(ii) The estimated number of specimens sought to be covered by the permit;

(iii) The year, country, and approximate place where taking occurred or will occur;

(iv) A brief description of the applicant's expertise and facilities as related to the proposed activity;

(v) A justification of the activities sought to be authorized by the permit and the relationship of such activities to scientific purposes, enhancing the propagation or survival of the species, or other objectives consistent with the purposes and policy of the Act; and

(vi) A statement of the applicant's willingness to participate in a cooperative propagation program, and to maintain or contribute data relating to such efforts.

(2) For activities involving seeds obtained from the wild and cultivated plants, provide the following information:

(i) The scientific names of the plants sought to be covered by the permit;

(ii) A statement of the applicant's willingness to participate in a cooperative propagation program, and to maintain or contribute data relating to the success of such efforts; and

(iii) A justification of the activities sought to be authorized by the permit and the relationship of such activities to scientific purposes, enhancing the propagation or survival of the species, or other objectives consistent with the purposes and policy of the Act.

(3) For importation or exportation involving the non-commercial loan, exchange or donation of herbarium or other preserved, dried or embedded museum specimens of all threatened species between scientists or scientific institutions, provide the following information:

(i) The name and address of the institution or other facility where the plants sought to be covered by the permit will be used or maintained; and

(ii) A justification of the activities sought to be authorized by the permit and the relationship of such activities to scientific purposes, enhancing the propagation or survival of the species, or other objectives consistent with the purposes and policy of the Act.

(4) If the activity sought to be authorized is with a species also regulated by the Convention on International Trade in Endangered Species of Wild Fauna and Flora, additional requirements as indicated in § 23.15(c) of Part 23 of this subchapter must be met. For the convenience of the applicant, § 23.15 (c) is repeated here:

Applications for permits or certificates under this section must be submitted to the Director by any person subject to the jurisdiction of the United States who wishes to engage in the activity. Each application must be submitted on an official application form (Form 3-200) provided by the Service, or must contain the general information and certification required by § 13.12(a) of this subchapter, and must include, as an attachment, as much of the following information as relates to the purpose for which the applicant is requesting a permit or certificate.

(1) The scientific and common names of the species (or taxa to the rank listed in Appendix I, II or III) sought to be covered by the permit, the number of wildlife or plants, and the activity sought to be authorized (such as importing, exporting, re-exporting, etc.);

(2) A statement as to whether the wildlife or plant, at the time of application, (i) is living in the wild, (ii) is living but is not in the wild, or (iii) is dead;

(3) A description of the wildlife or plant, including (i) size, (ii) sex (if known), and (iii) type of goods, if it is a part or derivative;

(4) In the case of living wildlife or plants, (i) a description of the type, size and construction of any container the wildlife or plant will be placed in during transportation; and (ii) the arrangements for watering and otherwise caring for the wildlife or plant during transportation;

(5) The name and address of the person in a foreign country to whom the wildlife or plant is to be exported from the United States, or from whom the wildlife or plant is to be imported into the United States;

(6) The country and place where the wildlife or plant was or is to be taken from the wild;

(7) In the case of wildlife or plants listed in Appendix I to be imported into the United States, (i) a statement of the purposes and details of the activities for which the wildlife or plant is to be imported; (ii) a brief resume of the technical expertise of the applicant or other persons who will care for the wildlife or plant; (iii) the name, address and a description, including diagrams or photographs, of the facility where the wildlife or plant will be maintained; and (iv) a description of all mortalities, in the two years preceding the date of this application, involving any wildlife species covered in the application (or any species of the same genus or family) held by the applicant, including the causes and steps taken to avoid such mortalities; and

(8) Copies of documents, sworn affidavits, or other evidence showing that either (i) the wildlife or plant was acquired prior to the date the Convention applied to it, or (ii) the wildlife or plant was bred in captivity, or artificially propagated, or was part of or derived therefrom, or (iii) the wildlife or plant is an herbarium specimen, other preserved, dried, or embedded museum specimen, or live plant material to be imported, exported, or re-exported as a non-commercial loan, donation, or exchange between scientists or scientific institutions.

(b) *Issuance criteria.* Upon receiving an application completed in accordance with paragraph (a) of this section, the Director will decide whether or not a permit should be issued. In making his decision, the Director shall consider, in addition to the general criteria in § 13.21(b) of this subchapter, the following factors:

(1) Whether the purpose for which the permit is requested will enhance the survival of the species in the wild;

(2) Whether the purpose for which the permit is requested will enhance the propagation of the species;

(3) The opinions or views of scientists or other persons or organizations having expertise concerning the plant or other matters germane to the application; and

(4) Whether the expertise, facilities, or other resources available to the applicant appear adequate to successfully accomplish the objectives stated in the application.

(c) *Permit conditions.* In addition to the general conditions set forth in Part 13 of this subchapter, every permit issued under this section shall be subject to the following special conditions:

(1) If requested, the permittee shall submit to the Director a written report of the activities authorized by the permit. Such report must be postmarked by the date specified in the permit or otherwise requested by the Director.

(2) A copy of the permit or an identification label, which includes the scientific name, the permit number, and a statement that the plant is of "wild origin" or "cultivated origin" must accompany the plant or its container during the course of any activity subject to these regulations, unless the specimens meet the special conditions referred to in paragraph (c)(3) of this subsection.

(3) In the case of plants that are herbarium specimens, or other preserved, dried, or embedded museum specimens to be imported or exported as a non-commercial loan exchange or donation between scientists or scientific institutions, the names and addresses of the consignor and consignee must be on each package or container. A description such as "herbarium specimens" and the code letters assigned by the Service to the scientist or scientific institution must be entered on the Customs declaration form affixed to each package or container. If the specimens are of taxa also regulated by the Convention on International Trade in Endangered Species of Wild Fauna and Flora, the letters "CITES" (acronym for the Convention) also must be entered on the Customs declaration form as indicated in § 23.15(e)(3) of Part 23 of this subchapter.

(d) *Duration of permit.* The duration of a permit issued under this section shall be designated on the face of the permit.

§§ 17.73–17.78 [Reserved]

[FR Doc.77-17817 Filed 6-23-77;8:45 am]

federal register

FRIDAY, JUNE 24, 1977

PART III

DEPARTMENT OF LABOR

Pension and Welfare Benefit Programs

DEPARTMENT OF THE TREASURY

Internal Revenue Service

■

EMPLOYEE BENEFIT PLANS

Exemption for Transactions Involving Insurance Agents, Brokers, Pension Consultants, Insurance and Investment Companies, and Principal Underwriters; Proposal To Adopt Additional Conditions With Respect to Prohibited Transaction Exemption 77-9

Title 26—Internal Revenue

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

SUBCHAPTER D—MISCELLANEOUS EXCISE TAXES

[T.D. 7491]

PART 54—PENSION, ETC., EXCISE TAXES

Exemptions for the Provision of Services or Office Space to Employee Benefit Plans, the Investment of Plan Assets in Bank Deposits, the Provision of Bank Ancillary Services to Plans, and the Transitional Rule for the Provision of Services to Plans

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the provision of services or office space to certain employee benefit plans, the investment of plan assets in bank deposits, the provision of ancillary services by banks or similar financial institutions to plans, and the transitional rules for the provision of services to plans. Changes in the applicable tax law were made by the Employee Retirement Income Security Act of 1974. These regulations provide necessary guidance to the public for compliance with the law, and affect all employees who are entitled to receive retirement benefits under certain employer plans, their employers, persons providing services to such plans, and banks or similar financial institutions, as well as other persons who enter into transactions with such plans.

DATE: The regulations are effective for taxable years ending after December 31, 1974.

FOR FURTHER INFORMATION CONTACT:

Mr. Larry E. Smith of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224 (Attention: CC:LR:T), 202-566-3909 (Not a toll-free call).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On July 30, 1976, the FEDERAL REGISTER published proposed amendments to the Pension Excise Tax Regulations (26 CFR Part 54) under section 4975 of the Internal Revenue Code of 1954 (the Code). 41 FR 31838. The amendments were proposed to conform the regulations to section 2003 of the Employee Retirement Income Security Act of 1974 (the Act) (88 Stat. 971). On December 29, 1976, the FEDERAL REGISTER published a notice of hearing which contained additional material relating to the proposed amendments. 41 FR 56758. A public hearing was held on February 14, 1977. After consideration of all comments regarding the proposed amendments, those amendments are adopted as modified by this Treasury decision.

By notice appearing in the same issue of the FEDERAL REGISTER, the Department of Labor (the Department) announced that it had under consideration a proposal to adopt similar regulations. By notice appearing in this issue of the FEDERAL REGISTER, the Department has announced the adoption of similar regulations.

Sections 4975 (a) and (b) impose excise taxes on disqualified persons who engage in transactions with employee benefit plans which constitute prohibited transactions as defined in section 4975 (c)(1). Section 4975(d) contains exemptions from these prohibited transaction provisions. Section 2003(c)(2) of the Act contains transitional rules which delay the effective date of section 4975 for certain transactions. These regulations explain certain of the exemptions and transitional rules which relate to the provision of office space or services to plans by disqualified persons, the investment of plan assets in deposits of a bank or similar financial institution, and the provision of ancillary services by banks or similar financial institutions to plans.

EXEMPTION FOR OFFICE SPACE OR SERVICES

Under the notices, the exemption for the provision of office space or services applied to those kinds of services which are "necessary for the establishment or operation of the plan". § 54.4975-6(b)(1)(i) (§ 2550.408b-2(b)(1)(i)).[1] A service was interpreted as being necessary "if it is of a type which is customarily furnished to plans of the kind in question in the ordinary course of their being established or operated." § 54.4975-6(b)(2) (§ 2550.408b-2(b)(2)).

This interpretation was criticized in various comments on the grounds that it would permit an improper service so long as the service was customary prior to the adoption of the Act. On the other hand, many comments noted that what is customary varies with the size and kind of plan as well as with the geographical region in which the plan is located, and that the proposed interpretation might not permit recognition of new kinds of services which may be developed in the future. Several comments stated that the services should be considered "necessary" only if they were essential to plan operation. The proposed interpretation of what constitutes a necessary service has been revised in light of these comments.

The notices provided that the service must be furnished under a contract or arrangement which is reasonable. § 54.4975-6(b)(1)(ii) (§ 2550.408b-2(b)(1)(ii)). Under the notices a contract is not reasonable unless the contract may be terminated by the plan "* * * without penalty to the plan on reasonably short notice under the circumstances * * *." § 54.4975-6(b)(3) (§ 2550.408b-2(b)(3)).

The length of the notice period as compared to the length of the lease was proposed as a factor to be considered in determining reasonableness.

Objections were made to the use of this factor on the grounds that it does not bear a sufficient relationship to commercial practice. Clarification was also requested as to whether a provision for a minimum fee or other provision which is designed to permit recoupment of start-up costs would be a "penalty" under the proposed amendments. These provisions in the proposed amendments have been revised in response to the comments.

The exemption does not apply if the arrangement for services or office space involves fiduciary conflicts of interest described in section 4975(c)(1)(E) or (F). In this regard, the notices provided a description of a "safe harbor" as follows:

> Thus, a person who is a fiduciary with respect to a plan may not provide additional services to the plan and receive any compensation or other consideration in connection therewith, unless such provision of services is arranged and approved on behalf of the plan by a fiduciary who is independent of and unrelated to the fiduciary providing such services, who is not a party to such arrangement for the provision of services, who does not receive any compensation or other consideration with respect to such provision of services, and who has no other interest with respect to the transaction that might affect the exercise of such fiduciary's best judgment as a fiduciary.

§ 54.4975-6(b)(1) (§ 2550.4089b-2(b)(1)).

Many comments were received criticizing the ambiguity of the above quoted provision. Further clarification was provided in the notice of hearing published on December 29, 1976, in the FEDERAL REGISTER. This notice was also criticized in various comments as being ambiguous with respect to the applicability of the "safe harbor" in certain common situations.

In response to these comments, this portion of the proposed amendments has been extensively revised to provide better guidance as to the circumstances under which the provision of services does or does not involve an act of self-dealing under section 4975(c)(1)(E).

INVESTMENT IN DEPOSITS OF BANKS OR SIMILAR FINANCIAL INSTITUTIONS

Under the notices, investments in the deposits of a fiduciary bank or similar financial institution in some circumstances must meet certain requirements as to express authorization. § 54.4975-6(c)(2)(ii) and (iii) (§ 2550.408b-4(b)(2) and (3)).

Several comments objected that a requirement of express authorization in plan instruments of the specific investment would necessitate amending hundreds of plans, a procedure which the commentators stated would be administratively burdensome. Further clarification was requested as to the exact language which would constitute a sufficient authorization under the regulations and whether retroactive amendment of plan instruments would be permitted. Consequently, these requirements have been clarified.

[1] References are to the parallel provisions of the proposed amendments issued by the Service and the Department, 26 and 29 CFR respectively. Reference to the parallel regulations of the Department are contained in the parentheses.

ANCILLARY SERVICES BY BANKS OR SIMILAR FINANCIAL INSTITUTIONS

In the notices, attention was called to the proposed regulations dealing with the exemption in section 4975(d)(6) of the Code and section 408(b)(6) of the Act for the provision to a plan of ancillary services by a bank or similar financial institution which is a fiduciary with respect to the plan. The Code and the Act require that such ancillary services be provided subject to specific guidelines determined by the agents after consultation with Federal and State supervisory authorities. The requirements for the specific guidelines were reserved in the notices, and comments were requested as to what provisions the guidelines should contain.

Section 54.4975–6(c)(3) has been reserved pending development of such guidelines. When such guidelines have been developed, a separate notice of proposed rule making will be prepared containing proposed § 54.4975–6(c)(3).

