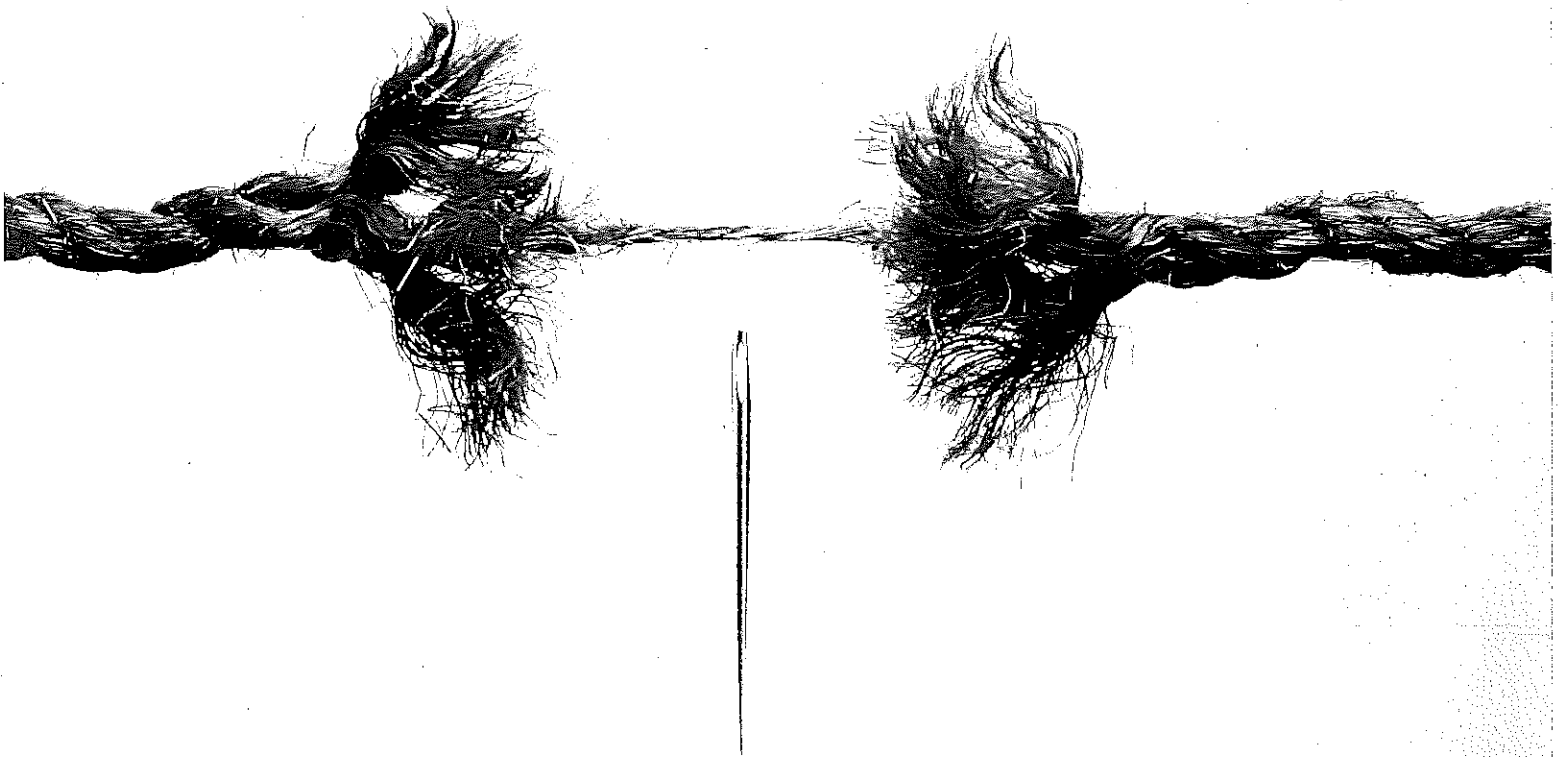


# USING PTEs TO DEFINE A FIDUCIARY UNDER ERISA

Threading the Needle with a Piece of Rope



**U.S. CHAMBER OF COMMERCE**





## **Using PTEs to Define a Fiduciary Under ERISA: Threading the Needle with Rope**

### **Summary**

The Department of Labor (DOL) has indicated that it intends to address concerns with its proposal to broaden the definition of fiduciary “investment advice” by utilizing prohibited transaction exemptions (PTEs) to carve back the rule so that it is appropriate in scope. However, the history of the use of the exemptive process to narrow overly broad rules demonstrates the many problems of using PTEs in this context.

