K&L | GATES

# Investment Management/Employee Benefits ERISA Fiduciary Alert

November 2010

www.klgates.com



## DOL Expands Definition of Fiduciary and Investment Advice

The U.S. Department of Labor ("DOL") recently released a proposed regulation that would greatly expand the circumstances in which a person could be considered a "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") when providing non-discretionary investment advice. ERISA provides that a person (either an individual or an entity) that provides investment advice for a fee is a fiduciary. An existing DOL regulation sets out a long-standing and widely accepted method of determining when a person is providing investment advice for purposes of ERISA. The proposed regulation would dramatically change this method and, therefore, is likely to prove very controversial. Public comments on the proposed regulation are due by January 20, 2011.

If the DOL adopts the proposed regulation in its current form, many financial institutions and other service providers, such as appraisers and other valuation firms and broker-dealers that are typically not now fiduciaries under ERISA, are more likely to become fiduciaries and, as such, will be subject to the fiduciary duties, prohibited transaction rules, and potential liability imposed by ERISA. The proposed regulation also would change the definition of "fiduciary" for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code ("Code"), and thereby will affect service providers to individual retirement accounts and other non-ERISA plans. The proposed regulation also would affect service providers to collective investment vehicles whose assets are "plan assets" for purposes of ERISA and the Code. The scope of the proposed regulation is mitigated somewhat by exceptions for certain brokerage services, investment education and valuation services.

### Background

A person is a fiduciary under ERISA to the extent the person "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property" of a plan or has any responsibility to do so, among other functions.[1] In 1975, shortly after ERISA was enacted, the DOL issued a regulation clarifying this part of the statutory definition. That regulation currently provides that a person is a fiduciary by providing investment advice if the person:

> Gives advice to the plan about the value of securities or other property or makes a recommendation about the advisability of investing, buying or selling securities or other property *and also*
>
> Either has discretionary authority or control over investment of plan assets *or* provides the advice on a "regular basis," pursuant to a mutual agreement with the plan or a plan fiduciary that the advice will serve as a "primary basis" for

[1] ERISA § 3(21)(A)(ii).

investment decisions and the advice is individualized based on the particular needs of the plan.

This regulation provides a relatively simple test for distinguishing between persons who should be subject to ERISA's fiduciary rules because they are providing investment advice to plans (or plan fiduciaries) and other persons who may discuss investments generally (*e.g.*, in a sales context), but who are not central to decisions about plan investments. The test has been widely adopted and relied upon by courts.

The DOL believes that this test has become outdated and unnecessarily limits the scope of the statute. In the preamble to the proposed regulation, the DOL tellingly asserts that the current regulation has hampered DOL enforcement actions against certain "consultants, advisers and appraisers." In the DOL's view, those persons significantly influence the decisions of plan fiduciaries and have a considerable impact on plan investments. However, if those persons are not fiduciaries under ERISA, the DOL asserts "they may operate with conflicts of interest that they need not disclose to plan fiduciaries . . . and have limited liability under ERISA for the advice they provide."[2]

## The Proposed Regulation

To remedy these problems and subject more persons to ERISA's fiduciary rules, the proposed regulation would delete much of the current regulation's test and provide that a person is an ERISA fiduciary if the person provides to a plan, plan fiduciary, plan participant or beneficiary:

(i) (A) Advice, or an appraisal or fairness opinion about the value of securities or other property,

(B) Recommendations as to the advisability of investing, buying or selling securities or other property, or

(C) Advice or recommendations as to the management of securities and other property,

*and*

(ii) the person:

(A) Represents or acknowledges that it is an ERISA fiduciary with respect to the advice or recommendations;

(B) Is otherwise a fiduciary under Section 3(21)(A)(i) or (iii) of ERISA;

(C) Is an "investment adviser" within the meaning of the Investment Advisers Act of 1940 ("Advisers Act") (without regard to whether the adviser is required to be registered); or

(D) Provides the advice or makes the recommendations pursuant to an agreement, arrangement or understanding between the plan (or plan fiduciary, participant or beneficiary) that the advice or recommendations "may be considered in connection with" investment decisions involving the plan's assets, and the advice is individualized based on the particular needs of the plan, plan fiduciary or participant or beneficiary.[3]

## Effect of the Proposed Regulation

The proposed regulation expands the circumstances in which a person may be considered to be providing investment advice under ERISA and the Code. Most significantly, the new test would eliminate the "regular basis" and "primary basis" elements of the current regulation. Together, these changes would make many persons fiduciaries who currently are not fiduciaries. Some examples may illustrate the sweep of the proposed regulation compared to the current regulation.

[2] 78 Fed. Reg. 65263, 65265 (Oct. 22, 2010).

[3] *Id.* at 65277.

- A plan fiduciary retains an appraiser to determine the fair market value of a parcel of real estate or a block of closely held stock. The proposed regulation appears to deem the appraiser's determination to be investment advice. Moreover, because the appraiser's determination of value will almost certainly be considered in connection with the plan fiduciary's decision to buy or sell the property or stock (indeed, it could be imprudent for the plan fiduciary to fail to consider it), the appraiser will be a fiduciary for purposes of Section 3(21)(A)(ii) of ERISA, even if the appraisal report is nothing more than a neutral statement of the asset's probable fair market value and the steps taken to determine that value. The appraiser would not be a fiduciary under the current regulation.

