DOL Practice Management

White paper

NATIONWIDE RETIREMENT INSTITUTE®

The Nationwide Retirement Institute® provides practical thought leadership through timely insights and education, client-ready tools and consultative support. Our comprehensive approach helps financial advisors and plan sponsors break down and simplify clients' complex retirement challenges to better prepare them for the future.

A prudent process – the key to demonstrating fiduciary compliance

Christine Cushman, JD, LLM, CLU

Technical Director, Advanced Consulting Group

Christine joined the Nationwide Advanced Consulting Group in early 2014, bringing more than 13 years of experience in employee benefits, ERISA and tax law to her role. Prior to joining the group, Christine worked for three years in Nationwide's Office of General Counsel supporting the Nationwide Trust Company and private-and public-sector retirement plans operations and sales. Christine received her JD from the University of Texas and her LLM (taxation) from New York University. Christine began her legal career as an attorney advisor to Judge Michael Thornton on the U.S. Tax Court. Following her clerkship, she worked for eight years as a private practice attorney in two large Philadelphia law firms, practicing in the areas of employee benefits, executive compensation, ERISA, taxes and nonprofit organizations.

In addition to her legal practice, Christine has taught a master's course at Drexel University entitled "Law in the Arts" and has lectured on retirement plan and nonprofit topics. She has also volunteered for several years as a tax return preparer for low-income individuals through the IRS's Volunteer Income Tax Assistance program and has provided pro bono legal assistance to numerous nonprofit organizations.

Her work in the Nationwide Advanced Consulting Group focuses on providing technical information and education to advisors and plan sponsors regarding qualified and nonqualified retirement and welfare benefit plans. She enjoys partnering with employers and their third-party benefit professionals, evaluating current plan offerings and/or identifying alternative solutions to ensure that the employer's objectives are being met and that employees have opportunities to plan for and live in retirement.

Executive summary

The Department of Labor's (DOL) new fiduciary rule is an expansion of a standard that's been in place for more than 40 years. In this paper, we will start by understanding the decades-old federal law that establishes the duties of a fiduciary, and then explore how advisors who find themselves in a fiduciary role can demonstrate compliance.

The Employee Retirement Income Security Act of 1974 (ERISA) was adopted by Congress to set minimum standards for most employer-sponsored retirement plans to provide protection for individuals in these plans. Part of that protection derives from the duties — and liability for breaching those duties — imposed on certain individuals and entities that are defined by ERISA as fiduciaries.

Historically, the DOL has had the responsibility for defining who is and who is not a fiduciary for purposes of both ERISA and the Internal Revenue Code (IRC) with regard to the prohibited transaction rules (discussed below). Thus, the new definition will affect both group and individual retirement plans directly and indirectly.

TABLE OF CONTENTS

This white paper is being distributed for informational purposes only. The law and analysis contained in this white paper are general in nature and do not constitute a legal opinion that may be relied on by third parties. Readers should consult their own legal counsel for information on how these issues apply to their individual circumstances. Advisors should consult with their supervisory entities to determine the approaches and policies established by those entities. The views contained in this article are those of the author and should not be attributed to any other person or entity. This paper is current as of September 2016; changes may have occurred since it was prepared. As a result, readers should consult with their legal advisors to determine if there have been any relevant developments since then.

The definition of fiduciary

ERISA and the IRC provide a three-part definition of fiduciary. A fiduciary is any person or entity who:

- Exercises discretionary authority or control in the management of the plan or exercises any authority or control over the management or disposition of the plan assets[1]; or
- Renders investment advice for compensation (direct or indirect) with respect to any assets of the plan or has any authority or responsibility to do so[2]; or
- Holds discretionary authority or discretionary responsibility in the administration of the plan.[3]

On April 6, 2016, the DOL issued final regulations regarding the second prong of the fiduciary definition. In addition to updating the long-standing five-part test for determining when someone is an investment advice fiduciary, the new regulation expands the definition to include advice in the context of distributions, rollovers and individual retirement accounts (IRAs).

The final regulations provide that a person is an investment advice fiduciary if he or she receives direct or indirect compensation for a recommendation as to:

- The advisability of buying, holding or selling securities or other investment property (together "Securities") or how such property should be invested after it is rolled over, transferred or distributed from the plan or IRA; or
- The management of Securities including or with respect to rollovers, distributions or transfers from a plan or IRA; or whether, in what amount, in what form, and to what destination such a rollover, transfer or distribution should be made.

