

ERISA for Money Managers: An Interactive Workshop

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Boston, MA





Fiduciary Duty and Status

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Fiduciary Status

- ERISA mandates fiduciary conduct to:
 - Protect participants and beneficiaries
 - Eliminate self-dealing and promote “arms-length” transactions
 - Identify persons with responsibility for the plan

Who is an ERISA Fiduciary?

- Investment discretion or authority
- Investment advice for a fee
- Discretion in plan administration
- Functional Test

Consequences of Fiduciary Status

- Heightened fiduciary duty
- Prohibited transactions
- Bonding
- Severe penalties and other consequences

Fiduciary Duties – Advisers Act

- Advisers Act imposes fiduciary duty on advisers
- Duty of care
- Duty of loyalty
- Compare with ERISA

Fiduciary Duties - ERISA

- Loyalty
- Prudence
- Diversification
- Adherence to Plan Documents (unless contrary to ERISA)

Common Prohibited Transactions

- Prohibited transaction rules apply to ERISA plans and IRAs
- Prohibited transaction rules apply to “parties in interest” and fiduciaries
- Party In Interest (Section 406(a)) & Fiduciary Transactions (Section 406(b))
- Similar prohibited transactions under the Code Section 4975

Common Prohibited Transactions

- Statutory exemptions
- Class exemptions
- Individual exemptions

Bonding

- Fiduciaries
- Plan officials
- Exempt entities
- Maximum and minimums
- Employer securities

Penalties and Other Consequences

- Excise taxes on parties in interest, and related reputational risk
- Make-whole relief -- Effectively insuring the underlying transaction
- Rescission and other equitable relief
- Return of fees



Common Prohibited Transactions for Money Managers

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Topics

- Introduction
- Revisions to Necessary Services Exemption
- QPAM/INHAM
- Service Provider Exemption
- PTE 75-1 & 77-4
- Agency Execution of Securities Trades
- Cross Trades
- Alternative Crossing Networks and Venues

Background - ERISA

- Purpose of ERISA
- Overlaps with Advisers Act

Is the Broker-Dealer a Fiduciary – ERISA or Otherwise?

- Through State Law?
- Through the Advisers Act?
- Through ERISA?

Prohibited Transactions Introduction

- Party in Interest Transactions: Not an overstatement to say that all transactions involving “parties in interest” to an ERISA-covered plan are prohibited, unless there is an exemption for them.
- Fiduciary Self-Dealing: A fiduciary of an ERISA plan or IRA must NOT cause the plan to engage in a self-dealing “prohibited” transaction with the fiduciary, its affiliates or any entity in which the fiduciary has an interest that “might” affect its best judgment as a fiduciary.

Prohibited Transactions Introduction

- Fiduciary Self-Dealing Cont.:
 - Can't exercise discretion to cause the plan to pay the fiduciary an additional fee.
 - Can't represent a party adverse to the plan in a transaction involving the plan even if done at market.
 - Can't get paid from a third party in connection with a plan transaction

Prohibited Transactions Introduction

- Party In Interest Transactions (Section 406(a))
 - Sales and exchanges/leasing of property
 - Lending and extensions of credit
 - Furnishing of goods, services or facilities
 - Use of “plan assets”
- Fiduciary Transactions (Section 406(b))
 - Self-dealing
 - Conflict of interest
 - Kickbacks
- Similar prohibited transactions under the Code Section 4975

Most Common Class/Individual Exemptions

- Review of some of the most relevant/commonly used class exemptions in the brokerage context.
- There are very few exemptions that permit fiduciaries to trade with the plan assets over which it is a fiduciary.

Revisions to Necessary Services Exemption (ERISA Section 408(b)(2))

- Broad exemption
- Proposed Regs: No contract for services will be considered “reasonable” unless it is in writing and requires the service provider to make specific disclosures to the plan
- Discussed further in “New Developments”

QPAM

- “Qualified Professional Asset Manager”
- The principal exemption that investment advisers and managers have traditionally relied upon when conducting business on behalf of a plan/IRA is “PTCE 84-14” or the “QPAM Exemption”
- QPAM Requirements

INHAM

- Similar to QPAM, except for U.S. registered investment advisers that are wholly-owned affiliates of the plan sponsor
- Must directly manage at least \$50 Million of the plan
- Requires annual audit
- Plan sponsor may veto transactions \$5 Million or more negotiated by the INHAM

Service Provider Exemption - ERISA Section 408(b)(17)

- Statutory exemption provided for certain transactions with service providers who are not fiduciaries (or an affiliate thereof) with respect to the assets involved in the transaction –
 - applies only in connection with a sale, exchange, lease, extension of credit, or transfer of plan income or assets transaction (not payment for services)
 - the plan receives no less, or pays no more than **“adequate consideration”**

PTE 75-1 / 77-4

- PTE 75-1
 - Principal and Agency Transactions by U.S. broker-dealers in securities. Parts I and II.
 - Purchase from another member of a 1933 Act underwriting syndicate by a fiduciary who is not the syndicate manager. Part III.
 - Principal trades as a market maker by a fiduciary on basis of better than best price. Part IV.
- PTE 77-4: Fiduciary directing plans into open end, no load mutual funds managed by fiduciary or affiliate so long as there is no double dipping on management fees.

