Future investment advice regulation

By Marcia S. Wagner, Esq.

On October 21, 2010, the Department of Labor ("DOL") issued proposed regulations expanding the categories of persons deemed to be fiduciaries subject to ERISA by reason of providing investment advice relating to plan assets. The DOL reasoned that such a revision was needed because the retirement industry had changed significantly in the 35-year period since adoption of the current rule. Bowing to public and Congressional pressure, however, the DOL announced on September 19, 2011, that the proposed regulations modifying the definition of an ERISA fiduciary would be reproposed in 2012. Many now wonder what the next iteration of the rules will bring.

Under the existing rules, an advisor is treated as offering investment advice if a five-part test is satisfied, including requirements that the advice be individualized based on the particular needs of the plan and serve as a primary basis for investment decisions regarding plan assets. The DOL argued that the need to prove all five elements of the old rule was too difficult for enforcement purposes. The 2010 proposal replaced the five-part test with a two-pronged test that focuses on: (1) the type of service provided, and (2) the function or status of the person providing the services.

Services considered as satisfying the new test's first prong included recommendations as to the advisability of investing in, purchasing, holding, or selling securities or property, as under the current rule, as well as appraisals and fairness opinions and recommendations as to the management of securities or property. To satisfy the second prong of the proposal, recommendations would have no longer needed to be made on a regular basis, as under the current rule, but could constitute investment advice even if made only once. Further, under the proposed rule, a person would have been deemed to have provided investment advice if there was any understanding by the recipient of the advice (which need not have been shared by the advisor) that the advice could be considered in connection with investment decisions regarding plan assets.

The DOL's September 19, 2011, announcement of a reproposal signaled that certain problematic areas of the original proposal would be addressed, if not fixed. Thus, the announcement stated that the revised rules would (i) clarify that fiduciary advice is limited to individualized advice directed to specific parties, (ii) respond to concerns about the application of the regulation to routine appraisals, and (iii) clarify the new rule's application to arm's length commercial transactions, such as swap transactions.

This appears to indicate that, under future rules, an advisor's statements in the media may not serve as the only basis for claims by readers, listeners, or viewers that they have received investment advice for purposes of ERISA. Further, there seems to be an intention to carve out certain appraisals from the definition of fiduciary advice, although this would presumably not apply to matters where the DOL has encountered abuse, such as the valuation of company stock to be purchased by a benefit plan. Finally, the next version of the rules will permit certain risk hedging techniques, such as swaps, which some had feared would become off-limits to plans.

One of the primary criticisms of the proposed regulation was that it overlapped issues being addressed by the SEC with respect to the duties of broker-dealers and investment advisors and ran the risk of disrupting their longstanding and well-accepted business practices. A related criticism was that the categorical proscriptions of ERISA's prohibited transaction rules, as applied to financial service providers, have, up to now, been balanced by exemptions whose applicability depended on an advisor or broker not itself being an ERISA fiduciary. This balancing would have been upset by the proposed regulation's broader definition of the term "fiduciary." For example, under the securities laws, payments of 12b-1 fees are permitted in appropriate circumstances, whereas under ERISA, acceptance by a fiduciary of payments from a party other than the client generally constitutes a prohibited transaction. Accordingly, if an advisor is an ERISA fiduciary, an advisor may not accept 12b-1 payments or, if it does, it must rebate them to clients.

The DOL's announcement regarding the reproposal indicated that the revised rules would include (i) exemptions addressing the effect of the new regulation on advisor fee practices, (ii) clarify the continued applicability of existing exemptions allowing brokers to receive commissions in connection with mutual funds, stocks, and insurance products, and (iii) craft new or amended exemptions preserving beneficial fee practices.

Notwithstanding these hints, details of the reproposed rules will remain unknown until they are reissued. Advisors should note that the current rules will likely be in effect when the impending fee disclosure requirement becomes effective April 1, 2012, at which time they will need to decide whether or not they must include a statement in their initial disclosures that the advisor expects to perform services as a fiduciary. ❖

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