

THE ASPPA Journal

ASPPA's Quarterly Journal for Actuaries, Consultants, Administrators and Other Retirement Plan Professionals

How to Identify and Avoid Conflicts of Interest When Selecting Service Providers

by Gary D. Blachman

In the last few years, plan fiduciaries have seen a dramatically increased focus on their responsibilities, resulting in dozens of class action lawsuits alleging that fiduciaries have breached their duties with respect to certain requirements, such as the selection and monitoring of prudent investments, providing required disclosures and the appointment of independent advisors.

Due to the increased attention that the government (*i.e.*, IRS, DOL and SEC) is giving potential conflicts of interest with a plan's consultants, plan fiduciaries should diligently assess each proposed service provider regarding the retirement plan to identify any potential conflicts that may impede the service provider's ability to provide objective advice for the benefit of the plan's participants. Many plan fiduciaries have robust procedures to recognize and manage conflicts of interest. However, many do not have such resources and may not be following best practices. It is vital that decisions are made by plan fiduciaries, and are perceived to be made, in the best interest of the plan participants and beneficiaries.

If a responsible plan fiduciary does not understand his or her responsibility in selecting and monitoring service providers or does not have appropriate experience in doing so, there can be significant financial consequences to the plan sponsor. This article discusses the laws relating to conflicts of interest that plan fiduciaries will need to know when selecting the investments and service providers for their retirement plans with a view to sharing best practices.



Identifying the Fiduciary

The Employee Retirement Income Security Act of 1974 (ERISA) as amended imposes significant responsibilities upon the plan sponsor of an employee benefit plan. Due to the significance of these responsibilities, many employers choose to create a benefits committee (a "Committee") to manage and control the daily operation and administration of any retirement plans they sponsor. ERISA Section 3(21) establishes a broad definition of a fiduciary. Generally, a person is a fiduciary to the extent that he or she has

Generally, a person is a fiduciary to the extent that he or she has any discretionary authority or responsibility in the administration or management of a plan or exercises any discretionary authority or control with respect to management or disposition of the plan's assets.

any discretionary authority or responsibility in the administration or management of a plan or exercises any discretionary authority or control with respect to management or disposition of the plan's assets. Under this definition, Committee members generally function as fiduciaries for purposes of ERISA and are subject to higher standards of conduct because they act on behalf of plan participants and beneficiaries.

What are the Fiduciaries' Responsibilities?

ERISA Section 404(a) contains the following standards to which fiduciaries are held in the discharge of their duties:

- Acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them and defraying reasonable expenses of administering the plan;
- Carrying out their duties prudently;
- Diversifying investments of the plan to minimize risk of large losses (unless under the circumstances it is prudent not to do so); and
- Following the plan documents (unless inconsistent with ERISA).

Therefore, plan fiduciaries have a duty of loyalty to participating employees and must act for the exclusive purpose of providing retirement benefits to participants. Further, the duty to act prudently requires plan fiduciaries to implement sound procedures when selecting service providers to the plan which requires careful consideration of any potential conflicts of interest.

Identifying Conflicts of Interest and the Prohibited Transaction Rules

When a conflict exists involving a tax-qualified retirement plan, either the fiduciary requirements of ERISA Section 404(a) and/or the prohibited transaction rules under ERISA Section 406(a) and/or (b) will be involved. A conflict of interest may arise when a fiduciary (which includes a trustee) is required to make a decision where:

- the fiduciary is obliged to act in the best interests of the participant and beneficiary; and
- at the same time he or she has or may have either
 - (a) a direct or indirect personal interest, or
 - (b) another fiduciary duty owed to a different beneficiary relative to that decision, giving rise to a possible conflict with the first fiduciary duty. For example, a retirement plan trustee of company "A" may own shares or have financial interests in various

companies in which the other retirement plan trustees of company "A" wish to invest the retirement plan assets of company "A," giving rise to a conflict of interest.

ERISA's prohibited transaction rules are considered "per se" violations and do not require fiduciary wrongdoing under ERISA Section 404(a). However, even if a transaction is statutorily exempt from the prohibited transaction rules, the fiduciary rules of ERISA Section 404(a) will still apply. For example, it is not a prohibited transaction or "per se" violation under ERISA Section 406 for a bank which serves as an ESOP trustee (fiduciary) to purchase the stock of employer "X" (plan sponsor) for the ESOP even though the bank was a secured creditor of employer "X." However, the bank could be held liable for a breach of its fiduciary duty upon sufficient proof that the decision was not prudent or entered into for the exclusive benefit of the plan participants and beneficiaries.

