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A Hot Issue in Employee Benefits in America – The DOL Proposes an Expanded Definition of Fiduciary

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US labor law known as ERISA imposes significant duties upon fiduciaries of employee benefit plans. Since its inception, the definition of who is a fiduciary or not for purposes of that law has excluded certain types of investment advisors, appraisers, and other entities and persons. Some concern has been raised that those rules allow for certain conflicts of interest and should be changed. A new proposal by the US Department of Labor would significantly expand the definition of fiduciary and eliminate many of those exclusions. The impact on the investment industry could be significant.

This article explains the proposal and its implications.

Introduction

There has been a flurry of activity by the US Department of Labor (**DOL**) of late attempting to increase transparency regarding pension plan fees and investment-related activities. The DOL, which along with the IRS is one of the principal regulators of pension plans, issued regulations requiring enhanced disclosure to plan fiduciaries by service providers,[47] new disclosure rules for

[47] ERISA Reg. §2550.408b-2, also known as the "408(b)(2) regulations". Requires registered representatives, investment advisers and others working with 401(k) plan sponsors to provide detailed overviews of their services and compensation, as well as declare whether they are acting as fiduciaries. This interim final rule represents a significant step toward ensuring that pension plan fiduciaries are provided the information they need to assess both the

participant-directed retirement plans,[48] and the expansion of the definition of "fiduciary" for investment advice purposes. This article will discuss the proposed definition of "fiduciary" for investment advice purposes. The expansion of the definition, if finalized as anticipated, will extend duties to many service providers to US plans who currently are not subject to fiduciary duties. As may be expected, the change is very controversial.

On October 22, 2010, the DOL proposed an important regulation[49] defining when a person or entity offering investment advice becomes a "fiduciary" under the *Employee Retirement Income Security Act* of 1974, as amended (**ERISA**). The proposed regulation would replace an earlier regulation that limited the meaning of fiduciary and as a result permitted what has been perceived as serious conflicts of interest. If the proposed regulation is made final in its current form, brokers and brokerage houses, appraisers and valuation firms, and various types of financial advisors face a changing regulatory landscape and may soon become exposed to new liabilities. Also, unless the DOL provides additional prohibited transaction exemptions (administrative exemptions to the prohibitions imposed by the proposed regulation), they may have to radically change the way they do business.

In March and April of this year, the DOL held hearings and collected comments on the roles and duties of fiduciaries in order to better understand the implications of their proposed changes to the definition. The comments came from industry and participant representatives, plaintiff law firms and public interest representatives that urged the DOL to take different positions on the same issue. The DOL is trying to issue a final fiduciary definition regulation by the end of the year.

Update on the Status of this Regulation since this Article was Scheduled to be Published

The U. S. Department of Labor announced on September 19, 2011 that it was going to withdraw this proposed regulation and re-propose it. The Department of Labor is targeting to re-propose the proposed regulation early in 2012. This action was in response to extensive criticism that the proposed extension of the definition of a "fiduciary" was too intrusive in the ordinary course of business. The Department of Labor said that it would re-examine the rule in light of new information that it received and also simultaneously issue prohibited transaction class exemptions where necessary. We believe that this article is still relevant because it explores the background and issues involving who is a fiduciary and it explores some of the places where change may be made to the proposed regulation.

Background

Under ERISA, there is overlapping jurisdiction with regard to many rules governing pension plans between the DOL and the Internal Revenue Service (**IRS**). From an early date, the regulatory agencies decided between themselves on certain allocations of responsibilities. Under that allocation, the DOL has the responsibility to determine who is a fiduciary and when a fiduciary's actions are prohibited (the "prohibited transaction" rules – ERISA does not merely enforce

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reasonableness of the compensation to be paid for plan services and potential conflicts of interest that may affect the performance of those services. This rule is effective April 1, 2012.

[48] ERISA Reg. §2550.404c. This rule is effective no earlier than May 31, 2012.

[49] ERISA Reg. §2510.3-21(c).

fiduciary standards of behavior but prohibits *per se* certain related party transactions). The DOL by going to court or by requesting voluntary compliance can enforce those determinations and have damages assessed. There also is the ability to exempt certain actions statutorily and administratively from the prohibited transaction rules. The administrative exemption process can be on an individual or class basis and is controlled by the DOL. In addition, the IRS has the authority to assess substantial fines on prohibited transactions.