Agency Execution of Securities Trades - PTE 86–128

- Exemption from transactions prohibited by ERISA Section 406(b) and from taxes imposed by Code Sections 4975(a) and (b).
- Allows certain types of agency cross transactions, but not where discretion on both sides.
- Specific requirements
- Individual Exemptions

Passive Cross Trades - PTE 2002-12

- Allows passive cross trades between 2 parties, when the same person is acting for the buyer and the seller – applies to Purchase and sale of securities between an Index Fund or Model-Driven Fund (“Fund”), and another Fund.
- Conditions for exemption

Cross Trades - ERISA Section 408(b)(19) / Code Section 4975(d)(22)

- Exemption from prohibitions of ERISA Sections 406(a)(1)(A) and 406(b)(2).
- Applies to transactions occurring after August 17, 2006.
- Allows investment manager to execute transactions involving purchase and sale of security between a plan and any other account managed by same investment manager.
- Specific requirements
- ***Recent DOL Final Rule that governs written policies and procedures that must be adopted before parties can engage in cross trading (effective February 4, 2009).***

Transactions via ECN or ATS – ERISA Section 408(b)(16) / Code Section 4975(d)(19)

- Generally permits purchases or sales of securities between an ERISA, Keogh or IRA account and a party in interest plan to be executed through a regulated electronic communications network (ECN) or alternative trading system (ATS)
- Specific conditions



New Developments and Hot issues for Investment Advisers with ERISA Clients

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Topics

- Introduction
- New Schedule C to Form 5500
- Revisions to Necessary Services Exemption
- Participant Disclosure
- DOL and SEC Cooperation on Examinations
- ERISA Fiduciary Litigation Update
- Gifts and Gratuities and LM-10
- Proxy Voting
- Social Investing

Introduction to New Fee Disclosure Rules

- Purpose: To aid plan fiduciaries and participants in assessing reasonableness of compensation paid to service providers and potential conflicts of interest, DOL has finalized/proposed the following:
 - Form 5500 Schedule C rules - [FINAL]
 - Regs under ERISA Section 408(b)(2) - [PROPOSED]
 - Regulations with respect to self-directed individual account plan fees – [PROPOSED]

New Schedule C to Form 5500 (Disclosure of Service Provider Compensation)

- On November 16, 2007 the Department of Labor (DOL) issued a revised Annual Return/Report of Employee Benefit Plan form (Form 5500).
 - [DOL FAQs](#)
- Changes v. Old Rule
- Service providers need to address ability to comply

New Schedule C to Form 5500 (Disclosure of Service Provider Compensation)

- “Reportable compensation”
- What is a service provider under the rules?
- Examples

New Schedule C to Form 5500 (Disclosure of Service Provider Compensation): Special Reporting Rules

- In the final instructions to the new Schedule C, DOL included two special reporting rules intended to mitigate the burdens of indirect compensation reporting:
 - Reporting relief for “bundled service arrangements”
 - Reporting relief for indirect compensation that qualifies as “eligible indirect compensation”

New Schedule C to Form 5500 (Disclosure of Service Provider Compensation): “Eligible Indirect Compensation”

- “Eligible indirect compensation” Examples
- Plans are permitted (but not required) to report far less information for “eligible indirect compensation”

Revisions to Necessary Services Exemption (ERISA Section 408(b)(2))

- Broad exemption
- Proposed Regs: No contract for services will be considered “reasonable” unless it is in writing and requires the service provider to make specific disclosures to the plan
- Still in Flux
- Contract Disclosures

401(k) Fee Disclosure

- Proposed regulation issued July 23, 2008. 73 Fed. Reg. 43014.
- Shift from 404(c) to requiring fee disclosure as direct responsibility of fiduciary.
- Proposed effective date: Plan years beginning on or after January 1, 2009, but will likely be moved back.

401(k) Fee Disclosure: Required Disclosures Under Proposed Regulation

DOL divides into two categories:

1. “Plan-Related Information”
 - *General plan information*
 - *Plan administrative expenses*
 - *Individual expenses*
2. “Investment-Related Information”

Plan-Related Information

Administrative Expenses

- Most important component of proposed regs
- Requires that participants receive information about plan fees and expenses at regular intervals
- Two layers of disclosure:
 - When individual becomes eligible to participate in the plan, and at least annually thereafter
 - Quarterly

Plan-Related Information

Individual Expenses

- Participants must receive information about expenses that are assessed **on an individual basis**, rather than plan-wide, such as fees related to QDROs, loans, and investment advice services.
- The timing of such disclosure tracks the administrative expenses rule:
 - Explanation of fees that may be charged to individual accounts at the time of plan eligibility and annually thereafter
 - Quarterly statement of amounts actually charged during the preceding quarter

Investment-Related Information

- Information must be provided **automatically** to each participant with respect to each designated investment alternative in the plan:
 - The name and category of the investment alternative (e.g., money market mutual fund, balanced fund, index fund, and whether the investment is actively or passively managed)
 - Internet address that will lead participants to supplemental information about the investment option
 - Average annual total return on the investment for one-year, five-year, and 10-year periods, if available

Investment-Related Information

- Performance data for “an appropriate broad-based benchmark” over time periods comparable to the performance data periods
- Fees and expenses related to the purchase, holding, and sale of the investment alternative, including:
 - *shareholder-type fees charged directly against the investment, such as sales loads, sales charges, and redemption fees; and*
 - *total annual operating expenses expressed as a percentage (i.e., expense ratio)*

