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DOL Proposes Significant Changes to "Investment Advice" Fiduciary Status Definition

November 1, 2010

In the October 22 edition of the *Federal Register,* the U.S. Department of Labor (DOL) published a proposed rule that would significantly revise its regulation on the definition of a "fiduciary" under the Employee Retirement Income Security Act of 1974, as amended (ERISA), by rewriting the five-factor test that has been used since 1975 to determine whether a person is an ERISA fiduciary by reason of giving "investment advice" for a fee. The proposal, in its present form, would greatly expand the types of services to be treated as subject to the ERISA fiduciary responsibility rules, potentially increasing the liability exposure for firms that provide these types of services to employee benefit plans. At the same time, DOL limited the expansive scope of the changes by including several limitations that may be crucial to permitting firms to be able to continue certain existing relationships with ERISA plans.

Background

DOL indicated that the proposed changes are prompted largely by its concerns about the difficulty of bringing enforcement actions under the current definition.

The underlying statutory language, Section 3(21)(A) of ERISA, defines the term "fiduciary" by listing three categories of functions with regard to a plan that would cause a person to become a fiduciary. The second category is providing "investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of" an ERISA plan. In 1975, DOL adopted a regulation that effectively narrowed the concept of "investment advice" through a five-factor test. In addition to meeting the "fee or other compensation" requirement, for an adviser to be deemed a fiduciary under the current regulation it must (1) provide investment recommendations, or advice on property values (2) on a regular basis (3) pursuant to a mutual agreement, arrangement, or understanding with the plan (4) that the advice will serve as a primary basis for plan investment decisions and (5) that the advice will be individualized based on the particular needs of the plan. DOL further narrowed the definition in a 1976 advisory opinion that concluded that a valuation of closely held employer securities for an employer stock ownership plan (an ESOP) would not constitute "investment advice."

According to DOL, there is now a need to re-examine the types of advisory relationships that give rise to fiduciary duties to account for changes in the retirement plan community and the financial marketplace, including the shift from defined benefit plans to defined contribution plans and the increasing types and complexity of investment products and services. In particular, DOL is concerned about the problems the current regulation has created for its enforcement initiatives. DOL said that the burden of proving each of the five elements of the "investment advice" test is time-consuming and diverts DOL from focusing

its efforts on demonstrating fiduciary misconduct. The five-part test, according to DOL, makes it too easy for such persons as investment consultants, advisers, and appraisers to avoid fiduciary status, even though they can significantly influence the decisions of plan fiduciaries and have a considerable impact on plan investments, and may operate under undisclosed conflicts of interest that, according to a recent Government Accountability Office report, can lower plans' investment returns. Therefore, DOL concluded that amending the current regulation along the lines of the proposal would better protect the interests of plans and their participants and beneficiaries.

DOL also noted its belief that the current approach to "investment advice" is not compelled by the statutory language, and that by subjecting persons who in fact provide investment advice to plan fiduciaries and participants to ERISA's standards of fiduciary conduct, its proposal is more consistent with ERISA.

Proposed Regulation

The proposed regulation would rewrite the five-factor test for "investment advice" that was the principal feature of the 1975 regulation, and would expand the categories and services that would make a person an "investment advice" fiduciary. At the same time, it would adopt limitations (in the nature of exceptions) to recognize that, subject to certain conditions, sales efforts and making available investments to defined contribution plans, and providing reports or statements that describe the value of investments, should not be treated as giving rise to fiduciary status.

Definition of "Investment Advice"

The first subsection of the proposal would adopt a two-part test for "investment advice," similar in structure to the existing regulation. The first part, as in the existing regulation, would describe the types of services that bring a person within this definition, namely the following:

1) **Providing advice, or an appraisal or fairness opinion, concerning the value of securities or other property.** The wording of this section parallels the existing language, with an added reference to appraisals and fairness opinions. While previous DOL interpretations had excluded valuations from these rules, the proposal would reverse that view by specifically including appraisals and similar reports, subject to certain limitations. The goal is to ensure that an appraiser's determination of value be unbiased, fair, objective, and made in good faith and based on a prudent investigation under the prevailing circumstances then known to the appraiser.

