

QUALIFIED PLANS 2004-5

Thursday, May 27, 2004

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1. Legislative Update – Pensions and Nonqualified Deferred Compensation

Significant changes to the rules that apply to nonqualified deferred compensation arrangements have been pending in Congress as part of Enron-related pension legislation and international and corporate tax reform legislation. There has been some activity in recent weeks, so this area is still very much in play. In addition, the Senate Finance Committee has now filed its report and introduced statutory language on its version of Enron-related pension legislation. Here is an update on these recent developments.

A. Senate Finance Committee Enron Pension Reform Bill

Last fall, the Senate Finance Committee approved its version of Enron-related pension reform legislation (the National Employee Savings and Trust Equity Guarantee Act of 2004 ("NESTEG")), including significant changes to the nonqualified deferred compensation rules and an amendment that would have dramatically curbed the use of corporate owned life insurance (COLI) ([Qualified Plans 2003-10](#)). In February, the Senate Finance Committee approved a revised version of the COLI

amendment in the NESTEG bill and moved the effective date for many of the pension and nonqualified deferred compensation amendments in the bill to years beginning after December 31, 2004.

On May 14, the Finance Committee finally filed its committee report on NESTEG and it was formally introduced as legislation (S. 2424). In general, the provisions in the introduced bill and Committee report track the Joint Committee on Taxation's descriptions of the provisions before the Committee last fall and in February. Despite the recent filing of the Committee report and introduction of the bill, it remains unlikely that the Senate will pass the NESTEG legislation in the relatively few legislative days remaining this year.

An update of our summary and comparison of key pension and COLI amendments in the Finance Committee NESTEG bill and the Enron-related legislation (H.R. 1000) approved by the House last year ([Qualified Plans 2003-6](#)) will be posted on our website (www.groom.com) next week.

B. International and Corporate Tax Reform Bill

In March, the Senate added the nonqualified deferred compensation amendments to the international and corporate tax reform bill (S. 1637,

the Jumpstart Our Business Strength ("JOBS") Act of 2004) on the Senate floor. Senate consideration of the legislation had been slowed by partisan disputes on whether and to what extent Senate Democrats would be permitted to offer certain non-germane amendments to the bill. In early May, Senate leaders reached a compromise regarding these amendments, and the Senate overwhelmingly passed S. 1637 by a vote of 92-5 on May 11.

The nonqualified deferred compensation amendments in the Senate-passed international and corporate tax reform bill generally mirror those in the NESTEG bill – but do not include the COLI amendments or repeal of the longstanding limitation on Treasury's ability to issue guidance in the deferred compensation area (sec. 132 of the Revenue Act of 1978). The proposed amendments generally would be effective for amounts deferred in taxable years beginning after December 31, 2004. Treasury would be directed to provide participants with a limited period of time after the date of enactment to terminate participation in the plan or cancel an outstanding deferral election with regard to amounts earned after December 31, 2004.

The version of international and corporate tax reform legislation (H.R. 2896) approved by the House Ways and Means Committee last fall also contains a package of amendments to the nonqualified deferred compensation rules (Qualified Plans 2003-10). Progress on the House version of the legislation has been stalled for months, in part because of differences between House Democrats and some Republicans on the distribution of tax reforms between international domestic business operations. Since the Senate passed its version of the legislation, Ways and Means Chairman Bill Thomas (R-CA) has been working with Republican Ways and Means members on a revised version of the legislation, and it now appears that the House may be able to pass the legislation before Congress breaks for its July 4th recess.

A side-by-side comparing the nonqualified deferred compensation changes in the versions of international and corporate tax reform legislation passed by the Senate and approved by the Ways and Means Committee is attached. This reflects comments on issues clarified in the recently released Senate report.

It remains to be seen whether international and corporate tax reform legislation including the nonqualified deferred compensation amendments will be enacted this year. Possible obstacles to final action on the legislation include attempts by Senate

Democrats to block the legislation from going to conference and likely disputes between the House and Senate over the extent to which the legislation must be "paid for" with revenue-raising provisions. Nevertheless, the Senate's approval of the legislation, and the recent efforts to reach a compromise in the House, increase the chances that far-reaching changes in the nonqualified deferred compensation area will be enacted this year.

