Should You Have a Formal ERISA Compliance Program?

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A broad range of financial services providers are impacted by the fiduciary and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974 ("ERISA") and the prohibited transaction provisions of the Internal Revenue Code of 1986 (the "Code"). Such providers include those who provide both fiduciary and non-fiduciary services to a plan or other entity subject to ERISA as well as those who provide such services to individual retirement accounts ("IRAs"). Yet, while many of these same providers have extensive written procedures to assure compliance with the myriad of state and federal securities laws and regulations that apply to them, very few have detailed written procedures on compliance with ERISA and the Code. The purpose of this article is to advise readers on some of the key ERISA and Code provisions to which advisers, brokers and other providers may be subject to by providing services to ERISA-governed plans ("Plans") and IRAs and to provide a framework for the establishment of an ERISA and Code compliance program and manual, which include such procedures.

Are you a fiduciary?

ERISA and the Code provide for a functional test for purposes of determining whether a party is acting as a fiduciary with respect to a Plan or IRA. In other words, it is irrelevant whether the governing documents of the Plan or IRA or the contracts or arrangements governing the relationship establish the person as a fiduciary. A fiduciary, in essence, is a person who exercises any discretionary authority or discretionary control respecting management or control of a Plan or an IRA (or their respective assets). In addition, a fiduciary includes a person who renders investment advice with respect to Plan or IRA assets for a fee or other compensation, or has any authority or responsibility to do so.

Notably, the Department of Labor ("DOL") has recently withdrawn proposed regulations that will significantly broaden the number of providers that would be fiduciaries. Such regulations may be re-proposed at some point this year.

What is the impact of fiduciary status with respect to a Plan?

If you are a fiduciary with respect to a Plan, section 404(a) of ERISA requires that you discharge your responsibilities with respect to a Plan in accordance with certain fiduciary duties. ERISA requires the following:

* a fiduciary must discharge his or her duties with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims (the "duty of prudence");
* a fiduciary must discharge his or her duties with respect to the plan solely in the interest of the participants and beneficiaries for the exclusive purpose of providing benefits to participants and their beneficiaries (the "duty of loyalty");
* the fiduciary must diversify the investments of the plan so as to minimize the risk of large losses when appropriate (the "duty to diversify"); and
* the fiduciary must follow the terms of the governing plan documents (the "duty to follow plan terms").

Note that a violation of ERISA results in personal liability to the fiduciary.

From a practical standpoint, fiduciary status means that you must evaluate all of your actions with respect to the Plan in light of these fiduciary duties in order to avoid personal liability for monetary or equitable relief. For example, this means that you should consider the following:

* Whether "appropriate consideration" has been given to certain factors including (i) an investment is reasonably likely to further the purposes of the Plan in light of the risks; (ii) diversification, (iii) liquidity; and (iv) the projected return of the portfolio relative to the funding objectives of the Plan;
* Whether an investment decision with respect to one Plan account is appropriate for other Plan accounts or whether the decision to act on behalf of one Plan account might cause a breach of the duty of loyalty with respect to the other plan account
* Whether an investment decision or recommendation is in line with the Plan's governing documents (e.g., the investment policy); and
* Whether voting and tender decisions are made within ERISA's fiduciary requirements.

In other words, your day-to-day operations need to be evaluated in light of ERISA's fiduciary requirements if Plan assets are involved.

What is the impact of fiduciary status with respect to both Plans and IRAs?

While IRAs are not subject to the ERISA general fiduciary duty provisions discussed above, they nevertheless are subject to the Code's self-dealing prohibited transaction provisions. Plans, however, are subject to the self-dealing prohibited transaction provisions of both the Code and ERISA. Section 406(b) of ERISA provides the following:

* A fiduciary may not deal with assets of the plan in his own interest or his own account;
* A fiduciary may not act in any transaction involving the plan on behalf of a party whose interests are adverse to the interests of the plan or the plan's participants and beneficiaries; and
* A fiduciary may not receive any consideration for his own personal account from any party dealing with the plan in connection with a transaction involving plan assets.

Section 4975 of the Code includes prohibitions against transactions that mirror those on the first and third bullet points above.

If a fiduciary causes a Plan or IRA to enter into a self-dealing prohibited transaction, that fiduciary will likely be subject to fiduciary liability under ERISA with respect to such Plan and

liable for excise taxes under the Code with respect to such Plan and/or IRA. However, such consequences will not arise if the fiduciary complies with the requirements of a statutory exemption in Section 408(b) of ERISA or Section 4975(d) of the Code or an administrative exemption (either a class or individual exemption) issued by the DOL. However, in many cases, there is no exemption for fiduciary self-dealing so steps must be taken to avoid these types of prohibited transactions.

