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The Department of Labor's Conflict of Interest Project: The Public Debate and Its Implications for the Final Rule

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Half a year after proposing a significantly expanded definition of ''investment advice'' giving rise to fiduciary status under the Employee Retirement Income Security Act of 1974 (ERISA), the Department of Labor (DOL or Department) has its hands full as it moves to finalize the proposed regulation. Since the DOL published the proposed regulation[2] in April of this year, the DOL has received more than 3,000 comment letters over two separate comment periods, the last of which closed in late September, and heard testimony from more than 70 witnesses over four days of public hearings.[3]

With the public record closed, the Department turns to finalizing what is arguably the most significant regulatory action within the retirement industry in the past 40 years. This article describes themes that emerged from the comment letters and testimony from the regulated community regarding the proposed expansion of the fiduciary-duty rules. The article also anticipates changes the Department may make before issuing a final rule in the coming months.

BACKGROUND

The Department's proposal would significantly expand the scope of fiduciary activity by redefining what constitutes ''investment advice'' under ERISA. Currently, DOL regulations use a 5-part test for determining what constitutes ''investment advice.''[4] The DOL proposal would replace the 5-part test with a broader definition that sweeps in, among other conversations, one time recommendations from broker-dealers, call center advice with respect to rollovers, and some types of discussion currently regarded as non-fiduciary investment education.

In connection with the proposed regulation, the Department proposed a new exemption referred to as the

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[2] Definition of the Term ''Fiduciary;'' Conflict of Interest Rule — Retirement Investment Advice, 80 Fed. Reg. 21,927 (Apr. 20, 2015).

[3] *See* Hearing on Definition of the Term ''Fiduciary,'' 80 Fed. Reg. 34,869 (June 18, 2015). Links to every comment letter and hearing transcript, including those cited in this article, can be found at the Department of Labor's ''Conflict of Interest Proposed Rule'' website, http://www.dol.gov/ebsa/regs/conflictsofinterest.html.

[4] 29 C.F.R. §2510.3-21(c).

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Best Interest Contract (BIC) Exemption.[5] The proposed BIC Exemption is designed to work in conjunction with the proposed definition of investment advice to facilitate the provision of investment advice to small plans, plan participants, and IRA owners, but is available only on satisfying a number of stringent requirements and would only be available for advice rendered with respect to certain asset classes. At the same time, the Department proposed to amend six prohibited transaction exemptions (PTEs) in an effort to incorporate the best interest standard of the BIC Exemption.[6] The Department also solicited comments about, but did not formally propose, a separate ''streamlined exemption'' that would make it easier for advisers to receive fees in connection with index funds and other ''high-quality,'' ''low-fee'' investments.[7]

AUTHORITY AND PROCESS

Before addressing substantive comments on the terms of the regulation and the exemptions, it is worth noting questions that have arisen over whether there is a basis for the regulatory package at all. A number of commenters and witnesses at the public hearings expressed concerns about the Department exceeding the scope of its legal authority. While these concerns were not discussed at length during the hearings and are not likely to slow publication of the final rule, they are worth noting because they could serve as the basis for a legal challenge to the rule once it is finalized.

- *IRAs:* Many commenters took direct aim at the Department's authority to regulate IRAs, which have historically been regulated by the Treasury Department.[8] While the Department's proposal does not regulate IRAs directly, the proposal would indirectly regulate conduct through the Department's authority to define prohibited transactions.
- *Broker-Dealers:* Many commenters and witnesses expressed concerns about overlapping regulations, specifically with respect to federal securities laws.[9] Section 913 of the Dodd-Frank Act[10] grants the Securities & Exchange Commission (SEC) the authority to implement a uniform fiduciary standard of care for investment advisers and broker dealers. As a result, numerous banks and asset managers encouraged the Department to let the SEC take the lead in this area and to defer to the Financial Industry Regulatory Authority's (FINRA's) existing regulatory standards for broker dealers.[11]
- *Remedies:* At least two witnesses questioned the Department's authority to create remedies other than those expressly provided for by ERISA.[12] Under the Department's proposal, individuals could pursue any alleged breach of a best interest contract in state court, potentially as part of a class action. The witnesses pointed out that not only does ERISA not provide for such a remedy, but state law claims are preempted by ERISA.[13]
- *Distributions:* A number of comment letters and some testimony expressed the view that the Department's proposed definition of fiduciary, which would pick up advice with respect to distributions from a plan, is broader than the statutory definition in ERISA, which makes a person a fiduciary to the extent the person ''renders investment advice for a fee or other compensation.'' The commenters and witnesses contended that advice with respect to distributions from a plan is different from ''investment advice for a fee.''[14]

Other comment letters and testimony challenged the Department's rulemaking process, primarily on the bases described below:

- *Regulatory Impact Analysis:* Several commenters and witnesses challenged the findings of the Department's regulatory impact analysis released in conjunction with the proposal.[15] The Department's analysis concluded that the proposal would result in net gains to retirement investors of tens

[5] Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21,960 (Apr. 20, 2015).

