The U.S. Department of Labor recently issued proposed regulations that make sweeping changes to the definition of the term “fiduciary” under the Employee Retirement Income Security Act (ERISA). To call this proposal controversial is an understatement. The proposed regulations pit the Department of Labor’s mission to protect retirement income against long-standing and entrenched compensation practices of the behemoth U.S. financial services industry, practices that will be largely uprooted with respect to retirement plans and IRAs if the proposed regulations becomes law. Caught in the middle are retirement plan participants and Individual Retirement Account (IRA) investors who seek nothing more than reliable advice in an effort to save for a secure retirement.

The Department of Labor claims that an earlier, 1975 regulation is out-of-date and badly in need of revision, principally as it affects participants in small retirement plans and individual IRA investors. The financial services industry demurs, claiming instead that the Department’s proposed approach, as embodied in a withdrawn 2010 rule, will hurt investors. There are constituencies on both sides of the political aisle for whom any solution but theirs is a non-starter. In one camp are those who would impose an impossibly high fiduciary standard on the financial services industry without regard to the consequences to plan participants and investors; there are others who think the status quo is fine, despite transformative changes in the retirement investing environment over the past 40 years. We believe that there is a middle ground between the competing constituencies, and that the proposed regulations strike an appropriate conceptual balance of competing interests. However, we also believe that the proposal, as currently drafted, falls short in some important, practical respects.

This post explains the proposed regulations and the context in which they arise. Future posts will examine the rule’s impact on large and small retirement plans, IRA investors, and advisers (i.e., registered investment advisers, broker-dealers, and registered representatives).

Background

The proposed regulation was issued along with a package of items that include the following:

- Proposed Regulations
- Proposed Best Interest Contract Exemption
- Proposed Class Exemption for Principal Fiduciary Transactions
- Proposed Amendment to PTE 75-1, Part V
- Proposed Amendments to and Proposed Partial Revocation of PTEs 86-128 and 75-1
- Proposed Amendments to Class Exemptions 75-1, 77-4, 80-83 and 83-1
- Proposed Amendment to and Proposed Partial Revocation of PTE 84-24
- News Release

ERISA governs fiduciary conduct and establishes rules that bar certain transactions, referred to as “prohibited transactions.” While ERISA’s fiduciary standards and prohibited transaction rules apply principally to retirement plans, ERISA also amended the Internal Revenue Code (the “Code”) to impose nearly identical prohibited transaction, but not fiduciary, rules on IRAs, Health Savings Accounts (HSAs), Archer Medical Savings Accounts and Coverdell Education Savings Accounts. While the Treasury Department and the Internal Revenue Service would ordinarily have jurisdiction over these latter types of accounts, the Department of Labor is charged with interpreting the ERISA and Code provisions relating to fiduciary status and prohibited transactions as a result of a 1978 Presidential order.
The Statute, the 1975 Regulation, and the Five-Part Test

ERISA imposes duties on those who act as plan fiduciaries of employee benefit plans. These duties include a duty of undivided loyalty, a duty to act for the exclusive purpose of providing plan benefits and defraying reasonable expenses of administering the plan, and a duty of care grounded in the “prudent man” standard derived from trust law. ERISA defines the term “fiduciary” functionally. Generally, a person is a fiduciary with respect to a plan to the extent that he or she:

- Exercises any discretionary authority or discretionary control with respect to management of a plan or exercises any authority or control with respect to management or disposition of its assets;
- Renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or
- Has any discretionary authority or discretionary responsibility in the administration of such plan.

The focus of the proposed regulation is on the second prong above, i.e., when does an adviser render “investment advice for a fee or other compensation”? In 1975, the Department of Labor issued a regulation that defines the circumstances under which a person renders “investment advice.” Under the 1975 regulation, for advice to constitute “investment advice,” an adviser who is not a fiduciary under another provision of the statute must:

1. Render advice 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.

This test — which is referred to as the “five-part test” — provides that an adviser is a fiduciary only if he or she meets each and every element of the five-part test with respect to the particular advice recipient or plan at issue.

