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Re-Defining Moment

DoL proposes broadening the definition of fiduciary

THE FIDUCIARY standards under the Employee Retirement Income Security Act (ERISA) are "the highest known to the law."[1] Unlike securities laws, which generally allow you to mitigate conflicts of interest through disclosure, the ERISA requires you to either eliminate the conflict or satisfy the strict conditions of a prohibited transaction exemption. On October 21, 2010, the Department of Labor (DoL) released its proposed regulations to modify the existing regulatory definition of an "investment advice fiduciary." These rules, if adopted, would broaden considerably the existing regulatory definition of "investment advice" under ERISA.

Under the current regulation, a person is deemed to provide fiduciary investment advice if:

(1) such person renders advice to the plan as to the value or advisability of making an investment in securities or other property
(2) on a regular basis
(3) pursuant to a mutual agreement or understanding (written or otherwise)
(4) such services will serve as a primary basis for investment decisions
(5) such person will render advice based on the particular needs of the plan.

It should be noted that this five-factor definition of "investment advice" is much more narrow than the definition under federal securities law. For example, the Investment Advisers Act of 1940 has a rather expansive view of the advisory activity that is subject to regulation as investment advice.

The proposed regulations, if adopted, would make two specific changes to the existing definition of "investment advice." Under the DoL's proposed rulemaking, an adviser is deemed to provide investment advice if there is any understanding or agreement that the advice "may be considered" in connection with a plan investment decision, regardless of whether it is provided on a regular basis. Under both the existing and the proposed rules, advice will constitute "investment advice" only if it is individualized advice for the particular plan client.

Safe Harbor for Avoiding Fiduciary Status

In addition to broadening the existing "investment advice" definition, the proposal effectively introduces a safe harbor that advisers would need to follow to avoid fiduciary status.

Generally, to avoid being characterized as an investment advice fiduciary under the proposed regulations, an adviser must be able to "demonstrate" that the plan client knows, or reasonably should know, that (a) the advice or recommendations are being made by the adviser in its "capacity as a purchaser or seller" of securities or other property, and (b) the adviser is not undertaking to provide "impartial investment advice." The proposal generally does not specifically require a written disclosure to be provided to the plan client, but the proposal clearly contemplates and encourages written disclaimers.

The proposed rules further state that investment education within the meaning of the DoL's long-standing guidance on non-fiduciary education, as provided under Interpretive Bulletin 96-1, shall not constitute investment advice.

Furthermore, investment advice shall not include a platform provider's marketing or making investment alternatives available to a plan (without regard to individual needs of a plan) or providing general financial information to assist a plan fiduciary's selection or monitoring of such investment alternatives, so long as the platform provider discloses in writing that it is not providing impartial investment advice.

Outlook for the Proposed Regulations

This regulatory proposal is consistent with the Administration's aim to reduce conflicts in the 401(k) plan industry, and it aims to impose ERISA's fiduciary standards on a large segment of financial professionals who do not currently hold themselves out as fiduciaries. If adopted, the proposed regulations would force them to adopt fee-leveling, change the nature of their services so that they are not viewed as providing fiduciary advice, or otherwise eliminate any perceived conflicts of interest. Given the significance of the DoL's rulemaking, the proposed regulations are expected to draw heavy comments. Written comments on the proposed regulations may be submitted to the DoL on or before January 20, 2011.

In the next issue, I'll discuss the potential implications of the new rule and the changes put in place by the Dodd-Frank Act.

[1] *Donovan v. Bierwirth*, 680 F.3d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).