[6] Proposed Class Exemption for Principal Transactions in Certain Debt Securities Between Investment Advice Fiduciaries and Employee Benefit Plans and IRAs, 80 Fed. Reg. 21,989 (Apr. 20, 2015); Proposed Amendment to PTE 75-1, 80 Fed. Reg. 22,004 (Apr. 20, 2015); Proposed Amendment to and Proposed Partial Revocation of PTE 86-128 and PTE 75-1, 80 Fed. Reg. 22,021 (Apr. 20, 2015); Proposed Amendments to Class Exemptions 75-1, 77-4, 80–83 and 83-1, 80 Fed. Reg. 22,035 (Apr. 20, 2015); Proposed Amendment to and Partial Revocation of PTE 84-24, 80 Fed. Reg. 22,010 (Apr. 20, 2015).

[7] Proposed Best Interest Contract Exemption, 80 Fed. Reg. 21,964 (Apr. 20, 2015).

[8] *See, e.g.,* Financial Services Roundtable, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[9] *See, e.g.,* Financial Services Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203.

[11] *See, e.g.,* Financial Services Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[12] Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 560, 609 (Aug. 11, 2015).

[13] *See id.*

[14] *See, e.g.,* Kent A. Mason, Davis & Harman LLP, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[15] *See, e.g.,* Chamber of Commerce, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015).

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of billions of dollars over a 10-year period. Commenters opined that the Department failed to consider alternative options, ignored key statistics or studies, and grossly underestimated the costs and overestimated the benefits associated with implementing the rule. Many commenters noted that the Department's regulatory impact analysis failed to quantify the harm the rule could impose on small businesses and individuals.[16]

A few groups within the retirement industry commissioned separate studies to refute parts of the Department's analysis.[17] Differences between the Department's and the industry's studies are significant because one of the more likely legal challenges to the final rule would argue that the Department's regulatory impact analysis was insufficient. Perhaps attempting to resolve any differences, the Department set aside half a day during the public hearings to discuss the data underlying the studies. After the hearings, the Department sent at least three letters inquiring further about the conflicting industry studies and also published additional studies in support of the proposal.[18]

- *BIC Exemption:* Commenters expressed their view that the Department had not done enough to determine the feasibility of the BIC Exemption, including not properly calculating the implementation costs for individual companies and for the industry as a whole. Several commenters provided their own estimates for implementing the BIC Exemption which were markedly higher than the Department's estimates.[19]
- *Streamlined Exemption:* Many commenters took issue with the Department's proposal for a ''streamlined exemption'' as being too vague and requested that the Department issue a separate more detailed proposal.[20] Other commenters disagreed with an idea of a ''streamlined exemption,'' reasoning that the Department would be favoring passive investment over active investment.[21]

Finally, several commenters and witnesses urged the Department to re-propose the rule before it is finalized.[22] The individuals argued that the numerous and complex issues created by the rule warranted further discussion and that the public should be afforded the opportunity to comment on any changes the Department made to the rule as a result of the extensive comment letters and hearings.[23] Further, at least one commenter highlighted an August 7th letter to Congress from Department of Labor Secretary Thomas Perez stating that the Department would move forward toward issuing a final rule.[24] The commenter noted the legal requirement that the decision to repropose the rule be based on the public record and asserted that Secretary Perez's letter — dated before the public hearings and second comment period — was evidence the Department would not consider the public record before deciding to move forward with the final rule.[25]

THE PUBLIC DEBATE

A common theme in the substantive comment letters and testimony the Department received — both in favor and opposed to the proposal — was that financial advisers should act in their clients' best interest. Indeed, Deputy Assistant Secretary for Program Operations Tim Hauser — who led the Department's efforts at the hearings — noted at one point in the hearings that ''virtually everybody who has come before us and has testified has said, 'we, of course . . . are okay with adhering to a best interest standard, it's just that your exemption is unworkable.' ''[26]

Comments and testimony from citizens and plan participant organizations such as the AARP and the

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[16] *See id.*

[17] *See, e.g.,* Investment Company Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015) (discussing the Institute's studies and conclusions); Securities Industry and Financial Markets Association, Comment Letter on Proposed Conflict of Interest Rule (July 2015) (discussing the Association's analysis of separately commissioned studies).

[18] The Department's three separate Requests for Supplementary Information were addressed to Mr. David T. Bellaire, Mr. Kenneth E. Bentsen Jr., and Mr. Kent A. Mason. The Requests for Supplementary Information and the Department's Additional Research Papers can be found at http://www.dol.gov/ebsa/regs/conflictsofinterest.html.

[19] *See, e.g.,* Securities Industry and Financial Markets Association, Comment Letter on Proposed Conflict of Interest Rule (July 2015) (discussing a survey that found ''total start-up costs [of the BIC] alone would be $4.7 billion and on-going costs would be $1.1 billion,'' which ''nearly double[s] the estimated cost provided by the Department'').

[20] *See, e.g.,* Great-West Financial, Comment Letter on Proposed Conflict of Interest Rule (July 17, 2015).