2. Employer Stock/Enron Litigation Update

Lawsuits contesting the propriety of investing pension plan assets in company stock continue to be filed across the country. Many of the previously-filed lawsuits that we have discussed in prior reports (most recently Qualified Plans 2004-1) are still pending. However, settlements have been reached in a number of cases – including a partial settlement in the closely watched Enron lawsuit – and two circuit courts recently ruled on claims that are typically advanced in employer stock cases.

A. Proposed Partial Settlements in Enron Litigation

On May 12, the plaintiffs in the Enron lawsuit (Qualified Plans 2003-10) announced that they had agreed to settle their claims against (1) members of the administrative committees of the Enron plans that had invested in the company's stock; and (2) members of Enron's Board of Directors. The plaintiffs' claims against Enron Corp., Kenneth Lay, Jeffrey Skilling, Northern Trust and Arthur Andersen were excluded from the settlement so the lawsuit will continue as to them.

The settlement principally provides for the payment of \$85 million under two of Enron's fiduciary liability policies. One of the individual defendants also agreed to pay \$100,000. In addition to these payments, the settling defendants agreed to cooperate with the plaintiffs by providing requested documents and information with respect to the plaintiffs' claims against the remaining defendants. Plaintiffs' counsel have requested that up to 20% of the settlement fund (approximately \$17 million) be set aside to pay attorneys' fees and an additional \$5 million be set aside to cover litigation expenses.

The Department of Labor ("DOL") similarly announced on May 12 that it had agreed to settle its claims against outside members of Enron's Board of Directors for \$1.5 million. The settlement bars the directors from knowingly assuming fiduciary

responsibility with respect to ERISA-covered plans for five years, unless approved by the DOL. The DOL settlement does not appear to cover its claims against Enron Corp., Mr. Lay, Mr. Skilling or the members of the administrative committees of the Enron plans that had invested in the company's stock.

The settlements are subject to approval by the district court. A hearing on the settlements is scheduled for August 20. Indications are that the non-settling defendants (e.g., Skilling and Lay) will oppose the settlement because (among other things) it exhausts all the insurance coverage.

B. Ninth Circuit Ruling Supports Employer Position

In Wright v. Oregon Metallurgical Corp., 360 F. 3d 1090 (9th Cir. Mar. 11 2004), the plaintiffs brought suit against the company, the fiduciaries of an employee stock ownership plan/stock bonus plan, certain officers and directors of the company, the directed trustee of the plan, and the union that represented the employees. The plan required a certain percentage of plan assets to be invested in the company's stock. Plaintiffs had unsuccessfully petitioned for an amendment of the plan to allow them to sell a greater percentage of the company stock. After the stock price fell, they filed the lawsuit claiming that defendants' refusal violated ERISA's prudence, exclusive purpose and prohibited transaction provisions.

The Ninth Circuit affirmed the dismissal of the plaintiffs' claims reasoning that, because individual account plans are exempt from ERISA's duty to diversify, defendants' refusal to amend the plan to allow a greater percentage of the employer stock to be sold is not an actionable violation of ERISA's prudence requirement. Moreover, the court did not believe that case presented a situation where the company's financial situation was seriously deteriorating and there was a genuine risk of insider self dealing, thereby possibly warranting the sale of the stock under the "intermediate prudence standard" adopted by the Third Circuit in Moench v. Robertson, 62 F.3d 553 (3rd Cir. 1995) (adopting rebuttable presumption that investment in employer stock is prudent). The court reasoned that (1) the published accounts of the company's earnings and financial condition established that the company was profitable and paying dividends; and (2) mere fluctuations in the price of the stock are insufficient to establish that it was imprudent to maintain the investment in employer stock.

The court further ruled that, by maintaining the investment in the employer stock, the defendants did not violate ERISA's exclusive benefit rule (sec. 404(a)(1)(A)). The court reasoned that "ERISA does not create an exclusive duty to maximize pecuniary benefits" and that the defendants had complied with the plan's lawful terms and were not obligated to deviate from them. The court also held that the failure to sell the stock was not a prohibited transaction, reasoning that the decision to continue to hold the stock in the plan was not a "transaction."

