New York
Menlo Park
Washington DC
London
Paris
Madrid
Tokyo
Beijing
Hong Kong

Davis Polk & Wardwell LLP
450 Lexington Avenue
New York, NY 10017
212 450 4000 tel
212 701 5800 fax

Re: Comments on Proposed Rules Relating to the Definition of the Term "Fiduciary" Under the Employee Retirement Income Security Act

29 CFR Part 2510
RIN 1210-AB32

February 3, 2011

VIA E-MAIL: e-ORI@dol.gov

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, NW
Washington, DC 20210

Ladies and Gentlemen:

We are submitting this letter in response to the solicitation by the Department of Labor (the "**Department**") for comments on the proposed rule under the Employee Retirement Income Security Act ("**ERISA**"), which defines the circumstances under which a person is considered to be a "fiduciary" by reason of providing "investment advice" to an employee benefit plan or a plan's participants (the "**Proposed Rule**").

We are a sponsor and contributor with respect to several ERISA plans covering our firm's employees. In addition, our clients include parties who serve in various roles with respect to employee benefit plans, including plan sponsors, plan investment committees, plan administrators, plan service providers and plan counterparties. However, the views expressed in this letter are our own and do not necessarily reflect the views of any particular client of our firm.

In designing ERISA, Congress forged a delicate balance between protecting benefit plans and ensuring a healthy market for the services required to operate and administer those plans. Over the years the Department has been unflagging in its efforts to ensure that its rulemaking and enforcement under ERISA continue to support this balance. It is clear that the Department's aim with the Proposed Rule is to adjust a perceived shift in this balance which the Department believes has left plans and plan participants unduly exposed to risks and harm. We commend the Department's efforts, but we believe that the Proposed Rule would ultimately impair the balance intended under ERISA and have a significant negative impact on both plans and plan service providers. Accordingly, we urge the Department to reconsider its adoption of the Proposed Rule.

The preamble to the Proposed Rule (the "**Preamble**") states that the Proposed Rule is intended, in part, to codify certain well accepted interpretations under existing authorities, such as the inclusion as fiduciaries under ERISA of:

- any party who acknowledges that it is acting as a fiduciary within the meaning of ERISA;
- any party acting as a manager-of-managers in the traditional sense with respect to plan assets; and
- any party providing investment advice with respect to plan assets in the traditional sense, whether to a plan or a plan participant or beneficiary.

We support these aspects of the Proposed Rule.

The Preamble also makes clear the Department's aim to ensure that parties who hold themselves out as general pension consultants or appraisers with respect to transactions involving Employee Stock Ownership Plans ("**ESOPs**") act in a prudent, expert and unbiased fashion, with full disclosure of any potential conflicts of interest. We support this objective as well.

However, we believe that the foregoing objectives are best achieved through guidance that is tailored to these objectives, rather than by an overhaul of the existing investment advice rules under ERISA.

This letter is divided into five parts. Part I summarizes the changes included in the Proposed Rule and the practical impact of these changes.

Part II provides a more detailed analysis of the concerns raised by the Proposed Rule. Again, while the Department clearly intends the Proposed Rule to strike a more positive alignment of the regulatory priorities under ERISA, we believe that the Proposed Rule will have the opposite effect. As described in Part II we believe that the Proposed Rule would:

- be inconsistent with the legislative intent of ERISA and would upset the long-standing balance between plan protection and a robust market for necessary plan services;
- inappropriately create a definition of investment advice under ERISA that is broader than the definition applicable under the Investment Advisers Act of 1940 (the "**Advisers Act**");
- impose an excessive duty and burden on courts to develop standards for determining when a party has acted as a fiduciary under ERISA, without appropriate regulatory guidelines;
- potentially classify as ERISA fiduciaries parties who act in roles never intended to confer ERISA fiduciary status; and
- create significant confusion and uncertainty at a time when other critical legislative and regulatory priorities are being implemented.

Part III focuses specifically on the exception under the Proposed Rule for advice rendered by parties engaging in sales or purchases with plans. This exception is essential if the Proposed Rule is adopted in its current form, and the exception would be welcomed by many plan service providers and

counterparties. However, we believe the inclusion of this exception in the Proposed Rule is an indication that the core provisions of the Proposed Rule are overbroad.

Part IV offers suggestions as to how the Department might better address the concerns which it has identified as the basis for its revision of the current rule.

Part V summarizes some of the critical changes that would be necessary if the Department decides to move forward with the Proposed Rule in spite of the concerns expressed in this and other comments that have been submitted to the Department.

Part I: Summary of the Existing Rule, the Proposed Rule and the General Implications of the Change

ERISA imposes exacting standards of conduct and strict self-dealing prohibitions on any party acting as a fiduciary with respect to an ERISA-covered benefit plan. These duties are widely regarded as the highest standards of prudence and loyalty known to law. ERISA identifies as fiduciaries to a plan any party who administers the plan, any party who exercises discretion with respect to the plan's assets and any party who provides investment advice to the plan. Under the current ERISA regulations (the "**Current Rule**"), a person is deemed to provide investment advice for these purposes if that person: (1) renders advice as to the purchase, sale or value of securities or other property, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement or understanding, written or otherwise, between such person and the plan or a plan fiduciary, that the advice will (4) serve as a primary basis for investment decisions with respect to plan assets, and (5) be individualized to the particular needs of the plan (the "**Five-Part Test**").

The Proposed Rule would dispense with this Five-Part Test and provide, in pertinent part and with certain exceptions, that a person will be deemed to provide investment advice 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; and

- is an investment adviser within the meaning of the Advisers Act or otherwise provides advice or makes recommendations described above pursuant to an understanding 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, a plan fiduciary, or a participant or beneficiary.

As noted, the Preamble to the Proposed Rule indicates that the Department's primary objective in eliminating the Five-Part Test is to aid its enforcement initiatives, particularly its initiatives against parties providing allegedly flawed stock valuations in the context of certain ESOP transactions and its initiative under its Consultant/Adviser Project ("**CAP**"), which seeks to identify potential conflicts tainting pension consultants who assist in the selection of investment funds for plans while providing other services to these plans. The Proposed Rule would undoubtedly improve the ability of the Department and the plaintiff bar to bring actions against plan service providers, but it seems to shift the scale too far. By eliminating the "regular basis," "mutual understanding" and "primary basis" elements from the definition of investment advice, the Proposed Rule would create an almost insurmountable presumption of an investment advisory relationship where such a relationship may not have been intended by any party. When coupled with the addition of "recommendations as to the management of assets" as investment advice, this would convert a broad range of typical communications between plans and their service providers into per se investment advice and give private plaintiffs unfettered recourse to hold plan service providers responsible for unforeseen investment outcomes, regardless of whether the plan service providers actually participated in the plan's decision making in any meaningful way.

The Preamble also argues that repeal of the Five-Part Test is appropriate in light of the evolution from defined benefit to defined contribution plans. However, the Five-Part Test is more critical and more beneficial to defined contribution plans than it ever was to defined benefit plans, as defined contribution plan sponsors and participants are more likely to be individuals with limited knowledge of the fundamental aspects of plans and plan accounts and in greater need of non-advisory assistance than pension plan administrators. The protection currently afforded to service providers under the Five-Part Test allows plans and participants who chose less costly non-advisory services to nonetheless get a minimal level of information and assistance from service providers. In our experience these services are invaluable to plans and plan participants, and service providers are typically careful to provide only the appropriate type and level of assistance with all appropriate disclosures.

