Insight

IN-DEPTH DISCUSSION

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Department of Labor Issues Sweeping Fiduciary Rule Proposal

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On April 14, 2015, the Department of Labor (DOL) released a proposal to re-define who is rendered a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act (ERISA) by providing investment advice to a plan or its participants or beneficiaries. In a press release, Labor Secretary Thomas Perez described the sweeping proposal as follows: "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." Yet, the more than 120-page proposed rule is far from simple. Its requirements and impact on access to advice about retirement savings accounts are far from certain.

In 2010, the DOL issued its first proposal to protect investors from conflicted advice by rewriting the definition of a fiduciary under ERISA. The controversial 2010 proposal was met with bipartisan criticism in Congress and from industry groups. Five years later, President Obama resurrected the issue in February 2015 by incorporating the goal of eliminating conflicts of interest in retirement advice as part of the "middle class economics" agenda. To this end, the President directed the DOL to issue a rule expanding the types of retirement investment advice subject to ERISA. According to the White House fact sheet on this directive, the "Department's proposal will update the definition to better match the needs of today's working and middle class families" and "will continue to allow private firms to set their own compensation practices by proposing a new type of exemption from limits on payments creating conflicts of interest that is more principles-based."[1]

The 2015 proposal takes a different approach than did the prior rulemaking effort. Yet, the objective and impact is even broader than that of the 2010 proposed rule. Individuals providing fiduciary investment advice to employer-based plan sponsors and plan participants are required to act impartially and provide advice that is in their clients' best interest. Under ERISA and the Internal Revenue Code, individuals providing "fiduciary investment advice" to plan sponsors, plan participants, and IRA owners are not permitted to receive payments creating conflicts of interest without a prohibited transaction exemption. In essence, the new proposal expands the scope of what is considered "fiduciary investment advice." Under the proposed definition, any individual receiving compensation for providing advice that is individualized or specifically directed to a particular plan sponsor or plan participant, such as an employee with respect to his or her 401(k), or IRA owner making a retirement investment decision, is a fiduciary. Such decisions can include, but are not limited to, what assets to purchase or sell and whether to rollover from an employer-based plan to an IRA.

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1 The White House, Office of the Press Secretary, *FACT SHEET: Middle Class Economics: Strengthening Retirement Security by Cracking Down on Backdoor Payments and Hidden Fees* (Feb. 23, 2015).

The proposed rule expressly carves out certain activities from the definition of fiduciary investment advice. General education on retirement saving does not trigger fiduciary duties. However, the scope of what is included in the retirement education carve-out remains a question and concern. With respect to "order-taking," the transaction does not constitute investment advice. Sales pitches to large plans with $100 million or more in assets and to large fund money managers with financial expertise may not be considered fiduciary investment advice if certain conditions are met, according to the proposal.

What is notably different about the DOL's revised proposal is its creation of a "best interest contract exemption" to allow firms to continue to set their own compensation practices so long as they meet a set of stringent, but not clearly defined, requirements. Among other things, the "best interest contact" exemption requires the company and the individual investment advisor providing retirement advice to enter into a contract with a client that:

- Commits the firm and the individual adviser to providing advice in the client's best interest. Committing to a best interest standard requires the adviser and the company to act with the care, skill, prudence, and diligence that a prudent person would exercise based on the current circumstances. In addition, both the firm and the adviser must avoid misleading statements about fees and conflicts of interest.
- Warrants that the firm has adopted policies and procedures designed to mitigate conflicts of interest. Specifically, the firm must warrant that it has identified material conflicts of interest and compensation structures that would encourage individual advisers to make recommendations that are not in clients' best interests and has adopted measures to mitigate any harmful impact on savers from those conflicts of interest.
- Clearly and prominently discloses any conflicts of interest that might prevent the adviser from providing advice in the client's best interest. The contract must also direct the customer to a webpage disclosing the compensation arrangements entered into by the adviser and firm and make customers aware of their right to complete information on the fees charged.

Notably, the "best interest contract exemption" would not apply if the contract contains exculpatory provisions disclaiming or otherwise limiting liability of the adviser or financial institution for violation of the contract's terms. Although the contract could require the parties to arbitrate individual claims, it could not limit the rights of the plan, participant, beneficiary, or IRA owner to bring or participate in a class action against the adviser or financial institution. Under the proposed rule, the "best interest contract exemption" allows customers to hold fiduciary advisers accountable for providing advice in their best interest through a private right of action for breach of contract. For IRA owners, the contract between the IRA owner and the adviser and financial institution forms the basis of the IRA owner's enforcement rights under the proposed rule.

The proposed rule also includes a new exemption for principal transactions to allow advisers to recommend certain fixed-income securities and sell them to the customer directly from the adviser's own inventory, as long as the adviser adheres to the exemption's consumer-protective conditions. The proposal also includes changes to existing prohibited transaction exemptions.

Reaction to the DOL proposed rule on Capitol Hill was swift. Some congressional leaders raised concerns about the speed with which the proposed rule emerged from the review process at the White House Office of Management and Budget. House Education and the Workforce Committee Chairman John Kline (R-MN) and Health, Employment, Labor and Pensions Subcommittee Chairman Phil Roe (R-TN) issued a joint statement in response to the proposed fiduciary rule, saying: "it will take time to examine this new proposal and determine whether it's a better approach or just the same flawed scheme we've seen before." Representative Ann Wagner (R-MO) has introduced a bill that would force the DOL to wait until after the Securities and Exchange Commission has acted on a similar fiduciary rule it is considering for retail investment advice.

Public comments on the proposed rule are due by July 6, 2015. The parameters of these new exemptions require much analysis, as does their practical impact on the delivery of retirement investment advice. An initial assessment of the expanded definition of fiduciary investment advice in conjunction with the new exemptions suggests uncertainty and impediments to access to investment advice and choice may await.

The Littler Employee Benefit Practice Group and the Workplace Policy Institute will continue to provide ongoing analysis of this significant development.

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