

QUALIFIED PLANS 2006-2

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1. **Pension Reform Legislation Update**

Action on comprehensive pension reform legislation (H.R. 2830; S. 1783) has generally been on hold since the passage by the House of Representatives of H.R. 2830 in December ([Qualified Plans 2005-12](#)). There have, however, been recent signs that a House-Senate conference to resolve differences between the two bills could begin in earnest in the next several weeks.

In the Senate, the pension reform bill was once again the victim of political wrangling as the House and the Senate began the process of appointing conferees. The latest episode occurred on February 16, when Senate Majority Leader Bill Frist (R-TN) asked for unanimous consent to appoint seven Republican and five Democrat conferees. Senate Minority Leader Harry Reid (D-NV) objected, demanding that at least six Democrats be appointed. Senator Reid's objection was due in part to his attempt to appoint as conferees both Senator Barbara Mikulski (D-MD), who briefly held up passage of S. 1783 in September by placing a hold

on the bill because of concerns regarding certain single-employer pension reforms in the bill ([Qualified Plans 2005-10](#)), and Senator Tom Harkin (D-IA), a staunch proponent of restrictions on cash balance plan conversions. Nevertheless, it is possible that a deal will be reached and that the Senate will appoint conferees in the next week or so.

The House has been waiting for the Senate to appoint conferees before appointing its own slate of conferees. Meanwhile, the recent election of Rep. John Boehner (R-OH) as House Majority Leader will likely be a further impetus to enact comprehensive pension reform legislation this year. As Chairman of the House Education and the Workforce Committee, Rep. Boehner was the chief sponsor of H.R. 2830 and has been a perennial advocate for pension reform. Despite his election to House leadership, we expect that Rep. Boehner will be appointed as a House conferee and will play a significant role in the negotiations. Senator Michael Enzi (R-WY), the Chairman of the Senate Health, Education, Labor and Pensions Committee, is expected to chair the conference committee.

Although there are many similarities between the two bills, significant differences remain that could slow the conference negotiations down. In particular, the conferees will have to resolve the following controversial issues:

- whether to use company credit ratings in determining plan funding requirements;
- whether to allow the use of "credit balances" and, if so, whether to include credit balances as part of plan assets for various purposes;
- whether and to what extent to permit the use of "smoothing" of asset values and the interest rates used in determining plan liabilities;
- whether to confirm the legality of cash balance and other hybrid plans under the age discrimination rules in ERISA, the Code, and ADEA, and whether to apply mandates on the conversion of traditional plans to hybrid plans;
- whether to include the "Boehner" or "Bingaman" investment advice provisions (or some combination of both), and certain other controversial changes to the ERISA Title I fiduciary and prohibited transaction rules; and
- whether to make permanent the pension and retirement provisions enacted as part of EGTRRA.

Our side-by-side comparison of the funding and cash balance provisions is enclosed.

Conference negotiations on the pension reform legislation may also be slowed in part by the pending conference on a tax-cut budget reconciliation bill (H.R. 4297). The conference on the tax-cut bill is expected to be dominated by negotiations over whether (and how long) to extend the reduced tax rates on capital gains and dividend income and whether to provide further stop-gap relief to middle-income taxpayers who are subject to the alternative minimum tax (AMT). In addition, other controversial issues such as lobbying reform and Congressional objections to the control of U.S. ports by a United Arab Emirates-owned company, could affect the timing of final action on pension reform legislation.

Although there are many potential obstacles, we think it is likely that comprehensive pension funding reform legislation will be enacted some time this Spring. Some key members of Congress have targeted April 15th as a possible deadline because many plan sponsors must begin making quarterly contributions by that date. This date could slip, however, in part because of the growing recognition by Congressional staff that plan sponsors may continue to use the temporary, corporate bond rate for purposes of determining the amount of the April 15th quarterly contribution under the "look-back" rules.

2. PBGC Premiums Increase Under Budget Legislation

The proposed PBGC premium increases that have been pending in Congress as part of the pension reform bills and budget-related legislation were recently enacted as part of the spending-cut budget reconciliation bill (S. 1932, the Deficit Reduction Act of 2005), which President Bush recently signed into law (Pub. L. No. 109-171, Feb. 8, 2006). The Deficit Reduction Act includes provisions to:

- Increase the single-employer flat rate premium from \$19 to \$30 per participant beginning in 2006 (and index it for inflation beginning in 2007).
- Impose a \$1,250 per participant premium to be paid by employers that have terminated their pension plans in bankruptcy. These premiums would be paid for three consecutive years once a company emerges from bankruptcy. The provision is generally effective for plans terminated after 2005 and expires at the end of 2010. Plans terminated with respect to a bankruptcy filing before October 18, 2005 are exempt.
- Increase the multiemployer premium from \$2.60 to \$8 per participant beginning in 2006 (and index it for inflation beginning in 2007).

The PBGC premium increases are first effective for the 2006 plan year. Because of the uncertainty over when these increases would become law, the PBGC has not yet issued new forms for paying the premiums (Form 1-EZ; Form 1, Schedule A). The PBGC has, however, rolled out its premium e-filing program on its website in time for

large calendar-year plans to meet the February 28, 2006 premium due date.

