BASICS OF ERISA

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BASICS OF ERISA

I. BASIC FIDUCIARY DUTIES AND STANDARDS

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") is the federal law regulating all employee benefit plans, including popular tax-qualified retirement vehicles like 401(k) plans. In recognition of the fact that the plan sponsor and other plan fiduciaries have the authority and the power to make decisions which unilaterally impact the plan's participants, ERISA imposes "great responsibility" on the plan's fiduciaries. And with great responsibility, comes "great potential liability." Not only can the plan sponsor be held personally liable for any fiduciary breaches, but fiduciary advisors as well as non-fiduciary service providers are potentially subject to the various liability and penalty provisions of ERISA.

Given the importance of these fiduciary duties and the related potential liability, it is important for advisors to plan clients to develop an awareness of the related rules.

A. General

Each plan subject to ERISA must have *at least one fiduciary* who ensures that the plan operates in accordance with the terms of the plan document, any trust agreement or insurance contract, and also with applicable laws and regulations. One individual or entity may function as a fiduciary for more than one plan.

A plan may also have more than one fiduciary.[1] For example, advisors who provide "investment advice" to a plan sponsor are also fiduciaries.[2] A fiduciary should be aware of others who serve as fiduciaries to the same plan, because all fiduciaries have potential liability for the actions of their co-fiduciaries.

Fiduciaries do not include any individuals who only perform ministerial functions and who do not have the power or authority to make decisions with respect to plan policy, interpretation, practices or procedures. For example, an individual who calculates benefits, processes claims, or makes recommendations about plan administration is not a fiduciary if the plan document does not give him the power or authority to make a decision about benefit payments or recommendations.[3]

B. Who is a "Fiduciary"?

ERISA fiduciaries are either named in the plan document or are identified by the function they perform for the plan. Since fiduciary status may be based on a person's conduct rather than his title, it is possible to be a fiduciary without being aware of it.

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[1] 29 CFR §2509.75-8, FR-12.
[2] ERISA §3(21).
[3] 29 CFR §2509.75-8, D-2.

1. Named Fiduciary. Typically, the plan sponsor is specifically identified as the "named fiduciary" of the plan in the plan's governing document, with principal responsibility for its oversight and management.

2. Functional Fiduciary. A fiduciary under ERISA also includes any person who:

a. Exercises discretionary authority or control over the plan's management;

b. Exercises any authority or control over the management or disposition of the plan's assets;

c. Renders "investment *advice*" for a fee or other compensation with respect to plan funds or property; or

d. Has discretionary authority or responsibility with respect to plan administration.[4]

The test for determining fiduciary status is a functional one. In other words, if a person or entity acts or possesses fiduciary-like powers, the person or entity will be deemed to be a fiduciary regardless of his title or official designation. Thus, if a person actually renders investment advice, as described above, for which he is compensated, he or she will be treated as a fiduciary.

3. Investment Advice Fiduciary (also known as "3(21) Fiduciary"). A person renders "investment advice" to a plan within the meaning of the above definition only if his activities are described by both of the following requirements:

a. The advice relates to the value of securities or other property or constitutes a recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and

b. Either

(i) The person has discretionary authority or control with respect to purchasing or selling securities or other property of the plan, or

(ii) The person renders advice to the plan on a regular basis under a mutual agreement or understanding (written or otherwise) that it

[4] ERISA §3(21).

will be a primary basis for investment decisions, and that it will consist of individualized investment advice to the plan based on its particular needs.

Thus, an Investment Advice Fiduciary can provide discretionary or non-discretionary advice.

Investment "education" or general advice relating to investment strategy, such as describing the asset classes that are consistent with long-term investing, does not fall within the definition of investment advice, because it is not geared to the particular needs of a plan.

4. Investment Manager (also known as "3(38) Fiduciary"). If the plan's Named Fiduciary (typically the plan sponsor) appoints an Investment Manager, the Named Fiduciary is not responsible for the individual acts or omissions of the Investment Manager. However, the Named Fiduciary remains responsible for the initial appointment and the ongoing decision to use the Investment Manager,

Unlike an Investment Advice Fiduciary, an Investment Manager must have the discretionary authority over plan assets. In addition, to be an Investment Manager, the provider generally must be a registered investment adviser ("RIA"), a bank or an insurance company. Lastly, the provider must acknowledge in writing that it is a plan fiduciary.