The new definition also requires that:

- The person represents or acknowledges that he or she is acting as a fiduciary;
- The advice is given pursuant to a written or verbal agreement or understanding that the advice is based on the particular investment needs of the client; or
- The recommendation is directed to a specific client regarding the advisability of a particular investment or management decision with respect to Securities of the plan or IRA.

Other ERISA fiduciaries

ERISA's three-part definition of fiduciary conduct encompasses five separate fiduciary positions.

Three positions are mandatory for all retirement plans subject to ERISA: the named fiduciary, the trustee and the plan administrator.

The other two are optional: the investment advice fiduciary and investment manager. The investment advice fiduciary is a co-fiduciary sharing fiduciary responsibility for plan investments with the trustee.

Prior to the adoption of the new DOL regulation, IRAs were not subject to ERISA. By including advice regarding IRAs in the definition of fiduciary investment advice for purposes of ERISA,[4] only this position — the investment advice fiduciary — will impact IRAs.

ERISA fiduciary duties

All five fiduciary positions, including an investment advice fiduciary, are subject to duties to the plan and the plan participants under ERISA. Fiduciaries must discharge their duties solely in the interest of plan participants:

- For the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan;
- With the care, skill, prudence and diligence that a prudent person acting in similar circumstances and familiar with such matters would use;
- By diversifying investments of the plan so as to minimize the risk of large losses (unless under the circumstances it is not prudent to do so); and
- In accordance with the terms of the plan and related documents, to the extent they are consistent with the provisions of ERISA.

The DOL, courts and common law have also established that a fiduciary has an ongoing duty to monitor fiduciary decisions (investment choices, service providers and such) to ensure that those decisions remain prudent.[5]

Note that these duties — though not enumerated in ERISA with the other fiduciary duties — will similarly apply to IRAs and IRA owners under the new DOL regulations.

Duty of loyalty

The duty of loyalty prohibits any form of self-dealing or conflict of interest. It also forbids favoring a third party over the interest of the plan. In essence, the client's interests must come before all others. Two examples where a fiduciary breached this duty are:

- An investment advisory firm invested a significant portion of plan assets in companies in which advisory firm members had substantial equity interests.[6]
- A plan trustee hired his stepson as a financial consultant for the plan.[7]

Duty to diversify assets

ERISA's legislative history indicates that under the diversification requirement, a fiduciary should not invest an "unreasonably large percentage" of plan assets in a "single security," in "one type of security," or in "various types of securities that are dependent upon success of one enterprise or upon conditions in one locality."[8]

Duty of prudence

The prudence standard charges fiduciaries with a high degree of knowledge. The standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment professionals.[9] Thus, it is often referred to as the "prudent expert" standard. Courts have interpreted the prudent expert rule to focus on the conduct of the fiduciary, the extent of the fiduciary's diligent investigation and the performance of acts consistent with the purpose of the plan. This is the doctrine of "procedural prudence"[10] or engaging in a "prudent process."

The prudent process

Fiduciaries who implement a prudent process in their interactions with a plan and participants or IRA owners will achieve two important objectives:

- They may limit their personal liability by showing that they complied with their fiduciary duties by documenting the processes used to carry out these responsibilities.[11]
- Because "prudence focuses on the process for making fiduciary decisions,"[12] implementing a prudent process will enable a fiduciary to demonstrate compliance with this duty.

The DOL has made it clear that a fiduciary's duties under ERISA are related to "the process used to carry out the plan functions rather than simply the end results."[13] For example, "an investment does not have to be a 'winner' if it was part of a prudent overall diversified investment portfolio for the plan."[14]

Numerous courts have weighed in on what prudence and a prudent process involves. One said that the test for prudence was whether the individual trustees, at the time they engaged in the challenged transactions, employed the appropriate methods to investigate the merits of the investment and to structure the investment.[15] Another found that a fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard.[16]

