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U.S. Department of Labor Proposes New Fiduciary Standard

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Last week, the U.S. Department of Labor (DOL) issued its highly anticipated, re-proposed regulation addressing when a person providing investment advice with respect to an employee benefit plan or individual retirement account (IRA) is considered a fiduciary under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (Code). The proposed rule, which comes more than two years after the DOL withdrew an earlier rule on the same subject after strong opposition from the financial services industry, offers a general definition of fiduciary investment advice, which is subject to specific carve-outs for particular types of communications that are not considered fiduciary in nature. In addition, the DOL has proposed a new set of prohibited transaction exemptions (PTEs) and certain amendments to existing exemptions to permit certain common fee and compensation practices to continue.

At present, with certain limited exceptions, broker-dealer recommendations must be based on a reasonable determination that the investment is suitable in light of the investor's financial situation and investment objectives. The proposed rule, while limited in terms of its scope, could be a turning point for the brokerage industry in terms of the applicable standard of care, an industry that already is highly regulated by the U.S. Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA). The SEC's consideration of a uniform fiduciary standard is ongoing and will be addressed briefly, as well.

Current Regulatory Regime

ERISA provides that a person is a fiduciary if he or she (1) exercises any discretionary authority or control with respect to management of an employee benefit plan or its assets; (2) renders investment advice for a fee or other compensation, direct or indirect, with respect to the money or property of such plan; or, (3) has any discretionary authority or responsibility in the administration of such plan. "Being a fiduciary simply means that the adviser must provide impartial advice in their client's best interest and cannot accept any payments creating conflicts of interest unless they qualify for an exemption intended to assure that the customer is adequately protected."

Pursuant to a 1975 DOL regulation, in order to be held to ERISA's fiduciary standards with respect to investment advice for a fee, one must (1) render advice to an employee benefit plan as to the value of securities or other property, or make recommendations as to the advisability of investing in, purchasing or selling securities or other property (2) on a regular basis (3) pursuant to a mutual agreement, arrangement or understanding, with the plan or a plan fiduciary that (4) the advice will serve as a primary basis for investment decisions with respect to plan assets, and that (5) the advice will be individualized based on the particular needs of the plan or IRA.

The DOL has expressed concern that the 1975 regulation lacks sufficient breadth. For example, advice delivered on a one-time basis is not subject to a fiduciary standard because the regulation only covers advice provided on a "regular basis." Similarly, advice that does not serve as the "primary basis" for an investment decision falls outside the scope of the current definition. According to the DOL, this "allows many advisers to avoid fiduciary status and disregard ERISA's fiduciary obligations of care and prohibitions on disloyal and conflicted transactions." The DOL maintains that the current regulation allows certain advisers to "steer customers to investments based on their own self-interest (e.g., products that generate higher fees for the adviser even if there are identical lower-fee products available), give imprudent advice, and engage in transactions that would otherwise not be permitted by ERISA and the Code."

The Proposed Rule

Expanded Definition of Investment Advice

The proposed rule would expand the definition of fiduciary investment advice to include any individual receiving compensation for providing advice that is individualized or specifically directed to an employee benefit plan, a plan fiduciary, participant or beneficiary, or an IRA owner for consideration in making a retirement investment decision. The new definition includes the following four categories of advice: (1) investment recommendations, (2) investment management recommendations, (3) appraisals of investments, or (4) recommendations of persons to provide compensated investment advice or to manage plan assets.

An investment recommendation is defined as "[a] recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution of benefits or a recommendation as to the investment of securities or other property to be rolled over or otherwise distributed from the plan or IRA." The proposal makes clear, however, that one does not act as a fiduciary simply by providing participants with information about plan or IRA distribution options, thereby drawing a distinction between investment advice and investment education.

An investment management recommendation is defined as "[a] recommendation as to the management of securities or other property, including recommendations as to the management of securities or other property to be rolled over or otherwise distributed from the plan or IRA." The rule excludes from such advice guidelines or other information on voting policies for proxies provided to a broad class of investors without regard to a client's individual interests or investment policy and which are not a recommended policy to be adopted.

Appraisals of investments are defined to include "[a]n appraisal, fairness opinion or similar statement whether verbal or written concerning the value of securities or other property if 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. The provision differs markedly from (and is significantly more narrow than) the DOL's prior proposal on the subject.

Recommendations of persons to provide compensated investment advice or to manage plan assets is defined to include "[a] recommendation of a person who is also going to receive a fee or other compensation for providing any of the types of advice in the prior three categories." This category was the DOL's attempt to "remove any possible ambiguity" that such a person would come within the fiduciary investment advice umbrella.

An individual providing one of these categories of advice offers "investment advice" within the meaning of the proposed rule, if he or she "represents or acknowledges" that he or she is acting as a fiduciary with respect to the advice, or "render[s] the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions with respect to securities or other property of the plan or IRA."