The goal in this regulatory initiative should be to enhance the ability of individuals to adequately save for retirement. We are very concerned that the DOL—in the name of investor protection—is actually taking an approach that will harm the very people it is trying to protect. By definition, a regulatory regime that prohibits every transaction unless it is specifically allowed through a PTE may unnecessarily eliminate choices and make it difficult to find new ways to better serve investors. Despite best efforts by the DOL, we remain concerned that no matter how well-crafted the PTEs are, they will prove to be insufficiently narrow and inflexible to accommodate the many beneficial ways that financial professionals serve the needs of investors today and in the future.

Unfortunately, the prohibited transaction regime has proven to be (1) lengthy and protracted; (2) burdened with conditions, limitations, and requirements; and (3) generally ineffective in addressing the needs of the employee benefits community. By utilizing a series of PTEs to narrow an overly broad regulation, the DOL is looking backwards rather than forward and unintentionally creating barriers to finding better ways to improve the system and protect investors. This paper provides several examples where the exemptive process has failed to appropriately limit expansive rules. As such, to the extent the DOL can demonstrate that changes are necessary, it should explore a narrowly-tailored approach that balances the need for protection of plan participants and also affords them the education and investment choices they need for a secure retirement.

### **Background**

In 2010, the DOL issued a proposed regulation on the definition of the term fiduciary under the Employee Retirement Income Security Act of 1974 (ERISA). According to the DOL, the intent of the proposed rule was to define more broadly the circumstances under which a person or entity is considered to be a fiduciary when giving investment advice to an employee benefit plan or a plan’s participants. Under ERISA, an investment adviser is a fiduciary if he or she provides investment advice for a fee. Under current DOL regulations, which interpret the statutory provision, there is a five-part test for determining whether fiduciary status exists by reason of



providing investment advice. Under the five part test, a person is deemed to provide investment advice if he or she:

- (1) renders advice on the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property,
- (2) on a regular basis,
- (3) pursuant to a mutual agreement, arrangement or understanding between the person and the plan or a plan fiduciary that,
- (4) this advice will serve as a primary basis for investment decisions with respect to plan assets, and that
- (5) this advice will be individualized based on the particular needs of the plan.

To be deemed a fiduciary by reason of providing investment advice, a person must meet each part of this test. In the proposed regulation, the DOL did away with the five-part test and instead based fiduciary status on whether the information provided by a person would reasonably be considered in making an investment decision.

The DOL's 2010 proposal was broadly criticized from many quarters, including from both Democrats and Republicans in Congress, as well as from various stakeholders that warned against its impact upon the ability of low and moderate income Americans to save for retirement. Specifically, commentators pointed out concerns about the rule's effect on individual retirement accounts (IRAs) and the ability of plan participants to receive valuable investment advice. Additionally, the proposal failed to include prohibited transaction exemptions that the DOL said would address some of the concerns raised by commenters.

Due to these significant concerns, in September 2011, the DOL withdrew its proposal and announced that it would re-propose the rule at a later date. The DOL has also indicated that it intends to propose certain PTEs in connection with the re-proposal of the regulation. While there may be merit in revisiting the definition of fiduciary under ERISA given the evolution in the retirement savings market over the last four decades, the U.S. Chamber of Commerce believes that any expansion of the definition of investment advice must be carefully crafted to ensure that it reaches only conduct that warrants imposition of ERISA fiduciary status and, more significantly, the sanctions of ERISA's prohibited transaction rules.

### **The PTE Problem**

The DOL intends to address concerns with its proposal to broaden the definition of fiduciary "investment advice" by utilizing PTEs to carve back the rule so that it is appropriate in scope. In some ways, this reflects the approach originally taken by Congress to the prohibited transaction



rules when it enacted ERISA in 1974. Congress was fully aware that the prohibited transaction rules in ERISA Section 406 and Code Section 4975 were significantly overbroad and, while it included in the statute a handful of specific statutory exemptions, it granted broad authority to the DOL to grant administrative exemptions where appropriate.

