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LEGAL ALERT

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DOL Proposes to Expand "Fiduciary" Status under ERISA

On October 22, 2010, the U.S. Department of Labor (DOL) proposed to replace its long-standing regulation defining the circumstances in which investment advice confers "fiduciary" status under ERISA, with a new, more expansive definition. The proposal would take effect 180 days after publication of a final regulation.

By way of background, ERISA imposes a famously "comprehensive and reticulated"[1] scheme of regulation for the terms of employee benefit plans, particularly retirement plans, and for plan reporting and disclosure. But for the management of plans, ERISA instead relies primarily on a standards-based form of regulation, and at the core of that regulation is the concept of a "fiduciary" to the plan. Such fiduciaries are charged with carrying out their duties for the plan in accordance with rigorous fiduciary standards (ERISA §404) and are barred from engaging in certain prohibited transactions (ERISA §406). For example, acting with a conflict of interest generally would be contrary to these fiduciary standards. Fiduciaries are personally liable for losses suffered by a plan resulting from a violation of these standards, as well as for other remedies and penalties.

ERISA §3(21) provides that three classes of persons are fiduciaries for purposes of ERISA, generally:

- Persons with discretionary authority or responsibility in the administration of the plan ("plan administration fiduciaries");
- Persons who provide investment advice for a direct or indirect fee or other compensation with respect to the moneys or other property of the plan ("investment advice fiduciaries"); and
- Persons who manage plan assets on a discretionary basis ("discretionary asset management fiduciaries").

Over the years, the second fiduciary category has perhaps required the most elaboration. Immediately after the enactment of ERISA, DOL promulgated in 1975 a regulation (which it now seeks to replace) specifying the circumstances in which a person providing investment advice becomes a fiduciary. For an adviser who does not have discretionary management authority, the regulation provides that the adviser is a fiduciary only if he or she satisfies a five-part test, specifically, if he or she for a direct or indirect fee or other compensation:

1. Renders advice 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
2. On a regular basis
3. Pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary, that
4. The advice will serve as a primary basis for investment decisions with respect to plan assets, and that
5. The advice will be individualized based on the particular needs of the plan.

[1] *Nachman Corp. v. PBGC*, 446 U.S. 359, 361 (1980).

In the early years of ERISA, DOL also provided guidance that:

- "Fees or other compensation" should be construed expansively for purposes of this definition, and may include, e.g., securities or insurance commissions; but that
- The valuation of closely held employer securities, for use by an employee stock ownership plan (ESOP) in purchasing the securities, does not constitute "investment advice" under the regulation.

Finally, "investment advice fiduciary" status has been litigated from time to time, with DOL's regulation usually, but not always, providing the framework for the courts' analysis of this issue.

Under the current Administration, however, DOL has made a judgment that, after 35 years, this regulation requires reconsideration. DOL argues that:

- Since 1975, ERISA retirement plans have shifted from predominantly defined benefit to predominantly defined contribution. The financial markets have also changed and have become more complex. As a result, the investment practices of plans, along with their relationships with their advisers, have changed.
- In this more complex environment, plan fiduciaries seek out impartial assistance and expertise from consultants, advisers and appraisers to advise them on investment-related matters.
- In structuring their relationships with plans, however, these advisers can too readily take advantage of the five-part test to avoid fiduciary status.
- "In recent years, non-fiduciary service providers – such as consultants, appraisers, and other advisers – have abused their relationships with plans by recommending investments in exchange for undisclosed kickbacks from investment providers, engaging in bid-rigging, misleading plan fiduciaries about the nature and risks associated with plans investments, and by giving biased, incompetent, and unreliable valuation opinions. Yet, no matter how egregious the abuse, plan consultants and advisers have no fiduciary liability under ERISA, unless they meet every element of the five-part test."[2]
- This is contrary to the expectations of plan officials and participants.
- Moreover, DOL feels hampered in its enforcement efforts – both by its need to allocate substantial resources for investigating and proving up all the elements of the five-part test, and its inability to redress cases it deems abusive if it cannot do so.
- And the five-part test is not compelled by the terms of ERISA §3(21). DOL contends that the plain terms of the statute are simpler and broader than the regulation.

For these reasons, DOL argues, the five-part test should be replaced with a new definition more faithful to the statutory definition that makes more investment service providers accountable as ERISA fiduciaries.