As a result of the enactment of these increases, the final pension funding reform conference agreement is not expected to include further increases in the flat-rate premium. We do expect the final conference agreement to repeal the "full funding limit" under the variable-rate premium rules.

3. Congress Increases FDIC Insurance Coverage for Retirement Accounts

Efforts to reform the federal deposit insurance system (which date back to 2002) culminated in the recent enactment of certain FDIC reforms, including increases in the insurance coverage of certain employee benefit plan and retirement accounts. These FDIC reforms were included as part of the larger spending-cut budget reconciliation bill (S. 1932, the Deficit Reduction Act of 2005), which was signed into law earlier this month.

Currently, the FDIC insures basic savings deposits in an amount up to \$100,000. In addition, the FDIC provides insurance coverage for certain retirement accounts and "pass-through" insurance for employee benefit plans. The rules in this area – finalized in 1993 in response to the 1991 FDIC reform legislation – potentially cover deposits in IRAs, qualified plans and section 457 plans. 12 CFR Part 330.12. In general, the FDIC insures qualifying deposits of retirement plans (which may include defined benefit and defined contribution plans) in an institution on a "pass-through" basis in an amount up to \$100,000. Similarly, the FDIC insures qualifying deposits in certain other retirement plans (e.g., IRAs, Keoghs and self-directed accounts in defined contribution plans) up to \$100,000. Deposits under certain retirement accounts must be aggregated for purposes of applying the \$100,000 cap; for example, if an individual holds two IRAs at the same bank, the amounts held in each IRA are aggregated and are only insured up to \$100,000.

Under the new law, insurance coverage for retirement accounts will increase to \$250,000. The increase in FDIC coverage will generally take effect when final regulations implementing the changes in the law are issued. The new law directs the Board of Directors of the FDIC to issue final regulations within 270 days of enactment (i.e., no later than October 8, 2006). The \$250,000 limit will be

indexed for inflation every 5 years starting April 1, 2010. In addition, with respect to "pass-through" insurance for employee benefit plans, institutions that are not "adequately capitalized" under the FDIC rules are prohibited from accepting deposits from such plans. While general FDIC deposit insurance is not increased under the new law, the basic \$100,000 insurance threshold will be indexed for inflation every 5 years starting April 1, 2010.

A companion bill (H.R. 4636, Pub. L. 109-173, Feb. 15, 2006) enacts similar changes in coverage for deposits in insured federal credit unions, including the higher limits for retirement accounts.

4. Administration Releases Its Latest Budget Proposal

On February 6, the Administration released its budget proposals for fiscal year 2007 (FY 2007). As expected, the Administration shied away from embracing wholesale tax reform as proposed by the President's Tax Reform Panel. The Administration did advance a number of benefits-related tax proposals, some of which we have seen in prior budget releases and some which support a primary goal of the Administration this year: containment of health care costs and increased tax equality in the purchase of health insurance. The following are some highlights of the employment and employee benefit-related tax provisions in the Administration's FY2007 budget.

Permanence of Previously Enacted Tax Relief. The President wants Congress to make permanent all the tax relief that was enacted in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs Growth and Tax Relief Reconciliation Act of 2003 (JGTRRA). This is one of the Administration's most important tax priorities this year and will be a major point of contention between the two political parties. EGTRRA contained the most extensive changes in the tax laws affecting pensions since 1986, including increases in contribution limits and the addition of "catch-up" contributions and the Roth 401(k). These changes will expire after 2010 if the provisions are not made permanent – which would cause massive confusion, problems in plan administration, and cut backs of contribution and benefit limit increases for plan participants. Permanence of the retirement plan provisions in EGTRRA is being considered as part of the pension funding reform bill, so there is the possibility that relief may be forthcoming this year.

Simplified Savings Vehicles. The Administration again proposed three new simplified retirement and savings vehicles: the Life-Time Savings Account (LSA), the Retirement Savings Account (RSA), and the Employer Retirement Savings Account (ERSA) in the same format that they proposed last year. Significantly, the Administration's FY 2007 LSA/RSA/ERSA proposal does not contain some of the simplification ideas that the Tax Reform Panel suggested, including the elimination of other account-based tax favored savings vehicles like health savings accounts, flexible spending arrangements, and education savings accounts. There did not appear to be widespread Congressional interest in moving forward with this element of the Tax Reform Panel's proposal last year, and we do not anticipate much activity on it in the coming year.

Expansion of Health Savings Account Incentives. Another important priority of the Administration is health care and, in furtherance of that goal, the FY 2007 budget includes several proposals to expand health savings accounts (HSAs). The Administration wants to eliminate the tax bias toward employer-provided health plans by providing similar tax breaks to individuals purchasing health insurance on their own account. The proposals include providing an above-the-line deduction for the purchase of HSA-eligible non-group coverage and a refundable tax credit that would approximate the FICA taxes imposed on amounts used to pay for health insurance premiums. Those individuals making contributions to an HSA on their own account (*i.e.*, not through a cafeteria plan) would also be eligible for a refundable tax credit which would approximate the FICA taxes on that contribution. A refundable tax credit for lower income individuals would be provided to assist in the purchase of HSA-eligible high deductible health plans.