Forty years of history has demonstrated that Congress' expectations about the ability of the administrative exemption process to remedy an overly broad prohibited transaction regime were seriously misguided. The prohibited transaction regime as administered by the DOL has proven to be (1) lengthy and protracted; (2) burdened with conditions, limitations, and requirements; and (3) generally ineffective in addressing the needs of the employee benefits community.

While the DOL's commitment to issue proposed class exemptions along with the proposed investment advice regulation ostensibly eliminates the "slow and unresponsive" issue, the likelihood that those exemptions will effectively address the concerns raised by an overly broad rule are remote. More importantly, even if the class exemptions effectively address concerns today, the market for financial products and services is continually evolving. Exemptive relief that is sufficient today may well become obsolete, constraining innovation in the marketplace.

This document outlines several concrete examples from among many to demonstrate the difficulties of using PTEs to solve the problems with an overly broad application of the fiduciary standard under ERISA.

### *The PTE process is lengthy and protracted*

The single most telling fact about the way in which the prohibited transaction program is administered is to consider how infrequently the DOL grants exemptive relief, particularly in recent years. In the program's 40 year history, only 55 class PTEs have been created and currently remain in effect. Of those 55 PTEs:

- Thirty-nine were granted during the 20 years following enactment of ERISA—less than two per year.
- Sixteen were granted in the last 20 years—less than one per year.
- Two were granted in the last decade, with the most recent class exemption granted in 2006. That exemption was an amendment and restatement of two prior class exemptions dealing with securities lending.<sup>1</sup>
- The most recent class exemption activity was to *withdraw* a PTE that had been proposed by the DOL under the prior administration.<sup>2</sup>

---

<sup>1</sup> PTE 2006-16 (an amendment and restatement of PTE 81-6 and PTE 82-63)



This dearth of class exemptive relief is paralleled in the granting of individual exemptive relief. In 2014, the DOL granted 11 individual exemptions and 6 exemptions under its EXPRO<sup>3</sup> procedure, which permits expedited consideration of transactions substantially similar to other exemptions for which individual exemptions have already been granted. This is down from a combined peak of 51 in 2009.<sup>4</sup> The process can take upward of two years and involves significant legal costs. There is no way to determine the number of exemption requests actually filed, or the number of requests that were never submitted because of the DOL's unwillingness to indicate whether the relief would be granted if requested. But the extremely limited use of the exemption process indicates how unworkable it would be in addressing the needs of the retirement community.

The failure of exemptive relief to remedy an overly broad rule was demonstrated with the statutory provisions in ERISA Section 406(a) dealing with party-in-interest transactions. These are highly technical rules that are overly broad and prohibit many otherwise desirable transactions for plans.<sup>5</sup> The DOL did not issue any exemption broadly addressing this over-breadth problem until 1984 (10 years after ERISA was enacted) when the qualified professional asset manager (QPAM) exemption<sup>6</sup> was issued. Even then, the over-breadth problem was not fully addressed because the availability of the QPAM exemption was limited to three classes of regulated entities (banks, insurance companies, and registered investment advisors) and was subject to a number of additional conditions and limitations. Twelve years later, in 1996, the DOL expanded the scope of generic 406(a) relief slightly when it issued the in-house asset manager (INHAM) exemption,<sup>7</sup> which provided comparably broad 406(a) relief with respect to a small number of large plans whose assets were managed by in-house registered investment advisors.

These exemptions still left a material number of situations where exemptive relief for nonabusive 406(a) transactions was still not available. Concerns over this issue were not addressed until 2006 (32 years after ERISA was enacted) when Congress, frustrated by the fact that its initial intent had not been fulfilled, enacted a statutory exemption<sup>8</sup> designed to provide broad generic exemptive relief from nonabusive Section 406(a) prohibited transactions.

<sup>2</sup> 74 Fed. Reg. 60,156 (November 20, 2009)

<sup>3</sup> PTE 1996-62. The mere fact that the EXPRO procedure was needed is evidence of the unwillingness of the DOL to use the class exemption process to address routine transactions where exemptive relief is appropriate.

<sup>4</sup> See Sutherland, Asbill & Brennan LLP, *Legal Alert: 2015 in Review: ERISA Individual Prohibited Transaction Exemptions and Advisory Opinions* (January 8, 2015) at <http://www.sutherland.com/NewsCommentary/Legal-Alerts/169426/Legal-Alert-2014-in-Review-ERISA-Individual-Prohibited-Transaction-Exemptions-and-Advisory-Opinions>

<sup>5</sup> ERISA Section 406(a) broadly prohibits many ordinary transactions that do not necessarily involve plan fiduciaries and that are essential and beneficial for the functioning of a plan, such as providing services to the plan, leasing property to the plan, or engaging in many common investment transactions for the plan.