The Preamble states that the Proposed Rule 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." As noted in Part II of this letter, clarity was certainly a critical element of the legislative intent when ERISA was enacted. However, we believe that the Five-Part Test under the existing rule offers far more clarity for plans and service providers by testing whether an advisory relationship exists based on the actual understanding and course of conduct between the plan representative and the service provider, focusing on the legitimate presumption and expectation of the plan representative.

Service providers who are deemed to be providing advice as fiduciaries to plans are required to undertake an extensive analysis of the plan's needs and objectives and possess the highest level of expertise in the fiduciary matters at hand. Fiduciaries are subject to liability if they are found in hindsight to have failed to meet these standards. These are appropriate standards in the context of a fiduciary advisory relationship, but these standards have not been deemed necessary or appropriate in service relationships that do not involve investment advice in the common, traditional sense under ERISA. The added responsibility and potential liability that would be imposed on service providers under the Proposed Rule would have a significant negative impact on both service providers and plans. The Proposed Rule would impose unwarranted expectations and exposure for service providers and harm plans by stifling critical non-advisory services and driving up the cost of these services, particularly affecting Individual Retirement Accounts ("**IRAs**") and smaller plans that have less leverage with service providers than larger plans and are less able to pay the fees required for added services.

In support of the Proposed Rule, the Department refers to evidence of abuse detected in its ESOP and CAP initiatives and reports prepared by the Government Accountability Office ("**GAO**") and Securities and Exchange Commission ("**SEC**"). The Department also refers to the benefits that it believes would be realized by plans under the Proposed Rule, including improved service values. Finally, the Department offers estimates of the costs that plan service providers would incur in complying with the Proposed Rule. The Department acknowledges that its assessment of these factors is uncertain. While we recognize that these factors are difficult to measure, based on our experience with plans we believe that the Department's assumptions as to the existence of service provider abuse and the improved service value that could be achieved under the Proposed Rule are overstated and the Department's estimate of the costs that would be imposed on service providers by the Proposed Rule are understated. In this respect, we concur in many of the observations included in the January 11, 2011 comment letter submitted to the Department by the firm of Whitaker, Chalk, Swindle & Sawyer L.L.P. on behalf of the Securities Committee of the Business Law Section of the State Bar of Texas, which raises a number of questions concerning the Department's analysis. We encourage the Department to reassess these factors, as we believe that the cost/benefit analysis in this case is critical given the fundamental changes which the Proposed Rule seeks to impose.

While the Proposed Rule may promote the Department's enforcement in discrete cases, we believe that from a policy perspective the larger adverse impact on plans and the plan service market, particularly for smaller plans, would far outweigh the enforcement benefits. We recognize the Department's desire to improve its enforcement leverage under its ESOP and CAP initiatives. However,

we do not believe that these situations are appropriately remedied by a broad, draconian rule that would arbitrarily put other service providers at risk in a business community where the overwhelming majority of service providers have diligently tried to operate in a way that draws a clear line for plans between advisory and non-advisory services, consistent with years of authority. Instead, the Department should create specific rules that address ESOP and plan consultant situations. To the extent that the Department has identified other situations that have escaped existing legal remedies under ERISA and other laws, we would suggest further analysis of these situations and a more probing assessment of the costs and benefits of attempting to address these situations with a broad overhaul of the current fiduciary rules.

While the foregoing summarizes our general concerns, the Proposed Rule raises a number of more fundamental legal and practical concerns, which are addressed below in the remainder of this letter.

Part II: Detailed Analysis of the Legal and Practical Concerns Raised by the Proposed Rule

A. The Proposed Rule is inconsistent with the legislative intent and design of ERISA, which balances appropriate plan protections against fair limitations on the duties of non-fiduciary service providers

In the Preamble to the Proposed Rule the Department states that it does not believe that the Five-Part Test under the Current Rule is compelled by the statutory language of ERISA. Nor does it believe the current framework represents the most effective means of distinguishing persons who should be held accountable as fiduciaries from those who should not. We believe that the Five-Part Test is critical to the balanced objectives that Congress intended to achieve under ERISA.

1. Legislative and regulatory background. The enactment of ERISA was intended to provide protection for both plan participants and service providers. Plan participants were often inexperienced investors and in need of greater protection than the then-existing laws gave them.[1] Service providers were in need of a clearer and more uniform approach to fiduciary liability than the state-by-state approach under trust law. The uniformity created by ERISA was intended to "help administrators, fiduciaries and participants to predict the legality of proposed actions without the necessity of reference to varying state laws."[2] In constructing the provisions of ERISA, Congress distinguished between non-fiduciary service providers and plan fiduciaries, with the former being subject to prohibited transaction rules and the latter being subject to the highest prudence and loyalty standards known to law. Congress understood the magnitude of the standards it was imposing on fiduciaries under ERISA, and it intended to impose these standards only where the circumstances required them. To this end, Congress exempted from the definition of fiduciary all consultants and advisers to plans, other than investment advisers, unless their "special expertise" rendered them able to meet the high standards imposed and effectively provide advice with respect to the management or administration of plan assets.[3]

Ultimately, ERISA was drafted to include three separate categories of actors who are regarded as fiduciaries. Section 3(21)(A)(i) includes actors who exercise discretion with respect to plan assets. Section 3(21)(A)(ii) includes those who provide investment advice to a plan. Section 3(21)(A)(iii) includes those who have discretion with respect to plan administration. The exercise of discretion with respect to the assets or administration of a plan are core fiduciary functions under any reasonable view. This strongly suggests that when Congress added investment advice to the list of fiduciary acts it had in mind acts of a clear and similarly substantial nature. To give a broad interpretation to the provision of investment advice would render Sections 3(21)(A)(i) and (iii) somewhat redundant, as Section 3(21)(A)(ii) would by definition

---

[1] S. REP. NO. 93-127, at 29 (1973); H.R. REP. NO. 93-533, at 12 (1973).

[2] Id.

[3] H.R. REP. NO. 93-1280, at 323 (1974) (Conf. Rep.).

impose fiduciary responsibility on any person with discretionary authority or control over the management of the plan or its assets or over the administration of the plan – a result that Congress would surely not have intended. Instead, Congress intended Section 3(21)(A)(ii) to include as fiduciaries only those parties who clearly provided investment advice that is understood and intended to be fundamental to a plan's investment decisions.

The Five-Part Test under the Department's Current Rule reflects this legislative preference for a clear and circumscribed definition of investment advice by providing that a party will only be deemed to provide investment advice if the party offers advice or recommendations as to the purchase, sale, or value of property on a regular basis pursuant to a mutual understanding that the advice will serve as a primary basis for the plan's investment decisions.

