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Department of Labor Proposes Expanded Definition of Fiduciary for Providers of Investment Advice to ERISA Plans and IRAs

by Susan P. Serota and Bradley A. Benedict

The Department of Labor ("DOL") has proposed a new regulatory framework for determining who is a fiduciary under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") as a result of providing investment advice in connection with a retirement plan or individual retirement account. The proposed rules would establish a new test to determine the activities and circumstances that confer ERISA fiduciary status in connection with providing investment advice to a plan, plan fiduciary or plan participant or beneficiary.

ERISA fiduciaries are subject to strict standards, including the duties of loyalty and care and to act for the exclusive purposes of providing plan benefits and defraying reasonable expenses. Fiduciary status can affect whether certain arrangements or transactions involving plan assets constitute impermissible conflicts of interest or "prohibited transactions," which could subject a plan to civil penalties. Further, individuals acting as ERISA fiduciaries may be personally liable for breaches of their fiduciary duties.

The new proposed definition would result in certain persons being fiduciaries who were not covered under the existing 35-year-old regulations, including advisers that provide appraisals of employer securities for employer stock ownership plans ("ESOPs") and valuations used for plan investment management and decision-making that are not provided on a regular basis. In addition, the proposed definition excludes specific activities that would not be considered investment advice, including communications related to arm's length purchase/sale transactions and, with respect to individual account plans, educational information and data, marketing materials and financial and historical data in certain circumstances.

Background

Certain activities performed in connection with the direction, handling or management of the assets of an ERISA plan can confer fiduciary status upon an individual or institution. One of these "functional tests"

concerns rendering investment advice for a fee or other compensation with respect to any moneys or other property of an ERISA plan. In 1975, the DOL issued regulations interpreting this investment advice functional test. Those regulations set forth a five-factor test providing that an adviser acts as an ERISA fiduciary if it (1) provides asset valuations or makes recommendations as to the investing, selling or purchasing of assets (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding with the plan under which such advice (4) will serve as a primary basis for investment decisions and (5) will be individualized based on the particular needs of the plan. In a 1976 advisory opinion, the DOL further clarified that appraisals of closely held employer securities made on behalf of an ESOP do not constitute "investment advice" within the meaning of the existing regulations.

The DOL has now concluded that a more expansive test is appropriate due to changes in the financial marketplace and the proliferation of investment products and services. Under the existing rule, the DOL is concerned that consultants, advisers and appraisers can avoid fiduciary responsibility in numerous circumstances where their advice has a significant impact on plan investments. Another stated purpose of the new regulations is to simplify the investment advice fiduciary test to facilitate enforcement actions. The proposed regulations would overhaul the five-part test and impose fiduciary obligations on more persons in more situations, but they also carve out certain activities.

The Proposed Rule

The proposed rule sets forth three categories of activities that may constitute investment advice for the purposes of the investment advice fiduciary definition and four conditions in which performing such activities will confer fiduciary status under ERISA (subject to the exceptions discussed further below).[1] Specifically, a person renders such investment advice if the person receives a fee or other compensation for providing to a plan, a plan fiduciary or a plan participant or beneficiary:

1. advice, or an appraisal or fairness opinion, concerning the value of securities or other property,

2. recommendations as to the advisability of investing in, purchasing, holding or selling securities or other property, or

3. advice or recommendations as to the management of securities or other property;

and such person either directly or indirectly (including through or together with any affiliate):

A. represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA when providing such services;

B. is a fiduciary with respect to the plan because it has discretionary authority or control over the plan's management, exercises authority or control over the management or disposition of plan assets or has any discretionary authority or discretionary responsibility over the plan's administration;

C. is an investment adviser within the meaning of section 202(a)(11) of the Investment Advisers Act of 1940 (the "Advisers Act"), but this Condition (C) does not apply if such person falls within an exclusion from the Advisers Act definition; or

[1] The proposed regulation also provides that it applies to the parallel definition of a fiduciary for purposes of the prohibited transaction provisions in section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”).

D. provides advice or recommendations described in items (1) through (3) above pursuant to an arrangement (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 such advice will be individualized to the needs of the plan, the plan fiduciary or the plan participant or beneficiary.

In the DOL's formulation, any one of Conditions (A) through (D) indicate that the person's degree of authority, control, responsibility or influence over the investment of plan assets is sufficient to support a basis for fiduciary status, or creates a reasonable expectation on behalf of the recipient of the advice that warrants such treatment (unless otherwise excluded). Proposed language clarifies that "fee or other compensation" for this purpose means any fee or compensation, direct or indirect, received from any source, and any fee or compensation incident to the transaction in which the advice has been rendered or will be rendered (including, e.g., brokerage fees, mutual fund sales and insurance sales commissions, and fees and commissions based on multiple transaction involving different parties).

