# Client Update

# DOL Catches Many in Expanded Fiduciary Net; Is Proposed Exemption an Escape Hatch or a Trap Door?

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As it first did in 2010, last week the U.S. Department of Labor ("DOL") proposed an extensive overhaul of the definition of "investment advice" for purposes of determining who is a fiduciary of employee benefit plans under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and with respect to individual retirement accounts ("IRAs"). Much like the 2010 proposal (which was withdrawn due to industry criticism), the revised definition would treat as a fiduciary virtually anyone who makes an investment-related recommendation to an ERISA plan, IRA, or an ERISA plan participant or IRA beneficiary (a "Retirement Investor") and receives any sort of compensation in connection therewith.

However, because forty years after enactment of ERISA the DOL has extensively expanded the scope of this basic concept in a manner that would prohibit essentially all current practices regarding the investment of the assets of IRAs and many smaller benefit plans, the DOL has simultaneously proposed a so-called "Best Interest Contract Exemption" from the otherwise applicable prohibited transaction provisions of ERISA and the Internal Revenue Code (the "Code"). This novel, "principles-based" proposed exemption purports to offer an avenue for financial institutions and their employees and other advisers servicing Retirement Investors ("Service Providers") to continue to provide investment services to Retirement Investors and still be entitled to receive commissions and other compensation arising from their investment recommendations. The question for Service Providers to decide is whether this avenue constitutes a viable opportunity to act on behalf of Retirement Investors on a modified basis or an abyss that presents substantial uncertainty and significant exposure to constant litigation and potentially material liability.

In conjunction with its proposed rule revision, the DOL also proposed revisions to long-standing class exemptions such as Prohibited Transaction Exemptions

75-1 (related to principal transactions), 84-24 (related to sales of insurance products) and 86-128 (related to directed brokerage). These revisions would largely conform the conditions of the previously granted exemptions (on which the relevant industry has relied for 30 years or more) to incorporate material aspects of the "Best Interest" conditions described below. Thus, the DOL's proposal would also materially change the previously established rules for broker dealers and insurance professionals in a way not contemplated in the 2010 proposal. Moreover, consistent with the administration's view of what constitute the "right" investments for Retirement Investors, the DOL also offered to entertain a "streamlined exemption for high-quality low-fee investments [that] could be subject to relatively few conditions, because such investments present minimal risk of abuse" to Retirement Investors.

## THE PROPOSED RULE

The DOL's proposal vastly expands the categories of activities constituting investment advice that cause a Service Provider to be deemed a fiduciary for purposes of ERISA and the Code. Under the current rule, status as a fiduciary requires both receiving a fee for services and meeting a five-part test that includes providing advice (i) as to the value or advisability of purchasing, selling or investing in securities or other property, (ii) on a regular basis, (iii) that is individualized for the needs of the plan, (iv) pursuant to a mutual agreement between the Service Provider and the plan, and (v) that would serve as the primary basis for an investment decision. Under the revised proposal, a Service Provider who receives a fee or other compensation is considered to have rendered "investment advice," and is therefore a fiduciary, if the Service Provider has met at least one condition in each of the following two columns:

| **The Service Provider directly provides a Retirement Investor with . . .** | | **The Service Provider directly or indirectly . . .** |
|---|---|---|
| 1. a ***recommendation*** as to the advisability of acquiring, holding, disposing or exchanging securities or other property; OR<br><br>2. a ***recommendation*** as to the management of securities or other property; OR<br><br>3. an ***appraisal, fairness*** | AND | 1. represents or acknowledges that he or she is acting as a fiduciary; OR<br><br>2. renders the advice pursuant to a written or verbal understanding that the advice is:<br><br>• ***individualized*** to, or |

| | | |
|---|---|---|
| ***opinion, or similar statement*** concerning the value of securities or other property if provided in connection with a specific transaction described in 1 above (excluding ESOP-related appraisals); OR<br><br>4. a recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice described in 1, 2 or 3 above. | | • ***specifically directed*** to<br><br>the Retirement Investor ***for consideration*** in making investment or management decisions. |

Thus, compared to the current rule, the level of advice required, and the degree to which that advice must serve as the basis for a Retirement Investor's ultimate decision, has been significantly reduced, and the requirement that the advice be provided on a regular basis has been eliminated.

Notably, a number of specific actions that many in the community do not think would constitute investment advice under the current rule will expressly trigger fiduciary status under the new proposal. A Service Provider that merely recommends that a Retirement Investor take a distribution of benefits from an existing plan, or roll over the assets of an existing plan (*e.g.*, a 401(k)) into a new plan (*e.g.*, an IRA) is considered to have given "investment advice." Similarly, persons performing appraisals or otherwise providing advice as to the value of securities or property in the context of a transaction, or recommending the appointment of someone to provide such a valuation or to provide investment advice, will be deemed to be a fiduciary (as long as there is some compensation for the recommendation). Thus, persons providing other kinds of services may be hesitant to recommend to ERISA plans or IRAs which Service Providers might be suitable for the plan or IRA to use.

