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DOL Proposes New ERISA Rule to Expand the Definition of "Fiduciary"

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On October 21, 2010, the Department of Labor (the "DOL") issued a new proposed regulation (the "Proposed Rule") that would expand the categories of persons who would be deemed to be fiduciaries subject to the Employee Retirement Income Security Act of 1974 ("ERISA").[1] The Proposed Rule would re-write and expand the scope of the current 35-year old regulation (the "Current Rule") that delineates when a person becomes a fiduciary by reason of providing "investment advice" for a fee or other compensation with respect to plan assets.

In issuing the Proposed Rule, the DOL noted that the retirement plan industry has changed significantly in the 35-year period since the Current Rule was adopted, the most significant trend being the growth of participant-directed defined contribution plans, along with the expectations of plan officials and participants and beneficiaries to receive investment advice that is free from conflicts of interest. The broadened definition is also intended to improve DOL's ability to enforce ERISA violations against investment advisers by reducing the amount of time and resources required to establish that an investment adviser is a fiduciary under the Current Rule.

Some of the significant changes to the Current Rule include expanding the scope of what constitutes investment advice to include (a) appraisals, (b) fairness opinions, (c) the routine valuation of investments, (d) advice and recommendations regarding the *management* of investments (in addition to acquiring and disposing of investments), (e) advice, whether provided on only a *one-time* basis or on a *regular* basis, and (f) advice, whether or not it serves as a *primary basis* for investment decisions.

Background – Who is a "Fiduciary"?

The fiduciary responsibility provisions of ERISA are designed to provide standards of conduct for persons who serve as "fiduciaries" with respect to plans and plan assets. Thus, a key question is – who is a fiduciary? Section 3(21)(A) of ERISA defines the term "fiduciary" to include both persons who have discretionary authority in the management and administration of plans and the management of plan assets, and any person who "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."

In 1975, in the context of issuing a class exemption (PTE 75-1) to permit broker-dealers to execute securities transactions for plans without engaging in technical violations of the prohibited transaction restrictions of ERISA, the question arose of whether broker-dealers would be deemed to be providing

investment advice for compensation (and, therefore, fiduciaries) by reason of providing routine stock buy and sell recommendations to plan fiduciaries. Recognizing that it was not the intent of Congress that such activities would make broker-dealers "fiduciaries" under ERISA, the DOL issued the Current Rule in an effort to make clear that such recommendations would not make persons fiduciaries by reason of providing "investment advice" if the recommendations were not provided on a regular basis, were not individualized to the needs of the particular plan and did not serve as a primary basis for plan investments decisions. Given the changes to retirement planning and saving resulting from the proliferation of the participant-directed defined contribution plan model, the DOL determined that modification of this Current Rule is now warranted.

The Proposed Rule

Under the Proposed Rule, a person will be deemed to be rendering investment advice for a fee or other compensation, direct or indirect, if: (i) such person provides one of the three types of advice set forth in the Proposed Rule; under (ii) any one of four categories of circumstances set forth in the Proposed Rule. In addition, the Proposed Rule effectively establishes four exceptions from providing "investment advice."

Types of "Investment Advice"

Under the Proposed Rule, a person will be considered to be providing "investment advice" only if such person provides one of the following types of advice to an employee benefit plan, a plan fiduciary, a plan participant or a plan beneficiary:

- 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 securities or other property.
- Advice or recommendations as to the management of securities or other property.

Subject to the circumstances and exceptions discussed below, the Proposed Rule would expand the categories of persons who will be deemed to be providing "investment advice" to include, for example: (i) real estate appraisers and persons who provide valuation services when the valuations are taken into account in making plan asset investment or management decisions;[2] (ii) stock brokers and real estate brokers; and (iii) property managers with respect to plan real estate holdings who provide recommendations that could impact plan asset investment or management decisions. In addition, the Proposed Rule clarifies that fiduciary status will result from the provision of investment advice not only to plans and plan fiduciaries, but also to plan participants and beneficiaries.

Categories of Circumstances for Providing Investment Advice

A person providing one of the types of investment advice listed above will only be considered a fiduciary pursuant to the Proposed Rule if such person, directly or indirectly, also meets one of the following conditions:

- Such person represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA with respect to providing the advice.

- Such person is a fiduciary with respect to the plan pursuant to the definition of "fiduciary" under ERISA *other than* the investment advice provision (i.e., as a result of exercising any discretionary authority or discretionary control with respect to management of the plan, exercising any authority or control with respect to management or disposition of the plan's assets or having any discretionary authority or discretionary responsibility in the administration of the plan).

- Such person is an "investment adviser" within the meaning of section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act"), whether or not such person is actually registered with the SEC as an investment adviser.[3]

- Such person provides one of the types of investment advice listed above pursuant to an agreement, arrangement or understanding (written or otherwise) between such person and the plan, plan fiduciary, plan participant or plan 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, plan fiduciary, plan participant or plan beneficiary.

