Halloween 2023: DOL Fiduciary Rule Returns from the Dead

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On Halloween, like the inevitable return of Michael Myers to raise havoc in the movie series of the same name, the Department of Labor ("DOL") essentially reincarnated the version of the fiduciary rule that was vacated by the Fifth Circuit Court of Appeals in 2018 (the "Vacated Rule"), just in a more fashionable mask.

In this latest sequel, the DOL has promulgated another proposed amendment to the rules determining when a person who makes a recommendation to someone responsible for the investment of the assets of an employee benefit plan or individual retirement account ("IRAs") (each, a "Retirement Investor") is deemed to be a fiduciary for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") and the prohibited transaction provisions of section 4975 of the Internal Revenue Code of 1986 (the "Code PT Provisions"). This proposed rule would, if adopted, substantially expand the occasions upon which such a recommendation will make a person a fiduciary. The rule would affect broker-dealers, banks and insurance companies, and could affect any other financial services business that markets investment products to U.S.-based retirement plans and IRAs.

Of particular note, and consistent with the DOL's efforts to change tis investment advice rule over the past decade, the proposed rule could render someone an ERISA fiduciary when the only connection that the person has to an ERISA-subject employee benefit plan is recommending that a particular Retirement Investor roll his or her assets from that plan into an IRA or individual retirement annuity.

The proposed rule and accompanying exemptions also appear to include two technical, but potentially material, glitches that one hopes are inadvertent—one related to insurance companies that use captive agents to sell annuities, and another related to recommendations made by persons with pre-existing discretionary fiduciary relationships to a Retirement Investor. These are both summarized below, and we expect these issues to be among the avalanche of comments the DOL will receive as part of this rulemaking process.

The Parameters of the New Rule: "Trust and Confidence"

In the DOL's view, if a person who makes recommendations to a Retirement Investor ***could possibly be viewed*** by the Retirement Investor as someone with whom there is a relationship of trust and confidence, that person should generally be a fiduciary with respect to those recommendations.[1] The DOL emphasized this perceived element of "trust and confidence" throughout the preamble to the proposed rule. This was in direct response to the criticism of the Vacated Rule in its 2018 opinion, which in keeping with the common law principles on which ERISA was based, focused heavily on the need for such a relationship to exist in order for a recommendation to be fiduciary in nature.

Under this revised rule, a person who makes a recommendation to Retirement Investors ***will be a fiduciary*** under ERISA and the Code PT Provisions if:

- the person makes a recommendation as to the investment of any assets of an employee benefit plan or an IRA;
- receives a fee or other consideration in connection with such recommendation, and either:
    - the person (directly or through or together with any of its affiliates) makes recommendations ***on a regular basis as part of the person's business*** and the recommendation is made under circumstances indicating that the recommendation:
        - is based on the particular needs or individual circumstances of the Retirement Investor; and
        - ***may*** be relied upon by the Retirement Investor as a basis for investment decisions that are in the Retirement Investor's best interest;

    OR

    - the person making the recommendation has (directly or through or together with any of its affiliates) a pre-existing discretionary fiduciary relationship with

[1] As noted below, in the preamble to the proposed rule the DOL suggest that parties could agree amongst themselves that recommendations are not fiduciary in nature. Any attempt to disclaim fiduciary status may nonetheless be refuted if it is effectively boilerplate and inconsistent with the communications and other course of conduct of the person making the recommendation.

respect to the Retirement Investor's assets, ***including personal, non-retirement assets***.

The most meaningful impact of this construct is that most ordinary course recommendations to roll over qualified employer plan assets into an IRA would become fiduciary recommendations subject to ERISA if the person making the recommendation receives any compensation as a result of the roll over. This would be the case even if that recommendation is the only one made with respect to ERISA plan assets—opening the door to a private right of action by the plan participant, and class actions by the plaintiff's bar, under the generally applicable enforcement provisions of Part V of Title I of ERISA, with respect to those rollover recommendations.

Prohibited Transaction Issues for Investment Advice Fiduciaries

As under the Vacated Rule, if a person is deemed an investment advice fiduciary, the receipt by such person of fees, commissions or other consideration in connection with its recommendations will be prohibited under ERISA and the Code PT Provisions, ***unless*** the person complies with one of the available exemptions provided by the DOL, as proposed to be amended in conjunction with the expanded scope of the re-proposed regulation. The need for a prohibited transaction exemption arises because, in any transaction involving the assets of a Retirement Investor, both ERISA and the Code PT Provisions generally prohibit a fiduciary from (i) dealing with such assets in the fiduciary's own interest or for the fiduciary's own account and (ii) receiving consideration in such a transaction from any party dealing with the Retirement Investor in such a transaction.