Notable Changes

The proposed rule features the following significant changes compared to existing regulations:

- Appraisals and fairness opinions are specifically included as investment advice activities that can confer fiduciary status unless there is a generally recognized market for such assets. This supersedes the DOL's earlier advice regarding valuation appraisals of closely held employer securities for ESOPs, and the DOL makes clear that the proposed rule also extends to valuations in other circumstances related to investment or management decisions with respect to plan assets (or prospective plan assets). For example, an appraisal of real estate being offered to a plan for purchase would fall within item (1) above. Further, the impact of this rule could extend to private equity funds and hedge funds.

- Advice relating to the *management* of securities or other property has been added to the specified investment advice activities. This would include, for example, advice to a plan, plan fiduciary or plan participant or beneficiary concerning proxy voting or the selection of managers to oversee plan investments.

- The proposed rule incorporates the DOL's long-standing position that advice provided to plan participants and beneficiaries falls within the scope of the investment advice fiduciary rules. However, as currently drafted, the language does not reflect previous DOL guidance stating that a recommendation to a participant or beneficiary to elect to receive a plan distribution to constitute investment advice, even if the adviser recommends how the distribution should be invested. The DOL is seeking comments on whether and to what extent the final regulation should address retain this exclusion.

- The circumstances in Condition (A) have been added to reflect the DOL's belief that an adviser declaring itself to be an ERISA fiduciary gains influence over the recipient of the advice and creates a reasonable expectation that the advice will be impartial and prudent.

- Condition (B) expands upon language in the current regulation to cover the full spectrum of non-investment advice activities that confer fiduciary status under ERISA's "functional tests." Under the functional test, a person is considered to be a plan fiduciary only to the extent of and with respect to the activities conferring fiduciary status. The effect of the proposed regulation, then, is to subject any of the activities described in items (1) through (3) above to a fiduciary standard if they are performed by a person who is a fiduciary for any reason under the functional test (e.g., because it has discretionary

authority over the administration of the plan for which it provides investment advice for a fee), even if the person does not satisfy all the factors in Condition (D).

- The DOL added Condition (C) in light of the fact that courts have held advisers under the Advisers Act to a fiduciary standard and the SEC acknowledges that such persons have an affirmative duty to their clients of utmost good faith, full and fair disclosure of all material facts, and an obligation to employ reasonable care to avoid misleading their clients.

- Finally, Condition (D) is a broader reworking of the current five-factor test. Two factors of the existing test have been eliminated: the requirement that advice under the arrangement between the adviser and the advice recipient be provided on a "regular basis" and the understanding that such advice shall serve as a "primary basis" for plan investment decisions. The DOL has concluded that there is little justification for excluding a person who provides investment advice regarding plan assets from fiduciary status merely because the advice is given on a one-time basis or because the recipient of the advice uses it as one of multiple factors in making plan investment decisions.

Excluded Activities

The proposed framework sets forth three categories of activities that are excluded from being considered investment advice for purposes of ERISA's fiduciary definition. These "limitations" are discussed below.

Purchaser/Seller Exception. A person would not be considered a fiduciary under the proposed rule if the recipient of the advice knows or reasonably should know that (i) the advice is being provided in the context of a purchase or sale of property, (ii) the interests of the person providing advice are adverse to the interests of the plan and (iii) the person is not undertaking to provide impartial advice. This limitation is intended to exclude normal communications between a purchaser and seller in an arm's length transaction to fall within the definition in the proposal, even if the regulatory language could be construed to apply, provided that there is no contrary expectation on the part of the advice recipient. This limitation is not available to a person that represents its status as a fiduciary to the plan, the named plan fiduciary or the participant or beneficiary.

Individual Account Plan Communications. This exclusion covers three types of activities in the context of individual account plans, where plan assets are invested in individual accounts on behalf of plan participants or beneficiaries:

i. Providing investment education information and materials to plans or plan participants or beneficiaries regarding investment options. This is consistent with previous guidance by the DOL and includes plan information, general financial and investment information, asset allocation models and interactive materials.

ii. Marketing or making available of investment options by a recordkeeper, administrator or other third party service provider to a plan fiduciary choosing the investments that will be made available to plan participants, if such options are offered without regard for the individualized needs of the plan and the provider discloses in writing to the plan fiduciary that it is not providing impartial investment advice.

iii. Providing investment financial and historical data concerning the options or prospective options for a plan's investment platform if the provider discloses in writing to the plan fiduciary that it is not providing impartial investment advice.

