STROOCK
SPECIAL BULLETIN

DOL's Proposed Changes to Definition of Fiduciary: Significant Impacts for Financial Companies and Plans

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Overview

Proposed Definition

On October 21, 2010, the Department of Labor ("DOL") proposed changes to the definition of fiduciary under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The proposed changes are the first such changes in almost thirty-five years and could change individuals' and entities' relationships with plans and entities subject to Title I of ERISA, or plans or entities subject to Section 4975 of the Internal Revenue Code of 1986, as amended (the "Code"), such as individual retirement accounts (collectively "Plans").

Under the proposed definition, the category of individuals and entities that would be considered fiduciaries under ERISA and analogous provisions of the Code is likely to be broadened substantially. This may affect not only plan sponsors, but broker-dealers, consultants, investment managers, custodians, administrators, appraisers, valuation agents and others providing services to, dealing with, or advising Plans.

Duties of a Fiduciary

Even without the DOL's proposed changes, becoming a fiduciary of a Plan carries with it substantial duties, including those of prudence, loyalty, diversification of plan assets, and compliance with a Plan's governing documents. In addition, fiduciaries of Plans are subject to broad anti-self dealing provisions.

For example, a broker that seeks to provide products and services to a Plan on a commission basis generally could not do so if the broker were deemed to be a fiduciary with respect to the Plan's assets in question.[1] Further, most of the exemptions from ERISA and the Code's prohibited transaction rules that counterparties rely upon to conduct ordinary course business with Plans require that the service provider or counterparty *not* be a fiduciary.

Consequences of a violation of these prohibited transaction rules can result in rescission, excise taxes, restoration of losses and other penalties. It is not surprising that service providers would seek to be deemed to be fiduciaries by design and not by circumstance.

DOL's Reasoning

The DOL's reasoning for the proposed changes, as explained in the preamble to the proposed regulations, is, in part, based on the difficulties in bringing enforcement actions under the current test and to more "efficiently allocate its enforcement resources." By revising the standard, the DOL believes that "investigators no longer would need to devote disproportionate time to prove that [the] elements of the [current standard's] five part test are met."

In addition, the changes are premised on the DOL's belief that the retirement plan community, financial marketplace and relationships between advisers and their Plan clients, have changed significantly since the standard was first promulgated. While the range of products and services has evolved significantly over the past thirty-five years, we question whether the fundamental nature of relationships between brokers, investment advisers, consultants and others on the one hand, and their Plan clients on the other hand has really changed.

Current Definition

Section 3(21) of ERISA confers fiduciary status on a person if:

- he exercises any discretionary authority or discretionary control with respect to management of such Plan or exercises any authority or control with respect to management or disposition of its assets;
- 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
- he has any discretionary authority or discretionary responsibility in the administration of such Plan.

In 1975, a year after the enactment of ERISA, the DOL published a regulation defining the circumstances under which investment advice is considered rendered.[2] Under that regulation, the DOL created a five-part test providing that a person renders investment advice and, therefore, is a fiduciary with respect to a Plan, if with respect to the Plan's assets:

- The person renders advice to the Plan as to the value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing, or selling securities or other property;
- The advice is rendered on a *regular basis*;
- The advice is pursuant to a *mutual* agreement, arrangement or understanding, written or otherwise;
- The advice will serve as *a primary basis* for investment decisions with respect to Plan assets; and
- The advice is *individualized investment advice* to the Plan based on the particular needs of the

Plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of Plan investments.

A person will also be considered a fiduciary under the regulation if he renders advice to the Plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property and the person, directly or indirectly, has discretionary authority or control, whether or not pursuant to an agreement or arrangement or understanding, with respect to purchasing or selling securities or other property for the Plan.