When fiduciaries violate ERISA’s fiduciary duties or the prohibited transaction rules, they may be held personally liable for any losses to the investor resulting from the breach. In addition, violations of the prohibited transaction rules are subject to excise taxes under the Code. Although ERISA’s general fiduciary obligations of prudence and loyalty do not govern the fiduciaries of IRAs and other plans not covered by ERISA, these fiduciaries are subject to the prohibited transaction rules of the Code. The sole statutory sanction for engaging in any illegal transaction is the assessment of an excise tax enforced by the Internal Revenue Service. Thus, unlike participants in plans covered by ERISA, IRA owners do not have a statutory right to bring suit against fiduciaries under ERISA for violation of the prohibited transaction rules and fiduciaries are not personally liable to IRA owners for the losses caused by their misconduct.

The 2010 Proposed Regulations

In 2010, the Department of Labor issued proposed regulations, which changed the definition of “fiduciary” under ERISA § 3(21)(A)(ii) for the purposes of correcting perceived shortcomings of the five-part test. The Department observed that the 1975 regulation acts to narrow the plain language of the statute. At the same time, the Department was having second thoughts about a 1976 advisory opinion that further limited the term “investment advice” (DOL Advisory Opinion 76-65A (June 7, 1976)). There, the Department concluded that a valuation of closely-held employer securities in an employee stock ownership plan was not investment advice.

In the 2010 proposed regulations, the Department noted that, while the current regulation has not been updated since its promulgation in 1975, the retirement plan marketplace has changed significantly. Specifically, the types and complexity of investment products and services available to plans have expanded, thereby calling for a reexamination of the rules governing fiduciary status. The Department identified certain advisory relationships that it believes should give rise to fiduciary duties on the part of those providing advisory services. These advisers significantly influence the decisions of plan holders.
fiduciaries, and they have a considerable impact on plan investments. In instances where these advisers are not fiduciaries, however, they may operate with conflicts of interest that they need not disclose to plan fiduciaries. Therefore, the Department concluded, as expressed in the preamble to the proposed regulations, that “it is appropriate to update the ‘investment advice’ definition to better ensure that persons, in fact, providing investment advice to plan fiduciaries and/or plan participants and beneficiaries are subject to ERISA’s standards of fiduciary conduct.”

The 2010 proposed rule amended and reorganized the 1975 regulation, focusing particularly on what constitutes “giving advice” and the meaning of the term “fee or other compensation, direct or indirect.” As proposed, the types of advice and recommendations that may result in fiduciary status under ERISA were:

- Advice, appraisals or fairness opinions concerning the value of securities or other property;
- Recommendations as to the advisability of investing in, purchasing, holding, or selling securities or other property; or
- Advice or recommendations as to the management of securities or other property.

Importantly, the 2010 proposal did not require the advice to be provided on a regular basis. Nor did the proposal require that the parties have a mutual understanding that the advice would serve as a primary basis for plan investment decisions. Rather, the proposed regulations required that when a service provider was retained to render advice, the plan would be able to rely on the advice without regard to whether the parties intended it to be a primary or lesser consideration in the fiduciary’s decision-making.

Also, under the 2010 proposal, appraisals and fairness opinions would be treated as fiduciary acts, thereby superseding the Department’s previous guidance. Moreover, this change was not limited to employer securities. Rather, it extended to real estate and other appraisals. As a consequence, all appraisals of plan assets would have been required to be “unbiased, fair, and objective, and must be made in good faith and based on a prudent investigation under the prevailing circumstances then known to the appraiser.”

The 2010 proposed rule included certain limitations with respect to the provision of advice or recommendations to plans. A person was not considered a fiduciary with respect to the provision of advice or recommendations if he or she could demonstrate that “the recipient of the advice knows, or under the circumstances reasonably should know, that the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property, or as an agent of, or appraiser for, such a purchaser or seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice.” This exception is referred to as the “seller’s exception.” While the 2015 proposed regulation also includes a seller’s exception, the exception has been pared back significantly and (in our view) detrimentally.