<sup>6</sup> PTE 1984-14

<sup>7</sup> PTE 1996-23

<sup>8</sup> ERISA Section 408(b)(17)



Because of the inability to address the over-breadth of Section 406(a) of ERISA through the use of PTEs, it is undoubtedly the case that plans were either precluded from engaging in otherwise beneficial transactions or forced to engage a QPAM or an INHAM, when they otherwise would not have done so.

Another example of the impracticality of relying on PTEs relates to foreign exchange transactions. Until the mid-1980s, no one focused on the fact that foreign exchange (FX) transactions are principal transactions that, when entered into with a counterparty that is a party-in-interest (as would typically be the case), give rise to a Section 406(a) prohibited transaction, absent an exemption. There was no exemption available at the time; nevertheless, it is clear that billions of dollars of FX transactions were entered into during this period without an exemption.

Once the issue was brought to the DOL's attention in the mid-1980s, it considered the issue for years until it eventually granted a class exemption<sup>9</sup> in 1994, nearly 20 years after the issue first arose and approximately 10 years after the issue was first raised with the DOL. As a result, for nearly two decades many FX transactions engaged in by ERISA plans constituted nonexempt prohibited transactions. When the exemption was ultimately issued in 1994, the DOL recognized the potentially disastrous consequences of its failure to address this issue sooner and granted broad retroactive relief for virtually all nonabusive FX transactions occurring prior to the issuance of the exemption.<sup>10</sup>

The DOL has said that it intends to issue proposed PTEs in connection with its proposed investment advice regulation. The proposed regulation and exemptions have already taken many years to develop, with numerous delays along the way. Only when the DOL finally releases its proposal will the regulated community be in a position to consider and analyze the regulation and any PTEs and the balance of complex policy choices they represent. They will be the subject of intense and widespread comment and debate. If the 40 year history of the exemption process is any guide, there is no reason to think that the DOL will ultimately be able to resolve these policy choices through PTEs expeditiously.

## *Exemptions granted by the DOL are burdened by conditions, limitations, and requirements*

The DOL typically imposes numerous conditions, limitations, and requirements on the availability of its exemptions. At a minimum, these conditions, limitations, and requirements (1) often create a significant amount of confusion and misunderstanding;<sup>11</sup> (2) impose significant administrative burdens and costs on the parties attempting to utilize the exemptions (3) fail to anticipate future developments and, as a result, become obsolete over time; and (4) represent a trap for the unwary in that a failure to comply completely with the relevant conditions,

<sup>9</sup> PTE 94-20

<sup>10</sup> *Id*

<sup>11</sup> In this regard, the DOL is loath to provide interpretive guidance regarding the many ambiguities to be found in its exemptions and certainly does not do so in an expeditious manner.



limitations, and requirements results in loss of the exemption, thereby creating a nonexempt prohibited transaction with all of the negative consequences that flow therefrom.

For example, the FX exemption referred to here, and a companion exemption issued in 1998<sup>12</sup> addressing standing instructions with respect to FX, both contain a number of requirements and limitations that make them inadequate in scope as well as difficult to use. This deficiency ultimately led Congress, when it considered these prohibited transaction issues in 2006, to enact a statutory exemption<sup>13</sup> that was intended to be more comprehensive and less complicated and thereby to address the deficiency of the class exemptions that had been issued by the DOL.

As time has passed, the DOL's class exemptions have become even more complicated, incorporating more and more restrictions and conditions. For example, the most recent class exemption dealing with securities lending<sup>14</sup> contains many conditions, limitations, and other special rules, some of which apply to all securities loans and others which apply only to loans to certain eligible non-U.S. borrowers. As a practical matter, for parties to securities lending transactions involving ERISA plans to engage in such transactions, it is necessary for both the lending fiduciary and the borrower to work with their respective ERISA counsel to ensure that the securities loans in which they engage will satisfy all these conditions, restrictions, and other special rules. Compliance with such complicated exemptions creates significant administrative burdens for both the plan fiduciaries and their counterparties. It also increases costs, which increases ultimately will be passed on to the plans in the form of higher fees.

