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Commenters React to DOL's Proposed Expansion of Fiduciary-Duty Rules

Four months after proposing a significantly expanded definition specifying when "investment advice" to employee plans and IRAs would give rise to fiduciary status under the Employee Retirement Income Security Act of 1974, the Department of Labor has its hands full grappling with comments on the multi-faceted proposal. The DOL received over 2,600 comment letters on the proposal and heard testimony from over 70 witnesses during public hearings from August 10 to August 13 in Washington D.C. This Alert describes some of the leading themes in the comment letters and the public hearings, focusing on the concerns of the regulated community.

Background

The Department's proposal would significantly expand the scope of fiduciary activity by redefining what constitutes "investment advice" under ERISA. In connection with the proposed regulation, the Department proposed a new exemption referred to as the Best Interest Contract ("BIC") Exemption. 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. 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. A more comprehensive summary of the DOL's proposed regulation and exemptions can be found here.

Summary of Public Comments

A common theme among the comment letters the Department received – letters both in favor and opposed to the proposal – was that financial advisers should act in their clients' best interest. However, different commenters seemed to understand that standard in different ways, as was noted at the public hearings.

Comment letters from citizens and plan participant organizations such as AARP and the 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 participants.

Comment letters opposed to the proposal varied in their reasons for opposition. Several commenters warned that the proposal could cause many firms to withdraw from the business of providing advice to small savers. A few questioned the Department's authority for issuing parts of the proposed guidance and the process that the Department undertook to issue the guidance. A greater number of letters criticized technical aspects of the proposed regulation and BIC Exemption 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 this Alert will do likewise.

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The Department's Authority

Several commenters expressed concern's about the Department exceeding the scope of its legal authority.

- *Distributions*: A number of comment letters expressed the view that the Department's proposed definition of investment advice, which would pick up advice with respect to distributions from a plan, is broader than contemplated by 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 contend that advice with respect to distributions from a plan is different from "investment advice for a fee."
- *IRAs*: Many commenters took direct aim at the Department's authority to regulate IRAs, which have historically been regulated by the Treasury Department. 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. At least one commenter noted that IRAs are already regulated by federal securities laws and banking regulators and that additional regulation of broker-dealers by the Department was unnecessary.
- *Broker-Dealers*: Many commenters expressed concerns about overlapping regulations, specifically with respect to federal securities laws. Section 913 of the Dodd-Frank Act grants the 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 also to defer to FINRA's existing regulatory standards for broker-dealers.

The Department's Process

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

- *Regulatory Impact Analysis*: Several commenters challenged the findings of the Department's regulatory impact analysis released in conjunction with the proposal. That analysis concluded that the proposal would result in net gains to retirement investors of tens 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. Several interested parties commissioned separate studies to refute parts of the Department's analysis.
- *BIC Exemption*: Commenters expressed their view that the Department had not done enough to determine the feasibility of the BIC Exemption.
- *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. Other commenters disagreed with the idea of a "streamlined exemption," reasoning that the Department would be favoring passive investment over active investment.

Comments on the Proposed Regulation

Comment letters in opposition to the Department's guidance frequently focused on the proposed redefinition of fiduciary investment advice under ERISA. Under the proposal, investment advice would consist of various types of recommendations or advice for a fee or other compensation that are given with an understanding that the advice is "specifically directed to" an advice recipient "for consideration in making investment or management decisions."

- *Definition of Recommendation*: Comments in opposition to the definition were nearly unanimous in arguing that it was too broad in scope. Criticism focused on the proposal that a communication reasonably viewed as a "suggestion" to take a course of action would be viewed as a "recommendation" giving rise to fiduciary status. During the hearings, Deputy Assistant Secretary Tim Hauser acknowledged these criticisms and stated that the Department intended to follow FINRA's overall facts and circumstances approach, rather than looking at whether there was a "suggestion" in isolation, and that a recommendation would need to include a "call to action."

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- *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. The existing standard, by contrast, defines investment advice as the product of a "mutual" understanding that the advice would serve as the "primary basis" for investment decisions. Many commenters expressed concern that the elimination of the "mutuality" 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.
- *Concern over "Specifically Directed"*: Still other commenters expressed concern about the "specifically directed" language in the proposal. The 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.
- *Impact on Requests for Proposals*: 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. 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.
- *Asset Allocation Models*: Commenters and witnesses raised concerns regarding the "investment education" carve-out to the proposed fiduciary definition. The proposal would allow parties to present asset allocation models without becoming fiduciaries but, in a reversal of current DOL guidance, the "investment education" exception would not apply if the allocation model named specific investments. Many commenters and witnesses took issue with this approach as unhelpful to retirement investors.