What is the impact of non-fiduciary, service provider status with respect to both Plans and IRAs?

Even if an adviser, broker, or other party is not a fiduciary with respect to a Plan or IRA, such a party (or its affiliates) is often a "party in pnterest" as defined under ERISA or a "disqualified person" as defined in the Code. The definitions of "party in interest" and "disqualified person" are broad, and while not identical, are very similar and include, among other things, service providers (both fiduciary and non-fiduciary) to Plans and IRAs. For ease of reference, a "party in interest" and "disqualified person" are collectively referenced below as a "Party in Interest."

Both ERISA and the Code prohibit a multitude of seemingly common transactions between a Plan or IRA and a Party in Interest including the following:

* any direct or indirect sale or exchange, or leasing, of any property between the Plan or IRA and a Party in Interest;
* any direct or indirect lending of money or other extension of credit between the Plan or IRA and a Party in Interest;
* any direct or indirect furnishing of goods, services, or facilities between the Plan or IRA and a Party in Interest; and
* any direct or indirect transfer to, or use by or for the benefit of, a Party in Interest of the income or assets of the Plan or IRA .

The above-listed transactions are often called the "per se" prohibited transaction provisions. In other words, the motive or intent of the party causing the transaction is not relevant. In the absence of an exemption (discussed below), a prohibited transaction results in an excise tax liability applicable to the Party in Interest.

The Code's prohibited transaction provisions are intentionally broad. The statute essentially starts with the premise that most transactions involving the Plan or IRA are prohibited. However, certain statutory and class administrative exemptions permit transactions that would otherwise be prohibited. The exemptions mandate implementation of limits on transactions to minimize the potential for abuse.

What can service providers do to protect themselves against liability for breaches of ERISA's fiduciary duty provisions and violations of ERISA's and the Code's prohibited transactions provisions?

As can be seen from the above truncated review of ERISA's fiduciary duty provisions and ERISA's and the Code's prohibited transaction provisions, compliance in this area can be complex. Furthermore, the economic consequences for failing to meet these requirements can be significant. Therefore, advisers, broker-dealers, and other providers should seriously consider implementing compliance programs and procedures comparable to those they employ to assure compliance with state and federal securities laws.***Step #1: Review Customer Accounts to Identify those with Assets Subject to ERISA or the Code***

In order to implement your compliance program, you need to identify your customer accounts that are related to entities that are subject to the fiduciary provisions in Part 4 of Title I of ERISA (such as Plans) and entities that are plans that are defined in Section 4975(e) of the Code (such as IRAs, health savings accounts, and Keogh plans) to which you provide fiduciary and non-fiduciary services. Importantly, accounts related to entities the assets of which are "plan assets" as defined under Section 3(42) of ERISA and the DOL Regulation § 2510.3-101, as modified by Section 3(42) of ERISA (the "Plan Assets Regulation") should be included for this purpose. For example, the assets of unregistered funds in which benefit plan investor participation (including Plans and IRAs) is "significant" as determined under the Plan Assets Regulation should be counted during the identification process unless an exception of the Plan Assets Regulation applies.

Step # 2: Determine whether You are Acting as a Fiduciary with Respect to Customer Accounts Subject to ERISA or the Code

Determining whether you (or an affiliate) are acting as a fiduciary is necessary for purposes of identifying whether you may be subject to ERISA's general fiduciary duty provisions or the self-dealing prohibited transaction provisions in ERISA and the Code. Determination as to fiduciary status will be dependent upon the circumstances governing the client relationship.

If you have the discretionary authority to manage or dispose of the assets in the accounts you identified above, you are a fiduciary for purposes of ERISA and the Code. Such a determination is fairly straight-forward. However, a determination as to whether you provide investment advice for a fee pursuant to ERISA and the Code is a much more nuanced determination. Under current regulations, an investment advice provider is a fiduciary if all of the following five conditions are present:

* The provider renders advice as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;
* On a regular basis;
* Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary;
* That the advice will serve as a primary basis for investment decisions with respect to plan assets; and
* That the advice will be individualized based on the particular needs of the plan, participant or beneficiary.

Under many circumstances, a provider can make a determination that it is not acting as a fiduciary if a strict interpretation of the aforementioned five-part test is applied. However, in light of the significance of fiduciary status, providers should often err on the side of caution and assume fiduciary status at least for day-to-day compliance purposes.

