Avoiding Conflicts of Interest As You Grow Your Business

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I. Cross-Selling Practices and Potential Conflicts of Interest

A. Background.

Cross-selling can be an effective means to growing a firm's retirement business, largely because selling new services to existing clients is easier and less costly than approaching new clients. Accordingly, many financial institutions that sell both retirement and non-retirement products and services are prospecting for new retirement plan business from their existing non-retirement client base. In addition, investment and service providers to defined contribution plans ("DC plans") are cross-selling these and other related services to their existing plan clients.

Cross-selling can be an especially effective way to gather assets in the rollover IRA market. In fact, a number of retirement plan providers are making an organized push to capture rollover business in light of the unprecedented number of Americans retiring, many of whom have yet to take a distribution from their 401(k) plan accounts. The U.S. Department of Labor is also scrutinizing the manner in which advisors to DC plans are cross-selling their firms' IRA products and services.

B. Products and Services Involved in Cross-Selling.

The products and services that can be involved in cross-selling practices include some or all of the following:

Services for DC Plans Only

- Plan recordkeeping
- Third party administration for plans
- Plan documentation
- Trust and custody services for plans
- Participant-level investment education or advice
- Pension consulting and plan sponsor-level advice
- Fund investments for defined contribution retirement plans ("DC plans")
- Asset management for defined benefit pension plans ("DB plans")
- Actuarial services for DB plans

Services For Plans and Non-Plan Clients

- Accounting services (for plans, employers or individuals)
- Valuation services for plans and employers
- Corporate banking
- Payroll and financial services for employers
- Personal banking and other professional services
- Financial / estate planning services for individuals
- Rollover IRA investments for individuals

- Insurance and annuity products (for plans, employers or individuals)
- Services for nonqualified plans, executive benefits and international arrangements

C. Potential Abuses of Cross-Selling.

Cross-selling practices by their nature create potential conflicts of interest. From a policy perspective, it is easy to see the potential abuse that can arise when a firm or business exploits the trust, which it has developed with a client through a longstanding relationship, to sell additional products and services at unfavorable terms to the client. However, in the context of retirement plans, the potential for abuse is even greater because individual plan participants (and not merely the plan sponsor) can be harmed. In theory, a plan sponsor could agree to investments or services that result in excessive fees which are borne by plan participants, in order to secure for itself free or discounted services or other personal benefits from the plan's provider.

The fiduciary standards under ERISA, which include prohibitions against transactions involving conflicts of interest, are regarded as "the highest known to the law."[1] The cross-selling practices of fiduciaries and non-fiduciary parties alike must comply with the strict, rigid requirements of ERISA to the extent any of the applicable services directly or indirectly involve plan assets.

II. Plan Sponsor's Duty to Avoid Conflicts of Interest

If a firm is cross-selling services to a plan sponsor, the employer should be wary of the applicable standards under ERISA concerning prohibited transactions, prudence and the reasonableness of fees.

A. Sponsor's Duty to Avoid Self-Dealing Under ERISA's Prohibited Transaction Rules.

1. Statute. ERISA imposes numerous fiduciary duties on an employer sponsoring an employee benefits plan, including the prohibited transaction rules under ERISA Section 406 and the mirror rules under Section 4975 of the Internal Revenue Code. ERISA Section 406(b) (and the mirror rules under the Code Section 4975(c)) provides prohibitions against fiduciary self-dealing. Specifically, these provisions state that a fiduciary may not (i) deal with the assets of the plan in his own interest or for his own account, (ii) act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan, or (iii) receive any consideration (*i.e.*, kickbacks) for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets.

In accordance with these prohibited transaction rules, a plan sponsor must not use the assets of the plan to benefit itself personally. In the context of cross-selling, the plan sponsor must not cause the plan (or its participants) to pay for investments or administrative services, if it results in free or discounted services or other personal

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

benefits for the plan sponsor. It should be noted that a violation of ERISA can occur even if the fees and costs borne by the plan or plan participants are commercially reasonable. In this regard, the prohibition against self-dealing is a *per se* prohibition against the use of plan assets for personal gain, and a violation will result even if plan participants receive valuable services for reasonable compensation and are not demonstrably harmed.

2. *DOL Advisory Opinion 89-12A*. In Advisory Opinion 89-12A, the Department of Labor (the "DOL") ruled that if an IRA owner takes advantage of a bank's offer to provide "free" checking account services to any customer who maintains an IRA with the bank, the IRA owner will be in violation of the self-dealing rules. Although this 1989 guidance was limited to IRAs, which are not subject to ERISA but are subject to the "mirror" self-dealing rules under Code Section 4975(c), it confirmed that self-dealing occurs whenever a fiduciary receives free or discounted services in exchange for transferring plan-related business to the same service provider.

Subsequent to the issuance of this Advisory Opinion, the DOL issued Class Exemptions 93-33 and 97-11. These Class Exemptions permit the receipt of services at a reduced or no cost by an individual for whose benefit an IRA (or a Keogh plan) is maintained at a bank or broker-dealer, respectively. However, the relief provided under these Class Exemptions does not apply to any retirement plans that are subject to ERISA (*i.e.*, tax-qualified plans with employees). The DOL specifically provided that the relief provided by these Class Exemptions narrowly apply to non-ERISA retirement accounts (e.g., IRAs and owner-employee plans), but do not apply to 401(k) plans or other types of ERISA plans.

The upshot of all this guidance is that the sponsors of 401(k) plans, and other retirement plans that are subject to ERISA, must not accept free or discounted services (which benefit the employer, its owner or employees) in exchange for agreeing to hire the firm to provide investments or services to the plan.

3. *DOL Enforcement Policy for Gifts and Gratuities*. Chapter 48 of the DOL's EBSA Enforcement Manual, *Fiduciary Investigations Program*, has a special section devoted to the enforcement of ERISA violations relating to a fiduciary's receipt of gifts, gratuities or anything else of value, which would include free or discounted personal services from the plan's various investment and service providers. The relevant section provides:

> Investigations may disclose possible fiduciary violations involving a plan fiduciary's acceptance, from a party dealing with the plan, of consideration such as meals, gifts, entertainment, or expenses associated with educational conferences. In such cases, the Investigator/Auditor should determine whether the facts support an allegation that the receipt of gifts, gratuities, or other consideration were for the fiduciary's personal account and received in connection with a transaction or transactions involving the assets of the plan as required for a violation of ERISA §406(b)(3).

Fortunately, the Enforcement Manual does provide an exception for DOL enforcement purposes only for gifts and gratuities of *de minimis* value as follows:

> The Investigator/Auditor should treat as insubstantial, and not as an apparent violation of ERISA § 406(b)(3), the receipt by a fiduciary (including his or her relatives) of the following items or services from any one individual or entity (including any employee, affiliate, or other related party) as long as their aggregate annual value is less than $250 and their receipt does not violate any plan policy or provision: (a) gifts, gratuities, meals, entertainment, or other consideration (other than cash or cash equivalents) and (b) reimbursement of expenses associated with educational conferences.

The Enforcement Manual indirectly recommends that fiduciaries adopt an applicable policy. Under the applicable provisions of Chapter 48, EBSA Investigators and Auditors are instructed to determine whether the fiduciary or the plan maintains "a reasonable written policy or plan provision governing the receipt of items or services from parties dealing with the plan and whether the fiduciary adhered to that policy."

B. Sponsor's Duty of Prudence under ERISA. In the context of cross-selling, an employer with a personal relationship with a financial institution may be pressured into transferring its 401(k) plan business to the same firm without conducting a proper evaluation of its plan administration services. However, such a rash decision could result in a violation of the prudence requirements of ERISA.

1. ERISA Section 404(a)(1). In The designation of any service provider to a plan is a fiduciary exercise of discretionary authority or control with respect to management of the plan.[2] Thus, a plan sponsor must designate the plan's service providers in accordance with ERISA's fiduciary standards of care.

The basic duty of a fiduciary under ERISA Section 404(a)(1) 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 the participants and their beneficiaries (and defraying reasonable administrative costs of the plan). In addition, a fiduciary must discharge his or her duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man 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." In other words, the fiduciary is held to the standard of a "prudent expert."

2. FABs 2002-3, 2007-1 - Guidelines for Selecting Service Providers. In selecting service providers, the DOL has stated that a fiduciary must "engage in an objective process designed to elicit information necessary to assess the qualifications of the provider, the quality of services offered, and the reasonableness of the fees charged in light of the services provided. In addition, such process should be designed to avoid self-

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[2] See, e.g., DOL Interpretive Bulletin 96-1, *Selection and Monitoring of Educators and Advisors.*

dealing, conflicts of interest or other improper influence." DOL Field Assistance Bulletins 2002-3 and 2007-01.