The limitations in (2) and (3) above are intended to cover situations where it is acknowledged that the service provider has financial or other interests in the selection of investments being offered and the service provider is not purporting to give impartial investment advice regarding the plan's investment menu.

Advice Rendered for Compliance Purposes. Investment advice that is provided to a plan solely for the purposes of compliance with reporting and disclosure requirements under ERISA the Code and their respective regulations, forms and schedules is excluded from the definition in the new rule, unless such report 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 and beneficiaries.

Impact of the Proposed Rule

Anyone providing advice concerning the investment or management of plan assets should assess how the proposed rule would affect the services they provide. Certain consequences are clear: if the proposed regulations are adopted, the scope of activities conferring fiduciary status would increase. Investment consultants and appraisers and valuation experts will be subject to ERISA fiduciary obligations in many instances where they are now excluded (or where there is currently a question as to their fiduciary status), which could result in a dramatic cost increase for appraisals and fairness opinions. The most significant expansion of activities includes valuation of plan assets (or potential plan assets) and advice used to manage or make investment decisions that is provided on a one-time or incidental basis. Registered investment advisers under the Advisers Act would also have fiduciary status any time they undertook non-excludible investment advice activities, which may raise concerns for registered broker-dealers, even in cases where they do not generally provide advice to a plan, if they are unable to avail themselves of the purchaser/seller exclusion. As registered investment advisors, such broker/dealers would no longer have to satisfy the five-factor test to be considered a fiduciary.

As a prophylactic measure, individual account plan sponsors, administrators and other service providers can take advantage of the proposed regulation's limitations by educating their employees as to the kinds of investment-related information that may be provided without crossing the line into the realm of "investment advice" within the meaning of the new regulation.

A number of current exemptions to ERISA's prohibited transaction rules in the handling of plan assets rely on the non-fiduciary status of plan service providers, counterparties and their affiliates. The current service provider exemption found in ERISA section 408(b)(17), enacted as part of the Pension Protection Act of 2006, may also be more limited if the expanded definition of a fiduciary is adopted. These exemptions will need to be reviewed to determine their continuing viability should the proposed regulations be finalized in their current form.

Effective Date

The DOL has set a tentative timetable for the new rules to become effective 180 days after the publication of the final regulations in the *Federal Register*. In the meantime, the DOL has requested comments on the proposed regulations and whether the proposed effective date should be changed. These comments are due on January 20, 2011.

If you have any questions about the content of this publication, please contact the Pillsbury attorney with whom you regularly work or the Executive Compensation & Benefits group.

New York

Susan P. Serota (bio)
+1.212.858.1125
susan.serota@pillsburylaw.com

Peter J. Hunt (bio)
+1.212.858.1139
peter.hunt@pillsburylaw.com

Scott E. Landau (bio)
+1.212.858.1598
scott.landau@pillsburylaw.com

John J. Battaglia (bio)
+1.212.858.1738
john.battaglia@pillsburylaw.com

Mark C. Jones (bio)
+1.212.858.1430
mark.jones@pillsburylaw.com

Kathleen D. Bardunias (bio)
+1.212.858.1905
kathleen.bardunias@pillsburylaw.com

Bradley A. Benedict (bio)
+1.212.858.1523
bradley.benedict@pillsburylaw.com

San Francisco

Christine L. Richardson (bio)
+1.415.983.1826
crichardson@pillsburylaw.com

Marta K. Porwit (bio)
+1.415.983.1808
marta.porwit@pillsburylaw.com

San Diego—North County

Jan H. Webster (bio)
+1.858.509.4012
jan.webster@pillsburylaw.com

Daniel N. Riesenberg (bio)
+1.858.847.4130
daniel.riesenberg@pillsburylaw.com

Kenneth E. Bonus (bio)
+1.858.847.4206
kenneth.bonus@pillsburylaw.com

Lori Partrick (bio)
+1.858.509.4087
lori.partrick@pillsburylaw.com

Silicon Valley

Cindy V. Schlaefer (bio)
+1.650.233.4023
cindy.schlaefer@pillsburylaw.com

Grace Chen (bio)
+1.650.233.4873
grace.chen@pillsburylaw.com

Washington, DC / Northern Virginia

Howard L. Clemons (bio)
+1.703.770.7997
howard.clemons@pillsburylaw.com