ERISA was enacted by Congress in 1974 to protect employee benefits plan participants and beneficiaries against the loss of benefits promised to them by their employers. A person is an ERISA "fiduciary" with respect to a plan to the extent he (1) has discretion over plan assets or plan management and administration, or (2) renders investment advice for a fee, direct or indirect.[50] ERISA both establishes affirmative obligations on fiduciaries[51] and prohibits particular transactions with respect to a plan and its assets.[52] Personal liability is imposed on fiduciaries for failing to live up to the affirmative standards or violating the prohibitions.[53] This article will focus only on fiduciaries offering investment advice.

In 1975, shortly after ERISA was passed, the DOL issued a regulation that narrowed the definition of a fiduciary, by providing that investment advisers would not be considered fiduciaries unless their (1) advice was provided, (2) on a regular basis, (3) pursuant to a mutual agreement, (4) that serves as the primary basis for investment decisions, and (5) the advice is individualized to the particular needs of the plan.[54] If the adviser does not meet any of these criteria, it is not a fiduciary. Thus, providing investment advice to a plan on isolated occasions may not suffice to confer fiduciary status.[55] The importance or effect of the advice to the plan is irrelevant under this regulation.

The DOL further provided in a 1976 advisory opinion that "investment advice" does not include providing a valuation of employer securities to an employee stock ownership plan (**ESOP** – generally, a plan that invests participant's accounts in employer securities, and is subject to certain special tax benefits and rules) in connection with the plan's purchase of those securities.[56] Such valuations are required at least annually for employer securities that are not publicly traded.

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[50] ERISA §3(21)(A).

[51] Under ERISA, fiduciaries are required to act for the exclusive purpose of the plan, act prudently, diversify plan investments, and act in accordance with the terms of the plan. ERISA §404.

[52] ERISA prohibits transactions between a plan and a fiduciary that involve self-dealing (i.e. a fiduciary dealing in plan assets for his own account or acting on behalf of someone with interests averse to the plan or its participants and beneficiaries) and prohibits transactions between plans and parties-in-interest to the plan unless specifically exempted by statute or DOL rulemaking. ERISA §406. Jurisdiction over prohibited transactions is shared by the DOL and the IRS. Engagement in a prohibited transaction for which there is no exemption thus also results in the imposition of an excise tax on the disqualified person.

[53] ERISA §409.

[54] ERISA Reg §2510.3-21(c)(1)(ii)(B).

[55] See, e.g. *Mid-Atl. Perfusion Assoc., Inc. v Prof'l Ass'n Consulting Servs., Inc*., No. CIV. A. 93-3027, 1994 WL 418990, at *6 (E. D. Pa. 1994) (absent evidence that adviser would provide investment advice regularly, adviser was not a fiduciary), *aff'd*, 60 F.3d 816 (3d Cir. 1995) (table); *Brown v Roth*, 729 F. Supp 391, 397 (D.N.J. 1990) ("provision of advice on two occasions is too infrequent to raise the inference that advice was provided on a regular basis").

[56] DOL Advisory Opinion 76-65A (June 7, 1976).

At the time the regulations were issued, the most common retirement plan was a defined benefit plan over which the employer exercised investment control; investment professionals were primarily advising sophisticated fiduciaries who were more capable of synthesizing market information and better able to identify and evaluate potential conflicts of interest. Since that time, there have been dramatic shifts in the retirement plan marketplace; most employees are in 401(k) plans and have to make their own investment decisions, despite their lack of investment experience or knowledge. There has been an increase in the types and complexities of investment products and services available to plans and to IRA investors in the financial marketplace. Thus, the plan participants are highly dependent on the advice offered to them by the investment industry, but the advice they receive may be subject to conflicts of interest. Indeed, some investment advisers receive undisclosed payments from the vendors of the products they recommend. This would be prohibited under ERISA if the investment advisers are ERISA fiduciaries, but a significant part of the investment advice industry claims that the 1975 regulation shields them from fiduciary status and allows them to accept these third-party payments. Currently, advisers who are not fiduciaries under ERISA may operate with conflicts of interest that they need not disclose and for which there is limited liability; the Department must prove each element of the five-part test at great expense, even if investment advice is abusive. A common problem identified in the DOL's recent ESOP national enforcement project involves the incorrect valuation of employer securities that are not publicly traded. Furthermore, the Government Accountability Office noted an association between pension consultants with undisclosed conflicts of interest and lower returns for their client plans.[57]

DOL Proposes Expanding Definition of "Fiduciary"

The DOL believes that redefining the types of advisory relationships that give rise to fiduciary duties will discourage harmful conflicts, improve rates of return, and enhance the Department's ability to redress abuses and more effectively and efficiently allocate its enforcement resources.