C. Sponsor's Co-fiduciary Liability for Fiduciary Provider's Conflicts. The plan sponsor should ensure that the vendor providing fiduciary services, which are typically investment-related services, does not violate any of the self-dealing prohibitions under ERISA. In light of the plan sponsor's fiduciary duties with respect to the designation of service providers to the plan, it could be subject to co-fiduciary liability to the extent it hires a vendor providing conflicted fiduciary services.

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 ERISA Section 404(a)(1) (*i.e.*, duty of prudence), 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, if a plan sponsor engages an investment fiduciary who provides conflicted services (e.g., investment managers causes plan to invest in affiliated investment products, increasing fees for itself and its affiliates), in addition to the investment manager being liable for engaging in self-dealing in violation of ERISA, the plan sponsor could also be liable as the co-fiduciary who enabled the breach by the investment manager.

D. Sponsor's Duty to Ensure Reasonableness of Fees

ERISA imposes three sets of rules requiring plan fiduciaries to ensure that any fees paid by the plan to its service providers are reasonable: (i) the "Establishment of Trust" rules under ERISA Section 403, (ii) the duty of prudence under ERISA Section 404(a)(1), and (iii) the prohibited transaction rules under ERISA Sections 406 and 408(b)(2).

1. Establishment of Trust Rules. The Establishment of Trust rules under ERISA Section 403 specifically require plan assets to be held in a qualifying trust "for the exclusive purposes of providing benefits and defraying reasonable expenses of administering the plan" (emphasis added).

2. Duty of Prudence. As discussed above, the duty of prudence under ERISA Section 404(a)(1) similarly allows expenses to be "defrayed" with plan assets if they are reasonable. And since this duty is subject to the "prudent expert" standard, it requires an employer to discharge all of its fiduciary duties to the plan, including its duty

to limit plan fees to reasonable expenses only, with the same level of skill and diligence that a prudent expert would use.

3. *Prohibited Transaction Rules*. ERISA Section 406(a) states that various types of transactions, including the use of plan assets to pay a plan's service provider, are prohibited transactions.[3] 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.

The applicable DOL regulations simply state that the determination of whether compensation is reasonable depends on the particular facts and circumstances of each case. In order for services to be furnished under a contract or arrangement which is deemed reasonable, they must be terminable by the plan on short notice and without penalty.

4. *Recent Explosion in Fee Litigation*. Litigation challenging the fees and expenses paid by 401(k) plans continues to proliferate and represents a major threat to the industry. With a few notable exceptions (e.g., Hecker v. Deere, 496 F. Supp. 2d 967 (W.D. Wis. 2007)), the trial courts have been cautious in dismissing these lawsuits at an early stage. Despite the fact that preliminary rulings are not the same as a judgment on the merits, the lack of early dismissals seems to have encouraged the plaintiffs' bar to file even more class action lawsuits over fees. This should come as no surprise, since this type of litigation has the potential to generate enormous legal fees. The current economic downturn appears to have also contributed to this trend, as participants seek to recover their 401(k) plan investment losses

a. The First Salvo. In the first salvo of 401(k) plan fee litigation, suits were launched against investment and service providers, alleging that they breached their fiduciary duties under ERISA in violation of ERISA Section 406(b)(1) (self-dealing) and 406(b)(3) (kickbacks).

- Haddock v. Nationwide Financial Services, Inc. (D. Conn. 2006) (investment provider sued over its receipt of fees from mutual funds offered under annuity contracts).

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[3] ERISA Section 406(a) provides, among other requirements, that a fiduciary must not cause the plan to engage in a transaction that constitutes a direct or indirect (1) sale or exchange of any property between the plan and a party in interest, (2) lending or extension of credit between the plan and a party in interest, (3) furnishing of goods or services between the plan and a party in interest, or (4) transfer to, or use by, a party in interest of any plan assets. A "party in interest" is broadly defined to include the plan's service providers, fiduciaries, the employer sponsoring the plan, and their respective affiliates.

- Ruppert v. Principal Life Insurance Company (S.D. Ill.) (complaint filed that fiduciary standards breached by service provider's receipt of revenue sharing payments from mutual funds).
- Phones Plus, Inc. v. Hartford Financial Services Group, Inc. (D. Conn. 2007) (complaint filed that The Hartford received revenue sharing payments for services that it was already obligated to provide to its plan clients).

b. Second Generation of Fee Litigation - The Main Thrust. More than a dozen participant claims against plan sponsors and related plan fiduciaries were filed in September and October of 2006 by the law firm of Schlicter, Bogard & Denton, LLP of St. Louis, MO. Defendants include sponsoring employers, plan committees, company officers, directors and employees, but not plan providers.

The core allegation is that these defendants breached their fiduciary duties under Section 404(a) of ERISA by causing or allowing plan providers to be paid excessive fees for their services. The alleged excessive payments included hard dollar payments made directly by plans as well as revenue sharing payments made by third parties. A novel aspect of these complaints is the allegation that the plan fiduciaries failed to capture revenue sharing monies embedded in the expense ratios of mutual funds offered under the plans even though these funds were not paid to any service providers.

Partial List of Cases:

- Abbot v. Lockheed Martin Corp. (S.D. Ill.)
- Beesley v. International Paper Company (S.D. Ill.)
- Kanawi v. Bechtel Corp. (N.D. Cal.) (case settled on November 20 2008).
- Loomis v. Exelon Corp. (N.D. Ill.)
- Martin v. Caterpillar, Inc. (W.D. Mo.) (case settled on November 5, 2009)
- Spano v. Boeing Co. (S.D. Ill.)
- Taylor v. United Technologies Corp. (2d Cir. 2009)
- Will v. General Dynamics Corp. (S.D. Ill.)

c. New Tactics. In December of 2006, the Schlicter law firm filed new complaints against plan sponsors and related fiduciaries seeking the same relief as in the cases filed earlier. In addition, the new round of complaints made defendants of plan service providers claiming that they had breached their fiduciary duties by (i) causing or allowing plans to pay plan service providers excessive fees either directly or through revenue sharing and (ii) "secretly" charging and retaining revenue sharing payments that should have been used to benefit plans and participants.

d. Defendant's Victories: Hecker v. Deere. Courts have generally been reluctant to dismiss 401(k) fee lawsuits before there has been fact finding to determine whether the plaintiffs' legal claims can be supported. A major exception to this trend is Hecker v. Deere, 2007 WL 1874367 (W.D. Wis. 2007), which granted early stage motions to dismiss made by the employer, Deere & Company ("Deere"), and two Fidelity entities that were plan service providers.

Deere sponsored and administered 401(k) plans for its employees. The plans offered at least 20 Fidelity investment options while trustee, recordkeeping, and administrative functions were handled by Fidelity Management Trust Company and Fidelity Management and Research Company. (Significantly, the Deere plan also made available a brokerage window that provided participants with access to more than 2,500 other mutual funds.) The complaint alleged that the defendants violated their fiduciary duties in two ways: (i) by providing investment options with excessive and unreasonable fees and costs; and, (ii) by failing to adequately disclose information about the fees and costs to plan participants. The District Court granted the defendants motion to dismiss which the plaintiffs then appealed to the Seventh Circuit Court of Appeals.

On February 12, 2009, the appellate court, in a landmark opinion, affirmed the dismissal, rejecting the plaintiff's first claim as to excessive fees on the ground that the mutual fund fees could not be excessive because they were offered to the general investing public with the result that expense ratios are set in response to market competition. The court stated that "[N]othing in ERISA requires every fiduciary to scour the market to find and offer the cheapest possible fund (which might, of course, be plagued by other problems)." The court also held that Deere's practice of limiting the funds' investment options to those offered by defendant Fidelity Investments was prudent given the diversity of those investment options, which included more than 20 Fidelity mutual funds, as well as the brokerage window through which participants could invest in more than 2,500 other funds. The Seventh Circuit appeared to hold that, given the array of investment options available through the brokerage window, the safe harbor defense provided by Section 404(c) of ERISA shielded the defendants from liability.

As to the plaintiff's second claim, the Seventh Circuit held that ERISA does not prohibit revenue sharing arrangements or compel their disclosure. The court found that the disclosure of total aggregate fees in fund prospectuses was adequate, stating that "the total fee, not the internal, post-collection distribution of the fee [to Fidelity affiliates], is the critical figure for someone interested in the cost of including a certain investment in her portfolio and the net value of that investment."

