

U.S. Department of Labor

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



July 30, 1998

98-06A
PTE 77-3

Mr. Donald J. Myers
Reed Smith Shaw & McClay LLP
1301 K Street, N.W.
Suite 1100 - East Tower
Washington, D.C. 20005-3317

Re: Federated Investors
Identification Number C-9171

Dear Mr. Myers:

This is in response to your request on behalf of Federated Investors ("Federated") for guidance concerning whether Prohibited Transaction Class Exemption 77-3, 42 Fed. Reg. 18734 (April 8, 1977) (PTE 77-3) provides relief for the investment by a bank's in-house plan in a mutual fund advised by the bank through an in-kind exchange of assets for mutual fund shares, assuming the conditions of the exemption have been satisfied.

You represent that Federated advises, administers and distributes its own mutual funds, and also administers, distributes and provides related services to funds that are advised by other financial institutions, including many banks. Federated has assisted its client banks in establishing "proprietary" mutual funds, i.e., open-end investment companies registered under the Investment Company Act of 1940 as to which the bank serves as investment adviser. These funds often come to serve as the investment vehicles for in-house bank plans through the conversion or partial conversion of the collective investment funds (the "CIFs") maintained by the bank. Federated assists these banks in the conversion process, and may serve as administrator and distributor, as well as in other capacities (such as transfer agent and portfolio recordkeeper) with respect to the proprietary mutual funds.

You state that on the date of a CIF conversion, assets representing the interests of investing plans in the converting CIFs are transferred to the mutual funds, in exchange for which the plans receive shares of the mutual funds of equal value to the assets transferred. These assets are valued for purposes of the transfer in a consistent and objective manner as of the close of business on the day of the transfer in accordance with the valuation conditions of Rule 17a-7 under the Investment Company Act of 1940 at 17 C.F.R. section 270.17a-7. Rule 17a-7 was adopted by the Securities and Exchange Commission as an exemption to permit, among other things, direct portfolio transactions between funds using the same investment adviser subject to specific conditions. That rule, at subsection 270.17a-7(b), requires that each security be valued at its "independent current market price" and stipulates the methods for determining price based on independent sources, as follows:

- (1) If the security is a 'reported security' as that term is defined in rule 11Aa3-1 under the Securities Exchange Act of 1934, the last sale price with respect to such security reported in the consolidated transaction reporting system ('consolidated system') or the average of the highest current independent bid and lowest current independent offer for such security (reported pursuant to rule 11Ac1-1 under the Securities Exchange Act of 1934) if there are no reported transactions in the consolidated system that day;
or

- (2) If the security is not a reported security, and the principal market for such security is an exchange, then the last sale on such exchange or the average of the highest current independent bid and lowest current independent offer on such exchange if there are no reported transactions on such exchange that day; or
- (3) If the security is not a reported security and is quoted in the NASDAQ system, then the average of the highest current independent bid and lowest current independent offer reported on Level 1 of NASDAQ; or
- (4) For all other securities, the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry.¹

You also represent that all plans involved in these transactions, both the in-house plans of the bank and the outside client plans of the bank, are treated in the same manner in these transactions and on a basis no less favorable than such dealings would be with other shareholders of the mutual funds. No brokerage commissions or other transaction costs are charged to the CIFs, the investing plans or the mutual funds in the exchange transaction.

PTE 77-3 provides that the restrictions of sections 406 and 407(a) of the Employee Retirement Income Security Act of 1974 (“ERISA”) and the taxes imposed by section 4975 (a) and (b) of the Internal Revenue Code (the “Code”), by reason of section 4975(c)(1) of the Code, shall not apply to the acquisition or sale of shares of an open-end investment company registered under the Investment Company Act of 1940 by an employee benefit plan covering only employees of such investment company, employees of the investment adviser or principal underwriter for such investment company, or employees of any affiliated person of such investment adviser or principal underwriter; provided that the conditions of the class exemption are met. The term “acquisition” is not defined in PTE 77-3.

In support of your argument that PTE 77-3 extends to the in-kind exchange of assets for mutual fund shares, you note that the regulation at 29 C.F.R. 2550.407a-2(b) defines the term “acquisition” for purposes of section 407(a) of ERISA to include both an acquisition “by purchase” and “by the exchange of plan assets.”² You assert that by distinguishing a “purchase” from an “exchange,” the regulation makes clear that, compared to a “purchase,” an “acquisition” is a broader term that includes both cash “purchases” and in-kind “exchanges.” In this regard, you argue that the meaning of the term “acquisition” in both the regulation and PTE 77-3 should be interpreted in a similar manner. However, the Department notes that the definition of the term “acquisition” in 29 CFR 2550.407a-2(b) does not control the meaning of that term in PTE 77-3, since the application of that definition is expressly limited to the implementation of section 407(a) of ERISA.