The notice proposed to require that ancillary services be furnished under an agreement which binds the bank or similar financial institution to comply with the guidelines for the furnishing of such ancillary services. § 54.4975–6(d)(2)(iv) (§ 2550.408b–6(b)(4)). Comments were received objecting to this condition on the grounds that it would involve unnecessary cost to plans and that compliance with the guidelines could be required by regulations. This requirement has been omitted.

TRANSITIONAL RULE FOR SERVICES

The notices directed attention to alternative interpretations of identical language contained in Act sections 414(c)(4) and 2003(c)(2)(D) for the transitional rule relating to the provision of services. In § 53.4941(d)–4(c) (relating to acts of self-dealing involving private foundations), the Treasury interpreted similar language to mean that, in certain circumstances, a lease or loan must be renegotiated by the parties even though the terms of the pre-existing contract do not permit either party to insist upon an adjustment of the contract terms. The Service proposed to adopt a similar interpretation under Act section 2003(c)(2)(D). However, the Department did not propose to require renegotiation until renewal if the terms of the pre-existing contract did not permit an adjustment of the contract terms.

Because parallel provisions appear in both Act sections 414(c)(4) and 2003(c)(2)(D), the two agencies proposed to review public comments on these alternative interpretations and to adopt a uniform rule. After reviewing the public comments, the agencies have decided to adopt the interpretation in the notice issued by Department, because of substantial differences in the operation of private foundations and employee benefit plans under their respective transitional rules.

OTHER MATTERS

These final regulations replace information releases issued by the Service relating to the matters dealt with in these regulations, e.g., T.I.R. No. 1329 (December 31, 1974), T.I.R. No. 1396 (July 24, 1975), and T.I.R. No. 1399 (August 13, 1975). In addition to other changes, various stylistic and clarifying changes have been made from the notices.

DRAFTING INFORMATION

The principal author of this regulation was Mr. Larry E. Smith of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service, the Treasury Department and the Department of Labor participated in developing the regulation, both on matters of substance and style.

ADOPTION OF AMENDMENTS TO THE REGULATIONS

Accordingly, 26 CFR Part 54 is amended as follows:

PARAGRAPH 1. Section 54.4975–6 is inserted in the appropriate place to read as follows:

§ 54.4975–6 Statutory exemptions for office space or services and certain transactions involving financial institutions.

(a) *Exemption for office space or services.*—(1) *In general.* Section 4975(d)(2) exempts from the excise taxes imposed by section 4975 payment by a plan to a disqualified person, including a fiduciary, for office space or any service (or a combination of services), if (i) such office space or service is necessary for the establishment or operation of the plan; (ii) such office space or service is furnished under a contract or arrangement which is reasonable; and (iii) no more than reasonable compensation is paid for such office space or service. However, section 4975(d)(2) does not contain an exemption for acts described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) or acts described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). Such acts are separate transactions not described in section 4975(d)(2). See §§ 54.4975–6(a)(5) and 54.4975–6(a)(6) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 4975(c)(1)(E).

Section 4975(d)(2) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(2). See, for example, the general fiduciary responsibility provisions of section 404 of the Employee Retirement Income Security Act of 1974 (the Act) (88 Stat. 877). The provisions of section 4975(d)(2) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Necessary service.* A service is necessary for the establishment or operation of a plan within the meaning of section 4975(d)(2) and § 54.4975–6(a)(1)(i) if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained. A persons providing such a service to a plan (or a person who is disqualified person solely by reason of a relationship to such a service provider described in section 4975(e)(2)(F), (G), (H), or (I)) may furnish goods which are necessary for the establishment or operation of the plan in the course of, and incidental to, the furnishing of such servi e to the plan.

(3) *Reasonable contract or arrangement.* No contract or arrangement is reasonable within the meaning of section 4975(d)(2) and § 54.4975–6(a)(1)(ii) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. A long-term lease which may be terminated prior to its expiration (without penalty to the plan) on reasonably short notice under the circumstances is not generally an unreasonable arrangement merely because of its long term. A provision in a contract or other arrangement which reasonably compensates the service provider or lessor for loss upon early termination of the contract, arrangement or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable start-up costs is not a penalty.

Similarly, a provision in a lease for a termination fee that covers reasonably foreseeable expenses related to the vacancy and reletting of the office space upon early termination of the lease is not a penalty. Such a provision does not reasonably compensate for loss if it provides for payments in excess of actual loss or if it fails to require mitigation of damages.

(4) *Reasonable compensation.* Section 4975(d)(2) and § 54.4975–6(a)(1)(iii) permit a plan to pay a disqualified person reasonable compensation for the provision of office space or services described in section 4975(d)(2). Paragraph (e) of this section contains regulations relating to what constitutes reasonable compensation for the provision of services.

(5) *Transactions with fiduciaries.*—(i) *In general.* If the furnishing of office space or a service involves an act described in section 4975(c)(1)(E) or (F) (relating to acts involving conflicts of interest by fiduciaries), such as act constitutes a separate transaction which is not exempt under section 4975(d)(2). The prohibitions of sections 4975(c)(1)(E) and (F) supplement the other prohibitions of section 4975(c)(1) by imposing on disqualified persons who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to

deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a fiduciary may not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction.

A person in which a fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary includes, for example, a person who is a disqualified person by reason of a relationship to such fiduciary described in section 4975(e)(2)(E), (F), (G), (H), or (I).

(ii) *Transactions not described in section 4975(c)(1)(E).* A fiduciary does not engage in an act described in section 4975(c)(1)(E) if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. This may occur, for example, when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, because the authority, control or responsibility which makes a person a fiduciary may be exercised "in effect" as well as in form, mere approval of the transaction by a second fiduciary does not mean that the first fiduciary has not used any of the authority, control or responsibility which makes such person a fiduciary to cause the plan to pay the first fiduciary an additional fee for a service.

(iii) *Services without compensation.* If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of paragraph (e)(4) of this section), the provision of such services does not, in and of itself, constitute an act described in section 4975(c)(1)(E) or (F). The allowance of a deduction to an employer under section 162 or 212 for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

(6) *Examples.* The provisions of § 54.4975–6(a)(5) may be illustrated by the following examples:

Example (1). E, an employer whose employees are covered by plan P, is a fiduciary of P. I is a professional investment adviser in which E has no interest which may affect the exercise of E's best judgment as a fiduciary. E causes P to retain I to provide certain kinds of investment advisory services of a type which causes I to be a fiduciary of P under section 4975(e)(3)(B). Thereafter, I proposes to perform for additonal fees portfolio evaluation services in addition to the services currently provided. The provision of such services is arranged by I and approved on behalf of the plan by E. I has not engaged in an act described in section 4975(c)(1)(E), because I did not use any of the authority, control or responsibility which makes I a fiduciary (the provision of investment advisory services) to cause the plan to pay I additional fees for the provision of the portfolio evaluation services. E has not engaged in an act which is described in section 4975(c)(1)(E). E, as the fiduciary who has the responsibility to be prudent in his selection and retention of I and the other investments advisers of the plan, has an interest in the purchase by the plan of portfolio evaluation services. However, such an interest is not an interest which may affect the exercise of E's best judgment as a fiduciary.

Example (2). D, a trustee of plan P with discretion over the management and disposition of plan assets, relies on the advice of C, a consultant to P, as to the investment of plan assets, thereby making C a fiduciary of the plan. On January 1, 1978, C recommends to D that the plan purchase an insurance policy from U, an insurance company which concerning the fact that C will receive a P. C thoroughly explains the reasons for the recommendation and makes a full disclosure concerning the fact that C will receive a commission from U upon the purchase of the policy by P. D considers the recommendation and approves the purchase of the policy by P. C receives a commission. Under such circumstances, C has engaged in an act described in section 4975(c)(1)(E) (as well as section 4975(c)(1)(F)) because C is in fact exercising the authority, control or responsibility which makes C a fiduciary to cause the plan to purchase the policy. However, the transaction is exempt from the prohibited transaction provisions of section 4975(c)(1) if the requirements of Prohibited Transaction Exemption 77–9 are met.

Example (3). Assume the same facts as in Example (2) except that the nature of C's relationship with the plan is not such that C is a fiduciary of P. The purchase of the insurance policy does not involve an act described in section 4975(c)(1)(E) or (F), because such sections only apply to acts by fiduciaries.

Example (4). E, an employer whose employees are covered by plan P, is a fiduciary with respect to P. A, who is not a disqualified person with respect to P, persuades E that the plan needs the services of a professional investment adviser and that A should be hired to provide the investment advice. Accordingly, E causes P to hire A to provide investment advice of the type which makes A a fiduciary under § 54.4975–6(c)(1)(ii)(B). Prior to the expiration of A's first contract with P, A persuades E to cause P to renew A's contract with P to provide the same services for additional fees in view of the increased costs in providing such services. During the period of A's second contract, A provides additional investment advice services for which no additional charge is made. Prior to the expiration of A's second contract, A persuades E to cause P to renew his contract for additional fees in view of the additional services A is providing. A has not engaged in an act described in section 4975(c)(1)(E), because A has not used any of the authority, control or responsibility which makes A a fiduciary (the provision of investment advice) to cause the plan to pay additional fees for A's services.

Example (5). P, a trustee of plan P with discretion over the management and disposition of plan assets, retains C to provide administrative services to P of the type which makes C a fiduciary under section 4975(e)(3)(C). Thereafter, C retains F to provide, for additional fees, actuarial and various kinds of administrative services in addition to the services F is currently providing to P. Both F and C have engaged in an act described in section 4975(c)(1)(E). F, regardless of any intent which he may have had at the time he retained C, has engaged in such an act because F has, in effect, exercised the authority, control or responsibility which makes F a fiduciary to cause the plan to pay F additional fees for the services C, whose continued employment by P depends on F, has also engaged in such an act, because C has an interest in the transaction which might affect the exercise of C's best judgment as a fiduciary. As a result, C has dealt with plan assets in his own interest under section 4975(c)(1)(E).

Example (6). F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 4975(c)(1)(E), because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. Such act is not exempt under section 4975(d)(2) irrespective of whether the provision of the services by S is exempt.

Example (7). T, one of the trustees of plan P, is president of bank B. The bank proposes to provide administrative services to P for a fee. T physically absents himself from all consideration of B's proposal and does not otherwise exercise any of the authority, control or responsibility which makes T a fiduciary to cause the plan to retain B. The other trustees decide to retain B. T has not engaged in an act described in section 4975(c)(1)(E). Further, the other trustees have not engaged in an act described in section 4975(c)(1)(E) merely because T is on the board of trustees of P. This fact alone would not make them have an interest in the transaction which might affect the exercise of their best judgment as fiduciaries.

(b) *Exemption for bank deposits.*—(1) *In general.* Section 4975(d)(4) exempts from the excise taxes imposed by section 4975 investment of all or a part of a plan's assets in deposits bearing a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a State, even though such bank or similar financial institution is a fiduciary or other disqualified person with respect to the plan, if the conditions of either § 54.4975–6(b)(2) or § 54.4975–6(b)(3) are met. Section 4975(d)(4) provides an exemption from section 4975(c)(1)(E) relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account), as well as sections 4975(c)(1)(A) through (D), because section 4975(d)(4) contemplates a bank or similar financial institution causing a

plan for which it acts as a fiduciary to invest plan assets in its own deposits if the requirements of section 4975(d)(4) are met. However, it does not provide an exemption from section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). The receipt of such consideration is a separate transaction not described in the exemption. Section 4975(d)(4) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(4). See, for example, the general fiduciary responsibility provisions of section 404 of the Act. The provisions of section 4975(d)(4) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Plan covering own employees.* Such investment may be made if the plan is one which covers only the employees of the bank or similar financial institution, the employees of any of its affiliates, or the employees of both.

(3) *Other plans.*—(i) *General rule.* Such investment may be made if the investment is expressly authorized by a provision of the plan or trust instrument or if the investment is expressly authorized (or made) by a fiduciary of the plan (other than the bank or similar financial institution or any of its affiliates) who has authority to make such investments, or to instruct the trustee or other fiduciary with respect to investments, and who has no interest in the transaction which may affect the exercise of such authorizing fiduciary's best judgment as a fiduciary so as to cause such authorization to constitute an act described in section 4975(c)(1)(E) or (F). Any authorization to make investments contained in a plan or trust instrument will satisfy the requirement of express authorization for investments made prior to November 1, 1977.

Effective November 1, 1977, in the case of a bank or similar financial institution that invests plan assets in deposits in itself or its affiliates under an authorization contained in a plan or trust instrument, such authorization must name such bank or similar financial institution and must state that such bank or similar financial institution may make investments in deposits which bear a reasonable rate of interest in itself (or in an affiliate.)

(ii) *Example.* B, a bank, is the trustee of plan P's assets. The trust instruments give the trustee the right to invest plan assets in its discretion. B invests in the certificates of deposit of bank C, which is a fiduciary of the plan by virtue of performing certain custodial and administrative services. The authorization is sufficient for the plan to make such investment under section 4975(d)(4). Further, such authorization would suffice to allow B to make investments in deposits in itself prior to November 1, 1977. However, subsequent to October 31, 1977, B may not invest in deposits in itself, unless the plan or trust instrument specifically authorizes it to invest in deposits of B.

(4) *Definitions.* (i) The term "bank or similar financial institution" includes a bank (as defined in section 581), a domestic building and loan association (as defined in section 7701(a)(19)), and a credit union (as defined in section 101(6) of the Federal Credit Union Act).

(ii) A person is an affiliate of a bank or similar financial institution if such person and such bank or similar financial institution would be treated as members of the same controlled group of corporations or as members of two or more trades or businesses under common control within the meaning of section 414(b) or (c) and the regulations thereunder.

(iii) The term "deposits" includes any account, temporary or otherwise, upon which a reasonable rate of interest is paid, including a certificate of deposit issued by a bank or similar financial institution.

