Pension Plan Fix-It Handbook

Employee Benefits Series THOMPSON November 2011 | Vol. 19, No. 2

Are You a Fiduciary? It's Debatable!

By Mary B. Andersen, CEBS, ERPA

Mary B. Andersen is president and founder of ERISAdiagnostics Inc., an employee benefits consulting firm that provides services related to Forms 5500, plan documents, summary plan descriptions and compliance/operational reviews. Andersen has more than 25 years of benefits consulting and administration experience. She is a CEBS fellow and member of the charter class. She has also achieved the enrolled retirement plan agent (ERPA) designation. Andersen is the contributing editor of the Pension Plan Fix-It Handbook.

As noted in our blog (http://smarthr.blogs.thompson.com), the Department of Labor (DOL)'s Employee Benefits Security Administration (EBSA) issued a press release Sept. 19, 2011, which announced that it will repropose its revised definition of fiduciary in early 2012. (An overview of the proposed definition of "fiduciary" appeared in our January 2011 *newsletter*, with an update in September's *newsletter*.)

EBSA received over 200 comment letters and held two days of public hearings. DOL Assistant Secretary for EBSA Phyllis C. Borzi held media interviews and contributed an article to *Pension & Investments*. The comment letters, transcript of the public hearings (more than 700 typed pages) and interviews are available on EBSA's website (see "Finding out More").

EBSA consistently noted that the 1975 regulation was in need of an update to reflect the changing times. When that regulation was issued, employers that sponsored "thrift plans" in which the employer selected three investment funds in which the participant could invest their money were prevalent. Profit sharing plans frequently offered no investment elections.

Enter 401(k) plans and the world of participant self-direction, multiple investment choices and even brokerage windows. EBSA's overarching goal is to protect participants. The press release indicated that EBSA wanted to take the time to "provide the strongest possible protections to business owners and retirement savers in plans and IRAs." EBSA's goal is to ensure that potential conflicts of interest will not compromise advice. EBSA will propose the regulations again and provide another opportunity for comment.

What provisions contributed to the outpouring of comment letters and requests to testify at the hearing? Consistent themes included the need for clarity, the potential to cause more harm than good and the need for coordination with other regulatory agencies. Here are just a few.

ESOPs

Both plan sponsors and employee stock ownership plan (ESOP) industry professionals reacted strongly to the original proposal that the definition be expanded to include stock appraisers. This expansion was a result of EBSA's national ESOP enforcement project (EBSA's national enforcement projects were mentioned in the October 2011 *newsletter*) which found that one of the most common violations was incorrect valuation.

Comments from plan sponsors and ESOP industry professionals included:

- probable increased appraiser costs;
- appraisers must be independent;
- labeling appraisers as "fiduciary" removes independence; and
- the proposed expansion would result in fewer appraisers willing to accept ESOP valuations.

For all of the above reasons and more, companies will terminate their ESOPs.

Many suggestions were offered to address EBSA's concern including:

- define and set standards for qualified appraisers such as mandatory credentialing;
- issue final ESOP valuation regulations; and
- develop a peer review process.

See *Fiduciary,* p. 2

Fiduciary (continued from p. 1)

Financial Industry

It was no surprise that the financial industry submitted a number of written comments. The proposed rule would encompass many individuals and activities heretofore not deemed to be fiduciaries or of a fiduciary nature.

A common thread was the need for coordinated guidance among the various regulatory agencies in the financial markets including the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC) and the Municipal Securities Rulemaking Board (MSRB), as well as recent regulatory guidance such as the Dodd-Frank Act. The Dodd-Frank Act called for studies regarding standards of conduct for investment advisors and broker-dealers, as well as authorizing the CFTC to develop standards for swap dealers. To impose additional rules before the dust settles on the implications of the Dodd-Frank Act could result in overlapping and potentially conflicting rules. One comment letter indicated that the results of a recent SEC study were "diametrically opposed" to the proposed definition of fiduciary.

