Morrison & Foerster News Bulletin

Volume 1, Issue 16 November 23, 2010

Structured Thoughts

News for the financial services community.

IN THIS ISSUE:

Proposed ERISA Regulation Would Expand Persons Considered Fiduciaries

As discussed in our client alert dated November 5, 2010 (http://www.mofo.com/files/Uploads/Images/101105-ERISA.pdf), on October 21, 2010, the Department of Labor issued a proposed regulation[1] that could significantly expand the categories of persons considered fiduciaries as a result of their providing investment advice to plans subject to ERISA or to participants or beneficiaries of such plans. This proposed regulation was issued under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which subjects fiduciaries to standards of prudence and loyalty to the plans for which they are fiduciaries, as well as to conflict of interest rules, referred to as the "prohibited transaction rules".

Because of the far-reaching nature of the proposed regulation, broker-dealers should consider evaluating their relationships with employee benefit plans now to determine whether this regulation could cause them to be considered fiduciaries for ERISA purposes.

Some of the more significant changes to the proposed regulation would include the following as "investment advice" for the purpose of establishing fiduciary status: (i) real estate appraisals and valuations, (ii) advice given on a one-time or irregular basis, and (iii) advice that *may be* considered in making an investment decision but that does not necessarily serve as the *primary basis* for an investment decision.

[1] See http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=24328&AgencyId=8&DocumentType=1.

Under the proposed regulation, a person is treated as a fiduciary if the advice is considered investment advice, the arrangement is one in which the person is considered to be rendering the investment advice to a plan, and the person receives a fee for such advice.

A person is considered to be rendering investment advice to a plan if the person has given investment advice to the plan, participant, or beneficiary, and such person either directly or indirectly (i.e., through an affiliate):

(a) represents or acknowledges that it is acting as an ERISA fiduciary with respect to such advice;

(b) is a fiduciary with respect to such plan under ERISA's rules other than by reason of rendering investment advice (such as the result of exercising discretion with respect to the management or administration of the plan or authority or control over the management or disposition of the plan's assets);

(c) is an investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940; or

(d) provides investment advice pursuant to an agreement, arrangement, or understanding (written or not) between such person and the plan or plan fiduciary, and 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, participant, or beneficiary.

Category (d) above significantly expands the current regulation, which requires that advice be given on a *regular basis*, and that it serve as the *primary basis* for investment decisions. Under the proposed regulation, there is no requirement that advice be given on a regular basis or that it serve as the primary basis for the investment decision. Instead, the proposed regulation provides merely that the advice may be considered in connection with the investment decision and encompasses situations where the advice is one-time or irregular.

Although the proposed regulation is not likely to become final until late next year, and will undoubtedly be subject to a significant amount of comment, employers, financial institutions, and service providers such as broker-dealers, investment managers, consultants, and appraisers should consider evaluating their relationships with employee benefit plans to establish whether they would be considered ERISA fiduciaries under the proposed regulation, and if so, take steps to ensure their compliance with the requirements of ERISA.

Disclosure Statement for Retail Investors

Title IX of the Dodd-Frank Act set forth a number of measures intended to improve investor protection. Section 913 of the Act directs the SEC to "facilitate the provision of simple and clear disclosures to investors regarding the terms of their relationships with brokers, dealers and investment advisers, including any material conflicts of interest." In October 2010, FINRA separately published Regulatory Notice 10-54 in which it requests comment on a new concept proposal to require FINRA member firms to provide retail customers with a written disclosure statement at the commencement of the relationship. Comments are requested by December 27, 2010.

In the notice, FINRA comments that even prior to the adoption of the Dodd-Frank Act, FINRA was focused on Plain English-type disclosures for retail customers that would describe the services and the types of accounts offered by the broker-dealer member, as well as the fees charged and any conflicts of interest. FINRA's proposal suggests that this disclosure statement might be similar to Part 2 of Form ADV (for investment advisers). FINRA notes that the disclosure statement should include information on the following matters: the types of brokerage accounts and services the firm provides to retail customers, such as research, underwriting, and recommendations of securities, products, and strategies; disclosures intended to permit existing and prospective retail customers to evaluate the scope of services and products offered and the fees associated with these; disclosures regarding the financial or other incentives that a firm would have to recommend certain products, investment strategies, or services over similar ones; disclosure of conflicts of interest and the firm's practices for managing those conflicts; and limitations on the duties owed by the firm to its customers. It is contemplated that the disclosure statement be provided to "retail customers" as defined by FINRA, which is a customer that does not qualify as an "institutional account" under

NASD Rule 3110(c)(4), which includes a bank, savings and loan, insurance company, registered investment company, registered investment entity, or entity or natural person with total assets of at least $50 million.

It is not clear whether the SEC will take action on a disclosure statement prior to the implementation of this FINRA requirement.

Know Your Customer and Suitability Update

We reported in a prior issue of *Structured Thoughts* (http://www.mofo.com/files/Uploads/Images/101004-Structured-Thoughts-Issue-13.pdf) on FINRA's amendments to proposed changes to the know your customer rule (Rule 2090) and the suitability rule (Rule 2111). On November 17, 2010, the SEC granted accelerated approval of the rule changes. Many commenters had noted that it might be sensible to delay changes to the know your customer and suitability rules pending clarity regarding the SEC's study of the standards of care applicable to broker-dealers. Although the concept of a fiduciary duty or other enhanced standard of care is different from the suitability standard, these are nonetheless related.

The proposed know your customer rule would require broker-dealers to use "reasonable diligence" with respect to the opening and maintenance of a customer account in order to know and retain the essential facts concerning every customer. Supplementary material defines "essential facts" as those required to "(a) effectively service the customer's account, (b) act in accordance with any special handling instructions for the account, (c) understand the authority of each person acting on behalf of the customer, and (d) comply with applicable laws, regulations, and rules."

The proposed suitability obligation would require a broker-dealer or associated person to have a "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." This belief would be "based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile, including, but not limited to, the customer's age, other investments, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation." In supplementary material added in the amendment, FINRA notes that these factors are those deemed to be generally relevant to the suitability determination, but that the importance accorded to each may vary based on facts and circumstances. The supplementary material also notes that a member or associated person should use reasonable diligence to obtain and analyze all of these factors unless it has a reasonable basis to believe (which is documented with specificity) that one or more of the factors are not relevant components of a customer's investment profile in a particular case.

The rule expressly covers recommended investment strategies understood broadly; however, the supplementary material excludes general financial and investment information and certain asset allocation models. The suitability rule modifies the approach to institutional customers by requiring that institutional customers affirmatively indicate that they are exercising independent judgment in evaluating transactions and investment strategies.

Contacts

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on *The American Lawyer*'s A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.