DOL Proposes Rule Redefining Fiduciary Status in the Investment Advice Context

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Background

The Department of Labor (DOL) released its long-awaited re-proposed rule (the 2015 Proposed Rule) defining when a person will be deemed a fiduciary investment adviser under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (Code) on April 14, 2015. See 80 Fed. Reg. 21928 (April 20, 2015). The DOL's proposed rule for a new fiduciary standard will have a farreaching impact on the retirement services community, and in particular, consultants, broker-dealers and others that have relied on the existing regulation to shield them from ERISA fiduciary status. This proposal includes significant changes from the 2010 release and marks a second DOL attempt to greatly expand ERISA fiduciary status to persons selling or recommending investments in the retail market.

The 2015 Proposed Rule is designed to replace the regulation that has been in effect since 1975 (29 C.F.R. § 2510.3-21(c)), and, when released in final form, will make it much easier for anyone consulting, selling or recommending investment options to plans, plan fiduciaries, participants, individual retirement accounts (IRA) or IRA owners to be deemed a fiduciary within the meaning of ERISA section 3(21)(A). The proposed changes would apply any time a person provides one of four categories of investment advice to plans, plan fiduciaries, participants, IRAs or IRA owners for a fee. As discussed more fully below, the 2015 Proposed Rule significantly expands the universe of persons who may be deemed to be a fiduciary adviser subject to ERISA's standard of care and prohibited transaction provisions. The 2015 Proposed Rule also expands the arrangements that are covered. Like the 2010 proposed rule, the 2015 Proposed Rule captures advice to IRAs, a non-ERISA covered tax-favored investment vehicle. Departing from the 2010 rule, however, the DOL is also proposing to include investment advice to other non-ERISA plans, such as Health Savings Accounts, Archer Medical Savings Accounts and Coverdell Education Savings Accounts.

The 2015 Proposed Rule includes several carve-outs for situations that the DOL has concluded should not be confused with fiduciary activity. Simultaneously, with the proposed redefinition of investment fiduciary, the DOL also proposed two new prohibited transaction class exemptions and amendments to several existing class exemptions.

The existing regulation sets a high bar for who can be deemed a fiduciary in the investment advice context. For persons who do **not** have discretion to affect the sale or purchase of securities or other property for a plan, the current regulations create a five-part test that must be satisfied before a person can be deemed a fiduciary within the meaning of ERISA Section 3(21)(A)(ii), which provides that a person is a fiduciary if the person "renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or property of a plan, or has any authority or responsibility to do so." The existing regulation provides that a person **without** investment discretion shall be deemed a fiduciary giving "investment advice" only if: (1) the person renders advice as to the value of securities or other property or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property, (2) the person does so on a regular basis and (3) pursuant to a mutual understanding, written or otherwise, (4) the advice will serve as the primary basis for investment decisions with respect to plan assets, and (5) the advice will be individualized based on the particular needs of the plan. Under the existing regulations, any investment advice that is provided on a one-time basis would not give rise to fiduciary obligations, irrespective of whether the recipient of the advice relied on that advice to make an investment and irrespective of whether the advice was based on knowledge of the individual's investment needs.

The DOL believes that the 1975 regulation is outdated because, when the rule was released, participant-directed 401(k) plans were virtually non-existent as were the common rollovers from "fiduciary protected plans to IRAs." 80 Fed. Reg. 21928. The DOL believes that, as a result of today's very different investment reality, the five-part test

allows many "investment professionals, consultants, and advisors [to] have no obligation to adhere to ERISA's fiduciary standards or to the prohibited transaction rules, despite the critical role they play in guiding plan and IRA investments." *Id.* The DOL therefore believes that without the proposed amendments, these advisers are free to provide investment advice with conflicts of interest that they need not disclose, resulting in these advisers steering customers to investments that benefit the adviser and not his or her customer. *Id.* In general, the investment institutions have countered that the DOL's allegations are not factually supported, and they have raised concerns that the DOL's proposed amendments to the 1975 regulation will ultimately result in limiting badly needed advice to the very market that the rule seeks to protect.