Investment-Related Information

- “Designated investment alternative” does not include a brokerage window, self-directed brokerage account, or similar plan arrangement that enables a participant to select investments beyond those designated by the plan.
- Disclosure must be in a chart or similar format that will permit comparison
- May use most recent fund prospectus or disclosure if it contains all required information

Investment-Related Information

Model Comparative Charts

I. Performance Information

Name/ Type of Option	Mgmt.	Fixed Return/ Term	Average Annual Total Return as of 12/31/0X 1yr. 5yr. 10yr.			Benchmark/Index as of 12/31/0X 1yr. 5yr. 10yr.		
Stock Funds								
A Fund/S&P 500 Index www.Web site.com	Passive	NA	15.6%	6.1%	8.3%	15.8%	6.2%	8.4%
B Fund/Large Cap www.Web site.com	Active	NA	8.9%	.22%	NA	-8.9%	5.9%	12.2%
C Fund/Int'l Stock www.Web site.com	Active	NA	4.3%	5.2%	11.2%	26.9%	15.4%	8.1%
D Fund/Mid Cap ETF www.Web site.com	Passive	NA	15%	12.7%	11.4%	15%	13%	12%
Bond Funds								
E Fund/Bond Index www.Web site.com	Passive	NA	4.3%	5.2%	6.2%	4.3%	5.1%	6.2%
Other								
F Fund/ GICs www.Web site.com	Active	NA	4.7%	4.4%	5%	5%	3%	3.8%
G Fund/Stable Value www.Web site.com	Active	NA	4.3%	4.0%	4.9%	4.7%	3.4%	4.3%
H 200X GIC www.Web site.com	NA	4% 2 yr.	NA	NA	NA	NA		

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Investment-Related Information

Model Comparative Charts

II. Fees and Expense Information

Name/ Type of Option	Total Annual Operating Expenses *	Shareholder/Shareholder-type Fees **
Stock Funds		
A Fund / S&P 500 Index	0.18%	\$20 annual service fee assessed for accounts holding less than \$10,000. May be waived in certain circumstances.
B Fund / Large Cap	2.45%	4.25% deferred sales charge against amounts redeemed within 12 months of purchase.
C Fund/International Stock	0.79%	5.75% sales charge against amounts invested.
D Fund/ Mid Cap ETF	0.20%	4.25% sales charge against amounts invested or redeemed.
Bond Funds		
E Fund/ Bond Index	0.50%	N/A
Other		
F Fund/ GICs	0.46%	10% charge against amounts withdrawn within 18 mos. of initial investment.
G Fund/ Stable Value	0.65%	Dollars withdrawn may not be transferred to a competing fund for 90 days after withdrawal.
H 200X GIC	NA	12% charge against amounts withdrawn before maturity.

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Proposed Amendments to Section 404(c) Regulation

- ERISA Section 404(c) relieves fiduciaries of liability for investment losses that result from a participant's exercise of control over assets. Regulations contain detailed disclosure rules.
- Proposed changes would:
 - integrate disclosure requirements under 404(c) and 404(a), and
 - “reiterate” DOL’s position that the relief Section 404(c) relief does not extend to a fiduciary’s duty to prudently select and monitor investment funds under the plan.

SEC & DOL Cooperation on Examinations

- Recently, the SEC and DOL entered into a Memorandum of Understanding (MOU) to facilitate the ongoing consultation and communication between the DOL and SEC.
- Signals greater communication between regulatory agencies

ERISA Fiduciary Litigation and Enforcement Fees and Expenses

- First wave of cases
 - St. Louis-based Schlicter, Bogard & Denton targeted 15 Fortune 200 companies and is poised to go after more
- Basic Claims (against sponsors)
 - Failure to ensure that direct and indirect compensation paid to service providers was reasonable
 - Failure to conduct a reasonable investigation into revenue sharing payments
 - Failure to disclose revenue sharing to plan participants
 - Offering more expensive funds (e.g., active vs. index)

ERISA Fiduciary Litigation and Enforcement Fees and Expenses

- Basic Claims (against service providers)
 - Revenue-sharing payments are plan assets for purposes of prohibited transaction rules.
 - Service provider receipt of payments violates ERISA Sections 406(a) (party-in-interest) and/or 406(b) (fiduciary self-dealing)
 - But see DOL's brief in Deere case: not plan assets

ERISA Fiduciary Litigation and Enforcement Is Schlichter Losing Traction?

- Hecker v. Deere (D. Wis.):
 - Twenty three funds offered, with expense ratios from 7 to 101 basis points.
 - Brokerage window allowing access to over 2500 publicly available mutual funds.
 - Bottom line: Investment fees fully disclosed, so “ to the extent participants incurred excessive expenses, those losses were the result of participants exercising control over their investments.”

ERISA Fiduciary Litigation and Enforcement Is Schlichter Losing Traction?

- Kanawi v. Bechtel (N.D. Cal.):
 - Bechtel retained investment advisory firm (FIA) that was partly owned by Bechtel family member.
 - Most claims dismissed based on statute of limitations.
 - Rejects claim that offering FIA mutual funds in plan was imprudent
 - Narrow issues remaining:
 - *Reasonableness of fees paid from plan during 4-month period*
 - *Potential self-dealing because adviser was fiduciary*

ERISA Fiduciary Litigation and Enforcement

The Next Wave?