Comments on the Proposed BIC Exemption

Many of comment letters in opposition to the proposal offered criticism of the BIC Exemption, and a number of letters focused exclusively on the BIC Exemption. Commenters opposed to the BIC Exemption generally argued that the limited scope of the Exemption, which applies to specific investments and would not apply to fiduciaries of participant-directed plans, coupled with its stringent requirements, made the Exemption unworkable as proposed and/or would impose significant costs on the industry and, in turn, on participants.

- *Contracts*: To rely on the BIC Exemption, fiduciaries would be required to enter into a bilateral contract with the plan or participant before providing investment advice. A common suggested alternative from the retirement industry was the use of a unilateral contract and a requirement that the contract be effective not prior to the recommendation, as proposed, but only prior to the transaction that results from the advice. Such an arrangement would alleviate the logistical difficulties of two or more parties entering into a written contract for each of the tens of millions of transactions that could potentially be covered by the proposed Exemption.
- *Disclosures*: Under the BIC Exemption, the advice provider would be required, among other things, to disclose the projected performance of the investments available to the investor for 1-, 5-, and 10-year periods. The fiduciary would also be required to disclose through a public webpage the compensation paid in connection with each investment available to purchase, hold, or sell through the adviser or financial institution. Commenters opposed to the BIC Exemption overwhelmingly opposed the disclosure regime as impractical and costly, emphasizing the difficulty of projecting the future performance of investments and noting that projecting future performance likely violates existing FINRA guidance. Many commenters expressed support for supplementing the existing service provider fee disclosures to meet the disclosure requirements under the BIC Exemption.
- *Arbitration*: Several witnesses at the hearings who generally supported the proposal criticized the permissibility of mandatory arbitration provisions in contracts issued under the BIC Exemption. As proposed, the BIC Exemption permits the best interest contract to require the parties to submit to mandatory arbitration in non-class action cases. Witnesses testified that such a requirement would limit individuals' ability to pursue their claims, with one referring to it as a "fatal flaw." Witnesses also expressed concern about the transparency and neutrality of the arbitration proceedings.

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<u>Comments on the Impact of the Proposed Guidance</u>

Many of the comment letters in opposition to the Department's guidance discussed what the commenters perceived to be the overall impact the guidance would have on Americans' retirement savings.

- *Individuals, IRAs 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. The critics warned against imposing fiduciary responsibilities on more advisers who would be unable to receive relief from prohibited transactions in light of the burden of the BIC Exemption. Commenters reasoned that advisers would be less likely to service participants with small plan account balances and small businesses because the compensation they 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. Many comment letters noted that the BIC Exemption does not appear to provide relief for a prohibited transaction related to IRA rollovers, and asked the DOL to clarify this point.
- *Private Funds*: Several comment letters expressed concern about the proposed regulation's effect on private funds. 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 exceptions or carve-outs to the definition of fiduciary investment advice, including a carve-out for "sophisticated investors," which the DOL defined in part to include fiduciaries that manage at least $100 million in plan assets. 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.
- *Lifetime Income Products*: Many insurance companies and trade associations requested that the Department revise the proposed BIC Exemption or PTE 84-24 to avoid adverse impacts on the sale of variable annuities. 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. 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.
- *Call Centers*: A number of service providers and employer organizations commented that they would not be able to provide rollover and education services through call centers. Some of the same commenters explained how the broad scope of the proposed regulation would define investment advice to include many of the services that call centers currently provide. 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.

Going Forward

The Department's proposed guidance states that the proposed regulation and exemptions would be effective eight months following the date they are finalized. This so-called "applicability date" prompted numerous comments objecting to the implementation timeline and requesting grandfathering of existing accounts.

It is possible that the retirement industry could challenge the proposal in court, which could delay the "applicability date." While no lawsuit has been filed, several comment letters appeared to outline legal challenges to the Department's economic analysis or the Department's authority to implement the proposal.

Meanwhile, the proposal has sparked debate in Congress. In February, Representative Ann Wagner (R-MO) reintroduced 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. Representative Wagner's bill has not yet advanced to a vote

of either the House Financial Services or Education and Workforce Committee. Appropriations bills containing riders prohibiting the Department from finalizing the proposal are also pending in the House and Senate. These riders are likely to be debated as Congress attempts to pass an omnibus spending bill by the October 1, 2015, deadline.

In the short term, the Department has invited another round of comments. Comments will be due two weeks following the date the Department posts the transcripts from the recent public hearings. The Department is likely to take several weeks to post the transcripts.

For more information on the proposed guidance and its potential effect on the retirement industry and investment providers, please contact a member of Ropes & Gray's employee benefits practice.

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