[21] *See, e.g.,* Investment Company Institute, Comment Letter on Proposed Best Interest Contract Exemption (July 21, 2015).

[22] *See, e.g.,* Securities Industry and Financial Markets Association, Comment Letter on Proposed Conflict of Interest Rule (July 2015); Department of Labor Proposed Conflict of Interest Rule Hearing Transcript p. 74 (Aug. 10, 2015), p. 972 (Aug. 12, 2015).

[23] *See id.*

[24] *See* Kent A. Mason, Davis & Harman LLP, Comment Letter on Proposed Conflict of Interest Rule (Sept. 9, 2015); *see also* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript p. 800 (Aug. 12, 2015).

[25] Kent A. Mason, Davis & Harman LLP, Comment Letter on Proposed Conflict of Interest Rule (Sept. 9, 2015).

[26] Department of Labor Proposed Conflict of Interest Rule

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Pension Rights Center voiced strong support for the proposal. Their letters argued that the definition of investment advice and the proposed BIC Exemption offered needed protection to retirement investors. Some letters pushed the Department to consider even more stringent restrictions.[27]

Comments and testimony opposed to the proposal varied in the reasons for opposition. Most of the critical letters and remarks attacked various technical aspects of the proposed regulation and exemptions and expressed concerns about the potential impact of the overall proposal on various aspects of the retirement industry. The DOL focused predominantly on these criticisms at the public hearings, and the following summary will do likewise — with a particular emphasis on discussions in the hearings that may indicate where the DOL intends to go with the proposal.

Defining "Investment Advice"

Throughout the hearings, the Department's focus on criticisms of the proposal repeatedly turned to two focal points of discussion. The first of these was the definition of ''recommendation'' and the impact of the definition on the proposed carve-outs. Over the nearly four days of testimony, Mr. Hauser repeatedly stated that the Department intended to define ''recommendation'' to require a ''call to action,'' and indicated a willingness to clarify the regulation to the extent necessary to eliminate uncertainty on this point.[28] The definition is critical because the final rule seems almost certain to retain the definition of ''investment advice'' as a ''recommendation'' for a fee or other compensation. Many commenters were extremely critical of language in the proposed rule that initially defined ''recommendation'' to include a ''suggestion.'' Comments in opposition to the proposed definition were nearly unanimous in arguing that the term ''suggestion'' made the definition too broad in scope.[29]

Early on the first day of the hearing, and throughout the remaining sessions, Mr. Hauser stated that the regulation's definition of ''recommendation'' was intended to be limited to ''recommendations in the FINRA sense,'' meaning ''a call to action . . . with respect to a particular investment.''[30] This statement was well received by witnesses, some of whom expressed surprise at the claim that the Department had used ''recommendation'' in this narrow sense in the proposal.[31] Throughout the hearings, the Department consistently supported use of the FINRA standard for determining when a ''recommendation'' has been given, even in the face of questions regarding the applicability of the FINRA concepts to recommendations not relating to particular investments (for example, recommendations of other persons who might provide investment advice).[32]

Despite the Department's apparent embrace of the FINRA standard, several comment letters submitted after the hearings urged the Department to further tailor the definition of ''recommendation.''[33] Some commenters requested a still more narrow definition of recommendation, while others urged the Department to fully incorporate the FINRA standard in the final rule, rather than incorporate it by reference.[34] These commenters expressed concern that incorporating the FINRA standard by reference could lead to unintended consequences in the event FINRA later amends the standard.[35]

Although the debate over the definition of ''recommendation'' featured prominently at the hearings, commenters and witnesses voiced concerns regarding other aspects of the proposal's definition of investment advice.

- *No Mutuality Standard:* A pervasive concern in comment letters opposed to the proposal was that under the proposal, a participant or investor need only *consider* the advice in making an investment decision.[36] The existing standard, by contrast, defines investment advice as the product of a ''mu-

Hearing Transcript p. 572 (Aug. 11, 2015).

[27] For example, many commenters argued that the Department should eliminate the proposed provision that permits advisers to include mandatory arbitration provisions in the Best Interest Contract. The commenters and many witnesses testified that the arbitration clause permitted individuals to waive their right to a jury trial and would result in claims being decided in an opaque arbitration process. *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript p. 572 (Aug. 10, 2015). Several opponents of the rule also criticized the arbitration provision.

[28] Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 91, 107 (Aug. 10, 2015), pp. 718, 723, 725, 851, 1032, (Aug. 12, 2015) (listing comments made by Deputy Assistant Secretary Tim Hauser that a ''recommendation'' required a ''call to action'').

[29] *See, e.g.,* Great-West Financial, Comment Letter on Proposed Conflict of Interest Rule (July 17, 2015); Invesco, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015); T. Rowe Price Associates, Inc., Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[30] Department of Labor Proposed Conflict of Interest Rule Public Hearing Transcript p. 91 (Aug. 10, 2015).

[31] *See, e.g., id.* at p. 1140 (Aug. 13, 2015).

