AMERICAN BENEFITS COUNCIL

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Dear Michael:

On behalf of the American Benefits Council, I want to follow up with you regarding an important fiduciary issue under ERISA. The Department recently provided technical assistance to Congress regarding the effects under ERISA of a legislative proposal regarding swaps.

We very much appreciated the opportunity to meet with you on this issue in May. The discussion was very helpful. The Department's views are very important to us and to the retirement plan system, which is why we are following up with you with respect to further clarification of the Department's position.

Background

The legislative proposal at issue, which is included in the Senate-passed financial reform bill, provides as follows:

> A swap dealer that provides advice regarding, **or offers to enter into**, **or enters into** a swap with a pension plan, endowment, or retirement plan shall have a fiduciary duty to the pension plan, endowment, or retirement plan, as appropriate. [emphasis added]

In a swap, the swap dealer is the plan's counterparty. Thus, under this language, if a swap dealer enters into a swap with an ERISA retirement plan on the other side of the transaction, the swap dealer owes a fiduciary duty to the plan. The concern that had been raised was whether this would create a prohibited transaction under ERISA. Obviously, if a swap dealer functions as an ERISA fiduciary in advising a plan counterparty with respect to a swap, the swap dealer would violate ERISA section 406(b) due to the clear conflict of interest between the swap dealer's interest as a counterparty and the swap dealer's duty to the plan.

Senate staff accordingly sought the Department's guidance in determining whether the proposal would create a prohibited transaction.

The Department provided "Technical Assistance to the Senate Agriculture Committee Staff on S. 3217, 'the Restoring American Financial Stability Act of 2010'", dated May 6, 2010. The assistance stated:

> we have not identified any prohibited transaction problems that would arise from S. 3217 . . . .

After the Department provided the technical assistance, the first question asked by the private sector was: what was the basis for the Department's conclusion? Oral reports have indicated that the Department's analysis was based on its view that fulfilling the fiduciary duty under the bill would not make the swap dealer a fiduciary for ERISA purposes. Our legal analysis is set forth below in the context of seeking greater clarification from the Department.

Fiduciary duty

The Senate bill does not specify the nature of the fiduciary duty under the bill. Some have argued that the duty under the bill is simply a duty of disclosure and fair communication. It is certainly possible to impose a fiduciary duty that consists solely of a duty of disclosure and fair communication. But in this case, there is no statutory language or legislative history pointing in that direction. Accordingly, it is difficult to conclude that the provision is so limited. Moreover, and most importantly, the Department did not condition its technical guidance on the provision's fiduciary duty being limited in this fashion. In light of the absence of any limitation on the Department's guidance, that guidance is best read to apply to the most natural interpretation of the statutory language, under which the swap dealer would have a duty to advise the plan with respect to the swap. Moreover, under common law principles, in providing such advice, the swap dealer has a duty of loyalty to the plan and must act in the best interests of the plan.[1]

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[1] *See* Pegram v. Herdrich, 530 U.S. 211, 224 (2000) (stating that "the common law . . . charges fiduciaries with a duty of loyalty to guarantee beneficiaries' interests"); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 201 (1963) ("The [Investment Advisers Act of 1940], in recognition of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested."); Goldstein v. SEC, 451 F.3d 873, 881 (D.C. Cir. 2006) (quoting Registration Under the Advisers Act of Certain Hedge Fund Advisers, 69 Fed. Reg. 72,054, 72,059 (Dec. 10, 2004)) (noting that "[t]he [Securities and Exchange Commission] recognizes more generally that the duty of loyalty 'requires advisers to manage their clients' portfolios in the best interest of clients'"); Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982) (the decisions of pension plan trustees "must be made with an eye single to the interests of the participants and beneficiaries"); Galfand v. Chestnutt, 545 F.2d 807, 809, 811 (2d Cir. 1976) (investment adviser must act with "duty of uncompromising fidelity" and "undivided loyalty" to fund); Miller v. Jackson Hosp. & Clinic, 776 So.2d 122, 124 (Ala. 2000) (principal-agent relationship is fiduciary in nature, imposing duty of loyalty, good faith, and fair dealing); Meinhard v. Salmon, 249 N.Y. 458, 463-64 (N.Y. 1928) (fiduciaries are bound by "the duty of the finest loyalty"); RESTATEMENT (THIRD) OF TRUSTS § 78(1) (2007) (trustee has duty to administer trust solely in interest of beneficiaries or in furtherance of its charitable purpose); 3 AUSTIN WAKEMAN SCOTT, WILLIAM FRANKLIN FRATCHER & MARK L. ASCHER, TRUSTS, § 17.2 (5th ed. 2006) ("The most fundamental duty of a trustee is the duty of loyalty . . . . A trustee is in a fiduciary relationship with the trust beneficiaries and must, therefore, administer the trust in the beneficiaries' best interest.").

So the next step is to set forth how the provision's fiduciary duty would apply with respect to a swap. If a swap dealer owes a duty of loyalty to a plan and must act in the plan's best interests in advising the plan with respect to a swap, clearly the swap dealer must at least advise the plan regarding (1) whether the swap is in the plan's best interest, (2) whether a different swap could be preferable, (3) the appropriate price for the swap, and (4) the appropriate terms of the swap, such as collateral.

Moreover, this advice would in many cases be provided over an extended period of time. In the context of an over-the-counter swap, it can take a year or more to negotiate the initial base swap documents (i.e., the ISDA schedule, credit support annex, and related documents) between a swap dealer and its plan counterparty. Once those base swap documents are in place, it is not uncommon for there to be repeated swap transactions entered into between the swap dealer and the plan counterparty.