2) **Making recommendations as to the advisability of investing in, purchasing, holding, or selling securities or other property.** This category is drawn from the existing rule.

3) **Providing advice or making recommendations as to the management of securities or other property.** This category is not found in the existing rule. According to DOL, this would include, for example, providing advice and recommendations on proxy voting and as to the selection of persons to manage plan investments (i.e., manager searches). This reflects DOL's view, as stated last year in the preamble to its final regulation on the participant investment advice exemption under section 408(b)(14) of ERISA (since withdrawn and reproposed), that individualized recommendations of particular investment managers are considered "investment advice" under ERISA.

The proposal specifies that these services are covered if provided to a plan, plan fiduciary, or plan participant or beneficiary, incorporating a 1996 interpretation that advice to plan participants and beneficiaries is covered.

The second part of the proposed two-part "investment advice" test sets forth four alternative conditions, at least one of which must be met for a person providing any of the services described in the first part of the test to be considered an investment advice fiduciary. These conditions generally relate to the degree of authority, control, responsibility, or influence exercised by the person giving the advice, and the reasonable expectations of the persons receiving the advice.

- **Acknowledged ERISA fiduciaries**. The first alternative covers persons who represent or acknowledge that they are acting as ERISA fiduciaries with respect to providing advice or making recommendations of the type covered in the first part of the definition. DOL believes that explicitly claiming fiduciary status, orally or in writing, enhances an adviser's influence and gives rise to a reasonable expectation that the advice will be impartial and prudent. DOL also expressed the view that someone who acknowledges fiduciary status should not then be able to escape fiduciary liability by arguing that it did not meet one or more of the factors necessary for fiduciary status.

- **Nonadvice ERISA fiduciaries**. The second alternative covers persons who are fiduciaries to a plan under the other two subsections of the statutory definition of an ERISA fiduciary, namely, those persons that exercise discretionary authority or control over management of the plan or that have discretionary authority or responsibility in plan administration. This is based on a provision in the current regulation, but broadens its scope—the existing provision is limited to persons with discretionary authority or control over the purchase and sale of plan assets.

- **Securities law investment advisers**. The third alternative covers persons who are investment advisers as defined in the Investment Advisers Act of 1940. DOL included such persons because, according to the Securities and Exchange Commission and the courts, they owe fiduciary duties to their clients under the Investment Advisers Act. This also parallels a recently adopted DOL regulation on plan service provider disclosures, which requires service providers to disclose whether they provide services as either an ERISA fiduciary or a securities law investment adviser. DOL noted that this reference to the Investment Advisers Act definition also includes the various exclusions from that definition, so that, for example, a bank or broker dealer that provides investment advice or recommendations would not be covered. However, such an entity may still come under one of the other alternatives.

- **Multifactor test**. The fourth alternative would substantially revise the provision in existing law that contains four elements of the five-factor test. It would cover persons that provide advice or make recommendations (as described in the first part of the definition) "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."

  This alternative contains two principal changes from the current rule. First, the advice need not be provided on a "regular basis." DOL does not believe that the significance of advice diminishes merely because it is rendered on a one-time basis—it may still be critical to an

investment decision. DOL added that removing this factor will reduce uncertainty by eliminating "difficult factual questions" as to what constitutes a "regular basis."

Second, the revised language would not require that the parties have a "mutual" understanding that the advice will serve as a "primary basis" for plan investment decisions. According to DOL, the plan should generally be able to rely on advice without regard to whether it is a primary or "lesser" basis for a fiduciary's decision and, in any event, the relative importance of different advice may be impossible to discern.

DOL retained the language requiring that the advice be "individualized" to the needs of the plan, although it eliminated the examples of the types of needs that the advice could address.

Each of these alternative conditions also applies where the person who provides the advice or recommendation is acting through or together with any affiliate.

