DOL RE-PROPOSES RULE TO MAKE BROKERS, OTHERS, ERISA FIDUCIARIES

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Investment Management Alert

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After almost five years of debate, the U.S. Department of Labor ("DOL") is again trying to modify the ERISA definition of "fiduciary" as it relates to providing investment advice.

On April 14, 2015,[1] DOL re-proposed rules (the "Proposal") to expand the fiduciary definition to address perceived conflicts of interest in connection with recommendations made to retirement plans, plan participants, and individual retirement accounts ("IRAs"). DOL simultaneously proposed new prohibited transaction class exemptions ("PTEs") and amendments to existing PTEs. If adopted, the Proposal will greatly expand the number and types of people that will be fiduciaries under the Employee Retirement Income Security Act of 1974 ("ERISA"), including many broker-dealers, individual financial advisers or representatives, and pension consultants. In addition, the Proposal and the proposed PTEs will place additional compliance burdens on new and existing fiduciaries alike. The proposed PTEs and amendments are intended, in part, to permit some current practices to continue while imposing conditions that DOL views as protective. The simultaneous proposal is intended to allow the industry to evaluate whether and how it can navigate the proposed changes. If adopted, the Proposal and proposed PTEs will have a particularly significant impact on the financial services industry as well as IRAs and 401(k) plans.

The Proposal's comment period ends July 6, 2015, after which DOL will hold a public hearing and solicit additional comments. DOL states that final regulations will become effective eight months after the final regulations are adopted.

I. POLITICAL CONTEXT

DOL, working in conjunction with the Obama Administration, has worked extensively to reformulate the Proposal and respond to previous criticisms. President Barack Obama included a reference to the fiduciary rule in his 2015 State of the Union Address, making the issue part of the Administration's agenda and thereby elevating its profile. Momentum for the Proposal picked up on February 23, when President Obama, DOL Secretary Thomas Perez, and several liberal and moderate Democrats announced their support for the Proposal at an event sponsored by the AARP. During the conference, President Obama reinforced the Proposal's link to the Administration's agenda of promoting middle-class economics and the crisis of retirement security in America. He strongly criticized "back-door payments" and "hidden fees" received by investment advisers and broker-dealers, and called for an end to conflicted investment advice.

II. EXPANSION OF FIDUCIARY DEFINITION, ELIMINATION OF FIVE-PART TEST

Under ERISA Section 3(21) a person acting in a non-discretionary capacity is an ERISA fiduciary "to the extent" he or she renders investment advice to a plan for a fee (or has any responsibility to do so).[2] This is important not only for purposes of the fiduciary duty and prohibited transaction provisions that apply to retirement plans under Title I of ERISA, but also for purposes of the prohibited transaction provisions that apply to retirement plans, IRAs, and other tax-favored savings accounts (such as Coverdell Education Savings Accounts and Health Savings Accounts) under the Internal Revenue Code ("Code").[3] The current and longstanding regulation[4] limits this aspect of the fiduciary definition to a person that satisfies each part of a five-part test: the person provides advice (1) for a fee, (2) on a regular basis, (3) pursuant to an express or implied mutual agreement, arrangement, or understanding that (4) such advice will serve as the primary basis for investment decisions, and (5) the advice will be based on the particular needs of the plan.

The Proposal would replace the 5-part test with a new definition under which a person would render fiduciary investment advice if: (1) for a fee or other compensation, direct or indirect, (2) he or she provides investment or investment management recommendations (including recommendations regarding distributions or rollovers) or appraisals to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner, and (3) either (a) acknowledges the fiduciary nature of the advice, or (b) acts pursuant to an agreement, arrangement, or understanding with the advice recipient that the advice is individualized to, or specifically directed to, the recipient for consideration in making investment or management decisions regarding plan or IRA assets.

If the Proposal is adopted, people who provide recommendations or suggestions about retirement-related investments would be much more likely to be ERISA fiduciaries because the Proposal removes or alters a number of the elements in the existing definition. For example: (i) advice would no longer need to be provided on a "regular" basis; a single recommendation would be enough to confer fiduciary status; (ii) the advice would no longer need to be the "primary" basis for the advice recipient's decision; just the fact that it is considered would be enough; and (iii) there would be no need for a "mutual" agreement that the advice be based on the "particular needs" of the plan; just an understanding that the advice is individualized for or specifically directed to the recipient.[5]

The Proposal states that if the advice provider acknowledges its fiduciary status with respect to the advice, that person is automatically a fiduciary. As a contractual acknowledgement of fiduciary status is built into the new "Best Interest Contract Exemption" (discussed further below), which many service providers will presumably need to comply with in order to avoid prohibited transactions, anyone attempting to comply with the Best Interest Contract Exemption would lose the ability to argue that it was not an ERISA fiduciary.

