GROOM LAW GROUP

April 16, 2015

DOL Proposes Major Changes to Fiduciary Advice Definition

On April 14, 2015, the U.S. Department of Labor ("DOL") made available its long-awaited re-proposed regulation on the definition of "fiduciary" under section 3(21) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The package of materials proposed by the DOL included:

- A regulation re-defining who is a "fiduciary" by reason of providing investment advice to a plan or an IRA (the "2015 Proposed Regulation");
- Two new prohibited transaction class exemptions; and
- Amendments to several existing prohibited transaction class exemptions.

This client alert prepared by Groom Law Group provides an overview of the 2015 Proposed Regulation. For information regarding the proposed revisions to existing class exemptions, introduction of new class exemptions or a summary of the DOL's regulatory impact analysis, please see our client alerts covering those subjects.

I. Executive Summary

The changes proposed by the DOL to the fiduciary definition will expand the universe of individuals and entities viewed as investment advice fiduciaries to ERISA retirement plans and IRAs. While the proposal includes some helpful exceptions to the application of the new fiduciary definition, these exceptions are relatively narrow. As a result, certain sales activities, and consulting, recordkeeping, participant education and valuation services that do not currently give rise to fiduciary status, would do so under the proposal.

Under the 2015 Proposed Regulation, a person would be considered a fiduciary advisor if the person, for a fee or other compensation, provides one of four types of advice directly to a plan, plan fiduciary, participant or beneficiary, IRA or IRA owner, and the person or an affiliate has either acknowledged fiduciary status or provides the advice under an agreement, arrangement or understanding that the advice is individualized to, or specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property. The 2015 Proposed Regulation also includes certain discrete carve-outs limiting those situations in which a person providing advice will be deemed a fiduciary.

II. Overview of the 2015 Proposed Regulation

Under current guidance, the DOL provides a 5-part test to determine whether a person will be acting as a fiduciary adviser (29 CFR sec. 2510.3-21(c)) (the "Current Rule"). Specifically, a person may provide investment advice if the person: (1) renders advice to a plan as to the value of securities or other property, or makes recommendations as to the advisability of investing in, purchasing, or selling securities or other property; (2) on a regular basis; (3) pursuant to a mutual understanding; (4) that such advice will be a primary basis for investment decisions; and that (5) the advice will be individualized to the plan.

The DOL initially proposed to expand the fiduciary advice definition in 2010 (the "2010 Proposed Regulation") but withdrew the proposal in 2011 in the face of strong opposition from the retirement services community and members of Congress from both parties.

The 2015 Proposed Regulation, like the 2010 Proposed Regulation, seeks to eliminate the current five part test and subject a person to ERISA's fiduciary standards if, for a fee or other compensation[1], the person:

- provides one of four types of advice directly to a plan, plan fiduciary, participant or beneficiary, IRA or IRA Holder ("Covered Advice"): and
- either directly or indirectly (e.g., through or together with an affiliate):
    - represents or acknowledges fiduciary status, or
    - provides the advice under an agreement, arrangement or understanding that the advice is individualized to, or specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property.

The 2015 Proposed Regulation defines four different types of Covered Advice that could subject a person to fiduciary status:

- recommendations as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including recommendations to receive a distribution of benefits or roll over assets from a plan or IRA;

- recommendations as to the management of securities or other property, including recommendations as to the management of assets be rolled over to or distributed from an IRA;

- appraisals or fairness opinions concerning the value of securities or other property if made in connection with a specific transaction involving the plan or IRA; and

- recommendations of a person who will also receive a fee or other compensation for providing any of the three Covered Advice categories listed above.[2]

A. Observations

Not surprisingly, the 2015 Proposed Regulation specifically applies to advice and recommendations regarding IRA rollovers. This is a reversal of the DOL's 2005 position on distribution-related advice—that a recommendation to a plan participant to take an otherwise permissible plan distribution does not constitute "investment advice." Somewhat more

[1] The 2015 Proposed Regulation provides that a "fee or other compensation" would include any fee or compensation for advice received by a person or an affiliate from any source and any fee or compensation incident to a transaction in which advice has been rendered or will be rendered. Examples include brokerage fees and mutual fund and insurance sales commissions.

[2] The 2015 Proposed Regulation defines the term recommendation to mean "a communication that, based on its content, context, and presentation, would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action."

surprising is that IRAs are defined to include Health Savings Accounts ("HSAs") and that Covered Advice also includes recommendations regarding advice with respect to other distributions from plans and IRAs (e.g., not involving rollovers). As such, the proposal does not appear to require an investment recommendation to accompany the distribution advice.