Many of the comment letters emphasized that the financial industry was already heavily regulated and to subject broker-dealers to more regulations could have the adverse effect of reducing or eliminating many of the services currently offered by broker-dealers.

While EBSA emphasized that the definition of "fiduciary" was written in 1975 and there has been a tremendous amount of change in the financial and employee benefit world since then, many comment letters countered that the definition has been in effect for 35 years, and the financial services industry (particularly services offered by broker-dealers) has evolved to a mutually beneficial arrangement for both the broker-dealer and IRA holder/plan sponsor without running afoul of ERISA's fiduciary requirements. The apparently broad sweep of the proposed definition would be counterproductive, these comment letters said.

Comment letters included potential examples of client/plan sponsor interactions with brokers, which under the proposed rule would have placed the fiduciary label on the broker. See the box for the potential ramifications of the proposed rules as excerpted from a comment letter, page 8.

Other comment letters noted than in the course of day-to-day interaction, it is not unusual for broker-dealers to provide input on investments. This casual conversation is not intended to be used by the recipient as advice given as a fiduciary. The broad nature of the proposed definition could conceivably include such conversations as fiduciary advice and subject the broker to fiduciary rules. Many small companies and individual IRA holders do not have the money to pay for investment advisory services and such conversations serve to provide information and education; to add the fiduciary label removes a valuable service to the population that needs it the most.

Also noted subtly in some comment letters (and not so subtly in others) was that in-depth expert financial industry knowledge is needed to understand the workings of the financial world. EBSA's expertise lies with ERISA and employee benefit plans, not the financial industry.

Pension Consultants

The preamble to the regulations mentioned EBSA's national project involving pension consultants and potential conflicts of interest when providing advice.

The comment letters from pension professionals noted that much has been done to educate plan sponsors and plan participants regarding service providers. The upcoming Section 408(b)(2) with the May 2012 effective date will provide more information to plan sponsors. A wait-and-see approach regarding whether more guidance is needed is warranted pending the implementation of this disclosure requirement. Many of EBSA's concerns regarding conflicts of interest may be resolved by this increased disclosure.

Economic Analysis

Proposed regulations include an estimate of the economic impact of the regulation. Comment letters took exception to EBSA's evaluation, noting that the $119-per-hour estimate for legal fees was far from accurate.

Where Do We Stand?

EBSA's press release indicated that there would be revisions to provisions such as:

- clarifying that fiduciary advice is limited to individualize advice to specific parties;
- concerns regarding routine appraisals; and
- clarifying continued exemption of long-standing broker practices.

EBSA intends to re-propose the rule in early 2012 and provide the opportunity for more public input regarding the rule and economic analysis as well as coordinate

See *Fiduciary,* p. 4

Make a Securities Broker a Fiduciary? No.

Designating a securities broker as a fiduciary for "recommending" or "advising" about a securities transaction will have a negative effect on plan options.

Consider, for example, a small business such as a flower shop that has a profit-sharing plan. The flower shop owner, due to years of service, has a majority interest in the plan and serves as the plan administrator. The plan administrator becomes absolutely convinced that the price of gold is going to increase substantially in the near future and that other types of investments will be subject to steep declines because of the poor performance of the economy and vast deficits which devalue the U.S. dollar.

A broker does not share that opinion and tells the customer so. Nevertheless, the customer wants a presentation of options that would allow him to take a position that would capitalize on the anticipated increase in the price of gold. The broker then presents various options including gold-related futures contracts, gold mining stocks and gold-related exchange traded funds, and he discusses the pros and cons such as comparative volatility, leverage, risk of capital calls and other relevant considerations.

After being fully informed, the customer chooses one of the options and the broker makes the purchase on the customer's behalf with the trade marked as "solicited" on the trade blotter. The price of gold then declines and the ERISA-covered customer loses money. Under the [proposed "fiduciary" definition] would the broker have acted as a fiduciary in such a transaction? If the customer sets the investment parameters and seeks options within those parameters is presenting those options a recommendation or advice? Is this the kind of recommendation or advice that EBSA is targeting under the expansion of the fiduciary standard? Is this the kind of activity that a broker should be liable for damages based on the market conditions outside of its control relating to the decline of the price of gold?

