

DOL Proposed Regulation Expands The Definition Of An ERISA Fiduciary

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On October 21, 2010, the Department of Labor (“DOL”) issued a proposed rule that would broaden the definition of “fiduciary” by expanding the types of investment advice activities that may give rise to fiduciary status under the Employee Retirement Income Security Act of 1974¹ (“ERISA”), modifying a regulation that has remained unchanged for 35 years.

The proposed rule, published in the Federal Register, invites public comment until January 20, 2011.² It is estimated the final version of the regulation will be effective in late 2011 or early 2012.

I. BACKGROUND AND STATUTORY DEFINITION OF “FIDUCIARY”

ERISA is a statute designed to “promote the interest of participants in employee benefit plans and their beneficiaries by establishing standards of conduct, responsibility, and obligation for fiduciaries of those plans.”³ ERISA broadly defines a fiduciary as a person who renders investment advice with respect to any moneys or other property of a plan, or has any authority or responsibility to do so; and the person receives a fee or other compensation, direct or indirect, for doing so.⁴

In 1975 (the year after ERISA was enacted), the DOL issued a regulation to define the circumstances under which a person may qualify as a fiduciary, or more specifically, what constitutes the rendering of “investment advice” under ERISA.⁵ The proposed regulation would be an updated replacement of this 1975 regulation.

II. THE DOL’S JUSTIFICATION FOR THE PROPOSED REGULATION

One reason the DOL is proposing the new rule is because it recognizes the retirement plan community has changed dramatically since 1975. The types and complexity of investment products and services available to plans have increased, and plan investment practices and relationships between advisers and their plan clients have changed.⁶

The DOL also acknowledges the current standard for “investment advice” is cumbersome, fact-intensive, and narrowly drawn, such that persons who do not meet the test, yet

¹ Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

² Definition of the Term “Fiduciary,” 75 Fed. Reg. 65263 (proposed October 22, 2010) (to be codified at 29 C.F.R. pt. 2510).

³ *Id.* at 65264.

⁴ 29 U.S.C. 1002(21)(A)(ii) (referred to as “section 3(21)(A)(ii)”).

⁵ 29 C.F.R. § 2510.3-21.

⁶ Definition of the Term “Fiduciary,” *supra*, 75 Fed. Reg. at 65265.

have considerable impact on plan investments, are not held to the stringent duties of a fiduciary under ERISA and may operate with conflicts of interest and unsanctioned misconduct.⁷

The DOL believes the proposed regulation will eliminate the cumbersome and narrow standard, and provide more protection to plan participants and beneficiaries who reasonably rely on the fiduciary's advice.⁸

III. THE STANDARD FOR "INVESTMENT ADVICE"

A. The Current Standard

The current regulation that defines the types of activities and circumstances that qualify as rendering "investment advice" as it relates to ERISA's fiduciary status is referred to as the fiduciary "five-part test." A person providing "investment advice" is deemed a fiduciary if the person:

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.

All five parts of this test must be met.⁹

B. The Proposed Standard

The proposed regulation replaces the "five-part test," although it still incorporates some of its elements. It no longer requires advice be given on a "regular basis" or that there be a mutual understanding that the advice will serve as a "primary basis" for investment.¹⁰ The proposed test entails three steps:

1. Types Of Advice Or Recommendations

First, a fiduciary renders investment advice when the person gives (any one of these):

1. advice, appraisals, or fairness opinions concerning the value of securities or other property;
OR

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* at 65264 (interpreting 29 C.F.R. § 2510.3-21).

¹⁰ *Id.* at 65267.

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.¹¹

2. Conditions

Second, the fiduciary must also satisfy *any* one of the following conditions that it:

1. represents or acknowledges that it is acting as a fiduciary; OR
2. has discretionary authority or control over the management of the plan, the plan assets, or in the administration of the plan; OR
3. is an “investment adviser” within the meaning of the Investment Advisers Act of 1940;¹² OR
4. provides advice or makes recommendations pursuant to an arrangement, agreement, or understanding that the advice
 - (a) may be considered in connection with making investment or management decisions about plan assets, AND
 - (b) will be individualized to the needs of the plan, a plan fiduciary, a participant, or a beneficiary.¹³

3. Fee Or Compensation Requirement

Third, the fiduciary must receive a fee or other compensation (directly or indirectly) for its rendering of advice or recommendations from any source, which includes fees and commissions based on multiple transactions involving different parties.¹⁴

