ERISA FOR SECURITIES PROFESSIONALS

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The following is an overview of how the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), applies to securities professionals such as registered investment advisers (“RIAs”) and registered broker-dealers who advise, manage, or trade for investment portfolios of employee benefit plans subject to ERISA.

The principal focus of this article is on securities registered under the Securities Act of 1933 (the “1933 Act”) and the Securities Exchange Act of 1934 (the “1934 Act”), and securities of investment companies registered under the Investment Company Act of 1940. Many of these principles also will apply directly to unregistered securities, as well as to other investments offered by banks, insurance companies, commodity trading advisers and real estate advisers, though there may be some variation.

The law broadly known as ERISA comprises a number of provisions of the Internal Revenue Code (the “Code”), the Federal labor laws, and other Federal laws. Except for the prohibited transaction rules of the Code, which fall mainly under the jurisdiction of the Department of Labor (“DOL”) and closely parallel the prohibitions in the labor provisions of ERISA, the Code provisions mainly govern the tax-qualification of plans and are beyond the scope of this discussion. The provisions of ERISA of greatest concern to RIAs and broker-dealers are the labor-law fiduciary requirements contained in Title I of ERISA. These can be broadly divided into five major categories:

- Coverage and definitions
- Reporting and disclosure
- General fiduciary obligations, including co-fiduciary principles
- Prohibited transactions
- Enforcement, including bonding requirements

Each of these areas is discussed in detail below.

COVERAGE AND DEFINITIONS

A securities professional will be subject to ERISA only if, and only to the extent, that he or she is dealing with ERISA plan assets. For this purpose, there must first be a “plan”; the plan must be subject to ERISA, and the assets in
question must be “plan assets” of that plan. Once this determination is made, the next question usually is whether the RIA or broker-dealer is an ERISA “fiduciary” or merely a non-fiduciary service provider to the plan.

What Is an ERISA Plan?

The requirements of ERISA Title I only apply to “employee benefit plans,” or simply “plans,” which are further subdivided into “pension plans” and “welfare plans.” At minimum, every ERISA plan requires:

- **A “plan.”** Certain *ad hoc* arrangements, for one or two individual employees usually are not plans.
- **A plan sponsor.** Specifically, there must be more than *de minimis* involvement of an employer or union sponsor – hence most 403(b) tax-sheltered annuities are sold directly to employees and are outside of ERISA.
- **Employees.** A plan must cover employees; accordingly, a plan covering *only* self-employed individuals and their spouses is not subject to ERISA.
- **Employee benefits.** Although not normally at issue, some common payroll practices and employee “perks” are not employee benefits for ERISA purposes.

For lack of an employer and/or employees, most individual retirement arrangements (“IRAs”) and many so-called “Keogh” plans (including director plans) are not ERISA plans. One major point of confusion, however, relates to the fact that IRAs and Keoghs are treated as plans for Code purposes; accordingly, they are subject to the prohibited transaction rules.

For securities professionals, the foregoing is mainly an academic exercise; the types of arrangements most frequently encountered, such as traditional tax-qualified pension and profit-sharing plans (including 401(k) plans) are ERISA plans.

What Plans Does ERISA Govern?

Not all plans are subject to ERISA (and some are partially exempt). Most private employer plans are subject to ERISA. Governmental plans generally are exempt, although many are subject to similar state-law requirements. For this reason, many fiduciaries apply their ERISA compliance procedures to governmental plans. Church plans also generally are exempt, but often can elect
ERISA coverage. Plans maintained outside the U.S. are not subject to ERISA, if they primarily cover nonresident aliens.

**What Are ERISA “Plan Assets”?**

Every security or other asset owned directly by an employee benefit plan is a “plan asset” subject to ERISA. The more difficult question is whether an asset owned indirectly is also subject to ERISA.

In theory, the concept of ERISA “plan assets” is simple – an entity that is not itself a “plan” subject to ERISA will be treated as holding plan assets if its primary purpose is to invest retirement plan assets. In effect, ERISA “looks through” the vehicle, and the persons who manage its assets will be treated as directly managing the assets of the plan.

In practice, these rules are complex and sometimes counterintuitive. ERISA itself defines “plan assets” only in the negative, exempting registered investment companies and insurance company guaranteed benefit policies. DOL regulations attempt to provide greater guidance. First, they clarify that the concept of “plan assets” only applies to equity investments; there is no look-through when a plan invests in any true debt instrument. Second, the regulations provide a look-through for every equity investment unless an express exception applies. The principal exceptions (in addition to registered investment companies and insurance company guaranteed benefit contracts) are:

- **“Publicly offered securities.”** Such securities must be 1) freely transferable, 2) widely held (more than 100 holders unrelated to management and to each other), and 3) registered under the 1934 Act (or scheduled to be registered subsequent to an IPO), i.e., most public companies.
- **“De minimis” holdings.** Any investment in an entity that does not have “significant” (25% or more) benefit plan investor participation (“benefit plan investor” is a broader concept than the definition of “plan” under ERISA). This is the exception utilized by many private equity and hedge funds. DOL currently is considering whether to apply certain “aggregation” rules to affiliated funds.
- **“Operating companies.”** Investments in companies that develop or market goods and services other than the investment of capital, plus certain “hybrid” entities known as “venture capital operating companies” and “real estate operating companies.”
On the other hand, certain entities always are deemed to hold plan assets, including group trusts (e.g., bank collective investment funds), most insurance company separate accounts, and any entity owned 100% by a single plan or group of related plans.

Accordingly, for example, if a plan invests in a mutual fund, the RIA that advises the fund as to the investment of its assets will not become an ERISA fiduciary, but any RIA that advises the plan as to its investment in the fund will be a fiduciary. However, if the plan invests in an unregistered hedge fund, both the RIA that advises the plan and the RIA which advises the partnership may be fiduciaries.

Ordinarily, interests in securitized vehicles (e.g., mortgage pools) that are treated as debt for tax purposes should constitute debt for ERISA purposes. However, the mere characterization of an interest as debt is not sufficient; it must be judged on its merits, including its credit rating. It should also be noted that holding debt of a “party in interest” raises certain prohibited transaction concerns. See below.

Who Is a “Fiduciary” Under ERISA?

ERISA defines three categories of fiduciaries: 1) those who exercise authority or control over the management or disposition of plan assets; 2) those who provide investment advice for a fee with respect to plan assets, or have authority or responsibility to do so; and 3) those who administer a plan.

Generally, RIAs fall into one or both of the first two categories with respect to client plans. Broker-dealers acting only as such generally are not fiduciaries; however, certain traditional broker-dealer activities can, in individual circumstances, cross the line into investment advice, as discussed below. Financial institutions acting as recordkeepers and third-party administrators typically are not acting as “plan administrators” for ERISA purposes and are not fiduciaries under that definition (this role usually remains with the employer).

