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Employee Benefits Advisory

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Department of Labor Issues Proposed Rule Broadening Types of Investment Advice Giving Rise to Fiduciary Status

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The U.S. Department of Labor (the "Department") recently issued a proposal that expands on and more broadly defines the circumstances under which a person is considered to be a "fiduciary" by reason of giving investment advice to an employee benefit plan or a plan's participants.

The current rules, which date back to 1975, include limits on the types of investment advice relationships that give rise to fiduciary status—inappropriately in the Department's view. This proposal is much anticipated, and it signals an important shift in the way that the Department views fiduciary status. It is also a part of a larger, multi-year effort by the Department to enhance transparency and accountability, particularly but by no means exclusively in the 401(k) plan market.

According to the Department, the proposed rule, "takes account of significant changes in both the financial industry and the expectations of plan officials and participants who receive investment advice." It is designed to protect participants from conflicts of interest and self-dealing by giving a broader and clearer understanding of when persons providing such advice are subject to the fiduciary standards of the Employee Retirement Income Security Act (ERISA). Once adopted in its final form, the rule will affect sponsors, fiduciaries, participants, and beneficiaries of pension plans and individual retirement accounts, as well as providers of investment and investment advice-related services to such plans and accounts.

This client advisory explains this narrow, yet important, proposal and speculates on some of its implications.

Background

ERISA establishes standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans. Toward that end, it imposes duties on those who act as plan fiduciaries. These duties include a duty of undivided loyalty, a duty to act for the exclusive purposes of providing plan benefits and defraying reasonable expenses of administering the plan, and a duty of care grounded in the prudent man standard from trust law. Congress further supplemented these general duties by imposing a ban on "prohibited transactions." Fiduciaries are personally liable for losses sustained by a plan that result from a violation of these rules.

ERISA defines the term "fiduciary" functionally. Generally, a person is a fiduciary with respect to a plan to the extent that he or she fits one of the following categories:

1. He or she exercises any discretionary authority or discretionary control with respect to management of a plan or exercises any authority or control with respect to management or disposition of its assets;

2. He or she renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so (i.e., a person 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); or

3. He or she has any discretionary authority or discretionary responsibility in the administration of such plan.

In 1975, the Department issued a regulation[1] that defines the circumstances under which a person renders "investment advice" to an employee benefit plan. A person who renders "investment advice" under the regulation, and receives a fee or other compensation, direct or indirect, for doing so is a fiduciary. Specifically, the current regulation provides in relevant part:

> A person shall be deemed to be rendering "investment advice" to an employee benefit plan, within the meaning of section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (the Act) and this paragraph, only if:
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> 1. Such person renders advice to the plan as to the value of securities or other property, or makes recommendation as to the advisability of investing in, purchasing, or selling securities or other property; and
>
> 2. Such person either directly or indirectly (e.g., through or together with any affiliate):
>
>   A. Has discretionary authority or control, whether or not pursuant to agreement, arrangement or understanding, with respect to purchasing or selling securities or other property for the plan; or
>
>   B. Renders any advice described in paragraph (c)(1)(i) of this section on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a fiduciary with respect to the plan, that such services will serve as a primary basis for investment decisions with respect to plan assets, and that such person will render individualized investment advice to the plan based on the particular needs of the plan regarding such matters as, among other things, investment policies or strategy, overall portfolio composition, or diversification of plan investments.

The Department observed that the regulation acts to narrow the plain language of the statute creating a five-part test that must be satisfied in order for a person to be treated as a fiduciary by reason of rendering investment advice. For advice to constitute "investment advice," an adviser who does not have discretionary authority or control with respect to the purchase or sale of securities or other property for the plan must:

1. Render advice as to the value of securities or other property, or make 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.

The Department further limited the term "investment advice" in a 1976 advisory opinion[2] in which the Department concluded that a valuation of closely-held employer securities that an employee stock ownership plan would rely on in purchasing the securities is not investment advice.

The Department noted that, while the current regulation has not been updated since its promulgation in 1975, the retirement plan marketplace has changed significantly. Specifically, the types and complexity of investment products and services available to plans have expanded, thereby calling for a reexamination of the rules governing fiduciary status. The Department identified certain advisory relationships that it believes should give rise to fiduciary duties on the part of those providing advisory services. These advisers significantly influence the decisions of plan fiduciaries, and they have a considerable impact on plan investments. In instances where these advisers are not fiduciaries, however, they may operate with conflicts of interest that they need not disclose to the plan fiduciaries. Therefore, the Department concluded that "it is appropriate to update the 'investment advice' definition to better ensure that persons, in fact, providing investment advice to plan fiduciaries and/or plan participants and beneficiaries are subject to ERISA's standards of fiduciary conduct."

The Proposed Rule

The proposed rule amends and reorganizes the 1975 regulation focusing particularly on what constitutes "giving advice" and the meaning of the term "fee or other compensation, direct or indirect."

Description of Advice

As proposed, the types of advice and recommendations that may result in fiduciary status under ERISA are:

- Advice, appraisals or fairness opinions 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.

Thus, under the proposal, appraisals and fairness opinions are fiduciary acts, thereby superseding the Department's previous guidance. Moreover, this change is not limited to employer securities. Rather, it extends to real estate and other appraisals. As a consequence, all appraisals of plan assets must be "unbiased, fair, and objective, and must be made in good faith and based on a prudent investigation under the prevailing circumstances then known to the appraiser."

Also covered by the proposed rule are advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies) and as to the selection of persons to manage plan investments. Lastly, the proposed rule makes clear that fiduciary status may result from the provision of advice or recommendations not only to a plan fiduciary, but also to a plan participant or beneficiary. (In this regard, the Department has asked for comments on whether and to what extent the final regulation should define the provision of investment advice to encompass recommendations related to taking a plan distribution.)