Although the Seventh Circuit quickly dismissed the case, the plaintiffs, supported by briefs from the DOL and other groups filed a petition for a rehearing by the full circuit. On June 24, 2009, the appeals court denied the petition, but, in

so doing, it issued an addendum to its original opinion which appears to limit some of the more extreme implications of its analysis. The addendum noted that the court had intentionally avoided a broad ruling on the issue of 404(c) protection and that it had left the area open for future development. The addendum also stated that, contrary to the Department's fears, the ruling was not broad enough to immunize from accountability a fiduciary that acts imprudently by selecting an overpriced portfolio of funds. Quoting the Department's brief, it added that the Deere opinion "was not intended to give a green light to such 'obvious, even reckless, imprudence in the selection of investments.'" The court explained that its opinion had been "tethered closely to the facts" that were before it and that the plaintiffs had failed to allege that any of the Deere plan's investment alternatives were unsound or reckless.

Notwithstanding its effort to narrow the Deere holding, when the dust settles, it appears that, in the Seventh Circuit's view, the selection, pursuant to a prudent and reasonable process, of a liberal number of investment options to be made available to plan participants would provide an impregnable defense to assertions of liability by participants. The Deere opinion has had, and is expected to continue to have, a far-reaching influence on existing litigation,

e. Defendant's Victories: George v. Kraft Foods Global, Inc.. In George v. Kraft Foods Global, Inc. (S.D. Ill. Jan. 27, 2010), the court granted the defendants' motion for summary judgment on all of plaintiffs' claims. The plaintiff participants had alleged that the Kraft Foods Thrift Plan's fiduciary committees had breached their duties under ERISA by (i) maintaining an excessive cash position in the employer stock funds and authorizing the payment of unreasonable fees from such funds, (ii) paying unreasonable fees to Hewitt, the plan's recordkeeper, (iii) failing to monitor the float on benefit payments, leading to the payment of excessive fees to State Street, the plan's trustee, and (iv) failing to make ERISA-required disclosures regarding plan fees to participants. The court's favorable ruling for the defendants was based largely on the fact that the undisputed facts demonstrated that the fiduciary committees had used a reasoned decision-making process in selecting its service providers, and that it had in fact been monitoring the relevant fees and expenses. The court also ruled that the information disclosed to participants in the SPD, fund prospectuses and quarterly statements (which included information on total annual operating expenses of which recordkeeping fees were one part) were sufficient.

f. Plaintiffs' Victories: Martin v. Caterpillar. More typical of early stage 401(k) fee litigation than the cases discussed above is the denial of defendant's motion to dismiss. The plaintiffs' claims in Martin v. Caterpillar, No. 07-cv-1009 (C.D. Ill. 2008) were also typical in that they alleged a breach of fiduciary duty arising from investment options with excessive and unreasonable fees and the failure to make adequate disclosures to plan participants. In addition, the plaintiffs alleged self-dealing arising from the plans' offering investment options that were advised by a wholly owned Caterpillar subsidiary. The court

upheld the viability of the central complaint that the defendants had charged excessive fees although it agreed with the defendant and the court in Hecker that ERISA does not require plan fiduciaries to disclose revenue sharing.

On November 5, 2009, the Caterpillar parties announced a $16.5 million settlement of the case. As part of the settlement, the parties agreed that during a two-year settlement period an independent fiduciary will monitor the Caterpillar plans. Further, during this period, retail mutual funds will not be included as core investment options under the Caterpillar plans. The use of retail mutual funds, which generally have a higher fee structure than wholesale funds, separate accounts and collective trusts is a common complaint in 401(k) fee cases. The Caterpillar settlement, once again, raised the question of whether plan sponsors should be using such funds if other investment options are available. Overall, the settlement may encourage further 401(k) fee litigation while motivating some plan sponsors to settle their own cases.

g. Plaintiffs' Victories: Braden v. Wal-Mart Stores, Inc.. In Braden v. Wal-Mart Stores, Inc., 2009 WL 4062105 (8th Cir. 2009), Wal-Mart had been charged with breaching its duties of prudence and loyalty by selecting retail class mutual funds as plan investment options. These funds were generally more expensive than institutional class funds. The plaintiffs' complaint compared the plan's investment options with less expensive funds available in the marketplace.

However, in October 2008, the district court held that this was not sufficient to allow the action to move forward, because there were no factual allegations that Wal-Mart had failed to investigate the funds or that the fund selection process was otherwise flawed. The district court reasoned that the mere existence of less expensive funds did not mean that the actual selection of more expensive funds was a breach of fiduciary duty. The court also dismissed claims that Wal-Mart had committed prohibited transactions involving revenue sharing, since revenue sharing is not inherently illegal or unreasonable. Finally, the district court dismissed the claim that Wal-Mart had failed to provide participants with complete and accurate information, since there was no duty to disclose revenue sharing and the information the plaintiffs sought was not material.

On November 25, 2009, the Eighth Circuit Court of Appeals vacated the district court's judgment and remanded the Wal-Mart case to the lower court for further proceedings. Generally, the appeals court faulted the lower court for imposing on the plaintiffs an overly rigorous standard of pleading. The Eighth Circuit held that the complaint's allegations, read as a whole, plausibly stated a claim that Wal-Mart's selection process for plan investment options was flawed. These allegations included assertions that (1) a plan the size of the Wal-Mart plan (one million participants and nearly $10 billion in assets) had the ability to obtain institutional class shares, but, instead, offered its participants higher-cost retail shares; (2) the majority of Wal-Mart plan funds charged 12b-1 fees, (3) the more expensive funds were retained even though they did not meet their performance

benchmarks, and (4) the funds had made revenue sharing payments to the plan trustee, not for trustee services, but to be included in the investment line-up.

The Eighth Circuit distinguished Hecker v Deere on the ground that the plan in that case provided access to over 2,500 mutual funds, making it untenable to suggest that all of such investment options had excessive expense ratios. In contrast, the Wal-Mart plan offered a far narrower range of investments, making it more plausible that the Wal-Mart plan was imprudently managed.

On the disclosure issue, the Eighth Circuit held that plan fiduciaries are required to furnish plan participants with material information that could adversely affect the participants' interest in the plan and that a reasonable trier of fact could find that such material information includes the fact that plan funds charged higher fees than comparable funds to which an employer, such as Wal-Mart, had access.

As to the plaintiffs' prohibited transaction claim involving the receipt of undisclosed amounts of revenue sharing funds by the plan trustee, the Eighth Circuit held that that the complaint alleged sufficient facts to aver an arrangement amounting to the provision of services to a plan by a party in interest, and that this shifted the burden to Wal-Mart to show that no more than reasonable compensation was paid. The court observed that the trust agreement between Wal-Mart and the trustee required that the amount of revenue sharing be kept secret and that, in view of their monopoly on information, the defendants were in the best position to demonstrate the absence of self-dealing.

III. Provider's Duty to Avoid Conflicts of Interest

A. Fiduciary Providers of Plan Services.

Just as plan sponsors are subject to prohibitions against self-dealing under ERISA's prohibited transaction rules, fiduciary providers of plan services are subject to the same restrictions. Thus, although plan sponsors must be careful when purchasing new services from a vendor that is cross-selling retirement plan services, fiduciary providers must also be careful when cross-selling plan services to their plan clients. When a vendor is a fiduciary, there is a potential conflict of interest where long-term business relationships and revenue agreements of the vendor may compromise the integrity of the decision making process with respect to the selection of new investment products or services for the plan client. In such situations, the vendor itself must not engage in self-dealing in violation of ERISA Section 406(b). In other words, the vendor must not use any fiduciary discretionary authority to cause the plan to purchase new products or services that would increase the compensation of the vendor and its affiliates (except to the extent expressly permitted by a statutory or administrative prohibited transaction exemption).

1. *Background – Definition of Fiduciary*. Under ERISA Section 3(21), a fiduciary is broadly defined to include any person who (i) exercises any discretionary authority or discretionary control respecting management of the plan or who exercises any authority or control respecting management or disposition of plan assets, (ii) renders investment advice for a fee or other compensation with respect to plan assets, or (iii) has any discretionary authority or responsibility in the administration of the plan. Given the "functional" nature of this definition, a person may be a fiduciary based on his actions, even if he or she has not been formally appointed to serve as a plan fiduciary. Fiduciary providers of plan services typically provide investment services, including but not limited to broker-dealers, banks, registered investment advisers and insurance companies.

2. *Investment Advice v. Other Advice*. A vendor that is an investment fiduciary must not provide any "investment advice" to the plan client to purchase securities or other investments that would increase the compensation of itself or its affiliates. If a vendor that is a plan fiduciary is cross-selling its proprietary investment products, it generally must not advise the plan sponsor to purchase such products if the resulting in sale would increase the aggregate compensation payable to itself and its affiliates.