To avoid unintended inclusion of persons as fiduciaries by reason of the all-encompassing revised rule, the DOL included in the proposal a number of "carve-outs" that provide safe harbors for certain activities which the DOL does not consider fiduciary in nature. Subject to certain conditions, these carve-outs apply to:

- counterparties dealing with (i) a plan fiduciary that possesses substantial financial expertise or (ii) any employee benefit plan in connection with a swap or security-based swap;
- an employee of an employer sponsoring the plan that provides advice to a plan fiduciary for no additional compensation above the employee's salary;
- platform providers that make securities or property available for investment under an employee benefit plan without regard to the individualized needs of the plan, its participants or beneficiaries;
- individuals or entities working with a platform provider to identify investment alternatives to be offered by the platform provider based on objective criteria produced by a plan fiduciary;
- individuals who provide appraisals, fairness opinions, or statements of value to: (i) employee stock ownership plans ("ESOPs") regarding employer securities, (ii) investment funds in which more than one unaffiliated plan has an investment, or (iii) Retirement Investors solely for purposes of compliance with their ordinary course reporting and disclosure obligations. (ESOP appraisers are excluded because the DOL intends to address their conduct in a separate regulatory action); and
- the provision of certain specified generic investment education.

Implicit in these seemingly obvious carve-outs is that the DOL was concerned that the proposed rule was sufficiently broad as to potentially treat counterparties and these other persons within the ambit of providing "investment advice." In addition, a number of these carve-outs do not apply at all to IRAs. The frightening aspect of these carve-outs is that the breadth of the proposal may confer fiduciary status on similarly situated persons who do not or cannot meet the enumerated conditions (such as counterparties dealing with IRAs or with smaller plans who have advisers with modest assets under management).

## THE BEST INTEREST CONTRACT EXEMPTION

The Best Interest Contract Exemption is a principles-based exemption that imposes a series of significant conditions and warranties. The exemption would only apply to transactions involving a specific segment of investment products:

- bank deposits, certificates of deposit ("CDs"), shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded real estate investment trusts ("REITs"), exchange-traded funds, corporate bonds offered pursuant to a registration statement

under the Securities Act of 1933, agency debt securities as defined in FINRA Rule 6710(l) or its successor, U.S. Treasury securities as defined in FINRA Rule 6710(p) or its successor, insurance and annuity contracts, guaranteed investment contracts, and equity securities within the meaning of 17 CFR section 230.405 that are exchange-traded securities within the meaning of 17 CFR 242.600. Excluded from this definition is any equity security that is a security future or a put, call, straddle, or other option or privilege of buying an equity security from or selling an equity security to another without being bound to do so.

To rely on the exemption, a Service Provider must enter into an enforceable contract with its client making the representations and incorporating the warranties included in the exemption. The material conditions to the exemption are:

1. Fiduciary Status. Service Providers must agree in the client contract that they will be making investment recommendations as fiduciaries under ERISA and the Code. This condition will assure that the person is providing investment advice under the revised regulations. For a person providing services to an IRA, which are not to subject to ERISA, the Service Providers will be contractually agreeing to be bound by ERISA's fiduciary rules, such that the DOL will have succeeded in effectively expanding the scope of these protections to IRAs by administrative fiat.

2. Impartial Conduct Standards. Service Providers must also contractually agree to adhere to the following "Impartial Conduct Standards":

   A. Best Interest. When providing investment advice to Retirement Investors with regard to any potential investment, the Service Provider must commit that its advice is in the "**Best Interest**" of the Retirement Investor. This means that the advice must (i) meet ERISA's prudent expert standard of fiduciary responsibility, taking into account the Retirement Investor's risk tolerance, financial circumstances and needs, and (ii) be given "without regard to the financial or other interests" of the Service Provider or its affiliates. ***Thus, to rely on the Best Interest Contract Exemption, a Service Provider whose compensation may increase based on its investment recommendation must be able to prove that such incremental compensation had no influence on its recommendation***;

   B. Reasonable Compensation. The Service Provider must contractually commit that it will not recommend an investment if the

total amount of compensation anticipated to be received by the Service Provider and its affiliates "will exceed reasonable compensation in regard to the total services they provide to the Retirement Investor" (the "Reasonable Compensation Requirement"). While the language of the exemption is not clear whether this Reasonable Compensation Requirement is the same "reasonable compensation" standard applicable under the statutory service provider exemption under Section 408(b)(2) of ERISA, the proposed amendment to PTE 84-24 does not alter the existing reasonable compensation condition of that exemption, which specifically incorporates the Section 408(b)(2) standard;

C. <u>No Misleading Statements</u>. Any statements that the Service Provider makes about the investment, the fees payable, the material conflicts of interests it may have, and "any other matters relevant to a Retirement Investor's investment decision" must not be misleading; and

D. <u>Notice to the DOL</u>. In what we believe to be a regulatory "first" in class exemptions, the Service Provider must advise the DOL that it is relying on the exemption.