The Administration also wants to make HSAs more consumer-friendly by increasing the amounts that can be contributed to an individual's HSA and making certain other changes:

- The maximum contribution to an HSA would be increased to the out-of-pocket limit for an HSA-eligible high deductible health plan (HDHP) (with a 2006 statutory maximum of \$5,250 for individual coverage and \$10,500 for family coverage) rather than the deductible amount for the individual's HDHP (with a 2006 statutory maximum

on contributions of \$2,700 for individual coverage and \$5,450 for family coverage).

- Expenses that can be paid for tax-free from an HSA would be those incurred after the individual is covered under an HSA-eligible HDHP rather than when the HSA is established, as long as the HSA is established by the end of the filing date for the individual's income tax return (generally April 15 of the following year).
- Premiums for non-group, HSA-eligible high deductible health insurance could be paid for tax-free from the HSA under the Administration's proposal (as compared to current law, where the purchase of health insurance before age 65 generally is subject to tax and the 10 percent additional tax).
- Employers would be able to contribute to an HSA the amounts allocated to participants under a health reimbursement arrangement (HRA) without running afoul of the contribution limits or the requirements that all employer contributions to employees' HSAs be comparable. This proposal would only apply to HRAs in existence on the date of enactment.
- The comparable contribution rules will also be revised under the Administration's proposal to allow employers to contribute a higher amount to an HSA on behalf of chronically ill individuals. This will address a concern that many employers had with HSAs – how can the chronically ill population be convinced that HSAs are appropriate for them when all the funds contributed to the HSA are used annually for their chronic health care expenses.

Defined Benefit Plans. Last year's proposals regarding pension funding reform, cash balance and other hybrid plans and the calculation of lump sum benefits were proposed again this year. These issues are currently being addressed in the pending conference on pension funding reform legislation.

Employee Leasing Companies. As employee leasing has become more commonplace, especially in the small business market, questions have been raised as to the extent to which the leasing company is liable for employment taxes on the employees it "leases" to other organization. The IRS realizes that leasing companies, as a whole, may be more likely to properly comply with the employment tax withholding rules than small businesses; however, there needs to be legal clarification as to the extent that the leasing company can fully assume the employment tax liability of the company that the employees are "leased" to. While the budget proposal does not get into specifics, a number of legislative proposals have been advanced which set out requirements for professional employee leasing organizations that, if met, will result in the leasing organization becoming solely or jointly liable for employment and withholding tax obligations for the leased employees.

5. SEC Proposes Increased Proxy Disclosures on Benefits

On January 27, the Securities and Exchange Commission (the "SEC") released new rules proposing extensive changes to the rules that govern public company disclosures of executive and director compensation. SEC Release 33-8655. 71 Fed. Reg. 6542 (Feb. 8, 2006). The SEC intends the new rules to improve the clarity and completeness of these disclosures.

One of the major changes is a requirement that a single figure for total compensation be provided for covered executives each year. This annual figure would include the value of option and other equity grants made and retirement benefits earned during a year. In addition, the rules would require dramatic changes to the disclosures on both retirement benefits and equity grants.

We highlight below some key changes in the proposed rules. We note that the Release also limits to some extent the benefits-related information required to be filed on a Form 8-K and provides new rules in the following areas that we do not address: related party transactions, director independence and other corporate governance matters. Comments on the proposal are due by April 10. Depending on when final rules are issued, they may well apply to proxies issued in 2007 which provide disclosures on 2006 compensation amounts.

A. Overview

The proposed rules follow the approach of the current rules with tables providing dollar amounts of particular compensation types and footnotes adding narrative explanations of the amounts shown on the chart. However, major changes are made to the current tables, including the elimination of certain tables. The proposed rules also require that narrative explanations be written in "plain English" and provide any information necessary to understand the numbers in the tables.

In addition to the revised compensation tables, a new "Compensation Discussion and Analysis" section would be required. This new section will discuss material factors underlying policies and decisions reflected in the compensation amounts disclosed. The report will replace the compensation committee report and company performance graph, which will no longer be required.

B. Expanded Summary Compensation Table

As noted above, the proposed rules require that a total compensation figure be included in the Summary Compensation Table (the "SCT") for each covered executive for each of the last three completed fiscal years. The amount in the new "total compensation" column of the SCT will equal the sum of the amounts in all the other columns (e.g., salary, bonus, equity awards). And as noted above, the value of equity grants made and retirement benefits earned during a year must be included in the SCT. Additional changes of interest to the SCT are as follows:

- All deferrals of salary and bonus, both elective and non-elective, must be disclosed in a footnote to the SCT (these will also be disclosed in the proposed nonqualified deferred compensation plans table described below).
- The value of equity awards granted during a year will be based on the grant date fair value used for accounting purposes. (A footnote is required disclosing all assumptions made in the valuation, by reference to a discussion of those assumptions in the company's other SEC filings.)