For example, if a registered investment adviser ("RIA") has been charged with the fiduciary duty of reviewing a 401(k) plan's investment menu for a flat or asset-based fee, it should not make a recommendation to the plan sponsor to add an affiliated mutual fund that, if acted upon, would result in the payment of fund management fees to the RIA's affiliate. However, if the RIA offsets its advisory fee by the amount of the fund management fee payable to the RIA's affiliate and/or satisfies the conditions of an applicable prohibited transaction (e.g., PTE 77-4), the transaction would not result in a violation of the prohibited transaction rules under ERISA.

On the other hand, a vendor that is an investment fiduciary is permitted to provide advice to the plan client concerning the purchase of services that are unrelated to the purchase of investment products ("non-investment advice"). The provision of non-investment advice is not a fiduciary act, and so it is not subject to the self-dealing prohibitions under ERISA Section 406(b). Thus, an investment provider with an affiliate in the plan administration business is permitted to cross-sell the affiliate's administrative services to the plan client without running afoul of ERISA's prohibited transaction rules.

Although there is little interpretive guidance on this point, based on the plain language of the statute, non-investment advice could include a recommendation to purchase investment services (e.g., hire another investment manager). Thus, an investment adviser serving a plan client that wished to cross-sell the advisory services of an affiliate could make a recommendation for the plan to hire an affiliated adviser to manage a separate sleeve of the plan's portfolio, without running afoul of ERISA's prohibited transaction rules.

2. *Co-fiduciary Liability for Self-Dealing by Plan Sponsor*. The provider of fiduciary services to a plan should not cause or participate in any act of self-dealing by the plan sponsor. With respect to cross-selling practices, a fiduciary provider of plan services should never offer free or discounted services to the plan sponsor. As discussed above, ERISA Section 405(a) provides that a fiduciary can be liable for a breach of fiduciary responsibility of another fiduciary in certain circumstances. Specifically, a fiduciary provider can be held liable as a co-fiduciary if (i) it knowingly participates in any act of self-dealing by the plan sponsor, or (ii) it has knowledge of any act of self-dealing by the plan sponsor, but the provider does not make reasonable efforts to remedy such breach.

B. Non-fiduciary Providers of Plan Services

An investment or administrative service provider that is not a "fiduciary" is not directly subject to the fiduciary requirements of ERISA. However, even if a plan's service provider is not a fiduciary, it must not knowingly participate in any prohibited transactions, including transactions which involve self-dealing by the plan sponsor. For example, if a plan sponsor allows a vendor to overcharge plan participants in exchange for free personal services from the same vendor, the vendor could be held responsible for the harm to participants even though the vendor has no fiduciary duty to the plan under ERISA. The vendor would also subject to substantial civil penalties and excise taxes.

Every service provider to the plan is a "party in interest" within the meaning of ERISA Section 3(14).[4] A provider's status as a party in interest is significant, because the U. S. Supreme Court has held that a party in interest that knowingly participates in a fiduciary's breach of duty under ERISA by causing the plan to enter into a prohibited transaction, can be held liable for such knowing participation in the prohibited transaction under ERISA Section 502(a)(3).[5] In addition, ERISA Section 502(l) empowers the DOL to assess a civil penalty against a fiduciary that breaches its duties and against any other person (including a party in interest) that knowingly participates in such breach. This penalty only applies to situations in which amounts are recovered pursuant to a settlement with the DOL, and the penalty amount is equal to 20% of the amount recovered. IRC Section 4975 also imposes an excise tax on non-exempt prohibited transactions. Accordingly, a non-fiduciary vendor could be subject to significant penalties, in addition to making the plan and its participants whole for any harm caused, in connection with any knowing participation in an ERISA violation.

Due to the potential liability that may arise under such rules, ERISA Sections 502(a)(3) and 502(l) and IRC Section 4975 effectively require non-fiduciary service providers to ensure that they do not knowingly participate in any non-exempt prohibited transactions. Thus, with respect to cross-selling practices, the service provider must not knowingly allow the plan sponsor to engage in any type of self-dealing. Accordingly, it should never agree to provide any

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[4] The term "party in interest" is generally defined to include a plan's fiduciaries, other service providers, the employer sponsoring the plan, and their respective affiliates.

[5] Harris Trust & Savings Bank v. Salomon Smith Barney Inc., 530 U.S. 238 (2000).

discounted or free personal services to the employer (or any employee) when cross-selling plan services.

C. Investment Providers Offering Participant-Level Investment Services.

Many fiduciary and non-fiduciary providers of investment funds to DC plans are also offering participant-level advisory services. In the absence of exemptive relief from the prohibited transaction rules, these providers would not be able to offer participant-level investment advice simultaneously because of the obvious conflict between (i) providing allocation advice in the best interest of participants, and (ii) pursuing its self-interest to maximize profits by steering participants to funds paying the highest fees to itself (or an affiliate).

Fortunately, investment providers can provide participant-level investment services by

(1) limiting participant-level services to "investment education" only,

(2) providing investment advice to participants using an objective computer model, or

(3) providing such advice with fee-leveling.

1. *DOL Interpretive Bulletin 96-1*. To allay plan sponsor fears that their efforts to provide educational guidance to participants might be interpreted as giving investment advice for which they could be held liable, the DOL issued Interpretive Bulletin 96-1. This 1996 release describes four safe harbors representing examples of the type of information, materials and educational services that can be furnished to participants without constituting investment advice. The DOL noted that there could be many more such examples of investment education that did not reach the level of fiduciary investment advice. Based on this guidance, investment providers to DC plans may provide "investment education" to participants without violating the self-dealing prohibitions under ERISA.

2. *SunAmerica Ruling*. In 2001, the DOL issued the so-called SunAmerica ruling, DOL Advisory Opinion 2001-09A, which allowed investment providers of DC plans to simultaneously give asset allocation advice to DC plan participants. One of the key conditions of this ruling requires the investment provider to deliver its asset allocation advice to participants in accordance with a computer model overseen by an independent financial expert. If all the applicable conditions are satisfied, the investment provider's aggregate fees are allowed to vary based on the investment options selected by the participants. A number of investment providers have developed participant "investment advice" services based on the SunAmerica ruling.

3. *Pension Protection Act*. Under the Pension Protection Act of 2006, Congress had intended to encourage the availability of participant-level investment advice by enacting a new prohibited transaction exemption (the "PPA Statutory Exemption") to provide relief from fiduciary liability for providing such advice under certain conditions. To qualify for this exemptive relief, a fiduciary adviser (e.g.,

investment adviser, broker-dealer) is required to ensure that the fees for its investment advice are level (i.e., fees will not vary based on any recommended investment options that are selected by a participant). Alternatively, the investment advice can be provided through the utilization of an objective computer model that is independently certified not to favor investment options that would result in greater fees for the adviser.

The basic statutory requirements are as follows:

a. Fiduciary Adviser. The participant investment advice must be provided by a "fiduciary adviser" which is defined as person who is a fiduciary by reason of the provision of investment advice and who is (i) a registered investment adviser, (ii) a bank, (iii) an insurance company, (iv) a registered broker-dealer, (v) an affiliate of the foregoing persons, or (vi) an employee, agent or registered representative of the foregoing persons.

b. Eligible Investment Advice Arrangement. The advice must be provided under an "eligible investment advice arrangement" which is an arrangement under which (i) fees received by the fiduciary adviser for investment advice do not vary depending on the basis of any investment option selected (the "Fee-Leveling Safe Harbor"), or (ii) such advice is based on a computer model that operates in a manner that is not biased in favor of investments offered by the fiduciary adviser or its affiliates and that is certified by an independent expert (the "Computer Model Safe Harbor"). As announced in its Field Assistance Bulleting ("FAB") 2007-1 interpreting the PPA Statutory Exemption, the DOL believes the fee-leveling requirement must be imposed on the fiduciary adviser and the individual adviser. However, the compensation of the fiduciary adviser's affiliates (e.g., affiliated investment advisers managing mutual fund options for a plan) may vary based on the investment options selected by plan participants. Thus, in the DOL's view, the PPA Statutory Exemption gives fiduciary advisers a new type of self-dealing relief that was not previously available under ERISA. Prior to the enactment of the PPA Statutory Exemption, with certain narrow exceptions, ERISA would have imposed fee-leveling on the individual representative of the fiduciary adviser, the fiduciary adviser itself, and the fiduciary adviser's affiliates.

c. Other Requirements for Eligible Investment Advice Arrangement.

- Express authorization of an independent plan fiduciary.

- Annual audit conducted by an independent auditor, which includes a written report to the plan fiduciary authorizing the advice program.

- Notice from fiduciary adviser to participant before the initial provision of advice, including disclosure regarding fiduciary adviser's relationship with respect to the investment options and fees payable to the fiduciary adviser and its affiliates.

- Appropriate disclosures are provided in accordance with securities laws.

- Any investment transactions are solely at the direction of the recipient of the advice.