- Securities Lending
 - BP Corp. Savings Plan Investment Committee v. Northern Trust (filed 10/21/08)
- Stepped up DOL Enforcement
 - Chao v. Zenith Capital (filed 10/24/08) – undisclosed incentive fees from hedge fund manager
- Employer Securities/Subprime Losses

Gifts, Meals & Entertainment

- Gifts, meals and entertainment are considered indirect compensation for plan reporting purposes and are reportable on Form 5500 Schedule C unless:
 - the gift or entertainment is valued at less than \$50; and
 - the aggregate amount of gifts or entertainment provided in a year is less than \$100.
- Non-ERISA Business Accounts (FAQ 35)
- Educational conference registration fees (FAQ 33)
- DOL treats these disclosures seriously (Enforcement Guidelines)

LM-10 (Disclosure of Gifts and Payments to Labor Unions)

- Broad definition of “Employer” (any entity that has an employee) AND
- Broad Range of Payments Potentially Covered
- \$250 De Minimis Exception
- Reporting Compliance

Proxy Voting and Shareholder Activism

- Who cares? DOL does.
- Who votes?
 - Allocation of voting responsibility among plan fiduciaries
 - *Adopting proxy voting policies and procedures*
 - Plan participants
- Special issues

Social Investing and ETIs

- ERISA's exclusive benefit rule
- **PROCESS IS KEY**
- **DOL Interpretive Bulletin 2008-1**



Hedge Funds

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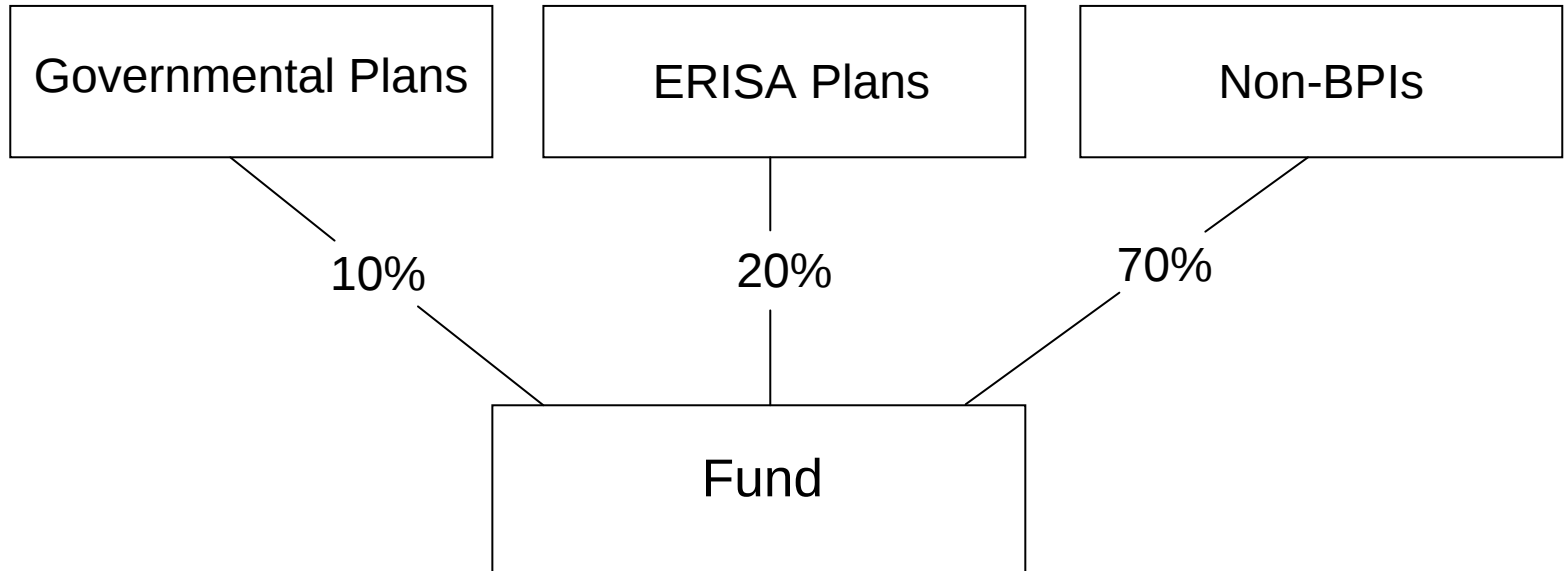
Retirement Assets in US

- Some stats
- US Pension Investors Are Generally Slow to Invest And Slow to Redeem