(c) *Exemption for ancillary bank services.*—(1) *In general.* Section 4975(d)(6) exempts from the excise taxes imposed by section 4975 the provision of certain ancillary services by a bank or similar financial institution (as defined in § 54.4975–6(b)(4)(i)) supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions in § 54.4975–6(c)(2) are met. Such ancillary services include services which do not meet the requirements of section 4975(d)(2), because the provision of such services involves an act described in section 4975(c)(1)(E) (relating to fiduciaries dealing with the income or assets of plans in their own interest or for their own account) by the fiduciary bank or similar financial institution. Section 4975(d)(6) provides an exemption from section 4975(c)(1)(E), because section 4975(d)(6) contemplates the provision of such ancillary services without the approval of a second fiduciary (as described in § 54.4975–6(a)(5)(ii)) if the conditions of § 54.4975–6(c)(2) are met. Thus, for example, plan assets held by a fiduciary bank which are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest-bearing checking account in the bank if the conditions of § 54.4975–6(c)(2) are met, notwithstanding the provisions of section 4975(d)(4) (relating to investments in bank deposits). However, section 4975(d)(6) does not provide an exemption for an act described in section 4975(c)(1)(F) (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the income or assets of the plan). The receipt of such consideration is a separate transaction not described in section 4975(d)(6).

Section 4975(d)(6) does not contain an exemption from other provisions of the Code, such as section 401, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 4975(d)(6). See, for example, the general fiduciary responsibility provisions of section 404 of the Act. The provisions of section 4975(d)(6) are further limited by the flush language at the end of section 4975(d) (relating to transactions with owner-employees and related persons).

(2) *Conditions.* Such service must be provided:

(i) At not more than reasonable compensation;

(ii) Under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and

(iii) Only to the extent that such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of § 54.4975–6(c)(3).

(3) *Specific guidelines.* [Reserved]

(d) *Exemption for services as a fiduciary.* [Reserved]

(e) *Compensation for services.*—(1) *In general.* Section 4975(d)(2) refers to the payment of reasonable compensation by a plan to a disqualified person for services rendered to the plan. Section 4975(d)(10) and §§ 54.4975–6(e)(2) through 54.4975–6(e)(5) clarify what constitutes reasonable compensation for such services.

(2) *General rule.* Generally, whether compensation is "reasonable" under sections 4975(d)(2) and (10) depends on the particular facts and circumstances of each case.

(3) *Payments to certain fiduciaries.* Under sections 4975(d)(2) and (10), the term "reasonable compensation" does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers (any of whose employees are participants in the plan) or from an employee organization (any of whose members are participants in the plan), except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. The restrictions of this paragraph (e)(3) do not apply to a disqualified person who is not a fiduciary.

(4) *Certain expenses not direct expenses.* An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.

(5) *Expense advances.* Under sections 4975(d)(2) and (10), the term "reasonable compensation", as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if:

(i) The amount of such advance is reasonable with respect to the amount of the direct expense which is likely to be properly and actually incurred in the immediate future (such as during the next month); and

(ii) The fiduciary or employee accounts to the plan at the end of the period covered by the advance for the expenses properly and actually incurred.

(6) *Excessive compensation.* Under sections 4975(d) (2) and (10), any compensation which would be considered excessive under § 1.162–7 (relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be "reasonable compensation". Depending upon the facts and circumstances of the particular situation, compensation which is not excessive under § 1.162–7 may, nevertheless, not be "reasonable compensation" within the meaning of sections 4975(d) (2) and (10).

PAR. 2. Section 54.4975–15 is inserted in the appropriate place to read as follows:

§ 54.4975–15 Other transitional rules.

(a) [Reserved]

(b) [Reserved]

(c) [Reserved]

(d) *Provision of certain services until June 30, 1977.*—(1) *In general.* Section 2003(c)(2)(D) of the Employee Retirement Income Security Act of 1974 (the Act) (88 Stat. 979) provides that section 4975 shall not apply to the provision of services before June 30, 1977, between a plan and a disqualified person if the three requirements contained in section 2003(c)(2)(D) of the Act are met. The first requirement is that such services must be provided either (i) under a binding contract in effect on July 1, 1974 (or pursuant to a renewal or modification of such contract); or (ii) by a disqualified person who ordinarily and customarily furnished such services on June 30, 1974. The second requirement is that the services be provided on terms that remain at least as favorable to the plan as an arm's-length transaction with an unrelated party would be.

For this purpose, such services are provided on terms that remain at least as favorable to the plan as an arm's length transaction with an unrelated party would be if, at the time of execution (or renewal) of such binding contract, the contract (or renewal) is on terms at least as favorable to the plan as an arm's-length transaction with an unrelated party would be. However, if in a normal commercial setting an unrelated party in the position of the plan could be expected to insist upon a renegotiation or termination of a binding contract, the plan must so act. Thus, for example, if a disqualified person provides services to a plan on a month-to-month basis, and a party in the position of the plan could be expected to renegotiate the price paid under such contract because of a decline in the fair market value of such services, the plan must so act in order to avoid participation in a prohibited transaction. The third requirement is that the provision of services must not be, or have been, at the time of such provision a prohibited transaction within the meaning of section 503(b) or the corresponding provisions of prior law. If these three requirements are met, section 4975 will apply neither to services provided before June 30, 1977 (both to customers to whom such services were being provided on June 30, 1974, and to new customers) nor to the receipt of compensation therefor. Thus, if these three requirements are met, section 4975 will not apply until June 30, 1977, to the provision of services to a plan by a disqualified person (including a fiduciary) even if such services could not be furnished pursuant to the exemption provisions of sections 4975(d)(2) or (6) and § 54.4975–6. For example, if the three requirements of section 2003(c)(2)(D) of the Act are met, a person serving as fiduciary to a plan who already receives full-time pay from an employer or an association of employers, whose employees are participants in such plan, or from an employee organization whose members are participants in such plan, may continue to receive reasonable compensation from the plan for services rendered to the plan before June 30, 1977. Similarly, until June 30, 1977, a plan consultant who may be a fiduciary because of the nature of the consultative and administrative services being provided may, if these three requirements are met, continue to cause the sale of insurance to the plan and continue to receive commissions for such sales from the insurance company writing the policy. Further, if the three requirements of section 2003 (c)(2)(D) of the Act are met, a securities broker dealer who renders investment advice to a plan for a fee, thereby becoming a fiduciary, may furnish other services to the plan, such as brokerage services, and receives compensation therefor. Also, if a registered representative of such a broker-dealer were a fiduciary, the registered representative may receive compensation, including commissions, for brokerage services performed before June 30, 1977.

(2) *Persons deemed to be June 30, 1974, service providers.* A disqualified person with respect to a plan which did not, on June 30, 1974, ordinarily and customarily furnish a particular service, will nevertheless be considered to have ordinarily and customarily furnished such service on June 30, 1974, for purposes of this section and section 2003(c)(2)(D) of the Act, if either of the following conditions are met:

(i) At least 50 percent of the outstanding beneficial interests of such disqualified person are owned directly or through one or more intermediaries by the same person or persons who owned, directly or through one or more intermediaries, at least 50 percent of the outstanding beneficial interests of a person who ordinarily and customarily furnished such service on June 30, 1974; or

(ii) Control or the power to exercise a controlling influence over the management and policies of such disqualified person is possessed, directly or through one or more intermediaries, by the same person or persons who possessed, directly or through one of more intermediaries, control or the power to exercise a controlling influence over the management and policies of a person who ordinarily and customarily furnished such service on June 30, 1974. For purposes of this paragraph (d)(2) a person shall be deemed to be an "intermediary" of another person if at least 50 percent of the outstanding beneficial interests of such person are owned by such other person, directly or indirectly, or if such other person controls or has the power to exercise a controlling influence over the management and policies of such person.

(3) *Examples.* The principals of § 54.4975–15(d)(2) may be illustrated by the following examples.

Example (1). A owns 50 percent of the outstanding beneficial interests of ABC Partnership which ordinarily and customarily furnished certain services on June 30, 1974. On July 2, 1974, ABC Partnership was incorporated into ABC Corporation with one class of stock outstanding. A owns 50 percent of the shares of such stock. ABC Corporation furnishes the same services that were furnished by ABC Partnership on June 30, 1974. ABC Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example (2). A and B together own 100 percent of the beneficial interests of AB Partnership, which ordinarily and customarily furnished certain services on June 30, 1974. On September 1, 1974, AB Partnership was incorporated into AB Corporation with one class of stock outstanding. A and B each own 20 percent of such outstanding class of stock and together have control over the management and policies of AB Corporation. AB Corporation furnishes the same services that were furnished by AB Partnership on June 30, 1974. AB Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example (3). On June 30, 1974, M Corporation was ordinarily and customarily furnishing certain services. On that date, X, Y and Z together owned 50 percent of all classes of the outstanding shares of M Corporation. On January 28, 1975, all of the shareholders of M Corporation exchanged their shares in M Corporation for shares of a new N Corporation. As a result of that exchange, X, Y and Z together own 50 percent of the common stock of N Corporation, the only class of N Corporation stock outstanding after the exchange. N Corporation furnishes the services formerly furnished by M Corporation. N Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example (4). I Corporation ordinarily and customarily furnished certain services on June 30, 1974. On November 3, 1975, I Corporation organizes a wholly owned subsidiary, S Corporation, which furnishes the same services ordinarily and customarily furnished by I Corporation on June 30, 1974. S Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

Example (5). X Corporation, wholly-owned and controlled by A, ordinarily and customarily furnished certain services on June 30, 1974. Y Corporation did not perform such services on that date. On January 2, 1976, X Corporation is merged into Y Corporation and, although A received less than 50 per-

cent of the total outstanding shares of Y Corporation, after such merger A has control over the management and policies of Y Corporation. Y Corporation furnishes the same services that were formerly furnished by X Corporation. Y Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 2003(c)(2)(D) of the Act.

This Treasury decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

WILLIAM E. WILLIAMS,
Commissioner of Internal Revenue.

Approved:

LAURENCE N. WOODWORTH,
Assistant Secretary of the Treasury.

[FR Doc.77-17894 Filed 6-21-77;8:45 am]

Title 29—Labor

CHAPTER XXV—PENSION AND WELFARE BENEFIT PROGRAMS

SUBCHAPTER F—EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

PART 2550—RULES AND REGULATIONS FOR FIDUCIARY RESPONSIBILITY

Exemptions for the Provision of Services or Office Space to Employee Benefit Plans, the Investment of Plan Assets in Bank Deposits, the Provision of Bank Ancillary Services to Plans, and the Transitional Rule for the Provision of Services to Plans

AGENCY: Department of Labor.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the provision of services or office space to employee benefit plans, the investment of plan assets in the deposits of banks and similar financial institutions, the provision of ancillary services by banks and similar financial institutions to plans, and the transitional rule for the provision of services to plans under the Employee Retirement Income Security Act of 1974. These regulations provide necessary guidance to the public for compliance with the law and affect participants and beneficiaries of employee benefit plans, their employers, persons providing services to such plans, and banks and similar financial institutions.

EFFECTIVE DATE: January 1, 1975.

FOR FURTHER INFORMATION CONTACT:

Mr. Forrest Foss of the Plan Benefits Security Division, Office of the Solicitor, Department of Labor, 200 Constitution Avenue NW., Washington, D.C. 20210, Room C-4508 (202-523-6856, not a toll free number).

SUPPLEMENTARY INFORMATION:

BACKGROUND

On July 30, 1976, notice was published in the FEDERAL REGISTER (41 FR 31874) that the Department of Labor (the Department) had under consideration a proposal to adopt regulations 29 CFR 2550.408b-2, 2550.408b-4, 2550.408b-6, 2550.408c-2, and 2550.414c-4, under sections 408(b)(2), 408(b)(4), 408(b)(6), 408(c)(2), and 414(c)(4) of the Employee Retirement Income Security Act of 1974 (the Act) relating to the provision of services or office space to plans, the investment of plan assets in bank deposits, the provision of bank ancillary services to plans and the transitional rule for the provision of services to plans.[1] On December 29, 1976, the FEDERAL REGISTER published a notice of hearing (41 FR 56758) which contained additional material relating to the proposed regulations. On February 14, 1977, the Department and the Internal Revenue Service (the Service) held a public hearing on the provisions of the proposed regulations. After consideration of all the written comments received and the testimony given at the public hearing, the Department has decided to adopt the proposed regulations, as modified and set forth below.[2]

Section 406 of the Act prohibits a fiduciary with respect to a plan from knowingly causing the plan to engage in certain transactions ("prohibited transactions"). Section 408(b) of the Act contains exemptions from these prohibited transaction provisions. Section 414(c)(4) of the Act contains transitional rules which delay the effective date of section 406 for certain transactions. These regulations explain certain of the exemptions and transitional rules which relate to the provision of services or office space to plans by parties in interest, the investment of plan assets in deposits of a bank or similar financial institution which is a party in interest to the plan and the provision of ancillary services to a plan by a bank or similar financial institution which is a fiduciary with respect to the plan.

EXEMPTION FOR OFFICE SPACE OR SERVICES

Under the notices, the exemption for the provision of office space or services applied to those kinds of services which are "necessary for the establishment or operation of the plan." § 2550.408b-2(b)(1)(i) (§ 54.4975-6(b)(1)(i)).[3] A service was interpreted as being necessary "if it is of a type which is customarily furnished to plans of the kind in question in the ordinary course of their being established or operated." § 2550.408b-2(b)(2) (§ 54.4975-6(b)(2)).

This interpretation was criticized in various comments on the grounds that it would permit an improper service so long as the service was customary prior to the adoption of the Act. On the other hand, many comments noted that what is customary varies with the size and kind of plan as well as with the geographical region in which the plan is located, and that the proposed interpretation might not permit recognition of new kinds of services which may be developed in the future. Several comments stated that the services should be considered "necessary" only if they were essential to plan operation. The proposed interpretation of what constitutes a necessary service has been revised in light of these comments.