Finally, the court determined that the plaintiffs' claim against the plan's directed trustee must be dismissed. The court held that a directed trustee's liability is derivative of that of the underlying fiduciary and, therefore, the directed trustee cannot be held liable if the underlying fiduciary's direction to maintain the investment did not violate ERISA.

C. First Circuit Ruling Upholds Participant Claim

The First Circuit recently ruled, in Lalonde v. Textron, Inc., 2004 WL 1039844 (1st Cir. May 7, 2004), that participants in the company's employee stock ownership plan should be allowed to proceed with their claim that the defendants breached their fiduciary duties under ERISA by maintaining the investment of plan assets in the company's stock, but dismissed a claim against the plan's directed trustee.

In support of their claims against the plan's fiduciaries, the plaintiffs had alleged that (1) the company's earnings per share had declined over 70%, (2) the company had initiated a restructuring that was expected to culminate in the termination of 10% of its workforce, (3) the company had artificially inflated the price of its stock by concealing internal problems that led to its lost earnings and restructuring, and (4) the stock significantly underperformed in relation to the market as a whole and its peer group.

The court declined to adopt a "hard and fast" standard by which to measure a fiduciary's decision to maintain the investment of plan assets in employer stock. The court believed that, before enunciating a standard, additional evidence should be gathered, especially with respect to the intersection of ERISA's ESOP provisions and its fiduciary requirements. Nevertheless, the First Circuit did rule that plaintiffs' allegation that the company had artificially inflated the price of its stock by concealing internal problems that led to its lost earnings and restructuring was sufficient to put

defendants on notice of the nature of the plaintiff's claim and, combined with the other allegations, was sufficient to state a claim for relief. Accordingly, the First Circuit reversed the district court's dismissal of the lawsuit against the fiduciary defendants.

Significantly, the First Circuit affirmed the dismissal of the lawsuit against the plan's directed trustee, reasoning that there were no allegations in the complaint that the trustee knew of any malfeasance within the company. Further, the trustee had no inside knowledge and only learned of the drop in the stock price, the decline in the company's profits, and the restructuring of the company as the events were unfolding.

3. PBGC Announces Tougher Penalty Policy and Correction Program For Violations of Funding Notice Requirements

Section 4011 of ERISA generally requires the plan administrator of a plan subject to PBGC's variable rate premium to notify participants annually of the plan's funded status and the limits of PBGC's guaranty in the event of plan termination. Generally, the notice is due no later than 2 months after the deadline for the prior year's Form 5500. PBGC may assess a penalty against plan administrators that fail to provide the notice. Specifically, section 4071 permits a penalty of up to \$1,100 per day for failure to provide notices or material information in a timely manner. PBGC usually does not assess the full \$1,100 penalty for every violation, but announces policies indicating the amount of penalty it would assess for particular notice violations.

PBGC recently proposed a stiffer penalty policy for failure to provide the participant notices required under section 4011 of ERISA. 69 Fed. Reg. 25797 (May 7, 2004). In tandem with the proposed penalty policy, PBGC announced a voluntary correction program ("VCP") that would protect plan administrators from penalties for past violations of the section 4011 notice requirement. 69 Fed. Reg. 25792 (May 7, 2004). Both releases are summarized below.

We note also that IRS Announcement 2004-43 (May 24 IRS Bulletin, corrected by IRS Announcement 2004-51 (June 7 IRS Bulletin)), provides guidance on the additional participant notice requirements that apply to airlines, steel companies and the few other organizations that may elect an alternative deficit reduction contribution requirement under the Pension Funding Equity Act

of 2004. The proposed PBGC penalty policy would also be applicable to these new notice requirements.

A. Proposed Penalty Policy

Under the proposed policy, PBGC would assess a penalty for failure to provide notice based on the number of participants in the plan. Previously, PBGC based the penalty on the number of days the notice was late. Under the proposal, PBGC generally would assess a penalty of \$5 per participant if the plan administrator corrects the failure before PBGC issues a written notice to the plan that it may audit compliance with participant notice requirements. The penalty amount would be increased to \$20 per participant for repeat offenders.

If the failure is corrected only after a written PBGC audit notice has been issued, the penalty would be \$40 per participant, increased to \$100 per participant for repeat offenders.

