U.S. Department of Labor Announounces Proposed Rule To Update and Expand Definition of ERISA "Fiduciary"

On October 21, 2010, the Employee Benefits Security Administration ("EBSA") of the United States Department of Labor ("DOL") announced a proposed rule (the "Proposed Rule")[1] to update the definition of "fiduciary" for purposes of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Proposed Rule would expand the categories of persons and entities who are considered fiduciaries by reason of providing "investment advice for a fee." The public comment period will last until January 20, 2011, and the final rule will become effective 180 days after publication of the final rule in the *Federal Register* (although the DOL is inviting comments on whether the final rule should become effective on a different date).

I. Background

ERISA establishes standards of conduct, responsibility and obligation for fiduciaries of employee benefit plans ("Plans").[2] ERISA imposes certain duties on Plan fiduciaries, including a stringent duty of care, a duty of undivided loyalty and a duty to act for the exclusive purposes of providing Plan benefits to participants and their beneficiaries and defraying reasonable expenses of administering the Plan.[3] In addition, fiduciaries are prohibited from engaging in certain transactions involving Plan assets, such as self-dealing with Plan assets, acting on behalf of a party whose interests are adverse to the Plan's interests in a transaction involving the Plan, and receiving consideration for the fiduciary's own personal account from any party dealing with the Plan in a transaction involving Plan assets.[4] Fiduciaries who violate such rules may be held personally liable for resulting losses sustained by the Plan and may be subject to excise taxes.[5]

Section 3(21)(A) of ERISA provides that a person will be considered a fiduciary with respect to a Plan to the extent:

"(i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

(ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or

(iii) he has any discretionary authority or discretionary responsibility in the administration of such plan."

In 1975, the DOL issued a regulation (the "Current Regulation") that defined under what circumstances a person renders "investment advice" to a Plan, such that the person may properly be considered a "fiduciary" under

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1 *Available at* http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328. The proposed regulation was published in the *Federal Register* on October 22, 2010.

2 As used in this memorandum, "employee benefit plans" refer not only to plans that are subject to Title I of ERISA, but also to plans subject to Section 4975 of the Internal Revenue Code of 1986, as amended ("Code"). The Proposed Rule states that it also applies for purposes of the application of Section 4975 of the Code to any plan subject to said Section 4975, regardless of whether it is subject to Title I of ERISA.

3 *See* ERISA Section 404(a).

4 *See* ERISA Section 406.

5 *See* ERISA Sections 406 and 409, Code Section 4975.

the second category enumerated in ERISA Section 3(21)(A).[6] The Current Regulation significantly narrowed this second category by creating a 5-part test which must be met in order for a person to be considered a fiduciary by reason of rendering investment advice. Specifically, the person must:

(1) render advice as to the value of securities or other property, or make recommendations regarding the advisability of investing in, purchasing or selling securities or other property,

(2) on a regular basis,

(3) pursuant to a mutual agreement, arrangement or understanding with the plan or a plan fiduciary, that

(4) the advice will serve as a primary basis for investment decisions regarding plan assets, and that

(5) the advice will be individualized based on the particular needs of the plan.

The Current Regulation has not been revised since 1975. The DOL sets forth several key reasons in the Proposed Rule, however, as to why it believes that the Current Regulation should be modified. These reasons may be summarized as follows:

- Since 1975, retirement plans have shifted from predominantly defined benefit plans to mainly defined contribution plans. In addition, the complexity and variety of investment products and services available to plans have significantly increased. As a result, plan investment practices and the relationships between plans and advisers have changed;
- Although plan representatives usually want and expect impartial guidance from consultants, appraisers and other advisers, if such advisers are not fiduciaries under ERISA, they may operate with conflicts of interest (such as receiving compensation from the investment companies whose products they recommend) that they need not disclose to the plan representatives.[7] This may lead advisors to steer plans toward products for which they receive additional compensation, even if such products are not ideal for investment by the plan. Further, by not being an ERISA fiduciary, such advisers face only limited liability under ERISA for their guidance and advice, despite the fact that such guidance and advice may significantly influence decisions regarding the plan and plan investments, sometimes to the great detriment of plans and their participants;[8] and
- The Current Regulation focuses on establishing each element of the 5-part test rather than on the misconduct at issue. As a result, even in cases where an adviser provided advice that was wholly abusive, if the DOL cannot prove each of the five elements of the test, the adviser cannot be charged with a fiduciary breach and is able to escape related liability. The DOL does not believe that the current 5-part test is compelled by Section 3(21)(A)(ii) of ERISA, nor does it believe that

6 *See* 29 CFR § 2510-3.21(c). *See also* 26 CFR § 54.4975-9(c), a virtually identical regulation issued by the Department of Treasury that interprets Section 4975(e)(3) of the Code. References in this memorandum to sections of ERISA should be read to also refer to corresponding sections of the Code.

7 *See U.S. Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Staff Report Concerning Examinations of Select Pension Consultants* (May 16, 2005), *available at* http://www.sec.gov/news/studies/pensionexamstudy.pdf (reporting that a majority of pension consultants examined provided products and services to pension plan advisory clients, money managers and mutual funds on an ongoing basis without adequately disclosing conflicts of interest).