[32] *See, e.g., id.* at p. 718 (Aug. 12, 2015).

[33] *See, e.g.,* The ERISA Industry Committee, Comment Letter on Proposed Conflict of Interest Rule (Sept. 24, 2015); The SPARK Institute, Comment Letter on Proposed Conflict of Interest Rule (Sept. 24, 2015).

[34] *See id.*

[35] *See* The SPARK Institute, Comment Letter on Proposed Conflict of Interest Rule (Sept. 24, 2015).

[36] *See, e.g.,* Insured Retirement Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); PNC Asset Management Group, Comment Letter on Proposed Conflict of In-

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tual'' understanding that the advice will serve as the ''primary basis'' for investment decisions. Many commenters expressed concern that the elimination of the mutual understanding requirement made the definition subjective and would unnecessarily — and in many instances unknowingly — expose individuals to fiduciary status for making a sales pitch or an off-hand remark about a particular investment.[37] During the hearing, the Department expressed reservations about reintroducing a mutual understanding requirement, primarily because of its fears that advisers could easily disclaim their roles as fiduciaries. The DOL appeared to believe the ''call to action'' standard was sufficient to satisfy commenters' concerns about any subjective exposure to fiduciary status.[38]

- *Specifically Directed:* Still other commenters expressed concern about language in the proposal that would confer fiduciary status on a recommendation even if it was not individualized, as long as the recommendation was ''specifically directed to'' a recipient.[39] A concern was that the ''specifically directed'' language might qualify any mass mailing or marketing communication as ''investment advice'' and subject the sender or marketer to fiduciary status. This issue was debated, but not resolved, at the hearings and it is unclear if the Department will include the ''specifically directed'' language as part of the final rule.[40]

Proposed Carve-Outs

The Department's position that there is no investment advice absent a ''call to action'' led to a broader discussion of the function of the ''carve-outs'' in the proposed regulation. As proposed, there are several ''carve-outs'' from the definition of fiduciary, including a ''seller's carve-out,'' an ''education carve-out,'' and a carve-out for certain appraisals. Witnesses stated that the very existence of the carve-outs implied a broad conception of ''recommendation'' that, without the proposed carve-outs, would sweep in marketing, education and other ordinarily non-fiduciary activities.[41] Mr. Hauser responded that if there is no recommendation, there is no need for a carve-out, and to the extent the use of the term carve-out implied that statements falling outside a carve-out would be treated as advice regardless of whether there is a recommendation in the FINRA sense, the final regulation should take steps to clear up any misunderstanding.[42] This clarification resulted in several exchanges on whether ''carve-out'' was the right term for the provisions in the regulation that outline exceptions that do not constitute investment advice. Should these be viewed as something more like safe harbors, or even illustrative examples?[43] These exchanges seemed to raise a possibility that the very structure of the regulation — narrow carve-outs whittling away at a broad definition — may need to be rethought in light of the Department's intention to promulgate a narrower definition of investment advice.

Mr. Hauser's general reflections on the function of the proposed carve-outs led, in turn, to more specific discussion about certain carve-outs.

- *Seller's Carve-out:* Mr. Hauser seemed to question the need for a carve-out for marketing and sales activity when challenging the distinction many commenters made between sales and advice. If sales activity is accompanied by a recommendation in the FINRA sense, he reasoned, why should there be any exception to the obligation for the recommendation to be made in the customer's best interest?[44] Following this line of thinking to its conclusion, it seems possible that the Department may, upon clarifying that ''recommendation'' is intended to have a narrow scope of reference, decide to eliminate or at least trim the ''seller's'' or other carve-outs that were intended, in the proposed regulation, to make the regulation workable. At the same time, however, it should be noted that the Department seemed to lend a sympathetic ear to some testimony in favor of expanding the seller's carve-out — for example, to a broader range of sophisticated investors.
- *Investment Education Carve-out:* Another carve-out discussed repeatedly at the hearings was the carve-out for investment education. The Department's proposal narrows the current definition of investment education in some respects, and many commenters and witnesses noted in particular that

terest Rule (July 21, 2015).

[37] *See, e.g.,* Transamerica, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015).

[38] *See* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 635–38 (Aug. 11, 2015).

[39] *See, e.g.,* The SPARK Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[40] *See* Department of Labor Proposed Conflict of Interest Hearing Transcript pp. 870-73 (Aug. 12, 2015).

[41] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript p. 723 (Aug. 12, 2015).

[42] *See id.* at pp. 723–25 (Aug. 12, 2015).

[43] *See id.* at pp. 853, 873, 876 (Aug. 12, 2015).

[44] *See id.* at p. 623 (Aug. 11, 2015); *see also* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 107, 151–52 (Aug. 10, 2015).

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it seems to restrict advisers' ability to explain specific investments available to participants.[45] The Department appeared cautiously receptive to commenters' concerns and indicated a willingness to permit advisers to mention, and possibly even describe, specific investments to a participant as long as the adviser mentions each investment available under the plan within the same class of investments.[46] How this shapes out in the final rule is yet to be seen, but it seems quite possible that the Department will recast the regulation's redefinition of investment education to reflect these discussions.