- Compensation received by the fiduciary adviser and its affiliates is reasonable.

- The terms of any investment transactions are at least as favorable to the plan as an arm's length transaction would be.

- The fiduciary adviser must maintain appropriate records for at least 6 years.

4. *DOL's Investment Advice Regulations.* On February 26, 2010, the DOL issued newly proposed regulations concerning the manner in which a fiduciary adviser may provide investment advice to participants of defined contribution retirement plans under ERISA. These proposed regulations are intended to replace the controversial "final" regulations published by the DOL on January 21, 2009, which were withdrawn on November 20, 2009, before ever having taken effect.

a. Inclusion of Class Exemption in "Final" Regulations Triggers Their Withdrawal. The DOL had finalized its first iteration of the investment advice regulations during the last days of the Bush Administration, issuing them on January 21, 2009. This early 2009 release was highly unusual in that it included both (i) interpretive guidance with respect to the PPA Statutory Exemption, and (ii) a separate but related administrative exemption (the "Withdrawn Class Exemption") concerning investment advice.

The Withdrawn Class Exemption mirrored the PPA Statutory Exemption's Fee-Leveling and Computer Model Safe Harbors in many respects. However, the Withdrawn Class Exemption provided for significantly more expansive fiduciary relief as follows:

- Additional Fee-Leveling Safe Harbor. The Withdrawn Class Exemption would have created a similar but new safe harbor, mandating fee-leveling for the individual representative of the fiduciary adviser only (and not for the individual representative and the fiduciary adviser as required under the PPA Statutory Exemption). Thus, the compensation payable to the fiduciary adviser and its affiliates would be able to vary with the investment options selected by plan participants. For example, the Withdrawn Class Exemption would have allowed the individual representative of a broker-dealer to provide investment advice to participants, so long as the individual representative received a level fee.

Conversely, the broker-dealer itself and its affiliates would have been able to receive variable compensation, including 12b-1 fees and revenue sharing payments.

- Additional Computer Model Safe Harbor. Once investment advice based on an objective computer model had been provided to a participant, the Withdrawn Class Exemption would have allowed the fiduciary adviser to follow up with subjective, individualized advice to the participant. Any such individualized advice would not have been subject to any fee-leveling requirement.

The DOL under the incoming Obama Administration postponed on multiple occasions the effective date for both its interpretive guidance with respect to the PPA Statutory Exemption and the Withdrawn Class Exemption. Due to concerns over the Withdrawn Class Exemption and the perceived inadequacy of certain conditions, the DOL withdrew its final regulations in their entirety on November 20, 2009.

b. DOL Proposes Second Iteration of Its Investment Advice Regulations. The second iteration of the DOL's investment advice regulations, which were proposed on February 26, 2010 (the "Newly Proposed Regulations"), are substantially similar to the interpretive portion of the DOL's withdrawn regulations relating to the PPA Statutory Exemption. However, the Newly Proposed Regulations do not re-introduce any kind of new administrative exemption akin to the Withdrawn Class Exemption that had previously been incorporated into the DOL's withdrawn regulations.

Thus, the Fee-Leveling and Computer Model Safe Harbors under the Newly Proposed Regulations are consistent with the existing safe harbors under the PPA Statutory Exemption. Under the Newly Proposed Regulations:

- with respect to the Fee-Leveling Safe Harbor, participant investment advice may only be provided if the fees earned by both the individual representative of the fiduciary adviser and the fiduciary adviser itself (and not including the fiduciary adviser's affiliates) do not vary with the investment options selected by participants, and

- with respect to the Computer Model Safe Harbor, a fiduciary adviser may only provide investment advice to participants based on an objective computer model, and may not supplement such advice with subjective, individualized advice.

However, in the preamble to the Newly Proposed Regulations, the DOL highlighted one new interpretive requirement that it was proposing for the Computer Model Safe Harbor. Although it is not expressly required under the PPA Statutory Exemption, the Newly Proposed Regulations state that the

computer model advice must not "[i]nappropriately distinguish among investment options within a single asset class on the basis of a factor that cannot confidently be expected to persist in the future."

In the preamble, the DOL clarified that differences in investment options' fees and management styles are likely to persist in the future. However, unlike the historical performance of asset classes, the historical performance of investment options in the same asset class are less likely to persist and therefore are less likely to constitute appropriate criteria for advice. Since many advisory computer models consider the historical performance of investment options (rather than asset classes), the DOL is expected to receive significant commentary with respect to this proposed interpretive requirement, which had not been surfaced previously with the interpretive portion of the DOL's withdrawn regulations. The comment period for the Newly Proposed Regulations ends on May 5, 2010.

IV. Conflicts-Related Disclosure by Service Providers to Plan Sponsors

A. Background.

1. *Statute*. As discussed earlier, ERISA §408(b)(2) provides relief from ERISA's prohibited transaction rules for the use of plan assets to pay for services between a plan and a party in interest (e.g., broker-dealer). The conditions of this statutory exemption are satisfied if:

- the contract or arrangement is reasonable,
- the services are necessary for the establishment or operation of the plan, and
- no more than reasonable compensation is paid for the services.

2. *Current Regulations*. In addition to the above requirements in ERISA, the current regulations impose only one other significant additional requirement. The plan must be able to terminate the service contract or arrangement without penalty on reasonably short notice.[6] Neither ERISA nor the current regulations impose a significant administrative burden on service providers nor expose them to significant risk of legal liability.

[6] 29 CFR 2550.408b-2(c).

B. Proposed Regulations under ERISA Section 408(b)(2).

1. *Overview*. The U.S. Department of Labor ("DOL") has proposed amending its regulations to require service providers to disclose in writing their fees and conflict of interests.[7] If adopted as proposed, the new regulations will impose significant administrative burden on service providers and expose them to significant risk of legal liability for failure to disclose their fees and conflicts of interest.

DOL's proposed fee and conflict of interest disclosure rules for service providers are the second of three fee-related regulations. The first set applies to a plan's disclosures of fees that it pays on Form 5500, Schedule C. As discussed below, the DOL has already issued final regulations on the revised Schedule C and they apply starting with the 2009 plan year [8]. DOL has also proposed the third set of regulations that will apply to the disclosures by the plan to its plan participants.[9]

2. ***Rationale for Proposed Regulations*.** The three sets of fee-related disclosure regulations are the current installment in the 401(k) fee saga that began more than ten years ago. In 1997, several consumer magazines published provocatively entitled articles, such as "Protect Yourself against the Great Retirement Rip-off" and "Your 401(k)'s Dirty Little Secret."[10] These articles apparently prompted the DOL to launch its 401(k) plan fee initiative. In November 1997, the DOL held a hearing on 401(k) fees.[11]

In June 1998, the DOL published a 19-page booklet, "A Look At 401(k) Plan Fees," for plan participants and a 72-page report, "Study of 401(k) Fees and Expenses," for plan sponsors.[12] The study appears to have been an attempt to educate plan sponsors about their fiduciary responsibilities regarding fees and expenses for service providers. The booklet appears to have been an attempt to persuade plan participants to put pressure on plan sponsors to pay attention to the fees and expenses that plan participants were paying for investment management and plan administration.

The DOL's 10-year educational effort to persuade plan sponsors and plan participants to ask the right questions about 401(k) fees has apparently failed. In light of that failure, the DOL is proposing to require service providers to disclose the answers to questions that the DOL believes plan sponsors should have been asking.

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[7] 72 Fed. Reg. 70988 (Dec. 13, 2007). If DOL adopts the 408(b)(2) regulations as proposed, the final regulations would take effect 90 days after publication in the Federal Register.
[8] 72 Fed. Reg. 64710 (Nov. 16, 2007).
[9] Proposed 29 C.F.R. 2550.404a-5 published at 73 Fed. Reg. 43013 (Jul. 23, 2008).
[10] "Protect Yourself against the Great Retirement Rip-off," *Money Magazine* (April 1997). "Your 401(k)'s Dirty Little Secret," *Bloomberg Personal* (September 1997).
[11] The hearing notice is posted at http://www.dol.gov/ebsa/regs/fedreg/notices/97_27431.htm.
[12] A Look at 401(k) Plan Fees" is posted at http://www.dol.gov/ebsa/publications/401k_employee.html. The Study of 401(k) Fees and Expenses is posted at: http://www.dol.gov/ebsa/pdf/401kRept.pdf.

After the Hecker v. Deere decision, the final regulations are more important to the DOL than before because the 7th Circuit decided that ERISA's fiduciary responsibility rules do not require plan sponsors or their service providers to disclose revenue sharing arrangements.[13] The proposed regulations require service providers to disclose revenue sharing arrangements.

