SEC's and DOL's Cross Agency Waltz: The ERISA Connection to Disclosure, Advice, Compensation and Conflict of Interest

By Robert J. Toth, Jr.

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The path of securities compliance and risk management and the path of ERISA (or, for the non-initiate, the Employee Retirement Income Security Act of 1974) retirement plan compliance have only tangentially crossed in the past, as those two professions have largely been insulated from each other within the staffs of the various financial service companies. We have all likely noticed some "creep" in the past few years, as the SEC's growing interest in protecting the interests of retirement plan participants has caused the divergent staffs to at least introduce themselves to each other. The SEC sweeps of financial service companies focusing on disclosure of fees and "contingent compensation" a few years back, seemingly in response to the concurrent Spitzer investigations, really made a milestone moment. During those sweeps, the SEC actively used the antifraud provisions of the '33 and '34 Acts to conduct a (often cursory) review of many financial service companies' compensation practices as they related to 401(k) plans. Prior to this, the SEC had generally taken a very "non-involved" approach to 401(k) plans because of its exempted security status.

There is little wonder why the SEC has exhibited this increased interest: the Employee Benefit Research Institute (EBRI) estimates that privately trusteed retirement plan assets exceeded $9 trillion as of the end of 2008 (down from $12.5 billion at the end of 2007).[1] This does not take into account the assets in governmental retirement plans.

This article will hopefully help the securities compliance staff understand the strong connection between securities law and ERISA in the retirement industry, a relationship which both ERISA and securities professionals have largely been able to minimize in the past.

Last July, the SEC and U. S. Department of Labor (the DOL) launched a considerable shot across the compliance professional's bow: the two agencies, previously often at loggerheads and which had engaged in minimal cooperation, issued a joint Memorandum of Understanding[2], (the "MOU"). The MOU was particularly striking in that the two agencies committed to increased *investigative* cooperation. Many of us in the industry had been pressing for increased *policymaking* coordination, and were taken by surprise by the two agencies' enforcement initiative.

Then Chairman Cox said at the time that

> "With a growing number of seniors focused on managing their own 401(k) plans, it's important to improve disclosure to give them the information they need and in a form they can use. To accomplish this, the Department of Labor and the SEC are committed to coordinating closely on their behalf. This enhanced coordination of the SEC's investor protection efforts and the Department of Labor's regulatory responsibility for pensions and 401(k)s will greatly benefit the millions of hardworking Americans who are saving and investing for their retirement as well as those who have already retired."[3]

Last July, the SEC and U. S. Department of Labor (the DOL) launched a considerable shot across the compliance professional's bow: the two agencies … issued a joint Memorandum of Understanding…committed to increased investigative cooperation.

The SEC's and DOL's commitment should strike compliance professionals as extraordinary. Under the MOU:

> -The agencies have committed to regular, staff level meetings to discuss matters of mutual interest – including examination findings, trends, and examination results;
>
> -The agencies will designate staff in each agency's regional offices to serve as points of contact to assist in the communications between the agencies with respect to matters of mutual interest.
>
> -Each agency will seek to identify cross training opportunities to train each other's staffs on issues designed to "effectively protect the public."
>
> -Each agency will grant to each other access to their non-public investigation information, carefully honoring federal laws related to the safeguarding of federal financial privacy rules.[4]

What does this mean for compliance professionals? In conversations with DOL officials, it means that these agencies now feel they have the formal leverage they have been seeking to "go after the bad guys." For the compliance professional, it means that the presence of a DOL or an SEC audit within their firm, where either agency cites the firm for violations related to disclosure, compensation or advisory practices, also means that the firm would be well advised to prepare for an investigation by the other agency.

This increases the securities compliance staffs' burden, and will necessitate that the staff have a basic understanding of ERISA's disclosure, compensation and advisory rules which will now impact their own practices.

The Basics: ERISA's approach to Disclosure, Compensation, Advice and Conflict of Interests.

