

Commentary on DOL's Proposed Changes to the Definition of "Fiduciary"

As we do from time to time, the Newsletter co-editors solicited comments from EBC members and others on DOL's recent proposal to amend the definition of "fiduciary." We typically seek, and sometimes get, commentary from individuals with a variety of affiliations. If you'd like to be included the next time we put out a call for comments, please e-mail any of the co-editors. Here we begin with a very brief overview of the proposal. Then we have comments from three perspectives, in alphabetical order by the contributor's last name.

Overview

The key regulatory definition of when a person who provides "investment advice" to a plan becomes an ERISA fiduciary dates to 1975. ERISA Section 3(21)(A)(ii) describes the circumstances under which the rendering of investment advice gives rise to fiduciary status. In 1975, the Department of Labor issued a regulation interpreting the statutory provision. The regulation created a 5-part test, all parts of which must be satisfied for a person to become a fiduciary through the provision of investment advice to a plan.

On October 22, 2010 the DOL announced that, due to the changes in the financial markets and in the terms of benefit plans, it is proposing a revised definition of when an individual becomes a fiduciary by providing a plan with investment advice. By now many of our readers will have read numerous descriptions of the changes even if all of you have not yet read the proposal, which you can find at 75 Fed. Reg. 65,263. What follows is a very brief summary of the primary proposed changes. Then, we offer the insights of our commentators on what the implications of the proposals are for multiemployer plans, plan sponsors, and participants.

- The old five-part test is eliminated with the result that:
 - Investment advice no longer must be provided on a regular basis (one-time advice will be sufficient), and
 - The parties no longer need a mutual understanding that the advice will serve as the primary basis for a plan investment decision.
- Certain actions are specifically stated to constitute investment advice, such as the provision of:
 - Advice and recommendations regarding the management of securities or other properties (this includes such actions as advice on proxy voting),
 - Advice or recommendations to a plan participant or beneficiary, and

- Fairness opinions and appraisals (this eliminates an advisory opinion exclusion for valuations of closely held employer securities purchased by an ESOP).
- Other notable items in the proposal include:
 - If a provider of investment advice or recommendations represents itself to be an ERISA fiduciary then, as Yoda might say: “A fiduciary it is,” and
 - The DOL explicitly requested comment on “whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution.” 75 Fed. Reg. at 65,266. Comments on this and all other matters regarding the proposed definition are due to the DOL on January 20, 2011.

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ERISA Section 3(21)(A)(ii) requires only that a person render investment advice for a fee, direct or indirect, with respect to plan assets for such person to be accorded fiduciary status. The DOL narrowed this definition 35 years ago through adoption of a five-part test, according to which fiduciary status attaches only if, among other things, advice is provided “on a regular basis” and serves as “a primary basis” for the investment decision. Counsel for multiemployer plans should be gratified that the DOL is proposing to revise the definition to more closely reflect the statutory language not only by removing the “regular basis” and “primary basis” components but also by revising and expanding the definition of fiduciary to reflect both today’s (and yesterday’s) marketplace. This comment addresses just a few of the proposed rule’s many aspects.

First, Trustees seeking fiduciary advice for one-time transactions would obtain an increased measure of protection under the proposed rule. A not uncommon one-off transaction involves investment in a new asset class – for example, private equity – for diversification purposes. The Trustees may hire an investment adviser to research private equity managers and recommend finalists for selection by the Trustees, with the engagement ceasing upon the Trustees’ selection. Under the current regulation, the investment adviser might argue that it is not a fiduciary because it does not provide advice “on a regular basis.” The proposed rule forecloses that argument.

Second, the proposed rule raises many questions for broker-dealers (“brokers”) who provide investment advice to fiduciaries. Suppose a registered representative successfully sells the use of his or her firm’s investment platform and attendant bundled services to a participant-directed, individual account plan. The representative further recommends the investment line-up to the Trustees and the Trustees rely, in part, on those recommendations in selecting the investment options. However, there is no separate agreement with the broker to provide advice and the broker does not receive any monies other than commissions. Assume that a participant thereafter sues both the broker and the Trustees, alleging that they breached their fiduciary duties by imprudently recommending and imprudently selecting the specific investment options available to the participants.