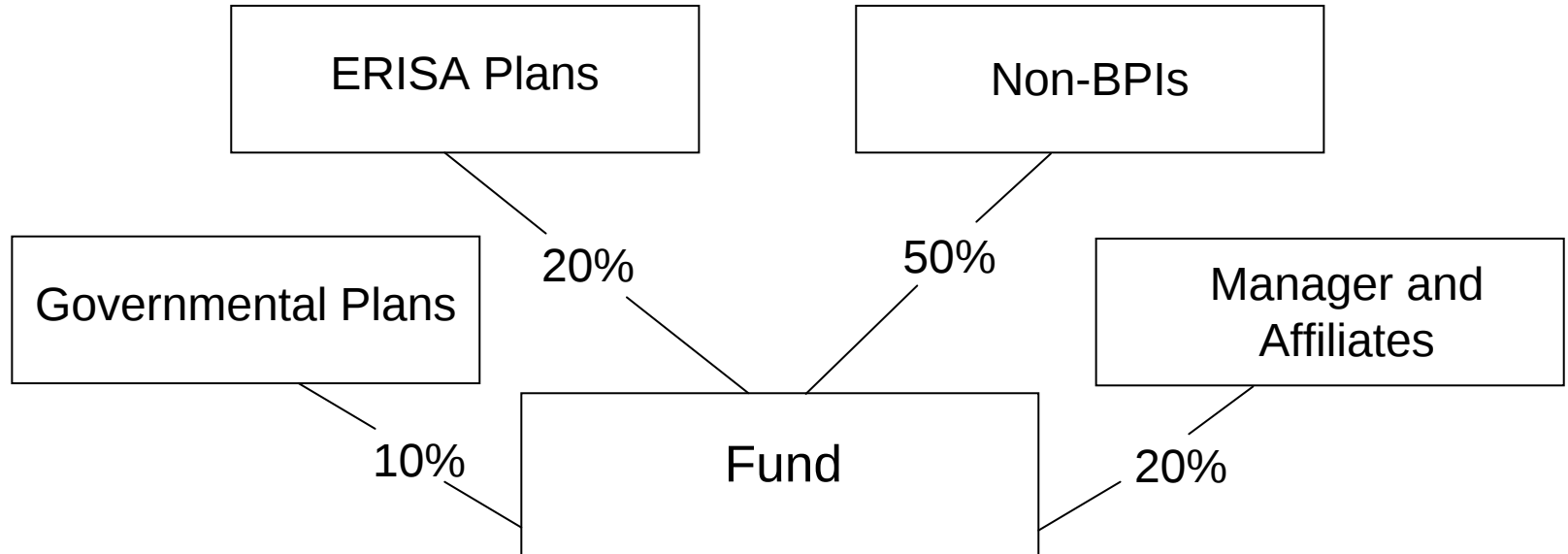
Plan Asset Exceptions

- Publicly-Offered Securities
- Registered Investment Companies
- Operating Companies
 - Venture Capital Operating Companies
 - Real Estate Operating Companies
- Participation by Benefit Plan Investors (BPIs)
Not Significant
- No ERISA/4975 Plans

