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Department of Labor's Proposal to Define "Investment Advice"

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On April 14, 2015, the US Department of Labor (DOL or Department) published 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 (Code).[1] If adopted in its current form, the Department's proposed rulemaking will have a significant impact on how providers of investment products and services to individual retirement accounts (IRAs) conduct their businesses.

Effectively, the Department intends to use the proposed definition of "investment advice," addition of a "best interest contract" exemption, and changes to current exemptions (collectively, the Proposal or 2015 Proposed Regulation) to more substantially extend its authority over IRAs and other "plans" as defined under Code section 4975(e)(1) that are not subject to the fiduciary duty provisions under ERISA section 404(a) or the prohibited transaction provisions under ERISA section 406. As a result, virtually all sales and marketing activities in connection with IRAs will be "investment advice" and subject to the prohibited transaction provisions. The purpose of this article is to explain how the Department proposes to accomplish this.

IRAs under Current Law

Certain "plans" as defined in Code section 4975(e)(1) are not subject to the fiduciary provisions in Title I of ERISA, but are subject to the prohibited transaction provisions of Code section 4975. These include IRAs under Code section 408(a), individual retirement annuities under Code section 408(b), an Archer MSA described in Code section 220(d), health savings accounts described in Code section 223(d), and Coverdell education savings accounts described in Code section 530. This article focuses on IRAs. However, the reader should note that the analysis in the article applies to the other plans described in this paragraph.

The Code's prohibited transaction provisions prohibit a fiduciary from causing, in the absence of an exemption, a transaction between a plan and a "disqualified person."[2] Additionally, fiduciaries to IRAs, in the absence of an exemption, may not deal with the income or assets of the IRA in his own interest or for his own account.[3] Finally, a prohibited transaction occurs, in the absence of an exemption, if a fiduciary receives consideration for his or her own personal account from any party dealing with the IRA in connection with a transaction involving the income or assets of the IRA.[4]

The consequences of engaging in a non-exempt prohibited transaction can be significant. Section 4975(a) of the Code imposes a 15 percent excise tax on the "amount involved" in a prohibited transaction.[5] In the event that the IRS notifies an IRA owner or beneficiary that it has discovered a prohibited

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transaction and it is not resolved within a certain period of time, a 100 percent excise tax on the amount involved is imposed under Section 4975(b) of the Code.[6] The tax is assessed against the disqualified person engaged in the prohibited transaction.[7] However, the tax will not be imposed on a fiduciary involved in the prohibited transaction unless the fiduciary was acting in some other capacity that made it a disqualified person (for example, a service provider).[8] Furthermore, if the prohibited transaction is caused by the IRA owner or beneficiary, an excise tax is not imposed. However, the IRA loses its tax-favored status and any gains attributable to assets within the IRA are immediately included in income.[9]

Effectively, the IRS enforces violations of Code section 4975 through the assessment of excise taxes. Moreover, while an IRA is not subject to ERISA, the Code's prohibited transaction provisions in large part mirror those in ERISA and, in fact, the Department's Employee Benefit Security Administration (EBSA) has the responsibility to interpret the prohibited transaction provisions for purposes of both the Code as well as ERISA.[10]

The Proposal represents an unprecedented exercise of such interpretive authority through which the Department intends to curtail what it perceives as abusive practices in the IRA marketplace. One also may view the Proposal as a statement by the Department that it believes other federal and state regulators that have regulatory and enforcement jurisdiction over IRAs have not done enough to protect IRA investors.

Definition of Investment Advice – Current Law

Under the Code and ERISA, a person will be a fiduciary by reason of giving investment advice if the person receives compensation for doing the following services:

(1) he or she makes recommendations regarding the advisability of buying, selling, or retaining securities;
(2) he or she does so on a *regular basis*;
(3) pursuant to a *mutual agreement*;
(4) that "such services shall serve as the *primary basis* for investment decisions with respect to plan assets;" and
(5) such advice is *individualized* to the plan taking into account factors such as investment policies, investment strategies, the plan's overall portfolio, or diversification of plan investments.[11]

This current definition of "investment advice" is commonly known as the "Five-Part Test" for determining whether a person is a fiduciary under ERISA and the Code.

The "regular basis," "mutual agreement," "primary basis," and "individualized" parts of the test often lead to conclusions that a person does not act as a fiduciary under current law. For example, sales of securities or other properties are often made on a one-time or sporadic basis such that the "regular basis" part of the test is not met. In addition, many sellers of securities to plans take the position that any advice is incidental to a recommendation to buy or sell the security and thus the "primary basis" part of the test is not met. In summary, there are many situations in which sellers of products and services to IRAs are not fiduciaries by reason of how the Five-Part Test is applied.

