DOL Proposes Sweeping Expansion of Fiduciary-Duty Rules

Proposed new guidance from the U.S. Department of Labor ("DOL") would significantly alter the regulation of investment advice to employee plans and IRAs. The guidance aims to reshape the marketplace for retirement-related individual and small-plan investment products and services.

Background

Under Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), a person can be an investment fiduciary not only by actively managing a plan's assets but also by "rendering investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so." A key part of the DOL's comprehensive new guidance is a proposed regulation construing "investment advice."

An ERISA plan fiduciary is subject to affirmative duties of loyalty and care under Section 404 of ERISA and to prohibitions under Section 406 of ERISA against specified transactions that present conflict-of-interest potential. Violations can result in liability to the fiduciary and equitable remedies. A violation of similar prohibited-transaction rules under Section 4975 of the Internal Revenue Code can result in significant excise taxes.

Shortly after ERISA was enacted in 1974, the DOL prescribed a five-part test for determining "investment advice" fiduciary status. Over time, the DOL came to view its original regulations as inadequate. In 2010 it proposed more comprehensive rules that were later withdrawn in response to concerns about scope and potential for market disruption. The 2015 proposal retains certain aspects of the 2010 proposal and jettisons others, while at the same time offering exemptive relief to create a more complex and nuanced regulatory regime than that presented by the 2010 proposal.

"Investment Advice" under the Proposed Regulation

The proposed regulation would replace the current test for determining "investment advice" fiduciary status. The chart below compares the requirements of the existing regulation with the requirements that would apply under the new proposal.

Issue	Existing Requirement	Proposed Requirement
Nature of Advice	Valuation advice or investment recommendations.	Similar but includes advising as to plan or IRA distributions and rollovers and recommending other paid advisors.
Frequency of Advice	Must be provided on a regular basis.	A single instance of advice would suffice, e.g., one-time advice to take a rollover distribution.
How the Advice Will Be Used	Requires a *mutual* understanding that the advisor's services will serve as the *primary basis* for investment decisions.	No "primary basis" mutuality of understanding required. Advice need only be offered for consideration in making investment decisions.
Customization of	Must be based on the client's particular	Similar but no tailoring required (directing the advice to a client for

Advice	needs.	consideration in making investments is enough).

The Carve Outs

Importantly, however, the new proposal presents several exceptions (or "carve outs") that would apply if the person has not otherwise acknowledged fiduciary status.

Name	Description
"Seller's Carve Out"	A counterparty to an ERISA plan with at least 100 participants can market to an independent plan fiduciary without thereby becoming an "investment advice fiduciary" if certain disclosure and independence requirements are satisfied and the counterparty is not paid directly for investment advice. A slightly simpler carve out applies if the independent plan fiduciary manages at least $100 million in plan assets.
Swaps	Certain swap parties dealing with an ERISA plan are carved out if they do not advise the plan in the transaction and obtain an advance representation that the fiduciary will not rely on them for recommendations.
Platform Providers; Selection and Monitoring	A person who markets securities or other property to an ERISA plan through a platform or similar mechanism will not be considered an "investment advice" fiduciary if the marketing is not individualized to the plan and the person discloses that it is not undertaking to provide impartial investment advice. A platform provider will not become an investment advice fiduciary merely by identifying investment alternatives that meet objective criteria or providing objective financial data and comparisons with independent benchmarks.
Investment Education	Generalized investment education is carved out (but not recommendations as to specific investments or decisions). The proposal contains specific safe harbors for providing generalized plan and investment information, asset-allocation models, interactive investment materials and similar information, subject in each case to specific limitations. Provision of other investment advice would be evaluated on a facts and circumstances basis.
Financial Reports and Valuations	The proposed rules carve out appraisals, fairness opinions and the like for ESOPs (as to employer securities), investment funds with more than one unaffiliated plan investor, or plans, IRAs and their fiduciaries or owners for purposes of complying with reporting and disclosure requirements under applicable law rules or regulations.
Employees	An employee of a plan sponsor providing advice to a plan fiduciary who receives no fee or other compensation beyond his or her normal compensation from the plan sponsor would not be an investment advice fiduciary.

Proposed New Class Exemptions

Best Interest Contract Exemption

The proposed "Best Interest Contract Exemption" (the "BIC Exemption") would permit advisers and financial institutions that are fiduciaries to receive compensation for services rendered in connection with the purchase, sale and holding of certain assets as a result of the fiduciary's advice but only if specified conditions are met. One key requirement of the exemption is a written contract that would give the advice recipient a remedy in the event of breach, even where the breach does not impair the exemption itself.

