ERISA Compliance Policies and Procedures: Where Are Yours?

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For most of its history, the Investment Advisers Act of 1940 (the "Act") did not require an investment advisor to maintain compliance policies and procedures. However, with the adoption of Rule 206(4)-7 of the Act in 2003, a registered investment advisor (and one who is required to register) must establish and implement written policies designed to prevent violations of the Act and to review such policies annually for effectiveness. The broker-dealer regulatory regime imposes similar requirements concerning "written supervisory policies and procedures" in NASD/FINRA Rule 3010. Further, Rule 204A-1 of the Act requires investment advisors to adopt a code of ethics setting forth a standard of conduct expected from their advisory staff. An investment advisor becoming an investment advice fiduciary under ERISA, then, should revise its written policies and procedures and its code of ethics to address its ERISA obligations. Industry practice, unfortunately, appears to not always include a complete discussion of the relevant ERISA risk considerations in the compliance manual.

Rule 206(4)-7 of the Act does not specify the content or format of the compliance policies, but it is generally understood to require *comprehensive coverage in terms of scope and relevancy to the particular aspects of the investment advisor's operational platform.* The Securities and Exchange Commission (SEC) has indicated that a top priority should be on identifying potential conflicts of interest and then on developing policies to address such risks; interestingly, the Department of Labor (DOL) seems to share the same view given the evolution of the disclosure regulations under ERISA Section 408(b)(2).

This article will identify a few examples of some common risk items for which written policies and procedures should be considered, as applicable, for purposes of enabling investment advisors to comply with their fiduciary duty under ERISA and indirectly with the Act.

ERISA Plan Identification

It is extremely important to identify ERISA-covered plan clients properly and to maintain the appropriate operational structures around such classification. Certain plans, such as traditional pension and profit-sharing plans and 401(k) plans are governed by ERISA; others, such as certain 457 and 403(b) plans, governmental plans, and IRAs are not. The failure to properly categorize the plan client may create problems in terms of applying the appropriate fiduciary standard of care, accepting certain forms of direct or indirect compensation, improperly engaging in a nonexempt prohibited transaction, or failing to make proper disclosures. There should be a written policy in place that enables the investment advisor to list and identify all of its ERISA governed plans, as well as IRAs insofar as the potential for prohibited transactions under the parallel provisions of the Internal Revenue Code. Proper identification of ERISA plans will also enable the investment advisor to properly determine whether the bond requirements under ERISA Section 412 are relevant or whether fiduciary insurance coverage should be considered for its investment advisory activity.

In the event that the client is invested in a pooled vehicle, the investment advisor must have a policy in place for application of the ERISA "25 percent test" immediately after the acquisition or redemption of an equity interest.

Standard ERISA Provision in the Advisory Agreement

The advisory agreement, and any corollary account opening information, should contain basic representations concerning the authority of the client to retain the investment advisor pursuant to the terms of the advisory agreement, the consistency of the investments with the terms of the governing plan documents (including the investment policy statement, or IPS), and the fees and expenses may be paid from plan assets. A written procedure should be in place that reviews and confirms the terms and conditions of the advisory agreement before acceptance.

ERISA Fiduciary Standards

The fiduciary standards under ERISA Section 404(a) should be expressly adopted with regard to the investment advisor in its capacity as a plan fiduciary. Further, account acceptance should be conditioned on a representation or confirmation that the ERISA plan assets are held in trust, and that the indicia of ownership of plan assets is held subject to the jurisdiction of U.S. courts.

Necessary Services Exemption Under ERISA Section 408(b)(2)

An investment advisor is a "party in interest" with regard to the plan client and so is prohibited from providing services unless ERISA Section 408(b)(2) is satisfied. A written policy should be in place to ensure that (1) termination of the arrangement is permitted without penalty on short

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notice; (2) no more than reasonable compensation is paid; and (3) the specific disclosures required under DOL Regulation 408b-2 are made.

Depending on the nature of the services provided and whether the investment advisor is acting as a nonfiduciary, there should also be policies in place concerning the availability of the qualified professional asset manager (QPAM) exemption under Prohibited Transaction Exemption (PTE) 84-14 and the statutory service provider under ERISA Section 408(b)(17).

Affiliated Brokerage

If trading and execution activities are conducted by an affiliate of the investment advisor, written policies should identify the specific statutory or administrative class exemption under which relief from the prohibited transaction rules is obtained. The most commonly used exemption is PTE 86-128, which addresses situations in which the broker dealer or an affiliate (such as an investment advisor) is acting as a fiduciary with respect to the transaction involving plan assets.

Proprietary Investments

Where the investment advisor is affiliated with the sponsor or manager of an investment option held by the plan, increased compensation will trigger a prohibited transaction. Written policies should address this conflict and impermissible payment of additional compensation, or otherwise utilize approaches such as those provided in the "Sun America" advisory opinion or with fee-offset mechanisms.

Cross Trades

A cross trade, in which the investment advisor is representing both sides of the transaction, may trigger a fiduciary violation under ERISA Section 406(b)(2). PTE 2002-12 may be available for index and model-driven funds. ERISA Section 408(b)(19) allows an investment advisor to execute cash transactions for securities, for which there are market quotations readily available, between certain plans. Written policies for cross-trading must be established in order to satisfy the numerous conditions required for relief under either of these exemptions

Revenue Sharing

The development of complex investment products and services, delivered in bundled fashion or informally by strategic partners, has been accompanied by numerous forms of fee-sharing structures among platform providers, financial institutions, and recordkeepers. These arrangements may involve a party in interest violation under ERISA Section 406(a)(1)(B) or (D) or fiduciary concerns with regard to self-dealing or kickbacks under ERISA Section 406(b). Depending on the facts and circumstances, it may be argued that the fee-sharing arrangement is not a prohibited transaction at all or that it fits within the guidance provided under various DOL advisory opinions, such as the "Frost" letter, the "Aetna" letter, or the "Country Trust" letter. The investment advisor will want to have compliance policies in place so that its revenue-sharing agreements comply with the appropriate authority.

Conclusion

The list of potential transactions for which a written policy would be extremely helpful to ensure fiduciary compliance is endless. Other common transactions include default investment options under ERISA Section 404(c)(5), participant investment advice under ERISA Sections 408(b)(14) and 408(g) (or other DOL sanctioned mechanisms), soft dollars and directed brokerage under ERISA Technical Release 86-1, and block trading under ERISA Section 408(b)(15), to name just a few.

Written policies and procedures that are reasonably designed to help the investment advisor comply with its fiduciary duties are consistent with the Act and the general procedural prudence guidelines of ERISA. Advisors should remember that failure to comply with a written procedure is likely to be viewed more harshly by regulators than the failure to have one. ❖

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