Under ERISA Section 406(a), fiduciaries are prohibited from allowing the plan to enter into certain transactions with "parties in interest" such as service providers or other fiduciaries. ERISA Section 406(a) is intended to prohibit fiduciaries from engaging in certain transactions with the plan such as selling or leasing property, lending money or extending credit or transferring plan assets to a party in interest. Fiduciaries who violate ERISA Section 406(a) can be held liable to the plan and required to return any unreasonable or excessive fees.

ERISA Section 406(b) prohibits fiduciaries from (1) dealing with plan assets for their own interest; (2) acting adverse to the plan; and (3) receiving consideration from a party dealing with the plan in a transaction involving plan assets. Fiduciaries who violate ERISA Section 406(b) can be held liable to the plan and required to disgorge any "ill-gotten profits" resulting from the breach even if the plan does not suffer any actual losses.

Evaluating whether transactions that involve a conflict of interest are violations of ERISA's fiduciary and prohibited transaction rules is challenging at best. Generally, when considering conflicts of interest, a fiduciary should consider these steps:

- identification—for any conflicts management procedure to be successful it must include a process for identifying conflicts;
- monitoring; and
- managing conflicts.

Fiduciaries are obligated by ERISA to (1) identify conflicts (or potential conflicts)

that may impact the management of the plan; (2) evaluate the conflicts and the impact they may have on the plan and its participants; (3) determine whether the conflicts will adversely impact the plan; (4) consider protections for the plan and participants arising from any conflicts; and (5) change service providers if the conflict negatively affects the plan and the participants and beneficiaries. Therefore, when selecting service providers, fiduciaries must engage in a prudent process. As part of that process, the fiduciaries must also consider avoiding conflicts of interest.

Fee Disclosures and Conflicts of Interest in the Current Environment

ERISA's existing fiduciary duties in Sections 404 and 408(b)(2) require plan fiduciaries to ensure that fees paid to service providers are reasonable. To satisfy this duty, plan fiduciaries must obtain information about fees and potential conflicts of interest. When selecting service providers, ERISA Section 404(a)(1) requires fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable plan expenses. It is paramount then that appropriate information be available so that fiduciaries can evaluate data and make informed decisions about services providers, the services being offered and the costs of those services. Current DOL guidance regarding the obligations of fiduciaries and required disclosures can be found in Field Assistance Bulletin 2002-3 (November 5, 2002) and Advisory Opinions 97-16A (May 22, 1997) and 97-15A (May 22, 1997). The DOL Web site (www.dol.gov/ebsa/publications) also provides guidance for plan fiduciaries to evaluate fees and service provider relationships including a Model Plan Fee Disclosure Form to compare the costs of investment products offered by service providers.

ERISA Section 406(a)(1)(C) prohibits the furnishing of goods, services or facilities between a plan and a party in interest to the plan. Without specific relief, a relationship between a plan and service provider would constitute a prohibited transaction. To alleviate this problem, ERISA Section 408(b)(2) provides exemption relief from the prohibited transaction rules for service contracts between a plan and party in interest if the contract is reasonable, the services are necessary for the establishment or ongoing plan operation and reasonable compensation is charged for the services. Current regulations clarify these conditions and provide that a contract or arrangement is not reasonable unless it permits the plan to terminate

without penalty on reasonably short notice.

Over the years technology has improved administrative efficiencies and reduced the costs of services offered to retirement plans and their participants and beneficiaries. However, the changes in the way services are provided have not always made it easier for plan sponsors and fiduciaries to know exactly what the plan pays for services, the extent to which service provider fee arrangements might present potential conflicts of interest or if a contract is reasonable. As a result, there is an increased demand for guidance regarding service provider compensation and conflicts of interest that may affect a service provider's performance.

Fee Disclosures and Conflicts of Interest under Proposed Legislation

In response to the complexities of service provider arrangements and the potential for conflicts of interest that may affect administrative costs and the services provided, a number of measures have recently been introduced in Congress that would require detailed disclosures of fees paid to service providers. These proposed laws are the direct result of a number of lawsuits filed against Fortune 500 companies alleging that these companies' 401(k) plans were paying unreasonable fees and the companies did not adequately disclose these fees to plan participants. In 2007, the US Department of Labor (DOL) issued proposed rules under ERISA Section 408(b)(2) regarding fee disclosures by fiduciaries of retirement plans. The purpose of the proposed rules is to help fiduciaries (1) determine the reasonableness of compensation paid to service providers to the plan and (2) identify any conflicts of interest that may affect a service provider's performance under its arrangement with the plan sponsor.