Sellers to IRAs take the position that they are not fiduciaries by reason of providing investment advice in other circumstances. Some sellers and providers of discretionary and non-discretionary advisory services take the position that the Five-Part Test only applies to securities, not investment services, although the Department has suggested it does not agree with that position.[12] Moreover, DOL Advisory Opinion 2005-23A (Dec. 7, 2005), commonly known as the "Deseret Opinion," states that a person is not a fiduciary when it provides a recommendation regarding whether to roll over plan assets from an ERISA-covered plan to an IRA so long as the person is not a fiduciary with regard to the plan.

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Definition of Investment Advice – Proposed

The proposed definition of "investment advice" is an attempt by the Department to address its concern that the current definition does not adequately identify fiduciaries in light of changes to the retirement services industry, which includes a move from employer-sponsored defined benefit pension plans to employer-sponsored defined contribution plans and to personal savings vehicles like IRAs. The Department would define the term of "investment advice" very broadly and then provide for a number of "carve outs" from the definition. Effectively, the Department would shift its, the IRS' or an investor's burden under current law to prove a person is a fiduciary by reason of providing investment advice to the person who claims not to be a fiduciary, who will have to prove he or she falls within a "carve out." Importantly, some carve-outs on which many financial services providers might rely do not apply when advice is provided to an IRA.

Proposed Definition of "Investment Advice"

Pursuant to the Proposal, a person is a fiduciary if he or she, for a fee,[13] provides one of four types of advice to an IRA (Covered Advice). 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 an ERISA-covered 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 ERISA-covered plan or IRA;
(3) appraisals or fairness opinions concerning the value of securities or other property if made in connection with a specific transaction involving an 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.[14]

A "recommendation" is "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."[15]

In addition to the four kinds of Covered Advice, the Proposal requires that a relationship element be met for a person to be deemed a fiduciary. In this regard, in order for a person to be deemed an advice fiduciary under the 2015 Proposed Regulation, 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.[16]

Importantly, the preamble to the proposed definition of "investment advice" states that the parties must have a "meeting of the minds" (that is, agreement or understanding) that the Covered Advice is individualized or specifically directed to the IRA owner, but no such "meeting of the minds" is required with regard to "the extent to which the advice recipient will actually rely on the advice."[17] This is different from the current definition of "investment advice," which requires a "mutual understanding" that the advice will serve as the "primary basis" for an investment decision by the IRA.

As you can see, the proposed definition of "investment advice" does not include the "regular basis," "mutual understanding," and "primary basis" requirements in the current rule and establishes a new functional test to identify fiduciaries. Of course, it is these parts of the Five-Part Test that

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result in many providers not providing investment advice. In addition, it would appear that many interactions involve a "recommendation," which would only involve a mere "suggestion" that the IRA owner take a course of action. Finally, the addition of the "specifically directed to" language as an alternative to an "individualized" communication would appear to result in almost any communication, particularly one that is customized in any way, as meeting the relationship test. As a result, many activities not considered fiduciary in nature today would be fiduciary, under the Proposal.

Most sales and marketing activities in connection with IRAs would be investment advice under the Proposal, while they are not fiduciary under current law. For example, a person who sells mutual funds shares or an annuity contract to an IRA on a one-time basis would take the position under current law that such sale, or any underlying recommendation, does not result in investment advice. However, under the Proposal, such sale would likely result in fiduciary status because the sale in most circumstances involves a recommendation (for example, a suggestion) that the IRA purchase the security or other property, and the advice is provided pursuant to an understanding of the IRA owner (not the advice provider) that the advice is specifically directed to him or her for consideration.

In addition, the recommendation of an investment manager also is included under the proposed definition, while under current law the recommendation of a manager may not be "investment advice." Interestingly, the Proposal can be interpreted so that the recommendation of oneself as an investment adviser or manager can result in fiduciary status. Thus, for example, an investment manager who sells its advisory services to a plan will be a fiduciary even though the compensation he or she may be paid does not raise the conflicts of interest concerns intended to be addressed by the Proposal, for example, the adviser receives a fee that does not vary by what investment recommendation he or she makes or cannot otherwise control the amount and timing of his or her compensation by what recommendations he or she makes.

Even more interesting is that the sale of investment products and services to an intermediary fiduciary may also be "investment advice." Thus, a provider of financial products and services to IRAs who distributes those products and services through financial intermediaries who are fiduciaries also may be a fiduciary if the provider otherwise provides "investment advice" as defined. This may be the case even if the provider never directly interacts with an IRA owner.

