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ERISA Update

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DOL Proposes Definition of "Investment Advice"

On April 14, 2015, the US Department of Labor (DOL or Department) issued a proposed regulation re-defining the meaning of "investment advice" for purposes of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (the Code), introduced two new prohibited transaction exemptions, and proposed to significantly amend several current exemptions (the Proposal).[1] If finalized in its current form, financial institutions and their employees, agents, and representatives will act as fiduciaries for purposes of ERISA and the Code in many more circumstances than they do today. For example, the sale of investment products and services to ERISA-governed plans and individual retirement accounts will result in fiduciary status. In addition, a recommendation to take a distribution from a plan or individual retirement account (IRA) and roll over to an IRA results in fiduciary status.

The Proposal is an attempt by the Department to revise the definition of "investment advice" to reflect the movement of Unites States workers from defined benefit pension plans to defined contribution 401(k) plans and personal savings vehicles like IRAs. More specifically, the Department believes that "retail" investors, many of whom invest through IRAs, need more protection than what is available under current federal and state law. Therefore, pursuant to the Proposal, plan and IRA fiduciaries will be required to comply with prohibited transaction exemption requirements that are substantially different than what they are today. For example, the fiduciary will be required in some cases to implement conflict management procedures that are more demanding than those required under federal and state securities laws and state insurance laws. The purpose of this update is to give readers a sense of how the Proposal will impact fiduciary status and some of the implications thereof.

The current definition of "investment advice" and the proposed definition of "investment advice" are substantially different. Under the current regulation, a person provides "investment advice" if he or she:

(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.

This is commonly known as the "five-part test" for determining fiduciary status with respect to the provision of "investment advice."

Pursuant to the Proposal, a person is a fiduciary if he or she, for a fee, provides one of four types of advice (Covered Advice) to plans subject to ERISA's fiduciary duty provisions (generally, private sector benefit plans), fiduciaries, participants or beneficiaries of such plans, and other plans defined in Code Section 4975(e)(1) not subject to ERISA (generally, IRAs and health savings accounts (HSAs)) and one of two relationship requirements are met. Covered Advice includes the following:

(1) 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;
(2) recommendations as to the management of securities or other property, including recommending that assets be rolled over or distributed from an IRA;
(3) appraisals or fairness opinions concerning the value of securities or other property if made in connection with a specific transaction involving a plan or IRA; and
(4) recommendations of a person who also will receive a fee or other compensation for providing any of the aforementioned types of Covered Advice.

A "recommendation" is defined in the Proposal as "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."

In addition to the four kinds of Covered Advice, the DOL also will require that a relationship or functional element be met for a person to be a fiduciary. In this regard, in order for a person to be an investment advice fiduciary under the Proposal, that person must also, either directly or indirectly:

(1) represent or acknowledge fiduciary status; or
(2) provide 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 definition of "investment advice" is sweeping, particularly when compared to the current regulation and its five-part test. The proposed definition specifically states that making a recommendation regarding whether to take a distribution or rollover assets from a plan to an IRA or other plan will be investment advice. This is not always the case under current law. In addition, the proposed definition provides that recommendations regarding investment managers results in fiduciary status, which some practitioners believe is not the case under the current regulation.

Importantly, the sale of investment products and services will in many cases result in the provision of "investment advice," which is generally not the case under current law. This result is in part due to the proposed elimination of the "regular basis," "mutual understanding," and "primary basis" requirements currently found in the five-part test. Furthermore, the addition of a requirement that the Covered Advice be only "specifically directed to" the advice recipient in lieu of just being "individualized" opens upon many sales presentations or even responses to requests for proposal to be "investment advice."

Even though the Proposal defines "investment advice" broadly, the Proposal provides for a number of "carve-outs" from the definition. The term "carve-out" is not currently used under ERISA or the Code. Typically, ERISA and DOL guidance provides for "exclusions" or "exemptions." The use of the term "carve-out" may suggest certain burden of proof issues that we do not see under the current regulation. As discussed, the Department intends to broaden the number of persons who will be fiduciaries for purposes of ERISA and the Code. The use of the term "carve-out" suggests that a person is a fiduciary, but he or she will not be treated as such if the requirements of the "carve-out" are met. As a result, the Department will bear less of a burden than it does today to prove that a person acts as a fiduciary. Rather, pursuant to the Proposal, such person will bear the burden of proving that he or she fits within a carve-out.

In any case, the provision of carve-outs is helpful to the extent a person does not want to be a fiduciary. There are several proposed carve-outs including the following: (1) counterparty carve-out; (2) swap and security-based swap transactions carve-out; (3) employees of fiduciaries carve-out; (4) platform provider and related selection and monitoring carve-out; (5) financial reports and valuations carve-out; and (6) investment education carve-out. The applicability of the counter-party and platform carve-outs is important because these carve-outs are indicative of one of the Department's stated objectives, which is the protection of "retail" investors.