The vast majority of questions regarding the fiduciary status of a financial professional revolve around the concept of “investment advice.” The term has a far different meaning under ERISA than under the securities laws, as well as different implications:
What is investment advice under ERISA? The definition of investment advice under ERISA is narrower than under the Investment Advisers Act of 1940. For recommendations to constitute investment advice, generally those recommendations must 1) be rendered on a “regular basis”; 2) be rendered for a fee, direct or indirect; 3) be provided pursuant to an agreement, arrangement, or understanding (which may be implied by course of dealing and reliance); 4) be individualized to the plan’s particular needs; and 5) serve as a primary basis for another plan fiduciary’s investment decisions. The DOL’s “employee education” interpretive bulletin (regulation), discussed below, though not directly applicable to relations between an investment adviser and a plan, provides some additional guidance as to what constitutes “individualized” investment advice.

Securities professionals should note that once the line is crossed under ERISA, for purposes of fiduciary liability there is no distinction between “discretionary” and “non-discretionary” investment advice (provided, of course, that the non-discretionary advice is followed by the client).

The law remains unresolved as to whether recommending managers constitutes investment advice under ERISA. In this respect, it can be argued that the recommendation of an investment fiduciary is neither a recommendation regarding “the value of securities or other property,” nor a recommendation regarding “investing, purchasing, or selling securities or other property” under the ERISA regulations. However, there is authority for the proposition that DOL reads the statute more broadly.

When does one cross the line between “education” and “advice”? In response to the growing use of 401(k) plans and reliance upon section 404(c), as well as criticism that its existing regulations did not provide clear guidance, in 1996 the DOL issued an interpretive bulletin indicating its position on what level of investment “education” services may be provided to plan participants and beneficiaries without crossing the line into fiduciary investment advice. The bulletin describes four categories of information that may be provided on a non-fiduciary basis:

- **Plan information.** This is basically descriptive information.

- **General financial and investment information.** This is general advice regarding investment “concepts,” terminology, risk assessment, etc.

- **Asset allocation models.** “Generic” models may be provided along with generic information regarding the means by which participants may assess
which model to use. The models may relate to specific plan-designated investment options if certain disclosures are made.

- **Interactive investment materials.** This extends the asset allocation concept through the use of “generic” questionnaires, computer programs, and other interactive means to allow participants to assess their retirement needs, goals, risk tolerance, etc. and to apply those assessments to available investment options.

Although binding on DOL, whether these guidelines would prevent a plan participant or beneficiary from challenging the fiduciary nature of an asset allocation program is unclear.

**When do broker-dealer “recommendations” become investment advice?**
The original investment adviser regulations under ERISA were designed to ensure that traditional advisory activities of broker-dealers would not, by themselves, be considered investment advice for ERISA purposes. For this reason, much of the discussion that follows relates only to fiduciary RIAs. However, particularly in the case of smaller plans that come to rely upon the advice of their brokers as a primary source of information on which to make investment decisions, in a number of individual cases DOL and the courts have found that broker-dealers have crossed the line and become ERISA fiduciaries.

**Who is an “investment manager” under ERISA (and why does it matter)?**
An RIA who has actual authority to acquire, manage, or dispose of plan assets can be appointed as an “investment manager” for ERISA purposes. A bank or insurance company may also be an investment manager. For this purpose, the RIA must acknowledge in writing its fiduciary status. The appointment of an investment manager under ERISA *is not mandatory* and is solely for the benefit of the appointing fiduciary; a plan fiduciary who properly appoints an investment manager (and any trustee who follows the manager’s directions) generally will not be liable for investment decisions of the investment manager. The appointing fiduciary must be a “named fiduciary” under the plan, and remains liable for prudently selecting the manager and monitoring its performance.

DOL requires that a state-registered adviser must file a copy of its registration with DOL; a recent DOL proposal would require that state-registered advisers file their registrations electronically, through the Investment Advisor Registration Depository.
REPORTING AND DISCLOSURE

ERISA imposes a number of reporting (to DOL) and disclosure (to plan participants) obligations on plan fiduciaries, including required distributions to participants of “summary plan descriptions” (SPDs) and “summary annual reports” (plus disclosure of certain other information upon request), and filing with the DOL of annual reports on a 5500-series form. Provided certain requirements are met, disclosures to participants under ERISA may now be made electronically.

With limited exceptions, the basic reporting and disclosure requirements of ERISA will not apply directly to an RIA serving as an investment advisory or investment management fiduciary. The primary reporting and disclosure obligations of RIAs are those imposed by the securities laws. One exception is that an RIA managing plan assets will be obligated to provide to the plan administrator certain financial information necessary for the filing of the plan’s annual reports, and to cooperate as reasonably necessary in any required independent annual plan audit. In addition, although certain reporting and disclosure obligations are not imposed directly on RIAs by ERISA, in many cases the RIA may be required by contract to fulfill obligations otherwise imposed on the plan sponsor or other plan fiduciary who has retained the RIA. Some of the principal obligations of RIAs are as follows:

Non-Registered Investment Vehicles. In some cases, in lieu of assisting directly in the preparation of each plan’s annual report, an investment manager advising a separate (non-registered) commingled investment entity holding plan assets may prepare a single entity-level annual report pursuant to DOL’s “alternative compliance” regulations. For an RIA, this generally involves the regulations at 29 CFR section 2509.103-12, sometimes referred to as the “103-12” regulations. These regulations provide that the RIA may, within prescribed time periods, file a single audited financial report for the entity with DOL (based on Form 5500), and, if it does so, each plan administrator need only report the value of the plan’s interest in the entity on its annual report. Generally, this method of compliance is simpler for all parties and, accordingly, often is mandated in investment contracts involving private investment vehicles. Similar reporting is done for bank collective funds.

ERISA Section 404(c) Disclosures. A participant-directed plan that is structured to comply with the fiduciary protections afforded by ERISA section 404(c) and the regulations thereunder (see below) must comply with certain disclosure obligations. Although these obligations generally are imposed on the plan’s sponsor or other named fiduciary(ies), by contract or course of dealing,
many employers expect that an RIA or broker-dealer offering investment options or investment advice to participants will undertake to fulfill them or, at minimum, will be in a position to advise the plan sponsor as to its obligations. Information regarding investment options that automatically must be given to all participants includes:

- An explanation that the plan is intended to constitute a section 404(c) plan and a description of the relief afforded to the plan’s fiduciaries by that section.

- A description of the investment alternatives available under the plan and a general description of the investment objectives and risk and return characteristics of each alternative.

- If any option involves retaining an RIA to act as investment manager, identification of the RIA.

- An explanation of the mechanics of giving investment instructions.

- A description of any fees imposed with respect to an investment option, e.g., fees imposed directly (such as sales loads, direct management fees, etc.). Fees imposed “inside” a mutual fund are not imposed on plan assets and are indirect for this purpose.

- Information identifying a plan fiduciary (usually the plan sponsor, but may be the RIA) who will provide the additional “on request” disclosures described below.

- In the case of an investment option that is an employer stock fund, certain additional information.

- With respect to any investment option that is registered under the 1933 Act (including mutual funds), a copy of the prospectus delivered immediately before or immediately following a participant’s initial investment.