Finally, and very importantly in the context of IRAs, the Proposal provides that recommendations regarding whether to take a distribution from an ERISA-covered plan or IRA and to roll over such distribution to an IRA are included in the definition of investment advice. Thus, the Department proposes to reverse its prior conclusion in the Deseret Opinion. Practically speaking, providing rollover advice involves several transactions including (i) the recommendation to take a distribution from an ERISA-covered plan or another IRA, (ii) the recommendation to contribute the rollover proceeds to an IRA or other IRA, and (iii) the recommendation regarding how to invest the proceeds in the recipient IRA.

Carve-Outs from Fiduciary Status

While proposing to substantially broaden the definition of "investment advice" (and thus the persons who are fiduciaries) through the 2015 Proposed Regulation, the DOL also provides certain "carve-outs" that allow persons who may otherwise be deemed investment advice fiduciaries to be excepted from fiduciary status. These carve-outs are an attempt by the DOL to preserve certain common business practices within the retirement services industry for which the DOL believes fiduciary protections are not needed.

The following carve-outs are particularly relevant to IRA providers: (i) counterparty carve-out; (ii) platform and investment selection and

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monitoring carve-out; and (iii) investment education carve-out. Each of these carve-outs is explained in more detail below. These carve-outs are notable in that they are largely not available to IRA providers or of limited availability to IRA providers. This lack of or limited availability to IRA providers is significant in that it demonstrates the Department's intention that most sales, marketing, and other activities fall within the definition of "investment advice." We also summarize two other carve-outs that may be helpful to IRA providers.

Counterparty Carve-Out

The counterparty "carve-out" allows a person, acting as a counterparty (or counterparty representative) to a plan, to provide incidental 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 the plan or a fiduciary representing the plan meets certain minimum requirements. Such requirements are designed to assure that a fiduciary of the plan independent of the counterparty is sophisticated enough to understand that the counterparty is selling something and not acting in the best interests of the plan to which it is selling.[18] The carve-out may primarily provide a carve-out for an arm's length sale, purchase, loan, or bilateral contract, or proposal by a seller of a product or service to either (i) an independent plan fiduciary with more than $100 million in assets under management, or (ii) an independent plan fiduciary of a plan with more than 100 participants.[19]

Intentionally, this carve-out is not available for a counterparty that sells to an IRA. This is because the DOL believes such persons cannot distinguish when a person acts as a counterparty (for example, the person is selling something) from when the person is providing advice.[20]

Platform Provider/Selection and Monitoring Assistance Carve-Out

The Proposal 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 he or she is not providing investment advice to the plan.[21] Moreover, in connection with those platform provider services, a platform provider is not a fiduciary if the person "merely identifies investment alternatives that meet objective criteria specified by the plan fiduciary (for example, 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."[22]

However, the platform carve-out is not available with respect to IRAs. Again, this is intentional. The Department believes that the carve-out should not be available to IRAs due to the lack of an independent fiduciary between the IRA owner and the platform providers, such as would be the case with an ERISA-governed plan that has a named fiduciary acting on its behalf.[23]

Investment Education Carve-Out

Like under current DOL guidance, the Proposal provides a carve-out for the provision of investment education.[24] This carve-out would supersede and replace the Department's commonly used Investment Bulletin 96-1 (I.B. 96-1), which distinguishes between "investment advice" and "investment education" under current law.[25] In this regard, the I.B. 96-1 provides "a series of graduated safe harbors under ERISA for plan sponsors and service providers who provide participants and beneficiaries with four increasingly specific categories of investment information and materials": (1) plan information, (2) general financial and investment information, (3) asset allocation models, and (4) interactive investment materials.[26] The concept underlying all four safe harbor models is that the "safe harbor" information is not a "recommendation" with respect to any investments, but that it is simply information that enables participants to make their own investment decisions.

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While the 2015 Proposed Regulation is in large part the same as the guidance in I.B. 96-1, there are some material differences. These differences include the following:

(1) The carve-out specifically permits the furnishing of information that relates to retirement needs that extend beyond the date of retirement. In other words, education may include certain information about how to spend down assets after retirement, not just information on the accumulation of assets in anticipation of retirement.
(2) The carve-out specifically requires that information and materials provided to plans not include advice or recommendations regarding specific investment products, specific investment managers, or the value of particular securities or other property.
(3) While the carve-out continues to allow for the use of allocation models as part of an education program, the models may not be populated with specific investment products available under the plan or IRA.