In connection with its legislative effort to break the logjam that had arisen over the 30 years following ERISA's effective date by enacting a number of statutory exemptions as part of the Pension Protection Act of 2006, Congress also attempted to provide relief from the prohibited transaction rules in the context of the provision of investment advice to plan participants.<sup>15</sup> However, the DOL has subsequently issued regulations relating to this provision that are complicated, difficult to work with, and inconsistent with how most organizations desire to operate in this context. As a result, the issuance of the DOL regulations relating to this statutory exemption has not facilitated the use of the exemption, rather it has limited its use to a degree that is inconsistent with the legislative intent to promote the delivery of investment advice to participants.

Another example of the excessive conditions and complexity in class exemptions is demonstrated by the class exemption for transactions in REIT shares involving plans sponsored by the REIT.<sup>16</sup> Because many REITs are organized as trusts rather than as corporations, it is unclear whether their shares are "qualifying employer securities," which they must be in order to

---

<sup>12</sup> PTE 98-54

<sup>13</sup> ERISA section 408(b)(18)

<sup>14</sup> PTE 2006-16

<sup>15</sup> ERISA section 408(b)(14).

<sup>16</sup> PTE 2004-07





be eligible for the general statutory exemption relating to transactions in employer securities.<sup>17</sup> Even though the statutory exemption and the administrative PTE address virtually identical situations and risks, the PTE incorporates numerous conditions and restrictions into the administrative exemption over and above the conditions and restrictions that Congress thought were appropriate in the more general context addressed by Section 408(e).

The exemption process has also resulted in gaps and inconsistencies in scope and application of exemptions to similar transactions. For example, the QPAM exemption referred to earlier provides very broad relief from ERISA Section 406(a) if its relatively generic conditions are satisfied. It generally applies to all types of transactions that a plan may engage in with a "remote" party-in-interest (i.e., a party-in-interest that is neither related to the QPAM nor affiliated with the fiduciary who appointed the QPAM).

However, the exemption specifically excludes from relief securities lending transactions. This exclusion appears to have been based solely on the fact that the DOL had previously issued a substantive exemption with a host of specific, substantive conditions, designed to address securities lending transactions. There was no apparent policy reason for singling out securities lending and imposing numerous specific, substantive conditions and requirements on securities lending compared with other types of transactions.<sup>18</sup> Rather, the dichotomy of treatment seems to have been driven solely by the fact that the DOL just happened to have addressed securities lending prior to issuing the QPAM exemption. Thus, this dichotomy demonstrates the difficulty of using the PTE process to narrow an overly broad rule in a consistent and effective manner.

***The exemptive process is generally ineffective in addressing the needs of the employee benefits community***

Another problem with the exemptive process is that the DOL does not have the experience or the expertise to recognize all the business realities of the context in which it is granting exemptive relief. As such, the exemptive process requires significant input and discussion with the business community or it risks the issuance of unworkable exemptions. A good example of this is the exemption that allows for investments in affiliated mutual funds if certain conditions are satisfied.<sup>19</sup>

This exemption includes one condition that completely fails to recognize the practical realities of the context in which the exemption will often be utilized. In particular, one of the conditions requires that, if any of the fees that must be approved affirmatively in writing by an independent fiduciary before any plan investments can be made in the affiliated mutual fund are subsequently modified, then a new affirmative written authorization must be obtained from the independent

<sup>17</sup> ERISA section 408(e)

<sup>18</sup> Securities lending is not inherently more risky or subject to abuse than other transactions (e.g., derivatives) as to which the QPAM exemption is available.

<sup>19</sup> TEC- 77-4



fiduciary. This requirement, when considered from the perspective of an isolated single plan, seems reasonable enough. However, many of the financial services firms that employ the exemption have in many cases thousands (particularly when IRAs and Keogh plans are taken into account) of plan clients whose fiduciaries provide the initial written authorization to invest in their affiliated mutual funds. To require these financial services companies to go back to the independent fiduciary of each one of these plans every time there is any modification<sup>20</sup> of the previously authorized fees to obtain affirmative written reauthorization is extraordinarily burdensome (indeed, completely, unrealistic). Even the DOL has recognized the difficulty created by this requirement by issuing a number of individual exemptions allowing utilization of a “notice and deemed consent” approach for subsequent fee increases over the past 20 years.