With regard to the reference to advice to plan participants, DOL noted that it has taken the position that, as a general matter, a recommendation to a plan participant to take a permissible plan distribution does not constitute "investment advice," even when combined with a recommendation as to how the distribution should be invested. However, in light of concerns that have been raised about the DOL position, DOL has requested comment on whether plan distribution recommendations should be covered by this rule.

Limitations

A separate subsection of the proposal lists three limitations on investment advice fiduciary status.

1) **"Purchasing or selling."** A person will not be considered an investment advice fiduciary if the person can demonstrate that the recipient of the advice knows, or under the circumstances reasonably should know, that the person has provided the advice in its capacity as a purchaser or seller of property, or as an agent or appraiser for such a purchaser or seller, whose interests are adverse to the interests of the plan, and that the person is not undertaking to provide impartial advice. DOL said that this provision reflects its understanding that, in the context of selling investments to a purchaser, a seller's communications with the purchaser may involve advice or recommendations that could come under the definition in the proposal, but that ordinarily should not result in fiduciary status if the purchaser knows that the seller has adverse interests and has not undertaken to act as an impartial adviser. This limitation would not apply to a person who represents or acknowledges its status as an investment advice fiduciary, as DOL believes that would give rise to an inherent expectation of impartial investment advice.

2) **Activities taken in connection with individual account plans, such as 401(k) plans.** This limitation covers three areas:

    a) *Provision of investment education and materials within the meaning of Interpretive Bulletin 96-1.* This incorporates the four categories of information and materials that, according to prior DOL guidance, do not result in the rendering of "investment advice" that makes one an ERISA fiduciary. DOL said that the proposed modifications to the regulation would not affect its prior guidance.

b) *Marketing or making available securities or other property to serve as designated investment alternatives for investment direction by plan participants*. Such activities do not result in the rendering of "investment advice" if (i) the marketing is done without regard to the individualized needs of the plan or its participants, and (ii) the person making the investments available discloses in writing to the plan fiduciary that it is not undertaking to provide impartial investment advice. This is designed to deal with the common practice of a plan recordkeeper or third-party administrator making available a menu of investments from which a plan fiduciary selects a more limited menu for plan investment.

c) In connection with marketing or making available designated investment options, *providing general financial information and data to assist a plan fiduciary's selection or monitoring of plan investment options*, if the person providing such information or data discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.

3) **Valuation services.** In recognition that plans require information on the value of plan assets to comply with ERISA's reporting and disclosure rules, DOL said that it did not intend for such information provided solely for compliance purposes to come within the categories of investment advice under the proposal. Therefore, this limitation provides that the term "advice, appraisal, or fairness opinion" does not include the preparation of a general report or statement that provides investment values for purposes of complying with the reporting and disclosure requirements of ERISA or other employee benefit plan rules. However, the limitation does not apply to a report involving assets for which there is not a generally recognized market, where such report serves as a basis on which the plan may make distributions to plan participants and beneficiaries.

Definition of "Fee or Other Compensation"

The existing regulation does not further define the concept of what constitutes a "fee or other compensation," which is a necessary element under the statutory definition for investment advice fiduciary status. DOL interpretations and court decisions have generally taken an expansive view of what comes within this definition. The proposal would adopt that expansive view. It would specify that a fee or other compensation, direct or indirect, means any fee or compensation for the advice received by the person (or by an affiliate) from any source, as well as any fee or compensation incident to the transaction in which the advice has been rendered or will be rendered. By way of example, the proposal says that it includes brokerage, mutual fund sales, and insurance sales commissions, as well as fees and commissions based on multiple transactions involving different parties.

Application to Parallel Internal Revenue Code Provisions

While the proposed regulation would be adopted under ERISA, DOL included a subsection stating that the regulation also would apply 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. This means that these rules would apply in determining whether a plan subject to Section 4975 (such as an ERISA-governed retirement plan or a non-ERISA individual retirement account (IRA)) has engaged in a prohibited transaction for purposes of Section 4975's prohibited transaction excise tax rules. DOL took the same approach in its recently adopted final regulation on service provider disclosure, which also was under a statutory section that has a parallel provision in Section 4975, although it generally excluded non-ERISA plans from those rules.