The 2010 proposal clarified that the provision of investment education information and materials does not constitute the rendering of investment advice. The Department previously identified four specific categories of information and materials — plan information, general financial and investment information, asset allocation models, and interactive materials — which, if furnished alone or in combination to plan participants or beneficiaries, would not result in the rendering of investment advice. The 2015 proposed regulation also provides that the provision of investment education information and materials does not constitute the rendering of investment advice, but like the seller’s exception, the investment education exception has been modified in a way that is both significant and (in our view) detrimental.

The preamble to the 2010 proposed rule included an important discussion of certain common practices that have developed with the growth of participant-directed defined contribution plans involving certain service providers. For example, record-keepers and third-party administrators sometimes make available a menu of investments from which a plan fiduciary selects a more limited menu that will be available under the plan for participant or beneficiary investment. In many instances, the provider may simply offer a “platform” of investments from which the plan fiduciary selects those appropriate for the plan, or the provider may select or assist the plan fiduciary in selecting the investments that will be available under the plan. Under this model, the service provider also sometimes retains the ability to later make changes to the plan’s investment menu, subject to advance approval by a plan fiduciary.

In some instances, the provider and the plan fiduciary clearly understand that the provider is offering investments to which the provider has financial or other relationships, and is not purporting to provide impartial investment advice regarding construction of the plan’s investment menu. In other instances, the plan fiduciary is relying on the provider’s impartial expertise in selecting an investment menu for the plan. When this is the case, to assist in the plan fiduciary’s selection or monitoring of investments from those made available, a service provider also might provide to the fiduciary general financial information and data regarding matters such as historic performance of asset classes and of the investments.
Lastly, the 2010 proposed rule clarified that the term "fiduciary" under ERISA also applies for purposes of the Code, regardless of whether such plan is an employee benefit plan. This rule is principally aimed at IRAs, with respect which an account owner is generally a fiduciary. But the 2010 proposal did not expressly expand the fiduciary standards to IRA rollovers. Of particular interest is the question of whether a recommendation that a participant take a distribution from his or her retirement and roll over the funds to an IRA is itself subject to ERISA’s fiduciary standards and the associated prohibited transaction provisions of ERISA and the Code. In a 2003 advisory opinion (DOL Advisory Opinion 2005-23A), the Department held that such a recommendation was generally not investment advice and did not, as a result, confer fiduciary status. The 2010 proposed regulations requested comments on whether advice to rollover plan assets to IRAs should be considered fiduciary advice on the investment of plan assets.

The (2015) Proposed Regulations

The proposed regulations update the definition of fiduciary investment advice, and also provide a series of carve-outs for communications that should not be viewed as fiduciary in nature. This approach to rulemaking mirrors the approach that Congress took when it enacted the ERISA prohibited transaction rules: start with an overly-broad standard, then create narrow exceptions. Under ERISA, the exceptions come in three varieties: statutory exemptions, “class exemptions” promulgated by the Department to address categories of common transactions that merit relief, and individual exemptions, also promulgated by the Department in response to individual applications. Class exemptions play a key role in the regulatory scheme envisioned by the proposed regulations.

The proposed regulations’ definition of fiduciary covers investment recommendations, investment management recommendations, appraisals, and recommendations of persons to provide investment advice for a fee or to manage plan assets. Investment advice is provided “for a fee” if “any fee or compensation for the advice received by the advice provider (or by an affiliate) from any source and any fee or compensation incident to the transaction in which the investment advice has been rendered or will be rendered” (emphasis added). A “fee or compensation” includes brokerage fees, mutual fund and insurance sales commissions. The backward looking phrase “has been rendered” may prove problematic in the context of sales presentations. Might an adviser’s sales presentation to a retirement plan committee make the adviser a fiduciary if the committee subsequently chooses the adviser, uses the presentation to select an investment lineup and the adviser subsequently receives a fee? In the absence of a carve-out for the sales process, fiduciary status might attach. Moreover, the issue is not limited to brokers and insurance agents. The same issue arises in the case of investment managers and trustees. We doubt this result was intended, but it does require clarification.