- An investment manager uses a broker-dealer to execute trades for its clients, including plans. The broker-dealer periodically provides information to the investment manager about a publicly traded security or an investment or commodities contract such as a swap or futures agreement. Although the investment manager has full discretion to invest assets of the plan and does so using its own investment process, the investment manager may consider information provided by the broker and the broker-dealer is aware of this. Even if the investment manager never uses the information provided by the broker-dealer as a primary basis for the manager's investment decisions for its plan clients, the broker-dealer may be a fiduciary under the proposed regulation because there is arguably "an understanding" between the broker-dealer and the investment manager that the investment manager may consider the broker-dealer's information. The broker-dealer would not be a fiduciary under the current regulation.

- A pension plan retains a consultant, which is registered under the Advisers Act. The consultant is asked to help identify potential investment managers for certain asset classes and, as to any asset class, recommend three investment managers that might be appropriate for the plan. The trustees will select from among the three recommended investment managers. Under the proposed regulation, the consultant likely would be a fiduciary because it is making recommendations as to the management of the plan's assets. Although some courts have held that consultants are fiduciaries in similar contexts, the consultant would not be a fiduciary under the current regulation because it is not providing advice about securities or other property.

## Exceptions under the Proposed Regulation

Perhaps recognizing the sweep of the proposed regulation, the DOL also proposed the following exceptions to the revised definition:

- *Financial Sales Activities* – Any person who provides advice or makes recommendations (other than a person who has acknowledged that it is an ERISA fiduciary) about a security or property is not a fiduciary *but only if* the person providing the advice or recommendation can demonstrate that (i) the recipient of the advice or recommendation knew or should have known that the advice or recommendation was provided in the person's own 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 plan or participant and (ii) that the person is not undertaking to provide impartial investment advice.

- *Investment Education* – The proposed regulation confirms the DOL's previously expressed view that providing "investment education," as described in the DOL's 1996 interpretive bulletin,[4] is not deemed to be investment advice.

- *Marketing or Platform Services* – Marketing or making available (through "a platform or

[4] 29 C.F.R. § 2509.96-1(d).

similar mechanism") investment options a plan sponsor may select for plan participants does not make the provider of these services a fiduciary, *but only if* (i) the investment options are made available without regard to the individualized needs of the plan or its participants and (ii) the service provider makes written disclosure to the plan that it is not providing impartial investment advice.

- *Provision of Investment-related Information* – The provision of general financial information or data in connection with a plan fiduciary's selection and monitoring of investments will not cause the provider of such information or data to be deemed a fiduciary, *but only if* the provider makes written disclosure to the plan that it is not providing impartial investment advice.

- *Appraisals and Valuations* – The term "advice, appraisal or fairness opinion" (that could make the provider a fiduciary) does not include a report or statement that reflects the value of a plan investment and is provided for purposes of compliance with the reporting and disclosure requirements of ERISA and the Code, *unless* the report or statement (i) covers an asset for which there is not a generally recognized market, and (ii) serves as a basis on which a plan may make distributions to participants.

## Further Observations

If adopted in its current form, the proposed regulation will have far-reaching consequences that may include, for example, expanded responsibility and liability for persons who are not now fiduciaries, expanded co-fiduciary responsibility for persons who are currently fiduciaries, and a greater risk that commonly used prohibited transaction exemptions will not be available to the extent that these exemptions depend on one (or more) parties not being a fiduciary.

Also, if adopted in its current form, the proposed regulation may not have the effect that the DOL desires. Faced with the possibility of new and very broad liability, many financial service providers may decide not to provide information or services to plans, at least not at their current level of compensation. Moreover, service providers may elect to do so only if they obtain indemnification from the plan sponsor (to the extent permitted by law) or if plan fiduciaries make representations that are undesirable or unworkable (*e.g.*, representations that effectively require a fiduciary to state that it will not consider any information offered by a service provider). Finally, because the proposed regulation attempts to regulate areas that may now be governed by state law (*e.g.*, state statutory or decisional law regarding defective appraisals), the DOL may inadvertently deprive plans of remedies that are available under state law but that might be preempted by the proposed regulation.

It is possible that the exceptions included in the proposed regulation – particularly the exception relating to financial sales activities – may mean that some service providers can continue to provide services without being deemed to be fiduciaries. However, invoking this exception would require disclosures that could be viewed as effectively encouraging other plan fiduciaries not to take the advice or recommendations into account. Thus, it remains to be seen whether this and other exceptions will provide meaningful relief from the likely impact of the proposed regulation.

Although some aspects of the proposed regulation are sensible (such as formalizing the DOL's view that investment advice to a participant is investment advice to a plan for purposes of Section 3(21)(A)(ii) of ERISA) or mirror other legal developments (courts have held that consultants are fiduciaries when they help select or evaluate investment managers), others are questionable. The proposed regulation is likely to be controversial among many sectors of the market for financial services and information. Additionally, the DOL's request for comments about how the proposed regulation should apply to advice or recommendations concerning distributions and rollovers may generate concerns among plan sponsors and service providers that assist with distributions. It is anticipated that the DOL will receive extensive comments as the January 20, 2011 deadline approaches.

*Please contact any member of the ERISA Fiduciary Group listed below if you have further questions.*

Catherine S. Bardsley
catherine.bardsley@klgates.com
202-778-9289

Mark J. Duggan
mark.duggan@klgates.com
617-261-3156

John J. Nestico
john.nestico@klgates.com
704-331-7529

David Pickle
david.pickle@klgates.com
202-778-9887

William A. Schmidt
william.schmidt@klgates.com
202-778-9373

Charles R. Smith
charles.smith@klgates.com
412-355-6536

William P. Wade
william.wade@klgates.com
310-552-5071

Kristina M. Zanotti
kristina.zanotti@klgates.com
202-778-9171