

**U.S. Department of Labor**

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



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93-06A  
Sec. 408(b)(2), 408(c)(2)

Mr. Steven Sacher, Esq.  
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Dear Mr. Sacher:

This is in response to your request for an advisory opinion that the reimbursement of Allied-Signal Inc. (ASI) by the ASI-sponsored Master Trust Plans for the direct expenses incurred by ASI in providing investment management services to such plans would not constitute a prohibited transaction under section 406 of the Employee Retirement Income Security Act of 1974 (ERISA) and section 4975 of the Internal Revenue Code of 1986 (the Code).

You represent that ASI, a corporation engaged in the manufacture and sale of products and services for the engineered materials, automotive, and aerospace markets, sponsors numerous benefit plans. Fourteen of those plans, the Master Trust Plans, are defined benefit plans covering certain U.S. employees of ASI or its affiliates.<sup>1</sup> Each of the Master Trust Plans is qualified under Section 401(a) of the Code. The assets of the fourteen Master Trust Plans are held in a single trust, known as the Master Trust, which holds only those assets. In addition to the Master Trust Plans, ASI maintains a number of other benefit plans, collectively referred to as the Other ASI Plans.

ASI is the Plan Administrator of each of the Master Trust Plans and ASI's Board of Directors has the sole power to amend each of them. Under ASI's corporate authorities and the terms of the Master Trust Plans, the Retirement Plans Committee (the Committee) of ASI's Board of Directors is the named fiduciary of each of the Master Trust Plans. ASI has delegated to the Committee the authority to exercise all of the powers of the Plan Administrator. The investment of the Master Trust assets is the responsibility of the Pension Investment Committee (PIC), which is a named fiduciary to the extent of its responsibilities. PIC members are appointed by and serve at the discretion of the Committee.

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<sup>1</sup> The Master Trust Plans are: (1) the Allied Corporation Salaried Employees' Pension Plan, (2) the Signal Companies, Inc. Retirement Plan, (3) the Allied Corporation Hourly Employees' Pension Plan, (4) Norplex Retirement Plan for LaCrosse, Wisconsin Bargaining Unit Employees, (5) the Pension Plan of Allied Corporation and Affiliated Companies, (6) the Pension Plan for Salaried Employees of King Radio Corporation, (7) the Pension Plan for Employees of Endevco Unit of Allied Corporation, (8) the Salaried Employees Pension Plan of Allied Corporation, (9) the Allied-Signal Inc. Pension Plan for Hourly Employees, (10) the Kansas City Division Hourly Employees' Pension Plan, (11) the Allied-Signal Inc. Defined Benefit Pension Plan for Hourly Employees - Autolite Division, Elberton, Georgia, (12) the Salaried Employees Pension Plan of Allied Corporation for Allied- Bendix Aerospace Employees at the Kansas City Division, (13) the Allied-Signal Inc. Pension Plan for Hourly Employees of the Galactic Division, and (14) the Allied-Signal Pension Plan for Hourly Employees of the Autolite Division Spartanburg, South Carolina.

The Master Trust Plans require the services of outside actuaries, trustees, investment managers, and counsel to provide a variety of consulting, administrative, investment, legal, and other services related to plan administration or investment of plan assets. Generally, these outside professionals have been compensated directly from the assets of the Master Trust Plans. In addition, ASI itself provides services to the Master Trust Plans. ASI employs a full-time staff of professionals and a clerical in its Investment Department to assist the PIC in carrying out its responsibilities. The Committee makes the decision to engage the Investment Department to perform investment management services for the Master Trust Plans and the Other ASI Plans.

All of the employees in the Investment Department are engaged exclusively in the provision of investment management services including direct management of assets, monitoring the performance of outside investment managers and trustees and making recommendations with respect to their selection and retention, formulating strategic portfolio decisions, and reviewing the financial performance of plans. All of the employees of the Investment Department, both professional and clerical, for whom ASI seeks reimbursement of compensation devote 100 percent of their time to plans maintained by ASI.

Historically, ASI has paid the compensation of the Investment Department employees without reimbursement by the Master Trust Plans. ASI now proposes to be reimbursed for future investment management services provided by the Investment Department employees to the Master Trust Plans. ASI will seek annual reimbursement from the Master Trust Plans for the portion of each Investment Department employee's total compensation that is attributable solely to the services that Investment Department employee provided to the Master Trust Plans during the preceding year. ASI also proposes to be reimbursed annually for the cost of telephone calls, travel for which receipts are submitted, mailings, and office supplies that are used or incurred by the Investment Department employees exclusively to provide the investment management services to the Master Trust Plans.

