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Legal Alert:

Recent Guidance of Interest to Employee Benefit Plan Service Providers and Administrators

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During recent weeks, both the Securities and Exchange Commission ("SEC") and the Department of Labor ("DOL") have issued important guidance affecting plan service providers and administrators. The SEC's final regulations on redemption fees indirectly impose requirements on plan intermediaries, including plan administrators. Proposed regulations and a prohibited transaction class exemption issued by the DOL provide a solution to the dilemma of what to do with an "abandoned plan." Finally, the DOL's most recent advisory opinion clarifies the information that must be disclosed on Schedule A to the annual report for employee benefit plans (Form 5500).

Mutual Fund Redemption Fees

The SEC has adopted a new rule permitting mutual funds to adopt redemption fees, but also requiring virtually all funds to enter into written agreements with financial intermediaries, including retirement plan administrators and recordkeepers, obligating the intermediaries to (1) provide certain information re trading to the fund, (2) implement the fund's redemption fees, and (3) restrict or prohibit purchases or transfers by plan participants in accordance with the fund's market timing policies. The rule was adopted on March 3, posted on the SEC's website on March 11, and published in the Federal Register on March 18, 2005.

Although this new Rule 22c-2 under the Investment Company Act of 1940 (the "1940 Act") has been adopted as a final rule, with an effective date of May 23, 2005, the "compliance date" for the rule is not until October 16, 2006. In addition, the SEC has requested comments on a number of points re implementation of and standards for redemption fees, most of which are not addressed by the new rule, and the SEC has indicated it may further revise the rule in response to these comments and may even delay the effective date further.

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Optional Redemption Fee; Mandatory Board Determination

Rule 22c-2 permits, but does not require, mutual funds to impose a redemption fee of up to 2% (two percent) of the amount withdrawn from or transferred out of a mutual fund portfolio when shares are redeemed shares within seven or more calendar days of purchase. Specifically, the new rule makes it unlawful for a fund to redeem shares within seven calendar days after the shares were purchased, unless the fund (1) has determined whether a redemption fee should be imposed for such trades, (2) has entered into written agreements with financial intermediaries as described below, and (3) satisfies certain recordkeeping requirements. Thus, with only limited exceptions, the rule requires that each mutual fund's board of directors must either:

- Adopt a redemption fee of no more than 2% of the amount of the shares redeemed within a short time period after purchase, as determined by the board (but no less than seven days); or

- Affirmatively determine that a redemption fee is either not necessary or not appropriate for the fund.

The rule will not apply to money market funds, funds traded on a national exchange or to funds that specifically permit short-term trading and disclose to investors in the prospectus that such trading will likely result in higher costs for the fund.

Obligations of Intermediaries

The new rule, in effect, imposes certain obligations on "financial intermediaries," *regardless of whether the fund adopts a redemption fee.* The term "financial intermediary" includes (1) in the case of a participant-directed employee benefit plan, the plan administrator, as defined under ERISA, or the recordkeeper for the plan; and (2) an insurance company separate account registered as a unit investment trust. The rule provides that all funds subject to the rule, even those that determine not to impose redemption fees, *must* have written agreements with financial intermediaries *that require the intermediary* to:

- provide, promptly upon request by the fund, the Taxpayer Identification Number of all shareholders (including participants in a participant-directed employee benefit plan) that purchased, redeemed, transferred, or exchanged shares held through an account with the financial intermediary, and the amount and dates of the transactions; and

- execute instructions from the fund to restrict or prohibit further purchases or exchanges by an investor that the fund has identified as violating the fund's market timing policies.

These provisions will allow funds to monitor trading in omnibus accounts, to oversee the intermediaries' assessment of redemption fees, and to obtain remedial action through intermediaries against market timers or other frequent traders. Accordingly, Rule 22c-2, through the required agreements between funds and financial intermediaries, will effectively mandate that plan administrators or recordkeepers implement a fund's redemption fee (if any) on participant transactions, remit the proceeds to the fund, and enforce a fund's market timing policies with respect to plan participants.

The SEC's original proposal would have required intermediaries to provide mutual funds with complete investor identification and transaction information on a weekly basis, and many commenters objected to this. In contrast, the rule as adopted requires the information to be provided only at the request of the fund, which allows each fund to determine when it should receive the information. The rule gives funds the flexibility to request information periodically, or when circumstances suggest that a financial intermediary is not assessing redemption fees or that abusive market timing activity is occurring. There is, however, no limit on how frequently a fund can "request" information, and the intent of the rule seems to be that recordkeepers would be obligated to comply with all such "requests." In addition, the rule says that financial intermediaries must provide investor transaction information "promptly" at the request of a fund, but neither the rule nor the Adopting Release define what is meant by "promptly."

Implementation Methods

In its proposal, the SEC set forth three alternative methods for implementing redemption fees. First, intermediaries could transmit to the fund, at the time of each transaction, the individual account number used by the intermediary to identify the transaction (this would permit the fund to match the current transaction with previous transactions in the same account and assess a redemption fee when applicable). Second, funds and intermediaries could enter into an agreement requiring the intermediary to identify redemptions that would trigger a redemption fee, and the intermediary could transmit to the fund only the information necessary to allow the fund to assess the amount of the fee. Third, the fund and intermediaries could agree that the intermediary would impose the redemption fees and remit the proceeds to the fund. Many commenters opposed this variable framework, arguing that it would require intermediaries to accommodate all three alternatives, which would be very costly.

