Fiduciary Duties for Financial Services Companies: The Unique ERISA Paradigm

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For more than a decade, the financial services industries have faced an escalating demand, from the market, legislatures, regulators, and litigants, for more transparency and accountability in the products and services they offer. When expressed in legal terms, this demand often takes the form of assignment of fiduciary status and responsibilities to the financial services provider. In the usual formulation, these responsibilities include compliance with heightened care and/or loyalty standards, including conflict of interest constraints. As the industries consider this trend and contemplate its future direction, it may be useful to compare and contrast these more recent developments with the 45-year old fiduciary standards that have been said (by no less of an authority than Judge Henry Friendly) to be “the highest known to the law”: the fiduciary...
paradigm enacted in the Employee Retirement Income Security Act of 1974, as amended (ERISA).\textsuperscript{2}

THE ERISA PARADIGM

The ERISA fiduciary regime is regarded as one of the landmark policy advancements (along with its funding standards and federal preemption principle) in the most comprehensive retirement legislation ever passed by Congress. Seeking to strengthen the integrity of the private retirement system, Congress crafted a system of fiduciary responsibility founded in the common law of trusts, but modified to address perceived abuses and mismanagement in the prior governance of retirement plans.

[ERISA's] fiduciary duties draw much of their content from the common law of trusts, the law that governed most benefit plans before ERISA's enactment. See Central States, Southeast & Southwest Areas Pension Fund v. Central Transport Inc., 472 U.S. 559, 570 (1985) ("[R]ather than explicitly enumerating all of the powers and duties of trustees and other fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility").

We also recognize, however, that trust law does not tell the entire story. After all, ERISA's standards and procedural protections partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection.\textsuperscript{3}

Fiduciary Status. The lynchpin of this new system is a novel definition of "fiduciary" that was intended to:

- Be functional rather than formalistic; and
- Encompass not only the legal owner of the plan's assets, but also all other persons with authority, discretion or control over the administration of the plan or management of its assets, or that provided investment advice for a fee.\textsuperscript{4}

Having extended the scope of fiduciary status beyond trustees to include other plan decisionmakers (exclusive of plan sponsors acting in their "settlor" capacity) and paid investment advisers, Congress then required the governing document for each plan to name, or have a
procedure for naming, at least one fiduciary responsible for administrative and investment decisions, respectively. The legislative objective, in broad scope, was a system of fiduciary accountability for all the operations of an ERISA plan important to the retirement benefits received by participants.

**General Care and Loyalty Standards.** The general care and loyalty standards imposed under ERISA on these fiduciaries are rooted in the common law of trusts. As stated in ERISA section 404(a)(1):

> [A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of [ERISA].

**Prohibited Transaction Rules.** Congress supplemented these general fiduciary standards with the so-called “prohibited transaction” rules, incorporated in both the labor title of ERISA and an excise tax provision in the Internal Revenue Code (Code). The prohibited transaction rules, which are a blend of common-law concepts and pre-existing tax constraints for private foundations, come in two forms:

- A *per se* prohibition in ERISA section 406(a) on fiduciaries causing a covered plan to engage in a “legal list” of everyday economic transactions—*e.g.*, a sale, exchange or leasing of property; loan or other extension of credit; or furnishing of goods, services or facilities—with a far-reaching group of ostensible “insiders” (“parties in interest” or “disqualified persons” in the language of ERISA and the Code, respectively) that hypothetically might be in position to abuse the plan; and
Elaborations in section 406(b) of the general “solely in the interest” and “exclusive purpose” loyalty standards, specifically prohibiting a fiduciary from engaging in self-dealing, acting with a conflicted interest on behalf of a party other than the plan, or receiving third-party compensation.

