

ERISA Trading Training



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CompliGlobe Ltd.

What is ERISA?

- U.S. federal law that protects the interests of participants in certain employee benefit plans
- Standards governing the conduct of employee benefit plan “fiduciaries,” such as investment managers
- Administered and enforced by the U.S. Department of Labor (“DOL”)
- Managers of ERISA accounts are subject to a fiduciary duty higher than that imposed upon SEC registered investment advisers (“RIAs”)
 - Must comply with **prohibited transaction** rules intended to limit or restrict self-dealing
 - Perform duties with the level of care, skill, prudence and diligence under circumstances then prevailing that a **prudent expert** would use when conducting similar business
 - Investments in a covered plan must be diversified to minimize the risk of large losses unless it is clearly prudent not to do so

What is a QPAM?

- A “qualified professional asset manager” (“QPAM”) within the meaning of Prohibited Transaction Class Exemption 84-14, as amended
- Must be
 - An RIA
 - Total client AUM and control in excess of \$85 million as of most recent FYE – soon to be increased to \$100 million; and
 - Shareholders’ or partners’ equity in excess of \$1 million *or* payment of liabilities unconditionally guaranteed by entities specified in QPAM Exemption

Are we a QPAM?



- In determining whether an entity qualifies as a QPAM
 - Assets under management only include assets managed by the QPAM, not assets managed by its affiliates
 - AUM does not include assets that investors have pledged to invest in a newly formed fund, but that are not yet actually managed by the QPAM
 - Assets under management do not include assets for which the QPAM provides only sub-advisory services and does not have *investment authority* e.g. QPAM is sub-adviser that provides non-binding advice to primary adviser
 - QPAM may not have been convicted of certain activities that could bear on financial trust
- The asset manager must represent in writing to the client that it acts as a fiduciary
- The QPAM must negotiate the terms of each transaction and decide on behalf of the plan whether to engage in the transaction

Prohibited transactions

- Two types of prohibited transactions
 - Transactions with a “party in interest” to the plan
 - Self-dealing transactions by a plan fiduciary
- A "party in interest" of a plan includes
 - i. any fiduciary of the plan
 - ii. any person providing services to the plan
 - iii. any employer whose employees are plan participants
 - iv. any employee organization (e.g., union) whose members are plan participants
 - v. certain persons and entities related to or affiliated with anyone in the first four categories

Prohibited transactions (cont'd) - parties in interest

ERISA specifically *prohibits* the following transactions with a “party in interest”

- Any sale, exchange or leasing of property
- Any loan or other extension of credit
- Any furnishing of goods, services or facilities
- Any transfer of plan assets to, or use of plan assets by or for the benefit of, a party in interest

QPAM CAN HELP WITH THIS!

Prohibited transactions (cont'd) - parties in interest

QPAM doesn't help where the party in interest itself is a QPAM or a person "related to" the QPAM

A person is considered "related" to the QPAM if

- the QPAM owns a 10% or greater interest in the party in interest, or a person controlling or controlled by the QPAM owns a 20% or greater interest in the party in interest
- the party in interest owns a 10% or greater interest in the QPAM, or a person controlled by or controlling the party in interest owns a 20% or greater interest in the QPAM; etc.

