes imposed by section 4975 (a) and (b) of the Internal Revenue Code (the Code) by reason of certain transactions described in Code sections 4975(c)(1) (A) through (F).³ Notice is also hereby given of the pendency before the Department of a proposed revocation of PTE 79-1 and PTE 84-46. In part, this proposal is the Department's response to an application filed by the Securities Industry Association (SIA), a trade association for securities broker-dealers. The application was filed under section 408(a) of ERISA and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) by letters to the Department from the SIA dated November 29, 1982, April 22, 1983, May 24, 1983 and July 23, 1984. In addition, the document contains proposals that the Department is making on its own motion pursuant to the authority described above.

Section 406(a) of ERISA prohibits, among other things, the provision of services between a plan and parties in interest (including fiduciaries) with respect to that plan and the transfer of plan assets to a party in interest unless a statutory or administrative exemption applies to the transaction. In addition, unless exempted, section 406(b) of ERISA prohibits, among other things, a fiduciary's dealing with the assets of a plan in his or her own interest. Although section 408(b)(2) of ERISA provides a conditional statutory exemption permitting plans to make reasonable contractual arrangements with parties in interest for the provision of services necessary for the plan's operations, that exemption does not extend to acts of self-dealing described in section 406(b) of ERISA.⁴ A fiduciary performing both

investment management and brokerage services for the same plan is in a position where his or her decision, as an exercise of fiduciary discretion, to engage in a portfolio trade on behalf of the plan would result in the plan's paying the fiduciary and additional fee for performance of the brokerage services. In the Department's view, such decision involves an act of self-dealing prohibited by section 406(b) of ERISA and not exempt by section 408(b)(2) of ERISA.

PTE 79-1 is intended to provide relief from the restrictions of section 406 in order to permit a plan fiduciary to act as both investment manager and securities broker for the same plan, under conditions designed as appropriate safeguards to ensure the protection of the plan assets involved in the transactions. Those safeguards rely heavily on the prior authorization and monitoring of the fiduciary's activities by a second plan fiduciary, who is independent of the first. PTE 84-46 is similar to PTE 79-1 but was designed to alleviate practical problems presented by certain conditions of PTE 79-1 as they apply to insurance company pooled separate accounts. For a more complete discussion of the relief provided by PTE 79-1 and PTE 84-46, interested persons are referred to the exemptions themselves as published in the *Federal Register* and cited above.

The principal respects in which the proposed exemption would, if adopted, provide relief that differs from that provided by the two class exemptions it would replace are discussed below.

A. Replacement of Annual Authorization Requirement

Sections II (b) and (c) of PTE 79-1 require that a transaction must be performed pursuant to a written authorization executed by a fiduciary of the plan who is independent of the person engaging in the transaction, and that the continuance of such authorization for more than one year must be similarly authorized at least annually by the independent fiduciary. The Department required annual authorizations when it granted PTE 79-1 because it believed that these requirements would provide a continuing safeguard against the conflict of interest which exists when a plan fiduciary can select itself to provide brokerage services for a plan at a profit.⁵

¹ 44 FR 5983 (January 30, 1979).² 49 FR 22157 (May 23, 1984).³ Section 102 of Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978) transferred the authority of the Secretary of the Treasury to issue exemptions of the type requested to the Secretary of Labor. For the sake of clarity, the remainder of the preamble refers only to Title I of ERISA. However, these references apply to the corresponding provisions of section 4975 of the Code as well.⁴ For a more complete explanation of the provisions of section 408(b)(2) and its relationship to section 406, see generally the Department's regulations at 29 CFR 2550.406b-2.⁵ 44 FR at 5985 (January 30, 1979).

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1. Summary of the SIA's Representations Concerning the Costs and Benefits of the Annual Authorization Requirement

In its application, the SIA represents the following: Based on its members' experience since the adoption of PTE 79-1, it fails to perceive any benefit to plan participants from the annual authorization requirement. It does not know of any instance in which an independent fiduciary, having initially authorized a broker-dealer fiduciary to execute trades for a plan, has failed ultimately to renew the authorization. However, the independent fiduciaries are very slow in responding to requests for annual authorizations.

If annual authorizations are not received in time because of administrative delays, plan accounts are denied the benefits of obtaining brokerage services from broker-dealer fiduciaries. For example, if a broker-dealer aggregates orders from various accounts, plan accounts for which renewals have not been received are denied the lower commission rates and better executions derived from that aggregation because a broker-dealer fiduciary must place orders to buy or sell securities for those plans with another brokerage firm. Generally, if a broker-dealer fiduciary places a securities order for a plan with another firm, the chances of an optimal execution are substantially reduced because of the inability of the broker-dealer fiduciary to control order flow.

Moreover, if the annual authorization is not received from a plan, some brokerage firms will close the plan's account because they are not structured to manage plan accounts and execute trades through another firm. Other firms will charge the plan a higher rate for management without brokerage. In addition, certain brokerage firms have simply decided not to offer brokerage services to their managed plan accounts because of the administrative burdens and costs of complying with the annual authorization requirement.

Compliance with the annual authorization requirement is costly and unnecessarily burdensome. These costs and burdens stem from the printing and mailing of the annual authorization forms and, more importantly, from the time spent by account executives or other firm employees ensuring compliance with the requirement.

