U.S. Department of Labor

Pension and Welfare Benefits Administration
Washington, D.C. 20210

92-08A
Sec. 406(a)(1); 406(b);
408(b)(2)

February 20, 1992

Mr. Leon E. Irish
Jones, Day, Reavis & Pogue
Metropolitan Square
1450 G Street, N.W.
Washington, D.C. 20005-2088

Dear Mr. Irish:

This is in response to your request for an advisory opinion regarding the application of the prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 (ERISA) to several aspects of the proposed formation and operation of the International Small Float Fund (ISFF), a limited partnership.

Your letters contain the following facts and representations. Philippe Investment Management, Inc. (PIM) is an investment adviser registered under the Investment Advisers Act of 1940. PIM currently serves as investment manager to four large pension plans. In this capacity, PIM selects stocks of foreign companies that, in its opinion, offer the potential for capital appreciation. PIM, under the authority granted to it by a named fiduciary pursuant to section 402(c)(3), directs the various plans it serves as to the transactions in such foreign securities; and each plan holds a portfolio of such foreign securities which is selected and managed by PIM.

PIM has identified a certain type of foreign security which it believes offers the potential for significant capital appreciation -- i.e., common stock which trades in a thin public market, "small float stock". PIM has on occasion invested assets of the plans it manages in small float stock and proposes to expand this practice. To accomplish this objective, PIM proposes to establish ISFF, which would be dedicated to small float stock investments.

PIM proposes to form ISFF as a limited partnership. PIM will be the corporate general partner of ISFF and act as its investment manager. A plan wishing to invest a portion of its assets in small float stock will become a limited partner in ISFF. A limited partner's interest in ISFF will be represented by limited partnership units (partnership units). These partnership units represent an undivided interest in ISFF's portfolio. The partnership units will be valued monthly at the pro rata share of the net asset value of ISFF. The partnership units will not be registered under the Securities Act of 1933.

ISFF will maintain a portfolio of small float stock; stock certificates acquired by ISFF will be held by the Chase Manhattan Bank as custodian and any subcustodian appointed by the Chase Manhattan Bank under an arrangement that complies with the indicia of ownership requirements of section 404(b) of ERISA.

No fee will be charged with respect to any acquisition or redemption of the partnership units. A plan will pay a quarterly fee representing a percentage of the value of all of that plan's assets which are under management by PIM, including the value of such plan's partnership units. This applicable percentage will decline as the value of assets under management increases.[1] At no additional cost, PIM also will provide ISFF with certain support services, such

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[1] In a subsequent letter it was represented that two plans had negotiated incentive fee arrangements with PIM and that it was anticipated that other plans might also seek similar arrangements. Under these arrangements PIM's fee is

as office space and administrative services. However, ISFF will reimburse PIM for certain other partnership expenses, provided that such are "direct expenses" as defined by ERISA regulation section 2550.408c-2(b)(3). PIM will also obtain, at no cost to ISFF, the required administrative services of Codafin, a Luxembourg Corporation engaged in providing such services in Europe. Each participating plan will be billed directly by ISFF for its pro rata share of custodial fees. Brokerage fees will be a separate charge against the assets of the partnership. Neither the custodian nor any broker will be related to PIM or ISFF.

The Holders of 66-2/3% (in value) of partnership units may replace the corporate general partner. Upon 60 days notice, any plan may terminate its investment in ISFF and have its partnership units redeemed without penalty, or, subject to the provisions of the Limited Partnership Agreement, a Limited Partner may transfer all or part of his partnership units.[2] No commissions or fees will be charged or paid with respect to any acquisition or redemption of a limited partner's units.

Once ISFF commences operations, PIM will not select or purchase a small float stock for an individual account if such stock is held by ISFF, or select or purchase a small float stock for ISFF if such stock is held by an individual account. Plans will not be permitted to transfer small float stock from an individual account to ISFF; a provision in the partnership agreement will require that partnership units be purchased for cash. Market conditions may lead PIM to decide to sell small float stock that is held directly by the plans in individual accounts before ISFF becomes operational. PIM will also gradually liquidate any small float stock held under the individual account of a plan that becomes a limited partner in ISFF. However, during a brief transition period, PIM may continue to manage small float stock investments for plans on both an individual account basis and through ISFF, and a plan may hold in an individual account shares of the same small float stock that is held by ISFF. Liquidations of any overlapping securities held by ISFF and an individually managed account will be on a pro rata basis.

The decision of any plan to invest in ISFF will be made solely by each independent plan fiduciary. The independent plan fiduciary must also acknowledge in writing that he or she is not relying upon advice from PIM regarding the plan's investment in ISFF. Furthermore, PIM represents that it shall disclose the relationship between PIM and ISFF, that the offering document will emphasize that neither PIM nor anyone affiliated with PIM is acting in the capacity of investment adviser to the Plan in presenting this information, and that the decisions whether, to what extent, and for how long to invest in ISFF will be made by a plan fiduciary independent of PIM.