The Proposal specifically provides that the following types of communications constitute fiduciary investment advice:

- recommendations regarding the acquisition, holding, disposing or exchanging of securities or other property, notably including recommendations to take a distribution or recommendations as to the investment of securities or other property to be rolled over or otherwise distributed from an ERISA plan or IRA;[6]
- recommendations as to the management of securities or other property, including individualized advice or recommendations as to proxy voting;

- appraisals or valuations of investments in connection with specific transactions (excluding valuations done solely to comply with reporting and disclosure provisions required by law, regulation, or self-regulatory organization, appraisals to collective investment funds or pooled separate accounts, and appraisals of employer securities to ESOPs); and
- recommendations on the selection of other fiduciary investment advisers or investment managers.

A "recommendation" under the Proposal is defined broadly to mean any "communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action." DOL is soliciting comments to determine whether it should adopt FINRA standards to assist in evaluating whether a particular communication could be viewed as a recommendation.

III. CARVE-OUTS AND EXCLUSIONS

There are a number of potentially useful carve-outs built into the Proposal. If a carve-out applies, then the person who would otherwise be considered a fiduciary by reason of providing investment advice would not be a fiduciary.[7]

A. The "Seller's Carve-Out"

The "Seller's Carve-Out" covers certain statements or recommendations made to a sophisticated ERISA plan fiduciary of a large plan (at least 100 participants) by a counterparty acting in an arm's-length transaction. Although deemed the "seller's" carve out, it would cover any incidental advice made in connection with an arm's-length sale, purchase, loan, or bilateral contract. Prior to making any recommendation with respect to the transaction, the counterparty must make disclosures and satisfy certain conditions designed to confirm that the independent plan fiduciary is sufficiently sophisticated and aware of the impartial nature of the recommendation.

The Seller's Carve-Out does NOT cover advice made to small plans, IRA owners, or plan participants and beneficiaries (e.g., in defined contribution plans under which participants direct their investments). For IRA owners, plan participants and beneficiaries, and plan sponsors of small, non participant-directed plans, the Best Interest Contract Exemption (discussed below) would be available for those arrangements, provided its conditions are met.[8]

B. Swap Recommendations

The Proposal would generally not cover offers or recommendations to independent plan fiduciaries of ERISA plans by swap dealers or major swap participants to enter into a swap that is regulated under the Securities Exchange Act or the Commodity Exchange Act, provided the swap counterparty obtains a written representation that the plan fiduciary will not rely on the swap counterparty's recommendations.

C. Employees

The Proposal would not cover statements or recommendations provided to a plan fiduciary of an ERISA plan by an employee of the plan sponsor acting in its capacity as employee, if the employee receives only his or her normal compensation.

D. Platform Providers

The Proposal would not cover the marketing of a non-individualized, pre-packaged, platform, or similar mechanism, to a participant-directed ERISA plan, through which a plan fiduciary may select or monitor investment alternatives, provided the platform provider discloses to the plan fiduciary that the provider is not undertaking to provide impartial investment advice or advice in a fiduciary capacity. A platform provider can also assist the plan fiduciary with identifying investment alternatives that meet objective criteria specified by the plan fiduciary and providing objective financial data and comparisons with independent benchmarks without being considered to provide fiduciary investment advice.

This carve-out would not be available with respect to IRAs and other tax-favored retirement vehicles that are not ERISA plans.

E. Certain Valuations and Appraisals

As mentioned above, the Proposal would carve out valuations done solely to comply with reporting and disclosure provisions required by law, regulation, or self-regulatory organization, appraisals to collective investment funds or pooled separate accounts, and appraisals regarding employer securities given to ESOPs. DOL notes that it remains concerned about ESOP appraisals and indicated that it may address that issue in a separate regulation.

F. Education

The Proposal generally adopts DOL's long-standing view that investment "education" is not fiduciary investment advice. The types of activities constituting education under the Proposal, such as basic information about the plan; general financial, investment, and retirement information; and asset allocation models, generally match up with those listed in Interpretive Bulletin 96-1 (which would be superseded). Importantly, however, the use of asset allocation models that identify specific investment alternatives would no longer be treated as non-fiduciary investment education.