The BIC Exemption would apply in respect of IRAs, participants and beneficiaries of self-directed plans and plan sponsors of non-participant directed plans with fewer than 100 participants. The BIC Exemption would also not be available for principal transactions (transactions for the financial institution's own account) or with respect to compensation received as a result of "robo advice" (e.g., advice provided by an interactive website).

The principal requirements of the BIC Exemption are as follows:

- *Impartial Conduct Standards.* The adviser and the financial institution must agree that:
    - Fiduciary Standard. Investment advice will be in the best interest of the investor (i.e., advice that reflects the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person would exercise based on investment objectives, risk tolerance, financial circumstances, and needs of the investor) – a standard similar to ERISA's fiduciary duty standard but made applicable by the BIC Exemption to IRAs.
    - Reasonable Compensation. The adviser and the financial institution will not recommend an asset with respect to which it would receive more than reasonable compensation for services rendered.
    - No Misleading Statements. Statements about the assets, fees, material conflicts of interest and other matters relevant to the investor's investment decisions will not be misleading.
- *Contract Terms.*
    - Required Warranties. The adviser and the financial institution must promise to comply with all applicable federal and state laws relating to the investment advice, investment, and payment of related compensation. The financial institution must give certain warranties regarding conflicts of interest and acting in the best interest of the plan, IRA or participant.
    - Transparency. The contract must disclose material conflicts of interest, the offering of proprietary products, and the receipt of third party payments with respect to an asset. The investor also must be informed of its right to obtain fee information about the assets.
    - Prohibited Contract Terms. The contract may not include provisions barring investor participation in class action suits against the adviser or financial institution, exculpatory provisions or limitations of liability in favor of the adviser or financial institution.
- *Required Disclosures.*
    - Initial and Annual Disclosure. Fiduciaries relying on the exemption must provide certain disclosures prior to the transaction and other disclosures on an annual basis during the reliance period.
    - Webpage. A public webpage must disclose certain information regarding the adviser's compensation.

- *Notification of the DOL*. Before relying on the BIC Exemption, the financial institution must notify the DOL of its intent to do so.
- *Recordkeeping and Access to Records*. The financial institution must maintain certain data for six years from the date of each transaction.
- *Asset Limitations*.
    - Only advice with respect to certain assets types (e.g., mutual funds, ETFs, registered bonds, agency debt, Treasury securities, insurance or annuity contracts, GICs and certain equity securities) qualifies for the exemption.

The financial institution generally must offer a range of assets broad enough to enable the adviser to make recommendations in the best interest of the investor. A limited range may be offered if the adviser satisfies a set of more stringent conditions.

<u>Exemption for Principal Transactions</u>

This proposed exemption would permit an investment advice fiduciary to engage in principal transactions with respect to certain debt securities where the buyer or seller is an IRA, participant or beneficiary of a self-directed plan, or a plan sponsor of a non-participant directed plan, and would permit the fiduciary to receive a mark-up, mark-down or other payment for itself or its affiliates, even where the transaction results from the fiduciary's advice. Like the BIC Exemption, the exemption would impose Impartial Conduct Standards on the adviser and financial institution, contains recordkeeping and disclosure requirements, and provides a list of required and prohibited contract terms.

Proposed Changes to Existing Exemptions

Amendments are proposed to existing Prohibited Transaction Exemptions dealing with certain transactions involving employee benefit plans and broker-dealers and banks (**PTE 75-1, PTE 86-128**); the investment of plans in open-end mutual funds (**PTE 77-4**); securities transactions where the proceeds may be used to retire certain indebtedness (**PTE 80-83**); the acquisition of interests in mortgage pools by plans (**PTE 83-1**); and certain transactions involving insurance agents, insurance companies, and certain other parties (**PTE 84-24**). In most cases, the DOL has proposed imposing Impartial Conduct Standards on fiduciaries relying upon the exemptions.

Possible "Low Fee" Exemption

The DOL mentioned and solicited advice with regard to, but did not formally propose, a "streamlined" exemption which would allow advisers to receive compensation in connection with a plan's or IRA's purchase of certain high-quality, low-fee investment options, which might include mutual funds which are index funds or certain target date funds.

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If the proposed guidance is finalized in a form similar to the proposal, the new rules will require compliance within eight months following finalization, a timeline that is likely to present significant practical market challenges. Further, while the proposal responds to certain concerns raised by the withdrawn 2010 proposal, there are many open questions that will require close analysis as the regulatory process unfolds.

For more information about the proposed rules, please contact any member of Ropes & Gray's <u>employee benefits practice group</u>.