Under the current rule, there seems little doubt that the broker would defend against a breach of fiduciary duty claim by arguing, among other things, that it had no fiduciary responsibility because there was no mutual understanding that its advice would serve as the primary basis for the selection of the mutual funds (or other investment products) in the investment line-up. The participant would counter by arguing that the advice was “the” and, in the alternative, “a”, primary basis for the Trustees’ decisions and that in either case the broker-dealer should be held liable. The Trustees might argue, also, that the broker acted as a fiduciary in providing investment advice and that they reasonably relied on such advice. Under the proposed rule, the broker loses the “primary basis” defense and could become subject to fiduciary duties.

Thus, assume that the broker (1) has not acknowledged that it is acting as a fiduciary in providing advice; (2) is not a fiduciary under ERISA Section 3(21)(A)(i) or (iii); and (3) is not an “investment adviser”¹ within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940.² Fiduciary status would turn on whether the broker’s actions fit within the scope of proposed regulation 29 C.F.R. § 2510.3-21(c)(3)(D), which greatly revises the current five-part test. The revised language places fiduciary responsibility on any person who for a fee or other compensation:

¹ Depending on the facts, a broker could argue that it did not act as an “investment adviser” under the Investment Advisers Act of 1940, claiming that it provided advice solely incidental to the conduct of its business as broker and for which it received no special compensation. See Investment Advisers Act § 202(a)(11).

² Under the proposed rule, if a person provides advice as to investments (as described in the rule) for a fee or other compensation, and meets any one of these three criteria, or a fourth, which I quote in full below, then that person will be found to have rendered investment advice for purposes of Section 3(21)(A)(ii) of ERISA. Prop. Reg. 29 C.F.R. § 2510.3-21(c)(1)(ii)(A)-(D).

(D) Provides advice or makes recommendations described in paragraph (c)(1)(i) of this section pursuant to an agreement, arrangement or understanding, written or otherwise, between such person and the plan, a plan fiduciary, or a plan 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, a plan fiduciary, or a participant or beneficiary.

There is no question in the hypothetical that the broker (through its registered representative) provided individualized investment advice pursuant to an understanding that it would be “considered” in connection with the Trustees’ choice of the investment line-up. It also seems clear that the broker would be receiving a “fee or other compensation incident to the transaction in which the investment advice has been rendered,” including commissions. *See* Prop. Reg. 29 C.F.R. § 2510.3-21(c)(3). As a result, the broker would be considered a fiduciary unless the limitation described below applies.³

The proposed rule contemplates that brokers and others may want to resist fiduciary status. It would allow the broker who is not otherwise a fiduciary to avoid fiduciary status if it “can 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 . . . seller of a security or other property . . . whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice.” Prop. Reg. 29 C.F.R. § 2510.3-21(c)(2). In practice, this means that the broker would have to disclose that its interests are adverse and that the advice is not impartial. The disclosure could be a bitter pill for brokers to swallow.⁴

³ Moreover, if the broker provided imprudent advice as to the selection of investment options, and an independent investment consultant also provided imprudent advice as to the selection of investment options, both the broker and the independent adviser could be held liable for breaching their fiduciary duties. “Primary basis” arguments would not exonerate either one of them.

⁴ Note, too, that under the proposed rule, to avoid the “investment advice” label regarding making available through a platform – on a non-individualized basis – the investment alternatives of a participant-directed, individual account plan, the person making these investments available must disclose “in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.” Prop. Reg. 29 C.F.R. § 2510.3-21(c)(2)(ii)(B). To accomplish the same end, a similar disclosure would have to be provided with respect to 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.” Prop. Reg. 29 C.F.R. § 2510.3-21(c)(2)(ii)(C). These provisions, as well as other portions of the proposed rule, signal a move away from always requiring advice to be individualized in order to count as “investment advice.”

The broker who does not make such a disclosure and who is willing to accept fiduciary status faces other challenges. Circumstances may be such that the broker simply cannot provide investment advice without running afoul of the prohibited transaction rules. Assuming for the sake of argument that an arrangement could be structured to avoid a *per se* prohibited transaction, the assumption of fiduciary status would heighten the broker's awareness of needing to avoid conduct that might give rise to prohibited transaction claims.

Third, the preamble raises an intriguing point regarding plan distributions. The DOL has previously taken the position that it is not investment advice for a person not already a fiduciary to recommend that a participant take a distribution, even when combined with a recommendation as to how the distribution ought to be invested. See Advisory Opinion 2005-23A. The DOL has asked for comment on whether it ought to change this position. A rule change would cause financial planners and advisers to reconsider whether they should be instructing their clients to roll over plan distributions into their own products. Trustees of multiemployer plans might welcome increased responsibility and scrutiny for advisers engaged by their plan participants.