3. *Service Providers Affected*. The proposed rules are limited to service providers that:

a. are fiduciaries under ERISA or under the Investment Advisors Act of 1940;

b. provide securities brokerage, investment advice (to the plan or plan participants), investment management, custodial, recordkeeping, consulting, or third party administration services, regardless of whether they receive the compensation directly from the plan or plan sponsor, or indirectly from third parties, or

c. provide accounting, actuarial, appraisal, auditing, legal or valuation services but only if they receive any compensation indirectly from third parties.

Thus, service providers who are plan fiduciaries (e.g., investment advice fiduciaries) and service providers involved with plan administration or investments are subject to the new disclosure rules, even if they do not receive any indirect compensation. However, accounting, actuarial, legal, and similar professional service providers are subject to the new disclosure rules only if they receive indirect compensation. According to the DOL, the distinction is based on its belief that the service providers subject to the enhanced disclosure requirements are most likely to have conflicts of interest.

Although the focus of the proposed 408(b)(2) regulations is 401(k) fees, the proposal applies to services provided to health or other welfare plans as well as 401(k) and other retirement plans.

4. *Fee Disclosures*. An affected service provider must disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, all services to be provided to the plan and, with respect to each such service:

- the fees to be received by the service provider (expressed as a specific monetary amount or formula, percentage of the plan's assets, or per capita charge);

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[13] Hecker v. Deere & Co., 556 F.3d 575 (7th Cir.), *reh'g denied*, 569 F.3d 708 (2009).

- whether the service provider will bill the plan, deduct fees directly from plan accounts, or reduce the plan's investment earnings to pay the fees, and

- how any prepaid fees will be calculated and refunded when a contract terminates.

a. Types of Fees. For purposes of the proposed rule, fees include money or any other thing of monetary value (e.g., gifts, awards, and trips) to be received by the service provider (or its affiliate) directly from the plan or plan sponsor, or indirectly from third parties (i.e., from any party other than the plan or the plan sponsor), in connection with the services to be provided pursuant to a contract or arrangement with the plan or because of the service provider's position with the plan.

Fees may include direct or indirect compensation to the service provider.

- Direct compensation: This is compensation received by a service provider directly from the plan sponsor or plan.

- Indirect compensation: This is compensation received by a service provide from a third party (i.e., not the plan sponsor or the plan). Revenue sharing would be example of indirect compensation. Indirect compensation is typically paid from the plan's investments (or the plan's investment providers) to the plan's service providers. Thus, indirect compensation in the context of DC plans is actually a cost that is ultimately borne by participants.

b. Special Fee Disclosure Rule for Bundled Services. If a service provider offers a bundle of services to the plan that is priced as a package, rather than on a service-by-service basis, then only the service provider offering the bundle of services must provide the required disclosures. In addition, the bundled service provider is not required to disclose the fee allocation among the services except for fees separately charged:

- against a plan's investment (e.g., management fees paid to a mutual fund's investment adviser) or

- on a transaction basis (e.g., brokerage commissions).

5. Conflicts of Interest Disclosures. An affected service provider must also disclose to the plan sponsor or similar plan fiduciary in writing, to the best of its knowledge, information about different types of relationships or interests that raise conflicts of interests for the service provider in performing plan services. The service providers must disclose whether they:

- will provide any services to the plan as a fiduciary either within the meaning of ERISA §3(21) or under the Investment Advisers Act of 1940;

- expect to participate in, or otherwise acquire an interest in, any transaction to be entered into by the plan in connection with the services and, if so, a description of the transaction and the service provider's participation or interest therein;

- have any material financial, referral, or other relationship or arrangement with other parties (e.g., a money manager, broker) that creates or may create a conflict of interest, and if so, a description of such relationship or arrangement;

- will be able to affect its own compensation or fees, from whatever source, without the prior approval of the plan sponsor or similar plan fiduciary; and

- have any policies or procedures that address actual or potential conflicts of interest or that are designed to prevent either compensation or fees or the relationships or arrangements from adversely affecting the provision of services, and if so, an explanation of these policies or procedures.

6. Timing and Format of Disclosures. There is no specified timeframe to disclose the information other than prior to entering into the contract. All of the required disclosures need not be contained in the service contract and may be provided in electronic format. The service contract must include a representation by the service provider that, before the contract was entered into, all the required conflicts of interest information was provided to the responsible plan fiduciary. During the term of the contract, any "material" change to the previously furnished information must be disclosed within 30 days of the service provider's knowledge of the change.

C. Curing Disclosure Failures Under Proposed Regulations. A service provider's failure to comply with the disclosure obligations under the proposed 408(b)(2) regulations would result in a prohibited transaction. Because the prohibited transaction could adversely affect the plan sponsor or similar plan fiduciary, the DOL has also proposed a class exemption[14] that would provide relieve for them. Conspicuous by its absence is any relief to the service provider that fails to comply with the proposed 408(b)(2) regulations.

D. No Conflict of Interest Relief for Fiduciaries. To some extent the proposed regulations are misleading because they require service providers, including fiduciary service providers, to disclose their fees and conflicts of interest. As a result, some fiduciaries—particular investment advisers—have inferred that they can cure conflicts of interest by

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[14] 72 Fed. Reg. 70893 (December 13, 2007). The class exemption would be effective 90 days after its publication in the Federal Register.

disclosing them as they do under the Investment Advisers Act of 1940. However, the inference is erroneous.

The regulations provide relief only from the party-in-interest transactions in ERISA Section 406(a), and not the conflict of interest rules under ERISA Section 406(b). Thus, a fiduciary disclosing its conflicts of interest under the proposed 408(b) regulations will not get any relief from ERISA's prohibitions against self-dealing. Essentially, the proposed 408(b) regulations are designed to force non-fiduciary service providers to disclose their conflict of interests, even though they are not subject to the conflicts of interest rules that apply to fiduciaries.

E.. Outlook for Finalization of 408(b)(2) Regulations. Assistant Secretary of Labor Phyllis Borzi expects the final regulations, unlike the proposed regulations, will be a lot more specific about how service providers must disclose their fees and conflicts of interests. Assistant Secretary Borzi also expects the final regulations to be published in May 2010.[15] If she is correct, it appears that the final regulations will preempt the fee disclosure legislation pending in Congress,[16] rather than vice versa. Thus, the content of the final regulations will be heavily influence by the disclosure standards in the pending legislation.

V. Cross-Selling Practices and IRA Rollover Advice

A. Rollover Advice – Avoiding Potential Legal Challenges

When a financial advisor has a pre-existing relationship with either a qualified plan or a plan participant, the line between services that are permissible and those that would result in a violation of the advisor's fiduciary duty may appear to be murky.

But clarification of these rules is critical in light of the DOL's campaign to curb the perceived abuses associated with "cross-selling," which it recently defined as "using existing clients, plan participants and beneficiaries … to market additional services or products." This definition of cross-selling and the DOL's views on the matter were expressed in the preamble to the first iteration of the investment advice regulations issued under ERISA Section 408(b)(14) (issued January 21, 2009 and withdrawn as of November 16, 2009).[17] The DOL believes that the fees received by an advisor in connection with rollovers to IRAs leads to a "potential for abuse" when an advisor cross-sells such services to plan participants. However, for the most part, the preamble merely restates the position first staked out in Advisory Opinion 2005-23A where the Department first articulated its position that responding to participant questions concerning the advisability of taking a distribution or the investment of the amount withdrawn could have fiduciary ramifications.

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[15] See *Live Q&A Session with EBSA* available at http://www.dol.gov/regulations/chat-ebsa-static.htm.
[16] See H.R. 2989, 401(k) Fair Disclosure and Pension Security Act, approved by the House Education and Labor Committee on June 23, 2009. See June 24, 2009, Press Release posted at http://edlabor.house.gov/newsroom/2009/06/house-committee-approves-bill.shtml.
[17] The second iteration of the investment advice regulations was proposed on February 26, 2010.

B. DOL Advisory Opinion 2005-23A.

1. *First Question*. Advisory Opinion 2005-23A posed three questions, the first of which asks whether an advisor who receives a fee for advising a plan participant on how to invest plan assets or for managing the participant's account is an investment advice fiduciary. Unsurprisingly, the answer was that the act of furnishing "investment advice" at a participant-level causes the advisor to be a fiduciary with respect to the plan.

2. *Second Question*. The second question has caused much uncertainty with respect to whether an advisor's recommendation that a participant roll over his or her account balance to an individual retirement account to take advantage of investment options not available under the plan constitutes investment advice with respect to plan assets. The advisory opinion answered this question in the negative, because a recommendation to take a distribution does not constitute advice pertaining to plan investments and a recommendation with regard to the investment of withdrawal proceeds concerns funds that are no longer plan assets.