In general, broker-dealer fiduciaries must mail two or three renewal forms to the relevant independent fiduciaries prior to securing renewal authorizations. Second mailings are virtually mandatory, and it is estimated that

approximately 50% of the relevant accounts return their renewal forms thereafter. The "success rate" of renewal form returns after the third mailing is approximately 78%. After a third mailing, repeated phone calls are necessary to obtain completed renewal forms, and sometimes account executives must pick up renewal forms on personal visits to the clients.

A typical procedure for compliance with the annual consent requirement involves the following: One month prior to the termination of an annual consent, renewal forms are printed and mailed to the independent fiduciaries. An employee is assigned to tabulate the results and to determine which plans have returned their renewals and which plans must receive second or third renewal forms. In certain firms, the particular account executives also track the renewal process with regard to the plan accounts to which they are assigned. They communicate with the independent fiduciaries of plan accounts to remind them of the renewal requirement. The expenditure of time by account executives in such "non-productive" activities can constitute a major cost of the renewal process to various firms.

Based upon reasonable best estimates available to the SIA, the costs of following this procedure amounts to \$15,000 a year for a brokerage firm with approximately 40 small plan accounts and \$75,000 for a firm with approximately 450 institutional-size plan accounts.

2. The SIA's Request for an Alternative Requirement

The SIA states in its application that a better approach towards accomplishing the objective of the authorization requirement at a smaller cost to the securities industry would be to require a broker-dealer fiduciary to send to the independent fiduciary annually a form for terminating the authorization of the broker-dealer to effect agency transactions for the plan. This form would state in a prominent manner that the authorization is terminable at will by the plan, without penalty, upon receipt by the broker-dealer of written notice from the plan. This form would be accompanied by instructions making clear that failure to return the form would result in the continued authorization of the broker-dealer to effect agency transactions for the plan. This approach would not penalize the plan and broker-dealer if the independent fiduciary fails to respond to a request for continued authorization. In addition, the deletion of an annual affirmative renewal by the plan would

be more consistent with SEC Rule 11a2-2(T) under the Securities Exchange Act of 1934 (the 1934 Act).*

3. The Department's Responses

On the basis of the SIA's representations, the Department has tentatively concluded that the benefits derived from the current annual authorization requirement compared with those that would be derived from an alternative such as suggested by the SIA, are not sufficiently greater that they warrant the annual authorization requirement's additional costs. Therefore, the Department is proposing to replace the annual authorization requirement with a requirement that the annual report to the authorizing fiduciary required by proposed section III(f) (and discussed below) be accompanied by a form that the authorizing fiduciary may return at any time in order to terminate the authorization. In addition, such a form must be supplied to the authorizing fiduciary before the initial authorization is made. See section III (c), (d) and (g) of the proposed exemption.

B. Amendments to Reporting Requirements.

Sections II (e) through (g) of PTE 79-1 require that reports be sent to independent plan fiduciaries not less than quarterly disclosing: the total charges related to exempt transactions in the past quarter, including a breakdown between the portion of those charges retained by the person covered by the exemption and the portion paid to other persons for execution or other services; rates for transaction-related charges anticipated to be made in the coming three months for transactions normally entered into by the plan; and a statement to the effect that brokerage commission in the United States are not fixed by any stock exchange of other authority and are subject to negotiation.

1. Summary of the SIA's representations concerning the costs and benefits of the quarterly reports

In its application, the SIA represents the following: It fails to see the benefits derived by plan participants from the requirement that independent

*17 CFR 240.11a2-2(T). In general, a member of a national securities exchange may not effect securities transactions on that exchange for an account with respect to which it or any associated person thereof exercises investment discretion without complying with Rule 11a2-2(T). That rule requires annual reports of these securities transactions by the investment adviser to the "person or persons authorized to transact business for the account," but does not require annual reauthorization to effect the transactions.

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fiduciaries be sent reports quarterly. With the information from the confirmation provided under SEC Rule 10b-10, the plan can closely monitor its agency transactions performed by a broker-dealer.⁷

With regard to the contents of the report, the SIA points out that SEC Rule 11a2-2(T) does not require estimates of future costs or a statement concerning the negotiability of brokerage commission rates. The SIA has no objections to the requirement that its members disclose the total transaction charges incurred by a plan and the amount of those charges retained by the broker-dealer or its affiliates. However, it is unnecessary to state that commissions are no longer fixed as the advent of negotiated rates in 1975 has been well publicized. Moreover, in the current era of negotiated commission rates, it is extremely difficult to predict accurately the transaction-related charges to a plan at some future date. Such a prediction may be misleading because actual charges would depend on the specific nature of the transaction and a variety of competitive factors.

The SIA contends that the costs involved in preparing the quarterly reports are unduly high, considering that they duplicate much of the information received in Rule 10b-10 confirmations. This is especially true for those firms that utilize outside service bureaus to handle back-office processing operations, since those bureaus do not usually provide a service to comply with the quarterly report requirements of PTE 79-1. Other firms must compile the data manually because it would be costly to redesign their own computer systems to perform a special run to comply with the requirement. The average time devoted to this requirement is approximately two weeks on the part of a brokerage firm employee before the end of each quarter. Estimates of the cost for a brokerage firm to comply with the quarterly report requirement range from \$2,500 to \$5,000 per year on a

regular basis, plus the time and expense involved in developing a special computer or manual system to handle this requirement.