- All proxies and voting materials incidental to a participant’s investment choice, and information regarding the exercise of voting and similar rights, to the extent that those rights are passed through to participants under the terms of the plan.
In addition to the foregoing automatic disclosures, certain additional disclosures must be made to participants upon request:

- A description of the annual operating expenses of each investment option, including a statement as to the aggregate amount of such expenses expressed as a percentage of net asset value.

- Copies of updated prospectuses, financial statements and reports, etc., to the extent otherwise provided (i.e., under the securities laws) to the plan.

- In the case of investments in (non-registered) vehicles whose assets are ERISA “plan assets,” certain additional information regarding the underlying investments of the vehicles.

- Information regarding the value of shares or units in available investment options, including past and current performance information (net of expenses). Generally, it would appear that this information must follow SEC (and NASD) requirements if applicable.

- Information regarding the value of shares or units in the participant’s account.

**General Fiduciary Obligations**

ERISA imposes certain general obligations on plans and their fiduciaries. Even a non-fiduciary service provider should keep in mind that these rules will impact its activities. Briefly, ERISA’s fiduciary obligations (other than the prohibited transaction rules, which are discussed separately) include:

*Exclusive Benefit Rule*

This is the duty of undivided loyalty to the plan, i.e., a fiduciary must discharge its duties *solely* in the interest of the plan and its participants and beneficiaries, for the *exclusive* purpose of providing plan benefits and defraying reasonable plan expenses. However, leaving aside the additional protections of ERISA’s prohibited transaction rules (discussed below), which often are considered extensions of the exclusive benefit rule to certain specified fiduciary actions, “exclusive” is read to mean “primary,” so that this rule is not necessarily violated if another party derives a truly *incidental* benefit from a plan transaction.
Recent court cases have made clear that under this rule, fiduciaries have a duty not to mislead plan participants when discussing plan-related matters; some courts have begun to expand this duty into an obligation not to mislead by omission or even to impose an affirmative duty to disclose material information. What is this disclosure obligation conflicts with another duty, such as the insider trading rules? In the recent Enron case, DOL argued, and the court agreed, that there is not necessarily a conflict; insider trading rules are not violated by, and indeed encourage, public disclosure. The result can be a dilemma for corporate insiders who have information that they are not yet ready to release to the public.

Under one novel theory now being advanced in the courts, a fiduciary’s committing or allowing a violation of the securities laws also might constitute a breach of the fiduciary’s duties under ERISA. The key rationale supporting this theory is that it would allow ERISA’s more generous enforcement scheme to be applied to what are, in essence, securities law violations. For example, failing to deliver a prospectus generally allows for a one-year rescission right under the securities laws. Plaintiffs attorneys now argue that failure to deliver a prospectus also may be a fiduciary breach, with the result that the rescission period may be extended to six years under ERISA. Several recent cases also suggest or imply that, despite SEC positions to the contrary, there may be a fiduciary obligation (if not a securities law obligation) to deliver prospectuses to individual participants rather than merely to the plan’s trustee (who is the actual legal “owner” of the securities) when participants direct their own investments.

**Prudence Requirement**

A fiduciary must act with the care, skill, prudence, and diligence under the circumstances then prevailing that a reasonably prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with like aims. The highlighted terms distinguish ERISA’s prudence rule, often described as the “prudent expert” standard, from traditional common law “good faith” prudence standards (though in most states the common law standard has been replaced by the Uniform Prudent Investor Act, which has adopted ERISA’s approach).

The prudent expert standard means, among other things, that the level of care imposed on an RIA may vary with the complexity of the investments involved. A 1996 letter from DOL to the Comptroller of the Currency, regarding plan fiduciaries’ obligations in connection with investments in derivatives, highlights this point.
Note that, in theory at least, DOL has embraced modern portfolio theory in applying the fiduciary standards; in practice, however, DOL’s enthusiasm is not so clear, and many professionals are beginning to question whether modern portfolio theory has been properly applied in the retirement plan context. In this respect, there is some evidence from the case law (at least when challenging investments in hindsight) that DOL expects individual investments to be demonstrably prudent on a stand-alone basis, rather than as part of an overall portfolio.

As for questions regarding whether modern portfolio theory has been properly applied in the retirement plan context, the issue has been highlighted in a number of recent articles and even in the Pension Benefit Guaranty Corporation’s newly announced investment guidelines, i.e., whether “asset based” investing that starts with a 60-40 equity-debt presumption, and that looks principally at the plan’s assets and risk tolerance to vary the mix, has been so overemphasized that plan liabilities and funding have been overlooked. Many believe that this is one of the reasons why the last market downturn resulted in a funding “crisis.” In other words, the question may not be whether the manager has chosen the right point on the efficient frontier, but whether the manager has chosen the right efficient frontier.

**Duty to diversify investments**

ERISA requires that a fiduciary must diversify a plan’s investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. For example, the expense of greatly diversifying a small portfolio may not justify the additional protection derived (although there may be other ways of achieving both ends, such as commingling the plan’s assets with those of other investors). To the extent that an investment manager is responsible only for a portion of a plan’s total assets, its obligation to diversify its own portfolio should be clearly spelled out in its investment management agreement; generally, however, it would remain responsible for diversifying within its range of discretion (e.g., a small cap manager would retain responsibility for maintaining a diversified small cap portfolio).

Generally, the duty to diversify does not extend to holdings of employer stock. To the extent that ERISA otherwise permits, and to some extent even encourages, investment in employer securities through various prohibited-transaction exemptions (discussed in more detail below), it also contains an explicit exception to the general fiduciary duty to diversify so long as the investment is otherwise prudent, in the interests of the plan and its participants, and consistent with the plan’s documents.
Compliance with Plan Documents

Plan fiduciaries are required to act in accordance with the documents governing a plan to the extent not inconsistent with the terms of ERISA. For example, if a plan’s trust document prohibits certain types of investments, an investment manager who invests in such assets may be in violation of ERISA even if such investments do not violate its investment management agreement. It should be noted that DOL has used the qualifying language in enforcement actions (for example, in the proxy voting context) to challenge fiduciaries who “passively” adhere to plan terms when it may not otherwise be prudent to do so. In the face of a potential conflict between the terms of a plan and the terms of ERISA, rather than decide which course is correct a fiduciary may wish to consider amending the plan.

Trust Requirement

ERISA plan assets must be held in trust, with certain limited exceptions (e.g., assets held by insurance companies). These rules, however, do not prohibit 1) the holding of securities in nominee or street name with a custodial bank, insurance company, registered broker-dealer, or clearing agency, or their nominees, provided that a trustee is the ultimate beneficial owner of the securities, or 2) the creation of certain single-owner or commingled investment vehicles (corporation, partnership, LLC, etc.) which hold “plan assets,” if interests in the vehicles are held in trust. A trustee must be named in the plan or trust documents or be appointed by a “named fiduciary” and must have exclusive authority or discretion to manage the assets held by it except to the extent that such authority is 1) reserved to a non-trustee named fiduciary or 2) is properly delegated to an investment manager (but only to the extent that the manager’s directions to the trustee do not on their face violate the terms of the plan or the requirements of ERISA).

