ALSTON & BIRD

WWW.ALSTON.COM

Employee Benefits & Executive Compensation ADVISORY ■

APRIL 17, 2015

Department of Labor Proposes New Regulation Governing When Financial Advisors Are Subject to Fiduciary Requirements

Introduction

The Department of Labor (DOL) has now proposed long-anticipated changes to the regulation that delineates when financial advisors become fiduciaries to certain benefit plans (such as retirement plans and Health Savings Accounts). This is an important distinction because fiduciary status imposes a number of requirements and implicates certain prohibited transaction rules (particularly concerning the receipt of fees).

Under ERISA, a person can become a fiduciary in three general ways: (1) they can be designated as such in the plan documents; (2) they can be a "functional fiduciary" in the sense that they have any control over plan assets and/or discretionary control over certain aspects of the plan; or (3) they can give investment advice to a plan. 29 U.S.C. § 1002(21)(A). The statute does not define what constitutes investment advice. That is what the proposed rule addresses.

According to Secretary of Labor Thomas Perez, "This boils down to a very simple concept: If someone is paid to give you retirement investment advice, that person should be working in your best interest." However, the proposed rules, and accompanying changes to the available prohibited transaction exemptions, are anything but simple. A large body of long-standing prohibited transaction exemptions is being displaced by a new series of proposed rules that interrelate with the new proposed regulation in complex ways. The proposed changes take hundreds of pages to explain and create a vastly expanded, and complex, regulatory structure.

What is the new proposed rule?

Under the proposed rule, a person renders investment advice by (1) providing investment or investment management recommendations or appraisals to a plan; and (2) either acknowledging the fiduciary nature of the advice or acting pursuant to an understanding with the recipient that the advice is individualized to, or specifically directed to, the recipient for the recipient's consideration in making investment or management decisions regarding plan assets.

When such advice is provided for a fee or other compensation, the person giving the advice is a fiduciary under the proposed rule.

However, the proposed rule also includes a number of carve-outs to this general definition and is accompanied by proposed changes to the prohibited transaction rules.

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

How is the proposed rule different from the existing regulations?

The proposed rule (and accompanying prohibited transaction exemption changes) marks quite a significant departure from existing law. The biggest difference between the proposed rule and existing regulations relates to two perceived "loopholes" in the existing regulation. The first requires that the advice be "ongoing" in order to become fiduciary in nature. The second requires that the advice be provided pursuant to an understanding that such advice would be a "primary" basis for investment decisions. 29 C.F.R. § 2510.3-21.

The proposed rule eliminates both requirements, such that a person can provide investment advice (and thus be a fiduciary) even if the advice is provided on a one-time basis and even if there were no expectation that the advice would serve as the primary basis for the decision. However, the proposed changes go further in altering existing prohibited transaction rules, particularly with respect to IRAs and HSAs. Moreover, the old rule required that the person "render individualized investment advice to the plan," whereas the proposed rule would require only that the advice be "individualized to, or that such advice is specifically directed to, the advice recipient for consideration in making investment or management decisions …." See 29 C.F.R. § 2510.3-21(c)(1)(ii)(B).

What carve-outs are included in the new proposal?

The proposed definition of "fiduciary" is broad and would capture a number of activities the DOL does not believe to be fiduciary in nature. Recognizing this, the proposed fiduciary definition includes a number of carve-outs to exempt certain activities from being treated as a fiduciary act. The following actions are protected by the carve-outs and will not be deemed fiduciary in nature:

- Advice to a "large plan investor with financial expertise" in connection with an arm's length transaction.
  - In order to make use of the carve-out, the person providing advice must either:
    - Obtain a written representation from the plan fiduciary that such plan fiduciary is a fiduciary of an employee benefit plan that covers 100 or more participants; or
    - Know or reasonably believe that the plan fiduciary has responsibility for managing at least $100 million in employee benefit plan assets.
  - In addition, the person giving the advice must also inform the plan fiduciary of the existence and nature of the person's financial interests in the transaction and may not receive a fee directly from the plan for the provision of investment advice.
  - This carve-out will not apply to cover recommendations to retail investors, which include small plans, IRA owners, and plan participants and beneficiaries.
- Offers or recommendations to enter certain swap or security-based swap transactions under the Commodity Exchange Act or the Securities Exchange Act.
  - In order to qualify for the carve-out, the person providing recommendations with regard to the swap must act as a dealer and may not be an advisor to the plan and must also have reasonable basis to believe that the plans have independent representatives who are ERISA fiduciaries.
- Advice provided by an employee of an ERISA plan sponsor to a plan fiduciary as long as the employee receives no compensation for the advice beyond their normal compensation as an employee.