Effective Date

The final rules would be effective 180 days after publication in the *Federal Register*. DOL invited comments on whether to use a different effective date.

Comment Period

Comments on the proposed regulation are due by January 20, 2011.

Observations

The proposal, if adopted in its current form, could significantly expand the number of parties who are subject to the ERISA fiduciary rules. It would remove three key arguments commonly relied upon by parties to disclaim investment advice fiduciary status—"regular basis," "primary basis," and "mutual agreement" (although a revised form of the "agreement" factor remains)—and also extend such status to appraisers and other valuation experts, who to date have generally not been subject to ERISA fiduciary standards.

Potential Impact

In the regulatory analysis section of the proposal, DOL acknowledged the likelihood of more parties being treated as ERISA fiduciaries if the proposal were adopted as a final regulation. It said that this could increase the cost of services provided to plans and also could result in some firms exiting the business, which could further increase costs and, as a result of fewer firms providing services, increase potential conflicts. However, DOL took the position that the expected benefits to plans from discouraging harmful conflicts, improving the value of services, and enhancing DOL and private enforcement efforts would be well worth the costs.

The extent of the impact of the new rules would differ, depending on the type of firm and its current business model. Firms that currently provide services as ERISA fiduciaries, acknowledging fiduciary status, would not be affected—they would be treated in the same manner under the new rules.

The following types of firms are more likely to be affected:

- **Investment consultants.** As one of the principal targets of the new rules, they are more likely to be treated as investment advice fiduciaries. This would be particularly true of those consultants that are registered investment advisers (which is generally the case), who would no longer be able to argue that they are not fiduciaries under the remaining multifactor test contained in the proposal.

- **Appraisers and valuation experts.** As the other principal target of the new rules, they also are more likely to be treated as investment advice fiduciaries. The implications for such firms are discussed further below.

- **Broker-dealers.** There was considerable concern that broker-dealer firms would be caught up in the expansion of the investment advice definition meant to reach investment consulting firms. To the extent this may be the case under the revised definition, the purchasing and selling limitation may alleviate the potential effect on brokerage firms. Whether it achieves that purpose is likely to be a significant issue in the comments on the proposal.

> There may be an additional issue for "dual hatted" broker-dealers (i.e., broker-dealers who are registered as both broker-dealers and investment advisers). The proposal treats investment advisers who provide investment recommendations as investment advice fiduciaries, without reference to the new multi-factor test. As a result, a dual-hatted broker-dealer, by virtue of being a registered investment adviser, may be unable to avail itself of the multifactor test for its dealings with its nonadvisory clients. This would be inconsistent with federal securities laws, which permit such a firm to treat clients as solely brokerage clients not subject to Investment Adviser Act requirements.

Purchasing and Selling Limitation

The limitations contained in the regulation will be important in making the rules workable. While some courts have acknowledged a "marketing"-type exception from investment advice fiduciary status, that has never been clearly articulated by DOL. It is crucial that firms be able to distinguish fiduciary activities from the marketing of additional products. The question is whether the limitation as described in the proposal, which is limited to purchase and sale transactions, is sufficiently broad to address this problem.

The "purchasing and selling" limitation would permit a party engaging in a transaction with a plan, or acting as an agent in such a transaction, to disclaim that it is acting as an investment advice fiduciary to the plan. It is designed to alleviate many of the concerns of firms that have sought to avoid fiduciary status due to such potential conflicts of interest.

DOL's exclusion of firms that represent their status as an investment advice fiduciary from the "purchasing and selling" limitation may require clarification. A firm should not be limited in engaging in transactions with plan assets that are outside the scope of its advice arrangement. While the proposal retains the language of the existing regulation that limits fiduciary status to those assets of the plan as to which the person is a fiduciary, it is not clear if this applies under the current wording of the purchase and sale limitation rule.

