The February 2011 Regulatory Update column outlined the recently proposed regulations on the definition of “fiduciary” under ERISA in the context of providing investment advice. Since the time that issue went to press, the Department of Labor (DOL) received nearly 200 comment letters and held two days of hearings on the proposed rule on March 1 and 2, 2011, with 39 witnesses testifying. This column will provide a brief overview of the comments and the testimony and a discussion of the next steps on the proposed rule.

Overview of the Proposed Rule
By way of brief recap, the proposed rule would replace 35-year-old regulations under ERISA that specify when a party providing investment advice to a plan is a fiduciary to that plan under Section 3(21) of ERISA. Under the current rule, a five-part test must be satisfied for a party providing investment advice to be a fiduciary. Among the conditions of the five-part test is that the advice be provided “on a regular basis to the plan pursuant to a mutual agreement, arrangement or understanding . . . that such services will serve as a primary basis for investment decisions with respect to plan assets . . . .” The proposed rule, in contrast, eliminates the requirement that advice be provided on a regular basis and the requirement that the advice serve as a primary basis for the investment decisions. Instead, the proposed rule requires that “such advice may be considered in connection with making investment or management decisions.” (emphasis added).

In addition, the proposed rule adds some functions to those that will be considered fiduciary functions, such as appraisals of the value of securities and other property, that may not have historically been viewed as fiduciary services. Also, rather than carving out only advice relating to the acquisition or disposition of securities, the proposed rule would also cover advice related to the management of securities or other property.

ERISA fiduciary status is significant for several reasons. First, stringent conflict of interest rules restrict the transactions that may occur between plans and fiduciaries, how fiduciaries structure their relationships with plans and how a fiduciary may be compensated. Second, ERISA fiduciaries are personally liable for losses resulting from a breach of fiduciary duty. There are numerous other consequences under ERISA as well.

The proposed rule includes two limitations on fiduciary status. One is for parties who are selling securities or other property to a plan, such that advice and recommendations from the seller...
would not make the seller a fiduciary if certain conditions are met. Another is for certain data and information provided to a plan by a plan investment platform provider, again, if certain conditions are met.

**Overview of Comments and Testimony**

As noted above, the DOL received over 200 comment letters on the proposed rule and held two days of hearings. Obviously, a review of all comment letters and testimony is beyond of the scope of this column, but it is possible to generally summarize certain recurring themes and questions.

Of the nearly 200 comment letters, more than one-fourth were from financial services providers or organizations representing primarily financial services providers. A general theme among those comments was concern that the proposed rule is overly broad and vague and will result in a broader (and uncertain) group of service providers becoming fiduciaries. These commenters are concerned about such expansion for several reasons. One concern is that certain parties may perform a service inconsistent with fiduciary status, which requires acting for the exclusive benefit of the plan and plan participants, because the relationship involved in the service may be inherently adversarial. It would be impractical, for example, for a seller to have to act for the exclusive benefit of a buyer. For example, certain types of transactions with plans are “principal” transactions, in which a broker or dealer may engage in a transaction with a plan directly (as opposed to brokering a transaction between the plan and a third party). Under ERISA, fiduciaries may not engage in principal transactions. Another concern is that fiduciary status, and the liability that goes along with it, would increase the cost of providing services to plans and perhaps prevent some service providers from continuing to serve plans.

Many commenters expressed concern that the elimination of the requirement that the advice be provided on a “regular basis” and form the “primary basis” for investment decisions creates the risk that parties could inadvertently become fiduciaries due to, for example, something as generic as preparing a newsletter or giving a presentation at a conference that a plan fiduciary may see and consider in plan investment decisionmaking. These commenters argue that it would be impossible for such an inadvertent fiduciary to satisfy the demanding standard of care applicable to fiduciaries. Many commenters expressed concern that, in addition to increased costs, this vagueness and open-endedness could also discourage service providers from working with plans at all.

Financial services commenters also expressed concern that the proposed rule is not sufficiently coordinated with other regulatory initiatives currently underway in overlapping areas. Particularly, the flurry of regulations being proposed under the Dodd-Frank Act also deal with who is a fiduciary and the concern is that the two sets of rules will end up with different standards, creating confusion or an inability to comply with both sets of rules simultaneously.