There are a few aspects of this carve-out that should be considered when providing information to IRA owners.

(1) While the carve-out provides guidance on how to educate ERISA-covered plan participants on how to spend down their account balances, the carve-out does not describe how to educate participants about their rollover options. Therefore, it is not clear whether the DOL draws the line between distribution and rollover education and advice in the same manner as FINRA.
(2) Given the broad definition of "recommendation," it may be difficult or impossible to develop communications intended to be education rather than advice, particularly if the communication identifies specific products and services.
(3) The prohibition on the use of specific examples of investments in allocation models, particularly if the investment is already designated as an investment option under an IRA, is a significant limitation. The Department's concern is that the inclusion of specific investment options in the model "function as tailored, individualized investment recommendations, and can effectively steer recipients to particular investments, but without adequate protections against potential abuse." However, one may question whether an asset allocation model without specific investment options is of any value to an IRA owner.

Thus, while the investment education carve-out is available to IRA providers, the aforementioned limitations may make it less useful to providers.

Appraisal Carve-Out

The Proposal states that, notwithstanding the fact the provision of an appraisal, fairness opinion, or statement of value, is Covered Advice, a person will not be a fiduciary if, among other things, such appraisal, fairness opinion, or statement of value is provided to an IRA or IRA owner solely for purposes of compliance with the reporting and disclosure provisions under the Code, and the regulations, forms and schedules issued thereunder, or any applicable reporting or disclosure requirement under a Federal or state law, rule or regulation or self-regulatory organization rule or regulation.[27] Further, as noted above, Covered Advice includes an appraisal, fairness opinion, or similar statement concerning the value of securities or other property, but only if such appraisal, fairness opinion, or similar statement is provided "in connection with a *specific transaction or transactions* involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA" (emphasis added).

The Proposal limits instances in which the provider of a valuation, fairness opinion, or similar report acts as a fiduciary. However, there will be instances where, with regard to a "specific transaction or transactions" involving the IRA, the provider of the

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appraisal, fairness opinion, or similar report acts as fiduciary. Thus, for example, if an IRA intends to sell a real estate asset and needs a valuation or fairness opinions to assure compliance with the Code's prohibited transaction provisions, the provision of such services is "investment advice" under the Proposal and the carve-out is not likely to be available. In addition, the language in the exclusions is somewhat concerning. For example, an IRA owner rarely uses an appraisal just to meet legally required reporting requirements.

Brokerage Services Carve-Out

The DOL also retained the provision in the current definition of fiduciary advice that the effecting of securities transactions by broker-dealers at the direction of plan clients or other unrelated parties is not "investment advice." The Proposal would expand the provision to IRAs.[28] Thus, broker-dealers could execute buy and sell orders from the IRA owner. Of course, the broker-dealer would be effectively limited to just taking orders. Any interaction beyond order taking, however, may be a Covered Advice.

In summary, the Proposal substantially broadens the definition of "investment advice" so that almost all sales and marketing activities directed at an IRA owner or at an ERISA-governed plan participant regarding a rollover to an IRA will give rise to fiduciary status. Further, by significantly limiting the availability of the carve-outs with respect to IRAs, the Department intends many IRA service providers to be fiduciaries for purposes of the Code. As a result, such providers must be concerned about complying with the prohibited transaction provisions of the Code and, in order to avoid non-exempt prohibited transactions, complying with statutory and class exemptions. It is through such exemptions, particularly the "best interest contract" exemption, that the Department would exercise more control over advisers and service providers to IRAs.

Prohibited Transaction Exemptions

The Proposal would substantially impact how IRA fiduciaries comply with the Code's prohibited transaction exemptions. The Department introduced a new class exemption called the "best interest contract" exemption (BIC Exemption). The BIC Exemption requires that the fiduciary (i) act in accordance with a "best interest" standard, (ii) adopt processes and procedures designed to mitigate conflicts of interest, particularly in the area of compensation, and (iii) meet disclosure, recordkeeping, and other requirements. Further, the Department proposes to amend several exemptions on which fiduciaries to IRAs currently rely so that fiduciaries are required to comply with the BIC Exemption. However, as we discuss below, there may be other exemptions or other strategies still available in some, albeit limited, circumstances.

