TESTIMONY OF DONALD J. MYERS

House Committee on Education and the Workforce
Subcommittee on Health, Employment, Labor, and Pensions

Redefining "Fiduciary": Assessing the Impact of the Labor Department's Proposal on Workers and Retirees

July 26, 2011

Chairman Roe, Ranking Member Andrews and other members of the Subcommittee, I want to thank you for giving me the opportunity to testify today.

My name is Donald Myers. I am a partner in the law firm of Morgan, Lewis & Bockius LLP in Washington DC. My practice focuses on the fiduciary responsibility rules of the Employee Retirement Income Security Act of 1974 ("ERISA"), primarily relating to investment matters. I assist pension plans and financial institutions in structuring investments for plans, and represent clients before government agencies, including the Department of Labor (the "DOL"), on ERISA-related issues.

Before entering private practice in 1984, I was Counsel for ERISA Regulation and Interpretation at the DOL. Previously, I was Assistant Chief of the Office of Disclosure Policy and Proceedings at the Securities and Exchange Commission. I have chaired various subcommittees of the American Bar Association dealing with employee benefit plans and ERISA fiduciary responsibility matters, and have been an Adjunct Professor at Georgetown University Law Center. In addition, I am a Charter Fellow of the American College of Employee Benefits Counsel. I have lectured and written extensively on employee benefits issues, with my publications including the book *ERISA Class Exemptions*, and chapters on class exemptions and trustee responsibility in the treatise *ERISA Fiduciary Law*.

My testimony today will provide some background on the ERISA fiduciary rules and then focus on the DOL's regulatory and exemptions process in the ERISA area, based on my experience at the DOL and in private practice. I am speaking here today on my own behalf.

ERISA Fiduciary Rules, Prohibited Transaction Provisions and Exemptions

The centerpiece of the ERISA framework for the administration and management of employee benefit plans is the role of the fiduciary. ERISA defines who is a fiduciary using a functional test, including the activities of discretionary management over plan assets and, as relevant to today's hearing, rendering "investment advice" for a fee or other compensation regarding plan assets.

A person who is an ERISA fiduciary is subject to the ERISA fiduciary responsibility rules, which can be divided into two categories – the general fiduciary responsibility rules, and the prohibited transaction rules.

The general fiduciary responsibility rules impose standards of fiduciary conduct. They require a fiduciary to act prudently and solely in the interest of the plan participants and beneficiaries, to diversify plan investments unless clearly prudent not to do so, and to follow the plan documents and instruments so long as they are consistent with ERISA.

The prohibited transaction rules consist of two parts. The first part prohibits transactions between a plan and parties with certain relationships to the plan, so-called "parties in interest" or "disqualified persons"; these include non-fiduciary service providers. The second part prohibits plan fiduciaries from engaging in self-dealing and conflicts of interest.

There are two sets of consequences to a breach of fiduciary duty. First, the breaching fiduciary can be personally liable to the plan for any loss suffered by the plan in the transaction that was a breach, or any gain received by the fiduciary as a result of the transaction. Second, where the transaction is prohibited, the disqualified person engaging in the transaction with the plan (which person may or may not be the fiduciary) is liable to the government for an excise tax of 15% of the amount involved in the transaction for each year until the transaction is corrected; if the transaction is not corrected, a 100% excise tax may be imposed. The DOL also may impose civil penalties of 20% of the amount it recovers from a breaching fiduciary in an enforcement action. These are serious consequences.

In my experience, financial services firms seek to avoid these potential liabilities and penalties by implementing policies and procedures intended to comply with DOL regulations and interpretations of the ERISA fiduciary rules.[1] In order to fashion and adopt effective policies and procedures (including structuring products) in this area, financial services firms need clarity and consistency in determining in what status, fiduciary or otherwise, they are acting when providing services to a plan.

This is in large part because the DOL has interpreted the prohibition on fiduciary self-dealing in an expansive way. According to the DOL, a fiduciary violates this prohibition wherever it has the authority to affect the amount of compensation it receives from the plan, or in connection with a transaction involving plan assets. Under this view, if a person becomes a fiduciary by giving investment advice for a fee for a transaction involving plan assets, and receives variable compensation as a result, the person has violated ERISA, even if the transaction is in the interests of the plan and is otherwise prudent.