So to summarize, the "normal" interpretation of the bill's fiduciary duty would require the swap dealer to advise a plan regarding all aspects of a complicated negotiation that could take a year or more and then advise the plan repeatedly over many years as future swaps occur. The question then becomes: why is the swap dealer not an ERISA fiduciary under these circumstances?[2]

ERISA fiduciary standard

ERISA section 3(21)(A)(ii) provides in relevant part that:

> a person is a fiduciary with respect to a plan to the extent . . . he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan . . . .

The regulations under this provision provide in relevant part:

> **(c) Investment Advice.**
> (1) A person shall be deemed to be rendering "investment advice" to an employee benefit plan, within the meaning of section 3(21)(A)(ii) of [ERISA] . . . only if
> (i) Such person . . . makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; and
> (ii) Such person either directly or indirectly . . .
> (B) Renders any advice described in paragraph (c)(1)(i) of this section on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment

[2] Courts have recognized that the definition of fiduciary for purposes of ERISA is to be broadly construed in keeping with ERISA's remedial purpose. *See* Thomas, Head & Greisen Employees Trust v. Buster, 24 F.3d 1114, 1117 (9th Cir. 1994); Consol. Beef Indus. v. New York Life Ins., 949 F.2d 960, 964 (8th Cir.1991); Am. Fed. of Unions Local 102 v. Equitable Life Assur., 841 F.2d 658, 662 (5th Cir. 1988).

policies or strategy, overall portfolio composition, or diversification of plan investments.

29 C.F.R. § 2510.3-21(c).

In short, here are the elements that, if present with respect to advice provided to the plan, make the advisor a fiduciary:

(1) The advisor must receive a fee or other compensation.
(2) The advice must relate to buying or selling securities or other property.
(3) The advice must be rendered on a regular basis.
(4) The advice must be rendered pursuant to a mutual understanding that the advice will serve as a primary basis for investment decisions.
(5) The advice must be individualized.

It is clear that requirements (1), (2), and (5) are met. Since the swap dealer benefits from the transaction, the advice is provided for a fee or other compensation;[3] the advice relates to investment in swaps; and the advice is required by law to be individualized. In addition, as described above, it is not uncommon for negotiations regarding the base swap documents to take a year or more prior to the initial swap between two parties.[4] It is also not uncommon for there to be repeated swaps between the parties after the initial swap. In this context, which is covered by the Department's guidance, it is clear that requirement (3) is satisfied.

That leaves requirement (4), a mutual understanding that the advice will serve as a primary basis for investment decisions. This is a purely factual matter that will vary from plan to plan.[5] Many plans with sophisticated advisors will not rely in any way on advice from the opposing party to the transaction. But the entire premise of the legislative proposal is that some plans do not have sophisticated advisors and need to rely on the swap dealer's help. Thus, under the legislative intent, requirement (4) will be met in many cases. And the Department did not condition its guidance on the plan and the swap dealer not reaching a mutual understanding that the plan would rely on the swap dealer's guidance. Therefore, requirement (4) does not appear to be the basis for the Department's conclusion.

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[3] A separately stated fee for advice has never been required; if that were to become the law, it would have major policy ramifications. *See* Definition of the Term "Fiduciary," 40 Fed. Reg. 50,842, 50,842 (Oct. 31, 1975) (stating fee should be deemed to include any fee or compensation incident to transaction). *See also* Thomas, 24 F.3d at 1120 (receipt of commission for sale of deed of trust notes satisfies fee requirement); Meyer v. Berkshire Life Ins., 250 F. Supp. 2d 544, 561 (D. Md. 2003) (receipt of commissions and fees on life insurance policies satisfies fee requirement); Daniels v. Nat'l Employee Benefit Servs., 858 F. Supp. 684, 688, 691 (N.D. Ohio 1994) (defendant found to be ERISA fiduciary where received commissions on sale of securities and insurance products).

[4] In some cases, those negotiations may occur prior to consideration of a specific swap transaction, so arguably the duty to advise may not yet be triggered. But as soon as a specific swap is considered, the base swap documents become subject to that duty. Thus, swap dealers will effectively need to treat the initial negotiations as subject to the duty to advise. Moreover, even if that were not the case, the fact that there may be numerous swaps between the parties would satisfy the regular basis requirement.

[5] *See* Olson v. E.F. Hutton & Co., 957 F.2d 622, 626 (8th Cir. 1992) (citing Farm King Supply, Inc. v. Edward D. Jones & Co., 884 F.2d 288, 293 n.6 (7th Cir. 1989)) (mutual understanding or agreement requirement is an issue for trier of fact, comparable to "meeting of the minds" in contract cases).

On the other hand, the above analysis leaves us with no explanation for the Department's conclusion. Perhaps the Department concluded that where an advisor's self-interest is clear, such advisor's advice cannot by law constitute a primary basis of a plan's investment decisions. This analysis -- which would be inconsistent with precedent -- would have major policy implications. But without more clarity, it seems to be at least one possible explanation for the Department's conclusion.

<u>Upcoming fiduciary regulations</u>

We believe that the regulations that the Department is working on would provide an excellent place for the Department to incorporate the basis for its conclusion. In that way, all members of the community would have the opportunity to understand and comment on the Department's analysis.

We look forward to continuing discussions of this important issue.

Sincerely,

Lynn D Dudley

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Senior Vice President, Policy

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