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LEGAL ALERT

February 16, 2011

DOL Advisory Opinions Consider Fiduciary Issues

The U.S. Department of Labor (DOL) recently issued three advisory opinions considering fiduciary or prohibited transaction issues arising in the management of ERISA plans.

Asset Manager's Selection of Remotely Affiliated Broker-Dealer

In Advisory Opinion 2011-06A (February 4, 2011), an asset manager (AAM) as a matter of policy would not execute trades for ERISA-covered plans through a remotely affiliated broker-dealer (Mitsubishi Group Brokers) even if that broker-dealer offered best execution or a unique investment opportunity. AAM was concerned that if it selected a Mitsubishi Group Broker while acting as an ERISA fiduciary, it might commit a non-exempt prohibited transaction – either a violation of the per se rules of §406(a) or the conflict of interest rule of §406(b)(2) – because the parent company of Mitsubishi Group Brokers:

- Owned 19.9% of AAM's corporate parent, and
- Appointed one of the 11 directors to the board of AAM's corporate parent. That director did not have veto or other special authority, and that board did not make any decisions with respect to AAM's trading partners, policies or procedures. The parent of Mitsubishi Group Brokers did not appoint any directors of AAM's board.

DOL opined that selection of a Mitsubishi Group Broker would not violate §406(a) because of PTE 84-14, the exemption for qualified professional asset managers (QPAM). The key question was whether AAM was "related to" Mitsubishi Group Brokers within the meaning of the exemption, which would preclude PTE 84-14 relief. DOL reiterated its view that the "related to" definition was concerned only with the ownership interest between the QPAM and the party with which it is dealing, and not with their affiliates. Accordingly, AAM was not "related to" Mitsubishi Group Brokers because:

- AAM owned no interest in Mitsubishi Group Brokers;
- Mitsubishi Group Brokers owned no interest in AAM;
- No entity that controlled, or was controlled by, AAM exercised control over the management or policies of Mitsubishi Group Brokers; and
- The parent of Mitsubishi Group Brokers neither owned directly or indirectly 20% or more of AAM nor exercised control over the management or policies of AAM.

DOL could not provide comfort on the §406(b)(2) issue — whether AAM had a relationship with Mitsubishi Group Brokers that might affect AAM's best judgment as an ERISA fiduciary. A DOL regulation (§2550.408b-2(e)) provides that a fiduciary may have such a conflicted interest with respect to a person who is a party in interest to the plan by reason of a relationship with a fiduciary described in ERISA §3(14)(E), (F), (G), (H) or (I), but Mitsubishi Group Brokers was not such a party in interest. DOL argued that the analysis did not stop there, however, but required consideration of all the facts and circumstances. In DOL's view, other types of common control, supervision or ownership may be so substantial that they would give rise to a conflicted interest under §406(b)(2), including where:

- The fiduciary and the entity with which it was dealing are members of an Internal Revenue Code §414(b) controlled group of corporations or §414(m) affiliated service group, or under common control within the meaning of §414(c); or

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- A common parent has "substantial control and close supervision" of the fiduciary and such other entity.

DOL did not say whether a conflicted interest was present on these facts (consistent with its usual policy for factual issues) and did not provide comprehensive guidelines for determining whether such a conflicted interest exists. DOL did note, however, that it is sometimes possible to develop objective criteria and policies, approved by the investing plans, that would divest the asset manager of functional fiduciary responsibility for a particular decision and thus avoid §406(b)(2) concerns.

DOL has long argued for a broad reading of the §406(b)(2) prohibition. Advisory Opinion 2011-06A articulates that position in both specific ways (its incorporation of the Code §§414(b), (c) and (m) affiliation rules, which goes beyond DOL's published regulation) and unspecific ways (its open-ended facts and circumstances analysis). Consequently, even well-conceived structural solutions to §406(b)(2) concerns like the arrangement in the advisory opinion – where the fiduciary had an attenuated relationship with the service provider that apparently was outside of every black-letter affiliation rule DOL deems relevant – may not reliably resolve those concerns. DOL's position thus could steer more plans and their fiduciaries to either (i) prohibit the selection by the fiduciary of service providers with even minimal relationships to that fiduciary or (ii) develop a mechanical selection process that deprives the plan of the benefit of the fiduciary's judgment and insight.

Use of Demutualization Proceeds for the Benefit of Current Participants

Advisory Opinion 2011-05A (February 3, 2011), presented a variation on a recurring fiduciary issue: whether an accretion to plan assets must be used for the benefit of participants at the time the accretion arose or may instead be used for the benefit of current participants. For example, the termination or merger of funded welfare benefit plans has raised similar issues in the past; more recently, DOL has addressed the issue in the context of the proceeds of insurance company demutualizations where the plan was a policyholder of that company. This advisory opinion considered demutualization proceeds received by a welfare benefit plan and attributable to participant contributions; those proceeds were therefore plan assets. Consistent with at least its more recent guidance, DOL opined that, under ERISA's fiduciary standards and absent plan terms to the contrary, it would be permissible to use those proceeds can be used for the benefit of all current participants and beneficiaries, not just those who actually contributed to the premium payments for the insurance policy, and that the interest of former participants no longer covered under the plan need not be considered.

IRA Purchase of Promissory Note for which IRA Owner is Obligor

In Advisory Opinion 2011-04A (February 3, 2011), DOL opined that it would be a prohibited transaction for an IRA to purchase a deed of trust and promissory note for which the IRA owner and his wife were the obligors. Under the facts of the Advisory Opinion, the IRA owner and his wife had financed the purchase of certain real property with a loan from Chase Bank. The loan was evidenced by a promissory note, and the bank's interest in the property was secured by a deed of trust. The IRA owner's family trust, of which the owner and his wife were the trustees and sole beneficiaries, held the title to the real property. The IRA owner proposed to have the bank assign the promissory note and deed of trust to the IRA, so that the obligors would make future payments on the note to the IRA's custodian. The transaction was to be structured in a way that would avoid creating a new loan or other extension of credit between the IRA and the obligors. Based on these facts, DOL concluded that:

- The IRA owner, his wife and the family trust were disqualified persons for purposes of Code §4975;
- The IRA's proposed acquisition and holding of the note and deed would constitute an impermissible lending of money or other extension of credit between the IRA and the obligors under Code §4975(c)(1)(B), on the basis that the loan was a continuing transaction even if there was no "new" extension of credit between the parties; and
- The proposed transaction would constitute prohibited self-dealing under Code §§4975(c)(1)(D) and (E). DOL reasoned that the transaction would constitute "an agreement, arrangement or understanding in which the fiduciary caused plan assets to be used in a manner designed to benefit such fiduciary (or persons in which such fiduciary had an interest that would affect the exercise of his best judgment as a fiduciary)" because the owner would know that the IRA's assets were being used to create a prohibited transaction (*i.e.*, a debtor-creditor relationship between the IRA and the obligors).

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