The notices provided that the service must be furnished under a contract or arrangement which is reasonable. § 2550.408b-2(b)(1)(ii) (§ 54.4975-6(b)(1)(ii)). Under the notices, a contract is not reasonable unless the contract may be terminated by the plan "* * * without penalty to the plan on reasonably short notice under the circumstances * * *." § 2550.408b-2(b)(3) (§ 54.4975-6(b)(3)).

The length of the notice period as compared to the length of the lease was proposed as a factor to be considered in determining reasonableness. Objections were made to the use of this factor on the grounds that it does not bear a sufficient relationship to commercial practice. Clarification was also requested as to whether a provision for a minimum fee or other provision which is designed to permit recoupment of start-up costs would be a "penalty" under the proposed regulations. These provisions in the proposed regulations have been revised in response to the comments.

The exemption does not apply if the arrangement for services or office space involves fiduciary conflicts of interest described in section 406(b) of the Act. In this regard, the notices provided a description of a "safe harbor" as follows:

> Thus, a person who is a fiduciary with respect to a plan may not provide additional services to the plan and receive any compensation or other consideration in connection therewith, unless such provision of services is arranged and approved on behalf of the plan by a fiduciary who is independent of and unrelated to the fiduciary providing such services, who is not a party to such arrangement for the provision of services, who does not receive any compensation or other consideration with respect to such provision of services, and who has no other interest with respect to the transaction that might affect the exercise of such fiduciary's best judgment as a fiduciary.

§ 2550.408b-2(b)(1) (§ 54.4975-6(b)(1)).

Many comments were received criticizing the ambiguity of the above quoted provision. Further clarification was provided in the notice of hearing published on December 29, 1976, in the FEDERAL REGISTER. This notice was also criticized in various comments as being ambiguous with respect to the applicability of the "safe harbor" in certain common situations.

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[1] By notice appearing in the same issue of the FEDERAL REGISTER (41 FR 31838), the Internal Revenue Service announced that it had under consideration a proposal to adopt similar regulations.

[2] By notice appearing in this issue of the FEDERAL REGISTER, the Service has announced the adoption of similar regulations.

[3] References are to the parallel provisions of the proposed regulations issued by the Department and the proposed amendments issued by the Service, 29 and 26 CFR respectively. Reference to the parallel amendments of the Service are to the Pension Excise Tax Regulations (26 CFR Part 54) and are contained in the parentheses.

In response to these comments, this portion of the proposed regulations has been extensively revised to provide better guidance as to the circumstances under which the provision of services does or does not involve an act of self-dealing under section 406(b)(1) of the Act.

INVESTMENT IN DEPOSITS OF BANKS OR SIMILAR FINANCIAL INSTITUTIONS

Under the notices, investments in the deposits of a fiduciary bank or similar financial institution in some circumstances must meet certain requirements as to express authorization. § 2550.408b-4(b)(2) and (3) (§ 54.4975-6(c)(2)(ii) and (iii)).

Several comments objected that a requirement of express authorization in plan instruments of the specific investment would necessitate amending hundreds of plans, a procedure which the commentators stated would be administratively burdensome. Further clarification was requested as to the exact language which would constitute a sufficient authorization under the regulations and whether retroactive amendment of plan instruments would be permitted. Consequently, these requirements have been clarified.

ANCILLARY SERVICES BY BANKS OR SIMILAR FINANCIAL INSTITUTIONS

In the notices, attention was called to the proposed regulations dealing with the exemption in section 408(b)(6) of the Act and section 4975(d)(6) of the Code for the provision to a plan of ancillary services by a bank or similar financial institution which is a fiduciary with respect to the plan. The Act and the Code require that such ancillary services be provided subject to specific guidelines determined by the agencies after consultation with Federal and State supervisory authorities. The requirements for the specific guidelines were reserved in the notices, and comments were requested as to what provisions the guidelines should contain.

Section 2550.408b-6(c) has been reserved pending development of such guidelines. When such guidelines have been developed, a separate notice of proposed rulemaking will be prepared containing proposed § 2550.408b-6(c).

The notice proposed to require that ancillary services be furnished under an agreement which binds the bank or similar financial institution to comply with the guidelines for the furnishing of such ancillary services. § 2550.408b-6(b)(4) (§ 54.4975-6(d)(2)(iv)). Comments were received objecting to this condition on the grounds that it would involve unnecessary cost to plans and that compliance with the guidelines could be required by regulations. This requirement has been omitted.

TRANSITIONAL RULE FOR SERVICES

The notices directed attention to alternative interpretations of identical language contained in Act sections 414(c)(4) and 2003(c)(2)(D) for the transitional rule relating to the provision of services. In 26 CFR 53.4941(d)-4(c) (relating to acts of self-dealing involving private foundations), the Department of the Treasury interpreted similar language to mean that, in certain circumstances, a lease or loan must be renegotiated by the parties even though the terms of the pre-existing contract do not permit either party to insist upon an adjustment of the contract terms. The Service proposed to adopt a similar interpretation under Act section 2003(c)(2)(D). However, the Department did not propose to require renegotiation until renewal if the terms of the pre-existing contract did not permit an adjustment of the contract terms.

Because parallel provisions appear in both Act sections 414(c)(4) and 2003(c)(2)(D), the two agencies proposed to review public comments on these alternative interpretations and to adopt a uniform rule. After reviewing the public comments, the agencies have decided to adopt the interpretation in the notice issued by the Department, because of the substantial differences in the operation of employee benefit plans and private foundations under their respective transitional rules.

OTHER MATTERS

The attention of interested parties is directed to the fact that regulation 2550.408c-2 replaces Interpretive Bulletin 2509.75-6 (ERISA IB 75-6) and regulation 2550.414c-4 replaces Interpretive Bulletins 2509.75-1 (ERISA IB 75-1) and 2509.75-7 (ERISA IB 75-7).

In addition to the changes noted above that have been made in the regulation as adopted in response to suggestions made in the written comment letters and testimony given at the public hearing of February 14, 1977, other minor changes intended to clarify the provisions of the regulations have been made.

ADOPTION OF FINAL REGULATIONS

Accordingly, 29 CFR Part 2550 is amended as follows:

PARAGRAPH 1. Section 2550.408b-2 is inserted in the appropriate place to read as follows:

§ 2550.408b-2 General statutory exemption for services or office space.

(a) *In general.* Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406(a) of the Act payment by a plan to a party in interest, including a fiduciary, for office space or any service (or a combination of services) if (1) such office space or service is necessary for the establishment or operation of the plan; (2) such office space or service is furnished under a contract or arrangement which is reasonable; and (3) no more than reasonable compensation is paid for such office space or service. However, section 408(b)(2) does not contain an exemption from acts described in section 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account), section 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries) or section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the assets of the plan). Such acts are separate transactions not described in section 408(b)(2). See §§ 2550.408b-2(e) and (f) for guidance as to whether transactions relating to the furnishing of office space or services by fiduciaries to plans involve acts described in section 406(b)(1) of the Act. Section 408(b)(2) of the Act does not contain an exemption from other provisions of the Act, such as section 404, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 408(b)(2). See, for example, section 401 of the Internal Revenue Code of 1954. The provisions of section 408(b)(2) of the Act are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related persons).

(b) *Necessary service.* A service is necessary for the establishment or operation of a plan within the meaning of section 408(b)(2) of the Act and § 2550.408b-2(a)(1) if the service is appropriate and helpful to the plan obtaining the service in carrying out the purposes for which the plan is established or maintained. A person providing such a service to a plan (or a person who is a party in interest solely by reason of a relationship to such a service provider described in section 3(14)(F), (G), (H), or (I) of the Act) may furnish goods which are necessary for the establishment or operation of the plan in the course of, and incidental to, the furnishing of such service to the plan.

(c) *Reasonable contract or arrangement.* No contract or arrangement is reasonable within the meaning of section 408(b)(2) of the Act and § 2550.408b-2(a)(2) if it does not permit termination by the plan without penalty to the plan on reasonably short notice under the circumstances to prevent the plan from becoming locked into an arrangement that has become disadvantageous. A long-term lease which may be terminated prior to its expiration (without penalty to the plan) on reasonably short notice under the circumstances is not generally an unreasonable arrangement merely because of its long term. A provision in a contract or other arrangement which reasonably compensates the service provider or lessor for loss upon early termination of the contract, arrangement or lease is not a penalty. For example, a minimal fee in a service contract which is charged to allow recoupment of reasonable startup costs is not a penalty. Similarly, a provision in a lease for a termination fee that covers reasonably foreseeable expenses related to the vacancy and reletting of the office space upon early termination of the lease is not a penalty. Such a provision does not rea-

sonably compensate for loss if it provides for payment in excess of actual loss or if it fails to require mitigation of damages.

(d) *Reasonable compensation.* Section 408(b)(2) of the Act and § 2550.408b–2(a)(3) permit a plan to pay a party in interest reasonable compensation for the provision of office space or services described in section 408(b)(2). Section 2550.408c–2 of these regulations contains provisions relating to what constitutes reasonable compensation for the provision of services.

(e) *Transactions with fiduciaries.*—(1) *In general.* If the furnishing of office space or a service involves an act described in section 406(b) of the Act (relating to acts involving conflicts of interest by fiduciaries), such an act constitutes a separate transaction which is not exempt under section 408(b)(2) of the Act. The prohibitions of section 406(b) supplement the other prohibitions of section 406(a) of the Act by imposing on parties in interest who are fiduciaries a duty of undivided loyalty to the plans for which they act. These prohibitions are imposed upon fiduciaries to deter them from exercising the authority, control, or responsibility which makes such persons fiduciaries when they have interests which may conflict with the interests of the plans for which they act. In such cases, the fiduciaries have interests in the transactions which may affect the exercise of their best judgment as fiduciaries. Thus, a fiduciary may not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay an additional fee to such fiduciary (or to a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) to provide a service. Nor may a fiduciary use such authority, control, or responsibility to cause a plan to enter into a transaction involving plan assets whereby such fiduciary (or a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary) will receive consideration from a third party in connection with such transaction. A person in which a fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary includes, for example, a person who is a party in interest by reason of a relationship to such fiduciary described in section 3(14)(E), (F), (G), (H), or (I).

(2) *Transactions not described in section 406(b)(1).* A fiduciary does not engage in an act described in section 406(b)(1) of the Act if the fiduciary does not use any of the authority, control or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by such fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may affect the exercise of such fiduciary's best judgment as a fiduciary. This may occur, for example, when one fiduciary is retained on behalf of a plan by a second fiduciary to provide a service for an additional fee. However, because the authority, control or responsibility which makes a person a fiduciary may be exercised "in effect" as well as in form, mere approval of the transaction by a second fiduciary does not mean that the first fiduciary has not used any of the authority, control or responsibility which makes such person a fiduciary to cause the plan to pay the first fiduciary an additional fee for a service. See paragraph (f) below.

(3) *Services without compensation.* If a fiduciary provides services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of § 2550.408c–2(b)(3)), the provision of such services does not, in and of itself, constitute an act described in section 406(b) of the Act. The allowance of a deduction to an employer under section 162 or 212 of the Code for the expense incurred in furnishing office space or services to a plan established or maintained by such employer does not constitute compensation or other consideration.

(f) *Examples.* The provisions of § 2550.408b–2(e) may be illustrated by the following examples.

Example (1). E, an employer whose employees are covered by plan P, is a fiduciary of P. I is a professional investment adviser in which E has no interest which may affect the exercise of E's best judgment as a fiduciary. E causes P to retain I to provide certain kinds of investment advisory services of a type which causes I to be a fiduciary of P under section 3(21)(A)(ii) of the Act. Thereafter, I proposes to perform for additional fees portfolio evaluation services in addition to the services currently provided. The provision of such services is arranged by I and approved on behalf of the plan by E. I has not engaged in an act described in section 406(b)(1) of the Act, because I did not use any of the authority, control or responsibility which makes I a fiduciary (the provision of investment advisory services) to cause the plan to pay I additional fees for the provision of the portfolio evaluation services. E has not engaged in an act which is described in section 406(b)(1). E, as the fiduciary who has the responsibility to be prudent in his selection and retention of I and the other investment advisers of the plan, has an interest in the purchase by the plan of portfolio evaluation services. However, such an interest is not an interest which may affect the exercise of E's best judgment as a fiduciary.

Example (2). D, a trustee of plan P with discretion over the management and disposition of plan assets, relies on the advice of C, a consultant to P, as to the investment of plan assets, thereby making C a fiduciary of the plan. On January 1, 1978, C recommends to D that the plan purchase an insurance policy from U, an insurance company which is not a party in interest with respect to P. C thoroughly explains the reasons for the recommendation and makes a full disclosure concerning the fact that C will receive a commission from U upon the purchase of the policy by P. D considers the recommendation and approves the purchase of the policy by P. C receives a commission. Under such circumstances, C has engaged in an act described in section 406(b)(1) of the Act (as well as sections 406(b)(2) and (3) of the Act) because C is in fact exercising the authority, control or responsibility which makes C a fiduciary to cause the plan to purchase the policy. However, the transaction is exempt from the prohibited transaction provisions of section 406 of the Act, if the requirements of Prohibited Transaction Exemption 77–9 are met.

Example (3). Assume the same facts as in Example (2) except that the nature of C's relationship with the plan is not such that C is a fiduciary of P. The purchase of the insurance policy does not involve an act described in section 406(b)(1) of the Act (or sections 406(b)(2) or (3) of the Act) because such sections only apply to acts by fiduciaries.

Example (4). E, an employer whose employees are covered by plan P, is a fiduciary with respect to P. A, who is not a party in interest with respect to P, persuades E that the plan needs the services of a professional investment adviser and that A should be hired to provide the investment advice. Accordingly, E causes P to hire A to provide investment advice of the type which makes A a fiduciary under § 2510.3–21(c)(1)(ii)(B). Prior to the expiration of A's first contract with P, A persuades E to cause P to renew A's contract with P to provide the same services for additional fees in view of the increased costs in providing such services. During the period of A's second contract, A provides additional investment advice services for which no additional charge is made. Prior to the expiration of A's second contract, A persuades E to cause P to renew his contract for additional fees in view of the additional services A is providing. A has not engaged in an act described in section 406(b)(1) of the Act, because A has not used any of the authority, control or responsibility which makes A a fiduciary (the provision of investment advice) to cause the plan to pay additional fees for A's services.