Best Interests Contract Exemption

According to the DOL, the BIC exemption allows an "Adviser," "Financial Institution," and their affiliates to receive compensation under circumstances that would otherwise be contrary to the Code's prohibited transaction provisions related to the use of IRA assets, self-dealing and the receipt of kickbacks.[29] In other words, they can receive compensation, like commissions, that would otherwise be prohibited in the absence of an exemption.[30]

The BIC Exemption is available when an Adviser provides investment advice to a Retirement Investor regarding the purchase, sale, or retention of Assets. The BIC Exemption defines "Assets" to include a number of investments, which generally are publicly traded and/or have values that are readily determined by independent sources. The definition does not include non-US securities, alternative investments, and other kinds of investments. The definition specifically excludes options and similar contracts.[31] In other words, if the Adviser sells or provides advice on securities or other property that are not Assets, the BIC Exemption is not available. This likely means that the Adviser and Financial Institution cannot receive transaction-based compensation (for example, commissions, trails, etc.) if they wish to sell such securities or other property because, except in the case of certain annuities, no

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other exemption is available to exempt the receipt of such compensation.

An "Adviser" is an employee, independent contractor, agent, or registered representative of a Financial Institution. A "Financial Institution" is a registered investment adviser, bank, insurance company or registered broker-dealer that employs an Adviser or otherwise retains the Adviser as an independent contractor, agent, or registered representative. The BIC Exemption extends to affiliates of the Adviser and Financial Institution, which generally are organizations within common control or in which the Adviser or Financial Institution have an interest.[32]

In any event, the DOL does not extend the BIC Exemption to cover particular relationships. These exclusions include when (i) the Adviser or Financial Institution engages in a principal transaction with the IRA or (ii) the Adviser or Financial Institution provides "investment advice" generated solely by an interactive website in which computer software-based models or applications provide the advice to the IRA owner based on personal information the investor supplies through the website without any personal interaction or advice from an individual Adviser (that is, robo-advice).[33]

BIC Exemption Conditions for Relief - "Best Interest" Standard

One of the conditions of the BIC Exemption is that the Adviser and the Financial Institution must contractually commit to adhere to "Impartial Conduct Standards" when providing investment advice to the IRA owner. This includes providing advice pursuant to the "best interest" of the Retirement Investor. The DOL states that the best interest standard is based upon the duties of prudence and loyalty under ERISA. Thus, the DOL expects it to be interpreted "in light of forty years of judicial experience with ERISA's fiduciary standards and hundreds more with the duties imposed on trustees under the common law of trusts."[34]

In effect, this provision subjects the day-to-day management of IRAs (not just advice regarding rollovers) to the duties of loyalty and prudence under ERISA if the relief of the BIC Exemption is sought. As such, through its statutory authority to issue class exemptions, the Department is subjecting IRAs to a standard of conduct that is different from and in addition to the standards of conduct required under the securities laws.

BIC Exemption Conditions for Relief - Warranties

The BIC Exemption also would require that the contract among the Retirement Investor, Adviser, and Financial Institution contain two specific warranties which, if broken, could result in contractual liability for breach of warranty. In effect, the warranty provision creates an ERISA-like cause of action whereby the IRA owner can bring suit against the Adviser and Financial Institution for breach of warranty and resultant losses. This provision was likely added to give the BIC Exemption "teeth" through the threat of private lawsuits due to limited enforcement in this area by the IRS and lack of enforcement authority by the DOL.

First, the Adviser and Financial Institution must warrant that they and their affiliates will comply with all applicable federal and state laws regarding the rendering of the investment advice, the purchase, sale or holding of the Asset, and the payment of compensation for such advice.

Second, the Financial Institution also must warrant that it has adopted written policies and procedures that are reasonably designed to mitigate the impact of material conflicts of interest that exist with respect to the provision of investment advice to Retirement Investors and ensure that individual Advisers adhere to the Impartial Conduct Standards described above. Those policies and procedures must -

(i) specifically identify material conflicts of interest and adopt measures to prevent those material conflicts from causing violations of the Impartial Conduct Standards; and
(ii) prohibit the use of quotas, appraisals, performance or personnel actions, bonuses, contests,

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> special awards, differential compensation or other actions or incentives to the extent they would *tend to encourage* individual Advisers to make recommendations that are not in the best interest of Retirement Investors.[35]

The meaning of the "tend to encourage" language mentioned above is not entirely clear. In the Preamble, the DOL noted that a "level-fee" structure, in which compensation for Advisers does not vary based on the particular investment product recommended, is not required to satisfy this condition. However, it also specified five examples of compensation structures that could satisfy the contractual warranty (independently certified computer models, asset-based compensation, fee offsets, differential payments based on neutral factors, and alignment of interests).[36] Interestingly, under current law, many practitioners would take the position that use of one or more of these arrangements would not require the use of any exemption.

BIC Exemption – Other Conditions

The BIC Exemption includes several other conditions, which are discussed or noted below.

