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TCRS 2010-09: DOL Proposes to Amend Definition of Fiduciary Under ERISA

On October 22, 2010, the Department of Labor (DOL) published proposed regulations that, upon adoption, would amend the definition of "fiduciary" under section 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (ERISA). The proposed regulations would modify and expand on the circumstances under which a person would be considered a fiduciary under ERISA and the Internal Revenue Code, as a result of providing investment advice to employee benefit plans, plan fiduciaries, participants and beneficiaries, and IRAs.

Background

ERISA section 3(21)(A)(ii) sets forth a 2-part test for determining fiduciary status in the context of providing investment advice: (i) a person renders investment advice with respect to moneys or other property of a plan, or has any authority or responsibility to do so, and (ii) receives a fee or other compensation, direct or indirect for doing so.

The current DOL regulations under section 3(21)(A)(ii) define the circumstances under which a person who renders investment advice is considered to be a fiduciary, and prescribe a 5-part test[1] to be used in the determination. This test has been unchanged for 35 years. Unless all elements of the 5-part test are met, the individual will not be a fiduciary investment adviser.

As explained in the Preamble to the proposed regulations, the DOL believes that, due to the many changes in plan investment practices and relationships between plan sponsors and advisers over the past 35 years, the current 5-part test is no longer sufficient to protect plans, participants and beneficiaries from potential abuse. Further, according to the DOL, the current framework does not represent the most effective means of distinguishing persons who should be held accountable as fiduciaries from those who should not, and there is a need to re-examine the types of advisory services that should give rise to fiduciary status. The DOL also believes the proposed regulations would better reflect the current practices of investment advisers and the expectations of plan sponsors and participants who receive investment advice from them.

Proposed Regulations

The proposed regulations would apply to plan sponsors, fiduciaries, participants and beneficiaries of employee benefit plans, IRAs, and providers of investments and investment-related services to such plans and IRAs.

Effective Date

The regulations are proposed to be effective 180 days after publication of the final regulations. Public comments may be submitted to the DOL on or before January 20, 2011.

Description of Covered Advice

Under the proposed regulations, the following types of service and recommendations may result in a person's being a fiduciary under ERISA section 3(21)(A)(ii) with respect to the provision of investment advice to a plan or IRA: (i) advice, appraisals or fairness opinions concerning the value of securities and other property; (ii) recommendations as to the advisability of investing in, purchasing, holding or selling securities or other property; or (iii) advice or recommendations as to the management of securities or other property.

[1] To be treated as a fiduciary by reason of providing investment advice, the adviser must (i) 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, (ii) on a regular basis (iii) pursuant to a mutual agreement, arrangement or understanding, (iv) the advice will serve as a primary basis for investment decisions, and (v) the advice is individualized based on the particular needs of the plan.

Conditions

A person providing covered advice to a plan, plan fiduciary, participant or beneficiary for a fee must also meet at least one of the following conditions in order to be a fiduciary under the proposed regulations: (i) the person represents or acknowledges in writing or orally that he or she is acting in a fiduciary capacity; (ii) the person is a fiduciary by virtue of exercising any discretionary authority or control over the management of the plan, or exercising any authority or control over the disposition of assets, or has discretionary authority or responsibility in the administration of the plan; (iii) the person is an investment adviser under the 1940 Act; or (iv) the person meets the conditions of the 5-part test described in the footnote above, with two significant modifications. First, the advice or recommendation need not be provided on a regular basis (a single engagement would qualify). Second, a mutual understanding that the advice or recommendation may be considered in making investment decisions is sufficient (there is no longer a requirement for the advice or recommendation to be the primary basis for the plan fiduciary's investment decision).

It is important to note that the DOL's removal of the "regular basis" and "primary basis" requirements significantly increases the number of individuals who could be fiduciaries if the proposed regulations are finalized. For example, registered representatives of broker dealers and insurance agents who are not generally fiduciaries under the current regulations could potentially become fiduciaries if the proposed regulations are finalized in their current form.

According to the DOL, the amount and frequency of advice should not be taken into consideration. Any advice, even if it is only provided once, is significant. Further, in the context of the "primary basis" requirement, the DOL believes that when a service provider is retained to render advice to a plan, the plan should generally be able to rely on the advice without regard to whether the plan intends to use the advice as a primary (or lesser) basis in the fiduciary's decision making. The DOL also believes these modifications would help address uncertainty in the current regulations by eliminating difficult factual questions relating to what constitutes regular basis (e.g. when it begins or ends) and issues surrounding the primacy of the advice rendered.

