Fiduciary Developments
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Agenda
• Background
• DOL Developments
• SEC’s Regulation Best Interest
• State Initiatives

Fiduciary Duties
• Duty of Loyalty - Operate the plan solely in the interest of participants and beneficiaries.
• Duty to act “prudently” – Act as a professional would perform under similar circumstances.
• Duty to diversify plan assets.
• Duty to follow the plan documents (unless they are inconsistent with ERISA).
Breach = Liability

- Personal liability.
- Cannot be relieved of responsibility or liability (no exculpatory provisions).
- Plan assets cannot be used to indemnify a fiduciary.

Allocation of Duties

- ERISA §402(b) – plan must include any procedures for allocating responsibilities of plan operation and management.

Delegation of Duties

- §405(c)(1) provides:
  - The instrument under which a plan is maintained may expressly provide, for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities
  - then such fiduciary shall not be liable for an act or omission of such person if prudently selected and monitored...
Allocation/Delegation

• No joint liability except for the situations in described in ERISA §405 where the co-fiduciary:
  • Knowingly participates in a breach;
  • Enables the breach; or
  • Has knowledge of a breach, unless reasonable efforts are made to remedy the breach.

5 Types of Fiduciaries

• Named fiduciaries (ERISA §402(a)(1))
• Plan administrators (ERISA §3(16))
• Functional fiduciaries (ERISA §3(21)(A))
• Plan trustees (ERISA §403)
• Investment managers (ERISA §3(38))

Named Fiduciary

• ERISA §402(a)
  • Plans must have one or more named fiduciaries who jointly or severally have the authority to control and manage the operation and administration of the plan.
Named Fiduciary
• Named in plan, or
• Pursuant to plan procedure, is identified as a fiduciary by:
  • An employer and/or an employee organization.
• You can’t be a named fiduciary by “accident”

Plan Administrator – §3(16)
• ERISA Definition – §3(16)(A) – The term administrator means:
  • The person specifically so designated by the terms of the instrument under which the plan is operated,
  • If an administrator is not so designated, the plan sponsor.

Functional Fiduciary
WHAT IF I TOLD YOU
YOU MAY BE A FIDUCIARY
Functional Fiduciary – 3(21)
• ERISA Definition – §3(21)(A) - a person is a fiduciary with respect to a plan to the extent he or she:
  • Exercises any discretionary authority or discretionary control respecting management of such plan, or
  • Exercises any authority or control respecting management or disposition of assets.
  • Renders investment advice for a fee or other compensation (direct or indirect), with respect to the plan, or has any authority or responsibility to do so, or
  • Has any discretionary authority or discretionary responsibility in the administration of such plan.

Ministerial Functions
• Not a fiduciary if you only perform ministerial functions.
• This is the case even if you have to make discretionary decisions in performing those ministerial functions.
Ministerial Functions

• DOL Interpretive Bulletin 75-8 provides that the following are generally not fiduciaries:
  • Attorney
  • Accountant
  • Actuary
  • Consultant

Ministerial Functions

• Applying eligibility rules to participation or benefits and calculating benefits and crediting service.
• Preparing employee communications and benefit statements.
• Preparing drafts of government filings.
• Maintaining records.
• Collecting and/or applying contributions, accounting and reconciling data.
• Processing approved claims and loans for distribution.
• Orientation of participants and providing plan information.
• Making plan administration recommendations.

“Good Samaritan”

• Trying to help correct violations generally not a fiduciary act
• But cannot usurp plan administrator’s discretionary authority

Beddall v. State Street Bank and Trust Co., 137 F.3d 12 (1st Cir. 1998)
and CSA 401(k) Plan v. Pension Professionals Inc., 195 F.3d 1135
(9th Cir. 1999)
Late Deposit of Deferrals

• TPA found that deferrals were not being deposited.
• TPA continued services because:
  • Employer agreed to repay the deferrals; and
  • Employer agreed to include on participant statements:
    “Contrary to the requirements of the Department of Labor and the Internal Revenue Service, a portion of the 401(k) benefits have not yet been received by the trust”
• TPA resigned when the repayments stopped and the TPA did not notify the government.

Late Deposit of Deferrals

• The argument was that the TPA was liable as a fiduciary because it exercised authority and control over plan administration after its discovery of the embezzlement and failed to take reasonable steps to warn the participants or the government.
• Court held the TPA was not a fiduciary.
  • TPA’s continuation of services were designed to assert control over its own engagement, and not to exercise authority or control over the plan’s management or administration.
  • Not clear what liability there would have been had the TPA continued services and not required a notice on participant statements.