To say that the 2015 Proposed Rule is controversial is an understatement. The DOL has been trying to replace the 1975 regulations since 2010, when it first released a proposed rule redefining an investment fiduciary. In time, the DOL was forced to withdraw the 2010 rule due to fierce political opposition primarily from investment institutions and their industry lobbyists. In the intervening years, the rule has continued to come under attack by the investment community, and both sides have engaged in intense lobbying, at times resulting in legislative proposals attempting to thwart the DOL's authority to re-propose the rule.

II. The 2015 Proposed Rule

Under the proposed rule, a person is subject to ERISA's fiduciary standards if the person receives a fee or other compensation for:

1. Providing investment or management recommendations or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, an IRA or IRA owner; **and**
2. Either directly or indirectly
    a. Acknowledges his/her fiduciary status; or
    b. Acts pursuant to an agreement, arrangement, or understanding with the recipient of the advice that the advice is individualized or specifically directed, to the recipient for consideration in making investment or management decisions regarding plan assets.

Advice constitutes fiduciary "investment advice" if the advice falls under any of the following four categories:

i. **recommendations as to the advisability** of acquiring, holding, disposing of or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA;

ii. **recommendations as to the management** of securities or other property, including as to securities or property to be rolled over or otherwise distributed from the plan or IRA;

iii. **appraisals, fairness opinions** or similar statements (verbal or written) concerning the value of securities or other property if provided in connection with a specific transaction or transactions involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA;

iv. **recommendations of a person** who is also going to receive a fee or other compensation for providing any of the types of advice in (i) through (iii).

III. Carve-Outs to Fiduciary Status

Recognizing that the four categories of investment advice could inadvertently capture non-fiduciary service provider activity, the 2015 Proposed Rule includes a carve-out for the following activities that the DOL does not believe give rise to fiduciary status:

1. **Seller's Carve-Out:** In general, this carve-out excludes incidental advice provided in connection with an arm's length sale, purchase, loan, or bilateral contract between a plan fiduciary with investment expertise (the buyer) and a seller counterparty (i.e. a broker-dealer) to the transaction. As discussed below, this carve-out is only available to large plans. The DOL has stated that the overall purpose of this carve-out is to avoid

imposing fiduciary obligations on sales pitches that are part of arm's length transactions where neither side assumes that the counterparty to the plan is acting as an impartial trusted adviser, even though the counterparty is making representations about the value and benefits of the proposed deal.

The carve-out is subject to several conditions. First, the advice can only be provided to a plan fiduciary that has no financial or other relationship to the counterparty. Second, one of two alternative conditions must be present:

a. Alternative one requires that (i) the counterparty receive a written statement from the independent plan fiduciary that he or she is an ERISA fiduciary that exercises authority or management over the plan or its assets; (ii) the plan must have 100 or more participants; (iii) the plan fiduciary understands the counterparty is not acting in the interest of the participants; (iv) the counterparty discloses its financial interest to the plan fiduciary; (v) the counterparty does not receive a fee from plan assets; and (vi) the counterparty reasonably believes that the plan fiduciary has the expertise to understand the transaction.

b. Alternative two applies if the counterparty (i) reasonably knows that the independent plan fiduciary has responsibility for $100 million or more in employee benefit plan assets; (ii) informs the independent plan fiduciary that he or she is not providing impartial investment advice; (iii) does not receive a fee from plan assets; (iv) discloses its financial interest to the plan fiduciary; and (v) reasonably believes that the plan fiduciary has the expertise to understand the transaction. Alternative two therefore does not require written assurance from the independent plan fiduciary that he or she can act with discretion over the plan or its assets. The regulation also provides that the counterparty can rely either on the Form 5500 disclosures or an authorized asset manager (in the case of a multiple employer benefit plan) to confirm the dollars under management in the plan.

2. **Swap Carve-Out:** Swap dealers, security-based swap dealers, major swap participants and security-based major swap participants who make recommendations to plans would avoid fiduciary status when acting as counterparties to a swap or security-based swap transaction.

3. **Employees of the Plan Sponsor Carve-Out:** Statements/recommendations made by an employee of the plan sponsor to plan participants would not be treated as investment advice of a fiduciary, provided that the employee receives no additional compensation for the advice beyond the employee's normal compensation.