- *Appraisals:* The latter half of the hearing included several witnesses urging that the Department expand the proposed carve-out for appraisals and valuations. The proposal carved out, among other things, appraisals and fairness opinions relating to employer securities within ESOPs. Some commenters requested that the carve-out include appraisals or valuations of assets other than employer securities.[47] The Department's questioning of witnesses at the hearings demonstrated the Department's reluctance to expand the carve-out for appraisals,[48] and the Department's recent enforcement actions with respect to valuations, although separate from the proposal, are further evidence that the Department is not likely to bend on this issue.

Overall, the first focal point of discussion regarding the proposed regulation and the related carve-outs, gives rise to certain inferences regarding the shape of the final regulation. First, it seems highly likely that the final regulation will link the concept of ''recommendation'' more closely to the recognized FINRA standard. Second, there seems to be a substantial possibility that at least some of the so-called ''carve-outs'' will be recharacterized, perhaps as safe harbors or even, possibly, as examples. The result could be, to some extent, a restructuring of the regulation. Third, it seems possible that the final regulation will address the fact that discussions with customers can, and perhaps typically do, involve both sales activity that is not intended as advice and advisory activity that is not intended as sales. This may lead to a substantial recasting of the crucially important ''seller's'' carve-out.

Refining the BIC Exemption

The second focal point of discussion that developed in the hearings was prompted by questions from various Department officials apparently intended to determine just how much the conditions of the BIC Exemption would need to be pared down in order for the exemption to work in operation, in the view of various witnesses. This discussion has implications for what the Department regards as essential to the BIC Exemption. Perhaps in response to the numerous comment letters stating that the BIC Exemption's stringent requirements were costly and unworkable, Mr. Hauser and other Department officials spent considerable time during the hearing teasing out assessments of the feasibility of the Exemption's core elements. Based on the repeated series of questions, the Department appears to consider the core elements of the BIC Exemption to be: (i) an enforceable undertaking to act in the customer's best interest; (ii) compensation that is reasonable in light of the services rendered; and (iii) policies and procedures to avoid creating incentives that would run counter to the best interest standard.[49]

These core elements emerged in a variety of lengthy exchanges between Mr. Hauser and industry witnesses who repeatedly expressed the view that, as proposed, the requirements of the BIC, most notably the contract timing requirements and the detailed disclosure requirements, made the BIC Exemption costly and unworkable — something very few entities would seriously consider implementing. At the heart of these discussions was what appeared to be an unstated disagreement about how to effectuate a best interest standard. While both the Department and the industry agreed that the industry should act in the best interest of participants, and seemed to agree on a number of potential simplifications, at times the two sides seemed at an impasse regarding the economic viability of the BIC Exemption.[50]

This discussion left an overall impression that the Department is amenable to simplifying the requirements of the BIC Exemption, and offered some hints as to the steps the Department might take in doing so. At certain points, Mr. Hauser seemed to be reciting the three core elements, together with certain other proposed fixes to the BIC Exemption, as if the Department were intending to redraft the BIC Exemption accordingly. In questioning one witness, to take just

[45] *See, e.g.,* The Business Roundtable, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); American Retirement Association, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015) (stating that the proposal ''unnecessarily changes the education and advice framework established by [the DOL's] Interpretive Bulletin 96-1'').

[46] *See* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 621–22 (Aug. 11, 2015).

[47] *See, e.g., id.* at pp. 1132–34 (Aug. 13, 2015).

[48] *See, e.g., id.* at pp. 1150–55, (Aug. 13, 2015).

[49] *See, e.g., id.* at pp. 87–88, 91–92 (Aug. 10, 2015).

[50] *See, e.g., id.* at pp. 91–94 (Aug. 10, 2015), pp. 575–80, 623–25 (Aug. 11, 2015), pp. 777–79 (Aug. 12, 2015).

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one of many examples, he asked the witness if the exemption would be feasible if the Department resolved the operational concerns about disclosure and data retention, clarified that the best interest standard imposes a duty of loyalty identical in scope to that in Section 404(a) of ERISA, and made it completely clear in what circumstances it would be permissible to sell proprietary products — specifically, the existence of a contract of some kind to ensure that the advice regarding such products would be prudent, the compensation would be reasonable in relation to the services, there would be full and upfront disclosure about fees and conflicts, and that the sales force would not have incentives running counter to these principles.[51] Although Mr. Hauser and other Department representatives were careful to indicate that no inferences should be drawn from hypothetical questions of this kind,[52] it is hard to avoid concluding that the Department recognizes a variety of features in the BIC Exemption that could be simplified while retaining those elements that the Department views as essential.

