

PTE 77-4
Final Exemption
42 Fed. Reg. 18732 (Apr. 8, 1977)

DEPARTMENT OF LABOR
Pension and Welfare Benefit Programs

DEPARTMENT OF THE TREASURY
Internal Revenue Service
[Prohibited Transaction Exemption 77-4]

EMPLOYEE BENEFIT PLANS

Class Exemption for Certain Transactions Between Investment Companies and Employee Benefit Plans

On November 16, 1976, notice was published in the FEDERAL REGISTER (41 FR 50516) that the Department of Labor (the Department) and the Internal Revenue Service (the Service) had under consideration a proposed class exemption from the restrictions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and from the taxes imposed by section 4975 (a) and (b) of the Internal Revenue Code of 1954 (the Code), by reason of section 4975 (c) (1) of the Code. The class exemption was requested in an application (Application No. D-055) filed by T. Rowe Price Associates, Inc., Scudder, Stevens & Clark, Stein Roe & Farnham and Thorndike, Doran, Paine & Lewis, Inc., investment advisory firms. The class exemption would exempt from the prohibited transaction restrictions the purchase and sale by an employee benefit plan of shares of a registered, open-end investment company when a fiduciary with respect to the plan (e.g., an investment manager) is also the investment adviser for the investment company. The exemption was proposed in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975 and Rev. Proc. 75-26, 1975-1 C.B. 722, and all interested persons were invited to submit comments on the proposed exemption.

Eight comments were received with regard to the proposed exemption, all supporting the grant of the exemption. Three comments supported the exemption as proposed, while one comment suggested that the exemption be expanded to cover so-called mutual fund "in house" plans. This comment was withdrawn after the publication of notice of the pendency of a proposed class exemption for mutual fund "in house" plans in 41 FR 54080.

Each of the remaining comments, while supporting the exemption, contained one or more suggestions for changes in the exemption.

One comment suggested a technical amendment to sections I (c) and II (c) of the exemption to make clear that payment of an investment advisory fee based on total plan assets, from which credit has been subtracted representing the plan's pro rata share of the investment advisory fees paid by the investment company, would not contravene the ban on payment of investment management or investment advisory fees with respect to plan assets invested in shares of the investment company. The comment was accepted, and incorporated in sections I (c) and II (c). In addition, a typographical error in section I (c) has been corrected. Another commentator suggested that the investment adviser be allowed to charge his investment advisory fee or the fee paid for management of the investment company, whichever was higher, so long as no double fee was charged, on the grounds that the higher fee is often necessary for the economic servicing of smaller accounts. This suggestion was not accepted, because it would provide a situation with a potential for abuse involving economic gain for the fiduciary which could not be easily monitored.

Three suggestions were rejected as unnecessary in light of existing provisions in the proposed exemption. The first was to amend section II (e) of the proposed exemption to permit the Board of Trustees to approve the fees paid to the fiduciary/investment adviser. Section II (e) provides for approval by a second fiduciary of fees paid to the fiduciary/investment adviser. Inasmuch as the Board of Trustees is a fiduciary to the plan, if it meets the criteria set forth in section II (d) of the exemption for a secondary fiduciary independent of and unrelated to the investment adviser, it may approve the fees paid. The second suggestion, that the investment adviser be allowed to invest in its money market fund without receipt of written approval by the second fiduciary, provided it has notified the trustees both by prospectus and orally of its intent to do so, was not accepted, as the methods provided for approval in section II (e) provide enough alternatives to allow flexibility in receipt of approval, and the method suggested by the commentator would not provide adequate documentation of prior approval. Another suggestion, to the effect that the exemption be clarified to state that it covers insurance company separate accounts which invest portions of their assets in mutual funds, the adviser to which is the insurance company, was not accepted because the exemption, as proposed, covers that situation. Plan assets invested in an insurance company separate account remain plan assets under section 401 (b) (2) (B) of the Act. The fact that the insurance company need not hold such assets in trust under section 403 (b) (2) of the Act, and that therefore the insurance company holds such assets in its own name and not in the name of the plan, does not alter the fact that it, as investment adviser to the plan, is investing plan assets in a mutual fund to which it is an investment adviser. Therefore, to the extent it meets the conditions set forth in the exemption, it may cause the purchase or sale by such separate account of shares of such mutual funds.

Similarly, a suggestion that the exemption be extended to no-load, closed-end investment companies was rejected because insufficient information was provided to determine whether such an extension would be justified.