5. Financial Advisors. Financial advisors can include both RIAs and broker-dealers. RIAs typically provide "investment advice" to their plan clients. Accordingly, RIAs are typically plan fiduciaries.

On the other hand, many broker-dealers do not intend to serve their plan clients as fiduciaries, but their activities can cause them to cross the line. Even if a broker-dealer does not intend to serve a plan client as a fiduciary, if it provides "investment advice" to a plan sponsor or plan participants, it would be deemed a functional fiduciary. For example, in Ellis v. Rycenga Homes, Inc., No. 1:04-cv-694, 2007 WL 837224 (W.D. Mich. 2007), periodic meetings between a broker and a plan trustee to review plan investments over the course of a 20 year relationship which was the plan's only source of investment advice and which resulted in the plan's consistently following the broker's suggestions led to the court's holding that the broker and its broker-dealer were fiduciaries.

C. Fiduciary Responsibilities

All plan fiduciaries are subject to strict standards of conduct under ERISA.

1. Fiduciary Standard of Care Under ERISA

A fiduciary must act **solely** in the interest of plan participants and their beneficiaries and alternate payees:

- With the exclusive purpose of providing benefits to plan participants and their beneficiaries;[5] and by
- Carrying out his or her duties prudently;[6]
- Following the terms of the plan documents (unless the documents are inconsistent with ERISA);[7]
- Diversifying plan investments;[8] and
- Paying only reasonable plan expenses.[9]

a. Exclusive Purpose of Providing Benefits

A fiduciary's primary responsibility is to discharge his or her duties solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits for participants and their beneficiaries and alternate payees.[10]

New Participant-Level Disclosure Regulations. In October 2010, the DOL finalized a rule adding a new disclosure duty for plan sponsors, which is now deemed to be a part of a plan sponsor's general fiduciary duty to its participants and beneficiaries. Under this new rule, plan sponsors have a fiduciary duty to disclose certain types of plan-related and investment-related information to participants on an ongoing basis. Specifically, these regulations require both quarterly and annual disclosures relating to the plan's fees and investments. The disclosure rules go into effect, starting with the first plan year that begins on or after November 1, 2011. However, under a favorable transition rule, initial disclosures will not have to be delivered to plan participants in the case of calendar year plans until May 31, 2012.

b. Carrying Out Duties Prudently

Fiduciaries must manage plan assets solely in the interest of participants and beneficiaries with the care, skill, prudence and diligence under the circumstances then prevailing that a

[5] ERISA §404(a)(1)(A)(i).
[6] ERISA §404(a)(1)(B).
[7] ERISA §404(a)(1)(D).
[8] ERISA §404(a)(1)(C).
[9] ERISA §404(a)(1)(A)(ii).
[10] ERISA §404(a)(1)(A)(i).

prudent person acting in a similar situation and familiar with such matters would exercise.[11] With regard to the duty of prudence and plan investments, the DOL and the courts measure prudence by analyzing the process used to select an investment (*e.g.*, the scope and diligence of the fiduciaries' evaluation of the investment), rather than focusing solely on investment performance.

c. Following the Terms of the Plan Document

Fiduciaries must follow the terms of the plan documents unless the documents do not comply with ERISA (*i.e.*, plan operations must comply with the terms of the plan document). Therefore, fiduciaries should be familiar with their plans and the plan documents. Furthermore, the fiduciaries should carefully review the documents periodically to ensure that the documents are legally compliant, and that the plans are operating in accordance with the terms of the plan document.[12]

d. Diversifying Plan Investments

The fiduciary is also responsible for diversifying the plan's investments in order to minimize the risk of large losses unless, under the circumstances, it is clearly not prudent to do so. Generally, fiduciaries should not invest a disproportionate amount of the plan's assets in a particular investment, particular type of investment or in investments concentrated in a particular geographic location. Special rules apply to plans that are intended to comply with Section 404(c) of ERISA, such as 401(k) plans where participants are responsible for investment allocations.

e. Paying Reasonable Plan Expenses Only

ERISA requires plan fiduciaries to ensure that any fees paid by the plan to its investment or service providers are reasonable. Specifically, ERISA Section 404(a)(1) allows expenses to be "defrayed" with plan assets if they are reasonable.