4. Exceptions

Even if the proposed three-step test is satisfied, the proposed regulation allows for certain exceptions, so that there is no fiduciary status under ERISA:

1. if the recipient of the advice knows or reasonably should know (under the circumstances) that the person is providing the advice in its capacity as a purchaser or seller of security or other property, or as an agent or appraiser for the purchaser or seller, and that person is not undertaking to provide impartial investment advice;
2. the person provided investment education information and materials pursuant to 29 C.F.R. 2509.96-1(d);
3. the person is marketing or making available an individual account plan (such as a participant-directed defined contribution plan), if the person making this information available discloses in writing the plan fiduciary that it is not undertaking to provide impartial investment advice;

¹¹ *Id.* at 65265. This section contains the same types of advice as the current regulation, but it also includes adding appraisals and fairness opinions as types of advice, includes advice for the *management* of securities and other property, and clearly shows that fiduciary status may result from advice to a plan fiduciary, participant, or beneficiary.

¹² *Id.* The Investment Advisers Act of 1940 (also known as the Advisers Act) is found at 15 U.S.C. § 80b-2(a)(11).

¹³ *Id.* at 65266. This section of the proposed regulation incorporates elements of the current “five-part test,” but the DOL believes the application here is more simplified and broadens their scope.

¹⁴ *Id.* at 65269.

4. the person is providing certain information to assist a plan fiduciary's selection or monitoring of plan investment alternatives, if the person making this information available discloses in writing the plan fiduciary that it is not undertaking to provide impartial investment advice;
5. the person is providing the information solely for compliance with ERISA's reporting and disclosure provisions as to the value of plan assets, such as the preparation of a general report that merely reflects the value of an investment of a plan or a participant or beneficiary, *unless* the report involves assets that are not a generally recognized market and serve as a basis on which a plan may make distributions to plan participants and beneficiaries.¹⁵

IV. Anticipated Impact Of The Proposed Regulation

The DOL discusses with great detail, in the Federal Register, what it anticipates the impact may be once the proposed regulation is codified.¹⁶ The DOL determined modification to the current regulation is necessary to more closely reflect the broad statutory definition of the term under ERISA; to recognize the diverse and complex fee practices that exist in today's service provider market and their potential conflicts; to account for the trend towards defined contribution plans; to expand the scope of fiduciary protections for plans and their participants and beneficiaries; and to permit the Employee Benefits Security Administration ("EBSA") investigators and attorneys to focus their efforts on the adviser's conduct rather than meeting the evidentiary requirements of the current regulation's cumbersome and narrow five-part test.¹⁷

Other benefits would include discouraging harmful conflicts where arrangements between a plan's service providers profit one plan at the expense of another plan.¹⁸ Also, the DOL believes the proposed regulation would force certain service providers (not considered fiduciaries under the current regulation) to modify their business practices to act in accordance with ERISA fiduciary status, so that plans receive better value for the service fees.¹⁹

The DOL anticipates the costs primarily involve initial compliance review costs for all service providers to determine whether they meet the fiduciary definition under the proposed regulation.²⁰ The DOL anticipates, but is uncertain of, the service provider costs that may arise and may be passed on to the plans. If service providers experience higher costs of doing business due to the increased liability exposure associated with ERISA fiduciary status, they may charge higher fees to their plan clients, or limit or discontinue the availability of their services or products to ERISA plans.²¹ The DOL also noted that there is a possibility the service provider market may shrink because of the costs and high standards that entail a ERISA fiduciary.²²

¹⁵ *Id.* at 65268. 29 C.F.R. 2509.96(d)(1) includes advice regarding plan information, general financial and investment information, asset allocation models, and interactive materials involving education.

¹⁶ *Id.* at 65270-76.

¹⁷ *Id.* at 65272.

¹⁸ *Id.*

¹⁹ *Id.* at 65273.

²⁰ *Id.* at 65274. The DOL estimates this cost alone would be about \$10.1 million in the first year of implementation of the regulation, and the costs for review of those service providers newly entering the market beginning in 2012 through to 2020 will total about \$17.7 million.

²¹ *Id.* at 65275.

²² *Id.*

Nonetheless, the DOL believes the proposed regulations' benefits would justify any potential costs.