While the purposes and potential effects of the revised rule on the business of persons who have historically provided assistance or sold investments products to Retirement Investors are essentially the same as under the Vacated Rule and its accompanying exemptions, the proposed rule and accompanying exemptions differ from the Vacated Rule in two significant ways:

1. Under the Vacated Rule, to qualify for an applicable exemption, the advice given had to be provided "without regard to" the interests of the persons providing the advice. Under each of the amended exemptions, the "best interest" standard that must be satisfied follows that of the Securities and Exchange Commission's (the "SEC") Regulation Best Interest: that the person making the recommendation cannot place his, her or its interests ***ahead*** of those of the Retirement Investor. Accordingly, the virtually impossible standard of the prior, so-called "Best Interest Contract Exemption" (the "BICE") has been replaced with a more achievable standard—one

which broker-dealers and others offering products and services subject to SEC regulation otherwise already have to satisfy.

2. To rely on the BICE, a written contract with the Retirement Investor with representations and covenants regarding compliance with the BICE's terms was required, thereby creating a private right of action against the investment advice fiduciary with respect to all recommendations, including those related to the investment of IRA assets. This requirement, and thereby the private right of action it created, has not been resurrected, leaving enforcement for violation of the Code PT Provisions solely in the hands of the Internal Revenue Service. However, a recommendation to effect a rollover from an ERISA-subject plan is subject to the fiduciary responsibility provisions of ERISA, and an affected Retirement Investor can bring an individual action under ERISA's statutory enforcement provisions for violations of such duties, without the need for the contractual claim that had been artificially created by the BICE.

However, as with the BICE, under the exemptions associated with the revised rule, the institution that retains the services of, or has the business relationship with, the individual making the recommendation to the Retirement Investor has a duty to: (i) establish policies and procedures to assure compliance with the conditions of the applicable exemption, (ii) periodically review compliance with such policies and procedures and (iii) produce an annual report, subject to review by a senior executive of the institution, regarding such compliance. Under the newly proposed exemptions, this report must be shared with the DOL upon its request.

To the extent that the activity of the investment advice fiduciary is related, at least in part, to a rollover from an employer-sponsored plan, under the revised rule the DOL will have enforcement jurisdiction over the recommendation to effect the rollover. The DOL can advance its inquiry and facilitate its cause of action by demanding that an entity relying on the exemption provide its own internal compliance report to the DOL. Accordingly, while an institution may still be able to compel the Retirement Investor contractually to seek relief through an arbitration process (which right was limited under the BICE), those relying on any exemption will have no assurance that the DOL will not pursue a public adjudication of perceived violations associated with rollover recommendations, fueled in part by documentation that the exemption requires the fiduciary to develop and produce.

Similar to the exemptions available under the Vacated Rule, in addition to meeting the more attainable best interest standard, the available exemptions that afford potential relief to an investment advice fiduciary under the current proposal would require:

(i) the person relying on the exemption to acknowledge in writing that it is a fiduciary to the Retirement Investor;

(ii) detailed disclosures of the compensation or other benefits that will be received by the person making the recommendation and its business associates in connection with the proposed course of action;

(iii) disclosure of the services that such persons will be providing, as well as disclosure of any conflicts of interest that they may have that may "consciously or unconsciously" influence the recommendation being made; and

(iv) if the recommendation being made is to effect a rollover from a qualified plan or IRA, a statement explaining the reasons for such recommendation.

Accordingly, just as was the case with the BICE under the Vacated Rule, to the extent that any recommendation pertains to an action affecting assets that are in an ERISA-subject employee benefit plan, including a recommendation to effect a distribution from such plan, there will be meaningful risk that these required disclosures and records will provide a basis for a claim against the parties engaged in making the recommendation, led or supported by the DOL. Further, in order to rely on the exemption, the person making the recommendation ***must acknowledge fiduciary status***. Financial institutions and financial professionals must therefore either be willing to live by the courage of their conviction that they are not acting in a fiduciary capacity when making recommendations, or accept fiduciary status to ensure compliance with the exemption, even if their course of conduct would not otherwise have resulted in fiduciary status.

A Glitch or Purposeful Omission for Insurance Companies Using Captive Agents?

As part of the proposed rulemaking, the DOL amended Prohibited Transaction Exemption 84-24 ("PTE 84-24"). PTE 84-24 currently provides broad relief from Section 406(a) and 406(b) of ERISA with respect to the purchase and sale of annuity contracts from an insurance company and the payment of sales commissions with respect to those transactions. The amendments to PTE 84-24 will exclude investment advice fiduciaries from its relief, unless they are independent agents of the insurance company who can sell the products of at least two insurance companies. If an insurance company uses captive agents to sell its products, it must instead rely on Prohibited Transaction Exemption 2020-02 ("PTE 2020-02").

