Potter Anderson & Corroon LLP

Expanded Fiduciary Rules Proposed by the Department of Labor

February 2011

Barbara Uberti Manerchia is counsel in the Wilmington, Delaware law firm of Potter Anderson & Corroon LLP. This material is published by Potter Anderson & Corroon LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. The author would like to acknowledge Meghan M. Dougherty, a former associate of the firm, for her assistance with the preparation of this article.

1313 North Market Street

P.O. Box 951

Wilmington, DE 19899-0951

(302) 984-6000

www.potteranderson.com

Introduction

The Department of Labor ("DOL") released a proposed rule that would expand the definition of a fiduciary under the Employee Retirement Income Security Act of 1974 ("ERISA"). If adopted, it will be easier for retirement plans to recover from investment advisers for losses caused by breaches of fiduciary duty. As Assistant Secretary of Labor Phyllis Borzi explained, "The proposal will ensure that plans receive advice based on reliable information that protects the interests of plan participants and beneficiaries. We believe that this proposal more closely reflects the statutory language of ERISA and the realities of the current investment marketplace, and therefore will ensure those who provide investment advice are held accountable as fiduciaries under the law."

ERISA sets forth a broad, functional definition of fiduciary. A person is considered a fiduciary to the extent (1) he exercises discretionary authority or responsibility over the administration of an employee benefit plan; (2) he exercises discretionary authority or control over the assets of a plan; or (3) he renders investment advice for a fee or other compensation.[1] ERISA imposes upon fiduciaries a number of stringent obligations including a duty of undivided loyalty, an elevated duty of care and a duty to act for the exclusive purposes of providing plan benefits and defraying reasonable expenses of plan administration.[2] When a fiduciary breaches one of these duties, he is personally liable for any losses to the plan that result from his breach. Accordingly, an investment advisor who is found to be a fiduciary has a high level of responsibility and accountability under ERISA. However, many investment advisors have been successful in contending that they are not plan fiduciaries, which has frustrated the DOL's ability to enforce ERISA and protect retirement assets.

The Current Rule

The core of the controversy is a 1975 DOL regulation that narrows the circumstances under which a person is deemed to render investment advice, and thus be considered an ERISA fiduciary. The DOL now seeks to change this regulation. The investment advisor is always a fiduciary if he has discretionary authority over the plan assets. Under other circumstances, an investment advisor is considered to provide advice as a fiduciary under the current regulation only if he meets each of following five factors:

1. He renders advice as to the purchase, sale or value of securities or other property or makes a recommendation on the sale or purchase of property;

1 ERISA §3(21)(A).

2 ERISA §404.

2. The advice is rendered on a regular basis;
3. The advice is provided pursuant to an agreement with the plan or a plan fiduciary;
4. The advice serves as a primary basis for investment decisions; and
5. The advice is individualized to the particular needs of the plan.[3]

The current five-factor test works reasonably well for defined benefit plans, which were the predominant form of retirement vehicle at the time the regulation was issued. In a defined benefit plan, the employer is responsible for the funding of the plan as well as for the sufficiency of plan assets to meet the promised retirement benefits. Typically, the employer hires an investment firm to manage the plan assets, and the success of the investment strategy has a direct relationship to the funding obligation of the employer. The employer's interest in lowering the plan's funding costs are aligned with the investment advisor's interests in producing a healthy investment return at competitive fees.

Today, defined contribution plans dominate the retirement landscape, with participant-directed 401(k) plans as the most popular plan design. Participants are responsible for making and managing their plan contributions. Ultimately, participants must meet their financial needs in retirement from the nest egg that they accumulate during their working years. The type and structure of investment advice delivered to defined contribution plans are fundamentally different from the advice delivered to defined benefit plans. Often, investment advisors are engaged at the plan level and are not accountable to the participants whose accounts bear the fees and whose retirement security is at stake. Under circumstances where participants engage investment advisors directly, the participants often do not have as much financial expertise or bargaining power as the employer who sponsors the plan.

The DOL found that the narrow definition of investment advisory fiduciary in its current regulation did not afford the DOL the ability to enforce ERISA properly. Investment advisors were found not to be ERISA fiduciaries because their relationships met only three or four of the five factors under the regulation. In one such situation, investment advisors could avoid fiduciary status when giving advice in connection with the purchase of annuity contracts because the advice is not provided on a "regular basis."

The New Rule

The proposed regulation would replace the current five-factor test and broaden the definition of a fiduciary. Under the proposed regulation, an adviser would be considered an ERISA fiduciary by reason of providing investment advice if three conditions are met, which are:

1. The advisor provides a plan fiduciary, participant or beneficiary with either:
   - advice, appraisals or fairness opinions concerning the value of investments;
   - 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.

3 Labor Reg. §2510.3-21, 29 CFR §2510.2-21.

2. The advisor, directly or indirectly:
   - represents itself as a fiduciary within the meaning of ERISA;
   - is a registered investment advisor;
   - is otherwise an ERISA fiduciary by virtue of its discretionary authority over the investment or administration of the plan; or
   - provides investment advice or makes recommendations which may be considered in making plan investment decisions to a plan fiduciary, participant or beneficiary under an arrangement that is individualized to the needs of the plan.
3. The advisor receives a fee, directly or indirectly, for providing the advice or recommendations.[4]

Implications and Limitations

The new regulation eliminates the requirements that the advice be provided on a regular basis and serve as the primary basis for investment decisions. In addition, an advisor can become a fiduciary by providing advice to a participant or beneficiary as well as to a plan or plan fiduciary. Furthermore, those advisors who issue appraisals or fairness opinions will be treated as ERISA fiduciaries. The appraisal provisions are expected to raise the costs and enhance the protection of employee stock ownership plans (known as "ESOPs").

The proposed regulation allows for the provision of investment education materials without imposing fiduciary status. Similarly, the preparation of statements for reporting purposes generally would not give rise to fiduciary status. The marketing of an investment platform or investment alternatives that are not individualized to a plan generally would not trigger fiduciary responsibility if the provider discloses that it is not providing impartial investment advice.

What Employers Can Do Now

Particularly in a 401(k) environment, employers and plan participants need access to impartial, prudent investment advice. Employers need to be alert to potential conflicts of interest. Because different types of investments generate different levels of fees to investment advisors, there can be an inherent conflict of interest when an advisor makes investment recommendations. Investment advisors who are ERISA fiduciaries may not engage in a transaction that would create a conflict of interest, such as recommending funds with different levels of fees. The proposed regulations were drafted to enhance the protection of participants from conflicts of interest as they seek investment advice. Should the proposed regulation be finalized in its present form, the DOL would have greater ability to hold investment advisors accountable as fiduciaries under ERISA.

A public hearing on the proposed regulation will be held on March 1, 2011, and is expected to generate heavy comments. In the interim, employers are encouraged to review their relationships with investment advisors so that they can better understand the overall fee arrangements and any potential conflicts of interest. We remain available to support your efforts to maximize the impact of your retirement programs with a minimum of risk.

4 Proposed Labor Reg. §2510.3-21, 29 CFR §2510.2-21.