While plan service providers may have outnumbered them, plan sponsors and groups representing plan sponsors also provided comments and testimony. Among the common themes of these commenters was concern that expanding the definition of fiduciary would either cause service providers to increase their fees for services or stop providing services to plans altogether. In a time when plans are squeezed to cut costs, increased costs, argued these commenters, would not be a welcome development. In addition, plan sponsors expressed...
concern that the proposed rule could even cause employees of the plan sponsor to become fiduciaries in certain cases, such as when employees provide plan participants with information about investment options.

A common theme among many different commenters related to the DOL’s cost-benefit analysis in the proposed regulations. As discussed above, many commenters believe that the proposed rule, if adopted, could result in considerable costs if it requires plans and service providers to restructure their businesses. The DOL acknowledged uncertainty in the cost-benefit analysis, but then estimated that sixteen hours of professional adviser time would be needed to perform a compliance review of the new rules. Many commenters agreed that this amount is inadequate (perhaps extremely inadequate) to capture the actual time and cost of complying with these changes.

Another theme expressed by both service providers and plan sponsors is that there should be a limitation or other carve-out for circumstances in which there is already a sophisticated fiduciary involved in the transaction. There may be instances, for example, where the plan fiduciary has the expertise, or has retained another party with the expertise, to serve as a fiduciary and is looking to another service provider for information or services that need not be provided in a fiduciary capacity. In those cases, it may not be worth it to the plan fiduciary to pay the additional cost that fiduciary service would entail.

Several commenters of all types also expressed concern that the new definition would cause service providers such lawyers, accountants, and actuaries to be fiduciaries.

While this discussion has focused thus far on the critical comments, other commenters were in favor of the proposal or proposed even more rigorous requirements, although they appear to be a minority of commenters. This group of commenters echoed the DOL’s sentiment in the commentary to the proposed regulations that changes in the retirement plan industry over the past 35 years necessitate the revision to the fiduciary definition. These commenters also argue that the proposed rule is more in line with the statutory language of ERISA and will better protect plan participants and beneficiaries.

According to these commenters, the current rules are too limited and improperly narrow the scope of activities to be treated as investment advice. These commenters applaud the move away from the “regular basis” and “primary basis” tests, arguing that these tests are not consistent with ERISA’s language and that the “primary basis” test is difficult to prove. Those in support also believe that the current rules create legal uncertainty because terms like “primary basis” and “regular basis” are subjective and must be determined on a case-by-case basis.

These commenters also advocated further narrowing the limitation in the regulations for parties selling securities or other property to plans. They argue that conflicts of interest that may be understood by sophisticated plan fiduciaries may not be understood by plan participants and beneficiaries, a theme that recurred in the comments from those supportive of the regulation.

What’s Next?
Witnesses providing testimony and observers at the hearing reported that the questioning from the DOL officials was lively and suggested that the DOL may not appear amenable to the many
calls from commenters to completely withdraw and, if necessary, re-propose the regulations. Also, the DOL has recently said in the press that it intends to finalize the rule by the end of 2011. Thus, it is probably reasonable to expect that some form of the rule will be finalized. Just in case the DOL felt that it had not heard enough from interested parties on this topic, however, it is accepted comments on the hearing testimony through April 12.

Of course, it remains to be seen what that final rule will look like. In the commentary that accompanied the proposed rule, the DOL expressed concern that the current rules provide too many opportunities for plan service providers playing a critical role in plan decisionmaking to avoid fiduciary status based on the five-part test. In other recent statements, the DOL has indicated that it views its role as moving the trend of ERISA regulation more towards the interest of plan participants and less towards the interests of financial services providers and plan sponsors. These views may guide the DOL’s ultimate conclusions on this subject. Given the drumbeat of criticism, however, and the extent to which the same concerns were raised repeatedly by a variety of parties, it may be difficult for the DOL to dismiss these points entirely.

NOTES
1  29 C.F.R. § 2510.3-21(c)(1)(ii)(B).
2  Prop. Reg. § 2510.3-21(c)(ii)(D).