You ask for opinions (or, in the alternative a prohibited transaction exemption) to the effect that:

> (a) The establishment and operation of ISFF, with PIM as its investment manager, does not constitute dealing by a fiduciary with the assets of a plan in his or her own interest in violation of ERISA section

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based upon achieving specified investment goals relative to certain benchmarks. Because each plan negotiates different benchmarks based on its investment goals, each such fee arrangement is unique. It is not known if either of these plans, or any plan which may in the future negotiate such fees, will become limited partners in ISFF. In such event, PIM represents that it will adjust the fees of such limited partner so that the fees paid by such limited partner will be the same whether its assets are directly managed by PIM or invested in ISFF. While you believe that these arrangements meet the guidelines established in the BDN and Batterymarch letters (Advisory Opinions 86-21A (Aug. 29, 1986), and 86-20A (Aug. 29, 1986)), you have not asked the Department's opinion concerning the application of ERISA to these incentive fee arrangements. We note that the Department has also addressed incentive fee arrangements in Advisory Opinion 89-28A (Sept. 25, 1989).

[2] You have not inquired, and the Department expresses no view concerning whether the effectuation of these redemption rights may result in violations of section 406(b)(1) and 406(b)(2) of ERISA.

406(b)(1) and does not constitute a transaction in which a fiduciary acts on behalf of a party whose interests are adverse to the interests of a plan in violation of ERISA section 406(b)(2);

(b) The acquisition or disposition by an employee benefit plan of partnership units in ISFF during any time in which PIM is the investment manager or otherwise a fiduciary with respect to ISFF, and where PIM is also a fiduciary with respect to such plan, does not violate ERISA sections 406(a)(1)(A), 406(a)(1)(D), or 406(b), or Code sections 4975(c)(1)(A), 4975(c)(1)(D) or 4975(c)(1)(E);

(c) The payment by an employee benefit plan or its sponsoring employer and the receipt by PIM of investment management fees with respect to assets invested either by it directly or through ISFF is not a transfer of plan assets to, or the use of plan assets by or for the benefit of, a party in interest or disqualified person in violation of ERISA section 406(a)(1)(D) or Code section 4975(c)(1)(D) or the receipt by a fiduciary of consideration in connection with a transaction involving the assets of the plan in violation of ERISA section 406(b)(3) or Code section 4975(c)(1)(F);

(d) The payment by an employee benefit plan and the receipt by PIM of investment advisory fees or compensation with respect to the portion of the plan's assets which are directly managed by PIM and not through ISFF does not violate ERISA section 406(b) or Code section 4975(c)(1)(F); and

(e) The furnishing by PIM of office space and other support services to ISFF, without separate charge therefor, does not constitute the furnishing of goods, services or facilities within the meaning of ERISA section 406(a)(1)(C) or Code section 4975(c)(1)(C).

Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of its investment, include any of the underlying assets of the entity. However, under 29 C.F.R. 2510.3-101(a)(2), in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security, nor a security issued by an investment company registered under the Investment Company Act of 1940, unless it is established that the entity is an operating company or that equity participation in the entity by benefit plan investors is not significant, the plan's assets include both the equity interest and an undivided interest in each of the underlying assets of the entity.

The partnership units issued by ISFF are equity interests, and it has not been established that ISFF is an operating company, nor that benefit plan investments in ISFF are not significant. Therefore, we are assuming, for the purposes of this opinion, that the underlying assets of ISFF will be plan assets and any person who exercises authority or control respecting the management or disposition of such underlying assets and any person who provides investment advice for a fee (direct or indirect), is a fiduciary of the investing plan.

Section 3(14)(A) of ERISA defines the term "party in interest" to include a fiduciary. Section 3(21)(A)(i) of ERISA defines the term "fiduciary" to include any person who exercises authority or control respecting management or disposition of plan assets. PIM is a fiduciary with respect to those plans for which it acts as an investment manager, and is, therefore, a party in interest with respect to those plans under section 3(14)(A) of ERISA. In addition, as general partner of ISFF, PIM exercises discretionary authority and control respecting the management and disposition of plan assets invested in ISFF, and is, therefore, a fiduciary and a party in interest with respect to plans which invest in ISFF.

Section 406(a)(1)(A) of ERISA[3] provides that a fiduciary shall not cause the plan to engage in a transaction, if he or she knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing of any property between a plan and a party in interest. Section 406(a)(1)(C) of ERISA provides that the furnishing of goods, services or facilities between a plan and a party in interest is likewise prohibited. Section 406(a)(1)(D) of ERISA prohibits transactions involving the transfer to, or use by or for the benefit of, a party in interest of any plan assets.