CSA 401(k) Plan v. Pension Professionals Inc., 195 F.3d 1135 (9th Cir. 1999)

Signing Authority

• You are a probably a fiduciary if you have signing authority over distributions
  • You have authority or control over plan assets
  • Different than control over management or administration of plan where discretionary authority is required
  • See Coldesina Profit Sharing Plan and Trust v. Estate of Simper, 407 F.3d 1126 (10th Cir. 2005)
Other Cases

- Furnishing blackout notices to plan participants not a fiduciary act (Milofsky v. American Airlines, Inc., 404 F.3d 338 (3d Cir. 2005))
- Consultant did not assume fiduciary status merely by calculating participant’s projected retirement benefit upon participant’s request (Lebahn v. National Farmers Union Uniform Pension Plan, 828 F.3d 1180 (10th Cir. July 11, 2016))
- Responsibility to perform ADP testing did not make service provider a fiduciary (Flanagan Lieberman Hoffman & Swaim v. Transamerica Life and Annuity Company, 228 F.Supp.2d 830 (S.D. Ohio 2002))

Definition of Fiduciary Advisor

- Provision of investment advice triggers ERISA fiduciary status.
- ERISA §3(21)(A)(i) and Reg. §2510.3-21(a) define the rendering of investment advice for this purpose.
- The definition of what constitutes the giving of “investment advice” (and therefore fiduciary status) has been based on a 40-year old regulation that contains a rather infamous “five-part test.”
“Prohibited Transactions”

• A fiduciary must not cause the plan to engage in a non-exempt prohibited transaction.
• Fiduciaries are prohibited from engaging in self-dealing transactions or receiving third-party payments in connection with plan transactions.

Self-Dealing/Third-Party Payments

• Example: Joe is hired to provide investment advice to participants in a 401(k) plan.
• Joe is a fiduciary because he gives investment advice.
• An investment provider of an investment product that Joe recommends to participants pays him a higher commission than the providers of comparable products.
• Because Joe is a fiduciary -
  • he has engaged in an act of self-dealing when he recommends the higher commission investment product; and
  • has impermissibly received third-party payments if he receives a commission from the provider (unless he otherwise fits within an exemption).
• If Joe wasn’t a fiduciary, there would be nothing wrong with his receipt of the commission.

Existing Definition of Fiduciary Advisor

• Current “five-part test” provides that a person is an investment advice fiduciary if he/she:
  (1) Makes recommendations on investing in, purchasing, or selling securities or other property, or gives advice as to their value;
  (2) On a regular basis;
  (3) Pursuant to a mutual understanding that the advice;
  (4) Will serve as a primary basis for investment decisions; and
  (5) Will be individualized to the particular needs of the plan.
Definition of Fiduciary Advisor

- Key components of the five-part test:
  - Advice must be given on a "regular basis" and
  - Must be the "primary basis" for investment decisions.
- Many advisors have maintained over the years that their recommendations did not meet all five parts of the test and therefore they were not fiduciaries.
- DOL has indicated that applying this test in enforcement actions has been problematic and one of the underlying justifications for the regulation that was adopted.

2016 Final Regulation

- The final regulation replaced the 5-part test with a new much more expansive definition of who would be a fiduciary by virtue of giving investment advice.
- It would have resulted in far more broker-dealer representatives being classified as ERISA fiduciaries.
- It would have applied to IRAs by virtue of the prohibited transaction excise tax rules under IRC section 4975.
- The Best Interest Contract Exemption would have allowed the receipt of commissions by fiduciaries if certain conditions were satisfied.
Final Regulation
• The final regulation became officially effective on June 7, 2016.
• With that said, the date on which the new rules actually were to be applied (the “Applicability Date”) was scheduled to be April 10, 2017.
• The Best Interest Contract Exemption was likewise scheduled to become effective on April 10, 2017, with a “slimmed down” BIC exemption transition period from April 10, 2017, until January 1, 2018.

Presidential Memo
• On February 3, 2017, President Trump issued a Presidential Memorandum directing the DOL to:
  “...examine the Fiduciary Duty Rule to determine whether it may adversely affect the ability of Americans to gain access to retirement information and financial advice.”

Effective Date
• On April 7, 2017, the DOL issued a final regulation that extended the Applicability Date for 60 days until June 9, 2017.
• The DOL pledged to examine the regulation in accordance with the President’s directive during the transition period and, if merited make revisions to the rule or the BICE.
DOL – Fiduciary Update

• On June 21, 2018, the Fifth Circuit Court of Appeals, in the case of Chamber of Commerce v. DOL, 885 F.3d 360 (5th Cir. 2018), vacated the final regulation making it null and void.
• The DOL announced at the time (in FAB 2018-02) that it would adopt a temporary enforcement policy indicating the Department would not pursue prohibited transaction claims against fiduciaries who are working diligently and in good faith to comply with the impartial conduct standards in the BIC exemption.