Example (5). F, a trustee of plan P with discretion over the management and disposition of plan assets, retains C to provide administrative services to P of the type which makes C a fiduciary under section 3(21)(A)(iii). Thereafter, C retains F to provide for additional fees actuarial and various kinds of administrative services in addition to the services F is currently providing to P. Both F and C have engaged in an act described in section 406(b)(1) of the Act. F, regardless of any intent which he may have had at the time he retained C, has engaged in such an act because F has, in effect, exercised the authority, control or responsibility which makes F a fiduciary to cause the plan to pay F additional fees for the services. C, whose continued employment by P depends on F, has also engaged in such an act, because C has an interest in the transaction which might affect the exercise of C's best judgment as a fiduciary. As a result, C has dealt with plan assets in his own interest under section 406(b)(1).

Example (6). F, a fiduciary of plan P with discretionary authority respecting the management of P, retains S, the son of F, to provide for a fee various kinds of administrative services necessary for the operation of the plan. F has engaged in an act described in section 406(b)(1) of the Act because S is a person in whom F has an interest which may affect the exercise of F's best judgment as a fiduciary. Such act is not exempt under section 408(b)(2) of the Act irrespective of whether the provision of the services by S is exempt.

Example (7). T, one of the trustees of plan P, is president of bank B. The bank proposes to provide administrative services to P for a fee. T physically absents himself from all consideration of B's proposal and does not otherwise exercise any of the authority, control or responsibility which makes T a fiduciary to cause the plan to retain B. The

other trustees decide to retain B. T has not engaged in an act described in section 406(b)(1) of the Act. Further, the other trustees have not engaged in an act described in section 406(b)(1) merely because T is on the board of trustees of P. This fact alone would not make them have an interest in the transaction which might affect the exercise of their best judgment as fiduciaries.

PAR. 2. Section 2550.408b–4 is inserted in the appropriate place to read as set forth below:

§ 2550.408b–4 Statutory exemption for investments in deposits of banks or similar financial institutions.

(a) *In general.* Section 408(b)(4) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406 of the Act the investment of all or a part of a plan's assets in deposits bearing a reasonable rate of interest in a bank or similar financial institution supervised by the United States or a State, even though such bank or similar financial institution is a fiduciary or other party in interest with respect to the plan, if the conditions of either § 2550.408b–4(b)(1) or § 2550.408–4(b)(2) are met. Section 408(b)(4) provides an exemption from sections 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account) and 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries), as well as section 406(a)(1), because section 408(b)(4) contemplates a bank or similar financial institution causing a plan for which it acts as a fiduciary to invest plan assets in its own deposits if the requirements of section 408(b)(4) are met. However, it does not provide an exemption from section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the assets of the plan). The receipt of such consideration is a separate transaction not described in the statutory exemption. Section 408(b)(4) does not contain an exemption from other provisions of the Act, such as section 304, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 408(b)(4) of the Act. See, for example, section 401 of the Internal Revenue Code of 1954 (Code). The provisions of section 408(b)(4) of the Act are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related persons).

(b)(1) *Plan covering own employees.* Such investment may be made if the plan is one which covers only the employees of the bank or similar financial institution, the employees of any of its affiliates, or the employees of both.

(2) *Other plans.* Such investment may be made if the investment is expressly authorized by a provision of the plan or trust instrument or if the investment is expressly authorized (or made) by a fiduciary of the plan (other than the bank or similar financial institution or any of its affiliates) who has authority to make such investments, or to instruct the trustee or other fiduciary with respect to investments, and who has no interest in the transaction which may affect the exercise of such authorizing fiduciary's best judgment as a fiduciary so as to cause such authorization to constitute an act described in section 406(b) of the Act. Any authorization to make investments contained in a plan or trust instrument will satisfy the requirement of express authorization for investments made prior to November 1, 1977. Effective November 1, 1977, in the case of a bank or similar financial institution that invests plan assets in deposits in itself or its affiliates under an authorization contained in a plan or trust instrument, such authorization must name such bank or similar financial institution and must state that such bank or similar financial institution may make investments in deposits which bear a reasonable rate of interest in itself (or in an affiliate).

(3) *Example.* B, a bank, is the trustee of plan P's assets. The trust instruments give the trustees the right to invest plan assets in its discretion. B invests in the certificates of deposit of bank C, which is a fiduciary of the plan by virtue of performing certain custodial and administrative services. The authorization is sufficient for the plan to make such investment under seciton 408(b)(4). Further, such authorization would suffice to allow B to make investments in deposits in itself prior to November 1, 1977. However, subsequent to October 31, 1977, B may not invest in deposits in itself, unless the plan or trust instrument specifically authorizes it to invest in deposits of B.

(c) *Definitions.* (1) The term "bank or similar financial institution" includes a bank (as defined in section 581 of the Code), a domestic building and loan association (as defined in section 7701(a)(19) of the Code), and a credit union (as defined in section 101(6) of the Federal Credit Union Act).

(2) A person is an affiliate of a bank or similar financial institution if such person and such bank or similar financial institution would be treated as members of the same controlled group of corporations or as members of two or more trades or businesses under common control within the meaning of section 414(b) or (c) of the Code and the regulations thereunder.

(3) The term "deposits" includes any account, temporary or otherwise, upon which a reasonable rate of interest is paid, including a certificate of deposit issued by a bank or similar financial institution.

PAR. 3. Section 2550.408b–6 is inserted in the appropriate place to read as set forth below:

§ 2550.408b–6 Statutory exemption for ancillary services by a bank or similar financial institution.

(a) *In general.* Section 408(b)(6) of the Employee Retirement Income Security Act of 1974 (the Act) exempts from the prohibitions of section 406 of the Act the provision of certain ancillary services by a bank or similar financial institution (as defined in § 2550.408b–4(c)(1)) supervised by the United States or a State to a plan for which it acts as a fiduciary if the conditions of § 2550.408b–6(b) are met. Such ancillary services include services which do not meet the requirements of section 408(b)(2) of the Act because the provision of such services involves an act described in section 406(b)(1) of the Act (relating to fiduciaries dealing with the assets of plans in their own interest or for their own account) by the fiduciary bank or similar financial institution or an act described in section 406(b)(2) of the Act (relating to fiduciaries in their individual or in any other capacity acting in any transaction involving the plan on half of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries). Section 408(b)(6) provides an exemption from sections 406(b)(1) and (2) because section 408(b)(6) contemplates the provision of such ancillary services without the approval of a second fiduciary (as described in § 2550.408b–2(e)(2)) if the conditions of § 2550.408b–6(b) are met. Thus, for example, plan assets held by a fiduciary bank which are reasonably expected to be needed to satisfy current plan expenses may be placed by the bank in a non-interest-bearing checking account in the bank if the conditions of § 2550.408b–6(b) are met, notwithstanding the provisions of section 408(b)(4) of the Act (relating to investments in bank deposits). However, section 408(b)(6) does not provide an exemption for an act described in section 406(b)(3) of the Act (relating to fiduciaries receiving consideration for their own personal account from any party dealing with a plan in connection with a transaction involving the assets of the plan). The receipt of such consideration is a separate transaction not described in section 408(b)(6). Section 408(b)(6) does not contain an exemption from other provisions of the Act, such as section 404, or other provisions of law which may impose requirements or restrictions relating to the transactions which are exempt under section 408(b)(6) of the Act. See, for example, section 401 of the Internal Revenue Code of 1954. The provisions of section 408(b)(6) of the Act are further limited by section 408(d) of the Act (relating to transactions with owner-employees and related persons).

(b) *Conditions.* Such service must be provided—

(1) At not more than reasonable compensation;

(2) Under adequate internal safeguards which assure that the provision of such service is consistent with sound banking and financial practice, as determined by Federal or State supervisory authority; and

(3) Only to the extent that such service is subject to specific guidelines issued by the bank or similar financial institution which meet the requirements of § 2550.408b–6(c).

(c) *Specific guidelines.* [Reserved]

PAR. 4. Section 2550.408c-2 is inserted in the appropriate place to read as set forth below:

§ 2550.408c-2 Compensation for services.

(a) *In general.* Section 408(b)(2) of the Employee Retirement Income Security Act of 1974 (the Act) refers to the payment of reasonable compensation by a plan to a party in interest for services rendered to the plan. Section 408(c)(2) of the Act and §§ 2550.408c-2(b)(1) through 2550.408c-2(b)(4) clarify what constitutes reasonable compensation for such services.

(b)(1) *General rule.* Generally, whether compensation is "reasonable" under sections 408(b)(2) and 408(c)(2) of the Act depends on the particular facts and circumstances of each case.

(2) *Payments to certain fiduciaries.* Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation" does not include any compensation to a fiduciary who is already receiving full-time pay from an employer or association of employers (any of whose employees are participants in the plan) or from an employee organization (any of whose members are participants in the plan), except for the reimbursement of direct expenses properly and actually incurred and not otherwise reimbursed. The restrictions of this paragraph (b)(2) do not apply to a party in interest who is not a fiduciary.

(3) *Certain expenses not direct expenses.* An expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.

(4) *Expense advances.* Under sections 408(b)(2) and 408(c)(2) of the Act, the term "reasonable compensation", as applied to a fiduciary or an employee of a plan, includes an advance to such a fiduciary or employee by the plan to cover direct expenses to be properly and actually incurred by such person in the performance of such person's duties with the plan if:

(i) The amount of such advance is reasonable with respect to the amount of the direct expense which is likely to be properly and actually incurred in the immediate future (such as during the next month); and

(ii) The fiduciary or employee accounts to the plan at the end of the period covered by the advance for the expenses properly and actually incurred.

(5) *Excessive compensation.* Under sections 408(b)(2) and 408(c)(2) of the Act, any compensation which would be considered excessive under 26 CFR 1.162-7 (Income Tax Regulations relating to compensation for personal services which constitutes an ordinary and necessary trade or business expense) will not be "reasonable compensation". Depending upon the facts and circumstances of the particular situation, compensation which is not excessive under 26 CFR 1.162-7 may, nevertheless, not be "reasonable compensation" within the meaning of sections 408(b)(2) and 408(c)(2) of the Act.

PAR. 5. Section 2550.414(c)-4 is inserted in the appropriate place to read as follows:

§ 2550.414c-4 Transitional rule for the provision of certain services until June 30, 1977.

(a) *In general.* Section 414(c)(4) of the Employee Retirement Income Security Act of 1974 (the Act) provides that sections 406 and 407(a) shall not apply to the provision of services before June 30, 1977, between a plan and a party in interest if the three requirements contained in section 414(c)(4) are met. The first requirement is that such services must be provided either (1) under a binding contract in effect on July 1, 1974 (or pursuant to a renewal or modification of such contract), or (2) by a party in interest who ordinarily and customarily furnished such services on June 30, 1974. The second requirement is that the services be provided on terms that remain at least as favorable to the plan as an arm's-length transaction with an unrelated party would be. For this purpose, such services are provided on terms that remain at least as favorable to the plan as an arm's-length transaction with an unrelated party would be, if at the time of execution (or renewal) of such binding contract, the contract (or renewal) is on terms at least as favorable to the plan as an arm's-length transaction with an unrelated party would be. However, if in a normal commercial setting an unrelated party in the position of the plan could be expected to insist upon a renegotiation or termination of a binding contract, the plan must so act. Thus, for example, if a party in interest provides services to a plan on a month-to-month basis, and a party in the position of the plan could be expected to renegotiate the price paid under such contract because of a decline in the fair market value of such services, the plan must so act in order to avoid participation in a prohibited transaction. The third requirement is that the provision of services must not be, or have been, at the time of such provision a prohibited transaction within the meaning of section 503(b) of the Internal Revenue Code of 1954 or the corresponding provisions of prior law. If these three requirements are met, section 406 of the Act will apply neither to services provided before June 30, 1977 (both to customers to whom such services were being provided on June 30, 1974, and to new customers) nor to the receipt of compensation therefor. Thus, if these three requirements are met, section 406 of the Act will not apply until June 30, 1977, to the provision of services to a plan by a party in interest (including a fiduciary) even if such services could not be furnished pursuant to the exemption provisions of sections 408(b)(2) or (6) of the Act and §§ 2550.408b-2 and 2550.408b-6. For example, if the three requirements of section 414(c)(4) of the Act are met, a person serving a fiduciary to a plan who already receives full-time pay from an employer or an association of employers, whose employees are participants in such plan, or from an employee organization whose members are participants in such plan, may continue to receive reasonable compensation from the plan for services rendered to the plan before June 30, 1977. Similarly, until June 30, 1977, a plan consultant who may be a fiduciary because of the nature of the consultative and administrative services being provided may, if these three requirements are met, continue to cause the sale of insurance to the plan and continue to receive commissions for such sales from the insurance company writing the policy. Further, if the three requirements of section 414(c)(4) of the Act are met, a securities broker-dealer who renders investment advice to a plan for a fee, thereby becoming a fiduciary, may furnish other services to the plan, such as brokerage services, and receive compensation therefor. Also, if a registered representative of such a broker-dealer were a fiduciary, the registered representative may receive compensation, including commissions, for brokerage services performed before June 30, 1977.