If a pre- or post-audit correction is made within one year after the notice originally was due, the amount of the penalty would be pro-rated based on the period of time elapsed before the correction. For example, if the notice were issued 90 days after the due date, the total penalty would be multiplied by 90/365 to determine the pro-rated penalty amount. The penalty for a pre- or post-audit failure is not increased if the correction is made more than a year after the date the notice originally was due.

PBGC would make an appropriate reduction in the penalty for a partial failure to provide the required notice. This could occur, for example, if some of the required information were omitted from the notice. PBGC would increase the penalty if it determined after audit that the plan administrator did not issue a required section 4011 notice and did not promptly issue a corrective notice. In these circumstances, PBGC warns that the penalty generally would be "significantly higher."

Comments on the proposal should be submitted by July 6.

B. VCP Requirements

To encourage non-complying plan administrators to begin issuing section 4011 notices, PBGC established a voluntary correction program that would protect plan administrators from penalties for past violations. The VCP covers section 4011 notices for 2002 and 2003 due before May 7, 2004 and is available for plan administrators that are not already subject to PBGC audit. PBGC generally will

not pursue penalties for failure to issue pre-2002 notices if the VCP requirements for failures with respect to 2002 and 2003 notices are met. PBGC has stated that participation in the VCP will not increase the likelihood that a plan will be selected for audit by PBGC.

To obtain penalty relief under the VCP, a plan administrator must (1) issue a VCP corrective notice and (2) notify PBGC that it is participating in the VCP.

The corrective notice must meet all of the requirements that would apply to a 2004 notice under section 4011, and also include the funded current liability percentage for 2002 and 2003. The VCP materials include a model corrective notice that meets these requirements. The corrective notice need not state that it corrects a failure to provide earlier notices. Moreover, the corrective notice must be sent only to participants entitled to receive a 2004 notice, not to participants who should have received the 2002 and 2003 notices.

The plan administrator must notify PBGC not later than 30 days after the due date for issuing the VCP corrective notice, *i.e.*, the due date for the 2004 notice (two months after the due date for the prior year's Form 5500) that it is participating in the VCP. If a plan administrator corrected a failure to issue a 2002 or 2003 participant notice before May 7, 2004, issuance of a corrective notice and notice to PBGC are not required for penalty relief under the VCP.

Finally, the annual PBGC premium filing requires the plan administrator to certify whether a section 4011 notice was required for the prior plan year and, if so, whether the notice was issued. Notifying PBGC of the plan's participation in the VCP will be treated as amending any erroneous certification in an annual PBGC premium filing submitted on or before May 7, 2004 with respect to 2002 or 2003.

4. IRS Guidance on Governmental 457(b) Plans Offered By Unions Representing Government Workers

The IRS recently issued Revenue Ruling 2004-57 (June 14 IRS Bulletin), which provides guidance on when a union representing governmental employees may offer and administer a governmental Code section 457(b) eligible deferred compensation plan for its members. We understand that the guidance was issued in response to

concerns that such arrangements were being "marketed" outside the parameters of the established governmental section 457(b) plan. Among other concerns, this raises issues as to whether the section 457(b) contribution limits and other requirements are being met when multiple arrangements exist. To address outstanding compliance issues, the Service also released guidance on how plans that do not meet the new guidance may be "fixed." Both items are summarized below.

A. Plan Requirements

Under Code section 457(b), a governmental 457(b) plan must be established and maintained by a state, a political subdivision of a state, or any agency or instrumentality of a state or a political subdivision of a state. Based on this requirement, Revenue Ruling 2004-57 provides that, as long as a governmental 457(b) plan is "established and maintained" by a governmental entity, a union may create, offer, and administer the plan. This extends to the union's selection of the investment funds (and, presumably, negotiating fees and other features of the program). The basis for the IRS' conclusion is that the union's activities are comparable to those undertaken by a third-party administrator on behalf of a sponsoring employer.