8 *See Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO 09-503T (Mar. 24, 2009) (reporting an association between pension consultants with undisclosed conflicts of interest and lower rates of return for their clients' plans).

this framework represents the most effective means for differentiating among persons who should be held accountable as fiduciaries and those who should not.

II. The Proposed Rule

Pursuant to the Proposed Rule, a person would be deemed to be rendering "investment advice" for a fee or other compensation, direct or indirect, within the meaning of Section 3(21)(a)(ii) of ERISA, if, with respect to a Plan, Plan fiduciary, participant or beneficiary, he or she (1) provides advice, or an appraisal or fairness opinion, concerning the value of securities or other property; or (2) makes recommendations regarding the advisability of investing in, purchasing, holding or selling securities or other property; or (3) provides advice or makes recommendations regarding the management of securities or other property. The Proposed Rule would thus modify the 5-part test under the Current Regulation by (i) eliminating the requirement that investment advice be provided on a "regular basis," (ii) eliminating the requirement that there must be a "mutual" understanding by the parties that the advice will serve as a "primary basis" for Plan investment decisions, (iii) specifically including the provision of appraisals and fairness opinions, (iv) making specific reference to advice and recommendations as to the management of securities or other property (which would include, for example, advice and recommendations as to the exercise of rights appurtenant to stock such as voting proxies and as to the selection of persons to manage Plan investments), and (v) making clear that fiduciary status may result from the provision of advice or recommendations not only to a Plan fiduciary but also to a Plan participant or beneficiary.

Under the Proposed Rule, a person providing one of the types of investment advice listed above would only be considered a fiduciary, however, if such person, directly or indirectly, also (1) represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA with respect to providing one of the types of investment advice listed above; or (2) is a fiduciary within the meaning of either of the other two prongs of Section 3(21)(A) of ERISA (*i.e.*, Section 3(21)(A)(i) or Section 3(21)(A)(iii)); or (3) is an "investment adviser" within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940;[9] or (4) provides one of the types of investment advice mentioned above pursuant to an agreement, arrangement or understanding, whether written or unwritten, between such person and the Plan, a Plan fiduciary, participant or beneficiary, that such advice may be considered in connection with making investment or management decisions with respect to Plan assets and will be individualized to the needs of the Plan, the Plan fiduciary, or a participant or beneficiary.

The Proposed Rule would, however, exempt certain persons from being deemed to provide investment advice. Specifically, a person would not be considered to be providing "investment advice" pursuant to the Proposed Rule if such person could demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property (or as an agent of, or appraiser for, such a purchaser or seller) whose interests are adverse to the interests of the Plan, its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice.[10]

The Proposed Rule also sets forth certain activities in connection with an individual account plan (as defined in Section 3(34) of ERISA) that would not in and of themselves be treated as the rendering of investment advice for purposes of ERISA Section 3(21)(A)(ii). These acts include:

- providing investment education information and materials;

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9 15 U.S.C. 80b-2(a)(11).

10 This exception would not apply if the person represented or acknowledged that it was providing the advice as an ERISA fiduciary.

- marketing or making available, without regard to the individualized needs of the Plan, its participants or beneficiaries, securities or other property from which a Plan fiduciary may designate investment alternatives into which Plan participants or beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts, so long as such person discloses in writing to the Plan fiduciary that he or she is not undertaking to provide impartial investment advice;
- providing general financial information and data to assist a Plan fiduciary's selection or monitoring of such securities or other property as Plan investment alternatives, so long as such person discloses in writing to the Plan fiduciary that he or she is not undertaking to provide impartial investment advice;
- preparing general reports or statements that merely reflect the value of an investment of a Plan or a participant or beneficiary, provided for purposes of compliance with the reporting and disclosure requirements of ERISA or the Code, unless the report involves assets for which there is no generally recognized market and serves as a basis on which a Plan may make distributions to Plan participants and beneficiaries.

The Proposed Rule further provides that for ERISA purposes, "a fee or other compensation, direct or indirect, received by a person for rendering investment advice," means any fee or compensation for the advice received by the person (or an affiliate) from any source and any fee or compensation incident to the transaction. Thus, "fee or other compensation" would include, for example, (1) brokerage, mutual fund sales, and insurance sales commissions and (2) fees and commissions based on multiple transactions involving different parties.

The DOL estimates that an additional 5,300 service providers offering investment- and valuation-related services would be considered "fiduciaries" and subsumed under the Proposed Rule. For example, broker-dealers who make securities recommendations to retirement plans and consultants who offer advice to retirement plans on proxy voting and the hiring of investment managers would be encompassed within the broadened definition of "fiduciary."

Comments on the Proposed Rule are due on or before January 20, 2011. One specific item on which the DOL is requesting input is whether and to what extent the final regulation should define the provision of "investment advice" to encompass recommendations related to taking an otherwise permissible Plan distribution, including when such advice is combined with a recommendation regarding how the participant should invest the distribution. The DOL has previously taken the position that such actions do not constitute "investment advice" within the meaning of the Current Regulation.[11] By specifically requesting comments on this issue, however, the DOL appears to be signaling an interest in reconsidering its position.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Michael Macris at 212.701.3409 or mmacris@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.

11 *See* Advisory Opinion 2005-23A (Dec. 7, 2005).