The DOL realized that plan fiduciaries may not always need all of the required disclosures from every type of service provider to evaluate the reasonableness of the service provider's compensation. Therefore, with regard to conflicts of interest, the DOL's proposed rules require disclosure of the following: (1) whether the service provider or an affiliate will be acting as a fiduciary, under ERISA or the Investment Advisers Act of 1940; (2) whether the service provider or an affiliate expects to acquire a financial interest in any transaction involving the plan that will occur in connection with the service arrangement; (3) whether the service provider or an affiliate has any material financial, referral or other relationship with any other parties that creates or may create a conflict of interest; (4) whether the service

When selecting service providers, ERISA Section 404(a)(1) requires fiduciaries to act prudently and solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable plan expenses.

provider or an affiliate has the ability to affect its own compensation (direct or indirect) without the prior approval of an independent plan fiduciary; and (5) whether the service provider or an affiliate has procedures to prevent and/or manage these conflicts of interest. Additionally, the proposed rules include ongoing disclosure obligations that should help in preventing conflicts of interest. Certainly with respect to fee disclosures and potential conflicts of interest, we can expect to see more attempts by Congress to develop new regulations with higher expectations that sponsors are aware of and avoiding any conflicts of interest with service providers.

Best Practices

Developing a process for identifying conflicts is instrumental to the management process. Fiduciaries who take the time to identify conflicts of interest are inherently better situated to manage conflict situations as they arise. Fiduciaries must manage actual conflicts and determine what types of action, if any, are required. The point at which a potential conflict becomes an actual conflict will vary and should be factored into the management process. Perceived conflicts are also very important. Such conflicts may surface when, although a trustee's decision is appropriate, it may appear to others (e.g., plan participants) as influenced, or open to influence, by other persons or responsibilities of the trustee. When selecting the plan's investments, fiduciaries should be careful to focus on the plan's interests and not be swayed by outside economic factors that may subordinate the interests of plan participants and beneficiaries.

Are Fiduciaries and Trustees Required to Declare Potential Conflicts?

Even before a real or potential conflict can be identified, all fiduciaries and trustees must be aware of the other interests or obligations owed by each to another party that may cause a conflict. A formal process to declare conflicts becomes essential at this point.

Is There a Formal Process to Identify Potential Conflicts?

A newly appointed fiduciary or trustee should be required to disclose any potential interests or conflicts. The declaration does not need to be formal and could consist of requiring the trustee to simply declare that he or she is not aware of any potential conflicts of interest that may adversely affect his or her new role, other than those

interests that were previously and expressly disclosed. This disclosure will enable the current named fiduciary to be aware of any current conflicts and monitor any potential conflicts that may arise down the road. To be effective, any declaration should be periodically updated (e.g., annually) and when circumstances change. Fiduciaries and trustees should consider discussing conflicts during committee meetings so that there is open communication about situations that could give rise to a potential conflict.

Should the Minutes of Meetings Record when Conflicts Are Disclosed or Identified and the Specific Actions to Be Taken to Address Real or Potential Conflict?

Formal meeting minutes should record any discussions of actual or potential conflicts and the agreed upon actions that will be taken to address such conflicts. A record of any conflicts, along with the actions taken and key factors influencing any decisions that are made, should be recorded and maintained for effective monitoring. This process allows time for sufficient planning and the development of any action steps necessary to recognize and diffuse any conflicts of interest. If litigation should ever arise, a practice of recording conflicts in the minutes will enable the trustees to demonstrate that appropriate steps were taken to satisfy their fiduciary duty to act independently. Of course, once a potential conflict is identified and recorded, specific actions must also be taken to monitor and avoid an actual conflict of interest in order to satisfy fiduciary duties.

Although ERISA permits named fiduciaries of a retirement plan to allocate non-trustee responsibilities for the operation and administration of the plan amongst themselves, and to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities), these limitations offer less than perfect protection to fiduciaries. Specifically, under ERISA Section 405(a), if a plan has more than one fiduciary, each fiduciary will be liable for a breach of fiduciary responsibility by a co-fiduciary if: (i) he or she participates knowingly in, or knowingly tries to conceal, the other fiduciary's act or omission, knowing that it is a breach; (ii) by his or her failure to comply with the fiduciary responsibility rules in the administration of his or her specific fiduciary responsibilities he or she has enabled the other fiduciary to commit a breach; or (iii) he or she has knowledge of a breach by the other fiduciary and does not make a reasonable effort to remedy the breach. For example, if the terms of a trust agreement require assets not to be invested in commodity futures and one of the two co-trustees suggests to the second trustee that he or she invest plan assets in commodity futures, if the second trustee makes the investment, both trustees will be



held liable for the breach of fiduciary duty under ERISA Section 405(a).