- For non-stock incentive awards, only amounts that have actually been earned are disclosed (as opposed to the value of new grants).
- Any compensation that is not reported in the other columns of the SCT must be disclosed under the "All Other Compensation" column, with footnote disclosure of items in excess of \$10,000 (See below for treatment of "perquisites"). Examples of amounts that would be included in this catch-all column include the following:
 - increase in present value of benefits under defined benefit plans
 - earnings on nonqualified deferred compensation (not just above market earnings as under current rules)
 - employer contributions or other allocations to defined contribution plans
 - all premiums paid on life insurance for the executive

The proposed rules outline some narrative disclosures which may be necessary for the SCT, including:

- assumptions for determining increase in present value of defined benefit plan benefits (thus, the rules do not specify how these calculations are to be made)
- method of calculating earnings in deferred compensation plans
- description of an executive's employment agreement
- any re-pricing or other material modification of an option or SAR (such as change in vesting or extension of the expiration date)
- description of the conditions for performance-based awards and any material waiver or modification of the performance goals

C. Retirement Benefits Disclosures

The proposed rules significantly revise the current requirements for retirement benefits disclosure. Under the current rules, a separate Pension Plan Table provides limited information on potential benefit amounts under a company's defined benefit plans. As noted above, the value of annual actuarial increases in defined benefits and the amount of employer contributions to defined contribution plans will need to be included in the SCT. In addition, the proposed rules will require two tables with more details on retirement benefits summarized below.

1. New Retirement Plan Table

A new "Retirement Plan Potential Annual Payments and Benefits Table" will disclose the estimated annual retirement payments under defined benefit plans for each covered executive. The following information must be provided for each qualified or non-qualified defined benefit plan in which an executive participates:

- plan name
- executive's years of credited service
- plan's normal and early retirement age
- estimated benefits at normal retirement age and early retirement age

The estimated retirement benefit amounts should be based on the form of benefit elected by the executive (e.g., single life annuity) and assuming no increase in pay. Presumably, where no election has yet been made, the default distribution form under the plan would be used. Additionally, the proposed rules require footnote disclosure of any credited years of service beyond actual years of service and any resulting benefit increase.

Disclosure of the lump sum value of these benefits is not required in all cases. However, if a plan allows for a lump sum election, the rules indicate that the narrative following the table should indicate the value of the lump sum at the end of the most recent year and the assumptions used to calculate the amount.

A narrative description of each plan's provisions would follow the table if needed for an

understanding of the amounts disclosed in the table. This narrative would address:

- material terms of each plan
- why, if there are multiple plans, such plans are maintained
- the compensation elements used in determining benefits
- policies regarding grants of additional years of service

2. New Nonqualified Deferred Compensation Plans Table

A new table will be required for non-qualified defined contribution plans, e.g., deferred compensation plans. This table will show the following amounts for each plan for the most recent year:

- executive contributions
- employer contributions
- earnings
- withdrawals and distributions
- ending balance

Unlike the current rules which require disclosure of only above-market earnings, the proposed rules require disclosure of all earnings. Additionally, the proposed rules require a footnote indicating the extent to which the contributions and earnings are reported in the SCT. This footnote requirement complements the footnote requirement in the SCT regarding the identification of amounts for which receipt has been deferred.

As with the defined benefit plan table, a narrative should accompany the table in order to provide a better understanding of the numbers in the table. This narrative could address the types of compensation permitted to be deferred, measures for calculating earnings, and distribution rules.

D. Equity and Incentive Award Disclosures

The current tables for equity compensation and incentive awards have been dramatically re-worked. Unlike the old tables which focused primarily on stock options and SARs, the new tables

require similar disclosures for all equity awards, including restricted stock and restricted stock units. In addition, the separate Long-Term Incentive Plan Award Table has been eliminated, and disclosures on these types of awards (e.g., cash bonus based on three year performance cycle) are now provided in the same tables with equity awards. We summarize below the new tables.

1. Performance-Based Equity Grant Table

A new table will be required disclosing performance-based awards made to covered executives during the last year. This covers equity awards (including restricted stock, restricted stock units, options, and SARS) as well as non-equity awards, such as a cash bonus based on a three-year performance period. Disclosure must be provided of the performance period and the expected future payout amounts (either in dollars or number of shares) under three assumptions: minimum, target, and maximum.

2. Other Equity Grant Table

A separate table summarizes the key terms of other equity awards made during the last year that are not performance-based.

3. Outstanding Equity Awards Table

A third table will list the outstanding equity awards (such as options, SARS, restricted stock, and restricted stock units) for each covered executive as of the end of the last year. This table will also show the values of awards at such time, such as the value of "in-the-money" options and unvested restricted stock and restricted stock units.

4. Option Exercises and Restricted Stock Vesting Table

A fourth table will show the number of shares acquired by a covered executive on the exercise of an option or SAR or the vesting of restricted stock or restricted stock units during the most recent year, as well as the value realized by the officer on exercise or vesting. This table will also show the grant date fair value of these awards as previously reported in the SCT.

