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# DOL'S PROPOSAL TO EXPAND FIDUCIARY DEFINITION WOULD BRING MANY SERVICE PROVIDERS INTO SCOPE

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As we previously reported, the US Department of Labor (DOL) released its reproposed rule "Definition of the Term 'Fiduciary'; Conflict of Interest Rule—Investment Advice" on April 14. The initial deadline for comments on the rule was July 6. The DOL recently announced that it intends to extend the deadline by 15 days to fall on or around July 20. The DOL has also announced that it intends to hold a public hearing on the reproposal during the week of August 10.

This White Paper examines the reproposed changes to the definition of an "investment advice fiduciary" for purposes of the Employee Retirement Income Security Act (ERISA) standards of fiduciary conduct and the prohibited transaction rules under ERISA and section 4975 of the Internal Revenue Code (the Code). It also covers the DOL's six proposed "carve-outs" from fiduciary status.

The reproposed definition of "fiduciary" is intended to expand the scope of activities that will result in fiduciary status and application of the prohibited transaction rules, particularly covering many services that broker-dealers and other financial advisers provide to plans, plan participants, and Individual Retirement Account (IRA) owners. The DOL has provided exceptions for certain activities that, in its view, should not result in fiduciary status. The reproposal leaves open questions about what types of investment-related activities or communications may still be viewed as nonfiduciary even though they do not fall within one of the six carve-outs.

## REPROPOSED DEFINITION OF "INVESTMENT ADVICE FIDUCIARY"

This section provides (1) a brief background on the DOL's regulatory initiative with respect to the definition of "investment advice fiduciary" under ERISA and the Code and (2) an outline of the DOL's reproposed definition and observations.

### Background

In addition to persons with investment discretion, the statutory definition of "fiduciary" under ERISA and the Code includes any person who "renders investment advice for a fee or other compensation, direct or indirect," with respect to a plan's assets. When ERISA was enacted, many expressed concern about the scope of activities that would be deemed fiduciary under the statute and the potential to disrupt customary transactions between financial intermediaries, such as between broker-dealers and employee benefit plans.

In 1975, the DOL, in part to address these concerns, issued a regulation that defined the types of advice that would be viewed as fiduciary using a five-part test. Specifically, under this rule (which the DOL's reproposal would replace), a person is an investment advice fiduciary if the person renders advice to a plan that

1. is a **recommendation** on investing in, purchasing, or selling securities or other property, or advice as to their value;
2. is provided on a **regular basis**;
3. is provided pursuant to a **mutual agreement, arrangement, or understanding**, either written or otherwise;
4. will serve as a **primary basis** for investment decisions with respect to plan assets; and
5. is **individualized** to the plan based on the **particular needs** of the plan.

The DOL now believes that changes that have occurred in the retirement market since 1975—particularly the growth of participant-directed plans and IRAs and the "increasingly complex financial marketplace"—warrant revisiting the current definition of "fiduciary" and expanding it to cover a broader array of advice and communications.

In its first effort to revise the definition in 2010, the DOL proposed to define "fiduciary investment advice" to include certain recommendations provided pursuant to an agreement or understanding that the advice may be considered in connection with plan investment-management decisions and would be individualized to a plan. The 2010 proposal would have effectively eliminated the "regular basis" "mutual" agreement, arrangement, or understanding and the "primary basis" prongs of the current test. Further, among other changes, the 2010 proposal would have included recommendations by registered investment advisers and discretionary fiduciaries, regardless of whether the recommendation fit the other requirements of the proposed test. Although the 2010 proposal would have included certain exceptions from the definition of "fiduciary," including for certain selling activities, the DOL did not propose any exemptions from the prohibited transaction provisions of ERISA and section 4975 of the Code, as would have been necessary to allow persons who would have become fiduciaries under the expanded definition to continue their established business practices under existing law.

Following criticism of the 2010 proposal during the comment period and public hearings, the DOL announced that it would withdraw the 2010 proposal and repropose the definition before proceeding to a final rule. In issuing the reproposed rule, the DOL stated that it attempted to address many of the issues identified by commenters regarding the 2010 proposal, including by proposing new prohibited transaction exemptions. Even so, if adopted as proposed, the expansive nature of the reproposal would have a significant impact on many financial services firms, their employees, registered representatives, and other professionals when working with employee benefit plans, plan participants, and IRAs, as well as plan sponsors and their fiduciaries. The next sections of this White Paper summarize key aspects of the reproposed definition and its carve-outs, and include some of our observations regarding potential impacts and questions the reproposal raises.

