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Once More Unto the Breach—The New "Fiduciary" Definition

On April 14, 2015, the Department of Labor (the "Department") re-proposed regulations (the "Proposed Regulations") that define when someone becomes a fiduciary by reason of providing "investment advice for a fee or other compensation." The Proposed Regulations are the Department's second attempt at rules that were originally published in 2010 but were subsequently withdrawn in the face of determined opposition from Congress, financial services providers, and others in the retirement plan community.

If finalized, the Proposed Regulations would replace a "five-part test" that was adopted by the Department in 1975, shortly after the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"). The Department now believes that the 1975 test is outdated, and that in today's ubiquitous defined contribution environment, the Proposed Regulations will better protect plan participants and individual retirement account ("IRA") owners. One of the avowed objectives of the Proposed Regulations is to expand the universe of investment professionals, advisers, and other service providers who can be held liable under the fiduciary standards of ERISA, especially in the "retail" market for smaller plans and IRAs. By making more advisers "fiduciaries," the Department's proposal will subject more advisers to conflict of interest restrictions and, in many cases, impose ERISA-like duties on IRA advisers to whom the statutory rules of ERISA do not apply.

Background

Under ERISA, a person is a fiduciary with respect to an employee benefit plan to the extent the person engages in certain activities, or performs certain functions, one of which is providing "investment advice for a fee or other compensation, direct or indirect," with respect to the assets of the plan. The same definition of "fiduciary" applies under the Internal Revenue Code (the "Code") with respect to IRAs. If a person is a fiduciary with respect to an employee benefit plan, that person is subject to ERISA's fiduciary duty standards, including the duty to act solely in the interest of the plan and its participants and beneficiaries (duty of loyalty), and the obligation to act with the care, skill, prudence, and diligence that a prudent person would use in similar circumstances (duty of prudence). In addition, fiduciaries of both employee benefit plans and IRAs are subject to strict prohibited transaction rules and conflict of interest restrictions under ERISA and the Code. Fiduciaries of employee benefit plans who breach their duties can be held personally liable under ERISA, but the Code's remedies against IRA

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fiduciaries are generally limited to the imposition of prohibited transaction excise taxes. IRA fiduciaries, although subject to prohibited transaction restrictions, are currently not subject to the standard of care that applies to an ERISA fiduciary (i.e., duties of loyalty and prudence).

The determination of who is a "fiduciary" is of critical importance, since so many duties and remedies apply only to fiduciaries. In 1975, in the early days of ERISA, the Department issued a regulation that attempted to come up with a rule that interpreted the phrase "investment advice"—which would be subject to fiduciary duties—while distinguishing it from other conduct that was commonplace in the financial markets but had never been understood as requiring the heightened standard of care of fiduciary status, such as selling (where the seller is not attempting to represent the interests of the buyer), execution of trades, sales pitches, and market research. Among other things, the 1975 regulation provided that conduct was "investment advice" subject to ERISA's fiduciary duties only if the advice was provided on a "regular basis," formed the "primary basis" for the plan's investment decisions, and was individualized based on the particular needs of the plan.

The current retirement landscape is unquestionably different than in 1975, with a shift away from traditional defined benefit pension plans to self-directed 401(k) plans and IRAs. In the current environment, the Department has become convinced that the existing five-part test allows too many retirement advisers to escape liability through boilerplate disclaimers and other practices, or through the technical workings of the five-part test. As a result, in 2010, the Department proposed a new regulation that would replace the five-part test with a new definition of what constitutes "investment advice for a fee." While the Department described the 2010 proposal as an "update" of the 1975 rules, the explicit goal was to replace the original rule entirely with new standards that would significantly expand the number of advisers, and activities (especially in the IRA market), that could be held accountable under ERISA or the prohibited transaction rules. The 2010 proposal drew a large number of comments from Congress, the financial industry, and retiree advocacy groups. In 2011, the Department announced that it had withdrawn the rule for reconsideration and further study, and that it planned to repropose the rule at a later date.

The Department now feels that its own 1975 regulation "significantly narrowed the breadth of the statutory definition" and finds fault with the regulation for adding a five-part test not found in the text of ERISA or the Code. To remedy these perceived shortcomings, the Department is now proposing a different regulation that appears to expand the statutory definition and is expressed in a substantially greater number of words and phrases also not found in the text of ERISA or the Code. In addition, the new proposal would effectively make IRA fiduciaries subject to ERISA's duties of prudence and loyalty, despite the fact that the text of ERISA and the Code provide no basis for doing so.