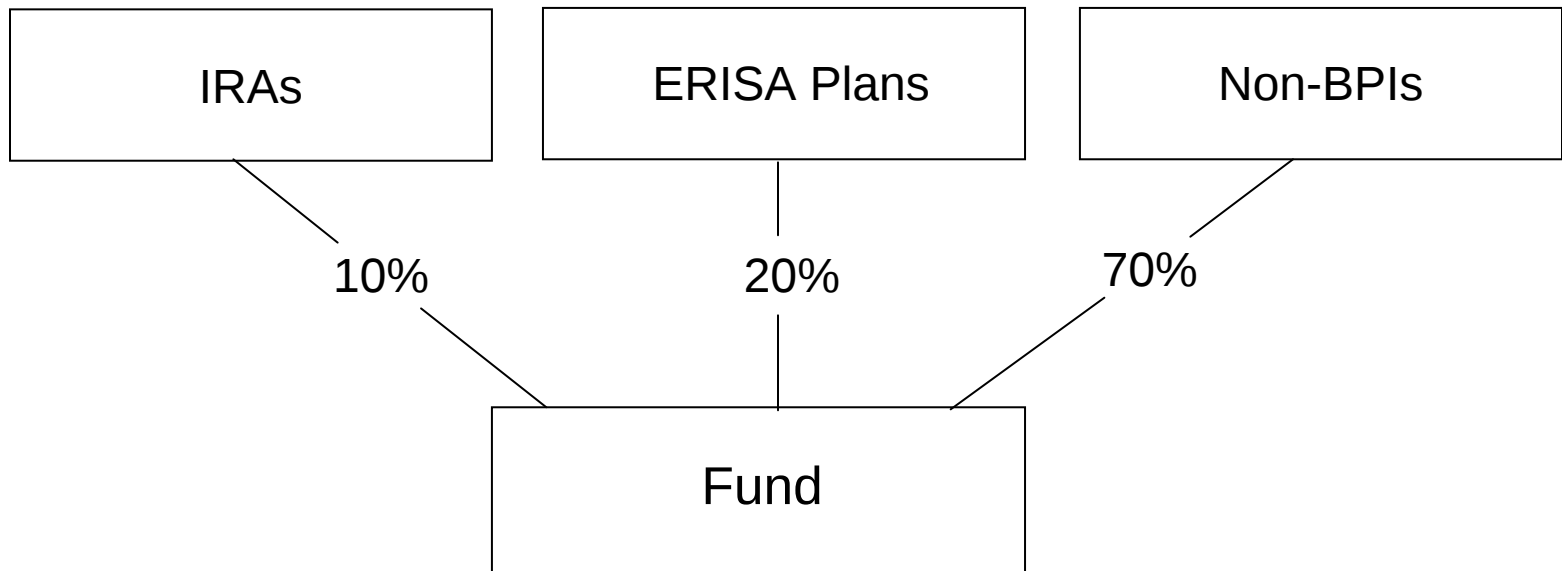
BPIs - Example 1



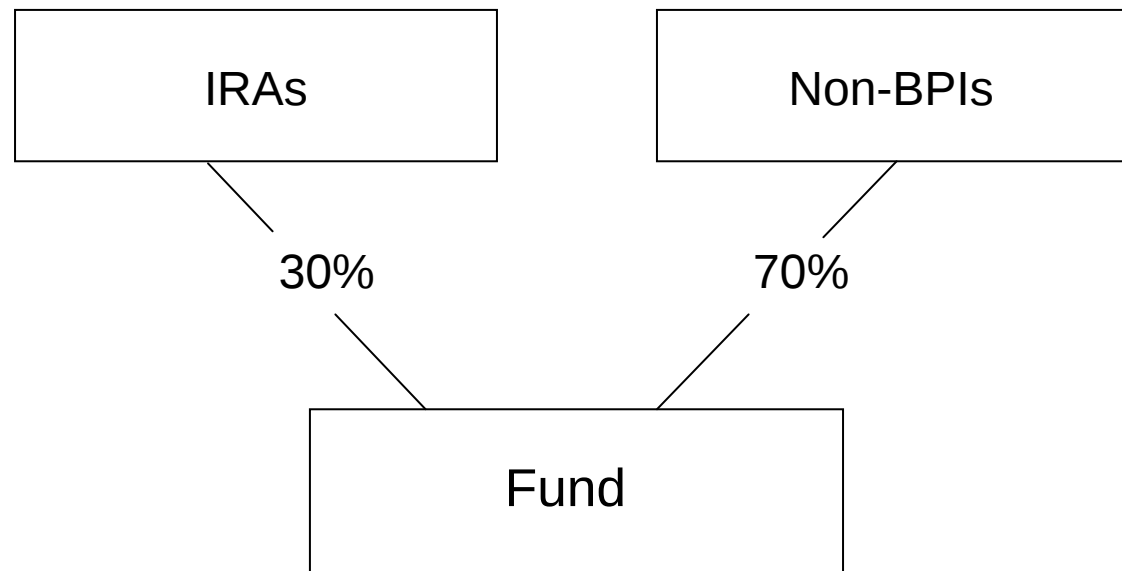
BPIs - Example 2



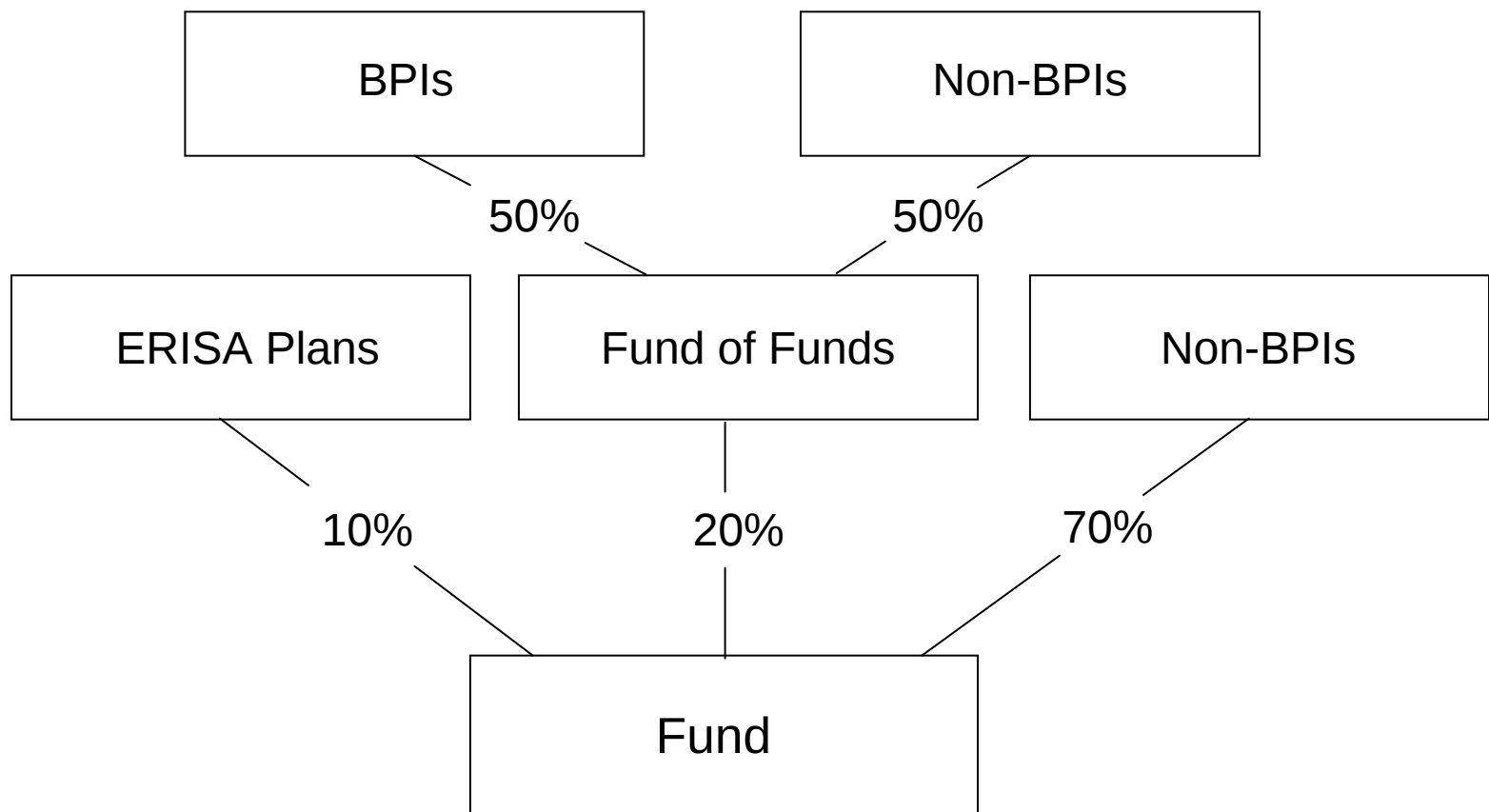
BPIs – Example 3



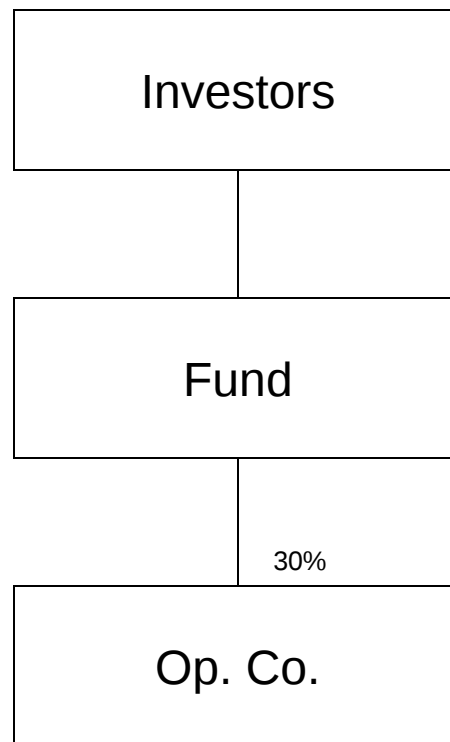
BPIs - Example 4



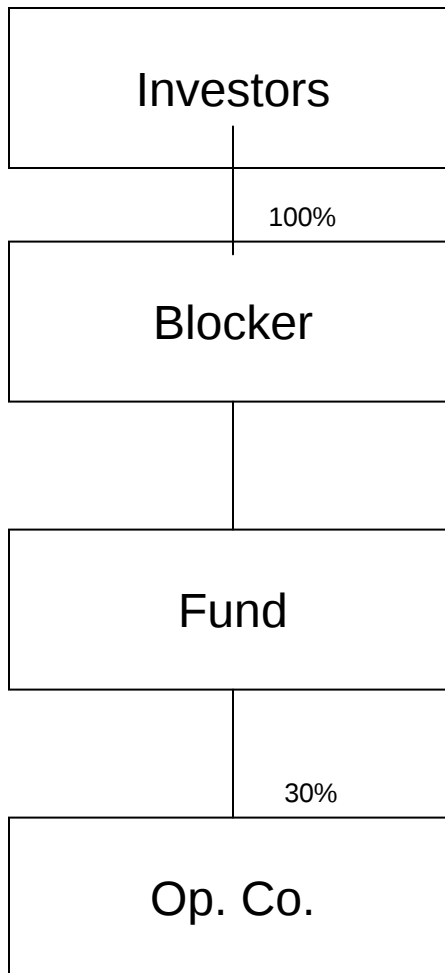
BPIs - Example 5



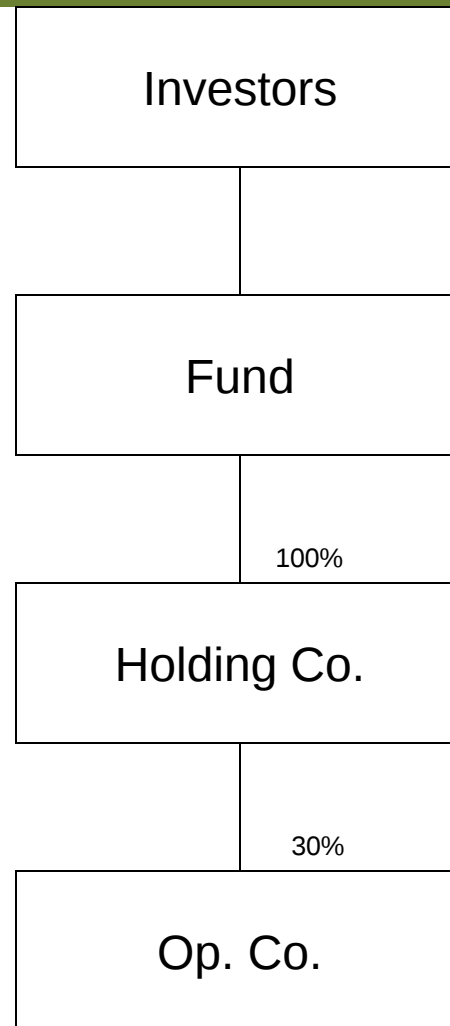
VCOC Examples 1



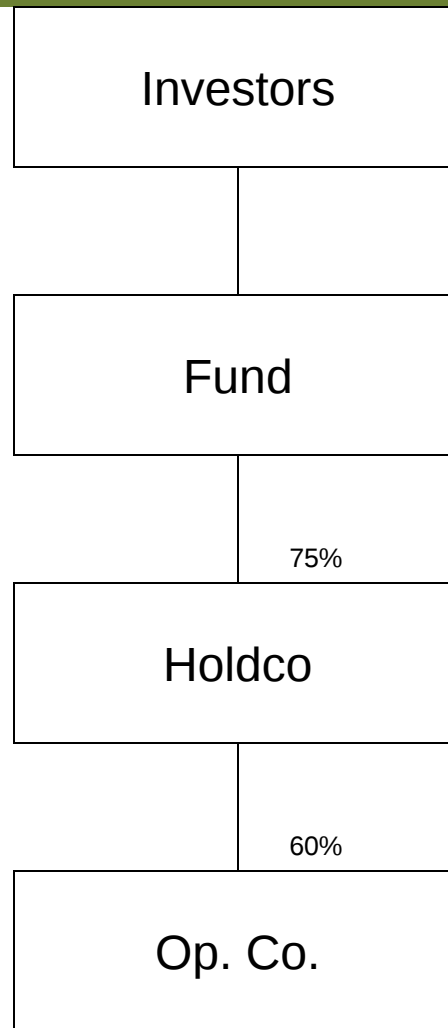
VCOC Examples 2



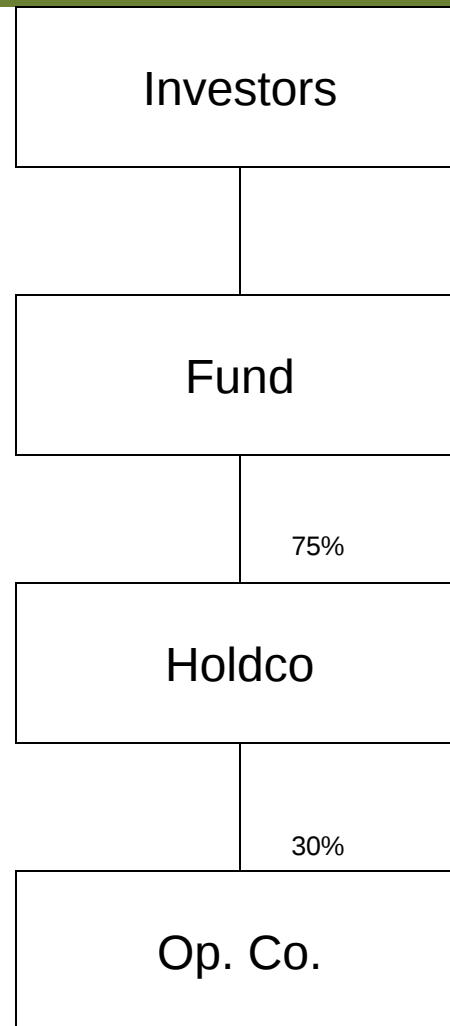
VCOC Examples 3



VCOC Examples 4



VCOC Examples 5



ERISA Implications

- Fiduciary obligations
- Prohibited Transaction Exemptions

Performance Fees

- Could be Self-Dealing PT
- Various ERISA Advisory Opinions

Other ERISA Issues

- Delegation
- Bonding
- Reporting
- Indicia of Ownership within jurisdiction of US District Courts

FASB Statement Standards No. 157

- Definition of Fair Value
- Developed to increase the comparability and consistency of fair value measures
- Why controversial?
- Bailout Bill

Boston DOL Letter

- The Boston office of the DOL issued a letter to pension plan fiduciaries in July 2008 asserting the way in which they valued their alternative investments.