Fourth, and finally, the proposed rule would make it clear that acknowledging fiduciary status, orally or in writing, when providing investment advice for a fee is sufficient to result in fiduciary status. This seems squarely directed against service providers who have attempted to deny fiduciary status even though they have expressly agreed to such status in their agreements with a plan. Counsel for plans will want to negotiate that much harder for the acknowledgments of fiduciary status that they have always sought.

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In 1975, DOL had to confront a basic question regarding ERISA's scope. Though the statute provided broad authority to regulate the conduct of investment advisors to ERISA plans, should this authority be used? Decades of insurance, securities and banking regulation had provided different codes of conduct, licensing requirements and legal duties of care for different kinds of financial advisors. Should choosing to advise an ERISA plan impose a new, uniform fiduciary standard of conduct for all of these different providers?

In answering this question 35 years ago, DOL decided not to impose ERISA fiduciary status on all advisors, and issued a regulation narrowing the application of the statute, making it possible for broker-dealers, agents and others to operate under their respective traditional standards. For the past 35 years, this regulation has provided a technical but relatively clear dividing line between fiduciary and non-fiduciary investment advisors.

Last month, DOL decided to revisit this fundamental question, issuing a proposed regulation on October 22, 2010 broadly redefining who is a fiduciary investment advisor. Its effect is to expand significantly both the types of advice and the types of advisors subject to ERISA's fiduciary standards. The scope of the proposal is sufficiently broad that this article cannot examine all of the issues presented. What follows is a brief summary of the new rule and some of the significant impacts it may have.

The comment period on the proposed regulation closes January 20, 2011, and attorneys with plan or service provider clients are well-advised to review the proposed regulation, discuss it with their clients, and consider whether to comment. The proposal likely affects their clients—and possibly their own fiduciary status as well.

The Proposal Would Fundamentally Change Current Law:

The implications of DOL's decision are far more consequential and far reaching today than they would have been 35 years ago, as more than three decades of reliance on the current standards forms the basis of service provider relationships and payment structures applicable to literally trillions of dollars of ERISA plan and IRA assets. The proposal, which affects not only ERISA plans but also IRAs and other retirement vehicles subject to the Internal Revenue Code's prohibited transaction rules, would effectively prohibit common payment arrangements that include variable compensation, require significant changes in the business operations of some service providers, increase costs for plans and participants, and potentially impose new restrictions and limitations on service providers engaging in cross-selling and plan rollovers.

In addition to these concerns regarding the activities of financial professionals, the proposal's broad language could well sweep into fiduciary advice the activities of service providers who are rarely fiduciaries under current law, including attorneys advising plans on compliance, investment, and other matters necessary to plan operations.

DOL cites several grounds to justify the costs attendant to expanding the definition of a fiduciary advisor, including its difficulty in conducting effective enforcement against non-fiduciary advisors with undisclosed conflicts, such as pension consultants who do not reveal that they are paid by the investment managers they recommend to plans. However, DOL does not mention in its proposal that such undisclosed third-party compensation is already prohibited by the Interim Final regulation amending the 408(b)(2) prohibited transaction exemption for "reasonable" arrangements. Scheduled to apply beginning July 16, 2011, such an undisclosed third party payment would generally result in a prohibited transaction. The proposal does not appear to take into account this new rule in weighing the costs and benefits of its amendments.

The Current Regulation:

DOL's 1975 regulation (29 CFR §2510.3-21(c)) establishes a five-part test for determining the fiduciary status of an investment advisor, all five of which must be met for an advisor to be an ERISA fiduciary. There are two types of advice covered by the regulation: recommendations regarding the value of securities and other property, and recommendations regarding the advisability of investing in, purchasing or selling securities or other property. The five part test directs that such advice is fiduciary advice if it is (1) individualized, (2) provided regularly, (3) for a fee, (4) and provided pursuant to a mutual agreement (5) that the advice will be the primary basis for the plan's decision-making.

Thus, some service providers may structure their arrangements to make it clear that there is no mutual understanding with the plan that their advice will form the primary basis for the plan's decision-making. For example, a broker-dealer may not be an ERISA fiduciary when it helps the plan fiduciary decide which of the available investment vehicles to select as plan investment options depending upon its arrangement with the plan.