Persons who provide investment advice are fiduciaries under the proposed regulations if they either:

- Represent that they are acting as a fiduciary under ERISA or the Code, or
- Provide the advice pursuant to an agreement, arrangement, or understanding that the advice is individualized or specifically directed to the recipient for consideration in making investment or investment management decisions regarding plan assets.

Under the first bullet, the Department is simply proposing to take an adviser at his or her word: if he or she claims fiduciary status, he or she is not later free to disclaim that status. The second bullet essentially revises the five-part test to remove those items that the Department deems most offensive. Thus, gone are the requirements that the advice must be “mutual,” “ongoing,” or serve as a “primary basis” for the investment decision.

Starting from this broad definition, the proposed regulations provide several carve-outs for persons who do not represent that they are acting as ERISA fiduciaries. These include: (1) the “seller’s carve-out,” (2) otherwise-regulated swaps, (3) statements by plan sponsor employees (4) marketing materials, (5) provision of objective information, (6) appraisals, fairness opinions and statements of value and (7) investment or retirement education. Below, we address each of these exceptions in turn.

1. Statements or recommendations made to a “large plan investor with financial expertise” by a counterparty acting in an arm’s length transaction (a/k/a the “Seller’s Carve-out”)

This carve-out applies to advice provided in connection with an arm’s length sale, purchase, loan, or bilateral contract between an “expert” or sophisticated plan investor and an adviser. It also applies in connection with an offer to enter into an arm’s length sale, purchase, loan, or bilateral contract transaction or when the adviser is acting as an agent for the plan’s counterparty. The exemption is limited to retirement plans. It does not apply to IRAs, nor does it apply to services.
The seller's carve-out is subject to the following conditions:

1. The advice must be provided to a plan fiduciary who exercises authority or control respecting the management or disposition of the plan’s assets, with respect to an arm’s length sale, purchase, loan or bilateral contract and who is independent of the adviser; and

2. One of the following alternative requirements must be satisfied: Under the first alternative, before providing any recommendation with respect to the transaction, the adviser must obtain a written representation from the plan fiduciary that he/she is a fiduciary who exercises authority or control with respect to the management or disposition of the employee benefit plan’s assets, that the employee benefit plan has 100 or more participants, and that the fiduciary will not rely on the adviser to either act in the best interests of the plan, provide impartial investment advice, or give advice in a fiduciary capacity. The adviser must also fairly inform the plan fiduciary of the existence and nature of the person’s financial interests in the transaction and may not receive a fee or other compensation directly from the plan (or plan fiduciary) for the provision of investment advice in connection with the transaction.

The second alternative applies in instances in which the adviser knows or reasonably believes (e.g., based on the plan’s most recently filed Form 5500) that the independent plan fiduciary has responsibility for managing at least $100 million in employee benefit plan assets. When this is the case, the adviser need not obtain written representations from its counterparty to avail itself of the exemption, but must fairly inform the fiduciary that the adviser is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity. However, as in the first alternative, the adviser may not receive a fee or other compensation directly from the plan (or plan fiduciary) for the provision of the advice in connection with the transaction.

According to the preamble to the proposed regulation:

“The purpose of this carve-out is to avoid imposing ERISA fiduciary obligations on sales pitches that are part of arm’s length transactions where neither side assumes that the counterparty to the plan is acting as an impartial trusted adviser, but the seller is making representations about the value and benefits of proposed deals.”

In contrast to the 2010 proposed regulations, the seller’s carve-out applies only to plans with 100 or more participants or to fiduciaries with responsibility for managing at least $100 million of plan assets. This carve-out does not extend to transactions involving plan participants, beneficiaries or IRA owners. Instead, recommendations to small plans and “retail” investors are addressed through separate prohibited transaction exemptions (which will be examined in a subsequent post).