2. The SIA's Request for an Alternative Requirement and Related Representatives.

The SIA requests in its application that reporting be required at least annually rather than quarterly. It suggests that the Department specifically include as a condition to the exemption that an independent fiduciary of a plan receive a confirmation under SEC Rule 10b-10 for each trade executed or effected for that plan by a broker-dealer or affiliated adviser that serves as an ERISA fiduciary to the plan. It also requests the elimination of the requirements of estimates of future costs and of the statement concerning the negotiability of commission rates.

The SIA makes the following representations relating to these requests: If a plan is an advisory client of a broker-dealer or an investment adviser controlled by or under common control with a broker-dealer, an independent fiduciary of the plan will receive a confirmation of each securities trade effected or executed by the broker-dealer for that plan because the plan is considered the "customer" under the confirmation delivery requirement in SEC Rule 10b-10. The information in the confirmations is sufficient to allow an independent fiduciary to evaluate the execution services provided by a broker-dealer. From the viewpoint of the plan, the critical elements of an execution are the price of the security bought, the total commission charges, and the date and time of the trade. These elements are all required by SEC Rule 10b-10 to be included in the confirmation. While the quarterly report summarizes the commission charges received by the broker-dealer during the quarter, such a summary can easily be constructed by an independent fiduciary from the confirmations. While it is true that the confirmations do not delineate the allocation of the commissions between the broker-dealer and its sub-agents, an independent fiduciary should be primarily interested in the total commissions charged to the plan, not the allocation. According to the SIA, as long as the total commissions are acceptable to the plan, it is of little relevance how the broker-dealer organizes its business relationships to achieve those commission levels. In any event, an independent fiduciary would receive at least annually a summary of the total commissions paid by the plan to the broker-dealer fiduciary and the amount of those commissions retained by the broker-dealer.

3. The Department's Response.

On the basis of the SIA's representations, the Department has tentatively concluded that in cases where transaction-by-transaction confirmations are supplied to independent fiduciaries, the benefits derived from the current reporting requirements compared with those that would be derived from the reporting requirements proposed in this document are not great enough to justify the current reporting requirements' additional costs.

However, the Department is not certain that in all cases the confirmations required by Rule 10b-10 are normally provided to the independent plan fiduciaries referred to above. For example, the Department believes it should assume, for purposes of this proposed exemption, that there are entities established for the collective investment of plan assets that would themselves, rather than the plans that invest in them, be considered the "customers" of broker-dealers effecting securities transactions on behalf of the entities. Where the managers of such entities are affiliated with the broker-dealers and, therefore, not independent, the substitution of the SIA's suggested reporting requirement for the quarterly reporting requirement contained in PTE 79-1 would impose an obligation on these collection investment entities to send a confirmation of every trade to every plan invested in the entity. The Department believes that this would increase, rather than decrease, the reporting burdens imposed on these entities. The Department, therefore, proposes to retain the quarterly reporting requirement as an alternative option for fiduciaries with respect to such entities who prefer to comply with it rather than with the SIA's proposed substitute. Section IV(d) of the proposal was designed to address the situation where the manager of the entity and the broker-dealer are affiliates. Conversely, if the manager of the entity is not affiliated with the broker-dealer, and the broker-dealer is not otherwise a person in whom the manager has an interest that might affect the manager's best judgement as a fiduciary, such manager would be an appropriate independent fiduciary for purposes of the authorization and reporting requirements under the proposal. In the latter case, it is expected that the broker-dealer could comply with the basic requirements contained in section III of the proposal.

The Department has also considered whether the proposed quarterly

⁷ SEC Rule 10b-10 under the 1934 Act, 17 CFR 240.10b-10, already requires a broker-dealer to provide each of its customers, with certain specific exceptions, with a confirmation for each securities transaction the broker-dealer effects for the account of the customer. This confirmation for an agency securities transaction must include: (1) A statement disclosing whether the broker-dealer is acting as an agent for the customer, for some other person, or for both; (2) the date and time of the securities transaction (or the fact that this information will be provided on request); (3) the identity, price and number of securities traded; (4) the amount of remuneration to be received by the broker-dealer from the customer in connection with the securities transaction; and (5) certain other information about remuneration received by the broker-dealer from other sources in connection with the securities transaction.

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reporting option should be modified to require reporting on a less frequent basis. While the Department believes that an annual summary of securities-related transactions, discussed in greater detail below, is appropriate in all cases, it also believes that the annual summaries alone would not provide sufficient up-to-date information to enable the independent plan fiduciaries responsible for monitoring the performance of the broker-dealer to discharge that responsibility adequately.* By its tentative decision to retain the quarterly reporting requirement on an optional basis (for pooled funds), the Department does not intend to suggest that in all cases quarterly reporting will provide information sufficient under the circumstances to permit adequate review under section 404 of ERISA by appropriate independent plan fiduciaries. Rather, the Department believes that it is reasonable to require, in the context of a class exemption, a uniform standard that may obviate, to a substantial degree, the necessity for monitoring fiduciaries to request additional information at what they believe to be reasonable intervals during the periods between receipt of the annual summaries.

With regard to the annual summaries, the Department has tentatively decided to retain certain information presently required under PTE 79-1 that does not necessarily appear in the confirmation slips: A breakdown of the charges retained by the authorized person and any portion paid to other persons. In addition, the Department proposes to require certain additional information in those summaries that it believes will make the other information provided more meaningful to the authorizing fiduciary.