Proposed Definition

The DOL's proposed regulations modify the five-part test, essentially creating a two-part test that may apply to a broader group of services. Under the proposed definition, a person would be a fiduciary under ERISA (or the analogous provisions of the Code) if, for a direct or indirect fee or other compensation: (i) the person renders certain defined types of investment services <u>and</u> (ii) the person is engaged in certain activity or has an established status. The following discusses each of these two prongs in greater detail.

Type of Service

The services considered under the first prong of the proposed fiduciary test include:

- Advice, or an *appraisal or fairness opinion*, concerning the value of securities or other property;
- Recommendations as to the advisability of investing in, purchasing, holding, or selling of securities or other property; and
- Advice or recommendations as to the management of securities or other property.

Function/Status

A person will satisfy the second prong of the test if the person, directly or indirectly:

- Represents or acknowledges that the person is acting as a fiduciary;
- Exercises any discretionary authority or discretionary control with respect to management of a Plan or exercises any authority or control with respect to management or disposition of its assets or has any discretionary authority or discretionary responsibility in the administration of such Plan;
- Is an *investment adviser* (within the meaning of Section 202(a)(11) of the Investment Advisers Act of 1940);[3] or
- Provides investment advice pursuant to an agreement, arrangement or understanding, written or otherwise, between such person and the Plan (or fiduciary or participant) that such advice *may be considered in connection with making investment or management decisions* with respect to the Plan and *will be individualized to the needs of the Plan* (or fiduciary or participant).

Exceptions

The proposed regulations provide for some limited carve outs. A person will not be a fiduciary (unless the person represents or acknowledges fiduciary status) if the person can *demonstrate* that the Plan party receiving the advice knows or, under the circumstances, reasonably should know, that the person providing the advice or making the recommendation is:

- *Acting in its capacity as purchaser or seller of security or property*, or such person is acting in a position that is *adverse to the Plan party* in such a transaction (*i.e.*, as principal or as an agent or appraiser for a party adverse to the Plan party); and
- The person is not undertaking to provide impartial investment advice.

This exception puts the onus on the service provider to demonstrate that the Plan knows or should know the service provider is acting with interests adverse to the Plan. Acknowledgment (such as a written representation) from the Plan at the inception of the relationship, however, should provide some certainty to the service provider.

In addition, the proposed regulations provide an exception from fiduciary status for marketing (and similar material) through a platform or similar mechanism for individual account Plans and for certain general reports or statements that reflect the value of an investment of a Plan, participant or beneficiary and are provided in compliance with reporting and disclosure requirements (provided such materials do not involve assets for which there is not a generally recognized market and serve as a basis on which a Plan may make distributions to its participants and beneficiaries).

Finally, the proposed regulations provide that "investment education," as described under DOL Interpretative Bulletin 96-1, generally will not be considered investment advice if provided to participant-directed individual account Plans. It is not clear whether the DOL intended to imply that such investment education materials (which can include very basic general investment concepts such as risk and return, diversification, dollar cost averaging, historic differences in the rates of return of different asset classes, the effects of inflation, etc.) provided outside of participant-directed individual account Plans, also would be considered investment advice.

Likely Impact on Financial Services Companies Dealing with Plans

The proposed regulations raise concerns and considerations for financial institutions and could cause such institutions to be deemed to be fiduciaries under ERISA and the Code if they provide <u>any</u> investment advice, recommendation or appraisals to a Plan unless the institution is engaging in certain principal transactions for the purchase or sale of securities or other property, or acting for a person whose interests are adverse to the Plan (and in either case, unless the institution is not otherwise providing impartial advice). The following illustrate some potential concerns.

- *Advice Definition Substantially Broadened*. Under the proposed regulations, advice and recommendations would no longer need to be "a primary basis" for an investment decision, or even be provided on a "regular basis" to give rise to fiduciary status. Moreover, the advice need only *potentially* be considered in connection with an investment decision.

Could this now include discussions of general market conditions or trends, research reports, or general investment ideas in the ordinary course of dialogue between, for example, a broker and a client? As appraisals are now included in the definition, would the services of valuation agents or calculation agents for funds and other investment products now give rise to fiduciary status?