¹ You indicate that according to the SEC staff, “reasonable inquiry” involves obtaining sufficient prices or quotations from disinterested broker-dealers or pricing services to allow a determination of actual value. In response to questions as to what constitutes “reasonable inquiry,” the staff has generally taken the position that use of three sources satisfies the “reasonable inquiry” standard.

² Regulation 2550.407a-2(b) provides that for purposes of section 407(a) of ERISA, an acquisition by a plan of qualifying employer securities or qualifying employer real property shall include, but not be limited to, an acquisition by purchase, by the exchange of plan assets, by the exercise of warrants or rights, by the conversion of a security (except any acquisition pursuant to a conversion exempt under section 408(b)(7) of the Act), by default of a loan where the qualifying employer security or qualifying employer real property was security for the loan, or by the contribution of such securities or real property to the plan. However, an acquisition of a security shall not be deemed to have occurred if a plan acquires the security as a result of a stock dividend or stock split. See also Regulation 2550.408e(b).

Nevertheless, it is the view of the Department of Labor (the “Department”) that relief under PTE 77-3 is available not only for cash purchases of investment company shares, but also for transactions involving the exchange of securities held on behalf of a plan for shares of the investment company. In this regard, the Department notes that section (d) of PTE 77-3 requires that all other dealings between the plan and the investment company, the investment adviser or principal underwriter for the investment company, or any affiliated person of such investment adviser or principal underwriter, are on a basis no less favorable to the plan than such dealings are with other shareholders of the investment company. The Department further notes that Prohibited Transaction Exemption 97-41 (62 FR 42830, August 8, 1997) permits a plan to purchase shares of an open-end mutual fund, the investment adviser for which is a bank that also serves as a fiduciary of a non-affiliated client plan, in exchange for plan assets transferred in-kind to the fund from a collective investment fund maintained by the bank. To the extent that the transactions described in your request involve both the conversion of CIF assets owned by outside client plans, which is within the scope of PTE 97-41, and the conversion of CIF assets owned by in-house plans, which is not, the Department interprets section (d) of PTE 77-3 to require that the methodology used to value the assets of the in-house plan transferred to the mutual fund and to determine the number of shares of the mutual fund received by the in-house plan, be the same as is applicable to the conversion of outside client plan assets under PTE 97-41.

Moreover, section 406(b)(1) of ERISA prohibits a fiduciary from dealing with the plan’s assets in his or her own interest or for his or her own account. In addition, section 406(b)(2) of ERISA prohibits a plan fiduciary from acting on behalf of a party whose interests are adverse to the interests of the plan or the plan’s participants or beneficiaries. Accordingly, a plan fiduciary considering the in-kind acquisition of shares of a mutual fund advised by the bank in exchange for assets of the bank’s in-house plan must ensure that the fiduciary’s or the bank’s interest in attracting and retaining investors in the mutual fund does not conflict with the interests of the plan or its participants and beneficiaries in the selection of appropriate investment vehicles.

In addition, it is the Department’s view that the class exemption prescribed in PTE 77-3 would not provide relief for any prohibited transaction that may arise in connection with terminating a CIF, permitting certain plans to withdraw from a CIF that is not terminating, or transferring any plan assets held by a CIF. PTE 77-3 only provides relief for the acquisition of a proprietary mutual fund’s shares by an in-house plan in exchange for assets that were transferred from a CIF.

The Department cautions that ERISA’s general standards of fiduciary conduct would apply to the plan’s acquisition of mutual fund shares in exchange for plan assets transferred in-kind to the mutual fund from a CIF maintained by the plan’s sponsor. 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 plan fiduciary must act “prudently” and “solely in the interest” of the plan’s participants and beneficiaries with respect to the decision regarding the in-kind acquisition of mutual fund shares by the plan.

The Department further emphasizes that it expects a plan fiduciary, prior to entering into the transaction, to fully understand the mechanics of the transaction and to evaluate the risks associated with this type of investment, following disclosure of all relevant information pertaining to the transaction, including the valuation methodology applicable to the transferred securities and the mutual fund shares received in exchange. If the decision by the plan fiduciary to enter into the transaction is not “solely in the interest” of the plan’s participants and beneficiaries, e.g., if the decision is motivated by the intent to generate seed money that facilitates the marketing of the mutual fund, then the plan fiduciary would be liable for any loss resulting from such breach of fiduciary responsibility, even if the acquisition of mutual fund shares was exempt by reason of PTE 77-3.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, it is issued subject to the provisions of the procedure, including section 10 thereof, relating to the effect of advisory opinions.

Sincerely,

Ivan Strasfeld
Director
Office of Exemption Determinations