Even as it enacted these purposefully overbroad prohibited transaction rules, however, Congress recognized that “some transactions between a plan and a party-in-interest may provide substantial independent safeguards of the plan participants and beneficiaries” and “some transactions which are prohibited … nevertheless should be allowed in order not to disrupt the established business practices of financial institutions … consistent with adequate safeguards to protect employee benefit plans.” Congress accommodated that concern by including in ERISA twenty statutory exemptions from the prohibited transaction rules, including seven exemptions added by the Pension Protection Act of 2006. It also authorized DOL to grant additional administrative exemptions (PTE) on a class or individual basis upon a showing that the exemption is (i) administratively feasible, and (ii) in the interest of and protective of the plan and its participants. To date, more than thirty class exemptions and hundreds of individual exemptions have been granted for transactions found by DOL to be beneficial, if not necessary, for plans.

**Enforcement Mechanism.** To give effect to this system of fiduciary accountability, ERISA first disallows, as against public policy, both (i) modification of these fiduciary standards by contract, and (ii) fiduciary exculpation agreements (although indemnification or fiduciary insurance is allowable). It then requires a series of governmental reports, which are publicly available, and participant disclosures, intended to inform regulators and participants about the status and management of the plan. Finally, ERISA imposes a multi-layered system of personal liability for breach of these standards by fiduciaries, variously enforceable by other fiduciaries, plan participants or the responsible agency, including:

- Damages, equitable remedies and/or civil penalties for violation of the general care and loyalty standards;

- Damages, equitable remedies, civil penalties and/or potentially confiscatory excise taxes for violation of the prohibited transaction rules; and

- Co-fiduciary liability for breaches by other fiduciaries, in certain circumstances.
THE UNIQUE FEATURES OF THE ERISA PARADIGM

The fiduciary standards of ERISA are “more exacting” than the common law of trusts, as noted by a number of judges including Justice Brennan,15 and the same can generally be said of the other bodies of fiduciary law to which financial services companies have been subjected. This particular rigor arises from certain critical features of the ERISA paradigm.

Fiduciary Status. The scope of the ERISA fiduciary definition plainly is broader than under other bodies of fiduciary law, but that follows in part from its purpose of regulating the retirement industry overall, rather than just a specific class of fiduciaries (e.g., trustees) or financial services sector (e.g., national banks). That having been said, the extension of fiduciary status beyond traditional categories to include administrative decisionmakers and paid advisers, including in some cases persons acting in a selling capacity, constituted a hugely significant expansion that only recently has been even contemplated under most other bodies of applicable law. Since at least 1976 and long before its 2016 regulation, DOL’s position has been that commissioned insurance and securities salespeople may be ERISA fiduciaries depending on the circumstances,16 thus extending fiduciary status well beyond the reach of the federal securities laws.

General Care and Loyalty Standards. In contrast, the general care standards have become perhaps the least singular feature of the ERISA paradigm, certainly in 2020 if not in 1974. The ERISA “prudent expert” standard tied to industry practice,17 for example, was a higher standard than the “prudent person” standard (if those characterizations may be allowed for convenience) then ordinarily applicable under the common law of trusts in 1974; ERISA universally held its fiduciaries to that higher standard, to which common-law trustees were subject only if they represented they possessed the requisite expertise.18 Over time, however, the ERISA care standards have been modeled if not borrowed in other bodies of law, such as the Uniform Prudent Investor Act that has been adopted in most U.S. jurisdictions, and now are quite familiar in the financial services industries.

This is not to say that a version of the ERISA care standards has been universally adopted. The Securities and Exchange Commission, for example, recently articulated the federal fiduciary standard for investment advisers in terms differing from the ERISA care standards, as a merged duty of care and loyalty to:

- “[P]rovide investment advice that is in the best interest of the client, including a duty to provide advice that is suitable for the
client … based on a reasonable understanding of the client’s objectives,” and

• “[M]ake full and fair disclosure to its clients of all material facts relating to the advisory relationship” and “eliminate or make full and fair disclosure of all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested such that a client can provide informed consent to the conflict.”19

Rather, our experience has been that complying with the ERISA care standards generally is the least disruptive practical aspect of financial services companies newly coming to terms with ERISA fiduciary status.