A representative exchange on Day 2 of the hearings focused on the mechanics of the best interest contract and on possible ways to simplify the contract requirement. The exchange began with Mr. Hauser describing as ''helpful'' a variety of suggestions in testimony about simplifying the contract requirement, and proceeded with questions specifically asking: (1) whether a negative consent procedure would be workable for existing customers; (2) whether a unilateral contract entered into only by the financial institution would be sufficient; and (3) whether the contract could be entered into at the time an investment is made, but with retroactive effect so that advice given earlier would be covered. The discussion went back and forth on the question of whether an enforceable undertaking by the financial firm and its affiliates would have to be signed, but that point of difference, if it was one, seemed relatively insignificant when compared with the overall tenor of the discussion, which appeared to concede that simplification is desirable and seemed to reflect a potential consensus view on what a simplified contract might look like.[53]

These discussions of the core elements of the BIC Exemption did not simply repeat themselves over the course of the hearings; rather, they developed and shifted in tone as the hearings wore on. At certain points, the questions seemed to take on mixed tone, in particular questions about one of the core elements of the proposed exemption — the BIC Exemption's requirement than an adviser provide contractual assurance that it has adopted policies and procedures designed to avoid incentivizing advisors to act contrary to the best interest standard. In some of these exchanges, the Department seemed to be expressing genuine concern about whether the warranty requirement was workable, while at the same time expressing skepticism that, absent the requirement, concerted efforts would be made to avoid conflicts of interest and act in the best interests of retirement investors. In other exchanges, the Department expressed receptivity to the regulated community's input on the content of existing policies and procedures used to ensure that financial institutions act in their clients' best interests, but at the same time seemed to express hesitancy about assuming that such policies and procedures actually exist.[54]

We think it is fair to infer from the exchanges between Department officials and industry representatives more than a willingness to imagine, for the sake of discussion, a BIC Exemption stripped down to a few core requirements. We think the evolution of this discussion over the course of the hearings suggests that the Department is likely to promulgate a final BIC Exemption that challenges the industry, based on its purported embrace of a best interest standard, to ''walk the walk'' by complying with a set of stripped down requirements that will include warranties regarding policies and procedures designed to avoid incentivizing advisors to act contrary to the best interest standard.

Impact of the Proposed Guidance

During the hearings, many of the witnesses used the two discussions summarized above as a basis to describe what the witnesses, and some commenters, perceived to be some of the significant impacts the proposal would have on Americans' retirement savings.

- *Individuals and Small Businesses:* The most prevalent criticism the DOL received on the overall impact of the proposal was that the guidance as a whole would severely limit investment advice for individuals and small businesses — a hotly contested point.[55] The critics warned against imposing fiduciary responsibilities on more advisers who would be unable to receive prohibited transaction relief in light of the burden of the BIC Exemption. Commenters argued that advisers would be less likely to service small businesses

[51] *See id.* at pp. 524–25 (Aug. 11, 2015).

[52] *See, e.g., id.* at pp. 90–91 (Aug. 10, 2015), pp. 524–25 (Aug. 11, 2015).

[53] *See id.* at pp. 575–88 (Aug. 11, 2015).

[54] *See, e.g., id.* at pp. 941–42 (Aug. 12, 2015).

[55] *See, e.g., id.* at p. 269 (Aug. 10, 2015), p. 602 (Aug. 11, 2015); *see also* Kristen Ricaurte Knebel, *Small-Business Plans Would Face Hurdles Under Fiduciary Rule, U.S. Chamber Says*, BNA Pension and Benefits Daily (June 9, 2015).

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and participants with small plan account balances because the compensation that advisers would receive would not outweigh the regulatory burdens. However, several witnesses at the hearings stated that their organization would happily step up to assist smaller retirement savers.[56] Without seeing the final rule, and what appears could be a substantially revised BIC Exemption, it is difficult to predict the exact impact on individuals and small businesses.

- *Private Funds:* Several comment letters expressed concern about the proposed regulation's effect on private funds.[57] The letters noted that the proposed definition of investment advice could make private fund managers fiduciaries when they provide valuations to IRA or plan investors, including a fund's net asset value. Commenters also focused on expanding the proposed ''seller's'' carve-out to include an exception for ''sophisticated investors,'' defined more broadly than the proposed definition referring to fiduciaries that manage at least $100 million in plan assets.[58] Several comment letters criticized the $100 million threshold as too high. At the hearing, following the lead of numerous comment letters, the Department inquired whether the SEC's accredited investor test would serve as a good measure for a sophisticated investor.[59] Although the Department did not indicate it would incorporate such a test, it would not be surprising if the Department incorporated some recognized test of individual investor sophistication in the final rule.
- *Lifetime Income Products:* Many insurance companies and trade associations requested that the Department revise the proposed BIC Exemption or Prohibited Transaction Exemption 84-24 (the existing exemption for sales of insurance products) to avoid adverse impacts on the sale of variable annuities.[60] As proposed, amended PTE 84-24 would no longer provide an exemption for sales of variable annuities and commenters noted that the BIC Exemption would be effectively unavailable to variable annuities.[61] Numerous comment letters and a significant amount of testimony focused on the fact that sales of variable annuities fulfill the Department's policy goal of providing middle-income individuals with investments that provide lifetime income. In response, Mr. Hauser asked several witnesses whether a separate and perhaps simpler exemption for annuities would alleviate this concern.[62] Given Mr. Hauser's inquiry, and the Department's separate lifetime income initiative, it is possible the Department could make more favorable accommodations for annuities in the final rule.
- *Call Centers:* A number of service providers and employer organizations commented that under the proposed regulation they would not be able to provide rollover and education services through call centers.[63] Some of the same commenters explained that the broad scope of the proposed regulation would define investment advice to include many of the services that call centers currently provide, in part because call center employees often receive a fee or other compensation for specific referrals. Since entering into the written contract required by the BIC Exemption is impractical for call center representatives and their customers, commenters indicated they may be forced to curtail their call center services due to the expanded liabilities they would face under the new guidance.[64] In response, the Department questioned one plan sponsor trade organization extensively about how the Department could clarify how the rule applies in the context of call centers.[65] Of course, even if the Department were to clarify the rule, call center employees, and the financial institutions they represent, would likely not be able to receive any fee or other compensa-

