

LEGAL UPDATE

The Fiduciary Status of Investment Platform Providers

Marcia S. Wagner, Esq.

In light of the DOL's finalized conflicts regulation expanding the definition of an investment advice fiduciary, it is worth noting that this definition is only one alternative branch of a three-part statutory definition, and there are other fronts on which the department seeks to broaden the concept of a fiduciary whose status is determined by the function it performs. This other campaign is being carried out through the DOL's participation in private lawsuits by submission of friend of the court briefs supporting 401(k) plan sponsors and participants seeking redress from plan investment or service providers.

DOL Amicus Briefs. Over the last few years, the DOL has consistently intervened in excess fee cases at the appellate level by asserting the fiduciary status of investment platform providers and attacking their fee structures as a fiduciary breach. The primary argument in these cases is that the investment provider exercises plan management responsibilities or possesses discretionary plan administration authority, not that the provider has rendered fiduciary investment advice. However, these endeavors have not gone well, and the DOL's position has been rejected by federal appellate courts dismissing claims against American United Life, John Hancock Life, and, earlier in 2016, Principal Life. In late March of this year, similar claims against Merrill Lynch were dismissed by a federal district court in the Southern District of New York.

Investment Advice Carve-out. Interestingly, the proposed version of the DOL conflicts rule (which was finalized as this issue went to print) provides for a carve-out from fiduciary status if a platform provider falls under the expanded definition of an investment advice fiduciary, for example, by making a recommendation as to the management of securities. Providers of 401(k) investment platforms can qualify for this exception as long as the provider markets the platform without regard to the individualized needs of a particular plan or its participants. The provider would also need to disclose in writing that it is not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. It should be noted, however, that the platform provider carve-out only applies where fiduciary status would otherwise be derived from rendering investment advice, and does not provide relief from the plan management and plan administration prongs of the fiduciary definition.

Principal Case. The DOL amicus brief filed with respect to the recent Eighth Circuit Court of Appeals decision involving Principal Life (*McCaffree Financial Corp. v. Principal Life Insurance Company*) may represent the fullest expression of the department's theories regarding fiduciary status under these other branches of the fiduciary definition.

The analysis applying these tests to a platform provider starts with the large menu made up of all the investment options being offered by the provider, which is then winnowed to a smaller number of investment alternatives in which plan participants can choose to invest. In many cases, the final decision regarding the make-up of the small menu is made by the plan sponsor, but in the *Principal* case, this decision to select 29 of the 63 possible investment funds as available investment options was made by the Principal. This should have been a favorable factor for the plaintiffs and the DOL.

The DOL's brief made much of the Principal's final say in narrowing the 63-fund large menu to 29 funds as well as its ability to choose share classes, and argued that this demonstrated the Principal's exercise of discretionary control over plan management, which is the test for fiduciary status under the first prong of the functional fiduciary definition. Further, the DOL asserted that the Principal's right to add or delete funds to or from the big investment menu gave it discretionary authority over plan administration and that the Principal's resulting fiduciary duty was breached by failing to use that authority to lower investment fees.

No Fiduciary Responsibility for Arm's Length Contracts. The Eighth Circuit rejected these claims of fiduciary status, because, in its view, "Principal owed no duty to plan participants" during the arm's length negotiations with the plan sponsor leading up to the contract for plan services. Citing *Hecker v. Deere* and its progeny, the court held that management fees and operating expenses charged against plan assets in accordance with the contractual arrangement reached in these negotiations could not be assailed as a breach of fiduciary duty.

Nexus Requirement. Principal's post-negotiation conduct, however, would not necessarily be covered by this holding and on this matter the DOL and the plaintiff raised a number of issues, such as Principal's post-negotiation winnowing of investment funds from 63 to 29, its discretion to increase management fees, its alleged rendering of investment advice to participants, and its failure to disclose certain management fees to the plaintiff's satisfaction.

The court, however, held with respect to each of these claims that the complaint failed to make a connection between the act complained of and the allegations of excessive management fees. For example, the plaintiff had failed to assert that Principal used the winnowing process to ensure that participants had access only to investment options charging higher fees and, in fact, the 29 chosen investments had roughly the same management fees as the larger group. As to

the Principal's power to increase fees, it was never asserted that it actually did so. Similarly, no connection was made between the alleged excessive fees and Principal's investment advice to plan participants or to the claimed inadequate disclosure of these fees. The so-called "nexus" requirement, which is the basis of these holdings, is built into the statutory definition and has been a consistent problem for plaintiffs and the DOL in cases against platform providers.

The Eighth Circuit ignored the DOL's suggestion that nexus could be established by a platform provider's failure to select lower fee funds and share classes where the provider has the contractual ability to substitute funds. However, this DOL position regarding the failure to take affirmative steps has been specifically rejected in other cases, notably the Seventh Circuit's 2013 decision in *Leimkuehler v. American United Life*.

Viability of Historic DOL Procedure for Investment Menu Changes. In DOL Advisory Opinion 97-16A, the department took the position that a platform provider offering a roster of mutual funds similar to those offered by the Principal would not be a fiduciary by virtue of changing a plan investment menu when the changes would be made under a procedure that gave plan fiduciaries advance notice and a reasonable opportunity to accept or reject the changes. Failure to respond to the notice was deemed to be an acceptance of the changes and rejection would result in termination of the contractual arrangement with the provider. The Eighth Circuit's decision in the Principal case did not find it necessary to address

the nearly 20-year-old advisory opinion, since the Principal's contract gave it the discretion to add or subtract investment funds unfettered by the procedures specified by the advisory opinion. The DOL's amicus brief, however, found it useful to distinguish the facts in the *Principal* case from those in the advisory opinion. This indicates that until further notice, compliance with the conditions set forth in the advisory opinion continues to enable avoidance of fiduciary status under the plan management and administration prongs of the fiduciary definition.

Conclusions. Publication of the final conflicts regulation will not resolve questions with respect to fiduciary status arising under the plan management and administration parts of the fiduciary definition. Platform providers wishing to avoid fiduciary status would be well-advised to examine judicial decisions relating to these definitional provisions in order to conform their operations to judicial views of nonfiduciary conduct and to adhere to the requirements of available administrative relief, such as Advisory Opinion 97-16A. Plan fiduciaries dealing with platform providers should realize that they are likely to be viewed as responsible from a fiduciary perspective for understanding and evaluating the platform provider's compensation before entering into a contract for services.

Marcia S. Wagner is the Managing Director of The Wagner Law Group. She can be reached at 617-357-5200 or Marcia@WagnerLawGroup.com.