The ERISA duties of loyalty present a significantly different case, but not primarily because of the general standards of section 404(a). The ERISA “solely in the interest” and “exclusive purpose” duties are very much akin, in statement, to the common law of trusts. While they are serious responsibilities to act with “an eye single to the interests of the participants and beneficiaries,” 20 the more exceptional feature of the ERISA loyalty standards arises under the prohibited transaction rules.

**Prohibited Transaction Rules.** The prohibited transaction rules are the most distinctive elements of the ERISA fiduciary paradigm, for two reasons.

• The section 406(a) *per se* prohibitions on transactions with parties in interests are nearly unique, potentially bar perfectly ordinary and beneficial business activity for retirement plans absent an exemption, and can introduce significant complexity into the operations of financial services companies in the ERISA setting that is not applicable to other types of investors.

• The section 406(b) conflicts rules are not anomalous in form; they are quite similar to loyalty standards under other bodies of fiduciary law. Unlike trust law, however, which generally allows the trust settlor to authorize or trust beneficiary to consent to a fiduciary acting in a conflicted capacity,21 ERISA instead requires a statutory or administrative exemption. That is, it is not enough that the ERISA plan sponsor in the governing documents, or the responsible plan officials or affected participants in operation, agree to a fiduciary acting with a conflict; the federal government must also give its approval to the conflicted transaction.22
These are extraordinarily consequential variances from normal fiduciary practice.

Enforcement Mechanism. Finally, the ERISA enforcement mechanism also has its uncommon features. The common law of trusts, for example, permits the governing trust documents to define the duties of a trustee and to relax the common-law care and loyalty standards to which the trustee is held, which essentially applies only in the event the documents are silent.ERISA fiduciaries are held to its statutory standards without regard to any attempted modification in the governing documents. On top of the substantive rules, the remedial scheme, with its combination of detailed reports and disclosures, public and private enforcement, remedies at law and in equity, and penalties in the form of civil fines and excise taxes, is particularly robust.

CASE STUDY: COLLECTIVE INVESTMENT TRUSTS

By way of illustration, consider the case of collective investment trusts or funds (CIT or CIF). These are trusts maintained by banks for pooled investment by tax-qualified retirement plans. As such, they are exempt from federal income tax pursuant to Rev. Rul. 81-100 and from federal securities registration pursuant to section 3(a)(2) of the Securities Act of 1933 and section 3(c)(11) of the Investment Company Act of 1940.

Prior to the enactment of ERISA, CITs were regulated primarily by banking law and the common law of trusts. For example, CITs maintained by national banks and trust companies are established under section 9.18(a)(2) of the Office of the Comptroller of the Currency (OCC) regulations. The OCC’s regulations provide, among other things, that the bank sponsoring a CIT have “exclusive management” of the CIT, subject to prudent delegation, and that CITs are subject to the OCC self-dealing and conflicts of interest provisions that apply to all bank fiduciary relationships.

ERISA adds its overlay of fiduciary standards to the operation of CITs. Under ERISA, the assets of the CIT are treated for regulatory purposes as if they were held directly by the investing plans. The consequence of this “plan asset vehicle” treatment is that the bank usually becomes an ERISA fiduciary with respect to the management of the CIT, in addition to its ERISA responsibilities if it is separately the trustee for an investing plan. The incremental effects of ERISA regulation are exemplified by the following three common transactions.

Participation in the CIT. In the historic example, the bank, acting as institutional trustee with investment discretion for a retirement plan, would make the decision to invest in its own CITs, usually to achieve
scale economies and diversification. The applicable OCC handbook describes this classic determination in classic fiduciary terms:

It is a bank’s fundamental duty to administer its CIFs solely in the interest of the bank’s fiduciary customers whose assets are invested in the funds. When a bank makes a determination that a CIF serves as a prudent alternative to an individualized investment strategy for a fiduciary account, it must ensure that the CIF used is appropriate for each account. The duty of loyalty is critical and underlies the administration of a CIF. Successful administration of a CIF equates to providing an investment opportunity that meets the needs of clients in a safe and productive manner while equitably balancing the interests of each CIF participant.28

Ordinarily, the governing documents for the retirement plan would anticipate potential conflicts on the part of the bank in this transaction by authorizing investment in the bank’s CITs.

