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Summary of DOL Regulatory Package Redefining Fiduciary Advice and Proposing or Amending Prohibited Transaction Class Exemptions

On April 20, the Department of Labor (“DOL”) proposed a package of regulations and prohibited transaction exemptions (“The Proposal”) expanding the definition of fiduciary investment advice applicable to ERISA plans, IRAs and rollovers. The Proposal is quite complex, representing the most comprehensive revision of fiduciary advice regulations since 1975. President Obama personally endorsed the regulatory effort, directing DOL to promulgate the Proposal in a publicity event in February. The extended comment period on these regulations currently expires on July 20, 2015, followed by a public hearing the week of August 10 and a 30-45 day re-opened comment period following the hearing.

The following is a high-level summary of the major provisions of the proposed regulation and associated prohibited transaction class exemptions. In brief, all investment recommendations to plans or plan participants, all rollover recommendations, and all investment recommendations to IRA owners would be fiduciary advice under the expanded ERISA definition. As a result, all advisors and financial institutions providing such advice would have to receive level compensation (in other words, the compensation could not vary depending upon the investments selected by the advice recipient). The Proposal includes a new prohibited transaction class exemption that may permit some limited forms of traditional compensation for advisors, but only in connection with a variety of conditions significantly limiting permissible compensation, requiring new and complex disclosures of anticipated and incurred fees and expenses, and greatly expanding legal liability.¹

There is still a considerable amount of debate over the meaning and impact of the Proposal, and a key area of uncertainty is exactly how the rollover provisions in the proposal are intended to operate. As a high-level summary, this does not address all of the literally hundreds of issues being discussed, but it does provide a general overview of the expanded definition and the key prohibited transaction class exemption, the Best Interest Contract Exemption (“BICE”).

In General:

The Proposal consists of a proposed regulation that redefines fiduciary investment advice for plans subject to ERISA and for IRAs, and six new or amended prohibited transaction class

¹ The prohibited transaction rules in ERISA §406 and §4975 of Internal Revenue Code broadly prohibit many common transactions between plans/IRAs and certain persons or entities close to the plan or IRA, as well as self-dealing by fiduciaries. DOL has authority under ERISA §408 to promulgate exceptions to these rules called “exemptions.” A “class exemption” is available to all of those meeting its requirements, providing relief from specified restrictions of the prohibited transaction rules.

exemptions. The regulation encompasses virtually any recommendation or advice related to investments that is directed to a plan, participant or IRA holder and indicates that the recommendation or advice makes the entity that provides it a fiduciary. The sweep of the new definition is very broad, including recommendations on investment management, on taking a distribution from a plan, whether or not rolled over to an IRA, and on certain valuation assistance.

The breadth of the proposed new definition also means that many recommendations or advice not previously thought to involve prohibited transactions will be subject to the self-dealing prohibited transaction rules of ERISA. In what DOL says is an effort to limit the impact of these prohibitions to some extent, it has made some very limited relief available through a new proposed class exemption, the “Best Interest Contract Exemption” (“BICE”). BICE would permit some variable compensation for advisors and financial institutions in limited circumstances, subject to compliance with detailed conditions. Among these are a requirement to enter into a contract with the client containing specific provisions, disclosures and warranties (enforceable as a class action lawsuit in state court for breach of contract), and to provide detailed disclosures regarding investments initially and annually thereafter.

Proposed Regulation Expands the Advice Definition:

The proposed regulation in the Proposal amends the definition of fiduciary advice for purposes of §3(21)(A)(ii) of ERISA.

Under the existing definition in ERISA regulations found at 29 CFR § 2510.3-21(c), a person renders investment advice if he or she:

- i. Makes recommendations as to the advisability of investing in, purchasing or selling securities or other property
- ii. Renders the advice on a regular basis,
- iii. Pursuant to a mutual agreement, arrangement or understanding,
- iv. That the service will serve as the primary basis for investment decisions, and
- v. The advice is individualized based on the particular needs of the plan.