Prohibited transactions (cont'd): self-dealing/conflicts of interest

Self-Dealing: DOL regulations state that this prohibits a fiduciary from

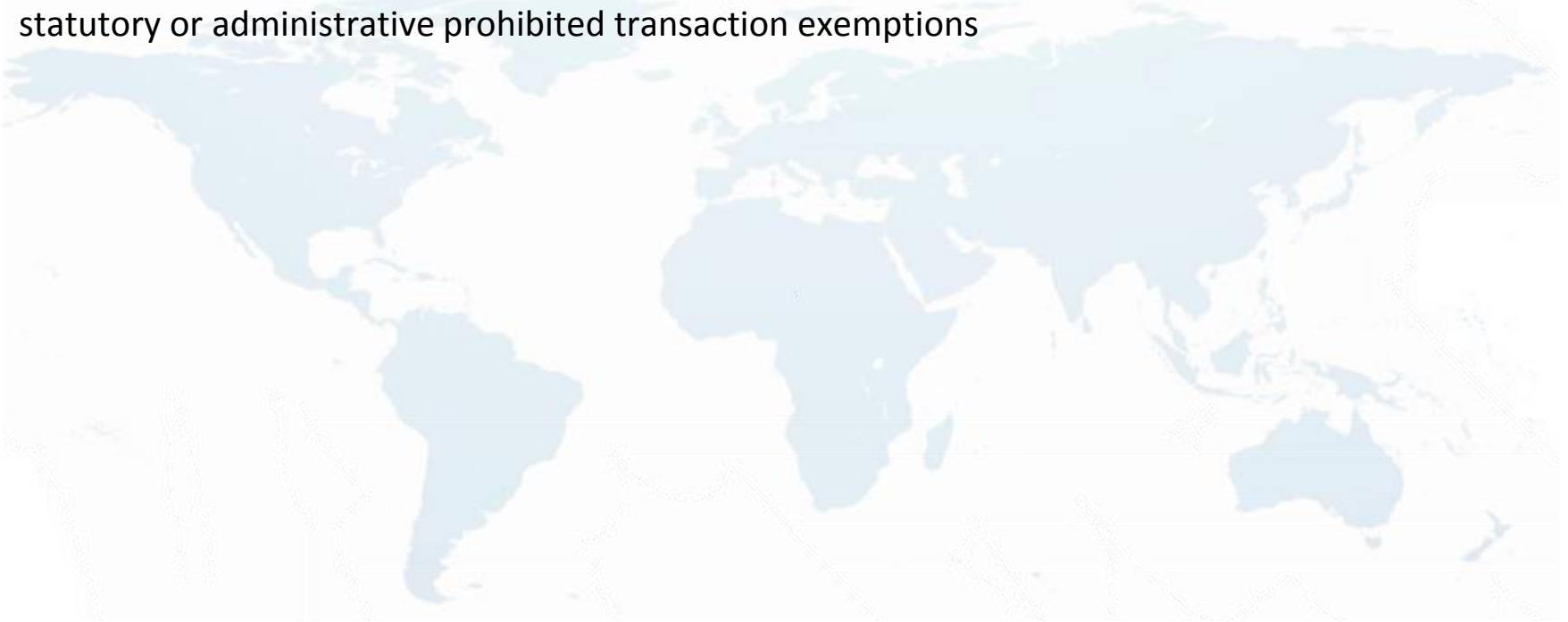
1. using any of its authority, control, or responsibility to
2. cause a plan to pay an additional fee – performance fee – to the fiduciary or a person in which the fiduciary has an interest that may affect the fiduciary's best judgment as a fiduciary – unless the DOL advisory opinions are followed (several conditions, most of which arise under the Advisers Act)

Conflicts of Interest: A fiduciary may not act in a transaction involving a plan on behalf of a party, or represent a party whose interests are adverse to the plan

QPAM *CAN'T* HELP WITH THESE!

Prohibited transaction exemptions

Because of the breadth of the ERISA prohibited transaction restrictions, investment managers for ERISA-covered plans would be effectively unable to invest without relying on one or more statutory or administrative prohibited transaction exemptions



Three types of exemptions

- Statutory exemptions contained in ERISA or the IRS Code – these apply to anyone who meets the terms of the specific exemption
- Class exemptions: created by DOL that apply not only to the applicant but to anyone who meets the terms of the exemption
 - Takes years to obtain
- Individual exemptions: sought by an applicant that only apply to the applicant; others may not rely on those exemptions even if the conditions apply
 - Can also take years to obtain, but there is an expedited process available

Some of the most common exemptions/PTEs

- Foreign exchange transactions PTE 94-20
- Repos with U.S. banks and U.S. broker-dealers. PTE 81-8
 - REVERSE Repos not exempted
- Securities lending transactions to U.S. banks and U.S. broker-dealers. PTE 81-6/2002-16
- Cross-trades. PTE 86-128
- Cross-trades among Index Funds and Model-Driven Funds; and Cross-trades between an Index or Model-Driven Fund and a “Large Account.” PTE 2002-12
- Purchase and holding of asset backed securities. PTE 83-1
- Agency execution of securities trades by a fiduciary. PTE 86-128
- “Services exemption” -- ERISA Section 408(b)(2)
- Service provider exemption - ERISA Section 408(b)(17)

ERISA and gifts

- ERISA prohibits the acceptance of fees, kickbacks, gifts, loans, money and anything of value that are given with the intent of influencing decision-making with respect to any employee benefit plan
- The acceptance or offering of gifts, entertainment or other items may be viewed as influencing decision-making and therefore unlawful under ERISA
- **Report all gifts and entertainment and, if possible, pre-clear all**



Cross trades involving ERISA plan assets – note *WAM*

- **Do not effect a cross trade involving ERISA plan assets unless you can satisfy all of these**
- **Know if and when you can aggregate ERISA and non-ERISA assets (discussed below)!**
- The transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available
- The transaction is effected at the independent current market price of the security
- No brokerage commission, fee (except for customary transfer fees, which is disclosed and no other remuneration is paid in connection with the transaction
- Pre-trade authorization and after the fiduciary receives disclosure regarding the conditions under which cross trades may take place (separate from any other agreement or disclosure involving the asset management relationship)
- Each plan participating in the transaction has assets of at least \$100,000,000 except that if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group (as defined in ERISA section 407(d)(7)), the master trust has assets of at least \$100,000,000