4. **Platform Providers/Selection and Monitoring Assistance Carve-Out:** This carve-out is directed at service providers such as recordkeepers and third party administrators that offer a selection of investment vehicles also referred to as a "platform" to participant-directed 401(k) plans. In general, a platform service provider will not be deemed an investment advice fiduciary, provided that the offering is not made based on the individualized needs of the plan, its participants, or its beneficiaries. The platform service provider also must provide a written disclosure that they are not providing impartial investment advice. These individuals may identify investment alternatives using objective criteria or provide objective financial data. Any advice that is individualized or otherwise directed at the specific needs of the plan would likely render the carveout unavailable. This carve-out would not apply to IRAs or other non-ERISA plans based on the theory that, in those situations, there would not be an independent plan fiduciary that could act on behalf of the investor.

5. **Educational Materials Carve-Out:** Furnishing or making available specific categories of educational information and materials to a plan, plan fiduciary, participant, beneficiary IRA or IRA owner would not be deemed investment advice provided that carve-out criteria are met. Education materials include: (i) plan information, (ii) general financial, investment and retirement information, (iii) asset allocation models, and (iv) interactive investment materials. This carve-out would supersede large sections of the DOL's existing guidance on participant education (Interpretive Bulletin 96-1). The following advice is expressly not covered under this carve-out: (a) advice or recommendations as to specific investment products, specific investment managers, or the value of particular securities or other property; and (b) asset allocation models and interactive materials that refer to specific investment products available under the plan or IRA.

6. **Appraisal Carve-Out:** This carve-out would exclude from the definition of investment advice appraisals, fairness opinions, or statements of value provided to (i) an investment fund holding assets of various investors in addition to at least one plan or IRA, or to (ii) ESOPs. The exclusion of ESOP appraisals from the 2015 Proposed Rule is a significant deviation from the 2010 proposal. ESOP industry lobbyists fought hard to keep ESOP appraisals from inclusion in the definition of fiduciary investment advice. The DOL has promised to issue guidance specific to ESOP appraisals in the future. Valuations provided solely for purposes of compliance with the reporting and disclosure provisions of ERISA, the Code, and any state/federal law are also excluded from the definition of investment advice.

VI. Overview of DOL's Proposed New Class Exemptions and Changes to Existing Class Exemptions

Because the 2015 Proposed Rule dramatically lowers the threshold of who can be deemed a fiduciary investment adviser, the proposal adds two new prohibited transaction class exemptions (PTEs) and amends six existing exemptions. Below is a summary of the new exemptions and proposed changes to the existing exemptions.

A. Proposed "Best Interest Contract Exemption"

This proposed exemption is designed to provide relief to fiduciaries who provide investment advice to plan participants and beneficiaries, IRAs, and certain employee benefit plans with fewer than 100 participants, also referred to as "retirement investors." The proposed exemption would allow investment advisers to retirement investors to receive compensation if they adhere to the following criteria:

- Contractually acknowledge fiduciary status;
- Contractually agree to adhere to basic standards of impartial conduct, which include (i) providing advice that is in the "best" interest of the recipient, (ii) receiving compensation that in total is reasonable, and (iii) making no statements that are materially misleading;
- Contractually warrant that they will comply with all applicable laws and that they have adopted policies and procedures to mitigate conflicts of interest; and
- Contractually disclose basic information on their conflicts of interest and on the cost of their advice.

The contract cannot include any exculpatory clauses or a provision that the retirement investors waive or qualify their right to bring or participate in a class action or other representative action in court, in the event there is a dispute with the Adviser or Financial Institution. Under the exemption, an "Adviser" is an individual person who is an investment advice fiduciary of a plan or IRA, and is also an employee, independent contractor, agent, or registered representative of a Financial Institution. A "Financial Institution" is an entity that (i) employs an Adviser or otherwise retains an Adviser as an independent contractor, agent or registered representative and (ii) is a registered investment adviser, bank, insurance company, or registered broker-dealer.