Finally, one commentator expressed concern that the standard set forth in section II (d) as to what constitutes an unrelated, independent fiduciary for purposes of the exemption would be used as the definition of what constitutes an "affiliate" of a bank for purposes of section 408 (b) (8) of the Act and section 4975 (d) (8) of the Code. Concern was also expressed as to how the standard would operate in situations involving common directors and officers. The first concern is unwarranted, as section II (d) clearly states that the definition set forth is "for purposes of this exemption." With respect to the other concern, section II (d) (3) has been amended to make clear that an officer, director, partner, or employee or relative of a fiduciary/investment adviser, or an affiliate thereof, could be a director of the second fiduciary without thereby automatically disqualifying the second fiduciary as being independent of and unrelated to the fiduciary/investment adviser. However, in that case the director must abstain from any participation in the selection of the investment adviser or the approval of any purchases or sales between the plan and the investment company, or the approval of any change of fees charged to or paid by the plan.

General Information. The attention of interested persons is directed to the following:

(1) The fact that a transaction is the subject of an exemption granted under section 408 (a) of the Act and section 4975 (c) (2) of the Code does not relieve a fiduciary or other party in interest or disqualified person with respect to a plan to which the exemption is applicable from certain other provisions of the Act 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 the Act which, among other things, require a fiduciary to discharge his duties respecting the plan solely in the interest of the plan's participants and beneficiaries and in a prudent fashion in accordance with section 404 (a) (1) (B) of the Act; nor does it 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) The exemption set forth herein is supplemental to, and not in derogation of, any other provisions of the Act and the Code, including statutory 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.

(3) The class exemption is applicable to a particular transaction only if the transaction satisfies the conditions specified in the class exemption.

(4) In accordance with section 408 (a) of the Act and section 4975 (c) (2) of the Code, and based upon the entire record, including the written comments submitted in response to the notice of November 16, 1976, the Department and the Service make the following determinations:

- (i) The class exemption set forth herein is administratively feasible;
- (ii) It is in the interests of plans and of their participants and beneficiaries; and
- (iii) It is protective of the rights of participants and beneficiaries of plans.

Exemption. Accordingly, the following exemption is hereby granted under the authority of section 408(a) of the Act and section 4975(c)(2) of the Code and in accordance with the procedures set forth in ERISA Procedure 75-1 (40 FR 18471, April 28, 1975) and Rev. Proc. 75-26, 1975-1 C.B. 722:

Section I—Retroactive. Effective January 1, 1975 until 90 days after the date of granting of this exemption, the restrictions of section 406 of the Act and the taxes imposed by section 4975(a) and (b) of the Code, by reason of section 4975 (c)(1) of the Code, shall not apply to the purchase or sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to the plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan, provided that the following conditions are met:

(a) The plan does not pay a sales commission in connection with such purchase or sale.

(b) The plan does not pay a redemption fee in connection with the sale by the plan to the investment company of such shares, unless (1) such redemption fee is paid only to the investment company, and (2) the existence of such redemption fee is disclosed in the investment company prospectus in effect both at the time of the purchase of such shares and at the time of such sale.

(c) The plan does not pay an investment management, investment advisory or similar fee with respect to the plan assets invested in such shares for the entire period of such investment. This condition does not preclude (1) the payment of investment advisory fees by the investment company under the terms of its investment advisory agreement adopted in accordance with section 15 of the Investment Company Act of 1940, (2) the payment of an investment advisory fee by the plan based on total plan assets from which a credit has been subtracted representing the plan's pro rate share of investment advisory fees paid by the investment company, or (3) the purchase by the plan of shares of the investment company during any fee period for which the plan prepaid its investment management, investment advisory or similar fee was or is paid by the plan for any subsequent fee period during any part of which such investment in shares of the investment company was or is retained by the plan.

Section II—Propective. Effective 90 days after the date of granting of this exemption, the restrictions of section 406 of the Act and the taxes imposed by section 4975 (a) and (b) of the Code by reason of section 4975(c)(1) of the Code, shall not apply to the purchase or sale by an employee benefit plan of shares of an open-end investment company registered under the Investment Company Act of 1940, the investment adviser for which is also a fiduciary with respect to the plan (or an affiliate of such fiduciary) and is not an employer of employees covered by the plan (hereinafter referred to as "fiduciary/investment adviser"), provided that the following conditions are met:

(a) The plan does not pay a sales commission in connection with such purchase or sale.