G. Order-Taking

The Proposal makes clear that a broker will not be deemed a fiduciary solely because the broker executes transactions in securities following specific directions of an independent plan fiduciary or IRA owner where no advice is provided.

IV. BEST INTEREST CONTRACT EXEMPTION

Many, if not most, of the persons who would be treated as fiduciaries under the Proposal receive compensation that could be viewed as violating the prohibited transaction restrictions of ERISA and the Code relating to prohibited self-dealing and conflicts of interest. In order to address these issues DOL took several actions to modify and propose new PTEs.

The most significant of the proposed PTEs is the "Best Interest Contract Exemption." Although a person providing investment advice (as defined in the Proposal) to an IRA owner or 401(k) plan participant would still be a fiduciary, the Best Interest Contract Exemption would allow the receipt of compensation by that person if its conditions are met. The Best Interest Contract Exemption applies only in connection with investment advice given to plan participants and beneficiaries, IRA owners, and plan sponsors of small (fewer than 100 participants) non participant-directed ERISA plans.

The Best Interest Contract Exemption has the potential to impose some significant compliance burdens. New contracts would need to be entered into that contain all of the required provisions, including an acknowledgement of fiduciary status and an obligation to adhere to certain "impartial conduct standards," which essentially impose by contract the ERISA prudence and loyalty requirements of ERISA Section 404(a).[9] Fiduciaries would also need to set-up or modify policies and procedures for managing conflicts of interest. Certain compensation structures for individual advisers would not be allowed if they would tend to encourage recommendations that are not in the best interest of the investor. The fiduciary would need to make additional disclosures of fees and conflicts of interests and maintain a public webpage showing direct and indirect compensation paid to individual advisers, the financial institution, and any affiliate in connection with any asset or class of assets that the investor is able to purchase, hold, or sell, or has purchased, held, or sold within the last 365 days, the source of compensation, and how the compensation varies within and among assets classes. Any fiduciary wanting to rely on the Best Interest Contract Exemption would have to notify DOL of its intent to rely on the exemption prior to receiving any compensation in reliance on the exemption and the fiduciary would be subject to additional recordkeeping requirements.

The exemption would only cover recommendations with respect to limited categories of investments. Although the categories listed include most "common" investments by plans and IRAs, certain types of assets would not be covered, such as real estate, security futures, puts, calls, straddles, and options, as well as non-publicly traded equity securities. Businesses seeking to make recommendations regarding these alternative investments may not be able to do so without violating ERISA.

The proposed exemption also requires that a financial institution offer for purchase, sale, or holding, and the individual financial adviser to make available to the investor, a broad range of investment options.[10] If recommendations are made with respect to a limited investment menu that does not provide a broad range of investment options (such as one that only includes proprietary funds) that would be permitted only if: (1) the financial institution makes a specific written finding that the menu limitations do not prevent the investment adviser from providing advice that is in the best interest of the investor; (2) the payments received in connection with the limited menu are reasonable in relation to the value of the specific services provided in exchange for the payments and not in excess of the services' fair market value; (3) before giving any recommendations, the financial institution or investment adviser gives clear written notice to the investor of any limitations placed by the financial institution on the investment products offered by the investment provider; and (4) the individual financial adviser notifies the investor if the adviser does not recommend a sufficiently broad range of assets to meet the investor's needs.

V. INSURANCE AND ANNUITY CONTRACT EXEMPTION

As part of the Best Interest Contract Exemption, DOL is proposing an exemption for transactions in insurance and annuity contracts subject to certain conditions. This portion of the exemption would be available with respect to recommendations made to IRA owners, participants and beneficiaries of participant-directed ERISA plans, and non participant-directed ERISA plans with fewer than 100 participants. The exemption generally requires that the annuities be purchased for cash as part of the insurer's ordinary course of business, and on terms at least as favorable as those that apply to non-retirement investors.

As discussed below, the existing exemption for insurance and annuity contracts transactions, PTE 84-24, would no longer be available for non-discretionary investment advice fiduciaries to IRAs in connection with transactions involving variable annuity contracts or other annuity contracts that would constitute "securities" under federal securities laws. Such fiduciaries would have to rely on this part of the Best Interest Contract Exemption.

VI. OTHER NEW PTES AND AMENDMENTS TO EXISTING PTES

Along with the Best Interest Contract Exemption, DOL is proposing other PTEs and amendments to existing PTEs. Although the primary focus of the Proposal is on non-discretionary investment advice providers, discretionary investment managers currently relying on an existing PTE subject to amendment should evaluate how the proposed changes would impact them.