Under a separate set of rules under ERISA, known as the prohibited transaction rules, a plan fiduciary ordinarily cannot use plan assets to pay for services. Fortunately, ERISA Section 408(b)(2) provides an exemption from these rules, allowing the use of plan assets to pay fees for services. However, the exemption applies strictly to a fiduciary's "contracting or making reasonable arrangements" with the plan's service provider for "services that are necessary" for plan operation, and only if no more than "reasonable compensation" is paid for them.

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[11] 29 CFR §2550.404a-1(a).
[12] ERISA §404(a)(1)(D).

New 408(b)(2) Disclosure Regulations. The DOL recently finalized its regulations under section 408(b)(2) of ERISA interpreting the definition and requirements for "contracting or making reasonable arrangements." Under the new regulation, service providers will be automatically obligated to make comprehensive fee disclosures to plan sponsors before they enter into service arrangements. The new rules are effective April 1, 2012, and providers will need to make the required fee disclosures to all existing plan clients before this effective date. These disclosure requirements are intended to help plan sponsors satisfy their existing duty to ensure that the plan pays no more than reasonable compensation to its service providers.

D. Fiduciary Liabilities

ERISA permits participants and beneficiaries to bring civil actions against a fiduciary who breaches his or her duty. The fiduciary is personally liable for any losses to the plan resulting from his or her breach(es) and any profits that the fiduciary obtains through the use of plan assets must be restored to the plan. Furthermore, the fiduciary is also subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.[13]

With the exception of the named fiduciary, a plan fiduciary's personal liability to the plan is limited to the functions he or she performs, or is required to perform, under the plan.[14]

E. DOL Penalty

The DOL must assess a civil penalty equal to 20% of the applicable recovery amount in the event of any breach of fiduciary responsibility or violation by a fiduciary or knowing participation in such breach or violation by any other person.[15]

The DOL may, in its sole discretion, waive or reduce the penalty if it determines in writing that:[16]

- The fiduciary or other individual acted reasonably and in good faith; or
- It is unreasonable to expect the fiduciary or other individual to restore all losses (or such other relief ordered by the DOL) to the plan without experiencing severe financial hardship unless the DOL grants the waiver or reduction.

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[13] ERISA §409(a).
[14] 29 CFR §2509.75-8, FR-16.
[15] ERISA §502(l).
[16] ERISA §502(l)(3).

Reduced penalties may apply if the plan official files an application with the DOL under the Voluntary Fiduciary Compliance Program.

<u>Note</u>: As discussed later in this presentation, there is a separate set of penalties for prohibited transactions.

F. <u>Co-Fiduciary Liability</u>

ERISA Section 405(a) provides that a fiduciary shall be liable for a breach of fiduciary responsibility of another fiduciary in the following circumstances:

- If he participates knowingly in an act of such other fiduciary, knowing such act is a breach;
- If, by his failure to comply with the fiduciary standard of care under ERISA Section 404(a)(1), he has enabled such other fiduciary to commit a breach;
- If he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.

Thus, a fiduciary who becomes aware of other fiduciaries' actions that might violate the standards for a fiduciary must take all reasonable and legal steps to prevent such actions.

II. ERISA BONDING REQUIREMENTS

A. <u>ERISA Bond</u>.

1. <u>Coverage.</u> ERISA Section 412 requires bonding for every plan fiduciary and every person that handles funds or other property of the plan. The bond must provide protection to the <u>plan</u> against loss by reason of acts of fraud or dishonesty on the part of fiduciaries or plan officials handling plan funds or property.