Fee or Other Compensation (Direct or Indirect)

A necessary element of fiduciary status is that a person rendering investment advice must do so for a fee or other compensation. The proposed regulations define fee or other compensation, direct or indirect, as compensation received by the person (or an affiliate) from any source and any fee or compensation incident to the transaction in which the advice is or will be rendered. For example, this would include (but not limited to) brokerage fees, mutual fund sales and insurance sales commissions as well as fees and commissions based on multiple transactions involving different parties.

Application to IRC 4975

The proposed changes to the definition of "fiduciary" also apply for purposes of applying Internal Revenue Code section 4975(e)(i), relating to the types of plans subject to Code section 4975, whether or not the plan is an employee benefit plan.

Exceptions and Limitations

The proposed regulations set forth certain specific acts that will not constitute fiduciary investment advice.

Advice That Is Not Impartial

- To satisfy this exception, the person providing the advice must demonstrate that the recipient of the advice knows or reasonably should know under the circumstances that the person providing the advice is a purchaser or seller of securities; has interests that are adverse to the interest of the plan and participants; and is not providing impartial investment advice.

  Under the proposed regulations, the burden of proof lies with the provider of advice for establishing that the recipient has, or reasonably should have, knowledge of the circumstances described above.

Certain Acts Relating to Individual Account Plans

Under the proposed regulations, the following acts would not, in and of themselves, be treated as the rendering of investment advice:

- Providing investment education information and materials (plan information, general financial and investment information, asset allocation models, and interactive investment materials) within the meaning of the DOL's safe harbor included in Interpretive Bulletin 96-1

- Marketing or making available securities or investment funds (through a platform or similar mechanism) without regard to the individualized needs of the plan, participants or beneficiaries and the person providing advice discloses in writing to the plan fiduciary that he/she is not undertaking to provide impartial investment advice
- With respect to the activities described above, the providing of general financial information and data to assist plan fiduciaries' selection or monitoring of securities or plan investment alternatives, if the person providing the information discloses in writing that he/she is not undertaking to provide impartial investment advice
- The preparation of a general report or statement that merely reflects the value of an investment of a plan, participant or beneficiary for purposes of meeting the reporting and disclosure requirements of ERISA and the Code and related forms and schedules, unless the reports include assets for which there is no recognized market.

It is important to note that persons who provide advice, but fail to make the disclaimer that they are not providing impartial advice will not be able to rely on this exception. These persons could include platform providers, third party administrators providing investment advisory services and brokers who receive non-level compensation for such services.

Impact on Plan Distributions

The DOL is soliciting comments on the possible application of the proposed regulations to recommendations being made to participants regarding plan distributions (for example, rollovers). Currently, the DOL's position is that a recommendation by a person that is not a fiduciary to take an otherwise permissible distribution, even if the recommendation includes suggestions on how to invest the distribution, does not constitute a fiduciary act. The DOL is specifically interested in information about other laws that may apply, how those laws protect participants and beneficiaries and the potential cost of extending these regulations to such distributions.

Conclusion

The proposed regulations, if adopted without change, will significantly broaden the categories of financial services providers who could be fiduciaries, and expand on the services that would constitute investment advice, thus increasing their potential exposure to fiduciary liability under ERISA. While the DOL recognizes this fact, it believes the proposed changes are necessary to address current investment practices and relationships between plan sponsors and advisers while protecting plans, participants and beneficiaries from conflicts of interest and self-dealing, improving service value and enhancing the DOL's ability to redress abuses. In addition, the DOL believes the proposed changes would provide a broader and clearer understanding of when persons providing investment advice are subject to ERISA's fiduciary standards.

For affected investment providers and advisers, there will be costs involved in determining whether their contracts and arrangements with plans and related activities would make them fiduciaries under the proposed regulations. The DOL anticipates that all service providers will need to go through this exercise initially to determine if they are affected. There may also be a need to modify their business practices in order to fully benefit from ERISA's protections. It is therefore possible that the economic impact of the proposed regulations would cause some small service providers to limit the availability of their products and services or discontinue servicing the ERISA plan market.