Summary of Re-Proposed Rule

The general approach of the Proposed Regulations is to apply a very broad definition of "fiduciary advice," coupled with narrow exceptions in the form of so-called "carve-outs." The Proposed Regulations provide that a person provides "investment advice for a fee" if the person provides, directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner any of the following types of advice in exchange for a fee or other compensation, whether direct or indirect:

- A recommendation as to the advisability of acquiring, holding, disposing, or exchanging securities or other property, including a recommendation to take a distribution from a plan or IRA, or with respect to investments related to a rollover;
- A recommendation as to the management of securities or other property, including the management of securities or property to be rolled over or otherwise distributed from a plan or IRA;
- An appraisal, fairness opinion, or similar advice concerning the value of securities or other property if provided in connection with a specific transaction involving the acquisition, disposition, or exchange of securities or other property; or
- A recommendation regarding the selection of money managers.

In addition, in order to be a fiduciary by virtue of providing the foregoing types of advice, the person providing the advice must have either:

- Represented or acknowledged that it is acting as a fiduciary; or
- Provided the advice pursuant to a written or verbal agreement, arrangement, or understanding that the advice is "individualized to" or that such advice "is specifically directed to" the advice recipient "for consideration" in making investment or management decisions.

Carve-outs

The Proposed Regulations include several "carve-outs" from the broad fiduciary definition. Advice or other communications covered by a carve-out will not cause the person providing the advice to become a fiduciary. The carve-outs (each of which includes details and interpretive challenges) cover:

- Certain arm's-length transactions entered into with large plans with financial expertise (Note: this is the only "seller's" carve-out in the Proposed Regulations. No similar "seller's" exception is available for small plans or IRAs.);
- Swap and security-based swap transactions that meet the business conduct standards adopted under Dodd-Frank regulations from the CFTC and SEC;
- Advice, analysis, and reports provided by employees of the plan sponsor to the plan's fiduciaries (e.g., reports and analysis from employees of the benefits or finance departments to the plan committee regarding investment performance or the plan's lineup of investment options);
- Marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for a participant-directed plan;
- Identification of investment alternatives that meet objective criteria specified by a plan fiduciary or the provision of objective financial data to such fiduciary;
- Appraisals, fairness opinions, or statements of value to an ESOP regarding employer securities, to a collective investment vehicle holding plan assets, or to a plan for meeting reporting and disclosure requirements; and
- Information and materials that meet the new (and narrower) definition of "investment education" or "retirement education."

Related PT Exemptions

To account for the fact that many advisers who previously were not fiduciaries would become so under the Proposed Regulations, the Department would add two new prohibited transaction class exemptions ("PTCEs"), amend several others, and revoke portions of other existing PTCEs.

Instead of providing any type of "seller's" exception for the small plan and IRA market, the Department introduced a new "Best Interest Contract Exemption" for those markets. The Best Interest Contract Exemption would allow certain common fee arrangements, such as commissions and revenue sharing. However, in order to qualify for the relief, the adviser and the adviser's employer must (i) acknowledge fiduciary status, (ii) commit to adhere to an "Impartial Conduct Standard" that requires advice to be in the "best interest" of the plan participant or IRA owner—a standard that combines ERISA's duties of loyalty and prudence and arguably goes even further, (iii) adopt policies and procedures reasonably designed to minimize the harmful impact of conflicts of interest, (iv) disclose information on any conflicts of interest and all fees, direct or indirect, (v) make several affirmative warranties, including that the adviser's financial institution does not use bonuses or other compensation incentives that would "tend to encourage" individual advisers to make recommendations that are not in the best interest of the plan participant or IRA owner, and (vi) commit to making all documents and records "unconditionally available" to the Department. The contract with the adviser is prohibited from including exculpatory provisions, and the adviser must also provide *advance notice* to the Department of its intention to rely on the Best Interest Contract Exemption.

