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A legal update from Dechert's Employee Benefits and Executive Compensation and Financial Services Groups

Sales of Open-End Registered Funds to "In House" Plans

DOL Clarifies Definition of "Sales Commissions" Under PTCE 77-3

The U.S. Department of Labor ("DOL"), in an advisory opinion issued on July 26, 2006,¹ held that the sale of proprietary mutual funds to a plan covering employees of the fund's adviser would be covered by ERISA Prohibited Transaction Class Exemption 77-3 ("PTCE 77-3"), even though distribution-related expenses such as 12b-1 fees were paid by the proprietary mutual funds to an unrelated broker. This holding represents the DOL's acknowledgement that the prohibition in PTCE 77-3 on plan payments of sales commissions applies only to such payments to the adviser or its affiliates, and not to an unrelated third party. Thus, this advisory opinion gives proprietary mutual funds greater flexibility to provide for arrangements involving 12b-1 fees in appropriate circumstances.

PTCE 77-3 provides relief from the prohibited transaction rules of ERISA and Section 4975 of the Code for the acquisition or sale of shares of funds 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. One of the requirements is that the plan must not pay a sales commission in connection with such acquisition or sale.

In the situation addressed in the advisory opinion, a mutual fund's investment adviser (the

"Adviser") sponsored a 401(k) plan (the "Plan") that permitted Plan participants (i.e., the employees of the Adviser and its affiliates) to invest in mutual funds advised by the Adviser (the "Funds") as well as unrelated mutual funds. Some of the Funds in which participants invested their accounts adopted 12b-1 plans, and the requesting parties asked whether the Funds' distributor could pay a 12b-1 fee to the broker maintaining a self-directed brokerage account for such participants, with respect to amounts invested in the Funds by Plan participants. The broker provided brokerage services to the Plan participants, was not a fiduciary to the plan, and was unrelated to the Funds, the investment adviser, and the successor trustee. It was represented that the Plan's investment in the Funds met the conditions stated in PTCE 77-3.

Based on the facts that (1) the broker was unaffiliated with the Fund, the Fund's principal underwriter/distributor, any investment advisers or any affiliate thereof, and any other fiduciary of the Plan, (2) neither the investment advisers nor their affiliates would receive any part of the 12b-1 Fees, nor would any fiduciary with respect to the Plan or affiliate of such fiduciary receive such fees, and (3) no commissions would be paid from the Plan participants' accounts other than 12b-1 Fees out of Fund assets, the DOL concluded that the term "sales commission," as used in PTCE 77-3, would not include 12b-1 fees that are paid to a broker by a distributor from Fund assets, where the

¹ Advisory Opinion 2006-06A (July 26, 2006).

broker is an unrelated party and the distributor keeps no part of the 12b-1 fees.

The holding in this advisory opinion is similar to the DOL's holding in Advisory Opinion 2002-05A² that PTCE 77-4 (which also contains a condition that no sales commissions be paid) would apply to a plan's purchase of shares of an exchange traded fund ("ETF"), notwithstanding the payment of sales commissions to an independent broker who executes the transaction on an exchange. In that ruling, the DOL

² Advisory Opinion 2002-05A (June 7, 2002).

explained that the prohibition in PTCE 77-4 on the payment of sales commissions by a plan was intended to avoid potential abuses that could arise if a mutual fund, its investment adviser, or an affiliate were to receive a commission or load in connection with the transaction. This latest ruling for in-house plan purchases contains the same analysis.



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