Comments:

- DOL comes dangerously close to arguing that "investment advice fiduciary" should be defined "in light of the mischief to be corrected and the end to be obtained,"[3] that is, if plan participants and beneficiaries are disserved by investment service providers with conflicted interests, then those service providers should be treated as fiduciaries to protect participants and beneficiaries.
- And by claiming that the statutory definition is broad, DOL assumes a result that also is not compelled by the text of §3(21); the statute itself provides no content for the term "investment advice."
- The proper approach to interpreting the defined terms of ERISA is, however, clear. The Supreme Court has instructed that, absent guidance from Congress to the contrary, terms used in ERISA

[2] See the preamble to the proposed regulation at 65271.
[3] *United States v. Silk*, 331 U.S. 704, 713 (1947).

should be given their ordinary meaning in the law and should not be stretched to accomplish some perceived remedial objective.[4]

- Any different approach would risk contravening the structure of ERISA, which after all requires only fiduciaries to be conflict-free. ERISA cheerfully allows service providers with conflicted interests to pursue their own business interests at the expense of the plan, subject only to a "reasonable arrangement" requirement within ERISA (§408(b)(2)) and the legal obligations intrinsic to the relationship outside that statute.
- Finally, any expectation by plan officials and participants that their service providers will be impartial of itself does not cause those providers to be ERISA fiduciaries. Over the years, DOL has been the first to argue that fiduciary status is determined on a functional basis and is not driven by the expectations of the parties. And to the extent plan officials and participants have not always correctly understood whether their investment service providers are impartial, DOL's new service provider disclosure requirement (which includes, for service providers intending to be ERISA fiduciaries, an express statement to that effect) will cure that misunderstanding starting in June 2011. A broadening of the "fiduciary" definition is not necessary to solve this problem.

In sum, while DOL's stated objectives are perhaps understandable given its mission and will be supported by respected commentators from the retirement community as a policy matter, DOL's legal justifications are somewhat circular or otherwise imperfect in their logic, and its proposal therefore should be carefully scrutinized for overreaching as compared to the legislative judgments reflected in the statutory language of ERISA.

Proposed Definition

DOL proposes to replace the existing five-part test with a two-part definition subject to a series of carve-outs. Under the proposal, the "investment advice fiduciary" definition would work as follows:

A person is a fiduciary if, for a direct or indirect fee or other compensation:	
Services	That person provides to a plan fiduciary, participant or beneficiary either: ▪ 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; or ▪ Advice or recommendations as to the management of securities or other property.
AND	
Status	That person either directly or indirectly (e.g., through or together with any affiliate) either: ▪ Represents or acknowledges that it is acting as an ERISA fiduciary in providing the above advice or recommendation (an "acknowledged" fiduciary); ▪ Is a plan administration or discretionary asset management fiduciary under ERISA §3(21); ▪ Is an investment adviser within the meaning of §202(a)(11) of the Investment Advisers Act of 1940 (Advisers Act). The preamble makes clear that the §202(a)(11) exclusions also apply for this purpose, but makes no reference to the exemptions from Advisers Act registration; or

[4] *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992).

	▪ Provides the above advice or recommendations pursuant to an agreement, arrangement or understanding, 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 will be individualized to the needs of the plan, a plan fiduciary, or a participant or beneficiary.
AND	
Carve-outs	The person or advice, as applicable, is ***not*** described in any of the following: ▪ The person can demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing its advice or recommendation in its 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 interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice. An acknowledged fiduciary may not make use of this carve-out. ▪ For a defined contribution plan, the advice is non-fiduciary "investment education" as defined in existing ERISA guidance. ▪ For a defined contribution plan, providing a platform of investment options on a non-individualized basis and/or general financial information and data to assist the plan fiduciary with its selection among or monitoring of those options, in either case with a written disclosure that the person is not undertaking to provide impartial investment advice. ▪ "Advice, or appraisal or fairness opinion" does not include preparing a general report or statement that merely reflects the value of an investment of a plan or a participant or beneficiary, and is provided for purposes of complying with ERISA or Internal Revenue Code reporting and disclosure requirements, unless that 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.

For these purposes, "fee or other compensation":

- Includes (i) any fee or compensation for the advice received by the person (or by an affiliate) from any source; and (ii) any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered; and
- Includes (i) brokerage, mutual fund sales, and insurance sales commissions, and (ii) fees and commissions based on multiple transactions involving different parties.

The proposal would retain the subsections of the existing regulation (i) specifying that an adviser is not a fiduciary with respect to any assets for which he or she does not render advice or otherwise have the requisite responsibilities, (ii) providing that clearing broker-dealers are not fiduciaries, in specified circumstances, and (iii) defining "affiliate" and "control" for these purposes.