Thus, the Department of Labor (DOL) has clarified that plan fiduciaries must be bonded only if they "handle" funds or other property of the plan and do not fall within one of the exceptions to Section 412.[17] Under DOL regulations, the touchstone for determining whether a person is handling plan funds or property is whether the person's duties and activities are such that there is a "risk" that plan funds or other property could be lost in the event of fraud or dishonesty by the person to be bonded.[18] Thus, those persons charged with the duty of receipt, safekeeping or disbursement of plan funds will generally be deemed to be "handling" funds and

[17] Field Assistance Bulletin 2008-4, Q-7.
[18] ERISA Regulation Section 2580.412-(6)(a)(1).

must be bonded. A person who renders investment advice to a plan in a fiduciary capacity, but does not exercise and does not have the right to exercise discretionary authority with respect to purchasing or selling securities is not required to be bonded unless that person is acting in some other capacity that constitutes "handling" plan funds.[19]

2. Amount of Bond. The bond amount must be 10% of plan assets with a minimum of $1,000 and a maximum of $500,000. Effective for plan years beginning after December 31, 2007, the maximum bond amount will increase to $1 million for plan that hold employer securities. The increased maximum applies to every person required to be bonded, even if that person does not have any duties relating to employer securities.

3. Special Rule for Registered Brokers and Dealers. Entities that are registered as a broker or a dealer under Section 15(b) of the Securities Exchange Act of 1934 will be exempt from the bonding requirement, provided that they are subject to the fidelity bond requirements of a self-regulatory organization. This rule is effective for plan years beginning after August 17, 2006, the date of enactment of the Pension Protection Act of 2006.

B. Other Types of Fiduciary Coverage: Professional Liability Insurance.

1. Coverage. Although this type of insurance coverage is not required under ERISA, it is customarily purchased by investment advisers, and it typically covers claims for improperly advising a retirement plan as well as imprudent decisions or improper processes with respect to investment matters. It may also be referred to as errors and omissions insurance and may be part of a commercial general liability (CGL) package. The language of the policy should be read carefully to make sure that it covers the activities engaged in by the insured.

2 Exclusions. Most policies will come with an additional schedule or addendum known as an endorsement. Endorsements exclude certain types of claims from coverage. Examples of such exclusions include:

a. Claims arising out of the propriety or impropriety of compensation paid out of the plan for administrative services;

b. Claims arising from late trading and market timing activities;

c. Claims arising from soft dollar or revenue sharing arrangements.

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[19] Field Assistance Bulletin 2008-4, Q-9.

3. Embedded Exclusions. Additional exclusions may be found embedded in the insurance policy, itself. These are harder to identify, but should not be ignored. For example, embedded exclusions frequently exclude commission-related complaints.

4. Importance of Negotiation. Exclusions can often be modified or eliminated by negotiation, particularly if the insured has a good history with respect to a particular issue. For example, if you can demonstrate that your fees are consistent with fees charged by similar service providers, insurers will consider the elimination of the exclusion relating to claims arising out of compensation matters. Because of the rise in litigation over soft dollar and revenue sharing practices, an insurer will require detailed disclosure of your treatment of these matters before it limits or eliminates exclusionary language in this area. The assistance of a skilled broker is often vital in negotiating the terms of an exclusion.

5. Policy Limits. Attention should also be addressed to the sufficiency of dollar limits on policy coverage. A significant issue is whether the coverage of defense costs is outside the limits of the policy, since such costs can quickly exceed the policy coverage.

III. PROHIBITED TRANSACTIONS

A. General

From a policy perspective, the "prohibited transaction" rules under ERISA are one of the key protections embedded in the statutory framework to ensure that all fiduciary decisions are made for the exclusive benefit of plan participants. There are similar sets of rules in federal securities laws (*e.g.*, Section 206 of the Investment Advisers Act), but ERISA's prohibited transaction rules are unique in that they are absolute. You can never enter into a non-exempt prohibited transaction under ERISA, even if conflicts have been fully disclosed and the client provides its written consent.

B. Scope of Coverage

The prohibited transactions rules cover both individual retirement accounts ("IRAs") and employer-sponsored retirement plans. However, the rules apply to the 2 types of retirement vehicles in different ways.

1. Employer-Sponsored Retirement Plans. Any "employee pension benefit plan," which includes all tax-qualified plans covering employees (*e.g.*, 401(k) plan), is subject to the prohibitions under both Titles I and II of ERISA.

a. Under Section 406 under Title I of ERISA. if a fiduciary causes an employee pension benefit plan to engage in a non-exempt prohibited transaction, the relevant party can and will be subject to civil penalties and liability for losses or improper profits.

b. Under Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), which was added to the Code as part of Title II of ERISA, the applicable party is subject to a substantial excise tax penalty.