2. Proposed Rule.

(a) General description of the Proposed Rule. The Proposed Rule provides, in relevant part, that a party will be deemed to provide investment advice if the party offers advice or recommendations as to the purchase, sale, or value of property or the management of plan property and that party (A) is an investment adviser within the meaning of the Advisers Act, (B) is a fiduciary with respect to the plan by reason of exercising discretion with respect to plan investments or serving as an administrator of the Plan, or (C) provides the advice or recommendations pursuant to an understanding 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 or a plan participant.

The provisions of prongs (A) and (B) above seem to imply that a party will be a fiduciary with respect to a plan investment decision even if the party's communications with plan representatives regarding that decision are provided in a context that makes clear that the communications were not intended as investment advice in any traditional sense. However, the precise intent of these prongs is not entirely clear. For example, it is not clear whether the reference in prong (A) to investment advisers under the Advisers Act is intended to mean that a party will be an ERISA fiduciary with respect to an investment decision by a plan if the party is an investment adviser under the Advisers Act (1) with respect to that specific investment decision, (2) with respect to investments of the plan generally or (3) with respect to its other customers generally.

In any case, we believe that a party should be viewed as an investment adviser and fiduciary with respect to an investment decision only if the party provides investment advice in the traditional ERISA sense with respect to that particular investment decision, not by reference to the party's identity or role in other contexts.

At a minimum the Advisers Act prong of the Proposed Rule would dispense with the Five-Part Test and determine a party's fiduciary status under ERISA by reference to the rules of the Advisers Act. In Part II.B. below we explain why this amalgamation of the ERISA and Advisers Act rules is problematic.

Even if the Proposed Rule is modified to delete the Advisers Act prong, the remainder of the Proposed Rule would still eliminate the "regular basis," "mutual understanding" and "primary basis" elements of the Five-Part Test. In addition, the Proposed Rule would add recommendations as to the management of assets to the list of activities that could constitute advice. These changes would have the sweeping effect of classifying as ERISA fiduciaries a variety of actors who were never intended to be treated as fiduciaries under ERISA. This is precisely what the Five-Part Test was intended to avoid. The Five-Part Test represents a 35-year-old regime supported by a wide body of judicial and administrative authorities, all focused on establishing a clear and balanced demarcation between fiduciaries and non-fiduciary service providers, as originally intended by ERISA. Each element of the Five-Part Test is essential to this purpose.

(b) Addition of "recommendations as to the management of assets" to the definition of investment advice. The elimination of the "mutual understanding" and "primary basis" elements, when coupled with the addition of "recommendations as to the management of assets" to the definition of investment advice would cause the investment advice standards to be applied to a broad range of communications that do not directly relate to plan investments activity. As described in Part II.D. below this aspect of the Proposed Rule could potentially classify as investment advice many typical communications between plan sponsors and their lawyers, accountants and actuaries.

The Preamble of the Proposed Rule states that the addition of the reference to the management of assets was intended to make clear that investment advice includes actions such as providing recommendations as to the voting of proxies on plan shareholdings and the selection of plan asset managers. As discussed in Part II.D., the reference to proxy voting recommendations may be overbroad. However, the provision of advice with respect to the selection and monitoring of specific investment managers in a typical "manager of managers" context has always been understood in the ERISA community to constitute investment advice for purposes of ERISA. But, rather than adding clarity on these points, the Proposed Rule muddies a line that is presently clear and well drawn.

(c) Elimination of the "mutual understanding" and "primary basis" requirements. The Current Rule provides that a recommendation is not investment advice unless it is provided pursuant to a mutual understanding that it will be a primary basis for an investment decision. The Proposed Rule would eliminate the primary basis and mutual understanding elements. In the Preamble to the Proposed Rule the Department lumps the mutual understanding and primary basis elements together and argues that ERISA does not compel conditioning fiduciary status on a requirement that an adviser and a plan have a mutual understanding as to the primacy of the advice given, in relation to other advice and information that the plan may have considered in making its investment decision.

The primary basis and mutual understanding elements are, in fact, related but separate elements of the Five-Part Test.

The "primary basis" element focuses on the degree to which a communication was relied upon by the recipient to determine whether the communication was given, received and used as investment advice. This analysis ensures that only communications that were considered significant enough to actually be relied upon by the plan are sufficient to result in the imposition of fiduciary duties. Plan representatives frequently converse with their service providers regarding various aspects of the plan, and the primary basis requirement allows these conversations to take place without necessarily causing the service provider to become an investment adviser and fiduciary and to allow plan representatives to access alternative opinions without the requirement of a formal investment advisory relationship. For example, where an unsophisticated sponsor of a self-employed plan has decided, based on personal research and consultation with a more sophisticated acquaintance, to invest a portion of the plan's assets in U.S. large cap equities, a service provider with no conflicting interest should not become a fiduciary when it suggests to the plan sponsor that there may be cost and diversification benefits in purchasing shares of an index fund rather than buying and selling individual stocks.

The "mutual understanding" element of the Five-Part Test is equally critical to the clear delineation of fiduciary status intended by ERISA. In many typical situations, even where a particular communication is a primary basis for a core investment decision, there is no expectation among the parties that this communication would be regarded as investment advice. For example, assume that a mid-sized retail company sponsors a frozen defined benefit plan managed by an investment committee which includes the company's Chief Financial Officer and other financial executives of the company. Rather than appointing an array of asset managers, the committee has determined that the plan should be invested primarily in a portfolio of institutional index funds. The committee retains a broker to expedite its investment plan and rebalance the portfolio periodically, but does not request or receive any investment advice from the broker in the ordinary sense. However, the committee asks the broker's opinion regarding the fees charged by index funds that are structured as mutual funds and bank collective investment trust funds. The broker

conducts some research on various mutual funds and collective trusts with respect to which the broker and his firm have no conflicting interest, and the broker reports back to the committee with a list of funds and their fees and general expense history. The committee ultimately chooses a portfolio of funds, including certain of the collective investment funds, indicated on the broker's list. Later, the plan experiences lagging returns in some of these collective investment funds, not as a result of fees and expenses, but because the lower fee funds chosen by the committee had engaged in stock lending to a greater extent than the higher fee mutual funds and had experienced problems with this stock lending activity.

The broker had merely responded to the committee's request for fee information. Although the fee information was individually tailored to the plan's request and was a primary consideration in some of the committee's fund selections, there was no understanding that the broker's limited assistance was intended to create an investment advisory relationship. Had the broker understood himself to be an investment adviser to the plan, he might have refused to respond to the committee's request for fee information or he might have insisted on gathering additional information from the committee to ascertain the committee's knowledge and experience with respect to the differences in how various funds managed their trading activity. The broker might have monitored the funds selected by the plan committee and might have been more alert to signs of emerging difficulties in certain stock lending relationships.

In scenarios like the one above, the "mutual understanding" element of the Five-Part Test gives the parties, the Department and the courts a clear basis for determining whether an investment advisory relationship existed by specifically looking to the mutual understanding of the parties. The Proposed Rule would eliminate the "mutual understanding" element but would still require an "agreement, arrangement or understanding, written or otherwise" that the advice provided will be individualized and may be considered in connection with an investment or management decision. This wording suggests a requirement for mutuality. However, this could be subject to question merely by virtue of the fact that the Department determined that the word "mutual" should be deleted under the Proposed Rule. In any case, it is important to retain intact the original requirement for a "mutual understanding," as this wording enhances the clarity of the rule, which is, again, consistent with the original intent of ERISA.