- *No Mutual Agreement Needed*. Under the proposed regulations, a service provider could be deemed to be a fiduciary even without a "mutual agreement" between the service provider and the Plan about the intent to provide investment advice or a recommendation. The proposed language suggests that the advice or recommendation need only be used by the Plan for its own needs, regardless of the intent or expectation of the service provider. Consequently, the proposed regulations appear to give the Plan control over whether the service provider is, or is not, a fiduciary.

- *Coverage as Registered Investment Adviser*. Providing advice, recommendations or appraisals with respect to securities or other property could result in fiduciary status if the person providing the advice is doing so on behalf of a registered investment adviser (even if, it seems, the entity were also registered as a broker-dealer or otherwise or is a bank or bank holding company), where the individual providing the advice is not excepted from Section 202(a)(11) of the Investment Advisers Act. For example, although certain advice provided by a broker that is solely incidental to the conduct of brokerage services may be exempt, not all individuals may be engaged in brokerage or otherwise have an exemption available to them (such as individuals who deal in futures, commodities or other assets for which securities brokerage is not required). The preamble suggests that similar organizational and structural concerns could arise for banks and bank holding companies under Section 202(a)(11) if banking and advisory functions are not performed through separately identifiable divisions or departments.

- *Principal Transaction Exception is Limited*. The exception for principal transactions in securities or property (or agency transactions where the service provider is acting adverse to the Plan party) will provide some relief from fiduciary status for some service providers, such as institutional broker-dealers, with respect to selected transactions. However, there are still a number of considerations that service providers will want to focus on, including:

  - <u>Agency Transactions</u>. For many brokers and other service providers – particularly those in the high net worth or retail markets – it may not always be clear when a broker is acting in a capacity that is "adverse" to the Plan party or when they are acting as an agent for the Plan party. Many brokers do not customarily view their clients as "adverse," and often share with their clients information regarding general market conditions and trends. Sharing such information may, based on the expanded definition of advice, rise to the level of fiduciary activity under the proposed rule. This dynamic could be of enhanced importance when transactions are then effected on a non-principal basis.

- Some Commonplace Transactions May Not Be Covered. In addition, some transactions (such as securities loans) even while conducted on a principal basis, are not technically "purchases or sales."

Comment Period

Comments on the proposed regulations are due on January 20, 2011. One subject for which the DOL seeks input, is whether a recommendation to a Plan participant to take an otherwise permissible Plan distribution should not constitute investment advice within the meaning of the current regulation, even when that advice is combined with a recommendation as to how the distribution should be invested. The DOL has, in the past, provided that such information does not constitute investment advice, but may now be reconsidering this position.[4]

Conclusions

The proposed regulations, if implemented, would result in substantial changes to the established definition of fiduciary (under ERISA and the analogous provisions of the Code) and would significantly alter traditional notions of fiduciary relationships. The DOL itself acknowledges that the change could result in "increased costs and liability exposure associated with ERISA fiduciary status," may result in higher fees for Plans, and that as a result, service providers might "limit or discontinue the availability of their services or products" to Plans.

Although these rules are in proposed form, Plans and their service providers should consider the implications of these developments from a legal and commercial standpoint, and also should consider whether they want to provide input during the comment period.

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1. But *see*, Prohibited Transaction Class Exemption 86-128 in connection with agency transactions in securities. Selected other exemptions have been issued for transactions when one acts as a fiduciary.
2. 40 Fed. Reg. 50,842, 50,843 (Oct. 31, 1975) (codified at 29 C.F.R. § 2510.3-21).
3. It is important to note that Section 202(a)(11) of the Investment Advisers Act includes a number of exceptions, including for broker-dealers that provide investment advice where such provision is solely incidental to the conduct of the business of being a broker-dealer.
4. Advisory Opinion 2005-23A (Dec. 7, 2005).

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