The 2015 Proposed Regulation also includes other significant changes from the Current Rule. For instance, under the proposal, advice would not be required to be provided on a "regular basis" or pursuant to a "mutual understanding" that the advice will serve as a "primary basis" for an investment decision. While the advice must be either "individualized" or "specifically directed to" the advice recipient, the only "understanding" required (although not necessarily mutual) is that the advice will be "for consideration" by the recipient. And where the advice provider or an affiliate has represented or acknowledged that it is acting as a fiduciary with respect to the advice provided, no further requirements apply to any Covered Advice. The 2015 Proposed Regulation also affirms DOL's position that recommendations regarding investment managers (not just securities) give rise to fiduciary status. These changes will certainly make it easier for many in the retirement services industry to be found to be fiduciary advisors – including for one-time advice or recommendations where the provider has no expectations that the advice will be relied upon.

Notably the 2015 Proposed Regulation differs from the 2010 Proposed Regulation in that it does not automatically require that an adviser registered under the Investment Advisers Act of 1940, as amended, be a fiduciary under ERISA. However, as discussed below, a person providing Covered Advice will not be eligible for any of the carve-outs if it has represented or acknowledged that it is a fiduciary in providing Covered Advice. Under many service contracts, a person may acknowledge that it is a fiduciary to the extent that it meets the requirements of ERISA's fiduciary definition. It is not yet clear whether such a contract term would render the provider ineligible for any of the proposed carve-outs, discussed below.

B. Exceptions to Fiduciary Status

Notwithstanding the broad swaths of activities that the DOL seeks to include as fiduciary investment advice under the 2015 Proposed Regulation, the DOL also proposed several carve-outs that allow persons who may otherwise be deemed investment advice fiduciaries escape fiduciary status. These carve-outs are discussed in more detail below.

1. Counterparty Exceptions

The first "carve-out" category included in 2015 Proposed Regulation is referred to as the "counterparty exceptions." These sales exceptions – which are only available for sales to certain plans or plan fiduciary and are unavailable for sales to individual participants, IRAs or IRA holders - allow a person, acting as or on behalf of a counterparty, to provide Covered Advice to an independent plan fiduciary in an arm's-length sale, purchase, loan or bilateral contract or proposal for such a transaction if certain other conditions are met. This counter-party carve-out is reminiscent of the "seller's rule" in the 2010 Proposed Regulation.

a. Plan Fiduciary Qualifications and Representations

With respect to transactions with plans represented by a fiduciary with responsibility for managing at least $100 million in employee benefit plan assets, the advisor/counterparty must confirm the fiduciary's "size" qualification either by relying on the plan's most recently filed Form 5500 or by obtaining a written representation from the fiduciary regarding its assets under management. For transactions with plans represented by fiduciaries having less than $100 million in assets under management, the advisor counterparty must obtain a written representation from the plan fiduciary that:

- It exercises authority and control with respect to the management and disposition of plan assets;
- The plan has 100 or more participants; and,
- The fiduciary will not rely on the person to act in the best interest of the plan, to provide impartial investment advice, or to give advice in a fiduciary capacity.

b. Required Disclosures by Advisor/Counterparty

For any transaction to be covered by a Counterparty Exception, the advisor/counterparty must: fairly inform the fiduciary representing the plan that the advisor/counterparty is not undertaking to provide impartial investment advice. Further, the advisor/counterparty may not receive any fee or other compensation directly from the plan or plan fiduciary for the provision of investment advice in connection with the transaction. Notably, it appears this requirement would not preclude the counterparty advisor from receiving compensation from the plan or plan fiduciary for other services rendered in connection with the transaction.

c. Swaps Based Carve-Outs

In recognition that swaps and other security based swaps transactions are already regulated under the Commodity and Exchange Act ("CEA") and the Securities Exchange Act ("Exchange Act") under Dodd-Frank, the 2015 Proposed Regulation provides a carve-out for swap dealers, security-based swap dealers, major swap participants and security-based major swap participants who make recommendations to plans to avoid providing investment advice under ERISA.

First, the swap dealer may not act as an "advisor" to the ERISA plan in the swap transaction. This suggests that a recommendation not "tailored to the particular needs or characteristics" of the ERISA plan does *not* amount to a Covered Recommendation. It also suggests the need for greater reliance on the second safe harbor (CFTC Regulation 23.440(b)(2), which would require the ERISA plan to be represented by a "qualified independent representative," within the meaning of CFTC Regulation 23.450. Second, the ERISA fiduciary must be "independent" of the swap dealer, and third, prior to making any recommendations, the swap dealer must obtain a written representation from the plan fiduciary that the fiduciary will not rely on such recommendation.