With regard to the five-part fiduciary test, the new regulation:

- eliminates the requirement that the investment advice be provided on a regular basis;
- provides that any advice that may be considered in connection with investment or management decisions is now covered (i.e. removes the individualized investment advice requirement); and
- provides that the advice no longer needs to be provided pursuant to a mutual agreement, just an agreement or understanding.

In addition, providing advice, appraisals or fairness opinions as to the value of investments, recommendations as to buying, selling or holding assets, or recommendations as to the management of securities or other property will result in fiduciary status. The DOL stated that the intent is to establish fiduciary responsibility on parties who provide valuations of

[57] *Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, GAO 09-503T (Mar. 24, 2009).

closely held employer securities and other hard to value plan assets.

Finally, acknowledgement of fiduciary status for purposes of providing advice will result in fiduciary status. This provision is significant because under the old test, a party could acknowledge fiduciary status in writing, but the rule controlled – they could still fail to be liable for a breach if they did not meet all five parts of the old test in fact.

The proposed regulations also clarify that providing the advice for a fee includes any direct or indirect fees received by the advisor or an affiliate from any source including transaction-based fees such as brokerage, mutual fund or insurance sales commissions.

Exclusions from Fiduciary Status

The proposed regulation provides the following exceptions from fiduciary status:

1. **Sales exception / disclaimer:** Persons providing advice or recommendations in their capacity as a purchaser or seller of a security or other property and whose interests are adverse to the plan or its participants or beneficiaries and who are not undertaking to provide impartial investment advice.

2. **Investment education:** Persons providing investment education in connection with an individual account plan.

3. **Platform providers:** Persons marketing or making available an investment platform without regard to the individualized needs of the plan or its participants or beneficiaries if the person making the platform available discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.

4. **General financial information:** Persons providing general financial information to assist a plan fiduciary's selection or monitoring of the investment options on an investment platform if the person making available the financial information discloses in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.

5. **Valuations for compliances with plan reporting (e.g. Form 5500):** Under the proposal, "advice, appraisal or fairness opinion" does not include the preparation of a general report or statement setting forth the value of an investment of a plan or its participants or beneficiaries that is provided to comply with the reporting and disclosure requirements of ERISA, "unless such 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".

Impact of the Definition Expansion

Some claim that the proposed regulations would prohibit broker-dealers from giving investment advice, based on the notion that the only permissible form of compensation paid to an investment adviser would be on a fee basis. Because the nature of IRA investments generally are different than employer based retirement plans and IRAs are often through custodial arrangements with services being provided through related parties, it is unclear how these rules would impact IRA investments. However, the DOL has indicated its willingness to issue prohibited transaction exemptions in addition to those that permit fiduciaries to receive commission-based compensation for the sale of mutual funds, insurance, and annuity contracts. In addition, the statute includes a prohibited transaction exemption for investment advice if fees are leveled or if the investment advice is determined through objective computer programs. Whether parts of the industry will try to make use of the "sales exception" is also in question.

Under the current regulations, many consultants that provide recommendations regarding the selection of investment advisers or other persons to manage plan assets took the position that they were not fiduciaries under ERISA. The proposed regulations change this result and make consultants fiduciaries.

The valuation of employer securities of an ESOP that are not publicly traded will now be considered the provision of investment advice and the DOL has made it clear that appraisals and fairness opinions concerning the value of securities or other property is not limited to employer securities. For example, valuing an interest in an alternative investment like private equity would make the evaluator a fiduciary.

Finally, the new status of investment advisors will, among other things, compel them to procure fiduciary liability insurance, expose them to litigation for potential breach of fiduciary duties and require greater disclosure. These new costs may drive some of these firms out of the marketplace.

Conclusion

The new regulation would apply the statutory rule that a person providing investment advice for a fee is a fiduciary but would continue to allow investment advisers with certain conflicting interests to offer advice under applicable prohibited transaction exemptions yet to be issued. On the one hand, this would prohibit advisors from offering investment advice when they face serious conflicts of interest, which would supposedly result in better investment advice, lower fees, and substantial additional retirement savings for employees. On the other hand, the proposed definition change will likely lead to greater exposure to liability for brokers, appraisers, financial advisors and others who provide services to employee benefit plans because they will likely find that they are fiduciaries as a result of the expansion of what constitutes "investment advice" in the new rules. And this may lead to greater compliance costs.

As one can imagine, the state of affairs has led to concern from and uncertainty for industry insiders. The next step in this process will be to review and analyze future guidance that is issued by the Department of Labor and to evaluate its impact on the industry.