This apparently liberal response was followed by elaboration that was both confusing and far more restrictive. If the advisor is a plan officer or someone who is already a plan fiduciary responding to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan, that fiduciary is exercising discretionary authority respecting management of the plan and must act prudently and solely in the interest of the participant. Under this "plan management" rationale, such advisor's response to participant questions as to the "advisability" of taking a distribution or as to the manner of its investment would be subject to the prohibitions against self-dealing under ERISA. The Department went on to point out that if the advisor exercises control over the plan assets so as to cause the participant to take a distribution and roll it into an IRA generating fees for the advisor, a prohibited transaction could result, because plan assets would have been used for the advisor's benefit.

In short, the DOL is drawing a distinction between two groups: (i) "a plan officer or someone who is already a plan fiduciary" and (ii) someone who is:

a. "neither chosen nor promoted by plan fiduciaries,"

b. "not otherwise a plan fiduciary,"

c. "not a plan fiduciary on some other basis," and

d. "not connected with the plan."

An adviser in the first group (i.e., "someone who is already a fiduciary") that recommends that a plan participant roll over his or her account balance to an IRA (or that "responds to participant questions concerning the advisability of taking a distribution or the investment of amounts withdrawn from the plan") could violate ERISA's conflict of

interest rules, if the adviser will earn fees on the IRA assets after a plan participant rolls over his or her account balance to the IRA.

However, an advisor in the second group (i.e., someone who is not already a fiduciary) can recommend that a plan participant roll over his or her account balance to an IRA, even if the investment professional will earn fees on the IRA assets after the rollover. In this situation, ERISA's conflict of interest rules do not apply to the investment professional's rollover recommendation.

3. *Third Question*. The third question raised in the advisory opinion was whether a recommendation by an advisor not "connected with" the plan, relating to distributions and the investment of distribution proceeds, would cause the advisor to be viewed as a fiduciary with respect to the plan. The answer was no, but it still left open the question as to the exact nature of the connection that will get an advisor into trouble. Nevertheless, it is clear that, in the DOL's view, being a plan fiduciary on some other basis would suffice.

The DOL's position that if an advisor has some connection with a plan that makes him a fiduciary, then he becomes a manager of plan assets when he makes any recommendation regarding rollovers and/or their investment is unconvincing. This allows no room for the possibility that the advisor may be operating in a non-fiduciary role when engaging in financial planning regarding rollover.

The DOL cited the Supreme Court decision in Varity Corp. v. Howe as the support for its plan management theory.[18] That case involved a plan sponsor that had held meetings and provided materials which misled plan participants about the likely future of their plan benefits. The question, which was ultimately resolved against the plan sponsor, was whether the plan sponsor was wearing its fiduciary hat when it made these communications. While the court approved the finding that the plan sponsor had been acting in a fiduciary capacity, this conclusion was made on the basis of the specific factual context in which the misleading statements were made. This made the case of very limited precedential value. In other words, in order to decide whether an advisor is a plan manager, it is necessary to look at the facts and circumstances of each case. You cannot simply impose a blanket rule, as the Department seems to have done, that turns everyone who happens to have a plan connection into a plan manager if he provides financial planning services as to distributions and rollovers.

4. *Preamble to First Iteration of DOL's Investment Advice Regulations*. In the preamble to the DOL's "final" regulations interpreting the statutory prohibited transaction exemption added by the PPA covering certain fiduciary advisers providing investment advice to plan participants (which were subsequently withdrawn and re-proposed on February 26, 2010), the DOL confirmed the continuing vitality of its 2005 advisory opinion.[19] In this prefatory guidance, the DOL stated that:

[18] 516 U.S. 489 (1996).
[19] Preamble at 74 *Federal Register* 3831(1/21/2009).

> With regard to the practice of "cross-selling," i.e., using existing clients, plan participants and beneficiaries in this case, to market additional services or products, the Department notes that, while advising a participant or beneficiary to take an otherwise permissible plan distribution would not normally constitute "investment advice" within the meaning of 29 CFR 2510.3-21(c), the Department has taken a different position with respect to such activities when the person making such recommendations is already a plan fiduciary, as would be the case with a fiduciary adviser. When a person is already acting in a fiduciary capacity with respect to the plan, the Department has indicated that recommendations relating to the taking of a distribution or the investment of amounts withdrawn from the plan would constitute the exercise of discretionary authority respecting management of the plan and, therefore must be undertaken prudently and solely in the interest of the participant or beneficiary, consistent with section 404(a)(1). The Department further notes that if, for example, a fiduciary exercises control over plan assets to cause a participant or beneficiary to take a distribution and then to invest the proceeds in an IRA account managed by the fiduciary, the fiduciary may be using plan assets in his or her own interest, in violation of ERISA section 406(b)(1).

The DOL also explained that the statutory prohibited transaction exemption for investment advice under ERISA 408(b)(14) did not provide relief from the rollover conflict of interest problem.[20] With certain limited exceptions, the recently proposed regulations (as of February 26, 2010) are substantially similar to the withdrawn regulations.

C. Interpretive Bulletin 96-1. The DOL has recognized a distinction between investment advice and education since publishing Interpretive Bulletin 96-1. In addition, the bulletin explains how investment education could be provided without providing investment advice that would make the provider an investment advice fiduciary. For example, the bulletin states that investment education includes informing plan participants about the impact of preretirement withdrawals on retirement income.

The preamble to the bulletin further explains the importance of rollover education as follows: "Plan participants also need to be informed about the impact on retirement savings of preretirement withdrawals . . . . The Department, therefore, encourages educational service providers to emphasize that participants should: . . . (3) if they change employment refrain from withdrawing their retirement savings, and opt instead to directly transfer or roll over their plan account into an IRA or other retirement vehicle. . . ." This indicates that an adviser providing a plan participant with educational information about the availability of rollovers would not be providing investment advice.

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[20] "The prohibited transaction relief offered by the statutory and class exemption, which apply to transactions related to the provision of investment advice to plan participants or beneficiaries, would not cover such a violation." See Preamble at 74 *Federal Register* 3831(1//21/2009).

D. Young v. Principal Financial Group, Inc. (S.D. Iowa, 2008). In the Principal case, a federal district court has allowed class action claims to proceed against a financial services company providing administrative services to plans whose agents had allegedly breached their ERISA fiduciary duties by encouraging plan participants to roll over their 401(k) assets into IRAs invested in the company's proprietary mutual funds. The letter from the company instructed them to call a 1-800 number to discuss how the changes in their employment status might affect their plan accounts. The telephone numbers directed the participants to the company's sales personnel rather than to pension counselors and the participants were advised to roll over their plan accounts into IRAs that were restricted to the company's proprietary investment vehicles thereby causing the participants to earn less and pay higher fees than if they had left their money in the 401(k) plan. The complaint further alleged that the company also breached its duties by supplying private information regarding individual participants to its sales personnel.

While the court granted the defendant's motion to dismiss the participant's claims seeking recovery of losses to their 401(k) plan, because the plan itself had not incurred any loss, Principal's motion to dismiss fiduciary breach claims for which participants could seek an equitable remedy was denied.

VI. Best Practices With Respect to Cross-Selling

A. Best Practices for Plan Sponsors. In light of the fiduciary duties imposed on plan sponsors and the potential liability that can result from ignoring them, plan sponsors should follow the "best practices" that are emerging in the benefits community with respect to the cross-selling of retirement plan services. The suggested safeguards and best practices are as follows:

1. No "Linking" of Plan and Non-Plan Services During Negotiations. When negotiating multiple services (one of which involves services with fees that are to be paid using plan assets), a plan sponsor should avoid "linking" the terms and conditions of plan services with the terms and conditions of any other service, and vice versa. Plan sponsors should never consider any personal benefits when considering the selection of service providers to the plan.

2. Policy Regarding Gifts or Free/Discounted Services. Plan sponsors should consider implementing and following a policy governing a plan sponsor's receipt of free or discounted services, or any other gifts or payment of value from the plan's investment or service providers. In no event should any gift or other payment received by the plan sponsor be contingent on the plan sponsor's agreeing to purchase additional services for the plan. In addition, the annual value of any gifts or gratuities from any existing or prospective provider (including affiliates) should never equal or exceed $250. The policy does not need to be a detailed legal document, and plan sponsors may wish to consider the following criteria:

- The policy is in writing.

- The policy appropriately restricts the receipt of gifts, free or discounted services, or other payments of value from the plan's investment and service providers.

- The policy is reviewed periodically and compliance is confirmed at least annually. For this purpose, the policy should establish the annual review period (e.g., calendar year, employer's fiscal year).