2. IRAs and Keogh Plans. Traditional, Roth and Rollover IRAs, which are maintained for the benefit of the IRA owner (and not any employees), are exempt from Title I of ERISA, including the prohibited transaction rules under ERISA section 406. Tax-qualified vehicles that do not cover any employees are not employee pension benefit plans subject to Title I of ERISA. Thus, like IRAs, "Keogh" plans, such as tax-qualified plans sponsored by sole proprietors, are not subject to the prohibited transaction rules under Title I of ERISA. However, both IRAs and Keogh plans are subject to the excise tax penalties under Code Section 4975.

C. Overview of Statutory Rules

1. ERISA Section 406. ERISA section 406(a) prohibits various types of transactions between a plan and "parties in interest" (i.e., plan sponsor and service providers and their affiliates). ERISA states that a plan fiduciary shall not cause the plan to engage in a transaction with a Party In Interest if the plan fiduciary knows or should know that such transaction constitutes a direct or indirect—

- Sale or exchange, or leasing, of any property;
- Lending of money or other extension of credit;
- Furnishing of goods, services, or facilities;
- Transfer to, or use by or for the benefit of a party in interest, of any assets of the plan; or
- Acquisition, on behalf of the plan, of any employer security or employer real property in violation of ERISA section 407.

As a technical matter, many routine transactions are actually prohibited transactions. For example, a plan sponsor's decision to use plan assets to pay a service provider (which is a Party in Interest) is a prohibited transaction. Fortunately, exemptions are available, and the related sanctions will not apply if the conditions for the exemption are met (as discussed below).

ERISA section 406(b) also prohibits transactions that involve any type of self-dealing by the plan fiduciary. A plan fiduciary is prohibited from using the plan's assets in their own interest or act on both sides of a transaction involving a plan. Further, fiduciaries cannot receive "kickbacks" or any other payments for their personal benefit from third parties in connection with performing their fiduciary duties on behalf of the plan.

2. Code Section 4975. In addition to being subject to Title I, employee pension benefit plans are also subject to Title II's prohibited transaction rules under Section 4975 of the Code. Both sets of rules mirror one another in terms of substantive restrictions, but the nature of their respective penalties differ. Under Code Section 4975, the disqualified persons involved in non-exempt prohibited transaction are subject to a "first tier" 15% excise tax on the amount of the prohibited transaction. If the failure is not corrected, the 15% excise tax is imposed again in each subsequent tax year. A "second tier" 100% excise tax is also imposed, if the prohibited transaction is not corrected by the time of the IRS's assessment of the excise tax. For example, if the IRS assesses an excise tax on an outstanding prohibited transaction in "year 3," the cumulative excise tax would be 145% of the amount involved in the prohibited transaction (15% + 15% + 15% + 100%), plus any applicable interest and penalties.

With regard to prohibited transactions involving an IRA and the IRA owner, special rules apply. If the prohibited transaction is caused by the IRA owner (*e.g.*, IRA owner sells personal property to his or her own IRA), the IRA itself will become disqualified and cease to be tax-qualified. If the IRA owner has investment discretion over the IRA (which is almost universally the case), the IRS takes the position that the IRA owner is also subject to the Title II prohibited transaction rules under Code Section 4975.[20] As discussed, IRAs are not subject to Section 406 of ERISA.

IV. EXEMPTIONS FROM PROHIBITED TRANSACTIONS

Certain types of transactions with Parties in Interest are exempt from the prohibited transaction rules, either because they are permitted by a statutory exemption, an administrative class exemption, or an individual exemption issued by the DOL.

A. Statutory Exemptions

ERISA section 408(a) and the mirror rules under Code Section 4975 contain over a dozen specific exemptions that allow plans to engage in various types of transactions with parties in interest, that would otherwise be restricted under the prohibited transaction rules. For example, the statutory exemptions, among other exemptions, allow the following types of transactions (subject to applicable conditions and restrictions):

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[20] See, e.g., PLR 200324018.

- The provision of services necessary for the operation of a plan for no more than reasonable compensation;
- Providing of any ancillary service by a bank or similar financial institution;
- Investments through a bank collective investment trust; and
- Providing investment advice to participants of 401(k)-style plans under an "eligible investment advice arrangement."