First, the Department believes that portfolio turnover calculations should be provided in the annual summaries. Second, the Department's current view is that it will be difficult, if not impossible, for monitoring fiduciaries to review adequately the performance of an investment manager unless the summary discloses the nature of any research services or other goods or services (in addition to brokerage

*For a brief discussion of the responsibility of appointing fiduciaries to review the performance of other fiduciaries they appoint, see Question and Answer FR-17 in ERISA Interpretive Bulletin 75-9 (29 CFR 2509.75-9). Fiduciaries with responsibilities regarding the obtaining or performing of brokerage services to plans are under a duty to obtain best execution for the plans, as part of their obligations under section 404(a) of ERISA. The proposed exemption, if adopted, would not diminish those obligations. See section I of the preamble, General Information, *infra*.

services) that the investment manager has received in consideration for commissions paid.*

In view of the foregoing, the Department is proposing to make the following changes: (i) Substituting annual reporting and the furnishing of confirmation slips for securities trades (proposed sections III (e) and (f)) for the quarterly reporting requirement of PTE 79-1; (ii) adding annual summaries of the confirmations and portfolio turnover calculations to the contents of the periodic reports (proposed section III(f)); and (iii) requiring that disclosure be made, in the annual report, as to the nature of any research services provided in exchange for brokerage commissions paid by the plan (proposed section III(f)(3)). The Department also proposes to eliminate the required statement concerning the negotiability of commissions (section II(f) of PTE 79-1), in view of the time that has elapsed since the advent of the negotiated rate system.

C. Changes in the Scope of the Exemption

PTE 79-1 provides an exemption from both section 406(a) and section 406(b) of ERISA. The proposed exemption, on the other hand, provides relief only from the restrictions of section 406(b). The Department believes that any relief from the provisions of section 406(a) that may be required in connection with the transactions covered by the exemption should be provided in accordance with the conditions contained in section 408(b)(2), the statutory exemption for the provision referred to above. One principal consequence of the proposed modification would be to make it clear that if the fiduciary engages in portfolio trading that is excessive under the circumstances ("churning"), the conditions of section 408(b)(2) would fail to be satisfied,¹⁰ and there would be no

*Section 28(e) of the 1934 Act provides, in part, that no person, in the exercise of investment discretion with respect to an account, shall be deemed to have acted unlawfully or to have breached a fiduciary duty under State or Federal law solely by reason of his or her having caused the account to pay a broker an amount of commission for effecting a securities transaction in excess of the amount of commission another broker would have charged for effecting that transaction, if that person determined in good faith that the amount of commission was reasonable in relation to the value of brokerage and research services provided by that broker.

¹⁰ The statutory exemption for services applies only in the case of "legal, accounting, or other services necessary for the establishment or operation of the plan". See section 408(b)(2) of ERISA. The Department's regulation 29 CFR 2550.408b-2 identifies such services as those that are "appropriate and helpful to the plan . . . in carrying out the purposes for which the plan is established or maintained". The exemption is

exemption for the fiduciary's violation of section 406(a) of ERISA.

In addition, restricting the relief in the manner proposed should help make clear that the Department does not intend that the exemption will apply to underlying securities transactions that are prohibited by section 406(a) (such as the sale of securities by a plan to a party in interest) merely because the fiduciary causing the plan to engage in the transaction is also acting as the plan's broker therefor.

D. Agency Cross Transactions

Agency cross transactions are transactions in which both a buyer and a seller of a security use the same broker. Submissions on behalf of the Investment Company Institute, the First Manhattan Company (a securities broker-dealer), and the SIA indicate that it is important to plans for broker-dealers who are fiduciaries to be able to effect or execute securities agency cross transactions on behalf of their plan clients. It is represented that SEC regulations adequately protect plans and that agency cross transactions often save clients money.

The SIA has sought either clarification that agency cross transactions are covered by PTE 79-1 or an amendment to the exemption that would remove any uncertainty regarding the applicability of the exemption to such transactions.

A broker-dealer that is not a fiduciary of a plan for which it is acting as an agent in an agency cross transaction does not need an exemption from the prohibitions of section 406(b) of ERISA, because that section applies only to acts by fiduciaries. Therefore, nothing in this exemption would apply to that situation.

However, a broker-dealer may be a fiduciary of a plan under the following circumstances. First, the broker-dealer may be a plan fiduciary for reasons unrelated to the transaction in question, so that he or she does not have the authority or control to cause plan assets to be involved in the transaction. In that situation, the broker-dealer is merely executing the transaction pursuant to appropriate instructions by another plan fiduciary but,¹¹ because of the broker-dealer's status as fiduciary, may be in violation of section 406(b)(3) of ERISA by receiving a commission from a party

further conditioned on the plan's paying no more than reasonable compensation for the services. "Churning" would result in the plan's paying excessively high compensation for brokerage services. The Department similarly proposes that the scope of the exemption from the prohibitions of section 406(b) not extend to fiduciary acts that result in "churning". See proposed section II(e).

¹¹ See 29 CFR 2510.3-21.

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to the transaction other than the plan.¹² The Department believes that the potential for abuse to the plan by the broker-dealer under such circumstances is minimal. Therefore, the Department proposes that the relief provided for such transactions be unconditional. See section IV(b) of the proposed exemption.