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[56] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 1061–67 (Aug. 13, 2015) (describing the work of Rebalance IRA and other ''investment innovators'').

[57] *See, e.g.,* Investment Program Association, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); Managed Funds Association, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); *see also* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 1081–86 (Aug. 13, 2015).

[58] *See id.*

[59] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 831–32 (Aug. 12, 2015).

[60] *See, e.g.,* American Council of Life Insurers, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); The Committee of Annuity Insurers, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); John Hancock Life Insurance Company, Comment Letter on Proposed Conflict of Interest Rule (July 17, 2015).

[61] *See, e.g.,* The Committee of Annuity Insurers, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); Lincoln Financial Group, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[62] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript p. 1043 (Aug. 12, 2015).

[63] *See, e.g.,* American Benefits Council, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); T. Rowe Price Associates, Inc., Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[64] *See, e.g.,* The SPARK Institute, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[65] *See* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 1157–58 (Aug. 12, 2015).

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tion as part of any referral if they hoped to avoid fiduciary status under the final rule.

- *Requests for Proposals:* Prior to the hearings, numerous commenters expressed concern that responses to Requests for Proposals (''RFPs'') would be viewed as investment advice, which could adversely affect parties' willingness to engage in competitive bidding processes.[66] RFPs are frequently used to seek competitive bids from asset managers or service providers, and are often considered a best practice in the retirement and investment industry. The Department's promise to incorporate the FINRA definition of recommendation should alleviate concerns regarding RFP's because most RFPs would not involve any recommendation under the FINRA standard.

GOING FORWARD

Transition Period

The Department's proposed guidance states that the regulation and exemptions would be effective eight months following the date they are finalized.[67] This so-called ''applicability date'' prompted numerous comments objecting to the Department's proposed implementation timeline. Many commenters and witnesses advocated for a transition period between 18 and 36 months, with the most common advocating for 36 months — the lengthy period being required not only because of the technological changes needed to comply with the complexities of the BIC Exemption, but also because of how the rule as proposed would impact compensation structures and overall business models.[68] During the hearing, several witnesses testified that it would be impossible to comply with an eight-month transition period.[69] The Department acknowledged the commenters' concerns, but did not make any concessions or statements during the hearing — perhaps because of the political pressures the Department faces from the White House to implement the rule before the change in the Presidential administration. Since the hearing, practitioners have speculated that the Department may adhere to an eight-month applicability date, but include a longer ''compliance aid period'' to help advisers transition to the new rules.[70]

While it is difficult to predict any particular transition period under the final rule, it appears the Department will grandfather certain existing arrangements as part of the final rule. Such a concession is a result of concerns expressed in comment letters and at the hearings that some investors would be forced to liquidate positions at an inopportune time simply to comply with the rule.[71] Other witnesses described the potential that the rule would force investors in commission-based accounts who prepaid investment-based fees, such as 12b-1 fees, to switch to an account-based fee arrangement and not receive the remaining services they already paid for.[72] Although it is difficult to predict the specifics of any grandfathering arrangements, the Department seemed sympathetic to the need for ''a broader grandfather provision,'' and stated at the hearings that it was ''looking very hard at how to reconfigure the grandfather provisions.''[73]

Legal Challenges

Complicating any transition period is the potential that the retirement industry could challenge the proposal in court. While no lawsuit has been filed, several comment letters — including one filed by Eugene Scalia, former Solicitor of the Department of Labor — appeared to outline legal challenges to the Department's economic analysis and the Department's authority to implement the proposal.[74] Many of the comment letters could be read both as substantive comments on genuine issues and ambiguities and as strategic interventions to build the administrative record in the event of a lawsuit. Since the hearings concluded, some within the retirement industry have stated they are considering filing a lawsuit against the DOL if the final rule is substantially similar to the ini-

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[66] *See, e.g.,* The American Bankers Association, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015); American Benefits Council, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015).

[67] Definition of the Term ''Fiduciary''; Conflict of Interest Rule — Retirement Investment Advice, 80 Fed. Reg. at 21,950.