You represent that the investment management services of the employees of the Investment Department for which reimbursement is sought from the Master Trust Plans are not the subject of any long-term agreement or contract. The proposed reimbursement arrangement described herein will be terminable by either the PIC or the Committee on reasonably short notice and without penalty to the Master Trust Plans. In addition, you represent that the Investment Department employees will not perform any "settlor" functions, such as the establishment, design, and termination of plans.

According to your representations, none of the employment positions in the Investment Department for which ASI seeks reimbursement would exist were it not for the services provided to the Master Trust Plans by ASI. If ASI ceased providing such services, it would eliminate those positions and either lay off the employees who hold them or allow such employees to compete for then-open positions in other areas of ASI. In such a case, the investment management services provided directly to the Master Trust Plans and the Other ASI Plans would be transferred to one or more outside managers, leaving only monitoring activity, which would be undertaken by a newly-hired individual. ASI represents that it will inform the Committee, in writing, that should ASI cease providing the services for which it seeks reimbursement from the Master Trust Plans, it will sever the employees engaged in providing those services, possibly allowing them to compete for existing open positions within ASI according to ASI guidelines governing transfers in the event of job elimination.

You further represent that ASI can properly identify and segregate all expenses, including compensation of the Investment Department employees, for investment services provided to the Master Trust Plans and to the Other ASI Plans. In this regard, you indicate that each Investment Department employee will maintain time records, specifying separately hours worked on behalf of the Master Trust Plans and hours worked on behalf of the Other ASI Plans. Reimbursement will not be sought for the compensation of each employee that is attributable to work on the Other ASI Plans.

With respect to all expenses other than the employees' compensation incurred by the Investment Department, ASI will make quarterly determinations of the expenses incurred in connection with the services that are performed for the Master Trust Plans by reviewing contemporaneous records of telephone calls, travel, mailings, and office supply costs. Reimbursement will not be sought for overhead expenses such as rent, electricity, heat, etc., or for travel expenses for which receipts were not submitted. ASI will seek reimbursement from the Master Trust Plans only for expenses incurred on their behalf. Overhead expenses and expenses incurred for investment services provided to the Other ASI Plans would continue to be paid by ASI.

Regarding the allocation of Master Trust Plan costs among the individual Master Trust Plans, you represent that the compensation and expenses for which reimbursement is sought can be allocated to each Master Trust Plan only on the basis of a proportional asset-based method. The compensation of all of the Investment Department employees, professional and clerical, and all expenses incurred in connection with the provision of the investment management services to the Master Trust Plans arise from the provision of investment management services on behalf of the Master Trust as a whole, and not on behalf of any one or group of the Master Trust Plans. The work performed by the outside investment managers, and monitored by Investment Department employees, is also not performed on behalf of any one of the Master Trust Plans, but rather on behalf of all of them. ASI therefore proposes that each Master Trust Plan would be charged the proportion of reimbursable compensation and expenses that is equal to the proportion of that Master Trust Plan's assets to the total assets of all Master Trust Plans.

You further represent that the Committee will retain, or will cause the PIC to retain, an independent consultant or consultants to advise it on a quarterly basis as to whether the services provided by the Investment Department employees are necessary for the administration of the Master Trust Plans and whether the quality of the services provided to, and level of compensation and expense to be reimbursed by, each Master Trust Plan are at least as favorable to such Plan as those that would be provided and paid under a reasonable third-party arrangement. In addition, the Chairman of the PIC will review the compensation levels of the Investment Department employees and, in his fiduciary capacity, will approve the reimbursable compensation only if he determines that it is reasonable when compared to the value of the services provided to the Master Trust Plans.

The methods of recording time and the allocations among the two groups of plans will be subject to quarterly verification and audit by ASI's internal auditors and its outside accountant. The time records and reports of the internal auditors and the outside accountant will be furnished quarterly to the independent consultant or consultants, and annually to the Chairman of the PIC before a determination is made respecting reimbursement for the year.

In addition, ASI's auditors will verify, prior to each year's reimbursement request, that the compensation and expenses charged to each of the Master Trust Plans for that year are, in fact, directly proportional to each Master Trust Plan's share of the assets in the Master Trust. The outside accountant for the Master Trust Plans will audit the allocations as part of the annual financial audit performed in connection with each Master Trust Plan's Form 5500.

Under Presidential Reorganization Plan No. 4 of 1978, effective December 31, 1978, the authority of the Secretary of the Treasury to issue rulings under section 4975 of the Code has been, with certain exceptions not here relevant, transferred to the Secretary of Labor, and the Secretary of the Treasury is bound by the interpretations of the Secretary of Labor pursuant to such authority. Therefore, references in this letter to specific sections of ERISA refer also to the corresponding sections of the Code.