As discussed earlier, these statutory exemptions allow plan assets to be used to pay reasonable costs for plan operation, and they also allow a number of other routine plan transactions.

B. Administrative Exemptions

The DOL may grant administrative exemptions allowing a person to engage in a variety of transactions involving employee benefit plans. DOL administrative exemptions can come in the form of "class exemptions" that are available to all persons that can satisfy the applicable conditions, or "individual exemptions" that may only be utilized by the person who requested the exemption.

Class exemptions are administrative exemptions that permit any person to engage in a covered transaction with a plan so long as it is done in accordance with the terms and conditions of the class exemption. Class exemptions typically cover routine plan transactions that were not foreseen when the statutory exemptions in ERISA were enacted. For example, DOL class exemptions permit:

- Investments in mutual funds by a plan when a plan's investment fiduciary is also affiliated with the fund's investment manager (subject to fee-leveling so that plan fiduciary does not receive "double" compensation and other conditions of PTE 77-4); and
- Providing brokerage services for a commission, where the broker-dealer or its affiliate is also acting as the plan's investment manager or adviser (subject to enhanced disclosure requirements and other conditions of PTE 86-128).

Individual exemptions are administrative exemptions that apply only to the specific person who requested the exemption from the DOL. Thus, other persons may not rely on these exemptions, even if they are able to meet all of the conditions. In many instances, the DOL will issue an individual exemption to a person who, for technical reasons, is unable to comply with all the conditions of an applicable class exemption. For example, the DOL has issued individual exemptions to foreign banks which more or less mirror the various class exemptions that are available to U.S. banks for routine investment transactions (*e.g.*, securities lending).

V. **STATUS OF THE FIDUCIARY STANDARDS**

The fiduciary standards under ERISA are "the highest known to the law."[21] And unlike securities laws which generally allow you to mitigate conflicts of interest through disclosure, ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption. Consistent with the Obama Administration's campaign to reduce conflicts of interest in the 401(k) plan industry, on October 21, 2010, the DOL released its proposed regulations to modify the existing regulatory definition of an "investment advice fiduciary." These rules, if adopted, would broaden the existing regulatory definition of "investment advice" under ERISA considerably.

A. Overview of Existing Regulatory Definition

Under the current regulation, a person is deemed to provide fiduciary investment advice if:

(1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
(2) on a regular basis,
(3) pursuant to a mutual agreement or understanding (written or otherwise)
(4) that such services will serve as a primary basis for investment decisions, and
(5) that such person will render advice based on the particular needs of the plan.

It should be noted that this 5-factor definition of "investment advice" is much more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

B. Two Specific Changes to Existing Regulatory Definition

The proposed regulations, if adopted, would make two specific changes to the existing definition of "investment advice." Under the existing rule, advisors are deemed to provide investment advice if, among other requirements:

- there is a "mutual" understanding or agreement that the advice will serve as the "primary basis" for plan investment decisions, and

- the advice is provided on a "regular basis."

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[21] Donovan v. Bierwirth, 680 F.3d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

However, under the DOL's proposed rulemaking, an advisor is deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Under both the existing and the proposed rules, advice will constitute "investment advice" only if it is individualized advice for the particular plan client. As of September 19, 2011, the DOL has withdrawn the proposal for further study.[22]

C. Safe Harbor for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the proposal effectively introduces a safe harbor that advisors would need to follow to avoid fiduciary status. Generally, to avoid being characterized as an investment advice fiduciary under the proposed regulations, an advisor must be able to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the advisor in its "capacity as a purchaser or seller" of securities or other property, (b) the advisor's interests are adverse to those of the client, and (c) the advisor is not undertaking to provide "impartial investment advice." The proposal generally does not specifically require a written disclosure to be provided to the plan client, but the proposal clearly contemplates and encourages written disclaimers.

D. Potential Impact on Financial Advisors

If the proposed regulations were finalized in their current form, brokers currently advising 401(k) plan sponsors and participants in a non-fiduciary capacity would undoubtedly need to change their service model and re-define their role as plan advisors. To avoid fiduciary status, they would effectively be forced to furnish written disclaimers to plan clients, stating that they are not providing impartial advice, as contemplated under the proposed DOL guidance.