Cross trades involving ERISA plan assets (cont'd)

- Cannot base fee on the plan's consent to cross trading, and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading
- Must effect cross-trades in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts and that include a description of the manager's policies and procedures for pricing and allocating – clear and objective manner
- Designated individual is responsible for periodically reviewing such purchases and sales to ensure compliance with the written policies and procedures described above, and following such review, the individual issues an annual written report no later than 90 days following the period to which it relates, signed under penalty of perjury to the plan fiduciary who authorized cross trading describing the steps performed during the course of the review, the level of compliance, and any specific instances of non-compliance
- Provide quarterly report detailing all cross trades executed by firm in which the plan participated during the quarter, including : (i) the identity of each security bought or sold; (ii) the number of shares or units traded, (iii) the parties involved in the cross-trade; and (iv) trade price and the method used to establish the trade price

Trading issues

- ERISA plans may only buy and hold ERISA eligible assets – note the SEC and DOL cases against WAM *keep an accurate list of what ERISA clients can and cannot buy*
- Block trades
 - Generally, cannot aggregate ERISA plan assets and non-ERISA assets
 - Exception: at the time of the block trade, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor), does not exceed 10% of the aggregate size of the block trade *train, monitor and test*
 - The terms of the block trade, including the price, are at least as favorable to the plan as an arm's length transaction *monitor*
 - The compensation associated with the purchase and sale is not greater than the compensation associated with an arm's length transaction with an unrelated party *monitor*
 - The block trade is of at least 10,000 shares or with a market value of at least \$200,000 *monitor and, if possible, pre-trade monitor and block if possible*

Directed brokerage requirements

- *If you do this*
 - Must request and obtain a written letter or electronic communication from the client that authorizes firm's use of brokerage commissions generated by that client's trade in a directed brokerage arrangement
 - Client's Directed Brokerage Arrangement's letter will list the eligible broker-dealers and specify the target percentage or dollar amount of transactions to be directed
 - The product or service acquired in the directed brokerage arrangement will be exclusively used for the plan's participants or other beneficiaries

Liability

- A fiduciary who breaches his or her duty to a plan is personally liable to the plan for any losses resulting from the breach and for disgorgement of any profits realized by the fiduciary as a result of the breach
- A fiduciary who engages in a prohibited transaction is liable for losses resulting from the breach and for disgorgement
- Parties in interest who engage in prohibited transactions may be subject to equitable relief to address the breach
- Penalties
 - The DOL is authorized to recover a penalty of 20% of any amount recovered by DOL in an action for breach of fiduciary duty
 - Personal liability (ERISA Section 409(a))
 - Correction (unwinding of any prohibited transactions)
 - Reimbursement for any loss
 - Imposition of IRS penalty rate
 - Excise taxes equal to 15% per calendar year for uncorrected violations
 - Reputational risk

Keep these in mind

- *Tibble v. Edison Int'l*, U.S. Supreme Court (2015): fiduciaries who breach their fiduciary duty by failing to monitor investments will not be excused because more than six years has elapsed from the time the investment was selected to the time of the suit. For plaintiffs, so long as the failure to monitor occurs within the six years prior to the suit, the claim is timely
 - Conduct investment reviews regularly **quarterly**
 - Keep evidence of ongoing and regular monitoring of investment options **monitor and test thoroughly and keep accurate records**
 - Negotiate to reduce fees, rebates and include less expensive share classes **be an effective, not aggressive, negotiator**

SEC and DOL cases: *Western Asset Management I and II*

- Ineligible investments
 - Ineligible ERISA investments purchased for ERISA accounts **always check before you trade**
 - Failures were due to coding issues – initially concluded that investments were, in fact, suitable and that no investment guidelines had been violated **code ERISA permissible investments**
 - When discovered, over-rode the system to permit same and then failed to timely address the issue – some accounts held ineligible assets for more than one year **address issues asap**
- 514 non-permissible ERISA cross trades
 - Pre-arranged dealer-interposed cross trades breached internal controls, WPPs and fiduciary standards, ERISA requirements – and resulted in conflicts of interest **ID conflicts and supervise to prevent “pre-arranged”**
 - Failed to disclose such cross-trading, undisclosed favorable treatment **monitor and test**
 - Compliance systems failed to pick up the cross trades – red flag was “trades should have been two separate arms-length ... transactions” but were “in reality effected at identical spreads” **monitor and test and act promptly upon anomalies**
 - Oversight left to a trades who failed to take proper steps to prevent such trading, no compliance training, trader not supervised **supervise, supervise!**



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