Second, the broker-dealer may be a fiduciary with respect to the plan assets involved in the transaction but neither exercises investment discretion nor provides investment advice with respect to any assets proposed to be committed to the transaction by any person on the "other side" of the transaction (i.e., sellers if the plan is a buyer, or buyers if the plan is a seller). Under these circumstances, subject to the conditions set forth in section III(h) of the proposal, section II (b) and (c) of the proposal provide the exemptive relief necessary to permit plans to participate in agency cross transactions.

The first three conditions in section III(h) are derived from Rule 206(3)-2 under the Investment Advisers Act of 1940 (17 CFR 275.206(3)-2, which relates to the effecting of agency cross transactions for an advisory client by registered investment advisers or by registered broker-dealers affiliated with any such adviser. These conditions differ in some respects from (but are not inconsistent with) the corresponding provisions of Rule 206(3)-2. Conditions III(h) (1) and (2) require that the information accompanying a request for authorization of the broker-dealer to effect agency cross transactions on behalf of the plan includes a statement to the effect that the person effecting the transactions will have a potentially conflicting division of loyalties and responsibilities regarding the parties to the transactions, and that the annual summary of transactions discussed above, separately identify the number of agency cross transactions and the remuneration from all sources received or to be received in connection therewith by the broker-dealer. Condition III(h)(3) requires, in summary, that the broker-dealer cannot have investment management authority or investment advisory responsibilities with respect to both sides of the transaction. This condition is designed to limit the applicability of the exemption to the situation described above.

Conditions III(h) (4) and (5) are derived from Rule 17a-7 under the

¹² Section 406(b)(3) provides that a fiduciary with respect to a plan shall not receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

Investment Company Act of 1940 (17 CFR 270.17a-7). They require that the security that is the subject of the transaction be one for which market quotations are readily available, and that the transaction be effected at a price no less favorable to any plan involved in the transaction than the "current market price" as defined in paragraph (b) of Rule 17a-7.¹³ These conditions are designed to provide an independent objective standard for the fairness to the plan of the underlying transaction and to assist the authorizing fiduciary in monitoring these transactions.

The SIA states that a broker-dealer executing an agency cross transaction performs services in addition to those that would be required if the broker-dealer were acting as agent for only one side of the transaction, and that the receipt of commissions from parties on both sides of any agency transaction is, therefore, warranted. The Department has not been persuaded, however, that agency cross transactions are not more profitable to the broker-dealer, taking into account the effort and expense involved, than other transactions. It believes, therefore, that the broker-dealer may be presented with a greater conflict of interest in agency cross transactions, even though the potential for abuse is less than if the broker-dealer had, for example, discretionary authority over both sides of the transaction. Accordingly, the Department has tentatively concluded that these additional conditions are warranted to restrict the ability of the broker-dealer to effect transactions for its own benefit.

¹³ Rule 17a-7(b) defines "current market price" to mean:

- (1) If the security is a "reported security" as that term is defined in rule 11Ac3-1 under the Securities Exchange Act of 1934 (17 CFR 240.11Ac3-1), the last sale price with respect to such security reported in the consolidated transactions reporting system ("consolidated system") or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to rule 11Aa1-1 under the Securities Exchange Act of 1934 (17 CFR 240.11Aa1-1) if there are not reported transactions in the consolidated system that day; or
- (2) If the security is not a reported security, and the principal market for such security is an exchange, then the last sale on such exchange or the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day; or
- (3) If the security is not a reported security and is quoted in the NASDAQ System, then the average of the highest current independent bid and lowest current independent offer reported on Level 1 of NASDAQ; or
- (4) For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.

Finally, there may be instances in which a broker-dealer has discretionary authority or renders investment advice with respect to both sides of the transaction. The SIA has not specifically requested, and the Department is not proposing to provide, relief in this situation. Proponents of any such exemptive relief will have the burden of demonstrating why and under what conditions such relief would be appropriate, in view of the additional potential for abuse that would appear to be present in such a situation.

E. Changes in the Definition of Affiliate

In addition to nonsubstantive language simplification changes, the Department has added a sentence to the end of the definition of the term "affiliate" stating explicitly that a person is not an affiliate of another person merely because the other person has investment discretion over the person's assets. Under the subdivision labeled (1) at the end of PTE 79-1 and section I(a) of the proposed exemption, a "person" includes affiliates of the person. Under the definitions of "affiliate" in the two documents, a person "controlled by" another person is an affiliate of the other person. The new sentence clarifies that a transaction between a plan and an entity whose assets are managed by a fiduciary of the plan is not considered to be a principal transaction between the plan and that fiduciary merely because of the fiduciary's investment discretion over the entity's assets.

F. Recapture Provisions

Section II(h) of PTE 79-1 permits a fiduciary broker to effect or execute transactions for a plan for which he or she is a trustee, etc., without annual authorizations from an independent fiduciary if that person returns or credits all profits he or she earns in connection with the transactions to the plan. The substance of the provision is in section IV(c) of the proposed exemption.

G. Special Rules for Pooled Funds

As indicated above, the Department has granted a class exemption, PTE 84-46, relating to insurance company pooled separate accounts. The applicants in that matter had requested relief that would permit an affiliate of the insurance company maintaining the pooled separate account to provide brokerage services for the account. The applications stated that the affiliated broker would return or credit to the account all profits derived from those brokerage activities.