Comments:

- The practical consequences of the proposal, if adopted, may primarily be to (i) treat firms that provide valuations and fairness opinions as fiduciaries and (ii) modify the burden of production and persuasion in at least certain cases where, under existing law, investment advice fiduciary status is not entirely clear.
- For a proposal said to model the statute, omitting in the description of covered services the reference to securities or property “of the plan” is curious. The proposal does not substitute the technical ERISA “plan asset” concept in its stead. This may create some ambiguity. For example:
  - Nothing on the face of the proposal clearly says that advice to participants on their assets held outside the retirement setting is not a covered service, although this is presumably just a drafting point.
  - Financial planners who give advice on a client’s overall financial position, including but not limited to retirement assets, often have been comfortable under the existing regulation that they are not ERISA “investment advice fiduciaries.” They may be less comfortable under the proposal, even though they are not its intended targets.
  - On the other hand, the proposal does not appear intended to affect the §3(21) status of managers for plan investment vehicles. For example, in its press conference introducing the proposal, DOL informally indicated that the proposal does not change the ERISA status of target date fund managers. Because of the potential for unintended consequences, however, clarification of this point in the text of the regulation would seem appropriate.
- The extension of fiduciary status to persons who provide appraisals and fairness opinions (beyond those who as a matter of business practice accept that status) would meaningfully expand the definition. While DOL has apparently encountered abusive behavior from this class of providers, it is not intuitively obvious that DOL’s judgment on this point in 2010 would better reflect Congressional intent than its contrary judgment in 1976.
- For the four “status” categories, the reference to a person acting “directly or indirectly (e.g., through or with any affiliate)” will create confusion; the import of this reference should be clarified.
- It is hard to argue that investment service providers who hold themselves out as ERISA fiduciaries should not be legally accountable as such. (On this point, the proposal properly distinguishes between acknowledgement of fiduciary status for ERISA purposes and for other legal purposes.) Further, it is understandable why DOL would, in the preamble, suggest that either oral or written acknowledgements will suffice. It seems worth considering whether there is a better solution than setting up swearing contests on this point, however.
- The existing regulation includes within its scope the investment advice provided by discretionary asset management fiduciaries. It is unclear what DOL intends to accomplish by proposing to do the same for plan administration fiduciaries; to the extent they are obliged to put a value on plan investments in order to perform their administrative function, for example, they would seem to be accountable as fiduciaries even without the proposal.
- As for securities firms, it appears that investment advisers (IAs) – possibly including, in addition to SEC-registered advisers, (i) state-registered advisers and (ii) advisers exempt from registration under Advisers Act §203 and/or state law – and their associated persons are generally intended to be ERISA fiduciaries under the proposal, unless a carve-out applies. The Advisers Act also makes IAs fiduciaries, but generally permits them to have conflicted interests so long as those conflicts are disclosed; this is a significant difference from ERISA. In contrast, broker-dealers and their representatives who are only recommending suitable investments – the traditional and permissible function of a selling firm – would seem often not to be ERISA fiduciaries under the proposal. (Depending on the outcome of the SEC’s pending study of fiduciary duties for broker-dealers, this

analysis could become more complex.) For dual registered firms, the capacity in which the firm is providing the particular service presumably would control.

- The fourth "status" category is a modification of the five-part test, without the "regular basis" and "a primary basis" elements. Those changes are intended to bring in advisers who provide one-time or special purpose advice and to escape the nuances of the "primary basis" analysis. The proposal also omits the term "mutual," although an "agreement, arrangement or understanding" all suggest a bilateral meeting of the minds; on this point, the service provider disclosure regime may provide a means to prevent disputes.
- The carve-outs seem well-conceived. The first carve-out (for salespersons or counterparties), while consistent with some practice in the market and the weight of case law, will be a welcome addition to the regulation and helpful in finally settling with the long-standing "inadvertent fiduciary" problem in these circumstances, although DOL's notion that only the providers who can affirmatively prove its elements are entitled to this exception hardly seems to follow from the statute. The second and third carve-outs, for investment education and platforms of investment options in defined contribution plans, also seem appropriate, although similar concepts also seem pertinent for defined benefit plans. The fourth carve-out, for providers who prepare reports incorporating asset values, seems right in concept but excessively narrow in formulation.

Comment Period

Comments on the proposal are due January 20, 2011. DOL is specifically soliciting comments on, among other things:

- Whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution; and
- Whether the final regulation should be made effective on a different date.

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Daniel M. Buchner	202.383.0869	daniel.buchner@sutherland.com
Adam B. Cohen	202.383.0167	adam.cohen@sutherland.com
Jamey A. Medlin	404.853.8198	jamey.medlin@sutherland.com
Alice Murtos	404.853.8410	alice.murtos@sutherland.com
Joanna G. Myers	202.383.0237	joanna.myers@sutherland.com
Robert J. Neis	404.853.8270	robert.neis@sutherland.com
Vanessa A. Scott	202.383.0215	vanessa.scott@sutherland.com
W. Mark Smith	202.383.0221	mark.smith@sutherland.com
William J. Walderman	202.383.0243	william.walderman@sutherland.com
Carol A. Weiser	202.383.0728	carol.weiser@sutherland.com