Before identifying the specific areas in which the compliance professional should most likely expect activity, it is first important to understand how and why ERISA rules apply to important areas of securities compliance. Throughout this paper, we will be using the term "revenue sharing." In the ERISA world, this is a reference to all revenue which is generated from the investments of a plan, and includes (but is not limited to) 12b-1 fees, sub-transfer agent fees, recordkeeping and marketing fees.

ERISA

Lets begin with ERISA itself. ERISA consists of four "Titles", which govern the whole range of employer-sponsored employee benefit programs from severance plans, to health benefits, to retirement plans and others. It is, as the U.S. Supreme Court has stated, a "highly reticulated"[5] statute designed to provide a comprehensive federal scheme for governing employee benefits – particularly for businesses that operate in many different states. To that end, ERISA has a very strong pre-emption clause under which it will prevent the application of most state laws to ERISA-governed retirement plans – except for those relating (with some exceptions) to securities, banking or insurance.[6] Just as ERISA will not preempt the application of state securities law,[7] it also does not preempt other federal laws. Its jurisdiction with federal securities laws is concurrent.

The references in this article are to provisions within ERISA's "Title 1", which contain virtually all of the rules to which securities laws may also have some applicability. Practitioners often refer to ERISA-governed plans as "Title 1" plans.

It is important for the compliance professional to recognize that ERISA does not cover all retirement plans. Exempted from its coverage are governmental retirement plans (such as those for school districts, state universities and police and fire departments) and most church plans.[8] Also exempted from ERISA coverage are certain plans with very limited employer involvement, such as certain retirement plans under Section 403(b) of the Internal Revenue Code and certain payroll-based IRA purchase plans.

An ERISA retirement plan is an entity which can sue or be sued, and which is required to establish and maintain a compliant corporate governance process.[9] The plan's fiduciaries are required to establish procedures by which they contract with others to run the plans, and to monitor the performance of those with whom they contract. Those who act on behalf of a retirement plan which is subject to ERISA are held to the strictest standard which exists under law: they must act for the exclusive benefit of the plan and its participants.[10]

This is how most financial services companies become intertwined with ERISA – they are hired by fiduciaries who allocate a portion of their fiduciary obligations to the service provider. Even where fiduciary obligations are not delegated, the manner in which a plan fiduciary deals with a non-fiduciary service provider is still governed by strict fiduciary rules.

Prohibited Transactions

Reality created a challenge for the drafters of ERISA: those who sponsor and maintain these retirement plans are employers who often have interests which conflict with those of the plan. The most glaring example of this was the infamous failure of Studebaker, which used its pension fund in a failed attempt to save the company from bankruptcy – an act which eventually led to the establishment of ERISA.[11]

Congress resolved the issue with a very simple rule: nothing can be done with any retirement plan asset unless it is specifically permitted by statute, regulation or administrative fiat.[12] This concept is embodied in a set of rules called the "Prohibited Transaction" rules. An example on how stringent these rules can be is that the only reason benefits can be paid from an ERISA governed retirement plan is because those payments are specifically authorized by the statute.

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These rules require that violative transactions be "corrected" and, for most retirement plans, a severe tax penalty and potential DOL civil penalty be paid. Correction involves "unwinding" the transaction to the extent possible, and putting the plan back into the position it would have been had the prohibited transaction not occurred. This is the most significant challenge facing financial service companies, and is very much akin to the twelve month right of recission granted for certain securities law violations – except that this particular recission is mandatory, and has up to a six year statute of limitations[13] for purposes of the civil penalty which is assessable by the DOL.

One of the most curious parts of the prohibited transaction rules is that these transactions also have a severe tax penalty, one which also carries a mandatory duty to report the transaction to the IRS. Failure to report the transaction keeps the statute of limitations on the tax open into perpetuity, or until three years after the transaction is reported, whichever is earlier.[14]

As you can imagine, this sort of regulatory scheme has led to the development of a very significant body of rules which governs all aspects related to the manner in which retirement plans can do business with financial service firms. Sales compensation can be paid; advisors can be paid; and products can be purchased – all only if the very specific terms of very specific prohibited transaction exemptions can be met.