Written Contract. The Adviser and Financial Institution must enter into a contract with the IRA owner prior to recommending the purchase, sale, or holding of an Asset.[37]

Reasonable Compensation. The fiduciary must state, within the written contract, that it will not recommend the purchase or sale of an Asset if the total amount of compensation anticipated to be received by the Adviser, Financial Institution, and their affiliates in connection with the purchase, sale, or holding of the Asset by the IRA will exceed reasonable compensation in relation to the total services they provide to the Retirement Investor.

No Misleading Statements. The Adviser's and the Financial Institution's statements in the contract about Assets, fees, material conflicts of interest, and any other matters relevant to an IRA owner's investment decisions must "not be misleading." In the Preamble to the BIC, the DOL states that failure to disclose a conflict is per se misleading.

Acknowledge Fiduciary Status. Both the Adviser and Financial Institution must acknowledge fiduciary status with respect to any recommendations to the IRA owner to purchase, sell or hold an Asset.[38]

Prohibited Contract Terms. The contract may not include an exculpatory provision that disclaims or otherwise limits liability for an Adviser's or Financial Institution's violations of the contract's terms. In addition, the IRA owner's agreement may not contain language that waives or qualifies his or her right to bring or participate in a class action or other representative action in a contract dispute with the Adviser or Financial Institution.[39]

Disclosures to the Retail Investor. The Financial Institution and Adviser also must provide specific written disclosures in the contract. Additionally, the Financial Institution or Adviser must provide to the Retirement Investor a point of sale disclosure, which would include among other things the "total cost" to the Retirement Investor for 1-, 5-, and 10- year periods expressed as a dollar amount, prior to the execution of any investment transaction. Finally, additional annual written disclosure must be provided within 45 days of the end of the applicable year regarding account-related activity and costs, and compensation paid. Note that under current law, Advisers and Financial Institutions provide some disclosure in order to comply with the exemption under Code section 4975(d)(2), but the requirements of the BIC Exemption go well beyond what is required under 4975(d)(2).

Website Disclosure. The Financial Institution and the Adviser must maintain a public webpage, updated not less than quarterly and written in a manner freely accessible to its IRA customers and the general public.[40] The website also must include a great deal of machine-readable compensation and revenue-related information for each Asset available through the Financial Institution.

Broad Range of Investment Options and Limited Range of Investment Options. Generally,

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the BIC Exemption provides that the Financial Institution must make a broad range of investment options available to the Adviser. The Preamble states that the Financial Institution should "enable an Adviser to make recommendations to the Retirement Investor with respect to all of the asset classes reasonably necessary to serve the best interests of the Retirement Investor in light of the Retirement Investor's objectives, risk tolerance and specific financial circumstances." However, the Preamble also notes an exception under the BIC for situations when "some Financial Institutions limit the investment products that a Retirement Investor may purchase, sell or hold based on whether the products generate third-party payments or are proprietary products, or for other reasons (for example, the firms specialize in particular asset classes or product types)." In this case, the BIC permits such limitations if certain requirements are met including (i) a specific written finding by the Financial Institution that the limitations do not prevent the Adviser from providing advice that is in the best interest of the IRA and (ii) the payments received in connection with limited investment options are reasonable.[41] Thus, for example, Financial Institutions that sell only proprietary products and services are held to a different standard than those who do not.

EBSA Disclosure. Before receiving prohibited compensation in reliance on the exemption, the Financial Institution must notify the DOL of its intention to rely on this exemption.[42] Furthermore, the Financial Institution must maintain and, upon request, disclose to the DOL information related to "Inflows," "Outflows," "Holdings," and "Returns."[43] This information must be maintained for six years from the date of the applicable transaction. Information must be provided within a reasonable time, but in no event longer than six months after receiving a request from the DOL. The Financial Institution must provide the DOL and others with access to certain records of the Financial Institution.[44]

Changes to Existing Exemptions

In the Proposal, the Department proposes to make significant changes to the prohibited transaction class exemptions (PTEs) on which Advisers and Financial Institutions currently rely to receive compensation (including commissions, revenue sharing, 12b-1 fees, and other payments) in connection with advice given to IRA owners. These exemptions are, primarily, PTEs 77-4, 86-128, 84-24, and 75-1.

One of the key proposed changes to the current PTEs that will impact IRAs is that PTE 86-128, PTE 84-24 (with one limited exception discussed below), and PTE 75-1 would be amended to provide that they are not available when advice is given to an IRA owner, but would still apply if the Adviser provided discretionary management services to the IRA. In effect, under an advice program, this change would require reliance on the BIC Exemption in order to receive commissions, revenue sharing, 12b-1 fees, and similar payments, and possibly in other situations.