5. Equity Award Disclosures Eliminated

Because the proposed rules require disclosure of the grant date fair value of option and SARs in the SCT, the current disclosure in the Options/SAR Grants Table on the potential realizable value of such awards is eliminated. Similarly, the Ten-Year Option/SAR Repricings chart in the current rules is eliminated.

E. Rules for "Perks"

As noted above, perquisites and other personal benefits ("perks") provided to covered executives must be included in the SCT, subject to the following new rules:

- Narrative disclosures on perks are required unless the total value of the perks is less than \$10,000. Disclosure is required under the current rules only if the value exceeds the lesser of \$50,000 or 10% of the total annual salary and bonus.
- Unless the de minimis exception above applies, each perk must be identified in a footnote. If a perk is valued at \$25,000 (or 10% of the total perks, if greater), then its "value" must also be disclosed.
- Perk values are still determined based on the aggregate incremental cost to the employer, rather than fair market value or other IRS standards (e.g., SIFL rates for airline travel).

The SEC declines to define the term "perk," but the rules do provide important guidelines on identifying perks, as well as a number of specific examples. Items that confer a direct or indirect benefit that has a personal aspect, unless available on a non-discriminatory basis to all employees, are considered perks. Items that are integrally and directly related to job performance, rather than merely facilitating job performance, are not perks. Finally, the SEC notes that it is not relevant to the determination that an item is deductible as an ordinary and necessary business expense, or is provided for some business reason or for the convenience of the company.

F. Severance and Change in Control Payments

As under the current rules, a narrative description of the material terms of any arrangement providing for payments upon severance or change of control will be required. In addition, estimated payment amounts (and the method used to determine such amounts) must be provided for different payment triggers under such arrangements.

G. Covered Executives

The new disclosure requirements will apply to a company's principal executive officer, principal financial officer, and the three other most highly compensated executive officers (based on total compensation) serving at the end of the last completed fiscal year. Narrative disclosures could also be required for up to three non-executive employees if their total compensation for the most recent year was greater than that of any of the covered executives. However, these individuals would not need to be named, and only their total compensation for the most recent year and job description would need to be disclosed.

H. Director Compensation

Because director compensation packages have become more complex, the proposed rules require disclosure of all director compensation for the most recent year in a table resembling the SCT. Although the proposed rules do not require tabular disclosure of director's outstanding equity awards, these awards would be disclosed in a footnote.

I. Tax Implications

The IRS is now actively auditing executive compensation arrangements at large companies, and agents are instructed to review annual proxies and other SEC filings to gather information on the arrangements. Thus, these new rules will give additional information to the IRS as it looks for problems under relevant Code provisions (e.g., sections 162(m) and 409A). In addition, employers will also soon be reporting annual amounts accrued under nonqualified retirement plans subject to section 409A on executives' Forms W-2. Coordination between those preparing the annual accrual numbers for the proxy and those preparing similar numbers for the Forms W-2 seems advisable.

6. DOL Liberalizes Widely Used Class Exemptions

The Department of Labor ("DOL") recently issued final amendments to two class exemptions commonly used for plan investments in mutual fund shares. 71 Fed. Reg. 5885, 5887 (Feb. 3, 2006). The amendments – which generally adopt changes proposed in 2004 – should come as good news to financial institutions because DOL has generally extended the availability of prohibited transaction class exemptions ("PTE") 75-1 and 84-24 to a broader range of plan service providers. In addition, DOL announced that amendments to PTE 75-1 are retroactively effective as of the effective date of the original exemption.

A. Amendments to Broker-Dealer Exemption

Part II of PTE 75-1 provides relief from the ERISA "party-in-interest" prohibited transaction restrictions (and the Code's corresponding excise tax provisions) for purchases and sales of securities between a plan and a broker dealer, reporting dealer or bank that meet certain conditions. Until now, the exemption also provided relief from the self-dealing restrictions of ERISA section 406(b) (and the corresponding provisions of the Code) for any purchase or sale by a plan of mutual fund shares, provided that no fiduciary of the plan was a principal underwriter or otherwise affiliated with a mutual fund company.

DOL finalized the amendments to PTE 75-1 proposed in April of 2004 (Qualified Plans 2004-4) without change. The amendments reorganize the exemption and generally increase the number of potentially covered transactions. In this regard, the amendments clarify that the exemption's self-dealing relief applies as long as the fiduciary of the plan who makes the decision to enter the transaction is not a principal underwriter or other affiliate of a mutual fund company. In addition, with respect to "party-in-interest" relief, the amendment makes clear that the broker dealer, reporting dealer or bank may not have or exercise discretionary authority or provide investment advice with respect to the specific assets involved in the transaction. Importantly, the amendments are retroactively effective as of January 1, 1975 – the original effective date of PTE 75-1.

In its proposed amendment, the DOL had requested comments on the "utility" of the exemption, suggesting that the agency was

considering more significant changes. DOL received three such comments, including one filed by our firm, and is reviewing the issues raised. As noted in our comments, we believe that the exemption is widely utilized by fiduciaries effecting purchases and sales of unaffiliated mutual fund shares on behalf of plan clients. One of the modifications under review by the Department would involve a repositioning of Part II of PTE 75-1 into PTE 86-128, the so-called "Securities Exemption." Pending further action by the Department, Part II of PTE 75-1 remains in effect.