(d) *Elimination of the "regular basis" element*. The Proposed Rule would also eliminate the "regular basis" element of Five-Part Test. Perhaps the most important function of the "regular basis" element of the Five-Part Test is its relation to the "mutual understanding" and "primary basis" elements. The frequency of a particular type of assistance is often critical to the analysis of whether there is a mutual understanding that the assistance would serve as a principal basis for the recipient's decision making. This element allows courts to look to the frequency of communications to assist them in determining whether an advisory relationship exists. At the same time, courts can exercise their own judgment as to the required frequency under the prevailing facts and circumstances. In one case a court found that in the absence of any other indication of a "mutual understanding" the provision of assistance by a service provider on two occasions was not sufficient to characterize the assistance as investment advice.[4] In another case, a court found under the applicable facts that annual meetings over a five-year period were sufficient to show that investment advice was regularly offered.[5]

The "regular basis" test, together with the other elements of the Five-Part Test, makes it possible for bankers and brokers to have ordinary conversations with their customers and respond to basic, discrete customer inquiries, such as:

- the banker or broker's view on whether it is preferable to contribute a savings amount to a retirement plan or a non-retirement account;
- the banker or broker's view on whether it is preferable to repay a plan loan rapidly or slowly;

[4] Brown v. Roth, 729 F. Supp. 391, 397 (D.N.J. 1990).

[5] Daniels v. National Employee Benefit Servs., 858 F. Supp. 684, 691 (N.D. Ohio 1994).

- the banker or broker's general views of the costs and benefits of the fee structures of two competing third-party mutual funds (load vs. no-load) in which the banker or broker has no conflicting interest; or

- the banker or broker's general view of two alternative web-based retirement planning tools in which the banker or broker has no conflict.

For example, if a customer maintaining an IRA or a small plan at a bank asks the bank for a referral of another type of non-manager service provider for a plan-related matter, it is not unusual for the bank to provide a list of several referrals in a manner that makes clear that the bank is merely offering requested information and is not advising the plan on its selection.

This same approach might apply even where a customer requests assistance in identifying an investment. Assume that a customer establishes a small plan with a bank and, after researching mutual funds and exchange-traded funds, decides to invest a portion of the plan in an S&P or Russell index fund. In response to the customer's request, the relationship banker provides the customer with a list compiled by the banker of S&P or Russell index funds with a trailing 5-year expense ratio below 0.15% as to which the banker has no conflict.

Certainly, if the responsible relationship banker in the cases above became aware of a reason to update the information provided to the customer, the banker would do so. However, under the existing fiduciary rules, because the bank did not undertake to provide this assistance on a regular basis, the bank is not necessarily under a duty to monitor the choice of the plan representative. The plan representative has not agreed to pay for such on-going monitoring and the bank has not charged the plan for the work and responsibility that such monitoring would entail. Plans, customers and accounts seeking low-cost banking and brokerage services, with occasional, non-advisory assistance in scenarios like those described above constitute a growing majority of the retirement plans and accounts in existence. Classifying this assistance as investment advice would chill this assistance and add costs that would be passed on to the plan customer.

In the Preamble to the Proposed Rule the Department notes that the "regular basis" test creates the potential that a service provider offering fundamentally significant investment advice may nonetheless evade ERISA's fiduciary rules by arguing that the advice was not provided on a regular basis. In our experience, the regular basis element is not seen by service providers as a shield for providing significant advice and at the same time avoiding ERISA's fiduciary requirements, but rather it is viewed as an important and reasonable source of comfort that a service provider's discrete, non-advisory communications with customers will not subject the service provider to unintended obligations and prohibitions.

B. <u>The Proposed Rule would inappropriately create a broader definition of investment advice under ERISA than the definition applicable under the Advisers Act</u>

As described above, the Proposed Rule includes two separate prongs that would eliminate the Five-Part Test. The first is the prong providing that any party offering advice or recommendations will be a fiduciary if the party is an investment adviser within the meaning of the Advisers Act. The second is the prong providing that a party will be an ERISA fiduciary if it provides investment advice pursuant to an understanding that such advice may be considered in connection with making investment or management decisions and will be individualized to the needs of the plan or a plan participant. The language of this second prong is similar to the definition of investment advice under the Advisers Act, and, accordingly, it would appear at first blush that the definition of investment advice under the Proposed Rule is coextensive with the definition under the Advisers Act. However, the authorities under the Advisers Act exempt a variety of types of advice from the meaning of investment advice under the Advisers Act. Since the second prong of the Proposed Rule does not include any similar exemptions, the Proposed Rule adopts a definition of investment advice that is broader than the definition under the Advisers Act. However, even if

the Department's intent is to adopt a rule that is identical in breadth to the Advisers Act, this would ignore the contrasting purposes and regulatory frameworks of ERISA and the Advisers Act.

Advisers Act	ERISA
The Advisers Act imposes registration, disclosure and SEC oversight requirements on service providers within its purview, and these basic requirements were intended to be applied broadly.	ERISA imposes exacting standards of conduct and prohibitions on parties deemed to be ERISA fiduciaries, and these standards and prohibitions were intended to apply only to a limited class of actors playing significant and fundamental roles with respect to benefit plans.
The SEC is well-resourced, expert and active in keeping abreast of the investment market and has issued extensive formal and informal guidance for determining the type of activities that constitute investment advice under the Advisers Act and the rules applicable to parties providing investment advice.	Although the Department coordinates with the SEC on pertinent regulatory issues, the Department is not a financial markets regulator and is less active in its rulemaking and its provision of informal advice relating to investment scenarios, and therefore the Department best serves the objectives of ERISA and the needs of plans and plan service providers by offering regulations which establish a clear and circumscribed framework for determining the parties who are and are not subject to the various rules under ERISA.
The Advisers Act is focused on registration, disclosure and agency oversight of investment advisers and, with limited exceptions, does not provide for private rights of action, but instead allows the SEC to apply its expertise and discretion with respect to issues under the Advisers Act.	ERISA's fiduciary rules impose a complex and comprehensive set of requirements and prohibitions on fiduciaries and provide a broad right of private action, subjecting service providers to both legitimate and opportunistic litigation attacks, and, accordingly, courts should be provided with a clear and circumscribed regulation-based framework for finding fiduciary status only where the facts support this.

Originally enacted to remedy the gaps caused by a patchwork of state regulation, the broad approach adopted by the Advisers Act has, in the ensuing years, required the SEC to continually refine the act's principles through rulemaking and interpretive guidance. As a result, the SEC is an active regulator that monitors the behavior of investment advisers through their required disclosures and by concerted agency oversight. The Advisers Act contains only limited private rights of action, leaving the SEC to address perceived violations with corrective action aimed at enforcing compliance and, where necessary, the recovery of losses. The broad definition of investment advice under the Advisers Act and the rules and guidance thereunder cast a wide net and subject significantly more advisers to the Advisers Act than the Five-Part Test subjects to fiduciary duties under ERISA. This is appropriate as the standards and limitations imposed under the Advisers Act are less onerous than those under ERISA, compliance questions are reviewed by an expert regulator rather than self-interested plaintiffs, and the consequences of inadvertent compliance lapses are generally less severe.