To lessen the potentially broad scope of the prohibited transaction rules, ERISA contains a series of exemptions from those rules, and authorizes the DOL to establish a procedure for granting exemptions. The DOL may grant an individual exemption to a particular party, or a "class" exemption that is available to anyone in a defined class that is able to comply with its conditions. To grant an exemption, the DOL must first find that the exemption is (1) administratively feasible, (2) in the interests of the plan and its participants and beneficiaries, and (3) protective of the rights of plan participants and beneficiaries. Exemptions are published for comment in the Federal Register, and, if the exemption provides relief from the prohibited transaction provisions on fiduciary self-dealing and conflicts of interest, there must be an opportunity for a hearing. Using this authority, the DOL has granted 59 class exemptions, several hundred individual exemptions, and additional exemptive relief through an expedited exemption procedure. The class exemptions have given rise to a regulatory framework that, along with the statutory exemptions, governs a significant portion of plan activities.

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[1] It should be noted that, with limited exceptions, individual retirement accounts ("IRAs") are not subject to ERISA, but are subject to the prohibited transaction rules through parallel provisions in the Internal Revenue Code. While fiduciaries of IRAs thus would not be subject to liability for a fiduciary breach under ERISA, disqualified persons (such as fiduciaries) of IRAs could still be subject to an excise tax under the Internal Revenue Code for engaging in prohibited transactions.

1975 Fiduciary Regulation and Class Exemptions

The ERISA fiduciary rules came into effect on January 1, 1975. According to the ERISA conference report, the conferees were concerned that the application of ERISA's fiduciary standard could be disruptive to the established business practices of financial institutions.

In 1975, the DOL both granted an exemption, Prohibited Transaction Exemption ("PTE") 75-1, covering securities brokerage transactions and related services, and issued a regulation defining the scope of the "investment advice" prong of the fiduciary regulation. PTE 75-1 established the conditions under which broker-dealers could continue to provide multiple services to plan clients without running afoul of the prohibited transaction rules. The regulation created a five-part test for determining when a "person" becomes a fiduciary to a plan by reason of providing "investment advice."

For almost 36 years, this five-part test has provided certainty and clarity as to whether a person had entered into a relationship that would subject that person to the ERISA fiduciary rules. It forms the basis upon which financial services firms historically have based their compliance procedures, structured their financial products and services, implemented their fee and compensation arrangements, established their business relationships and distribution channels, and generally interacted with their plan clients. The five-part test has now been in place for nearly four decades without any objection from Congress that it was contrary to legislative intent.

Rules for Individual Retirement Accounts of IRAs

There are currently more than 40 million IRAs. Most IRAs are not subject to ERISA or ERISA's standard of care. However, they are covered by the Internal Revenue Code's (the "Code's") prohibited transaction provisions, which are substantially parallel to those of ERISA. While responsibility for interpreting the Code's prohibited transaction provisions has been transferred to the DOL, the Internal Revenue Service (the "IRS") retains full enforcement authority over these Code provisions. Thus, DOL has no enforcement jurisdiction over the vast majority of IRAs.

As individual accounts, IRAs are fundamentally different from ERISA plans. These accounts are generally small and are overseen by the IRA beneficiary, who has the ability to choose an IRA's service providers and can generally move the account at will. Congress recognized these differences when it applied a comprehensive fiduciary standard of care to ERISA plans and only applied the prohibited transaction rules to IRAs. On a number of occasions, the DOL also recognized these differences, applying different conditions when crafting certain of its prohibited transaction exemptions and regulations. For example, PTE 86-128 (and its precursor PTE 79-1), a class exemption for securities brokerage, and the Interim Final regulation under ERISA section 408(b)(2), which contains disclosure requirements, do not apply certain of their conditions to IRAs.