The Proposed Regulation:

DOL's new proposal expands both the types of advice and the types of advisors subject to ERISA fiduciary status. In addition to valuation and buy/sell/hold recommendations, DOL proposes to add recommendations "as to the management of securities or other property." It is not clear how broad the term "management" was intended to be—the Department notes in the preamble only that management "would include, for instance," recommendations relating to proxy voting and the selection of investment managers. It seems plausible that other consulting services might be captured by this undefined term.

Instead of the five part test, the proposal identifies four categories of providers who would be fiduciaries for providing such advice for a direct or indirect fee:

1. Providers representing or acknowledging that they provide fiduciary investment advice,
2. Providers who are otherwise ERISA fiduciaries by reason of discretion or authority over plan assets or plan administration,
3. Providers who are investment advisers as defined in 202(a)(11) of the Investment Advisers Act of 1940, or
4. Providers who have an arrangement with the plan or participants that their individualized advice "may be considered" in decision-making.

The proposed regulation provides certain exceptions to these general rules.

- **The “Sales” Exception**

The proposal says advice will not be fiduciary in nature if the provider “can demonstrate” that the plan or participant knows, or reasonably should know, that the provider was acting as a seller “whose interests are adverse to the interests of the plan or its participants” and is therefore “not undertaking to provide impartial investment advice.” The sales exception is not available to providers who represent that they are providing fiduciary advice.

This exception seems to be of limited utility as currently written, as it appears to be limited solely to the actual sale of a product, and not to any further interactions between the plan and the service provider. Further, DOL’s assumption that a sales relationship must be “adverse” seems inconsistent with the duties generally imposed on financial advisors of all kinds to serve the interests of their clients. It also suggests that an arms-length transaction is not inherently beneficial to both parties, and that an alignment of interests is not possible between a seller and a buyer.

- **Education is Not Advice**

The proposal maintains the Department’s view, expressed in Interpretive Bulletin 96-1, that providing educational information, such as the importance of diversification or model asset allocation portfolios, is not fiduciary advice.

- **Platform Exception**

The proposal allows a provider of a platform of investment options to acknowledge in writing that it is not undertaking to provide impartial advice by making available its platform, and therefore not be a fiduciary investment advisor. Similarly, the platform operator may provide general information about the investments on the platform to assist the plan’s selection and monitoring of the plan’s investment options. However, the provider must do so “without regard to the individualized needs of the plan.”

This exception, though beneficial in implicitly acknowledging that developing a menu of investment options is not a fiduciary act, is quite narrow. It is not clear how the prohibition against “individualizing” the platform would work in practice. Is responding to a request by the plan to receive information about “low cost” funds on the platform individualized advice because it requires a subjective judgment and implicit recommendation regarding which funds are “low cost?” Given recent and current class action litigation against record-keepers offering

investment platforms, these are not idle questions, but issues of enterprise risk that service providers must evaluate.

- **Valuation Exception**

The proposal specifically finds that one-time appraisals or valuations of property are fiduciary advice, such as valuations of real estate investments, or employer securities in an ESOP. This is a significant change, subjecting appraisers to fiduciary duty and liability for the first time, and may well have a significant impact on the cost and availability of these services.

The proposal excepts a “general report or statement” reflecting the value of an investment prepared for compliance with reporting and disclosure requirements, unless the report involves an asset for which there is not a generally recognized market and “serves as a basis on which a plan may make distributions to plan participants and beneficiaries.”

While this exception serves to limit somewhat the scope of fiduciary valuations, it likely does not cover a number of routine valuations, such as the amount of a mandatory minimum distribution associated with an investment in certain insurance contracts. This could impact participant costs and may increase the potential liability of individual employees of plans and service providers.

Potential Impact on Legal Services:

The regulation does not provide an exception for legal services. While DOL staff suggest they did not specifically intend to include attorneys as potential fiduciary advisors under the proposal, it seems plausible that the plain language of the proposal could apply to some legal services to the plan.

For example, attorneys commonly give legal advice regarding plan investments involving complex financial instruments. If an attorney makes a recommendation against an investment because of the legal risks it poses, this could be construed as individualized fiduciary advice regarding the advisability of purchasing the investment, provided for a fee, pursuant to an arrangement in which the plan will consider the attorney’s advice.