Indicia of Ownership

In conjunction with the trust requirement, ERISA requires that the “indicia of ownership” of any plan assets be held within the jurisdiction of the U.S. Federal District courts. (What constitutes indicia of ownership of an asset generally will be determined by the securities laws or under state/common law.) However, DOL regulations permit the holding of certain foreign securities and currency outside the U.S., provided that they are held 1) under the management or control of a qualified fiduciary, or 2) in the physical possession or control of certain qualifying
financial institutions, which fiduciary or custodial institution is a U.S. domestic entity whose principal place of business is in the U.S. Although these requirements are complicated, generally a qualified fiduciary must be a U.S. bank, insurance company, or RIA meeting certain minimum size requirements (in the case of an RIA, $50 million in assets under management and $750,000 equity). A qualifying custodial financial institution must be a U.S. bank, insurance company, or broker-dealer meeting similar requirements, or certain of their foreign agents, provided that certain other requirements are met as to a plan’s ability to assert and enforce its ownership rights against the U.S. institution.

Prohibited Transactions

ERISA’s prohibited transaction rules are discussed separately below. However, it should be kept in mind that a prohibited transaction may be a fiduciary breach separately actionable by DOL or a co-fiduciary (apart from the express penalties imposed on the prohibited transaction itself).

Co-Fiduciary Obligations

One ERISA fiduciary may be held liable for a breach of another fiduciary if the first fiduciary 1) knowingly participates in, or knowingly undertakes to conceal, the other fiduciary’s act or omission, provided that he or she knows that the other party’s act or omission is a fiduciary breach; 2) in committing his or her own fiduciary breach, allows the second fiduciary also to commit a breach; or 3) knows of the second fiduciary’s breach, unless he or she makes a reasonable effort, under the circumstances, to remedy it.

Co-fiduciary liability is joint and several; that is, each fiduciary is fully liable for any damages to the plan. The majority position of the courts appears to be that a co-fiduciary held liable for a second fiduciary’s breach has no implied right to seek contribution from the second fiduciary; indeed, one or two have gone so far as to hold that ERISA preempts even an express agreement between fiduciaries for contribution or indemnification. In other words, a co-fiduciary may be held liable for the acts of the primary fiduciary, and may have no recourse against the primary fiduciary unless it is set out in a contract between them.

The full extent of co-fiduciary liability remains to be tested. What if the co-fiduciary obtains its knowledge while acting in a non-fiduciary capacity? What about knowledge of affiliates? Enron and other recent litigation may provide some guidance.
How Do the Fiduciary Rules Apply to Specific Securities-Related Issues?

**Proxy voting and corporate governance.** Generally, unless the authority to vote has been expressly (and properly) reserved or delegated to another fiduciary in accordance with ERISA, the fiduciary who is responsible for the management of securities held by a plan also will be responsible for voting those securities. DOL regulations recommend that plan fiduciaries adopt statements of investment policy and proxy voting guidelines and that those fiduciaries expressly require (i.e., in the investment management agreement) that the manager comply with those statements. Investment managers likewise are encouraged to adopt their own guidelines, particularly with respect to pooled investment vehicles whose investors otherwise may have differing priorities.

Typically, a broad policy of not voting will not be acceptable, though it may be prudent not to vote in certain specific situations, such as where the cost outweighs any potential benefit. For example, the preamble to the DOL regulations suggests that foreign securities may sometimes be costly to vote “due to the variety of regulatory schemes and corporate practices.” More generally, voting very small shareholdings may be costly in terms of staff time/research costs.

**Economically targeted investments.** DOL also has adopted an interpretive bulletin and provided other guidance with respect to the issue of “economically targeted investments,” or “ETIs.” These are investments that take into account non-economic “social” investment considerations. The guidelines, which are extremely controversial, generally provide only that it is permissible to take non-economic considerations into account if an investment otherwise satisfies all fiduciary considerations and otherwise is expected to provide no less a return than other investments with similar risk and return characteristics.

**Employer securities.** Even before Enron, it was obvious that holding employer securities in a plan could raise significant ERISA concerns both for employers as well as financial institutions administering plans. Particularly in the case of a troubled company, a key source of concern has been the conflict between following plan terms that mandate investment in employer securities and general fiduciary duties of loyalty and prudence, which may suggest ignoring those terms. Although the law remains unsettled, to date several courts have suggested that there exists a presumption that it is prudent to follow plan terms; in other words, the burden of proof may be on participants to show otherwise.
PROHIBITED TRANSACTIONS

As an extension of ERISA’s fiduciary duties, and in deviation from common-law fiduciary principles, ERISA and the Code incorporate very broad prohibitions against a wide range of activities. These prohibitions extend to a broad group of fiduciary and non-fiduciary parties. The prohibitions roughly fall into three categories: 1) prohibited transactions between a plan and any “party in interest” (“disqualified person” under the Code), which party need not be a fiduciary; 2) the acquisition or holding by a plan of certain “employer securities” or “employer real property”; and 3) fiduciary conflicts, including “self-dealing,” direct conflicts (representing a plan and an “adverse party” in the same transaction), or accepting compensation from a third party dealing with the plan (“kickbacks”).

Particularly for securities professionals, it is important to keep in mind that one overriding principle of ERISA’s prohibited transaction rules is that they were designed to avoid subjective determinations of violations, even if that result seems harsh. That is, there are no broad exceptions for transactions that are reasonable, “arm’s-length,” or based on disclosure and informed consent; however, some or all of these factors may be necessary, but usually not sufficient, steps in complying with certain administrative exemptions.

Typically, two of the three broad categories of prohibited transactions are relevant to securities professionals: 1) transactions between a plan and certain “parties in interest,” sometimes regarded as per se or “objective” prohibitions because they look only to result; and 2) fiduciary conflicts/self-dealing transactions, which typically involve a subjective “intent” of the fiduciary.

Party-in-Interest Transactions

Absent an exemption, ERISA prohibits certain direct or indirect transactions between a plan (including a vehicle holding plan assets) and a party in interest to that plan.

Who is a “party in interest”? Parties in interest with respect to a plan include, among others: 1) all fiduciaries of the plan; 2) any person providing services (fiduciary or non-fiduciary) to the plan; 3) any employer or union whose employees are covered by the plan; and 4) numerous parties affiliated with the foregoing in various direct or indirect ways. For a large plan, not even counting employees, there can be hundreds if not thousands of parties in interest.
What transactions are prohibited? By definition, virtually any direct or indirect transaction between a party in interest and a plan is prohibited in the first instance, including sales, exchanges, or leasing of property; lending of money or other extensions of credit (by a plan or to a plan); furnishing of goods or services; and transfers of assets to or for the benefit of a party in interest.