In contrast, ERISA was enacted not to facilitate state regulation, but to preempt it altogether and create nationally uniform regulations for the administration and operation of benefit plans. Toward this end,

ERISA established exacting standards and a broad and complex framework of rules, prohibitions and penalties on parties deemed to be providing investment advice to plans. The resulting fiduciary standards, prohibited transactions rules and punitive excise taxes and penalties, and the private right of action created under ERISA, dictate that market participants not be unnecessarily caught in the fiduciary regime under ERISA. A more definitive and limited definition of investment advice is essential for the purposes of ERISA, and if this definition is not provided by the regulation itself, the Department would need to fill the void and become an active regulator, a role for which it may be ill-suited. Unlike the SEC, the Department is neither active nor expert in providing guidance on financial market matters, and therefore the Department best serves the objectives of ERISA and the needs of plans and plan service providers by offering regulations which establish a clear and circumscribed framework for determining the parties who are and are not subject to the various rules under ERISA. Because ERISA's private right of action subjects service providers to both legitimate and opportunistic litigation, courts need to be provided a rules-based framework for applying the tests for fiduciary liability established by ERISA.

The contrasts between the Advisers Act and ERISA affect a wide range of dealings between plans and service providers. For example, when financial institutions conduct business with benefit plans they do not often have concerns that they might be regarded as investment advisers under the Advisers Act. Their conduct typically conforms easily with the exclusions or requirements pertaining to investment advice under the Advisers Act. However, they do need to focus carefully on whether the undertaking constitutes investment advice under ERISA, as this would impose significantly different requirements. The Advisers Act standards are frequently interpreted to permit advisers to address most conflicts of interest by disclosure and client waivers, whereas this is not permitted in many situations under ERISA. In addition, the Advisers Act often does not prohibit an adviser from providing multiple services with respect to a client, whereas this is generally viewed as presenting a conflict under ERISA. More generally, the legislative history and the wide body of subsequent judicial and regulatory authority under ERISA make clear that the standard of prudence and loyalty imposed on service providers acting as fiduciaries under ERISA are the highest known to law. It is difficult to quantify exactly how this standard differs from the “best interest” standard under the Advisers Act, but the Department and the courts have consistently recognized a heightened standard under ERISA, and the history of rulings and decisions under ERISA certainly exhibits an unforgiving standard.

These standards and limitations under ERISA are absolutely appropriate when applied to the class of actors and actions for which they were intended. If the rules under ERISA are altered to include a definition of investment advice that is as broad or broader than the definition under the Advisers Act, the Department would need to adopt additional rules and exemptions to at least partially restore the historical distinction between advice which is subject to scrutiny under the Advisers Act and advice which would trigger the more imposing standards and prohibitions of ERISA. Given the distinct purposes of ERISA and the Advisers Act, and the resulting differences in the judicial and administrative interpretations that have evolved under these two statutes, it would be inappropriate for the Department to adopt by reference the rules and interpretations under the Advisers Act. These statutes are not coextensive, and the Department’s attempt to establish a rule of convergence after 35 years is not appropriate.

C. <u>The Proposed Rule would impose an inappropriate duty and burden on courts</u>

The Proposed Rule would significantly increase the breadth of discretion afforded to courts in determining whether the facts of a case support the conclusion that investment advice has been rendered. This is the Department’s primary motive for the rule change, but we believe that the detriments of this approach outweigh the intended benefits.

First, by replacing the Current Rule’s explicit guidelines and its 35-year history of supporting interpretations with a broad and vague definition of investment advice will inevitably place courts in the position of de facto rulemakers as they will have to intuit the intended contours of the Proposed Rule. This is not an appropriate responsibility to impose on courts, and courts have been reluctant to accept this role. For example, in *Mertens v. Hewitt Assocs*. the Supreme Court states that “[t]here is … a ‘tension between

the primary [ERISA] goal of benefiting employees and the subsidiary goal of containing pension costs'... We will not attempt to adjust the balance between those competing goals that the text adopted by Congress has struck."[6]

Second, while the Department may not be as sophisticated as the SEC with respect to financial markets, the Department does possess a unique expertise regarding benefit plans and the general services required to operate them. Courts do not necessarily share this level of expertise and should not be saddled with a new rule that strips away essential guideposts such as those offered under the Current Rule and its history of interpretive authorities.

Third, the varying interpretations made possible by the ambiguity of the Proposed Rule will result in divisions among courts and circuits and a resulting patchwork of conflicting rules.

Fourth, the broad and vague scope of the Proposed Rule will increase the volume of disputes and the caseload burden of the courts. While the breadth and vagueness of the Proposed Rule will inevitably attract plaintiffs who seek to inappropriately exploit the rule, even conscientious plan fiduciaries often feel a fiduciary duty to test the possibility of recovery of unintended losses where the law presents any angle in which the chance of extracting a recovery outweighs the cost of litigation.

Finally, the net result of all of the foregoing will be market uncertainty. Since the markets usually overprice uncertainty, contrary to the Department's expectation, the Proposed Rule will by definition result in costs to plans which outweigh the intended benefits.

D. The Proposed Rule would classify as ERISA fiduciaries parties who were never intended to be regarded as ERISA fiduciaries

1. *Scope of the Proposed Rule.* Again, we must focus on the core language of the Proposed Rule which would classify a service provider as an ERISA fiduciary if the service provider makes recommendations as to the value of plan investments or the management of plan assets, in either case pursuant to an understanding that the recommendation is individualized to the needs of the plan and may be considered in connection with decisions relating to the management of plan assets. This wording is apparently intended to achieve the Department's primary objective of categorizing pension consultants and ESOP valuation providers as ERISA fiduciaries. However, the breadth of this wording could potentially affect a broad array of service providers that the Proposed Rule was probably not intended to capture.

2. *Parties and scenarios potentially impacted by the Proposed Rule.* Described below are a number of scenarios involving plan-related service. In the typical case, most of these scenarios are not subject to the Advisers Act, based on authorities under that act. These cases are presumably not intended to constitute investment advice under the Proposed Rule either. However, whereas the Five-Part Test under the existing ERISA fiduciary rules provided a framework for determining when these scenarios might cross the line into investment advice, the Proposed Rule offers no similar guidance.

(a) Certain professionals. The Proposed Rule would include within its scope professionals on both the plan sponsor and the plan investment side of a plan's operations.

> *(i) Accountants.* Accountants for a plan sponsor might have discussions with the sponsor which touch on issues relating to the volatility of plan funding levels, plan contributions and various other aspects of plan sponsorship which may bear plan assets and liabilities. On the plan investment side, the accountants for various pooled vehicles in which plans invest might issue accounting reports which include valuations derived from other sources relating to assets held in the pooled vehicle.

[6] 508 U.S. 248 (1993) (quoting Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504 (1981)).