Whether a fiduciary acted prudently in any given situation depends on the facts and circumstances of each case. With respect to investment duties, the DOL states that a fiduciary must give appropriate consideration to the facts and circumstances that the fiduciary knows or should know are relevant to the particular investment, including the role that the investment plays in the plan's investment portfolio, and should act accordingly.[17] The fiduciary should further determine that a particular investment is reasonably designed to further the purposes of the plan or IRA, taking into consideration the risk of loss and the opportunity for gain associated with such investment.[18]

Consideration should also be given to:

- The diversification of the investment portfolio;
- The liquidity of the investment in relation to the liquidity needs of the plan; and
- The projected investment return in relation to the funding objectives of the plan.[19]

A prudent process should be followed by ALL fiduciaries. Investment advice fiduciaries hired by a retirement plan can work with their clients to develop and implement a prudent process for the client. It is equally important, however, for investment advice fiduciaries — whether working with retirement plans, individuals or IRA owners — to implement their own prudent process that documents the advice they are providing to the client and the decisions behind those recommendations.

Helping a retirement plan client document a prudent process

Because all ERISA fiduciaries should establish procedural prudence, retirement plan advisors can work with their clients to establish and implement a prudent process around activities such as:

- Hiring and monitoring service providers.
- Selecting and monitoring investment alternatives for the plan.
- Diversifying the plan's investments.

Consider the following items for a plan fiduciary's documentation process:

Plan records	
Plan and trust documents	Plan and trust documents, including amendments
	Summary plan description, including updates and records of participant receipt
	IRS determination letter and a copy of the application package for the letter
Employee communications & education	ERISA 404(c) communications (Q&A brochure and any additional information provided)
	Correspondence announcing the plan
	Pre-enrollment and enrollment communications
	Summary Annual Report
Filings	Form 5500
	Auditor's statements, if applicable
Selection of investments and service providers	
Provider selection criteria and comparisons	Request for proposal and/or other documentation of provider search and requirements
	Documentation of criteria used for selection of provider, including provider proposal materials, consultant reports, references, etc.
	Cost comparison (e.g., DOL fee worksheet)
Service provider agreements and insurance	Investment provider and plan administrator agreements and any updates or amendments
	Proof of insurance supplied by service provider
	Fidelity bond
Selection of investment options	Investment policy statement
	Documentation used to select investment options (e.g., investment profiles, performance summaries and other information gathered for investment analysis)

Plan participants and IRA owners are not considered fiduciaries of their own accounts, so an advisor who works with individual clients can skip this portion of the prudent process and focus on documenting his or her own process.

Establishing a prudent process for the investment advice fiduciary

All investment advice fiduciaries, whether working with retirement plans, IRAs or individuals, should document their own prudent process with respect to the recommendations they make.

This documentation should focus on two main areas:

- The investments recommended and why; and
- A determination that the compensation being charged to the client is reasonable.

Reasons for the investment recommendations

An investment advice fiduciary must make an investment recommendation that is in the "best interest" of the client. Therefore, it is important that the documentation reflect why the advisor believes the advice is in the client's best interest.

If the client is an individual, the recommendation (and documentation) might reflect factors such as the client's:

- Age.
- Needs and investment objectives.
- Financial circumstances.
- Investment experience.
- Risk tolerance.

If the client is a retirement plan, the advisor should document that the investments suggested reflect the direction provided by the plan's investment policy statement, if one exists. If not, he or she should list the criteria that was considered, which might include factors such as:

- Average age of participants.
- Education level of employees.
- Income levels.
- Income replacement needs for participants.
- Whether other benefits such as a defined benefit plan or profit sharing exist.

Whether the client is a plan or individual, the advisor should focus on materials and analysis used to make the recommendation. Similar to the plan fiduciary, the advisor should document investment profiles, performance summaries and other information gathered for investment analysis. The main difference between the two will be that the advisor is focused on documenting why he or she believed the **recommendation** was correct for the plan at the time made, while the plan fiduciary will focus on the investment **decision** made based on the advisor's recommendation.

Reasonable compensation determination

An advisor's prudent process might also include documentation that his or her compensation is reasonable. Under the Prohibited Transaction exemptions 84-24 and Best Interest Contract Exemption (BICE), for an investment advice fiduciary to receive variable or third party compensation, the advisor and his or her financial institution must first determine that the fees they are charging are reasonable within the meaning of ERISA section 408(b)(2).[20] In addition, a plan fiduciary must also determine that the plan is paying no more than reasonable compensation for the service.