Proposed Fiduciary Regulation

The proposed regulation that is the subject of this hearing would make significant changes to the regulatory guidance that was adopted in 1975, and upon which the financial services industry has come to rely. I am not going to speak on the pros and cons of specific features of the proposal – those issues have been addressed in several hundred comment letters, and will be discussed further by the other witnesses on this panel. Instead, I am going to focus on the regulatory process.

There is much concern in the financial services industry about potential ramifications if the proposal is adopted in its current form. Many (if not most) of the issues being raised by the financial services industry stem from concern that currently accepted and long-standing business practices may, under the new regime, suddenly become prohibited transactions. The DOL staff has responded that these issues can be addressed through the exemptions process. In view of prior DOL practices, this is a logical response where new-found fiduciary status raises concerns about violations of the ERISA prohibited transaction rules.

What could facilitate this process is that there are already several class exemptions that could cover some of the transactions that would be affected by the new DOL rule. The three that come to mind are: (1) PTE 86-128, for a fiduciary to cause a plan to execute securities transactions for a fee through itself or an affiliate (*i.e.*, agency brokerage); (2) PTE 84-24, for a fiduciary to cause a plan to pay the fiduciary or an affiliate a commission as an insurance agent or broker in connection with the purchase of an insurance or annuity contract (*i.e.*, insurance brokerage) or as a mutual fund principal underwriter; and (3) PTE 75-1, Part II, for transactions in third-party mutual fund shares.

The question is whether the approach of dealing with the anticipated impacts of the new rules through the exemptions process would be effective here. I see two problems with the exemptions approach.

The first problem is that the existing class exemptions would not, without modification or clarification, provide exemptive relief for all transactions that would be affected by the proposal. The DOL could work to modify and/or clarify the existing exemptions, or propose a new class exemption more specifically focused on the business practices that would be affected. So this, standing alone, would not necessarily be a barrier.

However, this leads to the second problem, which is that modifying a class exemption, or granting a new class exemption, can be a long, complicated process. On average, the process usually takes at least a year, and frequently longer. For more complicated transactions and arrangements, as could be involved here, more time may be needed to sort through the necessary relief and to develop conditions that are workable for the plan fiduciaries and service providers. Yet more time would be necessary if a hearing were requested, which could be the case for a major exemption that affects a large portion of the financial services industry. The point is that modifying existing exemptions takes time, and developing a new exemption would take even more time – the process must allow for that.

The timing issue is important when considering how to coordinate the exemptions with the finalization of the regulation. It is likely, based on the 201 comments that were filed with the DOL on the original proposal, the testimony at the DOL hearing in March and the 65 additional comments submitted after the hearing, that there will be a number of significant changes to the proposal. That alone should be a reason for the DOL to re-propose its regulation, in order to give affected firms an opportunity to review the new provisions and comment on how they are dealing with the issues that were raised on the original proposal. Another reason is that the proposal did not mention IRAs, except for a brief reference in the opening summary, and provided no economic analysis of the impact on IRAs (the focus of the economic analysis was entirely on ERISA plans). There should be an analysis of the effect on IRAs, including whether there is any benefit to additional regulation of IRAs under the Code's prohibited transaction rules in light of the current regulatory regimes that govern the IRA market, and an opportunity to comment on that analysis.

There also is a need for affected parties to comment on whether any new or modified exemption proposed by the DOL effectively addresses the prohibited transaction issues created by the new rules. The parties will have to determine whether it is feasible for them to operate under the conditions of the exemptions – if the conditions are too complicated or unworkable, the exemptions will not be of any help. This cannot be done unless the exemptions are proposed in conjunction with re-proposal of the fiduciary definition regulation, so that the two can be considered together and modified as necessary based upon the comments.

For these reasons, it is my view that if the DOL elects to rely on exemptions to deal with the effects of an expanded fiduciary definition, it should re-propose the changes to the fiduciary definition in coordination with its proposal of exemptive relief. This would give affected parties sufficient opportunity to review and comment upon all aspects of this new regulatory structure.

Again, thank you for giving me the opportunity to testify, and I would be happy to answer any questions that you may have.