What exceptions apply? Notwithstanding the foregoing, ERISA also recognizes plans’ needs to engage in certain otherwise prohibited transactions, and so incorporates various statutory exemptions and provides that the DOL also may promulgate administrative exemptions. In this respect, certain statutory exemptions relevant to securities professionals include:

- **Reasonable services.** Perhaps the most important exemption is the one permitting a party in interest to contract with a plan for services “necessary” for the establishment or operation of the plan. Regulations indicate that a service is necessary if it is “appropriate” and “helpful” to the plan in carrying out its functions. However, the exemption only applies if the arrangement and the compensation are “reasonable.” The arrangement is reasonable only if it is terminable by the plan without penalty, upon reasonably short notice “under the circumstances.”

  It is important to note that this exemption has been interpreted as not extending to any fiduciary conflict (the so-called “multiple services” issue). For example, in the absence of a separate exemption, an investment adviser would engage in a separate act of “self-dealing” if it caused a plan to retain its affiliated broker-dealer to execute trades for additional compensation, no matter how reasonable.

- **Blind transactions.** Although not incorporated into the statute *per se*, ERISA’s legislative history indicates that a purchase or sale of securities between a plan and a party in interest would not be prohibited if the transaction is an ordinary “blind” transaction on a securities exchange where neither party (nor their broker agents) knows the identity of the other.

  The DOL has also promulgated a number of generic or “class” prohibited transaction exemptions (“PTEs”), which are broadly available to any party in interest who satisfies their conditions. (The DOL also issues individual PTEs, applicable only to the identified parties.) Many of these class exemptions apply to party-in-interest transactions involving securities, including:
• **Broker-dealer transactions.** The very first exemption, PTE 75-1, broadly exempts certain principal transactions, underwriting, and extensions of credit by non-fiduciary broker-dealers, as well as certain market-making transactions by parties in interest who may or may not be fiduciaries.

Generally, the exemption for principal transactions does not apply if the dealer (or its affiliate) is a fiduciary with respect to the transaction. However, there is a specific exception in PTE 75-1 for a broker-dealer who *as a fiduciary* (directly or in conjunction with its affiliates) receives a fee for causing a client plan to invest in unaffiliated mutual funds. Although styled as an exemption for principal transactions, it is clear that it was intended to cover typical mutual fund distribution (dealer) agreements. DOL recently proposed certain “clarifications” to the principal trading exemption, and has requested comments.

The exemption for underwriting (traditional IPOs) should not be confused with the so-called “underwriters exemptions,” which relate to the underwriting of asset-backed investment pools (see below with respect to mortgage pool investment trusts).

• **Certain IPOs.** PTE 80-83 exempts certain purchases of securities in an IPO where the issuer may use the proceeds to reduce or retire an indebtedness to a party in interest.

• **Securities lending.** PTE 81-6 permits plans to engage in securities lending transactions with counterparties who may be parties in interest. (See PTE 82-63, below, regarding the payment of fees to a fiduciary directing the transaction.)

• **Short-term investments.** PTE 81-8 permits a plan to enter into certain short-term investment transactions with parties in interest, including certain: 1) bankers’ acceptances; 2) commercial paper; and 3) repurchase agreements (but not reverse repos). Similar individual relief was granted in 1996 to Lehman Brothers in connection with the marketing of “synthetic” or “collateralized” GICs (“guaranteed investment contracts”).

• **Mortgage pool investment trusts.** PTE 83-1, as amended, grants broad relief for a variety of potential prohibited transactions involving plan purchases of interests in certain securitized residential mortgage pools. Dozens of individual “underwriter exemptions” have been granted to almost all financial institutions that participate in the offering of asset-
backed investments, and extending this relief to other types of asset-backed pools.

- **QPAM.** One of the most important exemptions, PTE 84-14, broadly exempts transactions effected by a plan at the direction of a “qualified professional asset manager,” or “QPAM.” A QPAM must meet the requirements of an investment manager (see above) and, if an RIA, must have total client assets under its discretionary management of $50 million and shareholders’ or partners’ equity of $750,000. The exemption is available to any plan whose assets (combined with those of any affiliated plan) represent no more than 20% of the QPAM’s discretionary client assets. It does not apply to transactions with the QPAM, any 5% affiliate of the QPAM, or any person with discretion to hire or fire the QPAM on behalf of the plan.

DOL currently is considering various changes to the QPAM exemption, including prohibiting its use by a fiduciary financial institution with respect to its own (in-house) plans.

- **Foreign exchange transactions.** PTE 94-20 permits a bank or broker-dealer, or their affiliates, who may be parties in interest with respect to a plan, to act as principal in a foreign exchange transaction with the plan, provided that the transaction is done at the direction of a fiduciary independent of the bank or broker-dealer. PTE 98-54 similarly covers certain foreign exchange transactions that are pursuant to standing instructions.

- **INHAM.** Because many larger plans manage their assets in-house and cannot rely upon the QPAM PTE, the DOL issued PTE 96-23 to permit certain transactions directed by such in-house asset managers (“INHAMS”). Among other things, an INHAM must be a separately incorporated RIA subsidiary of the plan’s sponsor, or a nonprofit RIA controlled by the sponsor, with at least $50 million under management. It is available only for larger plans ($250 million in assets).

Note that these exemptions contain various conditions and limitations and do not necessarily exempt fiduciary conflicts, which are separately discussed below.
Fiduciary Conflicts

As noted above, ERISA separately prohibits fiduciaries from engaging in certain transactions that may be viewed as resulting in conflicts of interest. These include 1) dealing with the assets of a plan for the fiduciary’s own interest or own account (“self-dealing”); 2) acting on behalf of, or representing (in any capacity), a party in a transaction if that party’s interests are adverse to the interests of the plan or its participants and beneficiaries (direct conflict of interest); or 3) receiving any consideration for the fiduciary’s personal account, from a third party, in connection with a transaction involving plan assets (a “kickback”). Such violations also may, but need not, separately constitute violations of the party-in-interest prohibitions. (Kickbacks may also result in criminal violations.) Types of transactions that may be prohibited by these rules include:

Performance of Additional Services/Hiring of Affiliates. Although a fiduciary is not prohibited from being retained on behalf of a plan to provide one or more services for a negotiated fee, a fiduciary cannot use its authority to hire itself or any affiliate to perform additional services for additional fees (“multiple services”). Conversely, there generally is no prohibited act of self-dealing if 1) neither the fiduciary nor any of its affiliates is exercising fiduciary authority but are acting solely at the direction of another, unaffiliated fiduciary (including the provision of “bundled” services) or 2) the additional services are provided for no additional consideration other than reimbursement of direct (out-of-pocket) expenses. Limited exemptions to this prohibition have been granted in connection with:

- **Securities lending services.** PTE 82-63 permits a fiduciary to receive additional compensation in connection with the provision of securities lending services to a plan, subject to prior authorization and certain other conditions.

- **Brokerage services.** PTE 86-128 permits the receipt of fees (brokerage commissions) by a plan fiduciary or its affiliate for “effecting or executing” securities transactions as agent for the plan, but only if trading is not excessive in amount or frequency (i.e., no “churning”). Permitted fees appear to include mutual fund front-end sales loads and 12b-1 fees, even though such fees technically are paid by the fund rather than directly by the plan. For this purpose, “effecting or executing” is used in normal securities law sense, and includes ancillary services such as clearance, settlement, custodial, or other functions (but not margin lending). If the fiduciary serves
as more than an RIA or trustee (e.g., as discretionary trustee, plan administrator, or plan sponsor), the exemption only applies if all profits earned on the trades are disgorged and paid to the plan. See also the discussion of PTE 84-24, below.