If they failed to provide any disclaimer, a broker could be viewed as an "investment advice fiduciary" and any variable compensation, such as 12b-1 fees, received by the broker would trigger a non-exempt prohibited transaction under ERISA. The penalties for a prohibited transaction generally include a right of rescission by the plan client, a "first tier" 15%-per-year excise tax and a "second tier" 100% excise tax, and a 20% civil penalty on any amounts recovered through DOL action.

[22] http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm.

Alternatively, a broker serving as a plan fiduciary could avoid these penalties by becoming a dual-registered investment adviser. This action would enable it to charge an asset-based fee (such as a wrap-fee), eliminating the problems associated with variable compensation.

E. Outlook for DOL Proposed Regulations

This regulatory proposal is consistent with the Administration's aim to reduce conflicts in the 401(k) plan industry, and it aims to impose ERISA's fiduciary standards on a large segment of financial professionals who do not currently hold themselves out as fiduciaries. If adopted, the proposed regulations would force them to adopt fee-leveling, change the nature of their services so that they are not viewed as providing fiduciary advice, or otherwise eliminate any perceived conflicts of interest. As of September 19, 2011, the DOL has withdrawn the proposal for further study.[23]

F. New Fiduciary Standard for Brokers Under The Dodd-Frank Act.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which was enacted on July 21, 2010, is expected to impact the standard of conduct of those financial advisors who provide their services as registered representatives of broker-dealers. Although these rules under the Dodd-Frank Act are unrelated to the DOL's regulatory initiative to broaden the "fiduciary" definition under ERISA, they are expected to impact the standard of care that brokers must adhere to when advising their "retail" clients, which presumably includes plan participants and may include certain types of plan sponsors.

Under the powers conferred by the Dodd-Frank Act, the U.S. Securities and Exchange Commission (the "SEC") is authorized to issue regulations that will impose on broker-dealers the same fiduciary standard that applies to investment advisers under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Under the Advisers Act, investment advisers have a fiduciary duty to act solely in the best interests of the client and to make full and fair disclosures of all material facts, including conflicts-related disclosures. However, under current law, brokers are generally only subject to a duty of "suitability," which requires the broker to recommend investments that are suitable for the specific investor. The recommended investment does not have to be in the best interests of the client. Many brokers who advise plan clients do so in a non-fiduciary capacity, so they are not subject to ERISA's fiduciary standards under current DOL regulations. Thus, non-fiduciary advisors are allowed to make recommendations which are

[23] http://www.dol.gov/opa/media/press/ebsa/EBSA20111382.htm.

conflicted, skewed to investments that generate higher fees, without any restriction under ERISA or the Advisers Act.

As required under the Dodd-Frank Act, on January 21, 2011, the SEC's staff published its study on the different standards of conduct that currently apply to broker-dealers and investment advisers. In sum, the SEC staff's report recommended that the SEC consider rulemakings consistent with the authority already granted to the SEC under the Dodd-Frank Act, to create a uniform fiduciary standard that would apply to both brokers and investment advisers when they provide personalized investment advice to retail customers. The report did not provide any guidance on the extent to which plan clients would be viewed as retail customers. Of the 5 commissioners serving on the SEC, the 2 Republican appointees released a separate statement, criticizing the report and making the following points: (i) the SEC staff's report does not reflect the views of the SEC or its individual commissioners, (ii) the report failed to properly evaluate the existing standards of care applicable to broker-dealers and investment advisers as required by the Dodd-Frank Act, and (iii) additional study, rooted in economics and data, is required to support any recommendation for a uniform fiduciary standard.

In her remarks before the Investment Company Institute on May 6, 2011, SEC Chairman Mary Schapiro indicated that the agency would be turning its attention back to the fiduciary rule and that it would address the concerns raised relating to the need for additional economic analysis. No Congressional approval is necessary for the SEC to proceed with its rulemaking. Depending on how the SEC decides to exercise its rulemaking authority under the Dodd-Frank Act, brokers who advise plan clients and participants may be significantly impacted and may be subject to new conflicts-related disclosure requirements. These changes would be in addition to any future regulatory changes imposed by the DOL concerning when and how a broker could be viewed as providing fiduciary "investment advice" for ERISA purposes.