Section 406(b)(1) of ERISA prohibits a fiduciary with respect to a plan from dealing with the assets of a plan in his own interest or for his own account. Section 406(b)(2) of ERISA provides that a fiduciary with respect to a plan shall not in his or her individual capacity or any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries. Section 406(b)(3) of ERISA provides that a plan fiduciary shall not receive any consideration for his or her own personal account from any party dealing with the plan in connection with a transaction involving the assets of the plan.

Section 408(b)(2) of ERISA provides a statutory exemption from the prohibitions of section 406(a) of ERISA for contracting or making reasonable arrangements with a party in interest, including a fiduciary, for office space or services necessary for the establishment or operation of a plan, if no more than reasonable compensation is paid therefor. Regulations issued by the Department clarify the terms "necessary service" (29 C.F.R. 2550.408b-2(b)), "reasonable contract or arrangement" (29 C.F.R. 2550.408b-2(c)), and "reasonable compensation" (29 C.F.R. 2250.408d-2(d) and 2550.408c-2) as used in sections 408(b)(2) and 408(c)(2) of ERISA.

With respect to the prohibitions of section 406(b), however, the regulation in 29 C.F.R. 2550.408b-2(a) indicates that section 408(b)(2) of ERISA does not contain an exemption for an act described in section 406(b) of ERISA, even if such act occurs in connection with a provision of services which that section exempts from the prohibitions of section 406(a). As explained in section 2550.408b-2(e)(1), if a fiduciary uses the authority, control, or responsibility which makes a person a fiduciary to cause the plan to enter into a transaction involving the provision of services when such fiduciary has an interest in the transaction which may effect the exercise if his best judgment as a fiduciary, a transaction described in section 406(b)(1) of ERISA would occur. This transaction would be deemed to be a separate transaction from the transaction involving the provision of services and would not be exempted by section 408(b)(2) of ERISA.

Conversely, the regulation, in section 2550.408b-2(e), explains that a fiduciary does not engage in an act described in section 406(b)(1) if the fiduciary does not use the authority, control, or responsibility which makes such person a fiduciary to cause a plan to pay additional fees for a service furnished by a fiduciary or to pay a fee for a service furnished by a person in which such fiduciary has an interest which may effect the exercise of such fiduciary's best judgment as a fiduciary. Nor does the provision of services by a fiduciary, in and of itself, violate section 406(b) if such services are provided 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).

Accordingly, in response to your requests in paragraphs (a), (c), (d) and (e), section 408(b)(2) of ERISA exempts the provision of services to employee benefit plans by PIM, and the provision of investment management services to ISFF by PIM as general partner, from the prohibitions of section 406(a)(1)(C) and 406(a)(1)(D) of ERISA, provided the conditions of the exemption are met. We note, however, that the questions of what constitutes a necessary service, a reasonable contract or arrangement and reasonable compensation are inherently factual in nature. The

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[3] References to Code sections that parallel provisions of Title I of ERISA are omitted from the following, but may be assumed to be incorporated by reference when the parallel section in Title I of ERISA is cited.

appropriate fiduciaries must determine based on all of the relevant facts and circumstances, whether the conditions of section 408(b)(2) are satisfied.

In regard to the possible conflicts of interest on the part of PIM, the initial appointment of PIM as general partner of ISFF by independent plan fiduciaries purchasing partnership units would not violate sections 406(b)(1) or 406(b)(2) of ERISA so long as PIM does not exercise any of the authority, control or responsibility which makes it a fiduciary to cause the plan to purchase such partnership units. Nor, under the facts presented in your opinion request, would PIM's receipt of fees from the plans, pursuant to the ISFF Limited Partnership Agreement, violate section 406(b)(3) of ERISA. Furthermore, based upon your representations with respect to liquidations, purchases and fees, the Department is of the opinion that where plans invest in partnership units and also retain PIM as an investment manager for individual accounts, PIM's provision of such services, in and of itself, would not appear to violate sections 406(b)(1) or 406(b)(2) of ERISA.

With respect to your request in paragraph (b), the Department is not prepared to issue an opinion that the purchase or sale of an interest in ISFF by a plan with respect to which PIM is a party in interest would not violate these provisions. Accordingly, the Department has addressed this issue in an administrative exemption which was published on January 4, 1991, at 56 Fed. Reg. 448.

This letter is an advisory opinion under ERISA advisory opinion procedure 76-1 (41 Fed. Reg. 36281, Aug. 27, 1976). Section 10 of the procedure explains the effect of advisory opinions. This opinion relates only to the specific issues raised in your request and not to any other provisions of the statute. For example, the Department is making no comment with respect to the general fiduciary responsibility provisions of section 404 of ERISA which, among other things, require a fiduciary to discharge his or her duties respecting the plan solely in interest of the plan's participants and beneficiaries and in a prudent fashion.

Sincerely,

Robert J. Doyle
Director of Regulations and Interpretations