- Service providers making or marketing "platforms" or other investment vehicles to a participant-directed individual account ERISA plan and identifying investment alternatives that meet objective criteria specified by an ERISA plan fiduciary.
  - The carve-out does not apply to IRAs, as there is typically no separate "plan fiduciary" in the IRA context.
  - The service provider must disclose in writing that they are not undertaking to provide impartial investment advice or to give advice in a fiduciary capacity.
  - The DOL emphasized that a plan fiduciary is always responsible for prudently selecting and monitoring service providers to the plan.
- The provision of information and materials that constitute investment or retirement education.
  - The regulation specifies that there are four types of information and materials that may qualify for the carve-out: (1) plan information, (2) general financial, investment and retirement information, (3) asset allocation models, and (4) interactive investment materials.
  - However, any information regarding specific investment products is considered to be individualized advice and will not qualify for the carve-out. For example, one may recommend that a portfolio should contain a certain percentage of stocks and bonds under the carve-out, but a recommendation of which particular stocks and bonds to invest in will not qualify for the carve-out and is fiduciary in nature.
  - The carve-out applies equally to information provided to plan fiduciaries and information provided to plan participants, beneficiaries and IRA owners. It also applies equally to information provided by plan sponsors, fiduciaries and service providers.
- The provision of an appraisal, fairness opinion or statement of value to an employee stock ownership plan (ESOP) regarding employer securities to a collective investment vehicle holding plan assets or to a plan for meeting reporting and disclosure requirements.
  - This carve-out is mentioned in the preamble but does not appear in the regulation itself. It is also not discussed in Section IV of the preamble, which details the other carve-out provisions. The DOL Fact Sheet states, "DOL may put forth a separate regulatory proposal to clarify the applicable law for ESOP appraisals."

What exemptions are being proposed to the prohibited transaction rules?

In addition to the proposed revisions to the definition of fiduciary, the DOL also proposed two new prohibited transaction exemptions, as well as proposed amendments to certain existing exemptions. Given the expanded definition of fiduciary, these simultaneous revisions are necessary because ERISA fiduciaries are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption. These proposed exemptions would allow certain advisers and firms to continue to receive compensation for otherwise prohibited transactions despite their newfound fiduciary status.

Proposed Best Interest Contract Exemption (Best Interest Contract PTE)

In a departure from past practices, the Department's proposed Best Interest Contract PTE is a principles-based exemption, as opposed to other transaction-based exemptions, but applies only to investments in certain products and is subject to a number of fairly onerous requirements. It would be available to investment advice fiduciaries who

receive compensation for investment recommendations to retail investors, including individual plan participants, IRA owners and small plans (fewer than 100 participants), but again, only with certain types of investments.

The proposed Best Interest Contract Exemption would require that the investment advice fiduciary and financial institution enter into a written contract with investors that includes the following provisions:

- contractual acknowledgment of fiduciary status;
- commitment to basic standards of impartial conduct (including to give advice in the customer's best interests, avoid misleading statements and receive no more than reasonable compensation);
- warranty of compliance with applicable laws;
- warranty of adoption of policies and procedures reasonably designed to mitigate any harmful impact of conflicts of interest and ensure compliance with the standards of impartial conduct; and
- disclosure of basic information on conflicts of interest and fees.

The Department stressed that these contractual provisions would be enforceable by plans, participants, beneficiaries, IRA owners and the Department to ensure compliance with the exemption. Further, the proposed exemption prohibits exculpatory provisions disclaiming or limiting liability for violations of the contract's terms. Finally, the proposed exemption contains certain notice and data collections requirements for financial institutions.

The Department is also seeking public comment on whether it should issue a separate streamlined exemption that would allow advisers to receive compensation in certain high-quality low-fee investments, subject to fewer conditions than in the proposed Best Interest Contract PTE.

Proposed Principal Transaction Exemption (Transaction Exemption PTE)

The Department also proposed a Principal Transaction PTE that would permit fiduciaries to sell certain debt securities out of their own inventory to plans, participants, beneficiaries and IRA owners.