(b) The plan does not pay a redemption fee in connection with the sale by the plan to the investment company of such shares unless (1) such redemption fee is paid only to the investment company, and (2) the existence of such redemption fee is disclosed in the investment company prospectus in effect both at the time of the purchase of such shares and at the time of such sale.

(c) The plan does not pay an investment management, investment advisory or similar fee with respect to the plan assets invested, in such shares for the entire period of such investment. This condition does not preclude the payment of investment advisory fees by the investment company under the terms of its investment advisory agreement adopted in accordance with section 15 of the Investment Company Act of 1940. This condition also does not preclude payment of an investment advisory fee by the plan based on total plan assets from which a credit has been subtracted representing the plan's pro rata share of investment advisory fees paid by the investment company. If, during any fee period for which the plan has prepaid its investment management, investment advisory or similar fee, the plan purchases shares of the investment company, the requirement of this paragraph (c) shall be deemed met with respect to such pre-paid fee if, by a method reasonably designed to accomplish the same, the amount of the prepaid fee that constitutes the fee with respect to the plan assets invested in the investment company shares (1) is anticipated and subtracted from the prepaid fee at the time of payment of such fee, (2) is returned to the plan no later than during the immediately following fee period, or (3) is offset against the prepaid fee for the immediately following fee period or for the fee period immediately following thereafter.

For purposes of this paragraph, a fee shall be deemed to be prepared for any fee period if the amount of such fee is calculated as of a date not later than the first day of such period.

(d) A second fiduciary with respect to the plan, who is independent of and unrelated to the fiduciary/investment adviser or any affiliate thereof, receives a current prospectus issued by the investment company, and full and detailed written disclosure of the investment advisory and other fees charged to or paid by the plan and the investment company, including the nature and extent of any differential between the rates of such fees, the reasons why the fiduciary/investment adviser may consider such purchases to be appropriate for the plan, and whether there are any limitations on the fiduciary/investment adviser with respect to which plan assets may be invested in shares of the investment company and, if so, the nature of such limitations. For purposes of this exemption, such second fiduciary will not be deemed to be independent of and unrelated to the fiduciary/investment adviser or any affiliate thereof if:

(1) Such second fiduciary directly or indirectly controls, is controlled by, or is under common control with the fiduciary/investment adviser or any affiliate thereof;

(2) Such second fiduciary, or any officer, director, partner, employee or relative of such second fiduciary is an officer, director, partner, employee or relative of such fiduciary/investment adviser or any affiliate thereof; or

(3) Such second fiduciary directly or indirectly receives any compensation or other consideration for his or his own personal account in connections with any transaction described in this exemption.

If an officer, director, partner, employee or relative of such fiduciary/investment advisor or any affiliate thereof is a director of such second fiduciary, and if he or she abstains from participation in (i) the choice of the plan's investment adviser, (ii) the approval of any such purchase or sale between the plan and the investment company and (iii) the approval of any change of fees charged to or paid by the plan, then paragraph (d)(2) of this section shall not apply.

For purposes of this exemption, the term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual, and the term "relative" as that term is defined in section 3 (15) of the Act (or a "member of the family" as that term is defined in section 4975 (e) (6) of the Code), or a brother, a sister, or a spouse of a brother or a sister.

(e) On the basis of the prospectus and disclosure referred to in paragraph (d), the second fiduciary referred to in paragraph (d) approves such purchases and sales consistent with the responsibilities obligations, and duties imposed on fiduciaries by Part 4 of Title I of the Act. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan and need not relate to any other aspects of such investments. In addition, such approval must be either (1) set forth in the plan documents or in the investment management agreement between the plan and the fiduciary/investment adviser; (2) indicated in writing prior to each purchase or sale, or (3) indicated in writing prior to the commencement of a specified purchase or sale program in the shares of such investment company.

(f) The second fiduciary referred to in paragraph (d), or any successor thereto, is notified of any change in any of the rates and fees referred to in paragraph (d) and approves in writing the continuation of such purchases or sales and the continued holding of any investment company shares acquired by the plan prior to such change and still held by the plan. Such approval may be limited solely to the investment advisory and other fees paid by the mutual fund in relation to the fees paid by the plan and need not relate to any other aspects of such investment.

Signed at Washington, D.C, this 31st day of March 1977.

J. Vernon Ballard,
Acting Administrator of Pension and Welfare Benefit Programs,
Department of Labor

William E. Williams,
Acting Commissioner of Internal Revenue

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