Ultimately, the DOL chose not to appeal the Fifth Circuit decision and as a result the regulation never came into effect.
• The DOL announced it would consider a new and revised regulatory proposal.
• In particular, DOL officials have indicated a desire to harmonize their regulation with the SEC’s Regulation Best Interest.
• The DOL guidance plan indicates the DOL expects to issue a proposed regulation in December of 2019. Obviously that timeline has not been met.
• Some have commented that with any further delay, a final regulation could be subject to invalidation in 2021 under the Congressional Review Act if the Democrats gain control of both Houses of Congress and the White House.

SEC REGULATION BEST INTEREST
SEC Regulation Best Interest

• On June 5, 2019, the SEC simultaneously adopted Regulation Best Interest (Reg. BI), several pieces of interpretative guidance and a new disclosure obligation to customers known as the Form CRS (Customer Relationship Summary).

• Although Reg. BI was effective September 10, 2019, the SEC has provided for a 1-year transition period with an actual compliance date of June 30, 2020.

SEC Regulation Best Interest

• Applies to brokers, dealers and their associated representatives (broker(s)).

• Obligates a broker, when making a recommendation to a retail customer regarding a securities transaction (or an investment strategy) to act in that customer’s best interest without placing the financial or other interest of the broker ahead of the customer’s interest.

• This general best interest obligation is satisfied by meeting 4 component obligations.

Reg. BI – Component Obligations

• Disclosure Obligation – at the time of (or prior to) a recommendation, a full and fair disclosure of:
  • All material facts regarding the scope and terms of the relationship such as the fees to be charged and the services to be provided;
  • Material limitations on the securities or strategies that may be recommended; and
  • All material facts relating to conflicts of interest associated with the recommendation.
Reg. BI – Component Obligations

• Care Obligation – the broker, in making the recommendation, must exercise reasonable diligence, care and skill to:
  • Reasonable Basis Component - Understand the potential risks, rewards and costs associated with the recommendation and have a reasonable basis that the recommendation could be in the best interest of at least some retail customers;
  • Customer Specific Component - Have a reasonable basis that the recommendation is in the best interest of a particular retail customer after consideration of his or her investment profile and does not place the broker’s financial interest ahead of the customer;
  • Quantitative Component - Have a reasonable basis to believe that a series of recommended transactions is not excessive and in the retail customer’s best interest and does not place the broker’s financial interest ahead of the customer.

Reg. BI – Component Obligations

• Conflict of Interest Obligation – the broker must establish, maintain, and enforce written policies and procedures reasonably designed to:
  • Identify, and at a minimum disclose in accordance with the disclosure obligation, or eliminate, all conflicts of interest associated with recommendations;
  • Identify and mitigate any conflicts associated the recommendation that would create an incentive for a person to place his or her own interest ahead of the retail customer;
  • Identify and disclose any material limitations placed on securities or investment strategies; and
  • Identify and eliminate any sales contests, sales quotas, bonuses and non-cash compensation that are based on sales of specific securities within a limited period of time.

Reg. BI – Component Obligations

• Compliance Obligation – In addition to the policies and procedures applied under the conflict of interest component obligation, the broker must also establish, maintain and enforce policies and procedures reasonably designed to achieve compliance with the regulation.
Reg. BI – Retirement Plan Issues

• Reg. BI applies to recommendations made with respect to a person's retirement account(s) such as IRAs, 401(k) plans, 403(b) plans.
• Reg. BI does not apply to recommendations made to an ERISA plan fiduciary (although not entirely clear with respect to a plan covering only the owner/trustee).

Reg. BI – Retirement Plan Issues

• Applies to investment strategy recommendations which include:
  • Rollover recommendations irrespective of whether a security transaction is recommended at the same time; and
  • Account recommendations such as recommendations to open an IRA, a brokerage account or an advisory account.

Reg. BI – Court Challenge

• In September of 2019, two lawsuits were filed in the Federal District Court for the Southern District of New York challenging the validity of Reg. BI.
  • One case was filed by the attorneys general of 8 states and the second by 2 investment advisory firms.
  • The lawsuit alleges the SEC did not follow the mandate in the Dodd-Frank Act with regard to a single standard for both broker-dealers and RIAs.
• The cases, which were consolidated, were dismissed by the District Court for lack of subject matter jurisdiction.
• The cases were refiled with the Second Circuit Court of Appeals which has jurisdiction under federal law.
• Many believe the Court will uphold Reg. BI.
STATE FIDUCIARY DEVELOPMENTS

Fiduciary – State Developments

• Various initiatives have been put forward at the state level to impose a fiduciary obligation under state law, particularly in light of the DOL rule being vacated and a belief that Reg. BI is not strong enough.
• Some states have already adopted legislation or regulations while others are expected to move forward shortly.