This carve-out, therefore, appears to hinge on how tailored the recommendation is to the ERISA plan. CFTC guidance indicates that certain recommendations can be individualized to an ERISA plan *without* subjecting the swap dealer to "advisor" status. Whether the recommendation would render the swap dealer an “advisor” to the ERISA plan, as set forth in CFTC Regulation 23.440, is a critical initial determination.

2. Employee Carve-Out

The 2015 Proposed Regulation also carves-out from the scope of fiduciary investment advice any employee of a sponsoring employer or employee organization provided that he or she receives no fee or other compensation in connection with the advice beyond the employee’s normal compensation for work performed for the employer or employee organization. While this carve-out should be useful to help quarantine in-house personnel that routinely assist the plan fiduciary, contracts for those persons may need to be amended to reflect that no additional compensation is paid to the employee as a result of services performed to assist the plan fiduciary.

3. Platform Provider and Selection and Monitoring Assistance Carve-Outs

The 2015 Proposed Regulation carves-out from fiduciary status those who market and make available platforms for a plan fiduciary to select and monitor investment alternatives that are offered to participants and beneficiaries provided that the person acknowledges in writing that they are not providing investment advice to the plan. Moreover, in connection with those platform provider services, a platform provider may avoid fiduciary status if the person “merely identifies investment alternatives that meet objective criteria specified by the plan fiduciary (e.g., stated parameters concerning expense ratios, size of fund, type of asset, credit quality)”; or “merely provides objective financial data and comparisons with independent benchmarks to the plan fiduciary.”

It is uncertain whether this rule will severely affect the types of services that service providers are willing to offer plans or their fiduciaries. It is also unclear whether, as currently drafted, investment advisers may provide routine performance monitoring metrics and data to plan fiduciaries without incurring fiduciary status under ERISA. The DOL also specifically declined to extend these platform and monitoring assistance carve-outs to those providing services to IRA Holders.

4. Appraisals

While including appraisals or fairness opinions as Covered Advice that may cause a service provider to become an investment advice fiduciary, the DOL also carves-out certain types of appraisals from fiduciary status. In particular, a person furnishing a appraisal or fairness opinion will not be deemed a fiduciary provided that the appraisal was rendered for 1) an employee stock ownership plan (“ESOP”), 2) an investment fund which holds the assets of more than one unaffiliated plan, or 3) for purposes of complying with ERISA’s reporting or disclosure requirements. The DOL cautioned, however, that appraisals rendered to ESOPs would be subject to separate regulatory guidance.

5. Investment Education Carve-Out

Lastly, the DOL also attempted to exclude from the definition of fiduciary advice the provision of investment education (“Investment Education”). This carve-out would supersede and replace commonly used Investment Bulletin 96-1, 29 CFR 2509.96-1 (IB 96-1). IB 96-1 generally permits the furnishing of (1) plan information, (2) general financial, investment and retirement information, (3) asset allocation models, and (4) interactive investment material by as plan sponsor to its participants (but has been widely understood to apply more broadly to other persons). While the DOL's Investment Education carve-out largely mirrors the provisions IB 96-1, the DOL added several new conditions that will need to be worked through in the upcoming days and months.

For example, DOL added a new condition that the information and materials provided not include advice or recommendations regarding specific investment products, specific investment managers or the value of particular securities or other property. The carve-out also specifically permits the furnishing of information to help participants assess their retirement needs past retirement and risks.

Most notably, however, and in a stark deviation from IB 96-1, investment allocation models may not refer to a specific investment product available under the plan or IRA. This is a departure from current guidance that would allow asset allocation models to be populated with specific investment choices. This approach would require any asset allocation model to be populated with asset classes and not specific investment choices regardless of whether a disclaimer is included that specifically highlights that other investment options are available under the plan. Also, the proposal does not address how to demonstrate that providing information about distributions or rollover may be education rather than advice.

6. Brokerage Services

The DOL also retained the provisions of the Current Rule that pertain to the effecting of securities transactions by broker-dealers at the direction of plan clients or other unrelated parties, but expanded the provision to also apply to IRAs. Thus, those relying on the exception should be permitted to continue their current practices without incurring fiduciary status under ERISA.