[68] *See, e.g.,* American Retirement Association, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015) (requesting at least two years because ''more than 400,000 qualified retirement plans will need to be amended''); Capital Group, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015) (requesting three to five years because of the rule's impact on the advisory relationships and the overall market); Davis & Harman LLP, Comment Letter on Proposed Conflict of Interest Rule (July 21, 2015) (requesting a ''minimum of three years'' because of the time it will take the retirement industry to ''enter into contracts with tens of millions of existing customers'').

[69] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 870, 967, 1016–17 (Aug. 12, 2015).

[70] Sean Forbes, *DOL's Fiduciary Rule May Include Compliance Aid Period*, BNA Pension and Benefits Daily (Sept. 14, 2015).

[71] *See, e.g.,* Department of Labor Proposed Conflict of Interest Rule Hearing Transcript pp. 1016–19 (Aug. 12, 2015).

[72] *See, e.g., id.* at p. 629 (Aug. 11, 2015), p. 1020 (Aug. 12, 2015).

[73] *Id.* at pp. 1022, 1025 (Aug. 12, 2015).

[74] *See* Eugene Scalia, Gibson Dunn, Comment Letter on Proposed Conflict of Interest Rule (July 20, 2015).

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tial proposal.[75] Any suit could at a minimum delay the applicability date.

Reactions from Capitol Hill

Meanwhile, the proposal has sparked significant debate in Congress. In February, Representative Ann Wagner (R-MO) re-introduced the Retail Investor Protection Act (H.R. 1090), which would prohibit the DOL from finalizing its proposal until the SEC finalizes regulations in this area.[76] Representative Wagner's bill passed the House Financial Services Committee on September 30 and advanced to the full House for consideration. Appropriations bills containing riders prohibiting the Department from finalizing the proposal have also been introduced in the House and Senate. These and similar riders are likely to be debated as Congress attempts to pass an omnibus spending bill in the coming months. Any legislation that prohibits or hinders the Department from finalizing the rule faces an uphill climb because of the threat of a veto from President Obama, who has prioritized finalizing the rule before he leaves office.[77]

The threat of a Presidential veto has not stopped Congress from weighing in on the proposed rule. Subcommittees of the House Ways and Means Committee and the Financial Services Committee each held hearings in September on the proposal, and a hearing was held in July by a subcommittee of the Senate HELP Committee. In addition to the hearings, over 300 Representatives and Senators — both Democrats and Republicans — have signed various letters commenting on the Department's proposal.[78] While Republicans have generally been more critical of the proposal, a September letter to the DOL signed by more than 90 House Democrats encouraged the Department to make several significant changes to the rule.[79] The broad interest in the rule within Congress underscores the significance of the rule to individual constituents as well as to the business community.

Timing of the Final Rule

The Department has not provided a timeline for publication of the final rule; however due to President Obama's commitment to finalizing the rule before he leaves office in January 2017, we anticipate that the rule will be published by early 2016.[80] Working with the eight-month applicability period, the latest the Department could finalize the rule and have it be effective during this Administration is May 2016. The DOL may well push to finalize the rule earlier than May given the potential for litigation and unforeseen transition or implementation issues.

CONCLUSION

Over the next few months, the Department will continue its work to finalize the rule based on the thousands of pages of input the Department received in the form of comment letters and testimony. If the public hearings are an accurate barometer, the final version of the rule will include a clarified definition of ''recommendation'' and amended carve-outs to reflect that definition. Based on the public hearings, we think the final package will also likely include a somewhat simplified BIC Exemption. In the meantime, although the public record is closed, the debate over the rule continues. The fact that the debate has now spread across two branches of government — and soon could involve the third — and has engaged such a broad spectrum of individuals and businesses, speaks to the magnitude and importance of the Department's efforts to rework the definition of fiduciary ''investment advice'' for the first time in decades.

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[75] Dan Jamieson, *Trade Groups Fixin' For a Legal Fight Over ERISA Rules*, Financial Advisor Magazine (Sept. 28, 2015).

[76] Retail Investor Protection Act, H.R. 1090, 114th Cong. (1st Sess. 2015).

[77] *See* Sean Forbes, *Democrats Urge DOL to Get Help Finalizing Fiduciary Rule*, BNA Pension & Benefits Daily (Sept. 23, 2015).

[78] ACLI News Release, *Labor Department Urged to Act on Congress's Concerns Over Proposed Fiduciary Regulation* (Sept. 25, 2015).

[79] Hazel Bradford, *Democrats Call for More Flexibility on Fiduciary Rule*, Pensions & Investments, Sept. 25, 2015 (describing the legislators' call ''for more flexibility on how the DOL addresses exemptions for 'best interest' contracts, education and lifetime income options, and a safe harbor for good-faith efforts'').

[80] *See* Nick Thornton, *Obama Doubles Down on DOL Fiduciary Rule*, BenefitsPro (July 13, 2015), *available at* http://www.benefitspro.com/2015/07/13/obama-doubles-down-on-dol-fiduciary-rule.

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