(b) *Persons deemed to be June 30, 1974, service providers.* A party in interest with respect to a plan which did not, on June 30, 1974, ordinarily and customarily furnish a particular service, will nevertheless be considered to have ordinarily and customarily furnished such service on June 30, 1974, for purposes of this section and section 414(c)(4) of the Act, if either of the following conditions are met:

(1) At least 50 percent of the outstanding beneficial interests of such party in interest are owned directly or through one or more intermediaries by the same person or persons who owned, directly or through one or more intermediaries, at least 50 percent of the outstanding beneficial interests of a person who ordinarily and customarily furnished such service on June 30, 1974; or

(2) Control or the power to exercise a controlling influence over the management and policies of such party in interest is possessed, directly or through one or more intermediaries, by the same person or persons who possessed, directly or through one or more intermediaries, control or the power to exercise a controlling influence over the management and policies of a person who ordinarily and customarily furnished such service on June 30, 1974.

For purposes of paragraph (b) of this section, a person shall be deemed to be an "intermediary" of another person if at least 50 percent of the outstanding beneficial interests of such person are owned by such other person, directly or indirectly, or if such other person controls or has the power to exercise a controlling influence over the management and policies of such person.

(c) *Examples.* The following examples apply the principles enunciated in paragraph (b) this section.

Example (1). A owns 50 percent of the outstanding beneficial interests of ABC Partnership which ordinarily and customarily furnished certain services on June 30, 1974. On July 2, 1974, ABC Partnership was incorporated into ABC Corporation with one class of stock outstanding. A owns 50 percent of the shares of such stock. ABC Corporation furnishes the same services that were furnished by ABC Partnership on June 30, 1974. ABC Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 414(c)(4) of the Act.

Example (2). A and B together own 100 percent of the beneficial interests of AB Partnership, which ordinarily and customarily furnished certain services on June 30, 1974. On September 1, 1974, AB Partnership was incorporated into AB Corporation with one class of stock outstanding. A and B each own 20 percent of such outstanding class of stock and together have control over the management and policies of AB Corporation. AB Corporation furnishes the same services that were furnished by AB Partnership on June 30, 1974. AB Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 141(c)(4) of the Act.

Example (3). On June 30, 1974, M Corporation was ordinarily and customarily furnishing certain services. On that date, X, Y, and Z together owned 50 percent of all classes of the outstanding shares of M Corporation. On January 28, 1975, all of the shareholders of M Corporation exchanged their shares in M Corporation for shares of a new N Corporation. As a result of that exchange, X, Y, and Z together own 50 percent of the common stock of N Corporation, the only class of N Corporation stock outstanding after the exchange. N Corporation furnishes the services formerly furnished by M Corporation. N Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 414(c)(4) of the Act.

Example (4). I Corporation ordinarily and customarily furnished certain services on June 30, 1974. On November 3, 1975, I Corporation organizes a wholly-owned subsidiary, S Corporation, which furnishes the same services ordinarily and customarily furnished by I Corporation on June 30, 1974. S Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 414(c)(4) of the Act.

Example (5). X Corporation, wholly owned and controlled by A, ordinarily and customarily furnished certain services on June 30, 1974. Y Corporation did not perform such services on that date. On January 2, 1976, X Corporation is merged into Y Corporation and, although A received less than 50 percent of the total outstanding shares of Y Corporation, after such merger A has control over the management and policies of Y Corporation. Y Corporation furnishes the same services that were formerly furnished by X Corporation. Y Corporation will be deemed to have ordinarily and customarily furnished such services on June 30, 1974, for purposes of section 414(c)(4) of the Act.

Signed at Washington, D.C., this 14th day of June 1977.

IAN D. LANOFF,
Administrator of Pension and Welfare Benefit Programs, U.S. Department of Labor.

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DEPARTMENT OF LABOR

Office of Pension and Welfare Benefit Programs

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[Prohibited Transaction Exemption]

EMPLOYEE BENEFIT PLANS

Class Exemption for Certain Transactions Involving Insurance Agents and Brokers, Pension Consultants, Insurance Companies, Investment Companies and Investment Company Principal Underwriters and Employee Benefit Plans

AGENCIES: Department of Labor, Department of Treasury/Internal Revenue Service.

ACTION: Grant of class exemption.

SUMMARY: This class exemption exempts from the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975 of the Internal Revenue Code of 1954 (the Code) certain transactions involving employee benefit plans and insurance agents and brokers, pension consultants, insurance companies, investment companies and investment company principal underwriters for, or in connection with the purchase of insurance or annuity contracts and the purchase or sale of securities issued by an investment company, if certain conditions are met. Such persons, because of their activities with respect to employee benefit plans, may be considered fiduciaries or other parties in interest[1] of such plans, thus rendering the described transactions prohibited transactions within the meaning of section 406 of the Act and section 4975 of the Code. The exemption affects participants and beneficiaries of employee benefit plans, their employers, and persons engaging in the described transactions.

FOR FURTHER INFORMATION CONTACT:

Mr. Forrest Foss, Room C-4508, Plan Benefits Security Division, Office of the Solicitor, Department of Labor, 200 Constitution Avenue, NW., Washington, D.C. 20210, 202-523-6856. Mr. Elliot Daniel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: E:EP:PT 202-566-3089. (These are not toll free numbers.)

SUPPLEMENTAL INFORMATION: On December 29, 1976, notice was published in the FEDERAL REGISTER (41 FR 56760) (reprinted on January 7, 1977 (42 FR 1525)) 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 sections 406(a)(1)(A) through (D) and 406(b) of the Act and from the taxes imposed by section 4975 of the Code. The class exemption was requested in applications filed pursuant to section 408(a) of the Act and section 4975(c)(2) of the Code by the National Association of Pension Consultants and Administrators, Inc. (Application No. D-183); jointly by the American Council of Life Insurance, the National Association of Life Underwriters, and the Association for Advanced Life Underwriting (Application No. D-301); the Investment Company Institute (Application Nos. D-419 and D-466); jointly by Marsh and McLennan Companies, Inc. and Johnson and Higgins (Application No. D-459); and jointly by Investors Diversified Services, Inc. and American General Capital Distributors, Inc. (Application No. D-473).

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. In addition, pursuant to notice published in the FEDERAL REGISTER (41 FR 56758, December 29, 1976), a public hearing was held on February 14, 1977, in which interested persons were afforded the opportunity to present their views on the proposed exemption.

In response to numerous comments, the exemption has been adopted by the Agencies in restructured form. In order to illustrate the operation of the exemption, as revised and adopted, the Agencies have set forth below a summary of its operation and effect. After the summary, there is a discussion of major comments received by the Agencies with respect to the proposed exemption, and a discussion of how these comments were treated in the exemption as adopted. In addition, the Agencies have published elsewhere in this issue of the FEDERAL REGISTER a proposal to impose two additional conditions on the exemption, but these conditions would be applicable only to transactions occurring after December 31, 1978.

EXPLANATION OF THE OPERATION OF THE EXEMPTION

1. *Transactions covered.* The exemption relates to six different classes of transactions involving insurance agents or brokers, pension consultants, insurance companies, investment companies, and investment company principal underwriters who, because of their activities with respect to plans, may be considered to be fiduciaries or other parties in interest of such plans, thus rendering the transactions described prohibited transactions within the meaning of section 406 of the Act and 4975(c)(1) of the Code. These transactions are set forth in section III, and describe situations involving the purchase of insurance or annuity contracts or the purchase or sale of securities issued by an investment company. The transactions are stated in general terms, thereby encompassing a broad range of transactions which could be prohibited but for the exemption. However, as described below, conditions imposed upon the exemption limit its availability for purchases made after October 31, 1977 to transactions involving only certain categories of parties in interest (see section V(a)).

The first three transactions cover the effecting by insurance agents or brokers, pension consultants, or investment company principal underwriters of the purchase with plan assets of insurance or annuity contracts or securities issued by an investment company and the receipt of commissions in connection with such purchase (see sections III (a), (b) and (c)). Paragraph (d) of section III covers the purchase with plan assets of an insurance or annuity contract from an insurance company.

The last two transactions, covered by sections III (e) and (f), are not subject to many of the conditions imposed on the first four transactions (see section V). These last two transactions are limited to purchases with plan assets of insurance or annuity contracts or securities issued by an investment company in situations where the insurance company, investment company or investment company principal underwriter is a fiduciary or service provider of the plan solely by reason of sponsorship of a master or prototype plan. These transactions contemplate situations in which the insurance company, investment company or investment company principal underwriter is a party in interest of a plan by reason of its sponsorship of a master or prototype plan (including its authority to make changes in the master or prototype plan) but has no other relationship to the plan, such as being an investment adviser to the plan directly or through an affiliate. The Agencies have determined that it is appropriate to distinguish the transactions involving sponsorship of master and prototype plans from the other transactions and to apply different conditions thereto because a person who may be a fiduciary or other party in interest only because it is the sponsor of a master or prototype plan is not as likely to be able to influence the investments and other purchases of the plan as persons who are fiduciaries or parties in interest as a result of other relationships. Therefore, if the insurance company, investment company, or investment company principal underwriter is also a fiduciary or party in interest for a reason other than or in addition to sponsorship of a master or prototype plan, the exemptions afforded for transactions described by section III (e) and (f) are not available, but the exemptions afforded for transactions described by sections III (b), (c) and (d) are available, if the conditions applicable to such transactions are satisfied. Further, sections III (e) and (f) do not cover the insurance agent or broker, pension consultant or investment company principal underwriter who is a fiduciary to the plan and who sells an insurance or annuity contract or securities issued by an investment company to the plan in connection with a master or protoype plan. Such persons would have to meet the conditions applicable to the transactions

[1] The term "parties in interest", as used in this preamble, includes "disqualified persons" as defined in section 4975(e)(2) of the Code.

described by sections III (a), (b) and (c).

It should be noted that the terms "insurance or annuity contracts" and "securities issued by an investment company" are designed to encompass all products issued by an insurance company or an investment company in the ordinary course of its business. For example, these terms cover variable annuities and investment contracts issued by an insurance company and described in section 801(g)(1) of the Code and face amount certificates as defined in section 2(a)(15) of the Investment Company Act of 1940 (15 USC 80a–2(a)(15)).

It is further noted that, as used in this exemption, the terms "insurance agent or broker", "pension consultant", "insurance company", "investment company" and "principal underwriter" include all affiliates of such persons (see definitions in section VI).

2. *Conditions.* Section IV provides certain basic conditions for all transactions described in section III between plans and parties in interest (including fiduciaries) without regard to the date of such transaction. These conditions require that the transactions be effected in the ordinary course of business, that they be as favorable to the plan as those which would have been engaged in by the plan and such party in interest if they were unrelated parties, and that the total of all fees, commissions and other consideration received be reasonable.

Section V provides further conditions for transactions involving purchases effected after October 31, 1977. The conditions of section V do not apply to the sponsors of master and prototype plans as described in sections III(e) and (f).

Paragraph (a) of section V limits the categories of parties in interest for which this exemption is available to persons who are parties in interest to the plan solely because they are service providers or certain types of fiduciaries to the plan. For example, a pension consultant who is a plan administrator would not be eligible for relief under the exemption. It should also be noted that, in general, this exemption would not be required for the effecting of a sale to a plan and the receipt of a sales commission with respect to such sale by an agent, broker, consultant or principal underwriter who is a party in interest with respect to the plan for which the transaction is executed, if the person is not a fiduciary[*] and the provision of such services by the party in interest satisfies the conditions of the exemption set forth in section 408(b)(2) of the Act and 4975(d)(2) of the Code. In this regard, such nonfiduciary is referred to the final regulations appearing elsewhere in this issue of the FEDERAL REGISTER which clarify the scope of the statutory exemption.

Paragraph (b) imposes a requirement designed to prevent purchases from being approved on behalf of the plan by a fiduciary who might have a conflict of interest with respect to the transaction. In addition, the paragraph requires that the party in interest recommending the purchase convey to the approving fiduciary certain information with respect to the transaction, and that such fiduciary acknowledge in writing receipt of such information prior to approving the recommended transaction.

Paragraph (c) of section V provides for certain limited disclosures to the approving fiduciary. These disclosures are designed to elicit certain information about the relationship of the party in interest recommending the purchase to the issuer of the recommended contract or securities and the commissions which will be received by the party in interest in connection with the sale. It is expected that this information will make the approving fiduciary aware, generally, of a potential for conflict of interest on the part of the person recommending the transaction.

Paragraph (d), which is reserved, is intended to impose two additional conditions on the exemption, but these conditions would be applicable only to transactions occurring after December 31, 1978. It would require additional disclosures for purchases made with plan assets, and would restrict the scope of the exemption for transactions described in sections III (a) through (d) to those where the purchase is made on behalf of plans with a limited number of active participants. The specific terms of this paragraph are proposed elsewhere in this issue of the FEDERAL REGISTER and interested persons are referred to that proposal.

Paragraph (e) of section V relates to disclosure requirements with respect to additional purchases of contracts and securities. It states that once the disclosures required by paragraphs (c) and (d) have been made, they need not be repeated unless such disclosures were made more than three years before the transaction in question, or the product sold or the commission received with respect to the previous transaction is materially different from the instant transaction or commission.

Paragraphs (f) and (g) require that the insurance agent or broker, pension consultant, investment company principal underwriter or insurance company maintain certain records for six years from the date of the transaction. Paragraph (h)(2) requires that records maintained pursuant to paragraphs (f) and (g) be available for examination by specified persons, while paragraph (h)(1) deals with certain situations where the records are lost or destroyed prior to the end of six years.

3. *Retroactive relief.* Section I provides retroactive relief from all the restrictions of sections 406 of the Act and 4975(c)(1) of the Code with respect to transactions described in section III of the exemption if the conditions that apply to all the transactions (section IV) are met. This relief is provided for all transactions entered into prior to November 1, 1977, regardless of whether the terms of section V of this class exemption or the transition provisions of sections 414(c)(4) and 2003(c)(2)(D) of the Act are met, in order to provide sufficient opportunity for affected persons to modify their practices to comply with the conditions of the exemption.

