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## REGULATORY MONITOR

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### DOL Targeting Corrections of Erroneous Trades

Last February, the Department of Labor (DOL) announced that it entered into a settlement agreement (Settlement) for \$5.2 million with ING Life Insurance and Annuity Company (ILIAC) involving the retention of gains realized by ILIAC through its error correction practices.<sup>1</sup> Since the Settlement was announced, DOL investigators who work for the Employee Benefits Security Administration's Office of Enforcement have repeatedly inquired into error correction practices during their examinations of plans and plan service providers, including registered investment advisers (RIAs). The purpose of this column is to (i) discuss some of the issues that trading error correction practices may raise under ERISA, (ii) note some of the focus areas of the DOL during its recent examinations, and (iii) highlight areas of focus for RIAs and broker-dealers (BDs) who may be involved with the correction of trading errors associated with retirement plans subject to ERISA's fiduciary requirements.

### DOL Position on Correcting Trading Errors and Fiduciary Status

Pursuant to the Settlement, an "error" occurs whenever a plan transaction is not correctly and timely processed by a plan recordkeeper. An error may result in a gain or loss depending on price movements between the date on which a transaction should have been processed pursuant to the plan's or participant's direction and the date on which the transaction is processed accurately. Underlying each recordkeeping transaction is one or more securities trades, which may be conducted through an affiliated or unaffiliated BD, trust company, or another arrangement.

The DOL has long recognized that service providers, like plan recordkeepers, do not act as fiduciaries in performing recordkeeping services for plans that are subject to ERISA.<sup>2</sup> Recordkeepers are not typically fiduciaries for purposes of ERISA because they do not (i) exercise any discretionary authority or discretionary control respecting management of the plan, (ii) exercise any authority or control respecting management or disposition of the plan's assets, or (iii) provide investment advice.<sup>3</sup> Rather, recordkeepers merely operate pursuant to procedures approved by an independent plan fiduciary (for example, the plan sponsor).

Notwithstanding this general rule, the DOL takes the position that a recordkeeper or another non-fiduciary service provider may act as a fiduciary with regard to a plan if it

acts in a manner contrary to written procedures approved by an independent fiduciary or does not have such procedures. The DOL took this position in DOL Field Assistance Bulletin 2002-3 (the Float FAB) with regard to the retention of “float” by recordkeepers or their affiliates earned from the temporary investment of plan contributions and distributions held in an omnibus account pending investment in mutual funds or pending the cashing of a distribution check.<sup>4</sup> This was also the position taken by the DOL in the Settlement with regard to the retention of gains generated through the error correction process.

### **DOL’s Treatment of Gains as Compensation**

Consistent with the Float FAB, the DOL took the position in the Settlement that any gains generated through the trading error correction process retained by the service provider should be treated as compensation for ERISA purposes. This interpretation is important due to certain requirements under ERISA’s prohibited transaction provisions, explained below.

As a general matter, a prohibited transaction under ERISA occurs if plan assets are used to pay the compensation owed to a plan service provider.<sup>5</sup> However, a statutory exemption under ERISA permits the payment of such compensation if (i) the agreement pursuant to which the services are provided and the compensation paid is reasonable, (ii) the services are necessary for the establishment or operation of the plan, and (iii) the compensation paid is reasonable in amount.<sup>6</sup> Effective in 2012, DOL regulations significantly increased the amount of information regarding compensation arrangements that must be communicated to a plan fiduciary in order for the agreement to be reasonable.<sup>7</sup>

The DOL, however, has long held the view that the services exemption described above does not apply if the service provider is a fiduciary and the service provider uses the discretion, authority, or control that makes it a fiduciary to increase its own compensation or that of a party in which it has an

interest.<sup>8</sup> Thus, in the case of the Settlement (and consistent with the Float FAB), the DOL determined that ILIAC failed to disclose procedures pursuant to which trading errors were to be corrected so that they may be approved by an independent fiduciary and retained gains as compensation without disclosing the compensation to such fiduciary. The result was a violation of ERISA’s fiduciary duty and prohibited transaction provisions. ILIAC was required to restore \$5.2 million to the plans on its recordkeeping platform and pay the federal government a \$520,000 penalty under ERISA section 502(I).

### **Application of DOL Findings to RIAs and BDs**

In light of the DOL’s position in the Settlement, RIAs and BDs who provide services to ERISA plans should consider the impact of ERISA on their own trading error correction policies and procedures. Such policies and procedures may exist in order to comply with Securities Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) requirements. However, RIAs and BDs should not assume that those policies and procedures comply with ERISA.