It is the prohibited transaction rules which underlay virtually all of the ERISA rules which attract the SEC's attention. Most financial service companies are well versed in these rules, though the knowledge of these rules is often held outside of the securities compliance staffs. Though the securities compliance staff, of course, is knowledgeable of the whole scheme of SEC and FINRA rules governing what an advisor or representative can be paid, how compensation can be structured, and what disclosures are required, there is often a lack of knowledge on how the ERISA rules should be applied – a point which will become critical as the SEC and DOL fully implement their Memorandum of Understanding.

Fiduciary Status

Fiduciary status under ERISA is the key to how the prohibited transaction rules will apply to financial service companies. One set of rules will apply if the service company or its reps are fiduciaries, and another applies if it is merely selling product or providing ministerial services. Three basic rules should provide a handy guide:

1. If products or services are merely being sold to a plan, or providing ministerial services to a plan, there is significant flexibility in the design of fee and compensation arrangements. The biggest burden is that such fees and compensation must be reasonable, disclosed and many of them eventually reported to the DOL.

2. If services being provided give rise to fiduciary status (including services being provided as part of a product), fees and compensation become severely restricted. The fiduciary can never exercise its fiduciary discretion or give advice in a manner which would affect compensation to either the fiduciary or affiliate of the fiduciary. Disclosure does not change this – mere disclosure cannot typically correct a fiduciary's improper exercise of discretion. This has particular impact on the receipt or payment of 12(b)-1 fees, other revenue sharing, or the payment of commissions which vary with the investment product which is purchased by the plan.

3. For product manufacturers, the fees paid to distribution must be disclosed, be reasonable, and be reported to the DOL. The manufacturer cannot retain authority within the product to act unilaterally (with certain exceptions) to increase fees without another fiduciary's effective consent. Further, the manufacturer's ability to receive revenue sharing is prohibited if it has discretionary control over the manner in which plan assets which generate the revenue sharing are invested.

The ERISA rules under the first category, merely selling investment products or other such services to the plan, closely mirror those under securities law: the rule of the day is disclosure. It is usually the case, with some very specific exceptions[15], that compliance with the securities laws and rules will suffice for ERISA purposes.

Where things become difficult, and where ERISA diverges from securities law, is in the matter of "fiduciary" activity: where the professional or company either advises (under ERISA's definition) or exercises any discretion with regard to the investment of plan assets or with regard to the administration of a plan, their compensation becomes severely controlled. The fiduciary's discretionary actions can never affect compensation to the fiduciary or its affiliates. The choice must be made to either sell or advise – both cannot be done.

Specific ERISA Challenges for Securities Compliance Staff

The Department of Labor has two specific initiatives which will impact the securities compliance professional, as they directly affect the payment and receipt of all types of "revenue sharing" and compensation which is typically under the jurisdiction of securities compliance staff. It is these matters under which the greatest impact of the MOU will be felt. The first initiative is a "three pronged" effort aimed at increasing the transparency of compensation; one of the "prongs" directly impacts the ability of financial service companies to receive fees from retirement plans. The second initiative relates to the provision of non-conflicted investment advice, and the efforts to seek out advisors who are acting in their undisclosed self-interest.

The Three Pronged Fee Transparency Effort

The DOL has three disclosure efforts underway, most of which are likely to be toughened further by Congressional action:

1. Government reporting of revenue sharing. All financial service companies who either pay or receive revenue sharing (such as 12b-1 fees) generated from any investment held by a plan (even though the revenue itself may not come from plan assets), must report the revenue sharing and all sales commissions on investment products purchased by a plan, to the employer for inclusion in the plan's annual report form, Form 5500.[16] Employers are required to report to the DOL any vendor who fails to provide this data to the plan. This is a new rule for the 2009 plan year, and is creating an administrative nightmare for most financial service companies.