  — Note: This category significantly modifies a similar provision in the Current Rule. One modification is that the Proposed Rule would eliminate the requirement that the advice be provided on a *regular basis*. Therefore, under the Proposed Rule a person who provides advice on a particular investment on a one-time basis may be considered a fiduciary. Another modification is that the Proposed Rule would eliminate the requirement that the parties have an understanding that the advice will serve as a *primary basis* for investment decisions. Therefore, under the Proposed Rule multiple advisers that provide advice to a plan fiduciary with respect to a single investment decision may be considered fiduciaries, which raises an interesting question about the co-fiduciary responsibilities of those advisers whose investment advice is *not* followed.

Exceptions

The Proposed Rule sets forth four exceptions as to categories of persons who will not be deemed to be providing investment advice.

- A person will not be deemed to be providing investment advice if the person can demonstrate that the recipient of its advice knows or reasonably should know that such person is providing the advice in its capacity as a purchaser or seller of a security or other property (or as an agent of, or appraiser for, such purchaser or seller) 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. This exception is inapplicable if the person represents or acknowledges that it is providing the advice as an ERISA fiduciary.

  — Note: A stock broker or real estate broker who makes a recommendation to a plan to buy or sell a security or property will not be able to rely on this exception if the broker is not the other party to the proposed transaction or the agent of such other party. On the other hand, an issuer of securities who also provides investment advice with respect to other assets of the plan may be able to rely on this exception provided that it makes clear it is not acting in an advisory capacity with respect to the issuance in question.

- A person who prepares general reports that merely reflect the value of an investment that are provided to the plan solely for the purpose of compliance with reporting and disclosure requirements under ERISA, the Code and regulations, forms and schedules issued thereunder. However, providing such a report will be considered "providing advice, or an appraisal or fairness opinion" if it involves assets for which there is not a generally recognized market and serves as a basis on which a plan may make distributions to plan participants.

  — Although this exception appears to imply that most appraisers and valuers would be deemed to be "fiduciaries", it is unclear under which of the four circumstances of providing "investment advice" under the Proposed Rule such appraisals or valuations would fall if the appraisals or valuations are not used in connection with the investment or management of plan assets.

The Proposed Rule also provides that the following activities taken in connection with individual account plans[4] will not be treated as rendering investment advice.

- A person who provides investment education information and materials to individual account plan participants or beneficiaries, as described in existing DOL regulations (see 29 CFR 2509.96-1(d)), including plan information, general financial and investment information, asset allocation models and interactive materials.

- A person who markets or makes available, without regard to the individualized needs of the individual account plan, its participants or beneficiaries, securities or other property from which the plan fiduciary may designate investment alternatives into which participants or beneficiaries may direct their individual account investments (and providing general financial information and data in connection with such activities to assist the plan fiduciary's selection or monitoring of such securities or other property), if the person making available such investments discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice. However, the preamble to the Proposed Rule provides that if a person substitutes or deletes investment options that may be selected by a plan fiduciary, such action may constitute an exercise of authority or control with respect to the management or disposition of a plan's assets and, therefore, such person would be a fiduciary under ERISA.

Fee Requirement

The Proposed Rule provides that the term "fee or other compensation, direct or indirect," as used in ERISA's definition of "fiduciary," means any fee or compensation for advice received by the person (or an affiliate) from any source and any fee or compensation incident to the transaction in which the advice has been rendered or will be rendered. This term includes brokerage, mutual fund sales and insurance sales commissions.

Comment Period

DOL is seeking public comments on the proposed rule until January 20, 2011.

The Proposed Rule, if adopted substantially as proposed, will sweep many more financial services professionals and their firms into ERISA fiduciary capacity, potentially opening them up to significant fiduciary liability exposure. Financial services professionals and their firms should provide comments to DOL on such things as:

- What will the impact on their businesses be if activities that are not currently "fiduciary" are transformed into fiduciary activities by this proposed rule?
- Will new or additional insurance be required to cover the new ERISA fiduciary risk and will it be available?
- What changes in the Proposed Rule are needed?

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The Proposed Rule would also apply for purposes of the prohibited transaction excise tax provisions in Section 4975 of the Internal Revenue Code of 1986, and thus would cover investment advisers to IRAs in addition to ERISA-covered plans.

[2] The preamble to the Proposed Rule provides that DOL intends for this provision to supersede Advisory Opinion 76-65A ("AO 76-65A"). In AO 76-65A, DOL concluded that a valuation of closely held employer securities that would be relied upon by an employer stock option plan in deciding whether to purchase such securities would not constitute investment advice under the Current Rule.

[3] Section 202(a)(11) of the Advisers Act generally defines an "investment adviser" as any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing or selling securities, or who promulgates analyses or reports concerning securities. Section 202(a)(11) of the Advisers Act provides a number of exclusions to this general rule.

[4] Section 3(34) of ERISA defines an "individual account plan" or "defined contribution plan" as "a pension plan which provides for an individual account of each participant and for benefits based solely upon the amount contributed to the participant's account . . . ."

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