ERISA adds another layer of analysis. On its face, the investment transaction would be a quintessential section 406(b)(1) act of self-dealing in the form of a fiduciary (the bank) exercising its responsibility (as plan trustee) to cause the receipt of additional revenue (the CIT fees) by the fiduciary or an affiliate in a transaction involving the plan. Even if the CIT is a prudent and beneficial investment for the plan, the transaction would be prohibited by section 406(b) absent an exemption. Happily, ERISA has from the outset contained, in section 408(b)(8), an exemption from section 406(a), (b)(1) and (b)(2)29 that permits the purchase or sale of an interest in a CIT, on the conditions that (i) the bank receives not more than reasonable compensation, and (ii) the transaction is expressly permitted in the governing plan documents or by a fiduciary independent of the bank that has investment authority for the plan. That is, while ERISA essentially adopts the common-law solution for this transaction, it becomes permissible only because the federal government has provided its authorization; approval in the documents or by an independent fiduciary would not cure the prohibited transaction absent the exemption.

Selection of Broker-Dealer for Trade Execution. Leaving aside ERISA, the selection of a broker-dealer to execute trades for a CIT is a matter of good fiduciary and safe and sound banking practice. Because the CIT's assets are treated for ERISA purposes as proportionately the assets of each investing plan, however, section 406(a) comes into play. In particular, section 406(a)(1)(C) prohibits the furnishing of services between a plan and a party in interest. This means that if the
broker-dealer the bank selects for the CIT also happens to be providing services to one of the investing plans in an entirely unrelated arrangement and thus is a party in interest to that plan.\textsuperscript{30} section 406(a) would prohibit its engagement for the CIT. Variations of this problem can arise in a range of other circumstances, such as the CIT’s investment in a publicly traded bond issued by the sponsor of or other party in interest to an investing plan, which would violate section 406(a)(1)(B).

- The inefficient solution for this problem is for the investing plans to provide and continuously update party in interest rosters, and for the bank to test proposed CIT transactions against those rosters, to prevent inadvertent dealings with parties in interest to the investing plans.

- The efficient solution is to make use of an available ERISA class exemption, most likely either or both of the exemption for qualified professional asset managers (“QPAM”) or the specific exemption for CITs.\textsuperscript{31} In brief, the QPAM exemption provides conditional section 406(a) relief for transactions managed by specified financial services firms, and the CIT exemption includes \textit{inter alia} conditional relief from sections 406(a) and 406(b)(2) in respect of plans that have a 10% or less interest in the CIT.

\textbf{Cross Trades}. Cross trades between fiduciary accounts, including CITs, are allowable under OCC guidance, as under common law.

A bank fiduciary may sell assets from one fiduciary account to another fiduciary account (cross-trades) if the transaction is fair to both accounts and not prohibited by applicable law. A bank fiduciary should administer each fiduciary account for the exclusive benefit of that account’s beneficiaries. A bank should be prepared to demonstrate the fairness of a transaction between accounts, and that the bank has fulfilled its fiduciary responsibility for each account.\textsuperscript{32}

These transactions receive far more skeptical treatment under ERISA, as administered. In general, section 406 is understood to prohibit cross trades involving ERISA plan assets that do not pass through a public market. At one time, there was some practice of running cross trades through unrelated broker-dealers, but DOL took the position in enforcement actions that this practice was ineffective to avoid prohibited transactions, at least where the netting of the purchase and sale was pre-arranged. Approved solutions took the form of:
• Individual exemptions granted by DOL from time to time;

• A class exemption for passive cross-trades, limited to index- and model-driven funds and on conditions similar to those approved in its individual exemptions, granted by DOL in 2002,33 and

• A statutory exemption enacted in the Pension Protection Act and codified at section 408(b)(19), which generally allows an investment manager to effect cash purchases and sales of securities for which market quotations are readily available, between large plans and another account under management by the investment manager, subject to extensive conditions.

