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DOL Investigations: Broker-Dealers and RIAs as Targets

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In recent months, we have heard of at least eight, and been involved in three, Department of Labor (DOL) investigations of broker-dealers related to their services to ERISA retirement plans. These investigations appear to be part of the DOL's ongoing Consultant/Adviser Project (CAP). The CAP initiative is a national enforcement project designed to focus on "the receipt of improper or undisclosed compensation by employee benefit plan consultants and investment advisers." This article discusses the background that led to the creation of CAP, the issues that financial advisers need to focus on and steps they may wish to take now to avoid liability exposure under ERISA.

Background

Traditionally, the DOL has focused its employee benefit plan investigations on plan sponsors and administrators. Periodically, as part of these investigations, the DOL would discover an issue with a plan's service provider that would lead to an investigation of that service provider and its services to all of its employee benefit plan clients. In the process, the DOL then discovered conflict of interest and fiduciary issues involving investment advisers (RIAs) and broker-dealers. Concerned that this might represent a pattern of abuse, the DOL began targeting these service providers for investigation.

The DOL's concern arose in part out of a staff report issued in 2005 by the Securities Exchange Commission (SEC) concerning pension consultants and conflicts of interest and fee issues. As part of their findings, the SEC noted that:

> Many pension consultants believe they have taken appropriate actions to insulate themselves from being considered a "Fiduciary" under ERISA. As a result, it appears that many consultants believe they do not have any fiduciary relationships with their advisory clients and ignore or are not aware of their fiduciary obligations under the Advisers Act.

Under ERISA, the implications of this finding is that if a provider is a fiduciary, it must comply with ERISA's fiduciary duty and prohibited transaction rules, even if the provider

does not acknowledge fiduciary status.[1] The pension consultant program was aimed at determining when a provider is in fact a fiduciary.

In conjunction with the issuance of the SEC's report on pension consultants, the SEC and DOL jointly issued a guide for plan fiduciaries – "Selecting and Monitoring Pension Consultants: Tips for Fiduciaries." This guide included a series of questions designed to encourage "the disclosure and review of more and better information about potential conflicts of interest." The guide suggests that fiduciaries ask a series of questions, including the following:

- Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, describe those relationships.
- Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your other income (revenue)?
- Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?

With respect to the last question, in particular, we have found that broker-dealers may not realize when they are giving individualized advice that results in fiduciary status under ERISA.[2] When that advice can affect their compensation (or the compensation of an affiliate), there is likely a prohibited transaction. For example, if the fiduciary receives variable compensation that is based on the particular advice or if the fiduciary recommends an investment fund that is managed by an affiliate of the fiduciary, there is a prohibited transaction.

Around the same time the DOL and SEC issued their guidance, the DOL initiated the CAP enforcement project. The CAP description indicates that investigations "seek to determine whether the receipt of such compensation, even if it is disclosed, violates ERISA because the adviser/consultant used its position with a benefit plan to generate additional fees for itself or its affiliates. ... The CAP will also seek to identify potential criminal violations, such as kickbacks or fraud."

Current Status

As part of CAP, the DOL has initiated investigations of plan service providers such as broker-dealers and RIAs. There is no official guidance on what triggers an investigation of any particular service provider, although we have informally heard that at least some investigations may be linked to referrals by securities regulators. This is consistent with the SEC's statements and publications regarding pension consultants and conflict of interest concerns.

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1 Note that under ERISA Regulation §2550.408b-2, service providers will be required to disclose their fiduciary status. This regulation becomes effective for all client relationships on April 1, 2012.

2 Existing guidance under ERISA provides that individualized investment advice based on the particular needs of the recipient (plan or participant) that is the primary basis for investment decisions by the recipient constitutes ERISA fiduciary advice. This status is not dependent on the proposed revision to the fiduciary definition that the DOL recently announced it is re-working.