## Reproposed Definition of "Fiduciary"

Under the reproposal, an "investment advice fiduciary" would include a person who

1. provides the following advice directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner in exchange for a fee or other compensation, whether direct or indirect:

    a. a buy, hold, or sell recommendation (defined below);

    b. a recommendation as to the management of securities or other property (e.g., proxy voting);

    c. a recommendation to roll over or distribute assets from a plan or IRA, and a recommendation as to the investment or management of such assets;

    d. an appraisal or fairness opinion regarding the value of securities or other property in connection with a specific transaction or transactions; or

    e. a recommendation of a person who will receive a fee in connection with any of the above (e.g., selection of investment managers and advisers)

and

2. either directly or indirectly (e.g., through or together with any affiliate):

a. represents or acknowledges that it is "acting as a fiduciary" with respect to the advice described in 1. above, **or**

b. provides advice that satisfies the following three primary elements:

   i. it is rendered pursuant to a written or verbal agreement, arrangement, or **understanding**;

   ii. it is **individualized—or specifically directed—**to the advice recipient; and

   iii. it is **for consideration** in making investment or management decisions with respect to securities or other property of the plan or IRA.

## Observations

The reproposed definition would substantially expand the types of activities and services that would result in fiduciary status compared to existing law and, unlike the 2010 proposal, would expressly include recommendations on rollovers and plan and IRA distributions (proposing to retract the DOL's position expressed in its Advisory Opinion 2005-23A that a recommendation to distribute assets from a plan is generally not a fiduciary act where there is no preexisting fiduciary relationship). Further, as proposed, the definition could include personnel with customer contact, including call center employees, who make statements viewed as "recommendations" under the definition, unless an exception applies.

Although the definition of "fiduciary investment advice" would be significantly broader under the reproposal, the DOL has made clear (both in the preamble and informally) that fiduciary status would remain a functional test and that the parties would still be able to define the scope of activities with respect to which a person would be acting as a fiduciary. Nonetheless, open questions remain about how a person who sells or offers investment services to a plan can, from an operational perspective, avoid fiduciary status (or otherwise effectively limit the scope of his or her responsibilities as a fiduciary) under the reproposal:

- **Mutual Understanding:** Unlike the current regulation, fiduciary status may result even where there is no "mutual" agreement, arrangement, or understanding between an adviser and a plan or IRA client. The DOL clarified in the reproposal's preamble that removal of the term "mutual" is intended to prevent advisers from marketing retirement investment services "in ways that clearly suggest the provision of tailored or individualized advice, while at the same time disclaiming in fine print the requisite 'mutual' understanding." With limited exceptions, it is unclear when an adviser's marketing or sales activities with respect to a plan, plan participant, beneficiary, or IRA would not give rise to an "understanding" that the adviser is acting as a fiduciary.
- **Specifically Directed To:** The reproposal continues to require that advice be "individualized," but adds an alternative that advice would also be considered fiduciary if it is "specifically directed to" the advice recipient. It is unclear what types of communications may be viewed as "specifically directed to" an advice recipient and under what conditions. More specifically, it is unclear whether this may encompass generalized information about investment options, strategies, or asset allocations that is "specifically" addressed to a particular plan or IRA client, even if, for example, sent by means of a mass mailing.
- **For Consideration:** Rather than requiring that advice serve as "a primary basis" for an investment decision, the reproposal would require that the advice be "for consideration."

This proposed change seems to lower the level of importance that advice has in the recipient's investment decision making.

- **Recommendation:** The reproposal defines "recommendation" as "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." The DOL noted in the preamble that it has based this definition, in part, on Financial Industry Regulatory Authority (FINRA) guidance about what would constitute a recommendation for purposes of FINRA Rule 2111 (Suitability). The proposed definition of recommendation, however, appears to omit certain aspects of that guidance, including that determining whether a communication is a recommendation is an objective rather than a subjective inquiry and that the level of individualization is an important aspect of that determination. The DOL has requested comments regarding whether it should adopt some or all of FINRA's standards to define "recommendation" for purposes of the rule.

  The DOL also noted in the preamble that recommendations related to proxy voting could be fiduciary, but generally, fiduciary status would not result from providing proxy voting guidelines to a broad class of investors without regard to an investor's individual interests and investment policy.