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The applicants stated that it was not possible, as a practical matter, for them to comply with the requirements of PTE 79-1 relating to authorizations and terminations of such authorizations. Under PTE 79-1, the required authorizations were ineffective unless and independent fiduciary with respect to every plan invested in the account authorized the use of the affiliated broker-dealer. In addition, if the arrangements were authorized, termination of the authorization by a single plan fiduciary would serve to terminate the authorization for the entire account. As adopted, PTE 84-46 provides relief similar to that provided by the recapture exemption under PTE 79-1, but with an alternative method for obtaining and continuing authorization for the use of a broker-dealer affiliated with the insurance company that was designed to accommodate the needs of funds or accounts in which the assets of many plans are collectively invested. The substance of these alternative requirements, modified to take into account other proposed changes to PTE 79-1 previously discussed, are incorporated in section IV(d) of the proposed exemption. In addition, for the reason stated above, the Department proposes to make the alternative authorization method available in the case of any account or fund for the collective investment of the assets of more than one plan without requiring the recapture of brokerage profits on behalf of that account or fund.

The elimination, in PTE 84-46, of the requirement that the authorizing fiduciary be independent of the insurance company in the case of a plan covering only employees of the insurance company has been extended in the proposal to apply to plans covering only employees of the investment manager (as defined in section 3(38) of EISA) that maintains a pooled fund for the collective investment of plan assets, provided that such manager recaptures brokerage profits on behalf of the pooled fund.

In the preamble to PTE 84-46, the Department stated that it would be willing to consider elimination of the quarterly reporting requirement and clarification of the term "profit" in that exemption with respect to transactions covered by the exemption in the course of this current proceeding.

As is discussed above, the Department has considered whether, as a general matter, the quarterly reporting option should be modified where independent plan fiduciaries do not receive transaction-by-transaction confirmations, and has tentatively

concluded that it should not. In the context of a managed account in favor of which brokerage profits are recaptured, the Department is not persuaded that recapture necessarily eliminates the necessity for independent performance review on a basis more frequent than annual. In part, the Department's concern arises from the fact that the recapture of "profit," as that term is used for purposes of PTE 79-1 and as is defined in PTE 84-46, allows recoupment by the manager of not only direct, but also indirect, expenses.¹⁴ The applicants and commentators in the proceeding that culminated in the granting of PTE 84-46 have raised additional questions concerning what is, or should be, included within the scope of the term "profits," such as whether losses in one year can be carried over to later years in computing amounts to be recaptured. Resolution of these questions may well have some bearing on whether the frequency of reporting should be reduced. Tentatively, however, the Department has concluded that the recapture of profits (as defined) does not necessarily result either in superior brokerage services being provided or in elimination of all motivation for excessive trading. Therefore, the Department has decided to invite interested parties to file comments setting forth changes they would like to see to the reporting requirements as they relate to the provisions relating to life insurance company pooled separate accounts (or other pooled investment funds), together with an explanation of why, in the absence of transaction-by-transaction confirmations to plan fiduciaries independent of the life insurance company (or other pool manager) involved, less frequent reporting would be appropriate.

II. Notice to Interested Persons

Because all plan participants and beneficiaries whose plans might authorize a broker to approve transactions between himself or herself and the plans could conceivably be considered interested persons, the Department has determined that the only practical form of notice is publication in the Federal Register.

I. General Information

The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption under section 408(a) of ERISA does not relieve a fiduciary or other party in interest from

¹⁴ See the preamble to PTE 79-1, note 12 (44 FR at 3004).

certain other provisions of ERISA and the Code, including any prohibited transaction provisions to which the exemption does not apply and the general fiduciary responsibility provisions of section 404 of ERISA. That section requires, among other things, that a fiduciary discharge his or her duties respecting a plan solely in the interests of the participants and beneficiaries of the plan and in a prudent fashion in accordance with section 404(a)(1)(B) of ERISA. In addition, it does not affect the requirement of section 401(a) of the Code that a plan must operate for the exclusive benefit of the employees of the employer maintaining the plan and their beneficiaries.

(2) Before an exemption may be granted under section 408(a) of ERISA, the Department must find that the exemption is administratively feasible, in the interests of the affected plans and of their participants and beneficiaries, and protective of the rights of those participants and beneficiaries.

(3) The proposed exemption, if granted, will be supplemental to, and not in derogation of, any other provisions of ERISA and the Code, including statutory or administrative exemptions and transitional rules. Furthermore, the fact that a transaction is subject to an administrative or statutory exemption is not dispositive of whether the transaction is in fact a prohibited transaction.

(4) The proposed exemption, if granted, will not extend to transactions described in section 406(a) of ERISA.

J. Written Comments and Hearing Request

All persons are invited to submit written comments or requests for a public hearing on the proposed exemption or the proposed revocation of PTE 79-1 and PTE 84-46 to the address and within the time period set forth above. All comments will be made a part of the appropriate record. Comments and requests for a hearing should state the reasons for the writer's interest in the matter. Comments received will be available for public inspection with the application for exemption at the address set forth above.

K. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1980 (Pub. L. 96-511), the reporting provisions that are included in this proposed class exemption are being submitted to the Office of Management and Budget for its review and approval.