The Principal Transaction PTE would include all of the contractual requirements of the Best Interest Contract PTE. In addition, it would require that the adviser obtain two price quotes from unaffiliated counterparties for the same or a similar security, and the transaction would have to occur at a price at least as favorable to the plan or IRA as the two price quotes. Additionally, the adviser would have to disclose the compensation and profit it expects to receive from the transaction.

Amendments to Existing PTEs

In addition to the Best Interest Contract PTE and Principal Transaction PTE, the Department proposed amendments to certain other existing exemptions. The proposed amendments would require adherence to the same impartial conduct standards contained in the Best Interest Contract PTE. The Department also proposed amendments to PTE 84-24 and PTE 86-128 such that investment advice fiduciaries to IRA owners would not be able to rely on those specific exemptions, but instead would have rely on the Best Interest Contract PTE when receiving compensation for certain transactions.

What are some of the implications of the proposed changes?

The proposed changes would significantly expand the universe of financial service professionals who are subject to fiduciary duties and prohibited transaction rules. Certain types of investments, particularly alternative investment products, may not fit into the currently proposed exemption scheme, at least without modifications to how such products are distributed. However, limited relief may be available for "eligible investment advice arrangements" that

include fee-leveling or independently certified computer models. 29 C.F.R. §§ 2550.408g-1 and 2550.408g-2. There are also interesting implications for HSAs, which are treated as IRAs by the proposed rule, but would not have access to the platform exception.

These changes, if adopted, would thus have a significant impact on the financial services industry. Many financial services professionals have already expressed deep concerns about the scope of these proposed changes. It is likely that additional objections will be raised as the extent of what is being proposed becomes clearer. It would not be surprising to see significant changes adopted following the comment period and anticipated hearings.

If you would like to receive future *Employee Benefits & Executive Compensation Advisories* electronically, please forward your contact information to **employeebenefits.advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Members of Alston & Bird's Employee Benefits & Executive Compensation Group

Robert A. Bauman
202.239.3366
bob.bauman@alston.com

Saul Ben-Meyer
212.210.9545
saul.ben-meyer@alston.com

Stacy C. Clark
404.881.7897
stacy.clark@alston.com

Emily Seymour Costin
202.239.3695
emily.costin@alston.com

Patrick C. DiCarlo
404.881.4512
pat.dicarlo@alston.com

Meredith Gage
404.881.7953
meredith.gage@alston.com

Ashley Gillihan
404.881.7390
ashley.gillihan@alston.com

David R. Godofsky
202.239.3392
david.godofsky@alston.com

John R. Hickman
404.881.7885
john.hickman@alston.com

H. Douglas Hinson
404.881.7590
doug.hinson@alston.com

Emily C. Hootkins
404.881.4601
emily.hootkins@alston.com

James S. Hutchinson
212.210.9552
jamie.hutchinson@alston.com

Johann Lee
202.239.3574
johann.lee@alston.com

Blake Calvin MacKay
404.881.4982
blake.mackay@alston.com

Emily W. Mao
202.239.3374
emily.mao@alston.com

Steven Mindy
202.239.3816
steven.mindy@alston.com

Craig R. Pett
404.881.7469
craig.pett@alston.com

Earl Pomeroy
202.239.3835
earl.pomeroy@alston.com

Jonathan G. Rose
202.239.3693
jonathan.rose@alston.com

Syed Fahad Saghir
202.239.3220
fahad.saghir@alston.com

Thomas G. Schendt
202.239.3330
thomas.schendt@alston.com

John B. Shannon
404.881.7466
john.shannon@alston.com

Richard S. Siegel
202.239.3696
richard.siegel@alston.com

Leah Singleton
404.881.7568
leah.singleton@alston.com

Carolyn E. Smith
202.239.3566
carolyn.smith@alston.com

Michael L. Stevens
404.881.7970
mike.stevens@alston.com

Jahnisa P. Tate
202.239.3670
jahnisa.tate@alston.com

Daniel G. Taylor
404.881.7567
dan.taylor@alston.com

Elizabeth Vaughan
404.881.4965
beth.vaughan@alston.com

Kerry T. Wenzel
404.881.4983
kerry.wenzel@alston.com

Kyle R. Woods
404.881.7525
kyle.woods@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2015

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333