The SEC has taken the enforcement position that RIAs should have policies and procedures to remedy “investment errors.” An article published in the March 2013 issue of *The Investment Lawyer* provides an overview of how to apply certain securities law and common law principles in the development of such policies and procedures.<sup>9</sup> Given the DOL’s position in the Settlement, RIAs who provide services to ERISA plans should also develop and evaluate those policies and procedures in light of the requirements under ERISA. As such, the RIA should focus on preparing well-developed policies and procedures to be communicated to and approved by an independent fiduciary. Further, compliance with ERISA’s services exemption discussed above should also be considered.

Another wrinkle that RIAs may face is that many RIAs are often plan fiduciaries. Therefore, as explained above, the services exemption discussed above may not be

available to an RIA who makes an “investment error” to the extent it is using its fiduciary discretion, authority, or responsibility in causing the error and the subsequent retention of any gains. As such, retention of gains may not be permitted unless the RIA can point to another exemption issued under ERISA Section 408. In the alternative, the RIA may argue that a mistake does not result in a fiduciary breach under ERISA, or the RIA may simply not keep the gains associated with such error.

RIAs should also be aware that the DOL is actively investigating the trading error correction practices of RIAs who provide services to ERISA plans. In several requests for information issued by the DOL during investigations, RIAs have been asked to provide the following information with regard to “trading errors”:

- Records, such as a list, which identify all proprietary, omnibus/aggregate recordkeeping accounts and subaccounts used to transact trades for participants in all ERISA covered plans.
- Any written policies, procedures, or manuals that pertain to how the RIA monitors trade processing errors for ERISA covered plans (for example, bought rather than sold, entered limit order at wrong price, failed to buy/sell as directed, violated a restriction or investment policy, entered for wrong account, processed next day, system errors, etc.).
- Any written policies, procedures, or manuals that address how the RIA handles gains and losses resulting from trade processing errors, and/or corrections attributable to ERISA covered plans and their participants.
- Any written policies, procedures, or manuals pertaining to the processing of “as of trades” for ERISA covered plans and their participants.
- Records, such as a list, which identify all trade processing errors that occurred in any of the RIA’s ERISA plan clients during a recent six month period, to include the transaction dates, securities involved, accounts and broker/dealers involved, and a summary of the errors and their ultimate disposition, including the conditions of any financial settlements.

- A list of all omnibus/aggregate position reconciliation reports for the RIA’s ERISA plans for the period under review.

While the above are directed at RIAs, several of the questions pertain to activities of BDs. The results of such investigations are not yet clear, but the DOL is clearly focused on the process for the resolution of trading errors.

BDs should also consider how their trading error correction practices are impacted by the DOL’s views. Many BDs have a proprietary trading error account through which they resolve trading errors. Further, BDs also often take the position that ownership of securities does not transfer to its clients until settlement. A natural extension of this position is that, as long as a trading error is resolved prior to the settlement date, an argument can be made that no “plan assets” were involved in the trade so ERISA is not implicated. However, whether the DOL will agree with that position is not clear. Based upon the request by DOL investigators, BD trading activities will likely be examined. Further, BDs may also be plan fiduciaries and thus may need to address similar issues as RIAs when acting in that capacity.

## Summary

Through the Settlement, the DOL appears to have introduced a new area in which it intends to focus its enforcement efforts. While the Settlement focused on the activities of a recordkeeper, RIAs and BDs should be aware that their own processes and procedures involving the correction of investment errors or trading errors may come under scrutiny as evidenced by the DOL Investigator’s information request provided in this article. We can glean from the terms of the Settlement and the DOL investigators’ requests that the DOL is focused on a number of areas including (i) adequate disclosure of error correction policies and procedures and their approval by independent plan fiduciaries, (ii) adequate disclosure of “compensation,” (iii) omnibus trading practices, and (iv) the netting of gains and losses. Therefore, RIAs and BDs should evaluate their practices and procedures for resolving investment and trading errors with an eye toward meeting ERISA’s requirements.

RIAs and BDs may also want to consider discussing these issues with the DOL so that it may better understand the potential complexity of this issue.

## Notes

1. A copy of the signed Settlement Agreement may be obtained from the author ([dkaleda@groom.com](mailto:dkaleda@groom.com)) or may be obtained by contacting the DOL's Information Office at (202) 693-4668.

2. DOL Adv. Op. 97-16A (May 22, 1997).
3. ERISA § 3(21).
4. DOL Field Assistance Bulletin 2002-3 (Nov. 5, 2002).
5. ERISA § 406(a)(1)(C).
6. ERISA § 408(b)(2).
7. 29 C.F.R. §408(b)-2(c)(1)(iv)(C)(2).
8. 29 C.F.R. § 2550.408b-2(e)(1).
9. Helm, Robert R., "Dealing with Investment Errors," *The Investment Lawyer*, Vol.20, No.3 (March 2013).

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