The Proposal’s Expanded Definition

The proposed regulation is much broader and drops the “regular basis,” “primary basis” and “mutual” requirements. It says a person renders investment advice if he or she:

- i. Receives a fee or other compensation incident to the transaction and,
- ii. Provides to a plan, plan fiduciary, plan participant, IRA or IRA owner, and
- iii. Advice consisting of:

- a. A recommendation regarding the advisability of acquiring, holding, disposing or exchanging securities or other property;
 - b. A recommendation regarding a rollover to a plan or IRA or other distribution;
 - c. An appraisal, valuation or fairness opinion, etc. (though ESOP valuations and certain valuations for reporting and disclosure purposes are excluded or “carved out”); or
 - d. A recommendation of a person who is going to receive a fee or other compensation for providing any of the foregoing recommendations or services; and
- iv. Provides the above advice pursuant to either:
- a. A representation or acknowledgement of fiduciary status, or
 - b. A written or verbal agreement, arrangement or understanding that the advice is individualized to the recipient, or is directed to the recipient (note that advice need not be individualized so long as it is directed to the recipient).

“Carve-Outs” from the Expanded Definition

There are a number of exclusions from fiduciary advice in the Proposal that the DOL calls “carve-outs,” including certain principal sales transactions and swaps, activities of plan sponsor employees, certain information provided by platform providers, and selection and monitoring assistance (that does not include advice or recommendations). Two of particular note involve educational information and information provided to large plan fiduciaries.

While the Proposal’s education carve out is modeled on current DOL guidance in IB 96-1, it does make some important changes. The education exclusion specifically applies to plans, participants and IRA owners (not just participants), and specifically includes information relating to retirement income. However, the exclusion does not permit the education to reference specific investment products, even those available on the plan menu. The effect of this change may be very great, negatively impacting education efforts, including online planning tools and in-person employee education events.

With regard to large plan fiduciaries, if the advisor is offering products to the fiduciary of a plan with more than with more than 100 participants, he or she will not be providing fiduciary advice if there is a written acknowledgement from the fiduciary that he or she understands that advisor is not operating as a fiduciary, and a number of fee and other disclosures have been provided. If the advisor is offering products to the fiduciary of a plan with more than \$100 million in assets, then this disclosure and acknowledgment do not have to be in writing.

The Proposed BICE Exemption:

The BICE exemption introduces a new concept to prohibited transaction exemptions, a so-called “principles based” exemption. Prior exemptions granted by the DOL have generally imposed strict, identifiable steps that must be taken for the exemption to apply. But BICE proposes to

permit fiduciary advisors, on a very limited basis, to receive compensation that varies based on their investment recommendations so long as they act in the “best interest” of the advice recipient. “Best interest” is defined essentially by the ERISA prudence standard.

The BICE exemption applies in a relatively limited number of cases (though the best interest concept is included in a number of the other proposed amendments to existing class exemptions released at the same time). The exemption permits advisors, financial institutions and their affiliates and related entities to receive compensation for advice related to “assets” given to “retirement investors.”

“Retirement investors” includes:

- Participants in participant-directed plans (but not in other plans);
- IRA owners; or
- The plan sponsor of non-participant directed plans with fewer than 100 participants (but not other plans).

“Assets” includes the most commonly used forms of plan investments, but notably do not include non-publicly traded securities, hedge funds, private equity funds, puts, calls, straddles, options, or real estate. Many commenters will likely inquire about the basis for providing relief for one kind of investment but not another, given that IRAs and ERISA plans have wide latitude in permissible investments.

“Best Interest” is defined as investment advice when the advisor or financial institution is acting:

- With “the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person would exercise...”
- Where the advice is “based on the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor” *and*
- Where the advice is given “without regard to the financial or other interests of” the advisor, financial institution, affiliate, related entity “or other party.”