Since CAP was initiated, the DOL has issued news releases regarding violations with respect to the fee arrangements of advisers and broker-dealers. The DOL discovered these issues while conducting investigations under CAP. In one case, DOL investigators alleged that a consulting firm and affiliated broker-dealer "received undisclosed and unauthorized compensation, and failed to timely provide promised commission rebates to certain ERISA plans." The consulting firm entered into a settlement, agreeing to pay over $300,000 and make changes to its disclosure processes.

With the DOL's focus turning to plan and participant-level disclosures and investment fee and conflicts of interest concerns, CAP is likely to become more prominent. In fact, as mentioned above, we are aware of several broker-dealers recently receiving letters initiating DOL investigations.

Scope of an Investigation

As part of the investigations, the DOL typically requests a large quantity of documents related to both broker-dealer and RIA accounts. Examples of some requests and the resulting consequences include:

- **Documents listing benefit plan clients and information about the client, such as service dates, and identification of other providers.**

  Observation: These documents may be difficult for the broker-dealers to gather as they may not have all of this information readily available.

- **Agreements between the service provider and employee benefit plan clients.**

  Observation: Depending on the size of the broker-dealer, this may be a massive amount of documents. As such, it is worth discussing with the DOL investigator whether samples or a smaller subset of documents may be provided. Further, not all broker-dealers have formal agreements with their benefit plan clients. In some cases, this may just be the account opening form.

- **Documents that describe services provided to benefit plan clients.**

  Observation: This could include marketing materials, website information and 408(b)(2) disclosures. Broker-dealers may need to inventory the different places this information can be found. They should also consider how the services are described and whether they may indicate functional fiduciary status. Making a determination on fiduciary status – or how to address the issue if that status is clear – may require that the firm consult with experienced ERISA counsel for assistance.

- **Documents relating to arrangements providing benefit plan clients with advice regarding securities valuation and investing in securities to be used as the basis for investment decisions.**

  Observation: It appears that the DOL is requesting this information in order to determine whether the provider is a fiduciary (or perhaps a functional fiduciary). Presumably, the DOL will use this information to determine whether providers

are acting as fiduciaries, what compensation they receive when acting as such and whether such compensation is permitted. As a result, providers should discuss these issues with counsel. Providers such as broker-dealers who do not acknowledge fiduciary status and believe they are not acting as fiduciaries may nonetheless become functional fiduciaries by virtue of providing individualized advice or being able to set their compensation. In such a case, the broker-dealers become subject to the DOL's jurisdiction for enforcing prohibited transactions between a fiduciary and a plan. (Even when not serving as a fiduciary, a broker-dealer is subject to the DOL's jurisdiction and prohibited transaction rules but the non-fiduciary prohibitions are generally easier to manage.)

> **Information regarding individuals who gave advice regarding the valuation of securities, made recommendations regarding selecting investments or exercised discretionary control over selecting investments.**

Observation: This too is likely aimed at determining fiduciary status and should involve discussions with counsel.

Overall, much of the requested information is not readily available to advisers and broker-dealers and involves a fair amount of culling of files and records. The requests tend to be over inclusive, designed to generate substantial information and documentation. The sheer quantity of documents may prove burdensome to both the providers and the DOL investigators. In part, this suggests trying to come to an understanding with the investigator about the volume of materials being requested.

Conclusion

While CAP and fiduciary concerns have been around for several years, it appears that they are becoming more prominent with the DOL's enforcement unit. RIAs and broker-dealers should be aware of this DOL initiative and consider examining their current practices and procedures with respect to employee benefit plan clients. We have worked with a number of broker-dealers and RIAs on investigations and reviewing their ERISA practices. We recommend that RIAs and broker-dealers initiate an internal audit, or work with ERISA counsel in performing an audit. As part of this review, RIAs and broker-dealers should consider the services they provide to determine if they are acting as fiduciaries and, if so, whether their compensation is appropriate and permitted. Such a review should also preferably pre-date the efforts to meet the new service, fee and status disclosures that will become effective April 1, 2012.

Investment Management Group

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