4. *Prospective relief.* Section II affords prospective relief from the prohibitions of sections 406(a)(1)(A) through (D) and 406(b) of the Act and 4975(c)(1) of the Code for transactions described in section III of the exemption arising out of purchases made after October 31, 1977. If the transactions are described in sections III (e) and (f), the only conditions which must be satisfied are those contained in section IV; if the transactions are described in sections III (a) through (d), they must satisfy the conditions of both sections IV and V in order to be entitled to relief under the exemption.

DISCUSSION OF MAJOR COMMENTS

1. EXEMPT TRANSACTIONS AND COVERED PERSONS

Numerous comments were received requesting clarification as to whether the normal sales presentation and recommendations made to a plan or a plan fiduciary by an agent, broker, pension consultant or principal underwriter constitute the rendering of investment advice within the meaning of sections 3(21)(A)(ii) of the Act and 4975(e)(3)(B) of the Code and the regulations issued thereunder (29 CFR 2510.3–21(c) and 26 CFR 54.4975–9(c)). If they do, the receipt of a commission by such agent, broker, pension consultant or principal underwriter in connection with the purchase, with plan assets, of an insurance or annuity contract or securities issued by an investment company would constitute a prohibited transaction under sections 406 of the Act and 4975 of the Code for which an exemption would be required. As stated in the proposal, a determination of whether such sales presentation, recommendations, and advice constitute "investment advice" under section 3(21)(A)(ii) of the Act and section 4975(e)(3)(B) of the Code and the regulations issued thereunder can be made only on a case-by-case basis.

Several comments stated that the class exemption, as proposed, would not cover transactions engaged in by registered representatives of a principal underwriter because such persons were not "employees" of the principal underwriter, and, accordingly, were not affiliates of the principal underwriter. The definition of "affiliate," now in section VI(c) of the exemption, has been modified in response to these comments so as to make it clear that a registered representative is an affiliate of a principal underwriter. Commentators also pointed out that, technically, investment company securities are sold in both agency and principal transactions by principal underwriters. Accordingly, section III(c) of the exemption has been amended so

[*] For example, a person is not a fiduciary if the person's sales activities do not constitute investment advice and only non-discretionary administrative support services are rendered (and such person is not otherwise a fiduciary). In this connection, see question D–2 of Interpretive Bulletin 2509.75–8 (ERISA IB 75–8, 40 FR 47491).

that the "effecting" of such transactions are covered.

Numerous comments reflected a misunderstanding as to which agents, brokers, consultants, insurance companies, investment companies and principal underwriters that are fiduciaries or other parties in interest with respect to a plan would be eligible for relief under the exemption. Comments were also received respecting the types of services that such persons could provide to a plan under the exemption. In response to these comments, proposed sections III(a) and III(d)(1) have been combined and modified and are now contained in section V(a) of the exemption.

As noted above, all transactions described in section III, which would otherwise be prohibited transactions, are exempt if the purchase is made prior to November 1, 1977, and the conditions of section IV are met. However, for transactions involving purchases made after October 31, 1977, section V(a) of the final exemption limits the exemption to persons who are parties in interest with respect to a plan solely by reason of being a service provider, fiduciary, or both. Furthermore, as noted above, certain limitations are placed on the type of fiduciary activity in which such persons may engage.

Comments were received urging the Agencies not to apply certain of the conditions of the exemption to an insurance company, investment company or investment company principal underwriter that may be a fiduciary or party in interest with respect to a plan solely by reason of sponsoring a master or prototype plan which is adopted as the plan. These comments indicated that independent insurance brokers, or dealers in investment company shares, often market insurance or annuity contracts or securities issued by an investment company together with a master or prototype plan prepared by the insurance company or the investment company or its principal underwriter. In these situations, while the independent agents, brokers, consultants or dealers in investment company shares may be fiduciaries to the plan in connection with the transaction, the insurance company, investment company or its principal underwriter would not be involved with the plan other than as sponsor of the master or prototype plan (and as issuer of the contract or security which is purchased to fund the plan). In response to these comments, the Agencies have modified the exemption so that, as noted above, such sponsors of master or prototype plans are subject only to a limited number of the conditions of the exemption. As noted above, however, the person effecting the transaction for the purchase of an insurance or annuity contract or of securities issued by an investment company to fund a master or prototype plan (i.e., the agent, broker, consultant or principal underwriter) is subject fully to all conditions of the exemption.[3]

2. *Reasonable Compensation.* Proposed sections III(b)(1), III(c) and III(d)(2) are now contained in section IV of the exemption, and, as noted above, are applicable to all covered transactions.

The proposal was criticized for not containing specific guidance as to what constitutes reasonable compensation and various standards were suggested by which to measure reasonableness. The Agencies have decided not to incorporate these comments because the forms of compensation can vary substantially, and any determination as to whether or not the total amount of compensation is reasonable depends on the particular facts and circumstances of each case. A similar position has been adopted by the Agencies with respect to "reasonable compensation" in the regulations issued elsewhere in this issue of the FEDERAL REGISTER under section 408(c)(2) of the Act (29 CFR 2550.408c-2(b)(1)) and section 4975(d)(10) of the Code (26 CFR 54.4975-6(e)(2)).

Comments were also received urging the Agencies to alter the commission disclosure requirement to reflect commissions received over a longer base period. Although these comments have not been adopted, the Agencies wish to emphasize that the disclosure requirements of the final exemption set forth minimum requirements respecting commissions, and that disclosure of additional information is, to the extent it is not misleading or obfuscatory, permissible.

Comments also urged the Agencies to provide that in those cases where the amount of compensation is judged to be in excess of reasonable compensation, the "amount involved" for purposes of the assessment of the excise tax under sections 4975(a) and (b) of the Code or the civil penalty under section 502(i) of the Act be limited to the amount of the compensation in excess of reasonable compensation. The exemption has been modified to incorporate these comments. Finally, in response to confusion evidenced by various comments, the reasonable compensation test has been rephrased to clarify that it is the total compensation received (which includes all fees, commissions and other consideration) that must be reasonable.

3. *Approval by a fiduciary.* In response to numerous comments, section V(b) of the exemption, respecting fiduciary approval of the exempted transaction, clarifies that the employer of employees covered by the plan may assume the responsibility of being the approving fiduciary.

[3] If a dealer in investment company securities is not a principal underwriter with respect to the investment company whose securities are being recommended for purchase with plan assets, such dealer need not comply with the condition of this exemption, but is instead referred to Part II of Prohibited Transaction Exemption 75-1 (40 FR 50845).

4. *Dislosure.* Pursuant to comments, a variety of changes from the disclosure requirements of the proposal have been made.

Many comments were received criticizing the requirement of the proposal that the agent, broker, consultant or principal underwriter disclose the names of all insurance companies and investment companies with which such person is affiliated. The exemption, as adopted, has been modified in response to these comments and limits the disclosure in this area to information concerning the relationship between the insurance company or investment company whose contract or security is recommended and the person making the recommendation.

Comments suggested that the exemption be conditioned upon the disclosure of the dollar amount of commission to be received. The Agencies did not adopt this suggestion because disclosure of the percentage rate of commissions will be required, and this will provide comparable information to the approving fiduciary and will be more easily developed by the person claiming exemption.

The provisions of the proposal respecting disclosure of special instructions, special incentive arrangements and sources of substantial amounts of commission income have been deleted. Comments indicated a great deal of uncertainty as to the meaning of these terms and questioned their relevance to the inforamtion needed by the approving fiduciary. In addition, the Agencies believe that the other disclosure requirements of the exemption will be sufficient to alert an approving fiduciary to the extent of the potential conflict of interest of the person recommending the purchase.

Several comments were received with respect to the necessity for and frequency of disclosures which might be occasioned by additional purchases of contracts or securities. Some commentators urged the Agencies to require repeat disclosure only when the applicable contract or security, or the commission with respect thereto, is materially different from that for which the approval was obtained, while others urged that disclosure be required each year. The requirement of the exemption, as adopted, is intended to reach a middle ground and reflects the Agencies' position that the approving fiduciary needs sufficiently current information with which to make an informed judgment with respect to additional purchases of the recommended product.

5. *Recordkeeping, availability of records.* In response to comments, the recordkeeping requirements of the proposal have been modified to specify the records that the agent, broker, consultant, insurance company and principal underwriter must retain. Comments were received urging the Agencies to modify the proposal so as to limit the persons to whom the retained records would be

available. However, these suggestions have not been incorporated because the final exemption clearly delineates the records which must be retained.

In addition to the changes noted above which have been made in the exemption, as adopted, in response to suggestions made in the written comment letters and the testimony received at the public hearing of February 14, 1977, other changes intended to clarify the provisions of the exemption have been made.

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 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 December 29, 1976, (reprinted on January 7, 1977) and the testimony given at the public hearing of February 14, 1977, 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 for purchases described in section III of this exemption made before November 1, 1977, the restrictions of section 406 of the Employee Retirement Income Security Act of 1974 (the Act) and the taxes imposed by section 4975 of the Internal Revenue Code of 1954 (the Code) do not apply to any of the transactions described in section III if the conditions set forth in section IV are met.

Section II—Prospective. Effective for purchases described in Section III of this exemption made after October 31, 1977, the restrictions of section 406(a)(1)(A) through (D) and 406(b) of the Act and the taxes imposed by section 4975 of the Code do not apply to any of the transactions described in section III of this exemption if the conditions prescribed in sections IV and V of this exemption are met.

Section III—Transactions. (a) The receipt, directly or indirectly, by an insurance agent or broker or a pension consultant of a sales commission from an insurance company in connection with the purchase, with plan assets, of an insurance or annuity contract.

(b) The receipt of a sales commission by a principal underwriter for an investment company registered under the Investment Company Act of 1940 (hereinafter referred to as an investment company) in connection with the purchase, with plan assets, of securities issued by an investment company.

(c) The effecting by an insurance agent or broker, pension consultant or investment company principal underwriter of a transaction for the purchase, with plan assets, of an insurance or annuity contract or securities issued by an investment company.

(d) The purchase, with plan assets, of an insurance or annuity contract from an insurance company.

(e) The purchase, with plan assets, of an insurance or annuity contract from an insurance company which is a fiduciary or a service provider (or both) with respect to the plan solely by reason of the sponsorship of a master or prototype plan.

(f) The purchase of securities issued by an investment company with plan assets from, or the sale of such securities to, an investment company or investment company principal underwriter, when such investment company or principal underwriter is a fiduciary or a service provider (or both) with respect to the plan solely by reason of the sponsorship of a master or prototype plan.

Section IV—Conditions with Respect to Transactions Described in Section III. (a) The transaction is effected by the insurance agent or broker, pension consulant, insurance company or investment company principal underwriter in the ordinary course of its business as such a person.

(b) The transaction is on terms at least as favorable to the plan as an arm's-length transaction with an unrelated party would be.

(c) The combined total of all fees, commissions and other consideration received by the insurance agent or broker, pension consultant, insurance company, or investment company principal underwriter:

(1) For the provision of services to the plan; and

(2) In connection with the purchase of insurance or annuity contracts or securities issued by an investment company is not in excess of "reasonable compensation" within the contemplation of section 408(b)(2) and 408(c)(2) of the Act and sections 4975(d)(2) and 4975(d)(10) of Code. If such total is in excess of "reasonable compensation," the "amount involved" for purposes of the civil penalties of section 502(i) of the Act and the excise taxes imposed by section 4975(a) and (b) of the Code is the amount of compensation in excess of "reasonable compensation."

Section V—Conditions For Transactions Described in Section III(a) through (d): The following conditions apply solely to a transaction described in paragraphs (a), (b), (c) or (d) of section III:

(a) The insurance agent or broker, pension consultant, insurance company, or investment company principal underwriter is a party in interest or disqualified person solely by reason of being a service provider or fiduciary (or both) with respect to the plan, but is not a trustee of the plan, a plan administrator (within the meaning of section 3(16)(A) of the Act and section 414 (g) of the Code), a named fiduciary of the plan (within the meaning of section 402(a)(2) of the Act) or a fiduciary who is expressly authorized in writing to manage, acquire, or dispose of the assets of the plan on a discretionary basis.

(b) A fiduciary with respect to the plan, following receipt of the information required to be disclosed pursuant to paragraphs (c), (d), and (e) of this section, and, prior to the execution of the transaction, acknowledges in writing receipt of such information and approves the transaction on behalf of the plan. Such fiduciary may be an employer of employees covered by the plan, but may not be insurance agent or broker, pension consultant, insurance company, investment company, or investment company principal underwriter involved in the transaction. Such fiduciary may not receive, directly or indirectly (e.g., through an affiliate), any compensation or other consideration for his or her own personal account from any party dealing with the plan in connection with the transaction.

(c) The insurance agent or broker, pension consultant, insurance company, or investment company principal underwriter provides to the fiduciary referred to in paragraph (b) of this section, prior to the approval described in that paragraph, written disclosure of the information set forth below, which information shall be in a manner and form calculated to be understood by a plan fiduciary who

has no special expertise in insurance or investment matters:

(1) If the agent, broker, or consultant is an affiliate of the insurance company whose contract is being recommended, or if the ability of such agent, broker or consultant to recommend insurance or annuity contracts is limited by any agreement with such insurance company, or if the person recommending securities issued by an investment company is the principal underwriter of the investment company whose securities are being recommended, the nature of such affiliation, limitation, or relationship;

(2) The sales commission, expressed as a percentage of gross annual premium payments for the first year and for each of the succeeding renewal years, that will be paid by the insurance company to the agent, broker, or consultant in connection with the purchase of the recommended contract; and

(3) The sales commission, expressed as a percentage of the dollar amount of the plan's gross payment and of the amount actually invested, that will be received by the principal underwriter in connection with the purchase of the recommended securities issued by the investment company.

(d) In the case of any purchase made after December 31, 1978, [Reserved].