Compensation to be considered for such a determination is as follows:

- Look at the facts and circumstances at the time of the recommendation.
- Consider compensation paid to the financial institution, advisor, affiliates and related entities.
- Consider the value of all services and benefits provided for the charge in assessing whether it's reasonable.[21]

The DOL is clear that the standard to apply is a "market-based standard." Ask: "What is the market value of the services, rights and benefits the advisor and its financial institution are delivering?" Note that what is "customary" may not be appropriate or "reasonable" if, for example, the fees are not transparent or bear little relationship to the value of the services offered.

Factors that can impact whether compensation is reasonable include:

- The complexity of the product.
- Market pricing of services provided.
- The scope of monitoring.
- Market pricing of the underlying assets.
- Whether the compensation is level across types of product sales.

No single factor is paramount in determining whether compensation is reasonable.

The DOL has also pointed out that:

- An advisor does not have to recommend the transaction that has the lowest cost or generates the lowest fees.
- Financial institutions may seek impartial review of their fee structures to safeguard against abuse.
- Fiduciaries and service providers may not charge more than reasonable compensation even if another fiduciary signs off on the compensation.

ERISA-prohibited transactions

ERISA also identifies prohibited conduct in which a fiduciary cannot engage. This conduct is known as a "prohibited transaction" or PT, and penalties and excise taxes may be imposed on a fiduciary who engages in a PT. Fiduciaries that commit a PT have likely breached their fiduciary duties as well.

There are two types of PTs: party in interest (PII) and fiduciary. A PII includes a fiduciary, a service provider, an employer, an employee, an owner of a business and certain relatives of any of these entities.

A PII PT involves any of the following transactions between a plan and a PII with respect to the plan:

- Selling, exchanging or leasing property.
  - For example, the sale of investment products to the plan and the related payment to the broker, consultant or advisor of a fee or commission.
- Lending money or extending credit.
  - For example, a plan loan to a participant.
- Furnishing goods, services or facilities.
  - For example, any provision of services to a plan for compensation — such as plan recordkeeping, serving as trustee and consulting — is prohibited absent an exemption.
- Transferring plan assets to or using them for the benefit of a PII.
  - For example, paying a fee out of plan assets to an individual serving as trustee who is already receiving compensation as an employee of the employer sponsoring the plan.

A fiduciary PT involves any of the following:

- Fiduciary self-dealing.
  - For example, dealing with plan assets for his or her own interest.
- Dual loyalties.
  - For example, representing a party in a transaction involving plan assets whose interests are averse to those of the plan.
- Anti-kickback.
  - For example, receiving any consideration for his or her personal account from any party dealing with the plan in a transaction involving plan assets.

As with the fiduciary duties, ERISA's prohibited transaction language is written in terms of "plan assets." Under the new DOL regulations, however, to the extent an investment advice fiduciary working with an IRA or IRA owner engages in one of the banned behaviors with respect to IRA assets (i.e., self-dealing), he or she will have committed a PT.

Recognizing that certain PTs may be necessary (e.g., necessary services for the establishment or operation of the plan), ERISA provides relief in some circumstances. This relief comes in the form of PT exemptions. While these exemptions allow PIIs and fiduciaries to engage in the PT, they do not absolve the advisor of his or her fiduciary duty.

ERISA's fiduciary duties and PTs should always be considered together when judging fiduciary conduct. For example, even if a fiduciary believes that a transaction was intended to exclusively benefit the plan, it may still result in a PT if it could be construed as self-dealing. In effect, ERISA assumes the existence of an ulterior motive (that is, self-interest) unless an exemption applies.[22]

Penalties and excise taxes for fiduciary breaches and engaging in a prohibited transaction

If a fiduciary breaches his or her fiduciary duty, the fiduciary is personally liable to restore any losses resulting from the breach.[23] The fiduciary may also be subject to criminal penalties for willfully violating ERISA — up to $100,000 in fines and up to 10 years in prison.[24] Participants and the DOL may bring a lawsuit against a fiduciary to halt a fiduciary's conduct or to request equitable relief.[25] Finally, the DOL may impose a civil penalty of 20% of the "applicable recovery amount" for the breach.[26] This civil penalty is reduced by any excise taxes paid pursuant to IRC section 4975.