DOL also finalized a corresponding amendment to Part V of PTE 75-1, the exemption for extensions of credit in connection with securities transactions. Part V of PTE 75-1 permits an extension of credit to a plan from a broker dealer in connection with securities transactions. Under the original exemption, the broker dealer could not be a fiduciary with respect to any assets of the plan, unless the fiduciary (and its affiliates) received no consideration in connection with the extension of credit. DOL's final amendment relaxes this condition. Under the final amendment, the broker dealer may not be a discretionary fiduciary or render investment advice with respect to the specific assets involved in the transaction.

B. Amendment to "Agent/Broker" Exemption

DOL finalized the amendment to PTE 84-24 it had proposed in September of 2004 (Qualified Plans 2004-9) without change. PTE 84-24 provides relief from ERISA's prohibited transaction rules for plan purchases of insurance and annuity contracts and shares of mutual funds, and for the receipt of sales commissions by insurance agents, pension consultants and mutual fund principal underwriters in connection with these transactions. Previously, PTE 84-24 was not available to an insurance agent, pension consultant or principal underwriter if such person was affiliated with a trustee with investment discretion over any assets of the same plan. The amendment, which was requested by our firm, broadens the relief provided by PTE 84-24 by extending it to purchase transactions involving insurance agents, brokers, pension consultants and principal underwriters whose affiliates exercise investment discretion over plan assets that are not involved in the transaction.

7. Plan Participant Not Bound By Arbitration Clause

The Ninth Circuit recently ruled that a plan participant was not bound by arbitration clauses in two investment management agreements that the plan trustees entered into with an investment advisor. Comer v. Salomon Smith Barney, Inc., Case No. 03-16560 (9th Cir., Feb. 1, 2006). The Ninth Circuit is the first appellate court to address whether participants are bound by arbitration clauses in contracts between plan trustees and service providers. It remains to be seen whether other circuits will share the Ninth Circuit's views.

Background – The trustees of two retirement plans operated by Micor, Inc. ("Micor") retained Salomon Smith Barney, Inc. ("Salomon") to provide investment advice. The trustees and Salomon signed investment management agreements that contained arbitration clauses. These clauses provided that "all claims or controversies" between the trustees and Salomon "concerning or arising from" any of the trustees' accounts are subject to arbitration. The plans suffered heavy investment losses when the "tech bubble" burst in early 2000. Kevin Comer, a participant in the Micor plans, sued Salomon for breach of fiduciary duty, filing the claim under section 502(a)(2) of ERISA on behalf of all plan participants. In response, Salomon asked the district court to stay the proceedings and compel arbitration based on the arbitration clauses. The district court declined and the Ninth Circuit affirmed its decision.

Analysis – By way of introduction, the Ninth Circuit observed that the Federal Arbitration Act and Supreme Court precedent make it clear that there is a strong federal policy favoring arbitration, even for claims arising under federal statutes like ERISA. The court nevertheless admitted that it harbored lingering skepticism about whether ERISA claims are subject to arbitration. Rather than resolving this skepticism, the court relied on contract law to decide this case.

The court began its analysis with the observation that "nonsignatories of arbitration agreements may be bound by the agreement under ordinary contract and agency principles." The court then looked at two theories of contract law – equitable estoppel and third party beneficiary – to determine whether the arbitration clauses were enforceable against the plan participant.

The court found that Comer was not bound by the arbitration clauses under equitable estoppel principles because, as a participant "in trusts managed by others for his benefit," he did not benefit from the investment management agreements and did not seek to enforce the investment management agreements in his lawsuit. Next, the court found that the arbitration clauses were not enforceable against Comer as a third party beneficiary of the investment management agreements. The court reasoned that the agreements did not "reflect[] the express or implied intention of the parties to the contract to benefit the third party."

Finally, the Ninth Circuit rejected the approach taken in an earlier decision. Bevere v. Oppenheimer & Co., 862 F. Supp. 1243 (D. N.J. 1994). The district court there had held that a participant would be bound by an arbitration clause where the participant's ERISA claim "arises out of the underlying contract to which it was an intended third party beneficiary." The court concluded that this "arises from" test was not consistent with Ninth Circuit precedent that treated participants' claims as "non-derivative," concluding that it would be "unfair" to allow a rule under which a plan by its act could extinguish a participant's individual claim.

Observations – We find this Ninth Circuit ruling problematic. The court assumed, but did not decide, that the plan trustees would be bound by the arbitration clauses if they tried to sue Salomon under section 502(a)(2) of ERISA on behalf of the plan participants. The court decided, however, that a participant's claim, also on behalf of the plan participants, would not be subject to arbitration. The court did not develop its analysis enough to explain how or why these similar situations should get different treatment. Another problem with the court's ruling is its reliance on the fact that Comer based his suit on ERISA, rather than on the investment management agreements. However, without the investment management agreements, Salomon would not have been a fiduciary. The court also did not consider the policy implications, specifically that its ruling could generally bar any plan service provider from enforcing service agreement arbitration clauses if participants bring a claim under ERISA.