Fiduciary Update – State Developments

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Fiduciary – State Developments

• Nevada was the first to move forward as a result of Nevada SB 383 which became effective July 1, 2017.
• The bill amended the definition of financial planner under Nevada law to include brokers, dealers, investment advisors and associated persons.

Nevada Fiduciary Standard

• Nevada law has provided for some that “financial planners” have “…the duty of a fiduciary toward a client.”
• Under Nevada law, financial planners are subject to a fiduciary standard when providing investment advice to customers.
• Effective July 1, 2017, broker-dealers, broker-dealer sales representatives and most investment advisors licensed under state or federal law became subject to this law when an statutory exemption was removed by SB 383.
• The net effect is that advisors could be subject to both a federal and a state imposed fiduciary duty.

Nevada Fiduciary Standard

• A “financial planner” is defined as “…a person who for compensation advises others on the investment of money or upon provision of income to be needed in the future or holds himself or herself out as qualified to perform either of these functions.”
• Needless to say, this definition could be read very broadly.
Nevada Fiduciary Standard

- Under the statute, a “financial planner” must:
  - At the time advice is given, disclose any gain (such as profit or commission) he or she will receive if the advice is followed;
  - Make diligent inquiry to ascertain initially the client’s financial circumstances and goals for his or her family; and
  - Keep currently informed concerning the client’s financial circumstances and family goals.
- A claim under state law may be filed for any economic loss caused by the “financial planner” as a result of negligence or a violation of his or her fiduciary duty.

Nevada Fiduciary Standard

- With regard to the new law’s application to broker-dealers, B/D sales representatives, or licensed investment advisors, the Nevada Division of Securities has been given broad authority to write implementing regulations that:
  - Define or exclude an act, practice or course of business that is a violation of one’s fiduciary duty;
  - Prescribe means reasonably designed to preclude one from engaging in acts, practices, or courses of business defined as a violation of such fiduciary duty.

Nevada Fiduciary Standard

- A “workshop” on potential regulatory approaches was held by the Nevada Division of Securities on October 6, 2017.
- ASPPA/ARA GAC submitted comment letters and testified at the October workshop.
- The letters outlined how ERISA pre-empts state laws that relate to ERISA plans and as a result, the Nevada law would not apply in the context of investment advice given to ERISA plan participants or fiduciaries.
- ASPPA/ARA recommended that the Nevada regulations specifically exclude advice to ERISA plans and participants from being covered by the new law.
**Nevada Fiduciary Standard**

- A draft of the regulation was released on January 18, 2019, and comments were due by March 1, 2019.
- The Nevada Securities Division is currently considering the comments that came in and has not yet issued final regulations.
- The proposed regulations DO NOT include an exemption for fiduciary advisory services to ERISA-covered retirement plans, participants or beneficiaries was included in the proposal but there remains a good chance it will be in the final regulation.

**Nevada Fiduciary Standard**

- The proposed regulations apply a rebuttable presumption that BDs are acting in a fiduciary capacity if they:
  - provides investment advice to clients;
  - manages assets;
  - performs discretionary trading
  - utilizes a title or term set forth on the next slide; or
  - who otherwise establishes a fiduciary relationship with clients.
- The proposal also applies a new fiduciary standard for investment advisors under Nevada law.

**Nevada Fiduciary Standard**

- Titles that raise a presumption of fiduciary status for BDs:
  - advisor, adviser;
  - financial planner, financial consultant;
  - retirement consultant, retirement planner;
  - wealth manager;
  - counselor; or
  - other titles Nevada regulators may, by order, deem appropriate.
Nevada Fiduciary Standard

• Titles that would presume BD fiduciary status under the regulation include:
  • Recommendations to buy, hold or sell a security;
  • Providing analyses or reports on the value of a security;
  • Recommendations regarding the type of account to open;
  • Providing information on a personalized investment strategy;
  • Providing a limited list of Securities that is tailored to the client; and
  • Recommendations regarding another BD, or investment advisor.