Revenue Ruling 2004-57 appears to require the following for a union-offered and administered governmental 457(b) plan to qualify as such:

- the governmental employer whose employees participate in the union governmental 457(b) plan must formally adopt the plan;
- the plan must state that it is established and maintained by the governmental employer, and union member participants must be informed of the governmental sponsorship of the plan;
- union-represented employees of governmental entities that do not adopt the plan may not participate;
- an adopting governmental employer must agree to forward annual deferrals under the plan, and to disclose the amount of deferrals made under any other governmental 457(b) plans maintained by the employer and any other information needed for proper

administration of the union governmental 457(b) plan;

- similarly, the union must agree to provide the information necessary to permit each governmental employer to complete the tax returns for their employees and to administer its other 457(b) plans;
- both the union governmental 457(b) plan and the other 457(b) plans adopted by a governmental employer must contain provisions addressing how excess deferrals attributable to contributions to the governmental employer's and the union governmental 457(b) plans will be handled. In this regard, contributions to all governmental 457(b) plans maintained by an adopting governmental employer must be aggregated and treated as made under a single plan for purposes of the Code section 457(b) limits;
- the normal retirement age for purposes of the "last-three years" catch-up contribution under 457(b)(3) must be the same under both the union governmental 457(b) plan and an adopting governmental employer's other 457(b) plans;
- in-service, plan-to-plan transfers between the adopting employer's other 457(b) plans and the union governmental 457(b) plan are permitted pursuant to the transfer rules described in the final 457 regulations;
- Union employees may not participate in the union governmental 457(b) plan. Instead, a union, as a tax-exempt labor organization under Code section 501(c)(5), may (subject to the ERISA top-hat plan rules) establish a separate, tax-exempt 457(b) plan for its employees.

While Revenue Ruling 2004-57 provides helpful guidance for determining when a union-sponsored plan may qualify as a governmental plan for tax purposes (Code sec. 414(d)), there remains the question of whether these types of plans are "governmental plans" excluded from ERISA coverage (ERISA sec. 4(b)(1)). A "governmental plan" is defined (generally the same for both ERISA

and tax purposes) as a plan established or maintained for its employees by the Government of the United States, by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing. According to DOL, a plan covering government employees is "established or maintained" by the government if it is funded at least in part through contributions made by the government, or if the government is "involved in the discretionary administration of the arrangement." DOL Op. 79-36A (June 11, 1979). While the governmental employer's formal "adoption" of the plan, disclosure of its sponsorship to participants, and coordination functions would support "governmental plan" status for these union plans, in the absence of actual funding of the plan by the governmental unit, the status of these plans under ERISA remains somewhat unclear.

B. Transition Provisions For Existing Union-Sponsored Governmental 457(b) Plans

Announcement 2004-52 (June 14 IRS Bulletin) provides guidance for existing union-sponsored 457(b) plans that do not satisfy the new requirements.

If a union-sponsored governmental 457(b) plan established before June 14, 2004, does not satisfy the Revenue Ruling 2004-57 requirements, the plan will be treated as established and maintained by an eligible governmental employer if:

- contributions to the plan cease before the first payroll period beginning after December 31, 2004;
- the plan satisfies all other applicable governmental 457(b) plan requirements; and
- by December 31, 2005, either an eligible governmental employer (as described in Code section 457(e)(1)(A)) adopts the plan, or the accounts under the plan are directly transferred (not rolled over) into another governmental 457(b) plan pursuant to the in-service transfer rules permitting in-service transfers between an employer's 457(b) plans.

If a non-conforming plan fails to take the above remedial actions by December 31, 2005, the plan will be treated as an ineligible plan under Code section 457(f) and plan participants may be subject

to current taxation on their plan benefits. Furthermore, the termination of a plan without corrective action will result in taxation of distributions under the Code section 457(f) ineligible plan rules. Lastly, a union-sponsored governmental 457(b) plan established after June 14, 2004, that does not satisfy the Revenue Ruling 2004-57, will be treated as an ineligible plan under Code section 457(f).

5. DOL Class Exemption Covers Acquisition and Sale of Trust REIT Shares Under In-House DC Plans

The Department of Labor ("DOL") recently issued Prohibited Transaction Exemption 2004-07, 69 Fed. Reg. 23220 (Apr. 28, 2004), to permit the acquisition, holding or sale of publicly traded units of beneficial interest in a real estate investment trust ("REIT"), structured under state law as a business trust, by individual account plans sponsored by the REIT or its affiliates. Because of the precedent it sets for conditions that DOL may impose, this class exemption also may be of interest to other non-corporate or hybrid entities that may be interested in offering non-stock ownership interests to their employees primarily through 401(k) plans.

