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Legal Update
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US Department of Labor Proposes to Expand Scope of "Fiduciary" Status under ERISA

The US Department of Labor's Employee Benefits Security Administration (DOL) has released a proposed amendment to its regulation defining the circumstances under which a person or an entity is considered to be a "fiduciary" under the Employee Retirement Income Security Act (ERISA) by reason of rendering "investment advice" to an ERISA plan.[1] If the rule is adopted in its proposed form, many service providers that are not currently treated as fiduciaries under ERISA may become fiduciaries and, therefore, be required to perform their services in accordance with ERISA's more stringent standards of care, conflict of interest and prohibited transaction rules. In addition, this new status as a fiduciary may affect the availability of many common prohibited transaction exemptions that condition relief on the service provider or other party in interest not being a fiduciary with respect to the assets involved in the transaction.[2]

Although the proposed regulation provides certain "safe harbors" for marketing activities, the "safe harbors" may require brokers and others involved in sales activities to notify the plan that they are not undertaking to provide impartial investment advice.

Written comments on the proposed regulation must be submitted to the DOL on or before January 20, 2011.

Background

Under section 3(21) of ERISA, a person is a fiduciary to a plan with respect to investment matters to the extent the person either (i) exercises any discretionary authority or control over the management or disposition of the plan's assets or (ii) renders investment advice for a fee or other compensation, either directly or indirectly.

Under a long-standing DOL regulation,[3] the investment advice prong of the fiduciary definition is currently limited to advice that meets a five-part test. Under this five-part test, an adviser that does not have discretionary authority or control (directly or through an affiliate) with respect to the purchase or sale of securities or other property for the plan will not be deemed to be a fiduciary by reason of rendering "investment advice" unless the adviser:

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.

In an early advisory opinion, the DOL further limited the scope of "investment advice" in the context of valuations. Under the facts described in

that opinion, the DOL concluded that a valuation of closely held employer securities on which fiduciaries of an employee stock ownership plan (ESOP) would rely in purchasing the securities would not constitute investment advice under the regulation.[4]

Proposed New Fiduciary Definition

The proposal would amend the investment advice regulation to eliminate the five-part test and replace it with a broader two-part test. The DOL has indicated that the proposed rule takes into account significant changes in both the financial industry and the expectations of plan officials and participants who receive investment advice, and that 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 ERISA's fiduciary standards. According to the DOL, the old rule may inappropriately limit the types of investment advice relationships that give rise to fiduciary duties on the part of the investment adviser, and impede enforcement. The new rule would facilitate enforcement by shifting the burden of proof with respect to fiduciary status to the purported adviser in some key situations (e.g. sales activities and offering 401(k) investment options).

Under the proposal, unless covered by one of the exclusions described below, a person will be considered a fiduciary under ERISA if that person:

- Provides advice, or an appraisal or fairness opinion, concerning the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, holding, or selling securities or other property, or provides advice or makes recommendations as to the management of securities or other property, to a plan, plan fiduciary or participant, *and*
- Directly or indirectly (e.g., through an affiliate) either (i) represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA with respect to such advice or provides such advice pursuant to an agreement, arrangement or understanding, written or otherwise, 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 (even if the advice is provided on a one-time basis for a single transaction), (ii) is otherwise acting as a fiduciary under ERISA (e.g., by reason of exercising discretion over plan investments or administration) *or* (iii) is an investment adviser within the meaning of the Investment Advisers Act of 1940 (the "Advisers Act"), regardless of whether registered or required to register.[5]

Specific Exclusions

The proposed regulation sets forth several exclusions from the scope of fiduciary status under the foregoing definition. Specifically, a person will not be treated as rendering investment advice under the proposed regulation solely by reason of:

- Providing the advice 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;[6]
- Providing investment education information and materials to participants in 401(k) plans within the scope of the existing DOL interpretive bulletin on investment education;[7]
- 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—investment alternatives into which plan participants may direct the investment of assets held in their individual accounts;[8] or
- In connection with the foregoing exclusion, providing general financial information and data to assist a plan fiduciary's selection or monitoring of such alternatives.[9]

Persons That May Become Fiduciaries under the Proposed New Definition

Although the scope of the proposed new definition of fiduciary is unclear in many respects, it is clear that a number of service providers that currently are not considered fiduciaries for ERISA fiduciaries may become fiduciaries, including:

- Consultants that advise on the selection of investment managers, asset allocation or other general investment consulting matters
- Securities brokers (especially dual registrants)
- Real estate brokers
- Insurance agents and brokers
- Valuation and appraisal service providers (including custodians)
- Persons that provide fairness opinions
- Persons that provide financial statements for purposes of complying with ERISA's reporting and disclosure requirements if the report includes assets for which there is no generally recognized market
- Persons that provide advice in connection with plan distributions[10]

For certain types of advisers, fiduciary status may be determined by the parties pursuant to a written contract, including whether the contract expressly disclaims that the adviser is undertaking to provide impartial investment advice. The DOL proposed that the new rules will be effective 180 days after publication of the final regulations in the *Federal Register*, although it has solicited comments on whether the effective date should be adjusted.

Investment Fund Managers

Generally, the ERISA fiduciary status of fund managers and general partners turns on whether the investment fund is deemed to hold plan assets of the ERISA plan investors.[11] If the fund is deemed to include plan assets of the ERISA investors, then the fund manager or general partner and other persons who exercise discretion or provide investment advice in connection with the management of the fund's assets are deemed to be fiduciaries under ERISA to each of the ERISA investors. But if the fund's assets are not deemed to be plan assets, then these fund-level management and advisory activities do not trigger ERISA fiduciary status.

However, regardless of whether a fund is deemed to hold plan assets for ERISA purposes, managers and general partners of investment funds typically provide services that cause them to fall within the definition of investment adviser under the Advisers Act. The DOL's inclusion in its proposal of persons who fall within the definition of investment adviser as fiduciaries under ERISA if they render advice or appraisals has caused confusion and raised concern among some practitioners that the proposed new definition could sweep in managers and general partners of non-plan asset funds that include ERISA investors. There is nothing in the DOL's proposal that suggests an intent to amend its plan asset regulation, override ERISA's statutory plan asset exclusions or otherwise affect the status of managers or general partners of non-plan asset funds. However, it is likely that this issue will be raised by commenters and addressed by the DOL in its final amendments to the regulation.

Endnotes

[1] The proposed regulation is available at http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=24328.

[2] For example, Prohibited Transaction Exemption 75-1 for certain securities transactions involving broker-dealers, reporting broker-dealers and banks.

[3] 29 CFR 2510.3-21(c). The definition also applies for purposes of determining who is a "fiduciary" for purposes of the prohibited transaction rules in Section 4975 of the Internal Revenue Code of 1986, as amended.

[4] Advisory Opinion 76-65A (June 7, 1976). The proposed amendments would supersede (effectively revoke) this Advisory Opinion.

[5] Under Section 202(a)(11) of the Advisers Act, an "investment adviser" generally includes any person that engages in the business of advising others about securities (including those that write reports about the value of securities and those that

recommend other investment advisers) and is compensated for the advice.

[6] In order to fall within this exclusion, a person must be able to demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know that the interests of the person providing the advice or making the recommendation are adverse to the interests of the plan (e.g., because the person is representing the other side of the purchase or sale transaction) and that the person is not undertaking to provide impartial investment advice. This condition generally appears to shift the burden of proof to the person denying fiduciary status. Therefore it appears that this exclusion may not be available for a broker executing a trade on an agency basis.

[7] 29 CFR 2509.96-1(d).

[8] In order to fall within this exclusion, the person making available such investments must disclose in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.

[9] In order to fall within this exclusion, the person providing such information or data must disclose in writing to the plan fiduciary that the person is not undertaking to provide impartial investment advice.

[10] In Advisory Opinion 2005-23A (Dec. 7, 2005), the DOL opined that a recommendation to a plan participant to take a plan distribution generally does not constitute "investment advice," but the proposed amendment indicates that the DOL is reconsidering this decision and the DOL has requested comments on whether the final recommendation should encompass recommendations relating to plan distributions.

[11] Under DOL regulation published at 29 C.F.R. § 2510.3-101, as modified by Section 3(42) of ERISA, the assets of an entity in which an ERISA plan invests is deemed to include plan assets of the ERISA investor unless investment by benefit plan investors in the entity is not significant, the entity qualifies as an operating company (including a "venture capital operating company" or a "real estate operating company") or another plan asset exception is available for the entity.

If you have any questions about the proposed rule or any other matter raised in this Legal Update, please contact any of the following lawyers. For information on more publications of interest, please visit www.mayerbrown.com/privateinvestmentfund.

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