2. Conditional payment and receipt of fees and revenue sharing. The DOL proposed regulations which would require specific disclosures of all "direct and indirect compensation" generated by a plan's assets, to be disclosed to a plan fiduciary prior to the product or services being provided to the plan. These are called the "408(b)(2) regs"[17], named after the statutory prohibited-transaction exemption which permits a plan to pay reasonable compensation to its service providers. This is a critical rule for financial service providers as it affects their ability to do business with, and receive revenue from, retirement plans.

   Failure to provide this notice would require the recipient of such compensation to return any fees so received, as it would be considered a "prohibited transaction." These rules have been put on hold while the new Administration reviews them. They are generally viewed as not being "tough" enough, and we can expect more difficult "conditional payment" rules later this year or early next year.

3. Participant disclosures. The DOL has proposed rules which will require the disclosure to plan participants of the amount of fees charged to their accounts, and a complete disclosure of all fees within investment products purchased by the plan.[18] Like the 408(b)(2) regulations, this has been put on hold until reviewed, and likely toughened, by the new Administration.

Investment Advice and Management

The DOL effort most closely related to the typical work of the securities compliance professional is that related to the provision of investment advice. ERISA is clear on the duties of investment advisors in giving advice or in managing the assets of a plan:

> A fiduciary with respect to a plan shall not—
>
> (1) deal with the assets of the plan in his own interest or for his own account,
>
> (2) in his 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, or
>
> (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.[19]

DOL's long standing position, established through a series of advisory opinions over a number of years, that advisors who receive compensation that varies with investments, must be independent of the investment company which provides the investment product. DOL regions are now actively involved in investigating investment advisors and broker dealers, seeking out those whose advice is "tainted", and where they are dealing with the assets of a plan as a fiduciary on their own behalf, or for the benefit of an affiliate. This work is being coordinated with the regional offices of the SEC.

ERISA Tasks of the Securities Compliance Professional

There are a few things that should be on the "ERISA short list" for a securities compliance staff, which are key to managing a firm's ERISA risk:

Checking on Client ERISA Status

The most straightforward function a securities compliance staff should perform is to insure that procedures are in place to identify the fiduciary status of any retirement plan client. The ERISA rules will not apply to significant numbers of retirement plans. The DOL has no jurisdiction over such plans, and likely has no legal authority to report such plans to the SEC.

The most important exception to this rule is the IRA business. Though most IRAs are not governed by Title 1 of ERISA, they are subject to the prohibited transaction rules and taxes found in Section 4975 of the Internal Revenue Code. Under a quirk in the statute, the DOL is given jurisdiction over those rules, which means that the conflict rules discussed in this article will also apply to IRA products.

Check on Advice vs. Education

Checking on fiduciary status is a critical issue for compliance staff. This will often determine what kind of compensation can be received, a threshold item that needs to be answered prior to dealing with the disclosure issues – and knowing the extent of compliance problems disclosure will ultimately cause. Two points are determinative of fiduciary status – the first is whether "advice" or education is being given, and the second is whether the advice actually gives rise to fiduciary status.

The DOL has recognized the need for participants to receive investment education, and has further recognized that not all investment information is of such a status to be considered advice. To that end, it issued Interpretive Bulletin 96-1[20] by which it provides a safe harbor under which information given to plan participants would not be considered advice, advice which may otherwise trigger fiduciary obligations. The difficult issue for the compliance professional is that some of this information may well constitute "advice" under their companies' own guidelines – which then may create a compliance conundrum.