In addition, the DOL exemptions are issued at a single point in time based largely upon a fact record presented to the DOL. As a result, they are frequently drafted in a way that, even if they address the existing fact situation adequately, fail to anticipate future developments, and as a result, become obsolete and/or unworkable as time goes on.

As previously mentioned, the DOL issued its initial securities lending exemption in 1981 authorizing plans to lend securities to U.S. banks and U.S. broker-dealers and to take cash and U.S. Government Securities as collateral. At that time, securities lending by ERISA plans was in its infancy and was largely limited to transactions involving regulated U.S. borrowers and the provision of cash and U.S. government securities as collateral.

However, market practice evolved significantly. Increasingly, foreign borrowers became involved and alternative forms of collateral were used. Because their securities lending transactions were subject to the straightjacket imposed by the conditions and limitations set forth in the exemption, ERISA plans were not able to take advantage of these evolving circumstances. It was not until 25 years later, in 2006, that the DOL addressed this deficiency by issuing revised exemptive relief, which expanded the range of permissible borrowers to include certain eligible foreign banks and foreign broker-dealers and permitted alternative forms of collateral to be utilized albeit, as noted, subject to a host of new and complicated conditions.<sup>21</sup>

The DOL has issued exemptions that are under-inclusive in that they are drafted address the more extreme contexts of the type of transaction that is intended to be covered by PTE. Therefore they fail to address contexts that are actually less subject to any potential for abuse. For example, Section 406(b)(1) of ERISA would typically preclude an investment manager of ERISA plan assets from utilizing its affiliated broker-dealer to perform agency trading services and receive commissions with respect to the plan assets it is managing.

<sup>20</sup> The DOL has provided subsequent guidance to the effect that this requirement only applies to fee modifications that result in an increase in fees. This interpretation provides some relief but does not eliminate the problem.

<sup>21</sup> PTE 2006-16



In 1986, the DOL issued an exemption that allows an investment manager to utilize an affiliated broker-dealer, subject to the satisfaction of a number of complex conditions.<sup>22</sup> However, to utilize this exemption, the broker-dealer must be affiliated with the investment manager as that term is defined in the exemption. While this definition picks up situations involving the most significant potential for self-dealing concerns, it fails to pick up more attenuated situations where the investment manager is not “affiliated” with the broker-dealer, but nevertheless may have an interest in the broker-dealer that is sufficient to create a self-dealing concern. For example, the investment manager may own 25% or 30% of the broker-dealer entity but, given all the relevant facts and circumstances, the broker-dealer may not be affiliated with the investment manager within the meaning of the exemption. Hence, this context is left without an exemption due to the particular wording utilized by the DOL in issuing the exemption. The DOL has long been aware of this deficiency and has issued several individual exemptions to address specific cases but has never proactively addressed the problem on a class basis. The result is an inconsistent regime that treats similar situations differently.

Finally, it should be noted that, in the majority of contexts and based on a majority of the relevant court decisions, the availability of an exemption to provide relief from a claim of prohibited transaction is considered to be an affirmative defense and, as a result, cannot be utilized by a defendant at the motion to dismiss stage. As a practical matter, this means that parties who enter into transactions involving ERISA plans in reliance on exemptions are potentially exposed to the threat of meritless claims that cannot be avoided at the motion to dismiss stage but that are likely to proceed through later stages of litigation (including discovery) at significant cost and administrative burden to such parties. Again, over the long term, these additional costs and administrative burdens will ultimately be passed on to, and borne by, the ERISA plan—participants who are intended to be protected by all of these rules. Alternatively, they may result in service providers deciding not to offer beneficial services or products to ERISA plans.

## Conclusion

When dealing with exemptions from the prohibited transaction rules of ERISA (and the Code), the DOL has historically provided incomplete relief and created complexity, administrative burdens and incremental costs that are unwarranted and excessive. Consequently, the DOL exemptions are an extremely poor means to cure an overly broad definition of fiduciary investment advice. To the extent that the DOL believes the current definition of fiduciary investment advice is deficient, the DOL should explore a narrowly tailored approach for addressing such deficiencies that balances the need for protection of plan participants and also affords them the education and investment choices they need for a secure retirement.

---

<sup>22</sup> PTE 86-128











## U.S. CHAMBER OF COMMERCE

U.S. Chamber of Commerce  
1615 H Street, NW | Washington, DC 20062-2000  
[www.uschamber.com](http://www.uschamber.com)