## SIX CARVE-OUTS FROM FIDUCIARY STATUS

This section provides an overview and observations regarding each of the DOL's six proposed carve-outs from fiduciary status. Generally, it is unclear from the reproposal whether the DOL views these carve-outs as nonexclusive safe harbors. (Note that the DOL would also preserve without change the current "safe harbor" exception for brokerage execution that was part of the original 1975 regulation.)

### 1. Seller's Carve-Out

The proposed seller's carve-out would apply to advice provided by a "counterparty" to a large plan or account (i.e., a plan with 100 or more participants, or an account of an independent plan fiduciary with responsibility for managing at least $100 million in employee benefit plan assets) for certain transactions. The covered transactions include a sale, purchase, loan, or bilateral contract. In addition to satisfying other conditions (such as that the person cannot receive a separate fee or compensation from the plan or plan fiduciary for the provision of advice), the person must represent that he or she does not intend to give advice in a fiduciary capacity.

The seller's carve-out would require a person to monitor the number of participants in a plan and a fiduciary's assets under management to ensure that he or she can continue to rely on the carve-out, or might instead need to rely on a prohibited transaction exemption, such as the proposed Best Interest Contract Exemption. For example, issues may arise where a person is relying on a seller's carve-out in its dealings with a plan fiduciary and the number of plan participants falls below 100 or the fiduciary's assets under management falls below $100 million. In such a situation, can the person still rely on the carve-out, or would the person be deemed an investment advice fiduciary (and have to acknowledge fiduciary status to rely on the proposed Best Interest Contract Exemption, to the extent that it is otherwise available)?

Relying on a seller's carve-out may be further complicated where a person previously relied on the proposed Best Interest Contract Exemption with respect to a small plan that subsequently turns into a large plan (by reason of exceeding the 100-participant limit under the Best Interest Contract Exemption), such that the exemption becomes unavailable. Because the Best Interest Contract Exemption requires an affirmative representation of fiduciary status, it is unclear how the person could later rely on the seller's carve-out, which requires a disclaimer of fiduciary status, without otherwise modifying its agreements.

Another question is whether the seller's carve-out covers sales of services. We believe—and the DOL has informally indicated—that the term "bilateral contract" may be interpreted to include contracts for services. Nonetheless, clarified regulatory language would be helpful in this regard.

The DOL has excluded advice to IRAs, plan participants and beneficiaries, and plan fiduciaries of small plans from the seller's carve-out, but has requested comments on whether the scope of the seller's carve-out is appropriate and whether there are additional conditions that could protect these types of investors.

## 2. Swap and Security-Based Swap Transactions

This exception would permit a swap dealer, security-based swap dealer, major swap participant, or major security-based swap participant to act as counterparty to an employee benefit plan in connection with a swap or security-based swap (as defined in the Commodity Exchange Act and the Securities Exchange Act) where a plan is represented by a fiduciary that is independent of the person relying on the exception. If the person relying on the exception is a swap dealer or security-based swap dealer, it cannot be acting as an "advisor" to the plan, as that term is interpreted by the Commodity Futures Trading Commission and the Securities and Exchange Commission under the Commodity Exchange Act or the Securities Exchange Act, in connection with the transaction. Further, a person relying on the exception must, prior to making any recommendations, obtain a written representation from the independent plan fiduciary that it will not rely on the person's advice. Note that this carve-out does not apply to IRAs, plan participants, or beneficiaries.

## 3. Employees of the Plan Sponsor

The DOL included a carve-out for employees of any plan sponsor that provide advice to a plan fiduciary, provided that the employees receive no fee or compensation for the advice beyond their normal compensation. The purpose of this carve-out is to permit a plan sponsor's human resources and other employees to advise the plan's investment committee or other named fiduciaries as part of their employment duties without being treated as paid fiduciary advisers. This carve-out would not appear to cover advice to plan participants or beneficiaries.

## 4. Platform Providers/Selection and Monitoring Assistance

The DOL has proposed two carve-outs for platform providers to participant-directed plans: One for providing a platform of investment options, and another for selection and monitoring assistance related to the platform. The first carve-out would permit a platform provider to market or provide to an employee benefit plan a platform of securities or other property, such as a mutual fund platform, from which the plan fiduciary may select investment alternatives into which participants may direct the investment of their assets. The platform may not be individualized to the needs of the plan, its participants, or its beneficiaries. Further, the person relying on the carve-out must disclose in writing to the plan fiduciary that he or she is not undertaking to provide impartial advice or to give advice in a fiduciary capacity.