Carve-outs to the Investment Advice Definition

The proposed rule carves out certain conduct from the definition of fiduciary investment advice. Specifically, the proposed rule provides that the following types of transactions will not be considered fiduciary investment advice:

1. Statements or recommendations made to a "large plan investor with financial expertise" by a counterparty acting in an arm's-length transaction;

2. Offers or recommendations to plan fiduciaries of ERISA plans to enter into a swap or security-based swap that is regulated under the Securities Exchange Act or the Commodity Exchange Act;

3. Statements or recommendations provided to a plan fiduciary of an ERISA plan by an employee of the plan sponsor if the employee receives no fee beyond his or her normal compensation;

4. Marketing or making available a platform of investment alternatives to be selected by a plan fiduciary for an ERISA participant-directed individual account plan;

5. The identification of investment alternatives that meet objective criteria specified by a plan fiduciary of an ERISA plan or the provision of objective financial data to such fiduciary;

6. The provision of an appraisal, fairness opinion or a statement of value to an ESOP regarding employer securities, to a collective investment vehicle holding plan assets, or to a plan for meeting reporting and disclosure requirements; and

7. Information and materials that constitute "investment education" or "retirement education."

Exemptions

As mentioned above, individuals providing fiduciary investment advice cannot accept any payments creating conflicts of interest unless their conduct fits within a PTE. Given the breadth of the definition of fiduciary investment advice in the proposed rule and complaints from the financial services industry that restrictions on compensation practices could make it inefficient for broker-dealers to serve certain accounts, the DOL proposed two new PTEs and amendments to existing PTEs. The two new

PTEs are discussed below, with particular emphasis on the best interest contract exemption that, in theory, will allow broker-dealers to retain a commission-based fee structure.[1]

The Best Interest Contract Exemption

This exemption seeks to promote investment advice that is in the best interests of retail investors, including IRA owners and plans with less than 100 participants. While ERISA and the Code do not permit fiduciary advisers to plans and IRAs to receive compensation that may differ based on the nature of the recommendation or from third parties, this exemption would appear to allow broker-dealers to maintain their current compensation structure provided that they comply with certain conditions. The exemption requires the company and the individual adviser to enter into a contract with the client in which they "acknowledge fiduciary status, commit to adhere to basic standards of impartial conduct, warrant that they have adopted policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest, and disclose basic information on their conflicts of interest and on the cost of their advice." Incident to this contractual relationship, the new exemption would allow a client to bring a private right of action for breach of contract against any adviser who fails to act in the client's best interest.

The proposed rule already has been criticized by some for the increased regulatory burden that it will place on broker-dealers trying to comply with the PTEs. Certain members of the financial services industry previously have expressed concern that the proposed rule could drive broker-dealers towards a fee-based compensation structure, making investment advice more expensive and potentially denying access to low-income investors. Whether this exemption mollifies those concerns remains to be seen.

The Principal Transaction Exemption

The proposed rule would generally prohibit a fiduciary from engaging in so-called principal transactions – that is, purchasing and selling securities on behalf of their own accounts. However, the Principal Transaction Exemption would soften this prohibition by allowing "investment advice fiduciaries to engage in purchases and sales of certain debt securities out of their inventory . . . , under conditions designed to safeguard the interests of these investors."

The DOL limited the Principal Transaction Exemption to widely-held debt securities, concluding that principal transactions involving other types of securities (e.g., equities, futures, derivatives, currencies, etc.) posed too much risk. The exemption requires the same contractual requirements as the Best Interest Contract Exemption (described above). In addition to the contract requirements, the exemption requires that the written contract disclose the material conflicts of interest involved and set forth the retirement investor's written consent to such transactions, which must be terminable at will at any time without penalty. The exemption also contains pricing conditions, pre-transaction and annual disclosure requirements and recordkeeping requirements.

Going Forward

Although SEC Chairwoman Mary Jo White recently voiced her support for adopting a fiduciary standard for retail investment advice outside the retirement account context, it does not appear that the SEC is ready to issue a proposed rule any time soon. That said, the DOL emphasized its cooperation with the SEC in its proposed rule, noting that it "consulted with staff of the SEC and other regulators on an ongoing basis regarding whether the proposals would subject investment advisers and broker-dealers who provide investment advice to requirements that create an undue compliance burden or conflict with their obligations under other federal laws." Thus far, there has been no comment from Chairwoman White regarding the DOL's rule.

The proposed rule has a 75-day notice and comment period, which begins 75 days after the proposed rule is published in the Federal Register. After the comment period ends, the DOL will schedule a public hearing within 30 days. Members of the financial services industry will want to pay close attention to this rule during the notice and comment period as it could have a significant effect on the industry if adopted.

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[1] In addition to the two new PTEs, the DOL also asked for comments on a new "low-fee exemption." The "low-fee exemption" would allow advisers to receive commissions for investment advice in connection with certain low-fee investments, but would be subject to fewer conditions than the "best interest contract" exemption.

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