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View From Groom: Fiduciary Advice Proposal Signals a Fundamental Shift in the DOL's Approach

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On April 20, 2015, the U.S. Department of Labor (''DOL'' or the ''Department'') published in the Federal Register 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'') (72 PBD, 4/15/15). The package of materials proposed by the DOL is impressively comprehensive, including not only the proposed regulation itself, but also two new prohibited transaction class exemptions and amendments to several existing prohibited transaction class exemptions.

Equally impressive has been the Obama administration's carefully calibrated messaging of the proposal, including a February 23 announcement of the rule by the President himself, flanked by Senators Elizabeth Warren (D-Mass.) and Cory Booker (D-N.J.), and the press-only meeting led by Secretary of Labor Thomas Perez to distribute the public inspection version of the proposal on April 14 (36 PBD, 2/24/15). But it is not just the comprehensive nature and carefully crafted message of the proposal that is noteworthy. The DOL's fiduciary proposal represents a fundamental shift in the Department's approach to regulating the retirement services industry.

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This article discusses three aspects of the proposal that illustrate this fundamental shift. The first is that the Department has chosen to reformulate the definition of fiduciary to encompass numerous types of sales activities that are clearly non-fiduciary in nature under current law. Because ERISA imposes legal responsibilities and liability on those acting in a fiduciary capacity, the effect of any revision to the regulation defining who is a fiduciary will necessarily be magnified. But assigning fiduciary status to sales activities is particularly disruptive under ERISA because of the statute's basic intolerance of conflicts of interest.

A second aspect involves the primary new prohibited transaction class exemption included in the 2015 proposal, the ''Best Interest Contract Exemption,'' or ''BIC Exemption.'' The ''principles-based'' approach utilized in this exemption may be a model for how the DOL sees the ''next generation'' of class exemptions, perhaps better able to accommodate a rapidly changing marketplace.

And finally, the proposal represents a dramatic shift by the Department toward the regulation of the IRA rollover marketplace. Given the size and rapid growth of the IRA market, this shift amounts to a significant expansion of the Department's role.

Fundamental Shift #1—No Room for Sales

Likely the most noticeable shift in approach in the 2015 proposal is the move toward classifying sales activities as fiduciary in nature. This is particularly noteworthy because every sale involves a fee conflict: if the sale is made, the seller gets paid. Relative to the standards of conduct applicable to broker-dealers, which primarily rely on the suitability rules to answer this inherent conflict, and the disclosure-based regime under the Investment Advisers Act, ERISA is particularly intolerant of fee conflicts.

The requirements of the current ''5-part test'' to determine fiduciary adviser status generally exclude sales activities by limiting the scope of fiduciary activities to those in which a person, for a fee: (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 (29 C.F.R. § 2510.3-21(c)). Sales activities are generally not conducted on a ''regular basis,'' nor is there a ''mutual understanding'' as to use of recommendations provided in a sales context. In addition, recommendations made in a sales context may not be individualized to the needs of the recipient.

Under the 2015 proposal, only the first prong of the current test survives. In fact, the resulting test is essentially an expansion of part of the first prong of the current test and focuses primarily on assigning fiduciary status on the basis of ''recommendations.'' Thus, the 2015 proposal defines four activities as ''Covered Advice'':

- 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 to 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.

For purposes of the proposal, the definition of ''recommendation'' is also very broad, and includes a communication that ''would reasonably be viewed as a suggestion that the advice recipient engage in or refrain from taking a particular course of action'' (80 Fed. Reg. 21,928, 21,960, 4/20/15).

A person who provides Covered Advice for a fee or other compensation will be an advice fiduciary if the person, directly or indirectly:

- 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 proposed rule could be interpreted as capturing within the ''investment advice'' definition virtually any conversation—including sales conversations—in which a provider of retirement products and services describes those products and services to a participant, beneficiary, plan fiduciary or IRA owner. While the proposal includes certain ''carve-outs'' that would permit limited sales activities to certain large plans, many ''sales'' activities could be deemed fiduciary activities under the proposal.