PTE 86-128 also extends to agency cross transactions, but only if the broker-dealer is acting solely as agent for the non-plan counterparty (i.e., is not exercising discretion or rendering investment advice).

Generally, a fiduciary exemption is not needed for fully directed brokerage transactions.

The exception to the above rules permitting reimbursement of a fiduciary for its direct expenses must be applied with caution. An expense is “direct” only if it does not represent overhead and only if it would not have been incurred “but for” the provision of services to the plan. In effect, the expense normally must be traceable to a specific plan, not merely allocable among a number of plans. For example, computer software normally would be considered overhead and/or would be usable for the benefit of more than one client; however, software purchased to implement a unique investment program of a single plan client might satisfy the rules for reimbursement.

**Investing Plan Assets in Proprietary Mutual Funds.** To the extent that a plan fiduciary also serves as investment adviser to a registered, open-end investment company, the fiduciary’s investment of plan assets in the mutual fund may involve one or more fiduciary conflicts. PTE 77-4 (for client plans) and PTE 77-3 (for the fiduciary’s own, in-house, plans) provide relief for such investments provided that certain conditions are satisfied, including disclosure and consent, and taking steps to avoid double fees. Similar relief is granted under PTE 79-13 for in-house plans of closed-end investment companies (but not for client plans, which effectively prevents most registered hedge fund managers from relying on these exemptions).

PTE 84-24 also exempts, among other things, a plan’s investment in a mutual fund where the fund’s adviser or principal underwriter is also a directed trustee, prototype plan sponsor, or other service provider with respect to a plan (but not a discretionary investment manager or trustee, nor the plan sponsor), where an affiliate of the fund’s adviser or principal underwriter will receive a sales commission with respect to the transaction. For this purpose, sales commissions generally include 12b-1 distribution fees. The PTE does not explicitly authorize the receipt of fund-level advisory and other fees (in contrast to PTEs 77-3 and 77-4),
though it appears to do so implicitly. (Note that PTE 84-24 is not limited to the marketing of proprietary funds, though it is often used for that purpose.)

**Investing Plan Assets in Non-Proprietary Mutual Funds.** To the extent that a plan fiduciary directs (or recommends) the investment of plan assets into a third-party mutual fund or other investment vehicle from which the fiduciary or any of its affiliates may receive compensation (12b-1, transfer agency, subadministration, referral, etc. fees), retention of such fees would be prohibited. DOL’s 1997 “Frost” advisory opinion indicates, however, that such fees may be received if they are fully applied, on a dollar-for-dollar basis, to offset plan-level fees or otherwise are credited back to the plan. (Based on the Frost and “Aetna” letters, a follow-up DOL information letter to the American Bankers Association confirms that a fully directed trustee/fiduciary generally may retain such fees with the knowledge and consent of the plan.) Generally, an RIA or broker-dealer acting only in a non-fiduciary capacity would not be subject to these concerns. However, it is important to bear in mind that if an affiliate is a fiduciary, the activities of the RIA or broker-dealer may be attributed to the affiliate.

As noted in the previous sub-section, PTE 84-24 may cover the receipt of sales loads and 12b-1 fees by a party providing (fiduciary) investment advice with regard to the investment of plan assets into a non-proprietary fund. However, DOL has suggested that the relief afforded by PTE 84-24 would not extend to separate charges for the investment advice over and above the sales commissions themselves.

See also the discussion above regarding relief to broker-dealers engaging in principal transactions (PTE 75-1), which covers certain transactions involving the investment of client plan assets in third-party mutual funds.

**Employee Investment Advice.** Many organizations are going beyond the non-fiduciary participant education services outlined by the DOL (as described above) and offering specific investment advice to participants in 401(k) and similar plans. When a fiduciary in this situation advises a participant to invest his or her plan account in an investment fund from which the fiduciary or its affiliates receive fees, prohibited transaction issues arise. The DOL has in recent years issued several individual PTEs, and several advisory opinions, which outline ways these programs may be structured to avoid prohibited transaction issues. Legislation proposed over the past several years would provide some relief from the prohibited transaction rules for these programs if structured in a certain way. However, this relief remains very controversial, and it is unclear whether any such relief will be enacted into law.
DOL’s recent letter to SunAmerica, Advisory Opinion 2001-09A (Dec. 14, 2001), is an important step in clarifying application of the prohibited transaction rules to a common form of asset allocation program, where the service provider offers its own funds as a package in partnership with an independent investment adviser or through a computer model, which makes recommendations to plan participants as to how their plan assets should be invested. Importantly, this advice may include recommendations that the participant invest in affiliated mutual funds or other affiliated investments, from which the bundled service provider or its affiliates may earn fees. The key to this opinion is that, although SunAmerica presumably accepted “ownership” of (and liability for) the investment advice provided by a third-party (financial engines), it had no influence over the advice given and could not modify it.

Fees. The DOL has interpreted the fiduciary prohibitions to extend to a fiduciary’s receipt of any compensation to the extent that the fiduciary’s own actions can affect either the amount or timing of such compensation. This interpretation extends to certain transaction-based fees, such as acquisition or disposition fees, and to certain performance or incentive fees, including cash flow fees.

However, in the case of performance fees payable to securities (and commodities) managers for transactions involving generally marketable securities, the DOL has issued several advisory opinion letters that approve the use of such fees if certain conditions are satisfied. The specific types of fees approved in these letters involved fees calculated 1) as a percentage of portfolio appreciation; 2) as a base fee plus a percentage of appreciation; and/or 3) in the form of a “fulcrum fee,” i.e., a fee that goes up or down as determined by the manager’s performance relative to an agreed-upon index. Among the various factors on which the DOL based its approval was the sophistication of the clients, the marketability of the securities and availability of market valuations, fixed performance measurement periods and preestablished valuation dates, inclusion of unrealized losses if unrealized gains were included in the calculation, use of standardized indices for base-plus or fulcrum fee calculations, ability of the plan to terminate the arrangement on reasonably short notice (60 days was noted), and compliance with SEC Rule 205-3. (Note that these letters have not been updated to reflect recent SEC revisions to Rule 205-3.) In 1999, the DOL extended the reasoning behind these letters to exchange-traded derivatives. It has also granted exemptive relief on a case-by-case basis for certain real estate managers.
**Soft Dollars and Directed Brokerage.** Generally, the payment of soft dollars would be prohibited if the services provided by the paying broker benefited the fiduciary manager or any of its affiliates. However, the safe harbor afforded by section 28(e) under the 1934 Act generally preempts ERISA. It provides generally that a discretionary fiduciary who causes a client (plan) to pay brokerage commissions for effecting a securities transaction, in excess of the commissions another broker would have charged for the same transaction, will not be deemed to have breached its fiduciary duty under any law if the commissions paid are reasonable in relation to the value of the brokerage and research services provided by the broker. Section 28(e) only covers agency transactions, and only the receipt of soft dollars in the form of research services. For other types of services and goods, DOL has indicated that a manager can direct a plan to a specific broker to procure goods and services for the benefit of the plan paying the commissions (subject, of course, to the manager’s overall fiduciary obligations to the plan and the overall reasonableness of the commissions). These exceptions do not relieve plan fiduciaries of their general fiduciary obligation to seek best execution of trades.