Conditions

The proposed rule establishes alternative conditions, at least one of which must be met in order for a person to be considered rendering investment advice. These alternative conditions generally relate to the degree of authority, control, responsibility or influence that is possessed, directly or indirectly, by the person rendering the advice, and the reasonable expectations of the persons receiving the advice. The conditions refer to and include:

1. Persons who represent or acknowledge that they are acting as fiduciaries with respect to such advice or recommendations;
2. Persons who render advice directly or indirectly and have discretionary authority or control with respect to purchasing or selling securities or other property for the plan;

3. Investment advisers (under the Investment Advisers Act of 1940), i.e., any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing, or selling securities, or who promulgates analyses or reports concerning securities; and

4. Persons who provide advice or make recommendations or management decisions with respect to plan assets pursuant to an agreement, arrangement, or understanding, written or otherwise, between such person(s) 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.

Importantly, the proposal does not require the advice to be provided on a regular basis. Nor does the proposal require that the parties have a mutual understanding that the advice will serve as a primary basis for plan investment decisions. Rather, when a service provider is retained to render advice, the plan is able to rely on the advice without regard to whether the parties intend it to be a primary or lesser consideration in the fiduciary's decision-making. The proposed rule includes the following example:

> "[I]n a complex investment decision, a plan fiduciary may need to consult advisers with different areas of investment expertise in order to make a prudent decision. The relative importance of the different kinds of advice that the plan fiduciary obtains may be impossible to discern, and should not affect the question of whether the adviser is a fiduciary. Accordingly, under the proposal it is sufficient if the understanding of the parties is that the advice will be considered in connection with making a decision relating to plan assets."

Limitations

The proposed rule sets forth certain limitations with respect to the provision of advice or recommendations to plans. A person is not considered a fiduciary with respect to the provision of advice or recommendations if he or she can demonstrate that the recipient of the advice knows, or under the circumstances reasonably should know, that the person is providing the advice or making the 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. There is, however, an inherent expectation of impartial investment advice involving representations or acknowledgment of ERISA fiduciary status with respect to providing advice or recommendations. Thus, if a person makes a representation of ERISA fiduciary status in connection with a sale, orally or in writing, then this exclusion is not available.

Separately, the proposal clarifies that the provision of investment education information and materials does not constitute the rendering of investment advice. The Department previously identified four specific categories of information and materials—plan information, general financial and investment information, asset allocation models, and interactive materials—which, if furnished alone or in combination to plan participants or beneficiaries, would not result in the rendering of investment advice.

The preamble to the proposed rule includes an important discussion of certain common practices that have developed with the growth of participant-directed defined contribution plans involving certain service providers. For example, record-keepers and third-party administrators sometimes make available a menu of investments from which a plan fiduciary selects a more limited menu that will be available under the plan for participant or beneficiary investment. In many instances, the provider may simply offer a "platform" of investments from which the plan fiduciary selects those appropriate for the plan, or the provider may select or assist the plan fiduciary in selecting the investments that will be available under the plan. Under this model, the service provider also sometimes retains the ability to later make changes to the plan's investment menu, subject to advance approval by a plan fiduciary.

In some instances, the provider and the plan fiduciary clearly understand that the provider is offering investments

to which the provider has financial or other relationships, and is not purporting to provide impartial investment advice regarding construction of the plan's investment menu. In other instances, the plan fiduciary is relying on the provider's impartial expertise in selecting an investment menu for the plan. Also, to assist in the plan fiduciary's selection or monitoring of investments from those made available, such a service provider also might provide to the fiduciary general financial information and data regarding matters such as historic performance of asset classes and of the investments available through the provider.

According to the preamble to the proposed rule, the marketing or making available (e.g., through a platform or similar mechanism), without regard to the individualized needs of the plan, its participants, or beneficiaries, securities, or other property from which a plan fiduciary may designate investment alternatives into which plan participants or beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts, *will not, by itself,* confer fiduciary status. In addition, the provision of certain information and data to assist a plan fiduciary's selection or monitoring of such plan investment alternatives will not be treated as rendering investment advice 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. However, a service provider's substitution or deletion of investment options selected by a plan fiduciary may, depending on the surrounding facts and circumstances, constitute an exercise of "authority or control respecting management or disposition of [a plan's] assets."

Fee requirement

A necessary element of fiduciary status is that a person must render investment advice for a fee or other compensation, direct or indirect. Under the proposed rule, a fee or other compensation, direct or indirect, received by a person for rendering investment means *any* fee or compensation for the advice received by the person (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered. This includes, for example, brokerage, mutual fund sales, and insurance sales commissions. It also includes fees and commissions based on multiple transactions involving different parties (i.e., commission overrides).

Application to individual retirement accounts

The Internal Revenue Code ("the Code") contains provisions paralleling ERISA that define the term "fiduciary" for purposes of the Code's prohibited transaction excise tax provisions. For historical reasons, the Department of Labor has interpretive authority under this provision of the Code. The proposed rule clarifies that the term "fiduciary" under ERISA also applies for purposes of the Code, regardless of whether such plan is an employee benefit plan. This rule is principally aimed at individual retirement accounts, with respect that an account owner is generally a fiduciary.

Effective Date

The Department envisions that the changes to the fiduciary standards set out in the proposed rule will take effect 180 days after publication of the *final* regulations in the Federal Register. The Department is also asking for comments on whether the final regulation should be made effective on a different date.

Endnotes

1 29 CFR 2510.3-21(c).

2 Ad. Op. 76-65A (June 7, 1976).

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