You represent that ASI, as the Plan Administrator of the Master Trust Plans, is a party in interest and a fiduciary with respect to the Master Trust Plans within the meaning of sections 3(14) and 3(21) of ERISA. You state that the Committee, as named fiduciary of each of the Master Trust Plans, and the PIC, as named fiduciary to the extent of its investment responsibilities under the Master Trust Plans, and each of their members are parties in interest and fiduciaries with respect to the Master Trust Plans under sections 3(14)(A) and 3(21) of ERISA. The Investment

Department professionals are also fiduciaries by virtue of their discretionary authority and control respecting the management and disposition of that portion of the Master Trust assets which are directly managed and for which they formulate strategic portfolio decisions. The Investment Department professionals may also be fiduciaries with respect to their responsibility to review the performance of and make recommendations relating to the appointment of the outside investment managers. As fiduciaries, the Investment Department professionals are parties in interest under section 3(14)(A). The Investment Department clerical, as a service provider, is a party in interest within the meaning of section 3(14)(B).

Section 406(a)(1)(C) and (D) of ERISA provides, in part, that a fiduciary with respect to an employee benefit plan 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 furnishing of goods, services or facilities between the plan and a party in interest with respect to the plan or transfer to, or use by, or for the benefit of, a party in interest, of any assets of the plan. Section 406(b)(1) of ERISA further prohibits a fiduciary with respect to a plan from dealing with the assets of the plan in his or her own interest or for his or her own account. Section 406(b)(2) of ERISA provides that a fiduciary shall not in his or her individual or in 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 prohibits a fiduciary from receiving a fee or other consideration for his or her own personal account from a party dealing with a plan in connection with a transaction involving the assets of the plan.

Subject to the limitations of section 408(d) of ERISA, section 408(b)(2) exempts from the prohibitions of section 406(a) any contract or reasonable arrangement with a party in interest, including a fiduciary, for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor. Section 408(c)(2) of ERISA provides, in relevant part, that nothing in section 406 shall be construed to prohibit any fiduciary from receiving compensation for services rendered, or for the reimbursement of expenses properly and actually incurred, in the performance of his or her duties with respect to the plan.

Regulations issued by the Department of Labor (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. § 2550.408b-2(d) and § 2550.408c-2) as used in sections 408(b)(2) and 408(c)(2) of ERISA.

Accordingly, the provision of investment management services by ASI's Investment Department to the Master Trust Plans would be exempt from the prohibitions of section 406(a) of ERISA if the conditions of section 408(b)(2) are met. We note, however, that the question of what constitutes a necessary service, a reasonable contract or arrangement, and reasonable compensation is inherently factual in nature. Section 5.01 of ERISA Advisory Opinion Procedure 76-1 (ERISA Pro. 76-1, 41 Fed. Reg. 36281, August 27, 1976) states that the Department generally will not issue opinions on such questions. The appropriate plan fiduciaries must determine, based on all of the relevant facts and circumstances, whether the conditions of section 408(b)(2) are satisfied.

With respect to the prohibitions in section 406(b), regulation 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 is exempt under section 408(b)(2). As explained in regulation 29 C.F.R. § 2550.408b-2(e)(1), if a fiduciary uses the authority, control, or responsibility which makes him or her 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 affect the exercise of his or her best judgment as a fiduciary, a transaction described in section 406(b) of ERISA would occur, and that transaction would be deemed to be a separate transaction from the one involving the provision of services and would not be exempt by section 408(b)(2)

of ERISA. However, regulation section 29 C.F.R. § 2550.408b-2(e)(3) provides that if a fiduciary furnishes services to a plan without the receipt of compensation or other consideration (other than reimbursement of direct expenses properly and actually incurred in the performance of such services within the meaning of 29 C.F.R. § 2550.408c-2(b)(3)), the provision of such services does not, in and of itself, constitute an act described in section 406(b) of ERISA. The mere selection of ASI to provide investment management services to the Master Trust Plans without the receipt of compensation other than the reimbursement of direct expenses would not, in itself, constitute a violation of section 406(b) of ERISA. However, because a violation of section 406(b) could occur in the course of the Committee's decision to retain ASI in accordance with the proposed arrangement described above, the Department is unable to rule that the decision, in operation, would in no case violate that section.

With regard to whether "direct expenses" includes the compensation paid to the employees of ASI's Investment Department, 29 C.F.R. § 2550.408c-2(b)(3) provides that an expense is not a direct expense to the extent it would have been sustained had the service not been provided or if it represents an allocable portion of overhead costs.<sup>2</sup> You represent that none of the employment positions for which reimbursement is sought would exist if it were not for the services ASI provides to the Master Trust Plans. You further indicate that, if ASI ceased providing such services to the Master Trust Plans, ASI would eliminate the positions and either lay off the employees who hold them or allow such employees to compete for then-open positions in other areas of the Company.