**Allocation of Investment Opportunities Among Client Accounts.** To the extent that an investment manager represents multiple clients, it may be presented with investment opportunities that are appropriate for more than one client but which cannot be acquired in sufficient quantities to meet all such clients’ needs. In order to avoid an assertion of a conflict of interest in allocating such investments among clients, the manager should have in place an allocation procedure that is incorporated by reference into each investment management agreement. ERISA does not dictate any particular procedure, as long as it is applied fairly and consistently so as to avoid favoring one client over another. This could include, for example, allocating investment opportunities pro rata among all similarly situated clients or allocating them to certain clients first based on a rotational basis.

**Execution of Client Trades.** Similarly, to avoid potential conflicts, a manager or broker-dealer should have in place procedures for the ordering of securities trades for its clients.

**Cross-Trading Among Client Accounts.** It is not unusual for a manager who manages multiple client accounts to buy securities for certain accounts at the same time it is selling the same securities for another account. “Crossing” the securities between the accounts on a pre-arranged basis may save transaction costs and may have other potential benefits. Nonetheless, if the manager has investment discretion with respect to both accounts, engaging in such cross-trading generally...
raises an ERISA conflict issue, as the manager is “representing” both parties. (To the extent that the manager is directed as to one side of the transaction, it should not have a conflict or the conflict may be exempted pursuant to PTE 86-128, discussed above.)

Some managers have attempted to avoid the conflict by running simultaneous trades through an unrelated broker. The DOL’s position is that the use of an unaffiliated broker is insufficient, at least if it is prearranged that the trades will be “netted” and are not truly “blind.”

The DOL has actively pursued enforcement actions against several securities managers and, until further DOL guidance is provided, all securities fiduciaries who may be in the position of placing simultaneous buy and sell orders for the same securities should evaluate their trading procedures carefully with ERISA counsel. A few financial institutions have obtained individual exemptions to permit cross-trading, but these exemptions are limited in scope and apply only to the institutions which obtained them.

Recently, DOL issued class PTE 2002-12 to permit certain “passive” cross-trading similar to the relief granted in various individual exemptions. DOL also held hearings and has requested guidance on how to grant broader exemptive relief for “active” cross trades, and active discussions are underway. In addition, at DOL’s invitation, an industry group representing “in-house” fiduciaries of large plans has requested relief for trading between affiliated plans, including trades carried out by outside managers.

**Investment Services to IRA or Keogh Accounts.** The DOL has taken the position that an IRA or Keogh customer of a broker-dealer who wishes to use his IRA or Keogh accounts to obtain discounts or services with respect to his or her non-plan portfolio assets may be engaged in a prohibited transaction. However, PTE 97-11 permits such services if certain conditions are satisfied.

**Restrictions on Employer Securities and Employer Real Property.** ERISA also generally prohibits a plan from acquiring and holding securities issued by the employer (even if acquired on the open market in a “blind” transaction), or real property leased to the employer, unless certain conditions are satisfied. To the extent permitted under the terms of the plan, and provided that the general fiduciary requirements are satisfied, a defined benefit pension plan (traditional plan paying fixed retirement benefits) may acquire qualifying employer securities and qualifying employer real property provided that, in the aggregate, such assets do not exceed 10% of the plan’s total assets.
Although certain recent legislative attempts have been made to change the requirements, generally the 10% limitation does not extend to “defined contribution” plans, including 401(k) plans, if the plan terms expressly authorize such investments. In addition, such plans are relieved of the diversification requirements of ERISA to the extent they invest in such assets. For this purpose, “qualifying employer securities” are stock or marketable debt instruments if certain requirements are met to ensure that such instruments were not issued primarily to be acquired by the plan, and if certain other conditions are met regarding price, etc.

In the case of a participant-directed plan, the regulations under section 404(c) impose various additional requirements on the offering of employer securities to participants in order to utilize the fiduciary relief afforded by that section.

In light of the various considerations surrounding the acquisition and holding of employer securities, many securities professionals simply adopt procedures designed to avoid acquisition of any employer securities on behalf of a plan, except through a separate employer stock fund established for that purpose or as otherwise individually agreed upon by the manager and the employer.

ENFORCEMENT

What Are the Potential Consequences of Violating ERISA?

General Equitable and Civil Remedies. ERISA provides that enforcement actions for fiduciary violations generally can be brought by the DOL or by other plan fiduciaries and, in some cases, by plan participants and beneficiaries. Remedies generally include the obligation to restore a plan’s losses incurred as a result of a fiduciary breach and to disgorge any profits made as a result of the breach, as well as any other “equitable or remedial” relief, including injunctive relief, that a court deems necessary and appropriate. In some cases, DOL has obtained injunctive relief to prevent a fiduciary from engaging in further violations (for the purpose of using contempt procedures if further violations occur) or even to prevent a person from acting as an ERISA fiduciary with respect to any plan (which could, for instance, effectively put an RIA out of business). In the event of any monetary settlement or court-ordered monetary relief, the DOL will also impose a civil penalty of 20% of the applicable recovery amount.
Criminal Penalties. “Willful” breaches of ERISA are also potentially subject to criminal penalties, recently increased under the Sarbanes-Oxley Act of 2002 to include imprisonment for up to 10 years and fines of up to $100,000 ($500,000 for non-individuals) per violation. Other non-ERISA federal criminal statutes may also apply and are sometimes enforced, e.g., in connection with kickbacks from pension funds.

Penalties on Prohibited Transactions. Violations of the prohibited transaction rules are subject to a two-tiered schedule of excise tax or civil penalties. The initial penalty is 15% of the “amount involved” in the transaction. In addition, if the transaction is not “corrected” by the parties after notice by the IRS, an additional 100% penalty is imposed. Correction usually involves undoing the transaction (rescission), to the extent possible, or such other steps as will put the plan in at least as favorable a position as it would have been in had the transaction not occurred. In the case of a party-in-interest transaction, the primary burden of the penalty will fall on the party in interest that engages in the transaction, although under ERISA (but not the Code) the authorizing fiduciary is also liable. In the case of a prohibited fiduciary conflict, the penalty will fall on the fiduciary. The annual report, Form 5500, requires that any known non-exempt prohibited transactions be reported under penalties of perjury.

Claims Against Non-Fiduciary Parties. Breaking from common law principles, the courts have held that persons who are not fiduciaries (such as recordkeepers, brokers, custodians) are not subject generally to liability for “aiding and abetting” a fiduciary’s breach of its duties. However, at least to the extent that it can be shown that the non-fiduciary has itself breached an ERISA “duty” (such as a duty of a party-in-interest not to engage in a prohibited transaction), more recently the courts have found that non-fiduciaries themselves may be subject to claims for “equitable” relief under ERISA, including, for example, disgorgement of fees.