To bring this example one step forward, assume that the customer decided to purchase the gold mining stock.

1) Can the broker's broker-dealer execute the trade order on a principal basis? That would depend on whether the broker was an ERISA fiduciary or not, which is uncertain. ERISA fiduciaries are barred from engaging in self-dealing with plans and a broker-dealer selling a security out of its inventory, even if sold at prevailing market prices, would be self-dealing with the plan. So principal trades would be forbidden, even if the securities could be closed at better net prices than agency trades through a securities exchange.

2) Can the purchase be done with margined funds or in a margin account? That would also depend on the uncertain determination of whether a broker was providing advice or making a recommendation under the presented fact situation. Margins are loans against the securities assets held in the securities broker-dealer accounts and loans from ERISA fiduciaries to serviced plans are prohibited transactions under ERISA.

3) Can the customer hedge the gold position with a countervailing short sale or put option? That also depends on the uncertain determination of whether the broker was determined to be a fiduciary under ERISA. Short sales and put options require margin accounts which are a credit facility to provide loans on demand against assets held in the customer's account. Margin accounts and such credit facilities to or from ERISA fiduciaries to plans are prohibited transactions under ERISA. Further, the short sale or put option would be barred if the broker-dealer is the counter-party.

4) Is there a disclosure that can be provided under the proposed "fiduciary" definition to clear this up?

    a) No. The proposed definition has a disclosure safe harbor that relies upon the customer's subjective perception and understanding or what would be deemed the customer's reasonable subjective perception or understanding. If the broker provided a comprehensive disclosure of all relevant conflicts, it would still be required to prove that the customer understood it or reasonably should have understood which in practical terms is an unsustainable burden and highly divergent from the standard for a broker-dealers disclosure responsibilities under federal securities laws. Those disclosure requirements contain no provision relating to needing to prove the customer's subjective or reasonable understanding.

    b) No. The proposal's disclosure safe harbor only applies when a broker is operating as the disclosed agent of the counterparty. There is no disclosure safe harbor when a customer has ordered the broker-dealer to go out and execute a specific trade on its behalf as an agent.

5) Is the flower shop's plan the kind of business that a typical broker-dealer would support under the proposal? No, the broker-dealer's legal and compliance departments will likely determine that it cannot offer trading or margin services to such accounts given the uncertainty as to whether such a transaction would cause it to be an ERISA fiduciary to the plan with attendant liability should the price of gold decline and that the uncertainly cannot be cured by the safe harbor disclosure because of the broker-dealer's agency position and because of the subjective understanding requirement in the safe harbor disclosure.

Source: Comment letter from Whitaker, Chalk, Swindle and Sawyer, LLP. (http://www.dol.gov/ebsa/pdf/1210-AB32-039.pdf)

Fiduciary (continued from p. 2)

closely with the SEC and the CFTC to ensure that EBSA's rulemaking effort "is harmonized" with other ongoing rulemakings.

This could take a while to fine tune and finalize.

Editor's Note: the comment letters range from two or three pages on specific aspects of the proposed rule to 10-plus pages of detailed analysis. The comment letters provide a refresher on ERISA and its congressional intent when first drafted. Some of the comment letters provide insights into the machinations of the financial industry which are worth a read. Sampling comment letters from various constituencies (including legal, financial and corporate recordkeepers) will provide many informative insights.

Finding out More

For information from EBSA's website, including the comments, hearing transcripts and interviews concerning the "fiduciary" definition, see http://www.dol.gov/ebsa/regs/cmt-1210-AB32.html.

For the press release announcing the new proposal, see http://www.dol.gov/ebsa/newsroom/2011/11-1382-NAT.html.