ERISA Litigation

DOL Proposed Rule Expands Definition of Fiduciary Investment Advice

On April 14, 2015, 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). [See 80 Fed. Reg. 21928 (April 20, 2015).] The DOL's proposed rule for a new fiduciary standard will have a far-reaching 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 proposed regulation and marks a second DOL attempt to significantly expand ERISA fiduciary status to persons selling or recommending investments in the retail market.

By Tess Ferrera and
Christine Ayako Schleppegrell

Tess J. Ferrera, Esq., is a partner in the Washington, DC, office of Schiff Hardin, LLP, and a member of the firm's Litigation and Employee Benefits groups. She is a former trial attorney for the ERISA litigation division at the Department of Labor and has over 20 years of experience advising and litigating in matters involving the fiduciary provisions of ERISA. She is the principal author of the *ERISA Fiduciary Answer Book* and a senior editor of the *Journal of Pension Benefits*.

Christine Ayako Schleppegrell, Esq., is an associate attorney in the Washington, DC, office of Schiff Hardin, LLP. She focuses her practice on SEC regulatory matters, as applicable to investment advisers, registered investment companies, broker-dealers, and self-regulatory organizations, including national securities exchanges, clearing agencies, FINRA, and the MSRB. Ms. Schleppegrell completed her undergraduate studies at Vassar College and the University of Oxford before attending the University of Washington School of Law.

I. Background

The 2015 Proposed Rule is designed to replace the regulation that has been in effect since 1975 {Labor Reg. § 2510.3-21(c)}, and if or 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.

Once a person is deemed to be a fiduciary under ERISA and the Code, the fiduciary is subject to ERISA's or the Code's prohibited transaction provisions. ERISA Sections 406(a) and (b) create *per se* prohibitions against certain transactions involving an ERISA plan and specified related parties, unless a statutory or administrative exemption is available. Code Section 4975 sets forth prohibited transaction provisions that mirror those in ERISA Sections 406(a) and (b). ERISA's and the Code's prohibited transaction provisions are prophylactic and apply irrespective of harm to the plan or IRA. ERISA fiduciaries are also subject to ERISA's standards of loyalty and prudence. The Code does not include mirror provisions to ERISA's duties of prudence and loyalty that would apply to the sale of investment products to an IRA owner.

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 also is 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:
    a. The advice will serve as the primary basis for investment decisions with respect to plan assets; and
    b. 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 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 nonexistent, 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 discussed 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 (such as a broker-dealer) to the transaction. As discussed below, this carve-out is available only 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 be provided only 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 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; or
   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 on either 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 to be 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 it is not providing impartial investment advice. Platform providers 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 carve-out 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: (a) plan information, (b) general financial, investment and retirement information, (c) asset allocation models, and (d) 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 (a) an investment fund holding assets of various investors in addition to at least one plan or IRA, or to (b) 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.

IV. 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:

- The adviser must contractually acknowledge fiduciary status and agree to be subject to ERISA's standards of loyalty and prudence;
- The adviser must 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;
- The adviser must contractually warrant that it will comply with all applicable laws and that it has

adopted policies and procedures to mitigate conflicts of interest; and
- The adviser must contractually disclose basic information on its conflicts of interest and on the cost of its 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 (1) employs an adviser or otherwise retains an adviser as an independent contractor, agent, or registered representative; and (2) is a registered investment adviser, bank, insurance company, or registered broker-dealer.

B. Proposed "Principal Transaction" Exemption (PTE)

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 (BIC) 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 (for example, 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 BIC 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 II(2) currently allows fiduciaries to receive a fee for selling mutual fund shares to plans and IRAs. The DOL is proposing to revoke Part II(2) because it believes that the amendments to PTE 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 BIC PTE.
- With respect to PTEs 77-4, 80-83, and 83-1, the DOL proposes to incorporate the BIC requirements into these existing exemptions.