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Proposed Exemption

On the basis of the facts and representations set forth in the application and this document, the Department proposes the following exemption under ERISA Procedure 75-1 and sections 408(a) of ERISA and 4975(c)(2) of the Code to read as follows:

Section I. Definitions and Special Rules

The following definitions and special rules apply to this exemption:

- (a) The term "person" includes the person and affiliates of the person.
- (b) An "affiliate" of a person includes the following:
- (1) Any person directly or indirectly controlling, controlled by, or under common control with, the person.
 - (2) Any officer, director, partner, employee, relative (as defined in section 3(15) of ERISA), brother, sister, or spouse of a brother or sister, of the person.
 - (3) Any corporation or partnership of which the person is an officer, director or partner.

A person is not an affiliate of another person solely because one of them has investment discretion over the other's assets. The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(c) An "agency cross transaction" is a securities transaction in which the same person acts as agent for both any seller and any buyer for the purchase or sale of a security.

(d) The term "covered transaction" means an action described in section II (a), (b) or (c) of this exemption.

(e) The term "effecting or executing a securities transaction" means the execution of a securities transaction as agent for another person and/or the performance of clearance, settlement, custodial or other functions ancillary thereto.

(f) A plan fiduciary is independent of a person only if the fiduciary has no relationship to or interest in such person that might affect the exercise of such fiduciary's best judgment as a fiduciary.

(g) The term "profit" includes all charges relating to effecting or executing securities transactions, less reasonable and necessary expenses—including reasonable indirect expenses (such as overhead costs) properly allocated to the performance of these transactions under generally accepted accounting principles.

(h) The term "securities transaction" means the purchase or sale of securities.

Section II. Covered transactions

Effective (insert date 30 days after date final exemption is published in the

Federal Register), if each condition of section III of this exemption is either satisfied or not applicable under section IV, the restrictions of section 406(b) of ERISA and the taxes imposed by section 4975 (a) and (b) of the Code by reason of section 4975(c)(1) (E) or (F) of the Code shall not apply to—

(a) A plan fiduciary's using its authority to cause a plan to pay a fee for effecting or executing securities transactions to that person as agent for the plan, but only to the extent that such transactions are not excessive, under the circumstances, in either amount or frequency;

(b) A plan fiduciary's acting as the agent in an agency cross transaction for both the plan and one or more other parties to the transaction; or

(c) The receipt by a plan fiduciary of reasonable compensation for effecting or executing an agency cross transaction to which a plan is a party from one or more other parties to the transaction.

Section III. Conditions

Except to the extent otherwise provided in section IV of this exemption, section II of this exemption applies only if the following conditions are satisfied:

(a) The person engaging in the covered transaction is not a trustee or administrator of the plan or an employer any of whose employees are covered by the plan.

(b) The covered transaction is performed under a written authorization executed in advance by a fiduciary of each plan whose assets are involved in the transaction, which plan fiduciary is independent of the person engaging in the covered transaction.

(c) The authorization referred to in paragraph (b) of this section is terminable at will by the plan, without penalty to the plan, upon receipt by the authorized person of written notice of termination.

(d) Within three months before an authorization is made, the authorizing fiduciary is furnished with any reasonably available information that the person seeking authorization reasonably believes to be necessary for the authorizing fiduciary to determine whether the authorization should be made, including a copy of this exemption, the form for termination of authorization described in section III(g), and any other reasonably available information regarding the matter that the authorizing fiduciary reasonably requests.

(e) The authorizing fiduciary is furnished with a confirmation slip for each securities transaction underlying a covered transaction within 10 business

days of the securities transaction containing the following information:

(1) A statement that the person effecting or executing the securities transaction is acting as an agent for the plan, and whether the person is also acting as agent for some other person.

(2) The date and time of the securities transaction.

(3) The identity, price and quantity of securities traded.

(4) The amount of remuneration to be received by the person effecting or executing the securities transaction from the plan in connection with the securities transaction.

(5) The source and amount of any other remuneration received or to be received by the person effecting or executing the securities transaction in connection with the securities transaction.

(f) The authorizing fiduciary is furnished with a summary of the information required under paragraph (e) of this section at least once per year. The summary must be furnished within 45 days after the end of the period to which it relates, and contain the following:

(1) The total of all securities transaction-related charges incurred by the plan during the period in connection with covered securities transactions.

(2) The amount of the securities transaction-related charges retained by the authorized person and the amount of these charges paid to other persons for execution or other services.

(3) A statement disclosing whether the securities transaction-related charges are attributable in any part to consideration for any goods or services other than effecting or executing the transactions, and, if so, a detailed description of those goods and services and the amounts paid therefor.

(4) The annualized portfolio turnover ratio calculated as a percentage of the plan assets consisting of securities or cash the authorized person had discretionary investment authority over (or rendered, or had any responsibility to render, investment advice with respect to) (the "portfolio") at any time during the period covered by the report. For purposes of this paragraph, the "annualized portfolio turnover ratio" is obtained by dividing the product of (A) twelve and (B) the lesser of the aggregate dollar amount of purchases or sales of securities in the portfolio during such time or times during the period that the authorized person had such authority or responsibility, by the product of (C) the aggregate duration of such time or times, expressed in months (and fractions thereof) and (D) the

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monthly average of the market value of the portfolio during such time or times.