In addition, it is not clear how the Ninth Circuit analysis would apply to arbitration clauses included in contracts relating to 401(k) and other plans that are participant-directed. For example, contracts for participant advice or self-directed brokerage services

may include arbitration clauses. In some cases, participants must acknowledge the arbitration requirements when enrolling in a plan advisory or self-directed brokerage option. In other cases, participants do not acknowledge the arbitration terms. However, under the Ninth Circuit analysis, the participant could be an intended third party beneficiary, so that the arbitration clause might be enforceable.

There is no way to know when these issues will be considered by other courts and the possible outcomes. In the meantime, service providers may want to consider how they might strengthen their arbitration clauses to account for this troubling decision.

8. Court Allows 401(k) "Revenue-Sharing" Class Action to Continue

In September 2001, a class of 401(k) plan sponsors filed suit against Nationwide Financial Services, Inc. and Nationwide Life Insurance Co. in connection with revenue-sharing payments received by Nationwide from mutual funds (Qualified Plans 2002-3). Haddock v. Nationwide Financial Services Inc. (Civ. No. 3:01cv1552 (SRU), D. Conn.). On February 24, 2006, the district court decided defendant's motion for summary judgment, ruling that 401(k) plan sponsors could continue their lawsuit because a rational fact-finder could conclude that (1) Nationwide's ability to select, remove and replace mutual funds offered to plans under its variable annuity contracts makes Nationwide an ERISA fiduciary, (2) revenue-sharing payments received by Nationwide under its contracts with mutual funds are "plan assets" under a functional approach, and (3) even if the revenue-sharing payments are not plan assets, Nationwide's receipt of the payments still might involve illegal "kickbacks" prohibited by ERISA (sec. 406(b)(3)).

Background – Revenue-sharing – where mutual funds pay fees, including so-called 12b-1 and similar fees, to companies that act as recordkeepers or service providers to defined contribution plans – is common in the retirement services industry. The Labor Department has previously issued guidance that essentially allows revenue sharing by mutual funds, under certain conditions. See DOL Advisory Opinions 97-15A and 16A (May 22, 1997). Under these interpretations, so long as a plan recordkeeper or other service provider does not exercise any discretionary authority or control to "cause" a plan (or a participant) to invest in a mutual fund, the

recordkeeper (or other service provider) would not be deemed to violate ERISA's anti-kickback prohibition (under ERISA section 406(b)(3)) by receiving fees from the mutual fund. Many companies in the 401(k) service-provider industry rely on this guidance in receiving revenue-sharing payments as part of their overall compensation for recordkeeping and other plan services.

Plaintiff's ERISA Claims – In their fourth amended complaint, the plaintiff 401(k) plan sponsors alleged that Nationwide's contractual arrangements with mutual funds and its retention of revenue sharing payments from those funds constitute breaches of fiduciary duty and prohibited transactions. The plaintiffs have two theories of liability.

- First, they propose a functional approach to defining ERISA "plan assets" and argue that, under this approach, the revenue-sharing payments are plan assets that Nationwide retained in violation of ERISA.
- Second, they contend that Nationwide engaged in a quid pro quo arrangement with the mutual funds, agreeing to include the mutual funds as investment options for the plans under Nationwide's variable annuity contracts in exchange for the revenue-sharing arrangements.

Nationwide disputed that it has any fiduciary duties as well as the characterization of the revenue-sharing payments as "plan assets."

Fiduciary Status – On the issue of Nationwide's status as an ERISA fiduciary, the court found that a reasonable jury could conclude that Nationwide exercised authority or control with respect to the disposition of plan assets by controlling which mutual funds were available as investment options for plans and participants, even if its control or authority was limited to deleting and substituting funds that were initially approved by the plans.

The court's discussion recognizes the Labor Department's position in Advisory Opinion 97-16A that plan service providers may make changes to a menu of funds offered to plans without assuming fiduciary status, under circumstances where plan sponsors have final authority to determine the plan's

investment options through a negative consent process. However, the opinion does not discuss in any detail whether Nationwide's authority under its variable annuity contracts was limited such that it should not become a fiduciary in connection with changes in mutual funds that are available to the plans. Presumably, Nationwide may provide additional evidence at trial with respect to whether it in fact had or exercised fiduciary authority or control in deleting or substituting funds that were initially approved by plans.

Revenue-Sharing Payments as "Plan Assets" – As to whether the revenue-sharing payments are ERISA "plan assets," the plaintiffs argued that (1) they would not have been made, but for the plan's investment through Nationwide, (2) Nationwide did not contract for the plan to receive the payments as compensation, despite the opportunity to do so, and (3) the payments could have been used for the benefit of the plans and participants. Rejecting this "overbroad" test, the court nevertheless adopted a functional test, concluding that "plan assets" could include benefits that a defendant receives (1) as a result of its exercise of fiduciary discretion or authority, and (2) at the expense of plan participants and beneficiaries.

Tested against this two-pronged approach, the court held that the plaintiff's claims should survive because, first, it was alleged that Nationwide received revenue-sharing payments in exchange for offering the mutual funds as investment options to the plans. Further, the payments were at the expense of the plan and participants because the mutual funds charged fees to plans to cover not only their normal fees, but also the revenue-sharing payments they were required to make to Nationwide.