A. Principal Transactions

DOL is proposing a new exemption that would allow non-discretionary investment advice fiduciaries to engage in purchases and sales of certain debt securities to plans, participant or beneficiary accounts, and IRAs out of their own inventory. Among other contractual requirements, a contractual acknowledgement of fiduciary status and the same "impartial conduct standards" from the Best Interest Contract Exemption would apply in addition to disclosure and recordkeeping requirements.

B. PTE 86-128 & PTE 75-1, Part II(2)

Non-discretionary investment advice fiduciaries to IRAs would no longer be able to use PTE 86-128, the exemption used for executing securities transactions with affiliated brokers. Going forward, they would likely need to rely on the Best Interest Contract Exemption. Investment advice fiduciaries to ERISA plans and discretionary fiduciaries would continue to be able to use PTE 86-128, but would be subject to the same impartial conduct standards set out in the Best Interest Contract Exemption. In addition, DOL proposes to limit the compensation permitted under PTE 86-128 to "commissions" rather than the broader forms of compensation described in PTE 86-128 in its current form.

DOL has also proposed to revoke PTE 75-1, Part II(2), which covers principal sales of mutual funds by brokers and the receipt of commissions for the same. PTE 86-128 would instead cover that type of transaction, but the definition of permissible commissions would specifically exclude 12b-1 fees, revenue-sharing payments, marketing fees, administrative fees, sub-TA fees, or sub-accounting fees.

C. PTE 75-1, Part I(b) and (c)

DOL would revoke PTE 75-1, Part I(b) and (c), which currently provide relief for certain non-fiduciary services to plans and IRAs, including clearance, settlement, custodial, and analyst services. Instead, such service providers would need to rely on the services exemption in ERISA section 408(b)(2) and Code section 4975(d)(2). This is the standard services exemption that applies to other types of service providers to ERISA plans and IRAs.

D. PTE 75-1, Part V

DOL would amend PTE 75-1, Part V to permit investment advice fiduciaries to receive compensation for lending money or otherwise extending credit for the limited purpose of avoiding a failed securities transaction. Currently, the exemption permits brokers to extend credit to a plan or IRA "in connection with" the purchase or sale of securities.[11]

E. PTE 84-24

PTE 84-24 currently permits certain non-discretionary investment advice fiduciaries to receive commissions in connection with the purchase of certain mutual fund shares and insurance or annuity contracts. DOL would amend 84-24 so that it could not be used for investment advice fiduciaries to IRA owners in connection with transactions involving (1) variable annuity contracts or other annuity contracts that would constitute "securities" under federal securities laws or (2) mutual fund shares. Those fiduciaries would have to rely on the Best Interest Contract Exemption. In addition, DOL would amend 84-24 to include the same impartial conduct standards found in the Best Interest Contract Exemption.

F. Import of Impartial Conduct Standards to Existing PTEs

DOL would amend several PTEs to include the impartial conduct standards found in the Best Interest Contract Exemption:

- PTE 75-1, Part III (relating to certain acquisitions of securities by plans from related parties in underwriting transactions);
- 75-1, Part IV (relating to certain acquisitions of securities by plans from fiduciary market makers);
- 77-4 (relating to transactions by plans with respect to open-end mutual funds advised by plan fiduciaries);
- 80-83 (relating to purchases of securities by plans the proceeds of which are used by the issuer to retire or reduce debt); and
- 83-1 (relating to certain mortgage pool investment trust transactions).

G. Low-Fee Exemption

DOL announced that it is considering an additional PTE for products that are high-quality but feature low-fees, and requested comments on possible terms for such an exemption.

VII. PARTICULAR FOCUS ON IRAS

The Proposal has a particular focus on advice provided with respect to IRAs. DOL expressed a special concern about the risks of conflicted advice to IRA owners, given an IRA owner's lack of an independent plan fiduciary to represent his or her interest, and the absence of a private right of action for IRA owners under the Code. The Proposal attempts to address these perceived risks by adding and amending exemptions to build in an ERISA prudence standard that does not currently apply to IRAs under the Code, and to give IRA owners a private contractual right of action for fiduciary breaches under the Best Interest Contract Exemption. As discussed above, DOL would also reverse its previous position on advice regarding rollovers, making recommendations to take a distribution or making investment recommendations with respect to a rollover explicitly fiduciary investment advice under the Proposal.