Cross-Selling and Rollover Solicitation:

One of the less obvious but extremely significant issues presented by the proposal is the issue of selling financial services to plan participants. There is a legal gray area regarding the ability of service providers to plans to offer to plan participants other financial services, or to receive participant rollovers from the plan. DOL has on several occasions expressed concern about the propriety of such service provider activity, but has not issued definitive guidance.

The preamble to the proposal, however, asks a closely related question, and it is likely to spark a debate on this significant issue. DOL asked for comment on whether the position it took in a 2005 Advisory Opinion--that solicitation of IRA rollovers by financial advisors unrelated to the plan was not subject to ERISA--left participants with sufficient protection. Specifically DOL asked for comment regarding what laws and regulations might protect participants receiving such solicitations.

This request for comment could lay the foundation for a broader DOL regulation governing the conduct of service providers to the plan as well as unrelated financial advisors.

Conclusion:

Knowing an entity's fiduciary status is crucial to an analysis of the ERISA issues presented by a transaction or a service provider relationship. Variable compensation arrangements that are perfectly appropriate for non-fiduciary service providers when approved by a plan fiduciary can be prohibited self-dealing for fiduciary investment advisors. The confusion this proposal would create if finalized would result in significant costs for plans and plan participants, along with the transition costs it would impose by requiring many service providers to restructure the business models and compensation arrangements. DOL's concerns about enforcement can be best-served by letting the new 408(b)(2) regulations prohibit undisclosed conflicts, rather than fundamentally altering the current regulatory environment.

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The Department of Labor's new proposed definition of "fiduciary" will, if implemented, help prevent plan participants from being whipsawed. Under the current framework, fiduciaries can evade responsibility for imprudent decisions by claiming reliance on a service provider, and service providers can often evade responsibility via several large loopholes in the existing regulation, such as its requirement that the advice have been provided on a "regular basis" or that the advice served as the "primary basis" for plan investment decisions.

The proposed regulation would both close some of these loopholes and bring the law into conformity with the realities of plan investment. In its analysis of the proposed regulation, the Department rightly points out that some egregious misconduct is allowed to go unchecked under the current five-part test. 75 Fed. Reg. 65267. A good example is that of the one-time advisor. An "account executive" advised a plan sponsor to fund a pension plan with insurance products and to take corresponding tax deductions which were later disallowed. *Omni Home Financing, Inc. v. Hartford Life & Annuity Ins. Co.*, 2008 WL 1925248 (S.D. Cal. Apr. 29, 2008).

Notwithstanding strong evidence that the bad investment decision was based on his advice, the court found that the account executive was not a fiduciary within the meaning of the regulation because his advice was only given when the plan was first formed, not on a “regular basis.” *Id.* The proposed regulation would confer fiduciary status on an advisor like this, which is more in line with ERISA’s purpose of preventing misuse and mismanagement of plan assets. Indeed, if some or all of a plan’s assets are invested on a long-term basis, why should the provider of advice regarding that investment not be held to the same fiduciary standard as one who gives advice regarding the investment of the same amount of assets in a series of shorter-term investments? Advice given at the outset of a plan – particularly initial appraisals done for the purchase of privately-held stock by an ESOP – can make the difference between success and failure of the plan. There is no reason why such advice should be outside ERISA’s fiduciary rules.

Although the plan sponsor and service provider community is likely to oppose the proposed regulation’s expansion of the fiduciary definition, the proposal may also be a boon to them. The proposed regulation incentivizes clear communication about the purpose and scope of service providers’ responsibilities. Advisors may be able to extract larger fees and/or broader indemnification provisions based on the risk of fiduciary liability, but ultimately, plans will benefit from the proposed regulation’s increased certainty. Two fiduciaries on the hook is better than one, both for the participant and for the plan.

On the other hand, a potential downside of the proposed regulation is that state law claims against advisors who qualify as fiduciaries may be preempted by ERISA. Whether this is a downside, of course, depends on the standards imposed by state law (and the remedies available for such claims).

Finally, the plaintiffs’ bar should take the Department’s invitation to comment on whether and to what extent the final regulation should define the provision of investment advice to include recommendations to participants about taking distributions (and investing them). One of the Department’s reasons for the new proposed regulation is the shift from defined benefit to defined contribution plans and the increase in the number and complexity of investment products and services available in the financial marketplace. These shifts profoundly impact participants, who must navigate this confusing landscape and bear the risk of investment loss. It seems intuitively obvious that advising a participant to take a distribution and invest it a certain way should be a fiduciary act.