B. Proposed "Principal Transaction Exemption"

The proposed PTE allows broker-dealers and other advisers that sell their own inventory to plans, participants and beneficiaries, and IRA owners to receive a fee without engaging in what would otherwise be a prohibited transaction. The proposed PTE would include all of the requirements of the Best Interest Contract Exemption. In addition, the adviser would have to obtain two price quotes from unaffiliated counterparties for the same or similar security. The transaction with the plan would have to occur at a price at least as good as the two price quotes and the contract would have to include disclosures explaining the financial conflicts of interest under which the adviser operates.

C. Amendment to Existing Class Exemptions

The DOL also proposes to amend the following PTEs:

- PTE 86-128 currently permits the receipt of fees (brokerage commissions) by a plan fiduciary or its affiliate for "effecting or executing" securities transactions as agent for the plan, but only if trading is not excessive in amount or frequency (i.e., no "churning"). The exemption is not available if the fiduciary is a discretionary trustee, plan administrator or plan sponsor. The existing class exemption does not apply to IRAs. The 2015 Proposed Rule would incorporate the Best Interest Contract Exemption into PTE 86-128 and apply to investment advice to IRAs.

- PTE 75-1 is a multi-part exemption for securities transactions between broker-dealers and banks as well as transactions between plans and IRAs. The DOL is proposing to revoke Parts I(b) and (c) and replace them with the statutory service provider exemptions in ERISA Section 408(b)(2) and the parallel provision for non-ERISA plans in Code Section 4975(d)(2). These statutory exemptions allow transactions between a plan and a service provider, provided that the services are necessary to the plan, the contract and fees are reasonable, and there is no fiduciary self-dealing.
- PTE 75-1, Part 2(II) currently allows fiduciaries to receive a fee for selling mutual fund shares to plans and IRAs. The DOL is proposing to revoke Part 2(II) because it believes that the amendments to 86-128 will provide a better exemption for these types of transactions.
- PTE 75-1, Part V currently allows broker-dealers to extend credit to a plan or IRA in connection with the purchase or sale of securities. The proposed amendment would prohibit an investment advice fiduciary from extending credit to a plan or IRA in connection with these types of sales except for the limited purpose of avoiding a failed securities transaction.
- PTE 84-24 currently includes exemptions for agents, brokers, and pension consultants in connection with the purchase of an insurance or annuity contract as well as an exemption for commissions received by a principal underwriter in connection with the purchase of mutual fund shares. The revision to this PTE would require all fiduciaries relying on this exemption to adhere to the same standard in the Best Interest Contract PTE.
- With respect to PTEs 77-4, 80-83, and 83-1, the DOL proposes to incorporate the Best Interest Contract requirements into these existing exemptions.

Industry Implications/Analysis and Next Steps

If enacted, the 2015 Proposed Rule will require that the investment community carefully examine its compensation practices and review its contracts to ensure that the contracts incorporate the new disclosure requirements. There is no question that a driving force behind the 2015 Proposed Rule is the goal of shining light on investment advice in the rollover IRA market. The irony of course is that the DOL would lack enforcement authority over IRAs because they are not ERISA-covered plans. Any enforcement in this market would have to be done by the Internal Revenue Service through the imposition of an excise tax. Given that the IRS is already over-extended, it is unclear whether these broad proposed changes to the existing regulations will result in more policing over IRA investments.

Critics, however, foresee a number of unintended consequences and fear, for example, that the 2015 Proposed Rule might effectively cut off investment assistance to low and middle-income individuals, reduce the likelihood that small businesses (currently without a plan) would offer a plan, and increase the chances that small businesses currently offering a plan would drop the plan. It remains to be seen how the 2015 Proposed Rule would impact this tension, especially given the proposal's requirement that professional roles be more clearly specified in writing.

Comment Period

The DOL initially provided for a 75-day comment period that would close on July 6, 2015. On May 18, 2015, the DOL extended the comment period by an additional 15 days, making the new closing date July 20, 2015. The final rule, the Best Interest Contract PTE, and other new and revised PTEs will become effective 8 months after publication. The DOL plans to hold an administrative hearing within 30 days of the close of the comment period.