The counterparty carve-out is available to exempt an arm's-length sale, purchase, loan or bilateral contract or proposal between the counterparty and a plan or plan fiduciary if certain disclosure requirements are met. However, the carve-out is not available to plans with less than one-hundred participants unless a fiduciary with at least $100 million of employee benefit plan assets under management makes the investment decision on behalf of the plan and the carve-out is not available to IRAs. Similarly, the platform provider and selection and monitoring carve-out is available to carve-out making available investment platforms and the provision of limited information regarding the platform's investments. However, the carve-out is not available for IRA or HSA platforms.

In effect, by limiting these carve-outs in this manner, the Department takes a policy position that employer sponsors or similar fiduciaries of small benefit plans, unless represented by an independent, sophisticated fiduciary, and IRA owners of any size are in need of the protections afforded by ERISA's fiduciary and prohibited transaction provisions and the Code's prohibited transaction provisions. This position, however, is contrary to the fiduciary requirements of ERISA, which does not hold fiduciaries of small plans to a different standard than fiduciaries of large plans. In addition, this position is incongruent with Rule 501 of Regulation D promulgated under the Securities Act of 1933, as amended (the Securities Act). As such, an "accredited investor" is sophisticated enough to invest in an exempt security under the Securities Act, but cannot invest in mutual funds without the benefit of the protections afforded by ERISA and the Code.

In the event a person is a fiduciary under ERISA when providing investment advice, he or she must comply with ERISA's prohibited transaction provisions under ERISA Section 406(b), which prohibit the advice provider from engaging in self-dealing, acting in the face of certain conflicts of interest, or receiving "kickbacks." Fiduciaries under the Code are subject to identical self-dealing and "kickback" prohibitions under Code Section 4975. In order to avoid violations of these provisions, the fiduciary must meet the requirements of one or more prohibited transaction exemptions. The Proposal, if finalized in its current form, will significantly impact the exemption strategy that would otherwise be applied under current law.

The most significant impact of the Proposal on exemption strategy is the introduction of a new class exemption called the best interest contract exemption (BIC Exemption). The BIC Exemption is significant in that it is very complex, the cost of compliance will likely be very high, and that it is aimed at the protection of retail investors, which are defined as "Retirement Investors" in the exemption. Retirement Investors include (1) participants or beneficiaries of participant-directed plans, (2) beneficial owners of IRAs and HSAs, and (3) sponsors (or similar fiduciaries) of non-participant-directed defined contribution and defined benefit plans that have fewer than one-hundred participants. While the BIC Exemption applies to both ERISA-governed plans and IRAs, the exemption's impact on IRAs is noteworthy. In many cases, the BIC Exemption is the only exemption available when investment advice is provided to IRA owners. The BIC Exemption will require, among other things, the adoption of an "Impartial Conduct Standard," which requires the fiduciary to act in accordance with a "best interest" standard. The Department states the "best interest" standard is its articulation of ERISA's fiduciary duties of prudence and loyalty. Thus, the Department proposes to use the exemption to effectively subject IRAs and their advisers to an ERISA fiduciary standard.

Also noteworthy is that the BIC Exemption mandates certain contractual provisions that give IRA owners an ERISA-like breach of fiduciary duty claim against investment advisers in state court. In addition, the contract must not contain exculpatory language or require that the Retirement Investor waive his or her right to a class action. Effectively, the Department intends to use the threat of a law suit for breach of the warranty provisions in the BIC Exemption as a mechanism to enforce compliance with the "best interest" and other requirements.

Finally, the Proposal calls for the substantial amendment of class exemptions on which many fiduciaries currently rely. Prohibited transaction exemption (PTE) 84-24, PTE 86-128, and PTE 75-1 are among those that would be amended. These PTEs are relied upon by many advisers, including registered representatives, insurance agents, and consultants to receive commissions as well as revenue sharing, 12b-1 fees, shareholder servicing fees, sub-transfer agent fees, and other third-party payments for the sale of affiliated and unaffiliated mutual funds, annuities, and securities that are not mutual funds. In the Proposal, the Department proposes to add the above-discussed Impartial Conduct Standards, including the "best interest" standard, to each of these exemptions. In addition, the Department will narrow the definition of "commission" in each of the three exemptions so that third-party payments cannot be paid to the representative or agent providing the advice as well as his or her associated financial institution. Finally, the proposed revisions to Part II of PTE 75-1 and PTE 86-128 appear to make it impossible to receive any compensation for the sale of unaffiliated mutual fund shares on an agency basis.

In summary, the Department's Proposal, if adopted as a final regulation in its current form, will have a substantial impact on the providers of investment products and services to ERISA-governed plans, IRAs, and similar arrangements. The Department has opened an official comment period through July 21, 2015, during which it will receive written comments from the public. Public hearings are scheduled for August 10 through August 13, 2015, after which another, shorter written comment period will likely be opened. The Department, which has the backing of President Obama, is highly motivated to publish a final regulation that is substantially effective before the end of the President's second term. As such, in the absence of Congressional action, readers should in the near future expect a substantial overhaul of their compliance procedures as they apply to benefit plans and IRAs.

NOTE

1 80 Fed. Reg. 21928 (Apr. 20, 2015).