A. Background

REITs are entities that combine the capital of investors to acquire, finance, and operate income-producing real estate, such as apartments, shopping centers, offices, etc. For state law purposes, REITs can be structured either as corporations ("Corporate REITs") or trusts ("Trust REITs"). Many REITs or their affiliates (an "Affiliate" is an entity that is owned 50% or more by a Trust REIT) sponsor tax-qualified individual account plans ("Plans") in which employees of the REIT and/or its Affiliates may participate.

Some publicly-traded Corporate REITs offer employer securities as an investment option under their plans. A plan will violate ERISA's prohibited transaction rules if it acquires or holds employer securities unless, among other things, the employer securities constitute "qualifying employer securities." Stock generally constitutes "qualifying employer securities," which means that plans sponsored by Corporate REITs may invest in and hold such stock without engaging in a prohibited transaction. Interests in Trust REITs, however, are not true "stock" and may not necessarily meet the requirements of "qualifying employer securities." Accordingly, plans sponsored by Trust REITs

generally are precluded from holding Trust REIT shares. The primary purpose of the exemption is to resolve this anomaly – retroactively and prospectively - by allowing eligible publicly-traded Trust REITs to offer their shares as investment options to the plans they sponsor. Although the exemption does not appear to put Trust REITs fully on a par with Corporate REITs, it does provide needed certainty and narrows the gap.

B. Overview of Conditions

The exemption generally applies to four types of transactions: (1) purchases/sales of Trust REIT shares at the direction of a participant; (2) purchases/sales of Trust REIT shares at the direction of an Independent Fiduciary; (3) employer contributions, in-kind or in cash, followed by the mandatory purchase of REIT shares under plan terms; and (4) a plan's subsequent holding of REIT Shares. For purposes of the prospective exemption, an Independent Fiduciary, among other things, must be independent of the Trust REIT or its affiliates, and must be a trustee or investment manager with equity capital of at least \$1 million and with at least \$50 million in assets under its management. Trust REIT shares are publicly-traded shares of beneficial interest in a Trust REIT with no trading restrictions other than those necessary to qualify for REIT status or to otherwise satisfy securities law or applicable exchange or market system trading rules. For this purpose, "paired shares" (a combination of Trust REIT shares and affiliated service corporation stock that trades as a single unit) are treated as Trust REIT shares.

Prospectively, effective after June 28, 2004, the exemption imposes numerous conditions, including –

- All covered transactions must meet an arm's-length test.
- Generally, all purchases and sales must be executed for cash on one of the primary national exchanges (*i.e.*, NYSE, AMEX, or NASDAQ National Market) by an independent broker at the market price for the REIT shares on the exchange at the time of the transaction. To save on transaction costs, the exemption will also generally be available to purchases and sales between plan accounts (or between the plan and an Independent Fiduciary in a principal transaction) provided the transaction is executed at the closing

price for the REIT shares on the primary exchange on the date of the transaction. In this regard, DOL seems to view trades "between" participant accounts as similar to cross-trades for the purposes of the exemption, but DOL does not suggest that such reallocations otherwise raise issues under ERISA.

- When REIT shares are contributed to, or purchased by, the plan from the Trust REIT with employer cash contributions, no fee or commission may be charged.
- Trust REIT shares may not be subject to a lock-up (*i.e.*, participants must be able to sell their shares no less frequently than monthly).
- Participants must have voting, tender and similar exercise rights with respect to the Trust REIT shares over which they have discretion.
- To avoid undue influence, plans must employ a number of methods to protect confidentiality with respect to participants' investment, voting, tender and similar decisions with respect to Trust REIT shares, including an appointment of independent fiduciary under certain circumstances.
- Trust REITs must also comply with detailed disclosure requirements at the time of purchase/sale, and with on-going disclosure obligations (*e.g.*, fees and transaction costs, Trust REIT's role as a principal in the transaction if applicable, the exchange or market system where REIT shares are traded, current and updated prospectuses, quarterly and annual report information.)

Most of the conditions imposed for the protection of participants reiterate requirements already contained in the DOL's 404(c) regulations. Some of the prospective conditions are waived or relaxed for the retroactive relief – which applies back to 1998.

Enclosure