The basic premise of 96-1 is that the "education" given cannot be specific to any individual participant. Thus, information about the plan itself can be given which describes the features of a plan; general financial and investment information that speaks of general investment concepts such as risk and reward, estimating future retirement income needs, assessing risk tolerance, and a number of financial concepts. The information and materials can have no direct relationship to investment alternatives available to participants and beneficiaries under a plan or to individual participants or beneficiaries. Asset allocation models may be used, as well as interactive investment materials.

Compliance professionals will be well-advised to review a copy of 96-1 for applicability to their circumstances. It may be particularly helpful when conducting on-site reviews to test the nature of "education" being provided by reps and agents.

Check on whether advice gives rise to fiduciary status

Not all advice becomes "fiduciary" in nature. Assuming an advisor (or the services within a product) has crossed the threshold and is providing advice instead of merely educating, the compliance professional should determine whether the advice given triggers fiduciary status. This analysis is similar in concept to the recently rejected Merrill Rule, where merely incidental advice may not give rise to regulated (here, fiduciary) status.

The relevant language from the regulation itself states the following:

> (1) A person shall be deemed to be rendering "investment advice" to an employee benefit plan, within the meaning of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (the Act) and this paragraph, only if:
>
> (i) Such person renders advice to the plan as to the value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and
>
> (ii) Such person either directly or indirectly (e.g., through or together with any affiliate)—

(A) **Has discretionary authority or control**, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or

(B) Renders any advice described in paragraph (c)(1)(i) of this section on a **regular basis** to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, **that such services will serve as a primary basis for investment decisions with respect to plan assets**, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

(2) A person who is a fiduciary with respect to a plan by reason of rendering investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so, shall not be deemed to be a fiduciary regarding any assets of the plan with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any authority or control, **does not render investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation,** and does not have any authority or responsibility to render such investment advice…..[21]

The emphasis in the statute is mine, outlining the four critical features of fiduciary advice: (i) the advisor must have managing control over the assets or, if not, (ii) the advice must be regular, (iii) serve as a primary basis for investment and (iv) be provided for a fee.

Conclusion

It is fair to say that the cooperation of the SEC and the DOL will eventually cause securities compliance staffs to become familiar with the parts of ERISA which intersect with the securities laws, adding to the already "over-full" plate of these staffs. It appears that we are already starting to see the beginnings of coordinated activity. With the DOL's increasing focus on broker dealer and advisory activities, expect to see an increase in coordinated audits. Securities compliance staffs should seek to become involved in DOL audits when they do occur, as the results of such audits are likely to be reviewed by SEC enforcement staff.

ENDNOTES

1 The EBRI report can be found http://www.ebri.org/pdf/publications/books/databook/DB.Chapter%2011.pdf
2 The text of the MOU can be found at http://www.sec.gov/news/press/2008/mou072908.pdf
3 SEC Press Release 2008-154, July 28, 2008
4 See footnote 1
5 Nachman Corp v. PBGC, 446 US 359, 1980
6 ERISA Section 514(a)
7 ERISA Section 514(b)(2)
8 ERISA Section 4
9 ERISA Section 402
10 ERISA Section 404
11 See an interesting historical explanation at http://www.erisalawfirm.com/faq/q/origin_of_erisa.asp
12 ERISA Section 406
13 ERISA Section 413
14 Internal Revenue Code Section 4975.
15 See Prohibited Transaction 94-24, which requires a specific method for the disclosure of insurance commission and for certain mutual find sales to retirement plans.
16 See the DOL's description of these rules at http://www.dol.gov/ebsa/faqs/faq_scheduleC.html
17 See the DOL's explanation at http://www.sutherland.com/file_upload/DOLFactSheeton408b2Guidance00041585.pdf
18 The text of the proposed regulation can be found at http://www.dol.gov/federalregister/PdfDisplay.aspx?DocId=20973
19 ERISA Section 406(b)
20 29 CFR 2509.96-1, which can be found at http://www.dol.gov/dol/allcfr/title_29/Part_2509/29CFR2509.96-1.htm
21 ERISA Reg 2510.3-21