(ii) Actuaries. Plan actuaries might offer the plan sponsor or fiduciary various information and opinions regarding the values of plan assets and liabilities, which the sponsor and fiduciary might take into account in plan investment and funding decisions.

(iii) Lawyers. Lawyers for a plan sponsor or fiduciary might offer various information and opinions relating to proposed courses of action regarding, for example, the optimal process and scope of information to be gathered and considered in making plan decisions.

(iv) Proxy advisers. Proxy advisory firms may issue recommendations relating to shareholder proxies on stock held in a plan's investment portfolio. Often these recommendations are not intended to be tailored to the interests of any particular investor, but they may be provided to specific investors who subscribe to the proxy adviser's services.

It is not entirely clear when, if ever, the above situations would be deemed to involve investment advice under the Proposed Rule.

(b) Valuation providers. It is also not entirely clear when valuations relating to both plan investments and investments held in non-plan asset vehicles are intended to fall within the definition of investment advice under the Proposed Rule.

(i) General valuation providers. There are numerous scenarios in which parties gather and use valuations relating to an ERISA plan's investments. These valuations are often individualized to the plan in the sense that they relate directly to an asset held by the plan, and the values may be considered by the plan, for example, for purposes of maintaining a desired asset allocation. These scenarios include situations in which prices from various quotation systems or industry pricing feeds are reported out to third parties by equity prime brokers, pooled investment fund administrators or valuation firms. Such prices may, in turn, be used by the third parties to assess the value of their portfolios and report out the value of interests in these portfolios to investors, including benefit plan investors. The sources providing these values are often not in direct privity with benefit plan representatives and provide the same valuations to all end users, benefit plans as well as the broader market of investors. These valuation providers are neither seeking nor expected to act as fiduciaries or agents of the consumers of their valuations, rather they are, by definition, independent and unbiased processors and evaluators of pricing information. It is neither practical nor appropriate that these service providers should be treated as ERISA fiduciaries merely because benefit plan investors might use their valuations for their own purposes.

(ii) Non-plan asset vehicles. Non-plan asset investment vehicles take a variety of forms, including: registered investment companies; investment funds in which benefit plan investors hold less than 25% of each class of equity interests; venture capital operating companies ("**VCOCs**"); and real estate operating companies. Each of these types of vehicles may hold investments of varying liquidity, may value these assets using a variety of sources and methods and may use those values to report positions to investors or compute a value for investors' interests in the vehicle. It is not clear when, if ever, a vehicle manager or other party preparing, reporting or using these values would be deemed to be providing investment advice to an investing plan under the Proposed Rule. Under existing ERISA rules a manager of a registered investment company would not be regarded as an ERISA fiduciary with respect to an investing plan when the manager buys and sells portfolio assets of the investment fund, and it would be incongruous if the manager or its service providers would become ERISA fiduciaries when they value fund portfolio investment and thereby establish the value of fund shares held by benefit plan investors. Similarly, managers of VCOCs may value portfolio investments, explicitly or implicitly, when they buy these investments and draw down committed capital from their participating investors and when they sell these investments. It has never been suggested that VCOC managers were ERISA fiduciaries with respect to these valuations. It would be odd if these managers (or their accountants) were

deemed to be ERISA fiduciaries when, for example, they reported values for these same portfolio investments to their accountants and those values were used in fund financial statements provided to ERISA and non-ERISA investors in the VCOC.

(iii) Plan asset vehicles. Plan asset vehicles can also take a variety of forms, including insurance company accounts, collective investment trusts and private investment funds which do not qualify for an exception under the ERISA plan asset rules. Managers of these vehicles are fiduciaries with respect to the plan assets held within the vehicles and are required to operate in accordance with applicable ERISA rules and guidance. However, like most managers, the managers of these vehicles receive pricing and valuation information for their portfolio investments from a wide variety of sources. It is unclear from the Proposed Rule which, if any, of these sources are intended to be viewed as providing investment advice.

Presumably, the provision or use of valuations with respect to investments of a non-plan asset vehicles would not trigger an investment advice analysis under the Proposed Rule because superseding concepts under ERISA provide a broad exemption for non-plan asset vehicles. In addition, the provision of valuation information by a third party to a manager of a plan asset vehicle should not make the third party an investment adviser where the relevant pricing and valuation services are objective and independent and are not individualized to any particular investor. However, the Proposed Rule fails to provide clarity on these and other valuation scenarios, some of which will undoubtedly raise thornier questions.

E. The Proposed Rule would create confusion and uncertainty at a time when other significant legislative and regulatory priorities are being addressed

1. *Background.* As demonstrated in the discussion and examples in various portions of this letter, the Proposed Rule would likely have significant impact on service providers that are registered under federal securities laws as broker-dealers, investment advisers or both. The legal and self-regulatory regimes governing these service providers are currently in a critical stage of evolution.

(a) Business conduct standards applicable to registered broker-dealers. Under the “shingle theory,” broker-dealers have traditionally been subject to a standard of fair dealing with respect to recommendations made to customers. The essence of this standard is embodied in the suitability rule under NASD Conduct Rule 2310, which requires that a broker-dealer making a recommendation to a customer “have reasonable grounds for believing that recommendation is suitable for the customer upon the basis of the facts, if any, disclosed by such customer as to his/her financial situation and needs.” Generally, the broker-dealer would have reasonable grounds to believe that a recommendation is suitable for a customer if the broker-dealer has made an informed determination that the recommended course of action is suitable for at least some investors’ needs, as opposed to the specific investor’s needs. If the customer has total assets under $50 million and is not an institutional customer (e.g., a bank, investment adviser, investment company), the broker-dealer is required to obtain information indicating the customer’s financial status, tax status and investment objectives and such other information considered to be reasonable by the broker-dealer in making the recommendation.

(b) Business conduct standards applicable to registered investment advisers. Investment advisers are typically subject to a “best interest” standard with respect to their recommendations and actions affecting advisory clients. This standard includes a duty of prudence to ensure that investment advice is suitable for the clients’ objectives, needs and circumstances and a duty of loyalty to eliminate, or at least expose, all conflicts of interest and specifically refrain from personal transactions that can cause harm to a client’s interests.

(c) Business conduct standards applicable to swap dealers. Historically, swap dealers have not been subject to a centralized conduct of business regime similar to the regimes applicable to SEC registered securities brokers and investment advisers.

2. _Dodd-Frank Act_.

(a) The Act. In the wake of the recent financial crisis, Congress undertook a sweeping initiative to review the standards of conduct applicable to broker-dealers, investment advisers, swap dealers and other significant participants in swap transactions. These measures, which were codified in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"), were a first-line order of priority for Congress and financial market regulators and will generate a complex set of new and far-reaching regulations governing the course of dealings between investors and their service providers in financial markets.