- May mean an independent valuation to be performed by the plan fiduciaries
- Not necessarily the position of the National DOL



Providing Advice to IRAs and 401(k) Plan Participants

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Topics

- 404(c) Compliance
- Affiliated and Non-Affiliated Mutual Funds
- Wrap-Fee Arrangements and Managed Account Programs
- Qualified Default Investment Alternatives
- Participant Education and Advice

404(c) Compliance

- If the conditions of Section 404(c) are met –
 - no plan fiduciary is liable for any loss or breach of ERISA's fiduciary responsibility rules which results from a participant's exercise of control over his or her individual account
- Conditions

404(c) Compliance

- Transactions not covered by Section 404(c):
- Additional transactions covered by Section 404(c) (after the Pension Protection Act of 2006):
 - “Blackout” periods
 - “Qualified” changes in investment options
 - “Qualified Default Investment Alternatives” / Automatic contribution arrangements

Affiliated and Non-Affiliated Mutual Funds

- PTE 77-4:
 - Summary
 - Conditions of this exemption
- DOL Adv. Op. 2005-10A (“Country Trust Bank”)
- DOL Adv. Op. 2001-09A (“SunAmerica Letter”)

Wrap-Fee Arrangements and Managed Account Programs

- Program Sponsor Issues
- Manager Issues
- Legislative Developments

Qualified Default Investment Alternatives

- ERISA Section 404(c)(5) added by PPA 06 and Final Regulations
- Fiduciary Relief Conditions

Qualified Default Investment Alternatives

- QDIA Requirements
 - General prohibition against QDIA being employer stock
 - QDIA imposes no restrictions, fees or expenses than would otherwise applicable to electing participants
 - QDIA managed by an ERISA investment manager, registered investment company or plan sponsor named as a fiduciary
 - Four types of investment alternatives - *plus* grandfather
 1. *Investment Fund*
 2. *Balanced Fund*
 3. *Investment Management Service*
 4. *Limited Capital Preservation Option*

Participant Education and Advice

- Background
- Statutory (PPA 06) Exemption
- Proposed Regulation implements a statutory exemption that permits fiduciary advisers to provide advice under 2 circumstances:
 - Fee-leveling arrangements
 - Computer Model-driven arrangements
- Disclosure to Participants

Thank you

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