Valuation Services

One of the more significant changes in the proposed regulation would be to bring certain valuation services under the scope of "investment advice" that makes one a fiduciary. The proposal would cover, at minimum, appraisals and valuations of assets in connection with purchase and sale transactions, such as the acquisition or sale of employer securities (for which there is not a generally recognized market) by an ESOP. Whether it would cover valuations for plan reporting and other purposes would depend on the scope of the valuation services limitation.

The valuation services limitation generally excludes the provision of investment values to be used for ERISA reporting and disclosure purposes from the scope of "investment advice." However, the exclusion does not apply to the appraisal of assets for which there is not a generally recognized market, where the value is used in connection with plan distributions. This is a very broad exception. Since asset values should not affect distributions from defined benefit plans, the result would be to cover appraisals of nontraded assets, such as privately held employer securities or real estate, for ESOPs and other individual account plans. This carve-out also raises a question about whether routine valuations of privately held plan asset funds (i.e., determinations of net asset value) would be covered where the fund's investors include individual account plans.

Plan Distribution Advice

While DOL reaffirmed that advice on plan distributions is not "investment advice," it left open the issue for comment. Expanding the definition in this manner would raise ERISA compliance issues for firms that provide rollover IRA services.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the authors, **Donald J. Myers** (202.739.5666; dmyers@morganlewis.com) or **Michael B. Richman** (202.739.5036; mrichman@morganlewis.com), or any of the following Morgan Lewis attorneys:

Chicago			
David Ackerman	ESOP	312.324.1170	dackerman@morganlewis.com
Theodore M. Becker	ESOP	312.324.1190	tbecker@morganlewis.com
Brian D. Hector	ESOP	312.324.1160	bhector@morganlewis.com
Charles C. Jackson	ERISA Litigation	312.324.1156	charles.jackson@morganlewis.com
Louis L. Joseph	ESOP	312.324.1726	louis.joseph@morganlewis.com
Elizabeth S. Perdue	ESOP	312.324.1180	eperdue@morganlewis.com
Dallas			
John A. Kober	ESOP	214.466.4105	jkober@morganlewis.com
Erin Turley	ESOP	214.466.4108	eturley@morganlewis.com
Los Angeles			
Scott E. Adamson	ESOP	213.612.7365	sadamson@morganlewis.com
New York			
Craig A. Bitman	Employee Benefits	212.309.7190	cbitman@morganlewis.com
Thomas M. Hogan	Employee Benefits	212.309.6778	thogan@morganlewis.com
Brian T. Ortelere	ERISA Litigation	212.309.6850	bortelere@morganlewis.com
Philadelphia			
I. Lee Falk	Employee Benefits	215.963.5616	ilfalk@morganlewis.com
Vivian S. McCardell	Employee Benefits	215.963.5810	vmccardell@morganlewis.com
Steven D. Spencer	Employee Benefits	215.963.5714	sspencer@morganlewis.com
Marianne R. Yudes	Employee Benefits	215.963.5490	myudes@morganlewis.com
David B. Zelikoff	Employee Benefits	215.963.5360	dzelikoff@morganlewis.com
Pittsburgh			
Lisa H. Barton	Employee Benefits	412.560.3375	lbarton@morganlewis.com
Lauren B. Licastro	Employee Benefits	412.560.3383	llicastro@morganlewis.com
San Francisco			
D. Ward Kallstrom	ERISA Litigation	415.442.1308	dwkallstrom@morganlewis.com

Washington, D.C.

Gregory C. Braden	ERISA Litigation	202.739.5217	gbraden@morganlewis.com
Benjamin I. Delancy	Employee Benefits	202.739.5608	bdelancy@morganlewis.com
Stuart P. Kasiske	Employee Benefits	202.739.6368	skasiske@morganlewis.com
Daniel R. Kleinman	Employee Benefits	202.739.5143	dkleinman@morganlewis.com
Donald J. Myers	Employee Benefits	202.739.5666	dmyers@morganlewis.com
Michael B. Richman	Employee Benefits	202.739.5036	mrichman@morganlewis.com

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