In the Department's view, compensation paid by a service provider to its employees, including employees who exercise discretion regarding plan investments, may be a properly reimbursable expense under 29 C.F.R. § 2550.408c-2(b)(3) if the expense would not, in fact, have been sustained had the services not been provided, if it can be properly allocated to the particular services provided, and if the expense does not represent an allocable portion of overhead costs. What constitutes a direct expense in a particular case, however, is a factual matter which can only be resolved by taking into account the relevant facts and circumstances. As noted above, the Department ordinarily will not issue an advisory opinion on such questions. The Department notes, however, that an expense would not be properly reimbursable to the extent it was incurred in connection with a service that was not otherwise exempt under sections 408(b)(2) and 408(c)(2), and the corresponding regulations.<sup>3</sup> Thus, the Committee, in its fiduciary capacity

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<sup>2</sup> The Department previously addressed the issue of "direct expenses" in Advisory Opinion 89-09A (June 13, 1989). In that Opinion, employees of the employer who sponsored the plans provided administrative and non-discretionary asset-management services to the plans. The employer sought to be reimbursed for the salary and fringe benefit costs attributable to these employees, none of whom was a fiduciary. The employer represented that the employees for whom it sought reimbursement devoted 100 percent of their time to one or more of its plans. The employer also represented that each of the employees with respect to whom it would be reimbursed for its salary and fringe benefits would not at the same time receive full-time compensation from the employer for services performed in connection with administrative and asset-management services provided to the plans from which reimbursement was sought. In addition, the employer represented that if it ceased providing such services, it would lay off the employees providing such services or allow such employees to compete for then-open positions elsewhere in the Company. In that opinion, the Department stated that compensation paid by a service provider to its employees may be a properly reimbursable expense under 29 C.F.R. section 2550.408c-2(b)(3) if the expense would not, in fact, have been sustained had the services not been provided, if it can be properly allocated to the particular services provided, and if it does not represent an allocable portion of overhead costs.

<sup>3</sup> ASI has represented that the compensation of the five professionals in the Investment Department consists of a base salary and certain incentive bonuses. ASI states that the compensation program for the Investment Department, including the incentive bonus, is consistent with competitive practice. The Department has not reviewed, and expresses no view regarding, the particular incentive bonus arrangement, but cautions the appropriate plan

with respect to selecting and retaining ASI's Investment Department, and not ASI, in its capacity as plan sponsor, must review each service to be provided by ASI through its Investment Department to determine whether such service is a "necessary service" for which reimbursement is lawful.

In addition, the allocation method selected must allocate each expense to reflect the actual service provided to the particular plan. In particular, where the expense is for a service that benefits other plans in addition to the reimbursing plan, the allocation method must include written criteria for reasonably determining the portion of the expense that is attributable to the reimbursing plan. Thus, the Committee must also determine whether the proposed allocation methods properly allocate the expenses to the Master Trust Plans, both as a group and individually. The question of whether a particular method properly allocates the expenses involved, including compensation of employees, is an inherently factual matter on which the Department will not normally issue an advisory opinion.

Further, because section 408(b)(2) of ERISA provides an exemption from the prohibited transactions described in section 406(a), and the implementing regulation at 29 C.F.R. 2550.408b-2(e)(3) sets forth an exception to the acts described in section 406(b) of ERISA, it is the Department's position that the parties claiming application of these provisions have the burden of establishing compliance with their terms. Establishing compliance with these provisions, as well as the non-inurement and exclusive purpose requirements of sections 403(c)(1) and 404(a)(1), requires that the parties maintain records adequate to verify that the allocation methods employed properly allocate expenses to the plans from which reimbursement is obtained.

The Department notes that ERISA's general standards of fiduciary conduct would apply to the proposed arrangement. Section 404(a)(1)(B) of ERISA requires that a fiduciary discharge his or her duties with respect to a plan solely in the interest of the participants and beneficiaries, and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Accordingly, the Committee must act "prudently" and "solely in the interest" of the Master Trust Plans' participants and beneficiaries when causing the Master Trust Plans to enter into the proposed arrangement. If the decision by the Committee to retain ASI's Investment Department to provide the investment management services specified in the proposed arrangement and to reimburse ASI for the services in accordance with the proposed arrangement is not "prudent" and "solely in the interest" of the Master Trust Plans' participants and beneficiaries, the Committee would be liable for any loss resulting from such breach of fiduciary responsibility, even though the retention and reimbursement of ASI may not constitute a prohibited transaction.

This letter is an advisory opinion under ERISA Procedure 76-1. Section 10 of the procedure explains the effect of an advisory opinion.

Sincerely,

ROBERT J. DOYLE  
Director of Regulations and Interpretations

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fiduciaries to consider any potential conflicts of interest in connection with such performance-based compensation arrangements. See generally Advisory Opinions 86-20A and 86-21A (Aug. 29, 1986).