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

As its name suggests, the carve-out for “swap and security-based swap transactions” is narrowly targeted to permit advice and other communications by counterparties in connection with certain swap or security-based swap transactions under the Commodity Exchange Act or the Securities Exchange Act. Like the seller’s carve-out, the carve-out for swaps applies only to retirement plans and not to IRAs or individual participants. The swap carve-out does not appear to extend to pooled funds that hold plan assets. (It is not clear that the Department intended this result, since these parties are included in previously issued guidance (DOL Advisory Opinion 2013-01A)).

The carve-out allows swap dealers, security-based swap dealers, major swap participants and security-based major swap participants who make recommendations to plans to avoid becoming fiduciaries when acting as counterparties to a swap or security-based swap transaction. Under the swap carve-out, if the person providing recommendations is a swap dealer or security-based swap dealer, it must not act as an adviser to the plan, within the meaning of the applicable business conduct standards. Before providing any recommendations with respect to the transaction, the person providing recommendations must obtain a written representation from the plan fiduciary that the fiduciary will not rely on recommendations provided by the dealer.

(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

Under this carve-out, an employee of a plan sponsor would not be treated as a fiduciary with respect to
advice provided to the fiduciaries of the sponsor’s plan as long as the employee receives no compensation for the advice beyond the employee’s normal compensation as employees of the plan sponsor. According to the preamble to the proposed regulations:

“This carve-out from the scope of the fiduciary investment advice definition recognizes that internal employees, such as members of a company’s human resources department, routinely develop reports and recommendations for investment committees and other named fiduciaries of the sponsors’ plans, without acting as paid fiduciary advisers.”

(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**

This carve-out is directed at service providers, such as record-keepers and third party administrators that offer a “platform” or selection of investment vehicles to participant-directed individual account plans subject to ERISA. In order for the carve-out to apply, the plan fiduciaries must choose the specific investment alternatives that will comprise the plan’s investment lineup. The carve-out also reaches certain common activities that platform providers may carry out to assist plan fiduciaries in selecting and monitoring the investment alternatives that they make available to plan participants.

(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**

This carve-out merely makes clear that persons will not be considered fiduciaries with respect to investment advice simply by marketing or making available investment vehicles, without regard to the individualized needs of the plan or its participants and beneficiaries, as long as such advisers disclose in writing that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity. Thus, merely identifying offered investment alternatives meeting objective criteria specified by the plan fiduciary or providing objective financial data regarding available alternatives to the plan fiduciary would not cause a platform provider to be a fiduciary investment adviser.

(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**

The carve-out for appraisals, fairness opinions, etc. is narrow one. Appraisals, fairness opinions, and similar statements relating to a particular transaction are not generally exempted. The carve-out in this instance is for reports or statements of value provided to satisfy required reporting and disclosure rules under ERISA and the Code or any federal or state law, rule, regulation or self-regulatory organization. Importantly, however, the proposed regulations do not impose fiduciary status on persons conducting valuations or appraisals for employee stock ownership plans (ESOPs). While the Department of Labor “remains concerned about the potential for abuse” in this context, “these concerns raise unique issues more appropriately addressed in a separate regulatory initiative.”

(7) **Information and materials that constitute “investment education” or “retirement education.”**

The carve-out for investment education is similar to the carve-out in the 2010 proposed regulations for the provision of investment education information and materials (as discussed above) but with one critically important exception. Under the 2015 proposed regulations, while furnishing or making available the specified categories of information and materials to a plan, plan fiduciary, participant, beneficiary or IRA owner does not constitute the rendering of investment advice, the carve-out for investment education no longer extends to advice or recommendations as to specific investment products, specific investment managers, or the value of particular securities or other property. Thus, while a participant might be told that his or her investments should include a large-cap stock fund with triggering fiduciary status, furnishing an example of a particular large-cap fund would trigger fiduciary responsibility for the providing party.

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In the near future we will continue this series with more blog posts on the new proposed regulations and the impact they will have on the financial services industry and on retirement plans and plan sponsors.
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