This shift in approach is extremely disruptive because of the fundamental tension that exists between the duties that attach to fiduciary status and the standards that apply in a typical ''sales'' context. And it stands in marked contrast with the current rule, under which most sales activities fall neatly outside of the fiduciary definition. One of the major impacts of this change is that it shifts the burden of proof regarding fiduciary status. Under the current rule, sales activities are more or less automatically excluded from the ERISA fiduciary definition—typically because there is no ''mutual understanding'' regarding the advice recipient's reliance on the recommendation provided. However, if the proposal were finalized as drafted, most sales activities would, by default, be fiduciary activities and the adviser would be required to show compliance with the conditions of a carve-out in order to escape fiduciary status.

Fundamental Shift #2—'Principles-Based' Exemption Approach

A second fundamental change in the DOL's traditional approach that can be seen in the 2015 Proposal involves the BIC exemption. According to the Department, ''[r]ather than create a set of highly prescriptive transaction-specific exemptions, which has generally been the regulatory approach to date, the [BIC] exemption would flexibly accommodate a wide range of current business practices, while minimizing the harmful impact of conflicts of interest on the quality of advice'' (80 Fed Reg 21,960, 21,961, 4/20/15).

Although the *conditions* of the BIC exemption hardly strike one as ''flexible,'' the relief offered by the exemption is, as the Department notes, less limited in application than many existing class exemptions—particularly those offering relief from ERISA's conflict of interest prohibited transaction provisions. Thus, the BIC exemption would broadly apply to a variety of transactions and compensation models, and, presumably, would stand the test of time while still allowing innovation and change in the marketplace.

While there are a number of very significant concerns within the retirement services industry about the workability of the BIC Exemption as drafted, those concerns generally relate to the particular conditions of the exemption and not to the ''principles-based'' approach itself. In fact, this approach could be viewed as part of the natural maturation of the exemption process, allowing the Department to better keep up with growth and change within the retirement services industry.

If the BIC can be seen as the prototype of the ''principles-based'' exemption approach, it also marks a significant shift towards regulating the conduct of the IRA rollover market. This shift is discussed, below.

Fundamental Shift #3—Application of ERISA Standards to IRA Fiduciaries

While many of the requirements of ERISA are accompanied by parallel provisions of the Internal Revenue Code (the ''Code''), ERISA's primary fiduciary responsibility provisions and the enforcement mechanisms contained in ERISA are not generally applicable to individual IRAs. Rather, fiduciaries of such plans are subject only to the prohibited transaction and excise taxes or IRA disqualification provisions described in the Code.

The 2015 Proposal includes an important shift that would subject an investment advice fiduciary with respect to an IRA to the same standards of prudence and loyalty as are applied under ERISA. The mechanism used by the DOL to accomplish this change is to condition the availability of exemptions from the prohibited transaction provisions of the Code on compliance with

a set of ''Impartial Conduct Standards'' that largely mirror the primary duties imposed on ERISA fiduciaries.

Specifically, these standards require that an advice fiduciary must act in the ''best interest'' of its client. This is defined as acting ''with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and the needs of the [plan or IRA].''

The Impartial Conduct Standards also limit the advice fiduciary's compensation to ''reasonable'' compensation in relation to the total services provided, and require that the fiduciary avoid ''misleading'' statements (including failure to disclose material conflicts of interest). As ERISA fiduciaries are already subject to the fiduciary responsibility provisions of ERISA Section 404, the effect of these conditions is to impose ERISA-like prudence and loyalty standards on IRA fiduciaries who wish to utilize any of the most common DOL class exemptions.

In the new BIC Exemption, the DOL has also required the fiduciary adviser to warrant to its clients that it will comply with the ''Impartial Conduct Standards.'' If broken, the fiduciary could be contractually liable for breach of warranty (although the breach would not result in loss of the exemption, as long as the breach did not involve violation of one of the exemption's other conditions). The exemption also forbids the fiduciary's contract with its clients from including any exculpatory provision that disclaims or otherwise limits liability for violations of the contract terms, and any waiver or qualification of the client's right to bring or participate in a class action or other representative action in a contract dispute with the fiduciary.

The result of this approach is not only the imposition of ERISA fiduciary standards on IRA fiduciaries, but an enabling of private class action enforcement of these standards. Given that the DOL generally does not have authority to enforce prohibited transaction rules against IRA fiduciaries, and the IRS does not have the resources, this approach represents a fundamental change in the duties and potential liability of IRA fiduciaries—and one the DOL seems likely to want to replicate to the extent possible in other exemptions, including future individual and class exemptions.

It remains to be seen whether this approach will be viewed by the industry as an acceptable trade-off for exemptive relief under future ''principles-based'' exemptions.