3. Prudent Process for Selection of Service Provider. When purchasing new or additional services from a vendor with an existing relationship with the plan sponsor (where the existing relationship is based on the provision of plan services or non-plan services), the purchase decision should be based an objective process which is designed to gather the information that is necessary (i) to assess the qualifications of the provider with respect to the proposed services, (ii) the quality of the new or additional services being offered, and (iii) the reasonableness of the fees charged in light of the services provided.

4. Review Reasonableness of Fees. When purchasing new or additional services from a vendor that has pre-existing ties to the plan, the fees payable by the plan to the vendor (or its affiliates) should be reviewed to confirm reasonableness.

- Fees can be evaluated by soliciting fee quotes from alternative providers.

- If soliciting quotes it too burdensome, informal or formal benchmarking can be conducted through various service providers.

- When assessing the reasonable of fees, be sure to evaluate them in light of the quality of the services being provided. No provision under ERISA prohibits the payment of higher fees in exchange for higher quality services.

5. Due Diligence Review of Vendor's Potential Conflicts. Plan sponsors should review arrangements with the plan's vendors to ensure that no cross-selling practices have resulted in any violations of the prohibited transaction rules under ERISA.

- Review any fiduciary recommendations to ensure the vendor did not engage in any self-dealing.

- As part of the due diligence review process, plan sponsors should request copies of any conflicts-related policies and procedures maintained by the vendor.

6. Conflicts-Related Disclosure in Contracts. When entering into contracts with vendors, in anticipation of the finalization of the new disclosure requirements under ERISA Section 408(b)(2), insert disclosures concerning any conflicts of interest and/or indirect compensation.

B. Best Practices for Plan Providers. Given the co-fiduciary liability and the non-fiduciary liability that may be imposed on plan providers for knowingly participating in a prohibited transaction, investment and service providers to retirement plans should also consider adopting best practices. Many of the suggested safeguards mirror the best practices applicable to plan sponsors, as follows:

1. No "Bundling" of Plan and Non-Plan Services. If a provider and its affiliates offer both plan and non-plan services (e.g., accounting, financial advice), it is critical that the provider not bundle or otherwise link the terms and conditions of plan services with the terms and conditions of any other service, and vice versa.

- For example, a bank should not agree to increase the employer's line of credit as a *quid pro quo* for using an affiliate's investment funds for the employer's 401(k) plan.
- Vendors should not offer "break points" or discounts that are conditioned on agreements to engage the vendor for a mix of plan-related and non-plan-related business.

2. Policy Regarding Gifts or Free/Discounted Services. Plan providers should adopt policies and procedures governing an individual representative's ability to provide gifts or other gratuities to plan clients. In no event should any gift or other payment be offered to a plan client in exchange for the plan client's agreeing to purchase additional services for the plan. In addition, the annual value of any gifts or gratuities to any single plan client (from any and all affiliates) should never equal or exceed $250. Plan providers may wish to consider the following criteria:

- The policy is in writing.
- The policy appropriately restricts providing gifts, free or discounted services, or other payments of value to plan sponsors.
- The policy designates a specific individual as responsible for ensuring and monitoring compliance with its terms.
- The provider's relationship managers and other sales personnel receive periodic training and are held accountable to the standards set forth in the policy.

Many providers of investment services to plan already maintain a gift and entertainment policy. Such policies should be reviewed to ensure compliance with ERISA standards. Furthermore, both investment and non-investment service provider should consider implementing an appropriate policy.

3. Documentation of Qualifications. To assist plan sponsors who are conducting due diligence with respect to prospective service providers, plan providers

should make documentation of their qualifications available to prospective plan clients. Such documentation should have more than merely promotional or marketing value, and should include substantive content, including details such as the provider's historical experience and track record, client base, expertise and other qualifications, available resources and personnel biographies.

4. Description of Services in Contracts. Given the regulatory and litigation-driven scrutiny of the reasonableness of fees in light of the services provided, any contract to provide plan-related services should include a detailed discussion of the type, frequency, scope and quality of the proposed services.

5. Policy Regarding Potential Conflicts. Providers of any type of service to plans should consider implementing policies and procedures to address potential conflicts of interest. Such policies might include the following provisions:

- The provider and its employees will refrain from participating in any type of self-dealing by the employer.

- If the provider is a non-fiduciary, any potential conflicts will be disclosed to the plan client (in the manner recommended under the proposed 408(b)(2) regulations).

- If the provider is a fiduciary, any potential conflicts must be addressed by either eliminating them or by complying with the conditions of an applicable prohibited transaction exemption.

- The policy designates a specific individual as responsible for ensuring and monitoring compliance with its terms.

- The policy provides that the applicable employee must escalate and report any possible violation of the policy or ERISA to an appropriate supervisor.

6. Conflicts-Related Disclosure in Contracts. When entering into contracts with plan clients, in anticipation of the finalization of the new disclosure requirements under ERISA Section 408(b)(2), insert disclosures concerning any conflicts of interest and/or indirect compensation.

C. Best Practices Concerning IRA Rollover Advice. If an adviser is not providing "investment advice" or any other fiduciary investment services for the plan or its participants, the adviser is permitted to provide advice and recommendation to participants regarding when they should take distributions from the plan and how they should invest the proceeds in an IRA outside of the plan. However, as discussed above, ERISA's conflict of interest rules prohibit an investment professional advising a plan sponsor or plan participants from recommending an IRA that will generate fees or other compensation for that investment professional. However, such an adviser may provide investment education about availability—not advisability—of a rollover, even if the adviser will earn fees or other compensation from the participant's rollover IRA assets.

This approach of restricting services to investment education about rollovers would be consistent with the guidance under DOL Advisory Opinion 2005-23A and Interpretative Bulletin 96-1.

Thus, if an adviser is already providing investment advice to a retirement plan sponsor or participants, the adviser cannot recommend an affiliated IRA. However, the adviser could educate (and not advise) participants with respect to rollovers in general and describe the ability (and not advisability) to withdraw funds from the retirement plan and to roll them over into affiliated and nonaffiliated IRAs generally. As a best practice, the adviser should also disclose to the participant that if a participant elects to contact the adviser after taking a distribution from the plan, the adviser may recommend IRA investments to the participant for which the adviser will receive fees or other compensation.

In the DOL's interpretive bulletin relating to participant education, the Department has indicated that certain information and materials are not "advice" or "recommendations". This includes information regarding the terms of the plan, for example, the circumstances under which the plan allows distributions. It also includes information relating to the benefits of plan participation and the impact of preretirement withdrawals on retirement income. To avoid providing "investment advice" to a participant with regard to IRA rollovers, the key would be to avoid any reference to a proper or desirable course of action, including the appropriateness of any particular investment option. Although an advisor would be prohibited from making a "hard sell" to participants, a neutral presentation of rollover investment information may be appreciated by many participants.

Please note that current DOL guidance does not specifically state whether an advisor can present asset allocation models that are available outside the plan. Obviously, this would assist the participant in assessing whether he or she should take a distribution in order to access such investment alternatives. This would be particularly true for a participant nearing retirement if the model portfolios are for hypothetical individuals with a short time horizon. In my opinion, this should not be treated as a recommendation or the giving of advice, provided that the model is accompanied by a statement that other investment alternatives with similar risk and return characteristics may be available and the advisor identifies where the participant may find information on such other investment alternatives. Once again, staying out of trouble requires an advisor to avoid making a recommendation, and the best way to do this is to make a balanced and neutral presentation.

D. DOL / SEC's Tips for Reviewing Conflicts of Pension Consultants. When considering or implementing policies and procedures to address cross-selling practices and the related conflicts of interest, it may be helpful to bear in mind the guidance provided by both the U.S. Securities and Exchange Commission (the "SEC") and the DOL with respect to pension consultants and their potential conflicts.

In a joint release published on June 1, 2005, the SEC and DOL issued a fact sheet of "tips" to help plan fiduciaries determine if pension consultants have conflicts of interest when it comes to advising the plan. The tips comprise 10 questions that plan fiduciaries should ask to assist them in evaluating the objectivity of the recommendations provided, or to be provided, by

a pension consultant. Highlighted below (in bold) are four recommended questions that plan sponsors can ask pension consultants (as well as any other plan providers) with respect to conflicts and indirect compensation. Providers should be prepared to answer and address these types of inquiries from plan clients.

1. Are you registered with the SEC or a state securities regulator as an investment adviser? If so, have you provided me with all the disclosures required under those laws?

2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships?

3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your income (revenue)?

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being considered when you provide advice to your clients?

5. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not overpay for its consulting fees?

6. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives the best execution for its securities trades?

7. Do you have any arrangements with brokers-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?

8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment adviser to the plan while providing the consulting services we are seeking?

9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?

10. What percentage of your plan clients utilize money managers, investment funds, brokerage services, or other service providers from whom you receive fees?

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