VIII. POTENTIAL CONGRESSIONAL RESPONSE AND NEXT STEPS

DOL and the Administration are clearly committed to finalizing the Proposal and proposed PTEs. At this time, the position of key constituencies is unclear. In 2010, the combined bipartisan opposition of Republicans, coupled with Members of the Congressional Black Caucus ("CBC") and the Congressional Hispanic Caucus ("CHC"), ultimately led to the withdrawal of the original rule. CBC and CHC members, in particular, raised concerns about the disparate impact of the rule on the minority community. However, the Proposal's principles-based approach and expanded PTEs, including the possibility of an exemption for high-quality, low-fee products, could reduce the CBC and CHC's opposition to the rule.

Most Members of Congress and their staffs have generally adopted a cautious approach on the Proposal, as they are still digesting the rule, given its relative complexity and the unclear effect it may have on the provision of retirement advice and services.

Oversight hearings, conferences, and litigation are all possible in the near future. We expect that Members of Congress and stakeholders opposed to the rule will emphasize arguments relating to cost-benefit analysis and a lack of coordination between the SEC and the DOL as the prime reasons to delay the Proposal. In contrast, supporters of the rule will most likely focus their efforts on building support with policymakers who were wary of the 2010 iteration but who might be more sympathetic to the current version of the Proposal, particularly groups such as the CBC and CHC. Given the rule's principles-based approach and Best Interest Contract Exemption, we expect that more policymakers will be in favor of the Proposal (particularly Democrats).

In sum, although there are both strong supporters and opponents of the Proposal, many policymakers and stakeholders are less certain, and are carefully analyzing the Proposal and its new structure, as well as analyzing its arguments supporting and opposing the Proposal, before they determine a position, issue public statements, and take next steps. However, given President Obama's public support for the Proposal, the relatively quick review of the Proposal by the Office of Management and Budget ("OMB") (completed in half the usual time),[12] and DOL's strong motivation to get this in place, the Proposal may move quickly towards finalization.

The Proposal raises the very real possibility of profound change. If finalized, many new fiduciaries will need to evaluate their ERISA responsibilities and their ability to comply with the various exemptions. Business and compensation models that do not fit within the PTEs would not be able to continue to operate without violating ERISA and the Code. Consequently, we recommend that interested parties identify the key issues that potentially affect their business and move quickly to develop and pursue a strategy to seek to influence the policy debate in order to resolve them.

Notes:

[1] Published in the Federal Register on April 20, 2015, 80 Fed. Reg. 21928 (Apr. 20, 2015).

[2] A person is also a fiduciary to the extent he or she exercises any discretionary authority or control with respect to the management of a plan or its assets or has any discretionary authority or responsibility in the administration of a plan.

[3] This Alert focuses on the effect of the new proposed regulations on ERISA employee benefit plans and IRAs. Generally, the new regulations impact Coverdell Education Savings Accounts, Health Savings Accounts and other covered tax-favored savings accounts in the same way as IRAs.

[4] 29 C.F.R. § 2510.3-21(c).

[5] This provision would still allow recommendations made to the general public, such as through newsletters.

[6] This would reverse DOL's previous position on advice regarding distributions and rollovers. See DOL Advisory Opinion 2005-23A (Dec. 7, 2005) in which DOL held that recommendations to a plan participant to take an otherwise permissible distribution, even combined with a recommendation as to how to invest distributed funds, is not fiduciary investment advice.

[7] Service providers that can take advantage of a carve-out need not worry about fiduciary self-dealing and conflicts of interest or complying with a PTE. In addition, because an advice provider that fits within a carve-out would not be a fiduciary at all under ERISA, there would be significant barriers to any plaintiff that sought to bring suit under ERISA for breach of fiduciary duty.

[8] Notably, however, neither the Seller's Carve-Out nor the Best Interest Contract Exemption would be available for advice to plan sponsors of small, participant-directed plans.

[9] As discussed below, this requirement seems primarily intended to give IRA owners a contractual right of action for breach of fiduciary duty where there is no statutory right of action under the Code.

[10] Unless the menu of investment options is selected by an independent plan fiduciary.

[11] Unamended, PTE 75-1, Part V is only available to brokers that are fiduciaries on a no compensation basis.

[12] Megan Leonhardt, "DOL Fiduciary Rule Released Publicly," (Apr. 13, 2015), http://wealthmanagement.com/industry/dol-fiduciary-rule-released-publicly (discussing OMB's expedited review).

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