In addition to penalties associated with a breach of a fiduciary duty, an excise tax may be imposed on a fiduciary or PII who engages in a prohibited transaction without an exemption. The rate of tax is equal to 15% of the amount involved for each year (or partial year) in the taxable period.[27] If the transaction is not corrected within the taxable period, a tax equal to 100% of the amount involved may be imposed.[28]

Summary

With the introduction of the new DOL fiduciary rule, many advisors will take on the new role of an investment advice fiduciary. This will require that they provide advice to their clients — whether a plan, participant, IRA or individual — that is prudent and in the client's best interest, charging reasonable compensation.

Establishing and implementing a prudent process may be the most valuable tool fiduciaries have as they carry out their duties under ERISA. The process should be monitored and reviewed on an ongoing basis, just like the underlying recommendations that are being made, to confirm that the process is effectively capturing the information required to support the fiduciary's actions. It's important to document the review process and any recommendations or decisions that are made and the reasons for them, including recommendations to refrain from acting.

1 ERISA sec. 3(21)(A)(i).

2 ERISA sec. 3(21)(A)(ii).

3 ERISA sec. 3(21)(A)(iii).

4 And also for purposes of IRC section 4975.

5 *See Tibble v. Edison International*, 135 S. Ct. 1823 (2015).

6 *Lowen v. Tower Asset Management*, 829 F.2d 1209 (2d Cir. 1987).

7 *International Brotherhood of Painters v. Duval*, 925 F. Supp. 815 (D.D.C. 1996).

8 "Fiduciary Issues in ERISA-Covered Plans," Andree M. St. Martin, Groom Law Group, April 2005, citing ERISA Conference Report at 304.

9 Joint Committee on Taxation, Overview of the Enforcement and Administration of the Employee Retirement Income Security Act of 1974, at 12 (JCX-16-90, June 6, 1990).

10 "ERISA Fiduciary Responsibility and Liability," David F. Jones, Kathleen Ziga, Sumi C. Chong, Dechert LLP, available at https://www.dechert.com/files/Publication/ee304282-37b8-45eb-b765-07b7f39613a7/Presentation/PublicationAttachment/b8d46e10-6060-4a9f-8354-0fdfc5f7f71a/D.%20Jones,%20K.%20Ziga%20-%20ERISA%20Fiduciary%20Responsibility%20and%20Liability.pdf.

11 "Meeting Your Fiduciary Responsibilities," the Department of Labor, available at https://www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.

12 *Id.*

13 "Profit Sharing Plans for Small Businesses," the Department of Labor, available at https://www.dol.gov/ebsa/publications/profitsharing.html.

14 *Id.*

15 *Donovan v. Mazzola*, 716 F.2d 1226, at 1232, (9th Cir 1983).

16 *Fink v. National Savings and Trust Company*, 772 F.2d 951, 957, (DC Cir. 1985).

17 29 C.F.R. § 2550.404a-1(b)(1).

18 29 C.F.R. § 2550.404a-1(b)(2).

19 *Id.*

20 ERISA section 408(b)(2) provides that a service provider to a plan could only avoid committing a PT if the services were necessary and no more than reasonable compensation was paid for the service.

21 For example, in the case of compensation paid for an annuity or insurance contract that includes services and the purchase of guarantees and financial benefits, it is appropriate to consider the value of the guarantees and benefits in assessing reasonableness.

22 "What it Means to be an ERISA Fiduciary: A Comparison to the Securities Laws," David C. Kaleda, NSCP Currents May/June 2013, available at http://www.groom.com/media/publication/1269_ERISA_Fiduciary_Comparison_to_Securities_Laws.pdf.

23 ERISA section 409(a).

24 ERISA section 501.

25 ERISA section 502(a).

26 ERISA section 502(l). The "applicable recovery amount" is any amount recovered from the fiduciary for the breach.

27 Code section 4975(a). "Taxable period" means the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of: (1) the date of mailing a notice of deficiency with respect to the tax imposed by IRC section 6212(a); (2) the date on which the tax imposed by IRC section 4975(a) is assessed; or (3) the date on which correction of the prohibited transaction is completed.

28 IRC section 4975(b).

Nationwide®

NFM-15900AO (10/16)