Nevada Fiduciary Standard

• Under the proposed regulations, the fiduciary conduct standard is breached if the BD or investment advisor:
  • Fails to perform reasonable due diligence on a security or investment strategy;
  • Recommends a security that is not in the client’s best interest;
  • Puts their own interest, the firm’s interest or other client’s interest ahead of their client’s interest;
  • Fails to disclose that a recommended investment product is a propriety product or from a limited list of products;
  • Fails to adequately disclose all information regarding a potential conflict of interest;
  • Recommends or charges a fee that is unreasonable;
  • Limits the availability of securities to certain clients unless based on a client’s investment strategy or firm limitations.

Nevada Fiduciary Standard

• Under the proposed regulations, it is not by itself a per se breach of the fiduciary conduct standard:
  • To sell a proprietary product or hold a cash position if the conduct doesn’t otherwise violate the law or FINRA rules and the client is advised of the risks associated with the product or cash position; and
  • To receive transaction based commissions as long as it is the client’s best interest to be charged on a transaction basis as compared to other types of fees and the commission is reasonable.
The proposed regulations clarify the "gains" (i.e., compensation that must be disclosed at the time investment advice is given) to include:
- percentage of managed assets fee;
- commission on the sale of a security;
- mark up or mark down commissions;
- market maker commissions (Electronic Communication Network rebates or credits);
- discounts based upon number of transactions or clients;
- management fees;
- deferred or trailed, fees or commission;
- front end load or back end load fees;
- service fees; or
- payment for order flow.

The proposed regulations DO NOT include an exemption for fiduciary advisory services to ERISA-covered retirement plans, plan fiduciaries and plan participants was included in the proposal. ASPPA/ARA remains optimistic that an ERISA exemption will be included in the final regulation.

The Nevada regulations are also expected to be challenged on the basis of federal preemption by the 1996 National Securities Markets Improvement Act. NSMIA precludes states from requiring broker-dealers to make and keep records that are different than those required under federal securities law. This same challenge is likely to made to other state efforts around the country.
New Jersey Fiduciary Standard

- New Jersey issued a pre-proposal announcement in October of 2018 and held hearings in November and December.
- On April 15, 2019, the New Jersey Division of Consumer Affairs issued proposed regulations for which comments were due by June 14, 2019.

New Jersey Fiduciary Standard

- Under the proposal, failure of a broker, dealer, investment advisor or their representative to act under a fiduciary standard when making recommendations would be defined as a "dishonest and unethical business practice" under New Jersey law.
- The New Jersey proposal provides a specific exemption for persons acting in their capacity as a fiduciary to an employee benefit plan and its participants and beneficiaries as defined under ERISA.

Mass. Fiduciary Standard

- On June 14, 2019, Secretary of the Commonwealth of Massachusetts, William Galvin, released through the Securities Division, a request for preliminary comment on a proposed regulation to apply a fiduciary conduct standard to broker-dealers, investment advisers and their representatives.
- On December 13, 2019, Secretary Galvin formally released a revised and more detailed proposed regulation.
- Comments were due by January 7, 2020.
Mass. Fiduciary Standard

- Under the proposal, failure of a broker, dealer, investment advisor or their representative to act under a fiduciary standard when making recommendations would be defined as a “dishonest and unethical business practice” under New Jersey law.
- It would apply when providing investment advice or recommending an investment strategy, the opening or transferring of assets of any type of account, or the purchase, sale, or exchange of any security, commodity, or insurance product.

Mass. Fiduciary Standard

- The proposal would require a broker dealer to adhere to duties of utmost care and loyalty to the customer or client.
- The duty of care is identical to the prudent man rule under ERISA.
- The duty of loyalty requires:
  - Disclosure of all material conflicts of interest;
  - That all reasonable steps be taken to avoid conflicts, eliminate conflicts that cannot be avoided or mitigated conflicts that cannot be avoided or eliminated; and
  - That all recommendations are made without regard to the financial or other interest of a party other than the customer.

Mass. Fiduciary Standard

- The proposed regulation provides a specific presumption that it is a breach of fiduciary duty to make a recommendation in connection with any sales contest, implied or express quota requirement or other special incentive program.
- The Massachusetts’ proposal, like the New Jersey proposal, provides a specific exemption for persons acting in their capacity as an ERISA fiduciary to an employee benefit plan and its participants and beneficiaries as defined under ERISA.
Fiduciary – State Developments

• Further state legislative activity is expected now that Reg. BI has been finalized.
• Earlier this year the Maryland Financial Consumer Protection Division released a report which recommended that legislation be enacted to apply a fiduciary standard to broker-dealers, investment advisors and their agents.
• A legislative proposal is expected to be introduced shortly.
• A similar legislative proposal is expected in New York.

Questions