One exception to this general requirement that all advice given in respect of IRAs be addressed through the BIC Exemption is advice given in connection with the purchase of an annuity that is not a security. The Department proposes that compensation paid for giving such advice could continue to be exempted under PTE 84-24. This means that the sale of fixed annuities, which are not securities, could be exempt from the Code's prohibited transaction provisions without reliance on the BIC Exemption. The requirements of PTE 84-24 are substantial, but not as demanding as those under the BIC Exemption. Additionally, even the sale of some variable annuity products could be addressed under PTE 84-24 if the Department intends to allow PTE 84-24 to apply to annuity products that are securities, but are exempted from registration under the securities laws.

Because this article is focused on investment advice, we do not address how the changes to the PTEs will impact discretionary investment programs. However, we note that the proposed

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changes to PTEs 75-1 and 86-128 will significantly limit the ability to receive 12b-1 fees, revenue sharing, and other third-party payments under such programs.

Other Exemptions and Options

Given the burdensome conditions of the BIC Exemption and the increased litigation and compliance risk attendant thereto, Advisers and Financial Institutions may look to other exemptions or DOL guidance as alternatives. As discussed, the Department intends to push Advisers and Financial Institutions towards the BIC Exemption through its proposed changes to several PTEs. However, there may be some other options. These include the following: (i) PTE 84-24 (exempts transactions in connection with sales of fixed annuities); (ii) Code Section 4975(d)(17) (exempts payment of compensation under advice programs if fee leveling or a computer model is used); (iii) managed accounts that use computer models as described in DOL Advisory Opinion 2001-09A; (iv) fee leveling in accordance with DOL guidance[45]; (v) Code section 4975(d)(4) (exempts investment in certain bank products); and (vi) Code section 4975(d)(8) (exempts investments in certain bank collective investment trusts and pooled insurance company separate accounts).

The aforementioned exemptions are not impacted by the Proposal and may be alternatives to the BIC Exemption. However, it is not clear how the BIC Exemption may be avoided if a recommendation is made to roll over assets from an ERISA-governed plan or IRA to another IRA. Normally, such recommendation would be made in connection with a recommendation regarding how to invest the rollover proceeds in the IRA once rolled over. The latter investment recommendation may be covered by one of these other exemptions. However, none of these exemptions address the rollover recommendation. Thus, the question arises whether the BIC Exemption could be avoided with regard to the rollover recommendation.

Conclusion

If finalized in its current form, the Proposal represents a significant shift in how investment products and services will be provided in the IRA marketplace. The Proposal is truly unprecedented in that the Department proposes to use its regulatory authority to regulate the IRA marketplace and require providers to meet compliance requirements that are more demanding than currently required under the Code and, arguably, more demanding than those currently required under federal and state securities laws and state insurance laws. While the definition of "investment advice," the BIC Exemption, and the changes to the PTEs are only proposed and the Department must sift through hundreds of comments letters and three and a half days of hearing testimony, the Department is motivated to produce a final rule and has White House support. A final rule issued by next Spring would not be a surprise. Application of the final rule to IRAs should be expected.

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NOTES

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

2 I.R.C. § 4975(c)(1)(A) – (D).

3 I.R.C. § 4975(c)(1)(E).

4 I.R.C. § 4975(c)(1)(F).

5 I.R.C. § 4975(a).

6 I.R.C. § 4975(b).

7 I.R.C. § 4975(a); (b).

8 I.R.C. § 4975(a); (b).

9 I.R.C. § 408(e)(2).

10 Reorganization Plan No. 4, 1978 (43 Fed. Reg. 47713, October 17, 1978).

11 29 C.F.R. § 2510.3-21(c).

12 Tybout v. Karr Barth Pension Admin., Inc., 819 F. Supp. 376, 383 (D. Del. 1993) (recommendation on hiring advisors is not investment advice); *but see* In Re Beacon Associates Litigation, 745 F.Supp.2d 386, 423 (S.D.N.Y. 2010) (recognizing language

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in the Preamble to DOL proposed regulations to change the definition of fiduciary that the definition of investment advice was always intended to include advice regarding the selection of an investment manager); Toledo Blade v. Inv. Performance Servs., 565 F.Supp.2d 879, 888 (N.D. Ohio 2008) (investment consultant acted as a fiduciary in advising fiduciaries on selection of investment managers); *but see* DOL Adv. Op. 84-03A (Jan. 4, 1984) (the provision of investment "consulting" consisting of (i) formulating an investment strategy; (ii) "implementing" the strategy by, among other things, advising plan fiduciaries as to the "general types" of investment managers; and (iii) analyzing the performance of the plan's investment managers involved the provision of fiduciary investment advice under ERISA); *see also* DOL Adv. Op. 84-04A (Jan. 4, 1984) (reaching the same conclusion with regard to a consulting arrangement similar to the one in DOL Adv. Op. 84-03A).