The rule as adopted does not include or specify any of these three methods. Indeed, Rule 22c-2 is silent regarding the method for implementing redemption fees. The SEC is requesting further comment on whether the rule should limit the ways that redemption fees may be assessed to promote greater uniformity in the enforcement of redemption fees, whether it should retain the three options specified above, and if so which entity should determine the option to be used.

Redemption Fee Standards; New Comment Period

New Rule 22c-2 does not impose uniform standards on redemption fees (other than the 2% maximum fee and minimum seven-day holding period). However, the SEC recognized the problems that recordkeepers and other intermediaries could face if they must implement redemption fees of various funds that differ with respect to matters such as the holding period, LIFO/FIFO accounting, the amount of the fee, hardship exceptions, de minimis exceptions, etc. Therefore, the SEC has opened a new comment period and is asking for comments on whether it should impose uniform standards and what those standards should be. The adoption of uniform standards (but not a mandatory fee) might, according to the SEC, substantially reduce the cost of fee collection and therefore enable more recordkeepers to participate in redemption fee programs.

The SEC is also considering whether the rule should require that redemption fees be limited to transactions initiated by investors. Under this approach, the fee would not apply to redemptions made pursuant to a pre-arranged plan, such as for periodic contributions or periodic rebalancing. The SEC requests comment on the need for such a provision, whether it is necessary if the rule provides for FIFO accounting and a de minimis exception, and whether such a provision should be mandatory or voluntary. The deadline for all comments is May 9, 2005.

Effective and Compliance Dates

As noted above, the effective date for Rule 22c-2 is May 23, 2005; however, the compliance date for the new rule is October 16, 2006. The delayed compliance dated is intended to allow funds and financial intermediaries time to make needed contractual amendments and system enhancements. Also, the compliance date may be extended if the SEC changes the rule in response to its request for comments.

Abandoned Plans

Overview

Difficult issues arise when a plan sponsor stops maintaining a retirement plan without taking steps to formally terminate it. Participants, many of whom have suddenly found themselves out of a job, often demand payment of their benefits from the plan's custodian or recordkeeper. This person, on the other hand, typically does not have the authority to distribute benefits without the approval of a plan representative, who may have vanished.

Recognizing this dilemma, the DOL has issued proposed regulations and a proposed prohibited transaction class exemption, which together are intended to remedy many of the problems associated with abandoned plans. The proposed regulations establish standards for determining when an individual account plan may be considered abandoned, as well as procedures for winding up the affairs of the plan and distributing benefits to participants and beneficiaries. The proposed class exemption would permit a Qualified Termination

Administrator (“QTA”) to receive fees for termination services and to select itself as a provider of individual retirement accounts or annuities (“IRAs”) for any automatic rollovers made from the abandoned plan.

Termination Procedure

Step One: Determination of Plan Abandonment. A QTA is the only entity that may determine that a plan has been abandoned. To qualify as a QTA, a person or entity must be eligible to serve as a trustee or issuer of IRAs and must hold assets of the plan for which it will serve as a QTA, though the DOL has requested comments on whether other parties should be allowed to be a QTA.

A QTA may find that there has been an abandonment if no contributions to or distributions from the plan have been made for a period of at least 12 consecutive months. If, however, the QTA has knowledge of facts or circumstances indicating that the plan actually has been or will be abandoned, it may find an abandonment without waiting for 12 months of plan inactivity. In either case, the QTA may find an abandonment if, after using reasonable efforts to locate or communicate with the plan sponsor, it determines that the plan sponsor no longer exists, cannot be located, or is unable to maintain the plan. Part of the reasonable efforts must include providing a notice to the plan sponsor of the QTA’s intent to terminate the plan. Specific information must be included in this notice, and the DOL has provided a fill-in-the-blank model notice indicating all the information needed.

Step Two: DOL Notification and Deemed Termination. Once the QTA determines that a plan has been abandoned, the winding-up process begins by notifying the DOL of the determination of abandonment. Again, the DOL has provided a model notice providing for all the required information. If the DOL does not object to the termination, the plan will be deemed to be terminated on the date that is 90-days after the filing of the DOL notice. The DOL has authority to waive the 90-day period in a particular case, in which event the plan will be deemed to be terminated when the DOL notifies the QTA of the waiver.

Step Three: Locating Plan Records and Calculating Benefits. The QTA generally must undertake reasonable and diligent efforts to locate and update the plan records necessary to determine plan benefits. If, however, the QTA determines in good faith that this process is impossible or will involve significant cost to the plan in relation to its benefits, the QTA will not be considered to have failed to act reasonably if it does not fully update the records. The QTA must use reasonable care to calculate benefits based on the records it has assembled.

