DOL's Retirement Security Rule Muddies Definitional Waters

By **Michael Kreps** (November 20, 2023)

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On Oct. 31, the U.S. Department of Labor released a new fiduciary rule — now dubbed the "retirement security" rule — to redefine "investment advice" under the Employee Retirement Income Security Act.

The White House and the DOL framed the new fiduciary rule as a narrowly tailored regulation necessary to protect consumers in light of changes to the retirement system over the past five decades. However, the new proposal is better viewed as a sweeping regulatory overhaul that would change how much of the retirement services industry interacts with plans, participants and individual retirement account owners.

Under ERISA, a person becomes a fiduciary when they render "investment advice for a fee or other compensation, direct or indirect." Fiduciaries are held to the highest standard of care under the law, and they are subject to a strict set of prohibited transaction rules. These rules prohibit, among other things, providing advice that affects the amount or timing of the fiduciary's compensation.

The consequences of inadvertently providing investment advice can be severe, particularly in the context of commission-based transactions. For example, a provider could be liable for not only breaches of the fiduciary standard of care but also excise tax.

Despite the significance of becoming an ERISA fiduciary, Congress did little to clarify when a person is providing fiduciary advice, so in 1975, the DOL issued a regulation creating a five-part test. Under this test, an investment advice fiduciary is a person who:

1. Renders advice or makes recommendations as to the advisability of investing in, purchasing or selling securities or other property;

2. Does so on a regular basis;

3. Does so pursuant to a mutual agreement between such person and the plan;

4. Provides advice that serves as a primary basis for investment decisions with respect to plan assets; and

5. Provides advice that is individualized based on the particular needs of the plan.

For over a decade, the DOL has opined that the five-part test undermines ERISA's consumer protections by, for example, not holding financial professionals to a fiduciary standard of care when providing one-time advice or recommending rollovers. This has led the agency to repeatedly try to replace the five-part test with something new.

Their first attempt was in 2011, but the DOL pulled back the proposal after facing resistance from much of the regulated community and Democrats in Congress.

The agency went back to the drawing board and proposed a completely new version of the rule in 2015. That rule — which was finalized in 2016 — defined "advice" broadly and would have treated many sales conversations as fiduciary investment advice.

However, the 2016 rule faced several legal challenges and was ultimately vacated by the U.S. Court of Appeals for the Fifth Circuit in U.S. Chamber of Commerce v. DOL. The court concluded that people engaged in sales activities are not fiduciaries for purposes of ERISA absent a special relationship of "trust and confidence" and that the DOL's attempt to broadly expand the universe of advice to include ordinary salespersons "fatally conflicts with the statutory text."

The DOL has now, for the third time, proposed replacing the five-part test with a new definition of advice.

Under the proposed rule, a person would become an advice fiduciary by receiving a fee or other compensation in connection with making certain types of recommendations.

The recommendations must be directed to a "retirement investor" — e.g., ERISA-covered plans, participants, IRAs and IRA owners — and the specific facts and circumstances surrounding the recommendation must lead a retirement investor to believe the person providing the information intends to act as a fiduciary.

The DOL believes this is the case where the salesperson, alone or together with an affiliate:

1. Has discretionary authority or control with respect to a transaction involving securities or other investment property of the retirement investor;

2. Makes recommendations on a regular basis to investors in the marketplace as part of the investment advice provider's business and the circumstances indicate that a recommendation is individualized and may be relied upon by the retirement investor as a basis for investment decisions that are in the retirement investor's best interest; or

3. Acknowledges fiduciary status.

In short, the new rule would replace the current bright-line, five-part test for fiduciary advice with a muddier standard that is often dependent on the specific factual circumstances and based on the reasonable — and arguably subjective — expectations of retirement investors.

This level of uncertainty might be acceptable for a regulator seeking to maximize its enforcement tools, but it is a tough pill to swallow for an industry that needs clear rules so it can efficiently distribute retirement products and services at scale.

There are meaningful technical differences between the new proposal and the 2016 rule. However, from a policy perspective, the changes are largely cosmetic and appear aimed at improving the rule's chances of surviving the inevitable legal challenge.

For example, the Fifth Circuit's decision held that the 2016 rule went too far by eliminating the regular-basis prong of the five-part test, so the new proposal technically retains a regular-basis component. However, the DOL has redefined "regular basis" to shift the focus from the frequency of the recommender's communications with a particular investor to the recommender's business generally.

The practical result is that many — if not most — recommenders would satisfy the regular-basis requirement simply by virtue of being in the financial services industry.

Unsurprisingly, the new proposal faces a considerable amount of opposition.

The American Council of Life Insurers accused the administration of engaging in "scare tactics to push regulations that will hurt Americans," while Rep. Virginia Foxx, R-N.C. — chair of the U.S. House of Representatives Education and Workforce Committee — stated: "This latest proposal is just new lipstick on the same old pig, and it will harm retirement plans, retirees, and savers."

The House of Representatives has even moved to block the rulemaking by removing its funding.

The administration clearly anticipated the opposition as President Joe Biden announced the new rule from the White House surrounded by supporters. The event was presumably designed to demonstrate the administration's commitment to the project, and shore up support from Democrats in Congress, many of whom would likely prefer to avoid a contentious political fight in an election year.

It is the same playbook the Obama administration used in 2015.

The DOL set an aggressive timeline for moving the rulemaking forward. The agency provided a 60-day comment period — closing on Jan. 2, 2024 — and, in an unusual move, announced that they will be holding a hearing approximately three weeks before the close of the comment period.

A number of industry trade associations requested that the DOL extend the comment period and that the hearing be held after the comment period ends to afford commenters the ability to respond to others' comments, but the DOL rejected the request stating that the proposal reflects input the DOL has "received from public engagement with this project since 2010."

To the DOL's credit, senior agency officials routinely encourage stakeholders to comment, and the agency has an admirable open-door policy for those who want to discuss issues. However, the expedited process is concerning to many given that there is a substantial risk that the rulemaking could have unintended consequences.

Plus, the last formal public engagement on the advice definition occurred before other major regulatory initiatives, including states' adoption of model legislation regulating annuity sales and the U.S. Securities and Exchange Commission's Regulation Best Interest.

It remains to be seen whether the DOL will be able to get its new fiduciary rule across the finish line in the face of motivated opposition. If the DOL does succeed, a court, Congress or new administration could still unwind the rule.

The only thing for certain at this point is that the fight over this fiduciary rule is shaping up to be a lot like the fight over the last fiduciary rule.

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