3. <u>Required Warranties</u>. The Service Provider must "affirmatively warrant" that:

A. <u>Compliance with Law</u>. It will comply with all applicable federal and state laws regarding the rendering of the investment advice, the purchase, sale and holding of the investment, and the payment of compensation related thereto, *thereby creating a contractual cause of action for any violations of any applicable law, regardless of whether such right otherwise exists at law*;

B. <u>Material Conflicts Policies</u>. It has established written policies and procedures "reasonably designed to mitigate the impact of Material Conflicts of Interest and ensure that its individual advisers adhere to the Impartial Conduct Standards";

C. <u>Coordination of Conflicts Policies to Prevent Violations</u>. In formulating its conflict of interest policies, the Service Provider has identified Material Conflicts of Interest and has adopted procedures to prevent such conflicts from causing violations of the Impartial Conduct Standards; and

D. No Compensation Practices that Encourage Violations. The Service Provider does not have any compensation program, policy or practice, including appraisals, bonuses or the payment of differential compensation, that "would tend to encourage individual advisers to make recommendations that are not in the Best Interest of the Retirement Investor." The DOL helpfully suggests a number of ways in which this condition can be met, including establishing "payment structures under which transactions involving different investment products result in differential compensation to the Adviser ***based on a reasonable assessment of the time and expertise necessary to provide prudent advice on the product or other reasonable and objective neutral factors.***"

It is not clear whether a violation of the warranties will cause the Best Interest Contract Exemption not to be applicable in respect of transactions on behalf of a Retirement Investor even if those transactions nonetheless satisfy the Impartial Conduct Standards and the Reasonable Compensation Requirement.

4. No Exculpatory Provisions; Class Actions Preserved. Service Providers may not include contractual provisions that would exculpate or otherwise limit the Service Provider's liability or preclude the Retirement Investor from enforcing its claims under the contract through class actions.

5. Disclosure Requirements. Service Providers must disclose, in advance of any purchase pursuant to a recommendation and in a specified tabular format, the projected costs of the investment over a period of 1, 5 and 10 years. An annual summary must be provided with regard to all recommended transactions, the costs paid in connection therewith and a statement of the total compensation received by the Service Provider in respect of the investments made or held by the Retirement Investor. And each Service Provider must maintain a webpage that is freely accessible by the public showing "the direct and indirect material compensation payable … for services in connection with each Asset (or, if uniform across a class of Assets, the class of Assets) that [a Retirement Investor] is able to purchase, hold or sell through the [Service Provider]… or has purchased, held or sold during the last 365 days."

6. Range of Assets and Conditions for Limiting Products. Financial institutions are generally required to offer a range of investments that is broad enough for its advisers to offer Retirement Investors

recommendations with regard to "all asset classes reasonably necessary to serve the Best Interests of the Retirement Investor in light of its investment objectives, risk tolerance, and specific financial circumstances." However, a financial institution may elect to limit the scope of the investments that it will recommend to Retirement Investors, if it meets additional conditions. In this circumstance, the institution must make a specific written finding that it has made available sufficient investment choices so that its advisers are able to provide advice that is in the Best Interest of the Retirement Investor (that is, advice that meets ERISA's prudent expert standard, as supplemented by satisfying the particular needs of the Retirement Investor). If the investment choices are limited, the compensation payable to the Service Provider must be "reasonable in relation to the value of the specific services provided to the Retirement Investor in exchange for the payments ***and*** not in excess of the services' fair market value." This appears to be a different and presumably higher standard than the Reasonable Compensation Requirement generally applicable under the Best Interests Contract Exemption; however, the Department offered no guidance in how to determine or apply these alternative standards.

The DOL has proposed a 75-day comment period, followed by 30 days during which a public hearing will be held, and an effective date eight months after publication of the final rule. Whether the DOL will be able to adhere to this timeline will likely depend on the extent of public comments received during the comment period, although interested parties should expect the DOL to aggressively pursue implementation of the final rule.

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Please do not hesitate to contact us with any questions.