Further, the court held that the plaintiffs' prohibited transaction claims are not entirely dependent on their theory that the revenue-sharing payments are plan assets. Specifically, the court held that a reasonable fact-finder could conclude that the revenue-sharing payments were consideration received by Nationwide from a party dealing with the plans, and thus, potentially, "kickbacks" prohibited by ERISA section 406(b)(3). Finally, the court distinguished Labor Department Advisory Opinions 2003-09A, 97-15A and 16A, noting that those opinions assumed that the revenue-sharing payments were consideration for "actual services," and that the plaintiffs had raised a triable issue concerning whether Nationwide in fact

performed any additional services in consideration for the payments.

Observations – Although only a district court decision, it is significant to recordkeepers and other plan service providers because it challenges common industry practices, which are based on Labor Department guidance holding that, generally, a recordkeeper or other plan service provider does not become a plan fiduciary merely by offering a menu of investment options to plans and making changes to those options from time to time. In addition, the court's decision suggests that revenue-sharing payments could be deemed to be "plan assets" – a legal conclusion that the Labor Department has not reached to date in its advisory opinions. We are also concerned that, like some initial court decisions against directed trustees (Qualified Plans 2003-6 and 2003-10), this opinion may encourage more costly protracted lawsuits against 401(k) plan recordkeepers and other service providers receiving revenue-sharing payments.

9. Agencies Further Extend Deadlines for Hurricane Katrina

Hurricane Katrina ravaged New Orleans and areas along the Gulf Coast on August 29, 2005. Clean up and reconstruction of the devastated areas have been very slow and many areas remain uninhabitable even six months after the storm hit. As reported in Qualified Plans 2005-9, the IRS extended deadlines for filing tax returns and submitting tax payments to February 28, 2006 in a series of complicated news releases. These news releases also extended deadlines for a number of "employee benefit-related acts" including Form 5500 filings, cafeteria plan elections under Code section 125, rollovers, minimum required distributions ("MRDs") and certain other acts listed in Treasury regulations and Section 8 of Revenue Procedure 2005-27. As a result, employee benefit plan administrators, plan sponsors, and plan participants affected by Hurricane Katrina who were otherwise required to meet certain deadlines on or after August 29, 2005 generally had until February 28, 2006 to meet these obligations.

In Notice 2006-20 (Feb. 17, 2006), the IRS has further extended these deadlines to August 28, 2006 ("affected taxpayers" may also request an additional six month extension after August 28th). While the IRS separately extended the same deadlines for victims of Hurricanes Rita and Wilma to February 28, 2006, Notice 2006-20 does not extend the February 28th deadline limited for

individuals and businesses affected by Rita and Wilma. PBGC announced a similar extension on February 24 (details are available on the PBGC's "disaster relief" web page), and DOL has now followed suit with a February 27 announcement that the deadline for Form 5500 filings are further extended to August 28, 2006. (See DOL Release 06-351-NAT (Feb. 27, 2006)).

Prior to Notice 2006-20, IRS guidance relating to the deadline extensions were generally only available to taxpayers located in the areas designated by FEMA as "Individual Assistance" or "Public Assistance" areas. "Individual Assistance" areas – areas that were considered the hardest hit by the Hurricane – received an automatic extension of the deadlines relating to the employee benefit-related acts. Taxpayers in areas designated as "Public Assistance" areas – where damage was more isolated – were required to identify themselves as Hurricane victims if and when the IRS questioned whether they are subject to any penalty taxes or interest for failure to meet their employee benefit-related deadlines. The IRS did not explicitly grant relief for taxpayers located outside of the affected areas but whose books, records, or tax professionals were located in areas affected by Katrina, but indicated that it would work with these taxpayers in determining whether they would be eligible for relief. The PBGC similarly limited relief to those areas identified by the IRS, but the DOL extended relief to plan sponsors located in "Individual" and "Public" Assistance areas and to plan sponsors located outside of the affected areas, but whose recordkeeper or service provider was located in the affected areas.

Notice 2006-20 explicitly lists those parishes and counties that are automatically eligible for the August 28, 2006 deadline extension (see also IRS News Release 2006-30). The Notice also provides a list of parishes and counties that are eligible for the deadline extension, and provides that individuals in these areas must identify themselves as an "affected taxpayer" by marking returns or other IRS documents with "Hurricane Katrina" in red ink (taxpayers eligible for automatic relief are nonetheless encouraged to mark their returns as well). (Those parishes and counties that were listed in past IRS guidance are not eligible unless listed in this latest Notice.) The Notice further provides that individuals and businesses who are not located in the affected areas, but whose books, records, or tax professionals are located in areas affected by Hurricane Katrina, may identify themselves as "affected taxpayers" by marking their returns or other

IRS documents or by contacting the IRS's Disaster Hotline. The PBGC generally extends relief to areas identified by the IRS in Notice 2006-20, while the DOL provides relief to plan sponsors directly or indirectly affected by Katrina.

Enclosure