(e) With respect to additional purchases of insurance or annuity contracts or securities issued by an investment company, the written disclosure required under paragraphs (c) and (d) of this section V need not be repeated, unless—

(1) More than three years have passed since such disclosure was made with respect to the same kind of contract or security, or

(2) The contract or security being recommended for purchase or the commission with respect thereto is materially different from that for which the approval described in paragraph (b) of this section was obtained.

(f) In the case of any transaction described in paragraphs (a), (b), or (c) of section III, the insurance agent or broker, pension consultant or investment company principal underwriter shall retain or cause to be retained for a period of six years from the date of such transaction, the following:

(1) The information disclosed pursuant to paragraphs (c), (d), and (e) of this section V;

(2) Any additional information or documents provided to the fiduciary described in paragraph (b) of this section V with respect to such transaction; and

(3) The written acknowledgement described in paragraph (b) of this section.

(g) In the case of any transaction described in section III(d) (for which no insurance agent or broker or pension consultant is required to maintain records under section V(f)), the insurance company shall retain the materials described in paragraphs (f), (1), (2), and (3) of this section V for a period of six years from the date of such transaction.

(h) With respect to the records required to be retained pursuant to paragraph (f) or (g) of this section V:

(1) A prohibited transaction will not be deemed to have occurred if, due to circumstances beyond the control of the insurance agent or broker, pension consultant, principal underwriter, or insurance company, such records are lost or destroyed prior to the end of such six-year period.

(2) Notwithstanding anything to the contrary in sections 504 (a)(2) and (b) of the Act, such records are unconditionally available for examination during normal business hours by duly authorized employees or representatives of the Department of Labor, the Internal Revenue Service, plan participants and beneficiaries, any employer of plan participants and beneficiaries, and any employee organization any of whose members are covered by the plan.

Section VI—Definitions. For purposes of this exemption:

(a) The term "principal underwriter" is defined in the same manner as that term is defined in section 2(a)(29) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(29)).

(b) The terms "insurance agent or broker," "pension consultant," "insurance company," "investment company," and "principal underwriter" mean such persons and any affiliates thereof.

(c) The term "affiliate" of a person means:

(1) Any person directly or indirectly controlling, controlled by, or under common control with such person;

(2) Any officer, director, partner, employee (including, in the case of a principal underwriter, any registered representative thereof, whether or not such person is a common law employee of such principal underwriter), or relative of any such person;

(3) Any corporation or partnership of which such person is an officer, director, partner, or employee;

(d) The term "control" means the power to exercise a controlling influence over the management or policies of a person other than an individual.

(e) The term "relative" means a "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.

(f) The term "master or prototype plan" means a plan which is approved by the Service under Rev. Proc. 72-7, 1972-1 C.B. 715, or Rev. Proc. 72-8, 1972-1 C.B. 716, or their successors.

Signed at Washington, D.C., this 16th day of June, 1977.

IAN D. LANOFF,
Administrator, Pension and Welfare Benefit Programs, Department of Labor.

ALVIN D. LURIE,
Assistant Commissioner (Employee Plans and Exempt Organizations), Internal Revenue Service.

[FR Doc.77-17896 Filed 6-21-77;8:45 am]

EMPLOYEE BENEFIT PLANS

Proposal To Adopt Additional Conditions With Respect to Prohibited Transaction Exemption 77-9

AGENCIES: Department of Labor, Department of Treasury/Internal Revenue Service.

ACTION: Proposal to Impose Additional Conditions on Prohibited Transaction Exemption 77-9.

SUMMARY: This notice contains a proposal to impose two additional conditions on Prohibited Transaction Exemption 77-9, the class exemption relating to certain transactions engaged in by insurance agents and brokers, pension consultants, insurance companies, investment companies, and investment company principal underwriters published elsewhere in this issue of the FEDERAL REGISTER. The proposed conditions, which would be applicable only to certain transactions described in Prohibited Transaction Exemption 77-9 occurring after December 31, 1978, would restrict the scope of the exemption for such transactions to those entered into on behalf of employee benefit plans with a limited number of active participants, and would require the disclosure of additional information with respect to such transactions. The additional conditions are being published in proposed form in order to allow interested persons the opportunity to comment, and would affect participants and beneficiaries of employee benefit plans, their employers, and persons engaging in the transactions to which the proposed conditions would be applicable.

FOR FURTHER INFORMATION:

Mr. Forrest Foss, Room C-4508, Plan Benefits Security Division, Office of the Solicitor, Department of Labor, 200 Constitution Avenue NW., Washington, D.C. 20210 (202-523-5856).

Mr. Elliot Daniel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: E:EP:PT (202-566-3089).

(These are not toll free numbers.)

SUPPLEMENTARY INFORMATION: Notice is hereby given that the Department of Labor (Department) and the Internal Revenue Service (Service) have under consideration a proposal to adopt additional conditions with respect to the exemption provided by Prohibited Transaction Exemption 77-9, the class exemption relating to certain transactions engaged in by insurance agents and brokers, pension consultants, insurance companies, investment companies, and investment company principal underwriters published elsewhere in this issue of the FEDERAL REGISTER. These persons, because of the services they render to plans, may be fiduciaries or other parties in interest with respect to such plans and thereby precluded by reason of sections 406(a)(1)(A) through (D) and 406(b) of the Employee Retirement Income Security Act of 1974 (the Act) and section 4975(c)(1) of the Internal Revenue Code of

1954 (the Code) from engaging in the transactions described in Prohibited Transaction Exemption 77–9. The additional conditions would affect only those transactions described in paragraphs (a) through (d) of section III of Prohibited Transactions Exemption 77–9 which are entered into after December 31, 1978.

The proposal has two parts. The first part would limit the availability of the exemption to those transactions (described in sections III (a)–(d) of Prohibited Transaction Exemption 77–9) entered into on behalf of plans with less than 100 active participants at the time of the transaction. The applicants for the class exemption, and many of those submitting comments thereon, emphasized that small plans have limited financial resources and, therefore, must rely heavily on the services of insurance agents and brokers, pension consultants, insurance companies and investment company principal underwriters. The comments noted that if such persons were precluded from engaging in the transactions described in paragraphs (a) through (d) of section III of the class exemption, they could not provide services to the plans, to the detriment of the plans and their participants and beneficiaries. The Agencies, however, have not received adequate comment on how to identify these plans.

In this regard, with respect to defining a small plan for purposes of this exemption, comments were received suggesting that the exemption be limited to plans with 25 or fewer active participants.[1] These commentators seemed to have chosen this limit based upon their understanding that certain insurance or annuity contracts would be inappropriate for plans with more than 25 participants. The Agencies are concerned, however, that such a limitation of the exemption could restrict the operation of many plans which, while having more than 25 active participants, nevertheless have limited resources and would be unable to operate economically without the availability of this exemption. Accordingly, while the Agencies are proposing to limit the exemption to small plans, they have tentatively described such plans as those having less than 100 active participants.

In the notice which proposed Prohibited Transaction Exemption 77–9 (41 FR 56760, December 29, 1976), the Agencies indicated that satisfaction of the conditions therein would not permit a breach of the general fiduciary responsibility provisions of section 404(a)(1) of the Act or excuse a violation of the "exclusive benefit of employees" requirement contained in section 401(a) of the Code. By way of example, the Agencies stated that such a breach or violation might occur if a fiduciary with respect to the plan recommends or causes the plan to select a funding medium or investment which, under the particular circumstances, is not suitable for the plan. Thus, in the circumstances of a given case, an insurance agent who is a fiduciary with respect to a plan might be found to have breached his or her fiduciary responsibilities if he or she caused the plan to purchase individual insurance or annuity contracts or other high commission products when similar benefits or protections could have been secured at a lesser cost to the plan under a group contract.

With respect to this particular example, many commentators observed that differences exist between individual and group contracts, some of which may be important to plan beneficiaries and participants; other commentators suggested that the potential for abuse is so great with respect to transactions of the type described that an absolute limit of 25 participants be placed on the size of plans which could engage in transactions covered by the proposed class exemption. The Agencies recognize that every alleged breach of fiduciary duty must be analyzed in connection with the facts and circumstances particular to that transaction. Therefore, the described example should not be interpreted to mean that a sale by an insurance agent who is a fiduciary to a plan of individual contracts to such plan would necessarily involve a breach of fiduciary duty. Similarly, with respect to the described example, the Agencies' determination to propose that the class exemption afford relief only where plans engaging in described transactions have less than 100 active participants should not be viewed as an interpretation by the Agencies that purchases of individual contracts would not involve a breach of fiduciary duty if the plan has less than 100 active participants. As explained above, the proposed delineation of "small" plans was determined primarily upon concerns as to the ability of a plan to secure certain necessary services, and many circumstances must be evaluated in determining whether the choice of a particular funding medium for a plan is in violation of section 404(a)(1) of the Act or the "exclusive benefit" rule of section 401(a) of the Code.

The second part of the amendment pertains to disclosure of information concerning various characteristics of the insurance or annuity contract or securities issued by an investment company recommended to the plan for purchase with plan assets. The disclosures required by the original proposal (41 FR 56760) were criticized in various comments as being misleading because they focused entirely on the commission and related forms of compensation of the agent, broker, consultant or principal underwriter, and ignored other information which would be useful to a plan seeking to evaluate the benefits available under a recommended insurance or investment company product. The proposed amendment would require disclosure of information relating to the nature of the contract or security being recommended for purchase, as well as the potential conflict of interest of the person making the recommendation. Specifically, the proposal would require disclosures relating to the cash surrender value of the insurance or annuity contract, the guaranteed rate of return, if any, with respect to the contract, and various provisions of the contract or security which could adversely affect benefits contemplated thereunder. Thus, the additional condition is designed to allow a fiduciary of the plan to make a more informed and independent judgment as to the suitability of purchasing the contract or security for the plan.

The proposal would require that the mandated disclosures be written in a manner and form calculated to be understood by a plan fiduciary who has no special expertise in insurance and investment matters. Generally, this will mean that technical, complex and legal jargon be eliminated and that easily understood examples and illustrations be provided. For example, it is anticipated that the disclosures relating to cash surrender value would be made in a tabular or graphic form that would facilitate a clear understanding of the information being presented. All information required to be disclosed should be clearly understandable without the necessity of referring to any other document. It is expected that any description of exceptions, limitations, reductions and other restrictions on benefits provided under the contract or security will not be minimized, rendered obscure or otherwise made to appear unimportant. Such exceptions, limitations, reductions or restrictions on benefits should be described in a manner which is not less prominent than the style, captions, printing type and prominence used to describe benefits. The disclosure should not be written in a way that emphasizes the benefits of the product being recommended and de-emphasizes any terms or provisions of the product which would adversely affect such benefits. In short, all disclosures respecting the nature of the product being recommended must be fair and even handed, but, of course, need not follow the order of items as set forth in the exemption.

These conditions are proposed to be effective only for purchases after December 31, 1978, to enable the Agencies to receive further comment from affected persons. All interested persons are invited to submit written comments on the proposal to adopt additional conditions to Prohibited Transaction Exemption 77–9 set forth below. In order to receive consideration, such comments should be received by the Department of Labor on or before September 30, 1977. In addition, any interested person may submit a written request that a hearing be held relating to the proposed additional conditions to Prohibited Transaction Exemption 77–9. Such written request must be received by the Department on or before September 30, 1977, and should state the reasons for such person's request for a hearing and the nature of such person's interest in the proposed additional conditions.

All written comments and all requests for a hearing (at least six copies) should

[1] Other commentators urged the Agencies to issue an exemption without regard to the size of the plans.

be addressed to Pension and Welfare Benefit Programs, Room C–4526, U.S. Department of Labor, Washington, D.C. 20216, Attention: Proposed Additional Condition to Prohibited Transaction Exemption 77–9. All such comments will be made part of the record, and will be available for public inspection at the Public Document Room, Pension and Welfare Benefit Programs, U.S. Department of Labor, Room N–4677, 200 Constitution Avenue NW., Washington, D.C. 20210 and at the Freedom of Information Reading Room, Internal Revenue Service, Room 1565, 1111 Constitution Avenue NW., Washington, D.C. 20224.

The proposal to adopt additional conditions to Prohibited Transaction Exemption 77–9, by inserting section V (d) in the appropriate place, is made 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. 72.

* * * * *

PROHIBITED TRANSACTION EXEMPTION 77–9
SECTION V

(d) In the case of any purchase made after December 31, 1978, the insurance agent or broker, pension consultant, insurance company, or investment company principal underwriter:

(1) Effects such purchase on behalf of a plan which, at the time of such purchase, has less than 100 active participants; and

(2) Provides to the fiduciary referred to in paragraph (b) of this section, prior to the approval described in that paragraph, written disclosure of all the information set forth below (in addition to the information required by paragraph (c) of this section):

(i) With respect to the first 20 years of the recommended insurance or annuity contract, a tabulation (or illustration) showing, by year, the following:

(A) The guaranteed cash surrender value for a contract with a gross annual premium of $1000 as compared to (B) the cumulative total of annual payments of $1000 with interest of 6 percent, compounded annually;

(ii) If the insurance or annuity contract includes a guaranteed rate or rates of return, the following information:

(A) The rate or rates of return and the period for which each rate is applicable,

(B) The percentage of the gross annual premium to which such rate or rates would be applied, and

(C) Any event which would alter such guaranteed rate or rates of return, and the effect of such alteration;

(iii) A description of any charges, fees, discounts, penalties, or adjustments which may be imposed under the recommended contract or securities in connection with the purchase, holding, exchange, termination or sale of such contract or securities.

The disclosures required by this paragraph (d)(2) shall be made in a manner and form calculated to be understood by a plan fiduciary who has no special expertise in insurance and investment matters.

* * * * *

Signed at Washington, D.C., this 16th day of June 1977.

IAN D. LANOFF,
Administrator Pension and Welfare Benefit Programs, Department of Labor.

ALVIN D. LURIE,
Assistant Commissioner (Employee Plans and Exempt Organizations) Internal Revenue Service.

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