The related carve-out for selection and monitoring assistance is intended to permit a platform provider to identify investment alternatives that meet objective criteria identified by the plan fiduciary (commonly referred to as "screening" or "narrowing" investment options) and to provide objective financial data and comparisons with independent benchmarks to the plan fiduciary.

It is unclear whether either carve-out would be available for persons offering brokerage windows or managed accounts. It is also not clear to what extent the proposed platform carve-out would provide relief for platforms provided to participants in participant-directed plans (i.e., in the context of an open brokerage window). In addition, the DOL indicated that the platform provider carve-out would not apply to IRAs and other non-ERISA plans (such as certain health savings accounts, or “HSAs”, and non-ERISA 403(b) plans) and expressed concerns that there would be no independent plan fiduciary interacting with the platform provider in the IRA market. The DOL did, however, request comment on whether (and if so, how) this exception could be extended to the IRA market.

### 5. Certain Valuations

This exception would cover appraisals, fairness opinions, and statements of value provided to:

1. employee stock ownership plans (ESOPs) regarding employer securities,
2. certain investment funds (such as collective investment trusts and pooled separate accounts) holding plan assets of more than one unaffiliated plan or in which more than one unaffiliated plan has an investment, and
3. plans, plan fiduciaries, plan participants or beneficiaries, or IRA owners, as required under ERISA, the Code, or other federal or state law.

The DOL indicated that separate rulemaking should be expected for ESOP valuations.

Although the proposed carve-out would cover valuations provided to investment funds that hold the assets of multiple plans, it is not clear the extent to which it would include or exclude valuations provided in connection with white label or custom institutional funds, such as custom target date funds and stable value funds structured as a fund-of-one or a separately managed account. Further, it is unclear how valuations that may fall within one of the exceptions, such as the calculation of an alternative asset’s value for tax purposes, will be treated where the valuation may also be used as the basis for an investment decision.

### 6. Investment Education

Finally, the reproposal includes a carve-out for four types of investment education:

1. plan information
2. general financial, investment, and retirement information
3. asset-allocation models
4. interactive investment materials

The carve-out for investment education would supersede the DOL’s Interpretive Bulletin 96-1 regarding participant investment education and would make several significant changes affecting the provision of educational materials. For example, although this carve-out would permit the provision of certain general information, any materials provided cannot identify specific investment products (other than as information about what investments are available under a particular plan). This change could have a significant effect on the structure of asset-allocation advice programs and tools.

The proposed carve-out clarifies that the concept of investment education is not limited to plan participants but can also apply to education provided to plan fiduciaries and IRA owners. The carve-out further clarifies that providing certain general information that individuals can use to assess retirement needs and risks, and information on how to manage those risks, is not fiduciary investment advice.

### Observations

As indicated in the above summary, each carve-out is limited and raises a number of technical drafting issues and other questions. Because the carve-outs are integral to defining the types of activities that would not be treated as fiduciary investment advice, it will be important to clarify their scope. Also important is their interaction with the newly proposed prohibited transaction exemptions, given that activities that fall outside the carve-outs may, if they are continued, require exemptive relief. In particular, because, as proposed, a plan may not qualify for both the seller's carve-out and the Best Interest Contract Exemption at the same time, it will be important to understand how a firm can move between the two rules without losing the benefits of both.

## COMMENT LETTERS

As noted above, the DOL recently announced its intention to extend the initial deadline for comments on the reproposal by 15 days. Comments are expected to be due on or around July 20, with a public hearing to follow the week of August 10. The public record will be reopened for additional comments after the public hearing. We strongly encourage those who would be affected by the rule to consider submitting comments to the DOL regarding anticipated effects on plans, plan participants, and IRA owners as well as current business practices and the availability of products and services, and whether certain aspects of the rule should be clarified or changed.

Read our past publications covering the DOL's fiduciary definition rulemaking:

- DOL Fiduciary Rule to Revamp Regulation of Advice to Plans and IRAs (April 15, 2015)
- Department of Labor Retirement Initiative Fails to Consider Current Regulatory Regime, Which Comprehensively Protects Investors, Including IRA Investors, and Preserves Investor Choice (March 23, 2015)
- DOL Sends Proposed Conflict of Interest Rule to OMB for Review (March 5, 2015)
- DOL Announces Intent to Repropose Rule on Definition of "Fiduciary" (September 21, 2011)
- DOL Proposes Significant Changes to "Investment Advice" Fiduciary Status Definition (November 1, 2010)

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