Is There a Documented Conflicts of Interest Policy?

Trustees should have a thorough understanding of their powers, duties and responsibilities so that they can more easily recognize conflicts. A solid conflicts policy should provide specific examples of the types of conflicts that could arise during the course of business. By identifying conflicts, plan fiduciaries are better situated to implement procedures to monitor and avoid conflicts. A documented conflicts of interest policy should include procedures to identify and manage conflicts. All of the plan trustees should approve any governing documentation to manage conflicts and ensure independence throughout the process. This policy will allow trustees to demonstrate to participants that appropriate measures have been taken to ensure conflicts are properly managed.

What Should Be Included in the Conflicts of Interest Policy?

The policy should include: (i) an explanation of the fiduciary obligation to act independently and in the best interests of participants and beneficiaries; (ii) a process for identifying conflicts; (iii) the types of conflicts that may arise; (iv) options for managing conflicts; (v) the process to avoid potential conflicts; and (vi) procedures for monitoring non-compliance with the policy.


What Happens if a Fiduciary Violates His or Her Duties?

To avoid liability for violations of ERISA's fiduciary or prohibited transaction rules involving conflicts of interest, fiduciaries must be able to identify when liability can be imposed. A fiduciary who violates his or her duties and fails to avoid a conflict of interest may, depending on the violation, be subject to certain excise taxes, lost opportunity costs, disgorgement of profits, equitable relief and personal liability to restore any losses to the plan.

Under the Employee Benefits Security Administration's (EBSA's) voluntary fiduciary correction (VFC) program, adopted by the DOL, certain persons who are potentially liable for a breach of fiduciary duties because of specified transactions may be relieved of (i) civil penalties and (ii) possible civil investigation or civil action by the DOL. The EBSA will issue a "no action letter" for any breach if the VFC program eligibility requirements are met and the fiduciary breach is corrected. A VFC correction requires any losses to be restored to the plan and to affected participants and beneficiaries.

The Internal Revenue Service (IRS) also provides a voluntary correction program for qualified retirement plans under Revenue Procedure 2008-50. This latest version of the Employee Plans Compliance Resolution System (EPCRS) revised earlier versions of the program and continues to have a self-correction program (SCP) available for minor errors and more significant, recent errors; a voluntary correction program (VCP) involving a submission to the IRS and a fixed fee for errors that cannot be corrected through SCP; and a correction program for errors discovered by the IRS on audit (Audit CAP). Generally, the most common fiduciary and prohibited transaction errors found in retirement plans may be corrected under either the DOL's VFC program or the IRS's EPCRS program.

Conclusion

Committee members often have discretion over the selection of plan service providers or investment providers and are therefore considered fiduciaries. Plan fiduciaries are responsible for prudently selecting investment consultants and monitoring their ongoing performance. By establishing appropriate practices to select and monitor investment consultants and other service providers, plan trustees can successfully fulfill their fiduciary duties to the plan participants and beneficiaries while avoiding conflicts of interest. Avoiding conflicts of interest and taking appropriate steps to reduce the negative impact of any conflicts is essential to safeguard retirement plans and the benefits of participants and beneficiaries. Given the desire by Congress to require greater transparency with regard to 401(k) fees and to reduce the number of potential conflicts of interest involving service providers, the retirement plan community should not be surprised to see more regulation in this area in the very near future. 

Given the desire by Congress to require greater transparency with regard to 401(k) fees and to reduce the number of potential conflicts of interest involving service providers, the retirement plan community should not be surprised to see more regulation in this area in the very near future.



Gary D. Blachman, Esq., is a partner with Thompson Hine, LLP where he is a member of the firm's national employee benefits and executive compensation group. He counsels large public and private companies in the design and administration of tax-qualified retirement plans, executive compensation under IRC 409A and health and welfare plan matters. Gary also has extensive experience in the employee benefit aspects of mergers and acquisitions. Additionally, he counsels clients on IRS and DOL compliance matters, including voluntary correction programs and determination letter filings. Gary is a past president of the Cincinnati ASPPA Benefits Council and is currently serving as Co-chair of 2009's The ASPPA Cincinnati Pension Conference. Gary is also a member of the Great Lakes Area IRS Tax Exempt and Government Entities Council. (gary.blachman@thompsonhine.com)