13 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. *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21960 (April 20, 2015). Examples include brokerage fees and mutual fund and insurance sales commissions. *Id*.

14 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21957 (April 20, 2015).

15 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21960 (April 20, 2015).

16 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21957 (April 20, 2015).

17 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21940 (April 20, 2015).

18 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21957 (April 20, 2015).

19 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21957 (April 20, 2015).

20 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21942 (April 20, 2015).

21 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21957–58 (April 20, 2015).

22 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21958 (April 20, 2015).

23 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21944 (April 20, 2015).

24 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21958–59 (April 20, 2015).

25 29 C.F.R. § 2509.96-1.

26 29 C.F.R. § 2509.96-1(d)(1)-(4); 61 Fed. Reg. 29586 (June 11, 1996) (preamble to final regulation).

27 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21958 (April 20, 2015).

28 *See* 2015 Proposed Regulation, 80 Fed. Reg. at 21959 (April 20, 2015).

29 I.R.C. § 4975(c)(1)(D); (E); (F).

30 The DOL contemplates that the BIC Exemption would cover commissions paid directly by the plan or IRA, as well as commissions, trailing commissions, sales loads, 12b-1 fees and revenue sharing payments paid by the investment providers or other third parties to Advisers and Financial Institutions. *See* BIC Exemption, 80 Fed. Reg. 21960, 21964 (April 20, 2015).

31 "Assets" include bank deposits, CDs, shares or interests in registered investment companies, bank collective funds, insurance company separate accounts, exchange-traded REITs, exchange-traded funds, corporate bonds offered pursuant to a registration statement under the Securities Act of 1933, agency debt securities as defined in FINRA Rule 6710(p) or its successor, US Treasury Securities as defined in FINRA Rule 6710(p) or its successor, insurance and annuity contracts (both securities and non-securities), guaranteed investment contracts, and equity securities within the meaning of 17 C.F.R. section 230.405 that are exchange-traded securities within the meaning of 17 C.F.R. section 242.600. *See* BIC Exemption, 80 Fed. Reg. at 21987(April 20, 2015).

32 More specifically, the BIC Exemption extends to "Affiliates" and "Related Entities." An "Affiliate" is (i) any person directly or indirectly through one or more intermediaries, controlling, controlled by, or under common control with the Adviser or Financial

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Institution; (ii) any officer, director, employee, agent, registered representative, relative, member of family, or partner in, the Adviser or Financial Institution; and (iii) any corporation or partnership of which the Adviser or Financial Institution is an officer, director or employee or in which the Adviser or Financial Institution is a partner. A "Related Entity" is any entity other than an Affiliate in which an Adviser or Financial Institution has an interest that may affect the exercise of its best judgment as a fiduciary. *See* BIC Exemption, 80 Fed. Reg. at 21987 (April 20, 2015).

33 *See* BIC Exemption, 80 Fed. Reg. at 21984 (April 20, 2015).

34 *See* BIC Exemption, 80 Fed. Reg. at 21970 (April 20, 2015).

35 *See* BIC Exemption, 80 Fed. Reg. at 21984 (April 20, 2015).

36 *See* BIC Exemption, 80 Fed. Reg. at 21971 (April 20, 2015).

37 *See* BIC Exemption, 80 Fed. Reg. at 21984 (April 20, 2015).

38 *See* BIC Exemption, 80 Fed. Reg. at 21984 (April 20, 2015).

39 *See* BIC Exemption, 80 Fed. Reg. at 21985 (April 20, 2015).

40 *See* BIC Exemption, 80 Fed. Reg. at 21985 (April 20, 2015).

41 *See* BIC, 80 Fed. Reg. at 21985–86 (April 20, 2015).

42 *See* BIC, 80 Fed. Reg. at 21986 (April 20, 2015).

43 *See* BIC, 80 Fed. Reg. at 21988 (April 20, 2015).

44 *See* BIC, 80 Fed. Reg. at 21986 (April 20, 2015).

45 DOL Adv. Op. 97-15A (May 22, 1997); *see also* DOL Adv. Op. 2005-10A (May 11, 2005).

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