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Step #3: Implement Procedures for Compliance with Fiduciary Duty Provisions in Investing Plan Assets

Once fiduciary status is determined with respect to an account that is subject to the general fiduciary provisions in Part 4 of Title I of ERISA (such as a Plan), you should implement written procedures to demonstrate how management and advisory decisions were made in accordance with the general fiduciary duty principles discussed above. Importantly, ERISA does not require that the fiduciary be "right" with respect to every investment decision. Thus, a fiduciary breach does not occur merely because an account experiences a loss. Rather, the fiduciary must be in a position to demonstrate that it underwent a thorough and thoughtful investment process establishing the decision was in compliance with ERISA at the time it was made. This process is often referred to as "procedural prudence." For evidential purposes, fiduciaries should document the basis for investment and other management decisions (such as voting securities) made with respect to a Plan account. The fiduciary should also make sure it follows any investment guidelines established by the Plan.

Step # 4: Identify Transactions in which Self-dealing May Occur and Identify Exemptions on which to Rely

If a provider is a fiduciary with respect to an account related to a Plan or IRA, such fiduciary should review its operations to determine if any self-dealing prohibited transactions are occurring. Thus, for example, the Code and ERISA prohibit a fiduciary from using its authority to increase the compensation it receives. Further, a fiduciary cannot be on both sides of a transaction involving "plan assets" (such as in the case of cross-selling).

To the extent a statutory or administrative prohibited transaction exemption is available, the provider should consider implementing procedures to assure that trades and other account activity are conducted within the requirements of the applicable exemptions. Otherwise, the provider should assure that it conducts its business in a manner that does not involve self-dealing (such as with respect to its compensation arrangements).

Step # 5: Identify Transactions that Occur Between Plans and IRAs and Parties in Interest and Identify Exemptions on which to Rely

As discussed above, even if a provider is a not fiduciary, almost every conceivable transaction between a Plan or IRA and a service provider (both fiduciary and non-fiduciary) will result in a prohibited transaction because the service provider is a Party in Interest. However, most of those common transactions are permissible if the requirements of applicable exemptions are met. For example, there are exemptions for (i) payment of reasonable compensation for necessary services (as long as no self-dealing occurs), (ii) agency and principal transactions with brokers, (iii) transactions initiated by qualified professional asset managers ("QPAMs"), (iv) certain transactions with service providers, and (v) block trading. Again, the key here is to understand that a commission of a prohibited transaction outside of the requirements of exemption is a "per se" violation, so implementation of procedures that assure compliance with such exemptions is highly recommended.

Step #6: Adopt an ERISA and Code Compliance Manual

Once you have completed Steps #1 through # 6, you should take your formal compliance procedures developed in the above-mentioned steps and incorporate them into a single compliance document or manual much as you would for purposes of meeting applicable securities laws requirements. Such a manual should, among other things, include the following:

* An explanation of how accounts that are subject to ERISA or the Code are identified;
* An explanation of the definition of fiduciary and the process for identifying what accounts to which you act as a fiduciary pursuant to ERISA or the Code;
* A summary of the procedures your investment committee, advisers, or other professionals that act as fiduciaries will follow to demonstrate compliance with ERISA's general fiduciary requirements and a process for documenting those decisions;
* A summary of the self-dealing and Party in Interest prohibited transaction provisions applicable to the accounts based upon your day-to-day business activities; and
* Identification of the specific prohibited transaction exemptions on which you will rely with respect to the identified transactions that would otherwise be prohibited.

For example, one area of increased enforcement and regulatory activity involves fee disclosure to Plans. The manual should include standard disclosures designed to help you and your clients meet compensation reporting obligations for Schedule C of the Form 5500 and to comply with the exemption under Section 408(b)(2) of ERISA for service provider fee disclosure.

In addition, to the extent providers are acting as fiduciaries, they would do well to verify that their professional or other liability insurance covers such acts. Providers should also determine if they are adequately bonded for purposes of Section 412 of ERISA. Finally, service agreements should be reviewed to make sure they are clear as to the services to be provided and compensation to be received as well as appropriate protective language is included (such as indemnification).

Conclusion

In view of the risk that a breach of fiduciary duty under ERISA will result in personal liability on the part of the fiduciary and that violations of the prohibited transaction provisions result in potentially significant tax penalties, compliance professionals should seriously consider implementing a compliance program designed to minimize ERISA and Code violations. Just as under the securities laws and regulations, formal compliance procedures and manuals increase providers' ability to meet their compliance obligations under ERISA and the Code. They will also help demonstrate to the DOL that you are focused on such compliance in the event of a DOL investigation. Finally, such a program certainly will help promote the "culture of compliance" that your securities regulators expect to see.✦

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