(g) A form must accompany each summary referred to in paragraph (f) of this section expressly providing an election to terminate the authorization described in paragraph (b) of this section with instructions on the use of the form. The instructions must include the following information:

(1) The authorization is terminable at will by the plan, without penalty to the plan, upon receipt by the authorized person of written notice from the authorizing fiduciary or other plan official having authority to terminate the authorization.

(2) Failure to return the form would result in the continued authorization of the authorized person to engage in the covered transactions on behalf of the plan.

(h) If an agency cross transaction to which section IV(b) does not apply is involved, the following conditions must also be satisfied:

(1) The information required under section III(d) or IV(d)(1)(B) of this exemption includes a statement to the effect that with respect to agency cross transactions the person effecting or executing the transactions will have a potentially conflicting division of loyalties and responsibilities regarding the parties to the transactions.

(2) The summary required under section III(f) or IV(d)(2) of this exemption includes a statement identifying the total number of agency cross transactions during the period covered by the summary and the total amount of all commissions or other remuneration received or to be received from all sources by the person engaging in the transactions in connection with those transactions during the period.

(3) The person effecting or executing the agency cross transaction neither has (A) the authority to cause both any seller and any purchaser to engage in the transaction, nor (B) provides any investment advice with respect to the transaction to both any seller and any purchaser engaged in the transaction.

(4) The agency cross transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available.

(5) The agency cross transaction is effected at a price no less favorable to any plan involved in the transaction than the "current market price" of the security, as that term is defined in Rule 17a-7(b) under the Investment Company Act of 1940 (17 CFR 270.17a-7(b)).

Section IV. Exceptions From Conditions

(a) *Certain Plans Not Covering Employees.* Section III of this exemption does not apply to covered transactions

to the extent they are engaged in on behalf of individual retirement accounts meeting the conditions of 29 CFR § 2510.3-2(d), or plans, other than training programs, that cover no employees within the meaning of 29 CFR § 2510.3-3.

(b) *Certain agency cross transactions.* Section III of this exemption does not apply in the case of an agency cross transaction, provided that the person effecting or executing the transaction (1) does not render investment advice to any plan for a fee within the meaning of section 3(21)(A)(ii) of ERISA with respect to the transaction; (2) is not otherwise a fiduciary who has investment discretion with respect to any plan assets involved in the transaction, see 29 CFR § 2510.3-21(d); and (3) does not have the authority to engage, retain or discharge any person who is or is proposed to be a fiduciary regarding any such plan assets.

(c) *Recapture of profits.* Section III(a) of this exemption does not apply in any case where the person engaging in a covered transaction returns or credits to the plan all profits earned by that person in connection with the securities transactions associated with the covered transaction.

(d) *Special rules for pooled funds.* In the case of a person engaging in a covered transaction on behalf of an account or fund for the collective investment of the assets of more than one plan (pooled fund):

(1) Sections III (b), (c) and (d) of this exemption do not apply if—

(A) The arrangement under which the covered transaction is performed is subject to the prior and continuing authorization, in the manner described in this paragraph (d)(1), of a plan fiduciary with respect to each plan whose assets are invested in the pooled fund who is independent of the person. The requirement that the authorizing fiduciary be independent of the person shall not apply in the case of a plan covering only employees of the person, if the person (i) is an "investment manager" as defined in section 3(38) of ERISA, and (ii) returns or credits to the pooled fund all profits earned by the person in connection with all covered transactions engaged in by the person on behalf of the fund.

(B) The authorizing fiduciary is furnished with any reasonably available information that the person engaging or proposing to engage in the covered

transactions reasonably believes to be necessary to determine whether the authorization should be given or continued, not less than 30 days prior to implementation of the arrangement or material change thereto, and, where requested, with any reasonably

available information regarding the matter upon the reasonable request of the authorizing fiduciary at any time.

(C) In the event an authorizing fiduciary submits a notice in writing to the person engaging in or proposing to engage in the covered transaction objecting to the implementation of, material change in, or continuation of, the arrangement, the plan on whose behalf the objection was tendered is given the opportunity to terminate its investment in the pooled fund, without penalty to the plan, within such time as may be necessary to effect the withdrawal in an orderly manner that is equitable to all withdrawing plans and to the nonwithdrawing plans. In the case of a plan that elects to withdraw under this subparagraph (d)(1)(C), the withdrawal shall be effected prior to the implementation of, or material change in, the arrangement; but an existing arrangement need not be discontinued by reason of a plan electing to withdraw.

(D) In the case of a plan whose assets are proposed to be invested in the pooled fund subsequent to the implementation of the arrangement and that has not authorized the arrangement in the manner described in subparagraphs (d)(1)(B) and (C) of this section, the plan's investment in the pooled fund is subject to the prior written authorization of an authorizing fiduciary who satisfies the requirements of subparagraph (d)(1)(A).

(2) Section III(e) of this exemption does not apply if the report described in section III(f) of this exemption and a compilation of the information described in section III(e) are furnished to the authorizing fiduciary of each plan whose assets are invested in the pooled fund at least once every three months and within 45 days after the end of the period to which it relates.

Proposed Revocation of Existing Exemptions

On the basis of the material referred to in this document, the Department is considering revoking PTE 79-1 and PTE 84-46, effective 30 days after notice of the revocation is published in the Federal Register.

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Signed at Washington, DC, this 18th day of January, 1985.

Robert A.G. Monks,
Administrator, Office of Pension and Welfare
Benefit Programs.

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