BICE contains a number of conditions. Unlike most other class exemptions, BICE requires the advisor or financial institution to enter into a contract with the advice recipient that contains certain provisions before making any investment recommendations. This contract would be enforceable in state court, and the Proposal indicates that the contract cannot contain exculpatory provisions limiting liability or a waiver of the right to bring or participate in a class action lawsuit. The effect of this private right of action is a significant expansion of legal liability, as many of the BICE contract requirements are subjective rather than objective. Further state contract laws likely make available a wider range of remedies than ERISA provides.

In the contract, the advisor or institution must:

- i. Acknowledge fiduciary status,

- ii. Agree to provide advice that meets the best interest standard,
- iii. Agree to receive no more than reasonable compensation,
- iv. Agree that all disclosures will not be misleading, and
- v. Make various “warranties.”

The warranties include an affirmative statement that the advisor or institution will comply with applicable laws and that the financial institution:

- i. Has identified, disclosed, and adopted policies and procedures reasonably designed to mitigate the impact of “Material Conflicts of Interest” (defined as an interest that could affect the fiduciary’s exercise of best judgment),
- ii. Has identified and adopted measures to prevent such conflicts, and
- iii. Does not use any form of reward, bonus or differential compensation that would tend to encourage recommendations not in the best interest of the investor.

With respect to the last point above, the BICE proposal exhibits a somewhat circular logic—while generally prohibiting compensation that would incent advisors to act against “best interest,” the exemption goes on to provide that financial institutions are not prevented from providing advisors with differential compensation, but only “to the extent such compensation would not encourage advice that runs counter to the Best Interest” of the investor. This appears to be, in effect, a level fee requirement for the advisor, unless the differential is based on “neutral factors” such as the difference in time and analysis necessary to provide prudent advice regarding different types of investments. It does, however, appear to permit the financial institution to receive differential compensation as long as the advisor is paid on a level fee basis and the other requirements are met.

The contract must also agree to provide a comprehensive set of disclosures that likely will be quite costly for financial institutions and advisors to compile. Some of these disclosures must be provided prior to the execution of a transaction, such as a chart with respect to each recommended asset showing the future total cost (including the acquisition, holding and disposition costs) for a 1-, 5- and 10-year period expressed as a dollar amount (as well as the assumptions used to make this calculation). There also an annual retrospective disclosure requirement which includes:

- i. A list of all assets purchased or sold, including the price,
- ii. A statement of the total dollar amount of all fees and expenses paid with respect to the assets purchased, held or sold, and
- iii. A statement of the total dollar amount of all compensation received on such assets.

Financial institutions are also required to maintain a website showing comprehensive compensation information that is machine readable.

Finally, the proposal says that a financial institution must offer and an advisor must make available to retirement investors a range of “assets” that is “broad enough to enable the Advisor to make recommendations with respect to all of the asset classes reasonably necessary to service the Best Interests of the Retirement Investor in light of its investment objectives, risk tolerance, and specific financial circumstances.” When giving advice regarding a limited menu of investments, the financial institution must determine in writing that a prudent recommendation can nonetheless be made. The scope of this provision will be very significant to certain IRA providers that have traditionally offered a narrow range of IRA investments.

Financial institutions are also required to notify the DOL in advance of their intention to rely on the exemption. There is a “grandfather” provision related to the receipt of variable compensation on transactions entered into before the proposed exemption becomes applicable, though the exception is fairly limited.

Conclusion:

DOL is somewhat unique among Federal regulators in that its jurisdiction over financial advisors is based on what they do rather than how they are licensed. It can regulate advisors who are securities professionals, insurance professionals, bank trust officials, or consultants. The ability to impose a uniform standard across all of these providers is likely a significant reason the White House has embraced DOL, rather than the SEC, as the lead agency on issues related to perceived conflicts by investment advisors.

While the regulation is quite controversial, the Administration remains committed to moving forward in the regulatory process. It is likely a final rule would be promulgated next year, following the comments, hearings and other process requirements associate with completing a regulation. Interest parties must plan on submitting comments by the July 20 deadline, as DOL is not obligated to consider comments received after the deadline. The Proposal will change on its way to a final rule, but the question will be how much.