In many cases, the amended PTCEs include additional conditions and limitations, generally including a requirement that the adviser agree to adhere to the Best Interest Contract Exemption. The scope of the PTCE changes is beyond the scope of this *Commentary*, but suffice it to say that in many or most cases, the price of qualifying for an exemption will be an acknowledgement of fiduciary status and new exposure to liability (especially for IRA advisers, who effectively have to agree to become subject to ERISA fiduciary standards in order to qualify for an exemption from prohibited transaction excise taxes for certain fee arrangements).

Comment Period and Effective Date

The initial deadline for comments on the Proposed Regulations is set to end on July 6, 2015 (75 days after publication of the Proposed Regulations in the *Federal Register*). In light of the fact that the Proposed Regulations are longer and more complicated than the 2010 proposal, and include a series of new or modified prohibited transaction exemptions, the 75-day comment period is likely to be regarded as insufficient. Several prominent financial services trade groups have already requested that the comment period be extended. The Department will hold a public hearing following the close of the initial comment period, and it will allow additional comments to be filed after the hearing.

If the Proposed Regulations are finalized, the final regulations are set to become effective 60 days after publication in the *Federal Register*, and would generally become "applicable" eight months after publication of the final rule. Many in the financial services industry feel that eight months is not a realistic time frame to adjust products, fees, marketing materials, and compliance systems to such a far-reaching set of new requirements.

Preliminary Observations

Given the fact that the Proposed Regulations are substantially different from the 2010 proposal and replace a set of rules and related exemptions that have been relied on by investment firms for up to 40 years, the impact of the Proposed Regulations will be significant and widespread. The following are some of our preliminary observations.

- Any person who regularly provides advice or services to retirement plans or IRA owners with respect to investment products or investment decisions will have to carefully review all products and services in light of the proposed rules.
- Many advisers, especially in the small plan and IRA markets, will likely become fiduciaries for the first time and must evaluate all fees and arrangements. For many of those advisers, the Proposed Regulations will force a choice between accepting the significant restrictions of the Best Interest Contract Exemption or giving up certain kinds of fees and revenue sharing.
- The Proposed Regulations would not require that advice be individualized to the needs of the plan, participant, or IRA owner. If the advice merely is "specifically directed to" the participant or IRA owner, that would be sufficient to cause it to be fiduciary advice. This is an expansion of the 2010 proposal.
- In response to comments to the 2010 proposal, the Preamble to the Proposed Regulations states that the new rules clarify that lawyers, accountants, and actuaries would not be treated as fiduciaries merely because they provide such professional assistance in connection with a particular investment transaction. Despite the Preamble statement, however, the actual language of the proposal is not clear on this point, and there is no express carve-out for such professional services.
- Fiduciary investment advice would include a recommendation to a plan participant on how to invest the proceeds of a contemplated plan distribution (e.g., a rollover distribution). This reverses the Department's prior position, represented by a 2005 advisory opinion. However, a person would not act as a fiduciary merely by providing information about plan or IRA distribution options, including the consequences associated with available types of distributions. The line between providing information in this context and making a recommendation is difficult to trace and will undoubtedly lead to interpretive challenges.
- As part of the "platform provider" carve-out, merely identifying investment alternatives that meet objective criteria specified by a plan fiduciary, or merely providing objective data for comparison of investment alternatives with independent benchmarks, would not be treated as fiduciary investment advice. However, recommending an investment manager or investment option would be fiduciary investment advice (as it would be under current law). In some cases, there could be a very fine line between these two categories of advice. It would not be hard to imagine circumstances in which providing benchmark data under the carve-out, coupled with a list of investment alternatives meeting objective criteria established by the plan fiduciary (also under the carve-out), could in practice get very close to the recommendation of specific investment options from the list, in which case the distinction starts to blur.
- In a departure from existing law that has been in effect since 1996, the carve-out for "investment education" would not permit the use of asset allocation models that

refer to specific investment products available under the plan or IRA. Plan sponsors and committees, as well as the advisers who assist plans in designing investment education materials for plans, will need to carefully review their current education tools in light of the Department's new, narrower view of "education."

- In response to comments, the Department added carve-outs for valuations, appraisals, and statements of value provided to pooled investment vehicles that hold "plan assets." However, the language of the actual carve-outs is too narrowly drawn at present, and it does not match the Department's own summary of the carve-outs in the Preamble to the Proposed Regulations.

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