While the conditions applicable to investment advice fiduciaries are substantially similar under the two exemptions, PTE 2020-02 only provides relief for the receipt of

reasonable compensation and for a set of narrowly defined principal transactions that are not applicable in the context of the sale of an annuity by an insurance company. It does not, like PTE 84-24, apply to the actual sale of the product that is the centerpiece of the transaction. If the insurer is deemed to be the investment advice fiduciary, the sale of the annuity contract will be a separate prohibited transaction for which explicit relief is required. Additionally, since PTE 2020-02 primarily exempts the receipt of compensation, it is not evident that the exemption would cover all potential violations arising under Section 406(b) that might arise from a conflicted recommendation.[2] This would appear to be an inadvertent gap, as the DOL stated throughout the preamble to the amendments to PTE 84-24 and PTE 2020-02 that Insurance Companies using captive agents can and should be able to rely on the relief set forth in PTE 2020-02. We would expect the DOL to receive substantial comments on this issue and address it in subsequent rulemaking activity.

Sophisticated Advice Recipients and Disclaimers

The Vacated Rule included a specific exception for recommendations made to independent fiduciaries who managed at least $50 million in assets, based on the presumption that such fiduciaries are sophisticated enough to understand whether or not a recommendation is made in a fiduciary capacity. The DOL specifically declined to include such an exception in the proposed rule, noting that if a recommendation does not come from a fiduciary with investment discretion over the Retirement Investor's assets (or from a person who has expressly acknowledged fiduciary status), then fiduciary status "would depend on the parties' understandings under the particular facts and circumstances." Putting aside that this looks a lot like the requirement in the current rule that there be a "mutual agreement and understanding" regarding the fiduciary nature of the relationship, which the DOL has otherwise determined to be inappropriately narrow, it does appear to create an opportunity for sophisticated buyers and sellers of financial products to agree amongst themselves that they are in fact buyers and sellers rather than parties in a relationship of trust and confidence. This will be of particular importance to asset managers who manage a portion of a plan's assets as an ERISA Section 3(38) investment manager wearing one hat, and who wear another hat in selling their fund and managed account products to the same plan but with respect to assets managed by others. Whether it will be of utility to the retail market is

[2] Section 408(b)(5) of ERISA provides an exemption for transactions involving the purchase and sale of an annuity contract but is only available to an insurance company if the total premiums and annuity considerations written by such insurer for life insurance, health insurance or annuities for all plans (and their employers) with respect to which such insurer is a party in interest do not exceed 5 percent of the total premiums and annuity considerations written for all lines of insurance in that year by such insurer (excluding from this calculation all premiums or annuity considerations written by the employer maintaining the plan). This limitation would seem to significantly limit the utility of the exception.

less clear, as the DOL specifically noted in the proposed rule that disclaimers of fiduciary status would be disregarded if communications, marketing materials, other applicable law or other courses of conduct are inconsistent with the disclaimer.

While the DOL did attempt, in the preamble to the proposed rule, to distinguish "hire me" recommendations as outside the scope of the regulation, it would appear that any financial services company with a discretionary management mandate over any portion of a plan's assets would not fit within the four corners of the exception. For example, if a private fund manager sponsors an ERISA plan asset fund (and thereby acts as a discretionary manager with respect the ERISA investors in the fund), any recommendation or suggestion to those ERISA investors to make an investment in another of that manager's funds could be construed as fiduciary investment advice, notwithstanding the expectations of the parties to the contrary. We would expect a number of comments to be made on this issue, and we would hope that the DOL will clarify that it did not intend to treat ordinary course fundraising activities as fiduciary advice.

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Please do not hesitate to contact us with any questions.

Lawrence K. Cagney
Partner, New York
+1 212 909 6909
lkcagney@debevoise.com

Jonathan F. Lewis
Partner, New York
+1 212 909 6916
jflewis@debevoise.com

Marilyn A. Lion
Partner, New York
+1 212 909 6108
malion@debevoise.com

Gregory J. Lyons
Partner, New York
+1 212 909 6566
gjlyons@debevoise.com

Franklin L. Mitchell
Partner, New York
+1 212 909 6104
flmitchell@debevoise.com

Jeff Robins
Partner, New York
+1 212 909 6526
jlrobins@debevoise.com

Alison E. Buckley-Serfass
Counsel, Washington, D.C.
+1 202 383 8084
aebuckleyserfass@debevoise.com

Douglas M. Hirn
Counsel, New York
+1 212 909 6490
dmhirn@debevoise.com