Many had pushed for the Dodd-Frank Act to include specific statutory provisions that would have imposed new standards of conduct on broker-dealers in their dealings with ordinary brokerage customers, as well as provisions that could have subjected swap dealers to ERISA's fiduciary standards in their dealings with plan counterparties. Both of these initiatives were debated and ultimately rejected by Congress. Given the importance and complexity of financial markets, Congress recognized a need for more expert and deliberate review of the standards of conduct that should apply in the various transactions and relationships between service providers and their customers and counterparties. Accordingly, among the initiatives included in the Dodd-Frank Act:

- Section 913 of the Dodd-Frank Act required the SEC to prepare a study of the standards of conduct applicable to broker-dealers and investment advisers and determine whether changes were necessary; and

- Section 713 of the Dodd-Frank Act amends the Commodities Exchange Act ("**CEA**") to authorize the Commodities and Futures Trading Commission ("**CFTC**"), in coordination with the SEC, to establish appropriate standards of business conduct for swap dealers and major swap participants when they undertake to act as advisers to certain counterparties in swap transactions.

(b) The SEC's Dodd-Frank study and its recommendation for standards of care applicable to investment advisers and broker-dealers. The SEC staff completed its study of broker-dealers and investment advisers, and this study recommends that rules be adopted under the Securities Exchange Act of 1934 to establish a uniform standard of care for broker-dealers and investment advisers when providing securities-related investment advice to retail customers, no less stringent than the "best interest" standard currently applicable to registered investment advisers. The study also recommends uniform standards relating to personnel supervision, advertising, the use of finders and solicitors, and licensing, registration and recordkeeping.

(c) Business conduct initiatives for swap dealers and major swap participants under Dodd-Frank and the related CFTC proposal. The Dodd-Frank Act imposes requirements on swap dealers and major swap participants ("**SD/MSP**") when they engage in swap transactions with special entities. Special entities include ERISA plans. CFTC proposals indicate that special entities should also include plan asset vehicles through which ERISA plans might invest, but the CFTC has requested comments on this point.

Among other things, before engaging in a transaction with a benefit plan investor a SD/MSP would be required to have reasonable basis to believe that a benefit plan investor is represented in the transaction by an adviser who is qualified and independent from the SD/MSP. Under current CFTC proposals, if an adviser to a benefit plan investor received any compensation from a SD/MSP within one year prior to negotiating a swap transaction with the SD/MSP, the benefit plan investor would need to be informed and provide a written consent that the adviser may act for the benefit plan investor in the transaction. This independence standard would be more strict than the standard applied under the ERISA guidance that applies to most swap transactions (i.e., the Department's class exemption for transactions by qualified professional asset managers (PTCE 84-14)).

Separately, under the Dodd-Frank Act and recently proposed CFTC rules, if a SD/MSP acts as an adviser to a benefit plan investor in a covered transaction, the SD/MSP must act in the best interest of the benefit plan investor. The Dodd-Frank Act and proposed CFTC rules do not specify what is required of a SD/MSP to show that it acted in the "best interest" of the counterparty. The relevant CFTC release refers to established principles in case law under the CEA, Advisers Act and ERISA, but the release also states that the Department has advised the CFTC that the determination of the status of a SD/MSP under the CFTC rules is separate and distinct from the determination of whether the SD/MSP is an ERISA fiduciary.

Swap dealers have expressed concern that by seeking to meet the requirements of the CFTC's proposed rules, a swap dealer will be required to provide information and assistance to benefit plan counterparties which could be regarded as advice or recommendations for purposes of ERISA rules and thereby cause swap dealers to be regarded as ERISA fiduciaries with respect to their benefit plan counterparties. This would create an untenable circular trap, because under ERISA a fiduciary is typically presumed to be prohibited from engaging in trades in which it has acted as a fiduciary to the benefit plan investor. This was clearly not the intent of the Dodd-Frank Act. In fact, this result was considered and rejected by Congress when it adopted the Dodd-Frank Act. While the Department's comments to the CFTC seem to imply that the Department understands this and does not intend that the information and assistance that swap dealers must provide to plan counterparties under the Dodd-Frank Act should cause swap dealers to be regarded as ERISA fiduciaries, the Department's Proposed Rule clouds this conclusion by significantly broadening the category of information and advice that could cause a swap dealer to become an ERISA fiduciary.

3. Impact of the Department's Proposed Rule in view of competing regulatory priorities. There is bound to be debate and confusion over the provisions of the Dodd-Frank Act and the flurry of related rulemaking by the SEC and CFTC. While a full analysis of the competing views in this area is beyond the scope of this comment, there are two related points of relevance here.

First, if any enhanced standards of care or loyalty are to be imposed on the dealings of brokers and dealers, these standards should be determined by the SEC and CFTC. Whether a broker-dealer should be subject to additional standards of care when dealing with a benefit plan counterparty and how those standards should be determined were topics that were debated and settled by Congress when it enacted the Dodd-Frank Act, and these provisions are being effectuated by appropriate SEC and CFTC rulemaking. Given Congress' recent consideration and resolution of this very topic under the Dodd-Frank Act and its provision for prescribed regulatory action in this area by the SEC and CFTC, it would be inappropriate for the Department to adopt rules that would impinge on the regulatory framework envisaged by the Dodd-Frank Act.

Second, if, despite the foregoing, the Department continues to believe that an ERISA rule change is appropriate, this rule change should be deferred until after the rules of the SEC and CFTC under the Dodd-Frank Act are finalized and their impact is absorbed by the relevant regulators and market participants. The transformative measures under the Dodd-Frank Act have been a consuming priority for Congress, financial market regulators, self-regulatory bodies and market participants. Market participants will continue expend substantial efforts and incur significant burdens absorbing these changes and their resulting ripple effects. Even if the Department concludes that the Dodd-Frank Act's refusal to expand the scope of conduct subject to the ERISA fiduciary standards does not preclude the Department from reopening this issue, the Department should at least wait until the express priorities under the Dodd-Frank Act have been finalized and absorbed by the market.

Part III: <u>The Proposed Exception for Adverse Parties</u>

The Proposed Rule provides that a party will not be considered to be providing investment advice if it can demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the party is 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, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice (the "**Transaction Exception**").

The Transaction Exception is sensible and is consistent with the traditional view of brokers and counterparties in various transactional settings. For example, as acknowledged in the SEC staff's recent study on investment advisers and broker-dealers, securities brokers commonly give a certain amount of advice to their customers in the course of their regular business, and the Advisers Act excludes from its definition of investment adviser brokers whose investment advisory services are performed incidental to their business as brokers and without added compensation.

The Transaction Exception is also consistent with the general trend of regulation applicable to financial markets. As noted, the proposals being suggested for securities brokers and swap dealers by the SEC and CFTC contemplate that such parties may provide advice to an investor with respect to a transaction and simultaneously act as a counterparty or agent for a counterparty in the transaction. Moreover, the Transaction Exception may be necessary based on the direction that these other proposed regulations seem to be taking. For example, if the CFTC conduct of business rules for SD/MSPs ultimately require an SD/MSP to provide certain specified of information to benefit plan counterparties (such as daily marks, as is currently proposed by the CFTC), the ERISA fiduciary rules may need to include an exception making clear that the SD/MSP does not become an ERISA fiduciary by virtue of meeting its obligations under the CFTC rules, otherwise the SD/MSP may be preempted from even trading with benefit plan investors by virtue of ERISA's prohibited transaction rules.