V. Commentary

Not surprisingly, the DOL's Proposed Rule has been met with fierce criticism from the financial institutions and their trade representative. The Securities Industry and Financial Markets Association (SIFMA) filed 263 pages of comments, criticizing not just the principal Proposed Rule expanding the definition of fiduciary, but also each of the two new proposed class exemptions and the modifications to the

existing class exemptions. The Financial Industry Regulatory Authority (FINRA) also issued comments, which, among other things, identifies those provisions in the Proposed Rule that directly conflict with long-standing FINRA rules that govern broker-dealer activity. One member of the Securities and Exchange Commission (SEC) wrote a scathing attack on the DOL's Proposed Rule urging the DOL to "scrap" the Proposed Rule and "start working in a meaningful way with the Commission to address the DOL's concerns about broker fees for retirement accounts." [*See* Daniel M. Gallagher's July 21, 2015, letter to Secretary Of Labor Thomas E. Perez.] Thus, it seems that the regulators of financial institutions have a sense that the DOL is stepping on their toes. Congressional opposition also continues to forge ahead. The House and Senate Appropriations Committees have both passed legislation that would cut funding for finalizing or implementing the Proposed Rule. But nothing seems to be giving the DOL much pause.

There are many problems with the Proposed Rule that are unlikely to be fixed if a Final Rule is ultimately released. First, replacing the current regulatory regime with one that essentially would turn selling agents into fiduciaries seems like a bad idea, and probably, like many critics have said, will result in the small plan and IRA markets receiving less investment advice rather than more conflict-free advice. While the Proposed Rule has a broader reach than the IRA market, it appears that a big motivator for the DOL was concern that IRA owners were insufficiently protected by the current regulatory environment. The assumption is belied by the many FINRA rules that have historically governed broker-dealers servicing the IRA market and the private enforcement actions that IRA owners file against broker-dealers.

Broker-dealers have been subject to, among other things, the suitability standard of FINRA Rule 2111. This standard generally requires that, among others, brokers "must have a reasonable basis to believe" that a transaction or investment strategy involving securities that they recommend is suitable for the customer. This reasonable belief must be based on information obtained through the reasonable diligence of the firm or associated person to ascertain the customer's investment profile. It includes collecting information about the individual such as: age; other investments; financial situation and needs; investment objectives; investment experience; liquidity needs; and risk tolerance. IRA owners have always been able to enforce their rights through contractual, tort, or fiduciary breach actions if they felt wronged by their broker. IRA owners just did not have a private right of action to prosecute a prohibited transaction. The Internal Revenue Service (IRS) has had exclusive enforcement authority for a prohibited transaction in the IRA market through the imposition of an excise tax. The BIC Exemption would give IRA owners a private right of action to prosecute a prohibited transaction. Some critics of the Proposed Rule have asserted that in so doing, the DOL has exceeded its rule-making authority.

The BIC Exemption is unlike the DOL's typical prohibited transaction exemptions. It breaks new ground and requires individuals advising an ERISA-covered plan or its participants and beneficiaries, or IRA owners, as well as the adviser's sponsoring financial institution, to enter into a written contract with the investor. The required terms introduce concepts that go well beyond the traditional parameters of administratively-issued class exemptions and require that the advisers and the financial institution agree to be bound by ERISA's standard of loyalty and prudence in the IRA environment. Here, too, the critics have accused the DOL of exceeding its rule-making authority. While the Code has prohibited transaction provisions that apply to IRAs, it does not include provisions similar to ERISA's duties of prudence and loyalty. Therefore, critics argue, the DOL should not be able through regulation to make rules that *directly* impose those ERISA fiduciary standards on the IRA market.

The DOL states in the Preamble:

> The contract is the cornerstone of the proposed exemption, and the Department believes that by requiring a contract as a condition of the proposed exemption, it creates a mechanism by which a Retirement Investor can be alerted to the Adviser's and Financial Institution's obligations and be provided with a basis upon which its rights can be enforced.

Ironically then, through the BIC Exemption, the DOL gives IRA owners the right to sue for a perceived wrong. Does this really give IRA owners that much more protection than they currently have? Probably not. The Proposed Rule will cause tremendous market disruption and require some institutions to radically restructure their business models to comply with the repercussions of the Proposed Rule. For example, although the Proposed Rule continues to permit commission-based compensation, the warranties that

must be included in the BIC make that type of compensation almost impossible to maintain. Remember that commission-based compensation is the primary method of compensation in the small plan and IRA markets.

VI. Conclusion

With the DOL's insistence to the contrary, it is unclear that the dramatic changes the Proposed Rule would make are needed to protect small plans or IRA investors. The disruption and the possible decimation of certain business sectors that now provide needed assistance to small plans and IRA investors seems an exaggerated response to a concern that may be overstated. Administrative hearings were held August 10 through 13. As this article was written prior to that, let's hope the DOL listened to those whose business it is to regulate financial institutions and their agents, and who better understand the business models, the abuses in the area, and who are better equipped to solve any existing deficiencies. ■