In daily operation, these approved solutions are often found lacking, and ERISA practice with respect to cross trades remains clouded, in CITs and otherwise.

CONCLUSION

The financial services industries continue to face a period of uncertainty with respect to the legal standards to which they will be held in providing products and services to investors. Although there may be exceptions extant or emerging in the law, the ERISA fiduciary regime generally merits its reputation as the most consequential fiduciary standard operating in the financial services industries to date. As such, it can provide a useful paradigm for the outer bounds of the demands to date on financial services companies to act in a fiduciary capacity.

NOTES

4. ERISA § 3(21)(A). The reach of the “investment advice” component of this definition was the subject of the Department of Labor’s (DOL) controversial 2016 regulation that was vacated by the Fifth Circuit in 2018.
5. ERISA §§ 16(a), 402, 403(a), 405(c).
6. To simplify, the ERISA version of the prohibited transaction rules applies to retirement and welfare plans sponsored by an employer or employee organization and covering common-law employees, unless a governmental, church or other exception applies. The tax version applies, absent an exception, to tax-qualified retirement plans and individual retirement accounts (IRAs), among other types of arrangements. There is no direct counterpart in the Code to the ERISA § 404(a) standards.
7. ERISA § 406(a); Code § 4975(c)(1)(A)-(D). The usual practice is to refer to the prohibited transaction rules by their ERISA citation rather than their Code citation.

8. ERISA § 406(b); Code § 4975(c)(1)(E)-(F).


10. ERISA § 408(b); Code § 4975(d).

11. ERISA § 408(a); Code § 4975(c)(2). Exemption authority was originally granted jointly to DOL and the Treasury Department, then was consolidated in DOL in 1978.

12. ERISA § 410. See IT Corp. v. Gen. Am. Life Ins. Co., 107 F.3d 1415, 1418 (9th Cir. 1997) (“If an ERISA fiduciary writes words in an instrument exonerating itself of fiduciary responsibility, the words, even if agreed upon, are generally without effect.”).

13. ERISA §§ 101-111.

14. ERISA §§ 405, 409, 411, 502; Code § 4975.


17. Lanka v. O’Higgins, 810 F. Supp. 379, 387 (N.D.N.Y. 1992) (“This standard requires that the fiduciary’s behavior be measured as against the standards in the investment industry.”).

18. See, e.g., Restatement (Second) of Trusts § 174 & comments (1959) (“Restatement”); Bogert’s Trusts and Trustees § 541 (“If a trustee has greater skill, the trustee must use that greater skill ….”). We refer to the Second Restatement, rather than the Third, because it better reflects trust law in 1974 when ERISA was enacted.


21. See, e.g., Restatement §§ 174(1) cmt. a., 216(1). Trust law in a minority of jurisdictions disallows exoneration provisions.

22. The ERISA exemption requirement, therefore, goes beyond the trust doctrine of advance judicial approval reflected in Restatement § 170(1) cmt. f.

23. Restatement §§ 164, 170 & comments.


26. Id. § 9.18(b)(2), (8).

27. ERISA Reg. § 2510.3-101(h)(1).

29. DOL Advisory Opinion 96-15A (Aug. 7, 1996), available at https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/1996-15A. DOL takes the position that the statutory § 408(b) exemptions may not provide comprehensive § 406 relief, in this case opining that no § 406(b)(3) exemption is provided.

30. Service providers are ERISA § 3(14)(B) parties in interest.

31. PTE 84-14, 47 Fed. Reg. 56945 (Dec. 21, 1982) and as subsequently amended; PTE 91-38, 56 Fed. Reg. 4856 (Feb. 6, 1991) and as subsequently amended.