However, the Department's inclusion of the Transaction Exception under Proposed Rule at this juncture demonstrates the fundamental regulatory shift inherent in the Proposed Rule. The regulatory trend which we noted above with respect to securities brokers and SD/MSPs merely recognizes that brokers and SD/MSPs have traditionally provided certain types of advice to customers and counterparties, and, accordingly, the rules being proposed by the SEC and CFTC simply attempt to impose standards with respect to this advice (or at least this was the original intent of the Dodd-Frank Act). The Department's Proposed Rule works in the opposite direction. It declares as investment advice a broad range of conduct that has never been viewed as advice under ERISA and then it exempts from existing fiduciary requirements any party who provides advice in the context of a self-interested transaction. In other words, because of the overbroad scope of the Proposed Rule's new definition of advice, the Proposed Rule must offer a broad exemption.

This is a curious and unprecedented approach for the Department. Historically, parties seeking to offer investments to a plan have been careful to ensure that they do not create any misunderstanding that they are providing advice to the plan. This would violate basic loyalty principles as well as applicable prohibited transaction rules. In our experience, and indeed pursuant to our advice, financial parties do not typically assume they can provide any level of advice (in the traditional sense of the word) to a plan counterparty and be sure that the plan understands that this advice is not necessarily intended to take full account of the plans needs, objectives and risk tolerance and may not be the same level of advice that a plan fiduciary might provide. While disclosures and acknowledgments may be used by financial parties in an attempt to make clear to a plan that the financial party is not undertaking a fiduciary role in a transaction, financial parties do not necessarily rely on these disclosures and acknowledgments. Instead, financial parties generally limit their conduct and communications in a manner that clearly avoids an advisory role. This is true in transactions involving large defined benefit plans, and it is true with respect to retail services provided to small defined contribution plans and IRAs. For example, banks and brokerage

firms typically offer the choice of two distinct platforms to defined contribution plans and IRAs – brokerage or advisory. These firms circumscribe their interaction with customers choosing the brokerage platform not only because customers are not the interested in paying for investment advice and the firm is not being compensated for the obligation and risk of providing this advice, but also because the provision of advice would preclude the firm's reliance on critical prohibited transaction exemptions.

While we believe that the Transaction Exception under the Proposed Rule is practical and may eventually be essential if the SEC and CFTC initiatives are adopted as proposed, the SEC and CFTC proposals have not been finalized, and, therefore, the Transaction Exception under the Proposed Rule is responsive, not to the SEC and CFTC proposals, but to an anomaly that would be created by the breadth of the Proposed Rule itself. This demonstrates the fundamental realignment posed by the Proposed Rule. Indeed, the Department's inclusion of the Transaction Exception in the Proposed Rule is the most concrete evidence that the Department appreciates the potential impact that the Proposed Rule would have on parties who provide services to plans.

Part IV. The Department's Concerns Driving the Proposed Rule

In light of the concerns identified above, we would suggest that the better approach would be for the Department to consider specific rules that provide workable guidance on the principal concern the Department is attempting to address – the opportunity for abuse by ESOP appraisers and pension plan consultants.

A. ESOP appraisals

With respect to ESOP appraisals:

- The Department could adopt specific guidelines providing clear standards for ESOP appraisers.
- The Department could also adopt guidelines for other fiduciaries in the ESOP context (e.g., ESOP trustees), requiring them to critically analyze and evaluate valuation reports.
- The Department could require ESOP appraisers to be credentialed by a professional organization which imposes a professional code of conduct on appraisers and periodic professional training requirements.
- The Department could require ESOP sponsors to notify the Department in advance of private sales of stock to an ESOP and permit the Department to conduct a valuation audit as precondition to the transaction.

B. Pension plan consultants

In the Preamble to the Proposed Rule, the Department expressed specific concerns regarding pension consultants who have allegedly failed to disclose conflicts of interest to their pension plan clients. The Department cited the GOA and SEC studies in support of its view that such undisclosed conflicts of interest translated into lower returns for client plans.

As a result of the well-publicized reviews of pension consultants by the Department, the SEC and the GAO, it appears that both pension consultants and consumers have already been educated about best practices and have developed policies to police their conduct. Moreover, the Department recently released interim final rules under ERISA Section 408(b)(2) will require detailed disclosures by pension consultants commencing in July 2011. Accordingly, we would suggest that the next step should be a review by the Department to determine if there continues to be any potential for abuse that is not sufficiently remedied by

the Section 408(b)(2) regulations. This would enable the Department to determine whether rulemaking is necessary and, if so, how that rulemaking can be tailored to most effectively address the current practices.

Part V: Critical Changes That Would Be Necessary If the Proposed Rule Is Adopted

For the reasons discussed above, we would encourage the Department to withdraw the proposed Rule. If the Department decides to move forward, we believe that the Proposed Rule should be subject to a more rigorous study by the Department and should be delayed until the ongoing priorities under the Dodd-Frank Act are completed and the Department and market participants have had sufficient time to analyze the manner in which the Department's initiative can be coordinated with the new rules under the Dodd-Frank Act.

If the Department ultimately chooses to work with the Proposed Rule in its current form, a number of modifications and ancillary measures would be required, including the following:

- Delete the provision of the Proposed Rule which defines investment advice by reference to the Advisers Act.

- Provide guidance on the meaning of the terms "advice," "recommendations" and "individualized" for the purpose of the Proposed Rule. Given the vagueness that would be introduced by deletion of the Five-Part Test, guidance on the intended meanings of these terms is essential.

- Exclude from the definition of "investment advice" services provided by parties not intended to be investment fiduciaries under ERISA, including accountants, actuaries, lawyers, information providers and valuation firms not acting as agents of plans.

- Expand the Transaction Exception under the Proposed Rule to cover (i) the sale of services and information and extensions of credit; (ii) sales and purchases by or through intermediaries other than agents of the seller/purchaser where, by definition, the intermediary has a potential misalignment of interest (e.g., brokerage and agency transactions); and (iii) situations involving arrangements other than sales (e.g., the provision of property, information or services without charge in connection with promotions or as an adjunct to a transactional relationship).

- Revise the Proposed Rule to (i) make clear that a party will not be deemed to be an ERISA fiduciary as a result of providing information, advice or recommendations to a plan representative who meets established criteria of sophistication under ERISA authorities (e.g., QPAMs) and (ii) permit a fairer basis for determining whether an investment advisory scenario exists when a non-advisory service provider offers incidental advice or recommendations to a plan customer or provides assistance to a sophisticated plan representative (e.g., a named fiduciary or trustee of a plan with assets in excess of $50M).

- Conduct a further study as to whether investment advice should include recommendations relating to the manner and timing of plan distributions. This aspect of the Proposed Rule has precipitated legitimate debate and warrants further study.

- Prepare a study of the impact of the Proposed Rule on the existing framework of ERISA exemptions covering plan transactions, and propose for public comment appropriate clarifying guidance and exemptions prior to the effective date of the Proposed Rule.

* * *

We appreciate the opportunity to participate in this process and would be pleased to discuss our comments or any questions the Department may have with respect to this letter. Any questions about this letter may be directed to Edmond T. FitzGerald or Erin K. Cho at 212-450-4000.

Respectfully submitted,

DAVIS POLK & WARDWELL LLP