What Contractual Protections Are Permitted?

ERISA voids any arrangement in a plan or agreement that purports to relieve a fiduciary of liability for its wrongdoing. This has been interpreted to include any indemnification paid out of plan assets. However, ERISA does not preclude a fiduciary from contracting with another fiduciary or the plan sponsor for indemnification, or from obtaining (or requiring another party to obtain for its benefit) fiduciary insurance to cover its financial losses.
What Are ERISA’s Bonding Requirements?

Every ERISA fiduciary and any other person who “handles” employee benefit plan assets must be covered under a fidelity bond, which relates to fraud, theft, embezzlement, etc., and not to breaches of fiduciary duty. Regulated banks and other entities with trust powers under local law are exempted if they have capital of at least $1 million. Broker-dealers acting only as such are also exempted under DOL regulations (pre-ERISA regulations were adopted on a “temporary” basis in 1975, and remain in effect) and those not exempted (e.g., because they also hold custody) may be covered by a proposed exemption discussed below. The amount of the bond must be not less than 10% of the funds handled as of the beginning of the fiscal year, with a minimum of $1,000 and a maximum of $500,000 per plan. Some plans maintain blanket bonds covering all persons who handle assets of the plan, or purchase riders covering agents. However, many sureties no longer provide coverage that extends to parties other than the purchaser and its affiliated persons. Thus, an RIA generally would have to obtain its own individual coverage covering its employees and agents, naming each client plan as the insured party.

Notwithstanding the foregoing, under proposed regulations published in 1987, broker-dealers and certain affiliated investment advisers would be exempted fully from the ERISA bonding requirements if they maintain certain minimum fidelity bonds under self-regulatory organization (stock exchanges and NASD) guidelines, with certain modifications. For a broker-dealer with possession and control of up to $50 million in client assets, the minimum coverage would be $1 million (blanket, not per client), scaled upwards to a maximum of $50 million in coverage for broker-dealers handling more than $2 billion in client assets. An adviser affiliate (under a common control test for affiliation) would be exempted if it is covered under the broker-dealer’s bond and does not have custody or possession of plan assets.

What Is DOL’s Audit and Enforcement Role?

The DOL has broad audit, subpoena, and enforcement powers and generally may review any books and records of any party that contain information relating to the filing of any return or report required under ERISA. Investigations may be initiated by DOL on its own initiative or at the request of plan fiduciaries. For certain industries, DOL auditors may target specific issues and auditors from the SEC, the OCC, the Federal Reserve, and other Federal agencies may request information regarding ERISA compliance and refer questionable cases to the DOL
for further investigation. Audit and enforcement actions generally originate from local and regional DOL offices, but may be coordinated with the National Office staff. Securities professionals who are asked to produce books and records should consult with counsel familiar with such matters; too often, audit targets react improperly to such requests – either by failing to cooperate fully or, at the opposite extreme, by producing far more information than is necessary.

“HOT” ERISA ISSUES

In recent years, retirement plans have been in the middle of a significant number of controversies and corporate scandals, and there has been a significant amount of litigation in recent years over investment decisions made by ERISA fiduciaries. Some of the more significant issues affecting retirement plans are summarized below.

Investments in Employer Securities

Participants have filed numerous suits against plan fiduciaries when employer stock held by the relevant plans dramatically deteriorated in value (e.g., Enron, WorldCom). These cases present a variety of relatively novel theories of liability and damages that, if successful, could prove troublesome for both plan sponsors and service providers. They include allegations of:

- fiduciary duty to disclose information not specifically required by ERISA and which no participant has requested;
- fiduciary duty to make plan investment decisions based on non-public or “inside” information;
- fiduciary duty to override plan design decisions relating to the form of the employer match and diversification of the employer stock account;
- the scope of the relief available to plan fiduciaries under section 404(c);
- fiduciary duty to exercise on behalf of participants rights they may possess under securities laws; and
- creative measures of losses on investments in participant-directed individual account plan.

Although prior case law in this area is supportive of plan investments in employer stock, the newly filed cases bear watching and could have a dramatic impact on the risks associated with such investments.
**Investments in Proprietary Mutual Funds.**

Actions have also been filed by plan participants against financial institutions that have invested benefit plan assets in the institutions’ proprietary funds. So far, these actions have been limited to the financial institutions’ own, in-house plans; however, in theory the allegations could apply to client plans as well. Plaintiffs have alleged that the institutions used the plan assets to “seed” new funds, thereby breaching their fiduciary duties and committing prohibited transactions. While there has been at least one court decision dismissing a prohibited transaction claim (in reliance on PTE 77-3 discussed above), other issues raised by these cases remain.

**Market Timing and Late Trading Issues.**

The recent controversies regarding late trading and market timing have raised various concerns for retirement plan sponsors and their fiduciaries. Earlier this year, DOL issued guidance on the issues for plan fiduciaries. Plan fiduciaries must act prudently by assessing the impact of these problems on plan investments and investment options available to participants, and then acting appropriately under the particular facts and circumstances. The DOL guidance explains that this calls for a deliberative process, with decisions as well informed as possible under the circumstances. Specifically, DOL suggests that plan fiduciaries consider the following actions:

- Where specific funds have been identified as under investigation, fiduciaries should seek information about, and consider the nature of the alleged abuses, the potential economic impact on the plan’s investment, steps taken by the fund to limit the potential for future abuses, and proposed remedial actions. Fiduciaries should consider contacting funds if this information is not provided by the funds or is not otherwise available.

- Because late trading and market timing abuses may extend beyond the mutual funds currently identified by Federal and state regulators and to other types of pooled investment funds, plan fiduciaries will need to ensure that all of a plan’s funds have safeguards to limit their vulnerability to late trading and market timing abuses.

- Fiduciaries of plans invested in funds that are identified as under investigation ultimately will have to consider whether to participate in settlements or lawsuits and, in doing so, will have to weigh costs to the plan against the likelihood and amount of recoveries.
Importantly, by focusing on a deliberative, procedurally prudent process, the DOL confirms that plans are not required (without due consideration of all relevant facts) to immediately eliminate investments in mutual funds that may have been named in late trading and market timing investigations. However, DOL makes clear that plan fiduciaries have heightened duties to investigate all of the plan’s mutual fund and other pooled fund investments to ensure that the plan will not be harmed by market timing and late trading activities, and to seek appropriate remedies if the plan has been harmed.

The DOL guidance does not squarely address whether ERISA permits the imposition of trading restrictions to address market timing problems. Nevertheless, two courts have agreed that market timing restrictions in ERISA-covered plans are permitted under some circumstances.

Finally, a DOL press release announcing the guidance notes that EBSA is conducting reviews of mutual funds, similar pooled investment funds and service providers to such funds to determine whether there have been any violations of ERISA in connection with market timing or late trading activities. These investigations are being coordinated with other Federal agencies.

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