Step Four: Notification of Participants and Beneficiaries. The QTA next notifies the participants and beneficiaries of the termination of the plan and the distribution options. This notice will also ask the participant or beneficiary to elect the form of payment or direct rollover and provide notice that the benefits will be subject to automatic rollover to an IRA if no election is made. The regulations include a model notice that can be used.

Step Five: Distribution of Benefits. The QTA is to distribute benefits in accordance with the participant's elections or, if no election was made, as an automatic direct rollover to an IRA, as specified in the regulations. The regulations provide a fiduciary "safe harbor" in connection with the automatic rollover, which if met, deems the QTA to have satisfied its prudence obligations regarding the selection of an IRA provider and the investment of the IRA assets. The conditions for these rollovers are similar to the conditions for automatic rollovers of cash-out amounts, although the $5,000 maximum and $1,000 minimum do not apply for this safe harbor. Also, the rollover safe harbor is only available for plans qualified or intended to be qualified under Internal Revenue Code ("Code") section 401(a); the DOL has requested comments on whether this safe harbor should be extended to plans under Code section 403(a) or (b) that are subject to ERISA. The proposed prohibited transaction class exemption provides relief enabling the QTA to choose itself as the IRA provider if specific conditions are met.

Step Six: Final Notice to DOL. The QTA must notify the DOL when all benefits have been distributed. A model final notice is provided in the regulations.

Fees and Expenses of Winding-up Plan

The proposed regulations make clear that plan assets may be used to pay service providers for reasonable services necessary for winding up the plan and distributing benefits, and the rules include guidance regarding the reasonableness standard for this purpose. The QTA may generally base reasonableness determinations on its own knowledge of industry rates for the services, provided, however that the amount paid must not be in excess of what the QTA charges for performing similar transactions.

The rules further require that the payment of fees must not be a prohibited transaction. In an effort to make the rules workable, the proposed class exemption would permit the QTA to select itself to provide termination services and to pay for such services from plan assets. The proposed exemption requires compliance with the abandoned plan regulations and sets standards for the rates and fees that may be charged as conditions for this relief.

Liability Limitations

The proposed regulations provide limited relief from fiduciary liability in connection with the duties performed by the QTA. First, the QTA will be deemed to have satisfied its fiduciary obligations, other than those involving the selection and monitoring of service providers, if it complies with the regulations. Also, as long as the QTA acts prudently in selecting and monitoring the service providers, the QTA will not be held liable for the acts or omissions of any service provider of which it does not have knowledge.

A QTA that satisfies the regulations will not be required to amend the plan to permit the actions contemplated by the regulations. In addition, the QTA will not be responsible for filing the plan's annual report (Form 5500), provided that it files the final termination report with the DOL. Finally, the preamble notes that the IRS has indicated that it will not challenge the qualified status of the abandoned plan if the QTA reasonably determines whether and the extent to which the qualified joint and survivor annuity rules apply to the plan, all benefits are nonforfeitable as of the deemed termination date, and notice of rollover rights, etc., under Code section 402(f) is provided to participants and beneficiaries.

Effective Date

The proposed effective date for the regulations is 60 days after the date final regulations are published in the Federal Register. The DOL has asked for comments as to whether a different effective date should apply.

Schedule A Disclosure

On February 24, the DOL issued Advisory Opinion 2005-02A, in which it clarified the information that must be reported by insurance companies on Schedule A to Form 5500. The regulations under ERISA require that an insurance company (or certain other service providers) providing benefits under a plan or holding plan assets in a separate account must certify certain information to the plan administrator in order to enable the administrator to accurately complete the plan's Form 5500. Schedule A is used for this purpose.

One of the items required to be reported on Schedule A is the amount of commissions and fees paid by the insurer or service provider in connection with the plan. Certain specific payments to "general agents" or "managers" for administrative functions need not be reported. In the event that a payment relates to more than just one plan, the form's instructions provide that a pro rata amount of the payments directly or indirectly attributable to a plan's contract must be reported for that plan.

The DOL issued the advisory opinion because it was concerned that insurers did not understand the DOL's position regarding the scope of the items that are to be reported on Schedule A. Among other things, the DOL clarified that the following amounts should be reported:

- Non-monetary forms of compensation (*e.g.*, prizes, trips, gifts);

- Amounts paid from separate funds other than the insurance company's general account;
- Amounts classified as profit-sharing, delayed compensation or marketing reimbursements;
- Finder's fees and similar amounts paid to third parties for business referral, whether as a separate component or part of an overall fee paid to the third party.
- Amounts paid to insurance brokers (*i.e.*, these are not considered administrative payments to a general agent or manager.

In the event that a pro rata portion of a payment is reported, the insurer must also disclose the method of allocating the amount between contracts, and the method must be reasonable.

While ERISA Procedure 76-1, which sets forth the guidelines to apply for an advisory opinion, says that only the party applying for an opinion may rely on it, the procedure also indicates that these opinions articulate established law, and the DOL is of the view that other parties with the same facts can and should follow its advisory opinions. In addition, Advisory Opinion 2005-02A describes the positions it takes as clarifications of existing rules. Thus, presumably, the reporting rules reflected in the advisory opinion are currently applicable to all insurance companies and service providers.

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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 the recent guidance affecting plan service providers and administrators.

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