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## The Times Are Changing: A First Look at the DOL's New Fiduciary Paradigm

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On April 14, 2015, the US Department of Labor (the “DOL”) issued its proposed rule clarifying when individuals and institutions providing advice to employee benefit plans and individual retirement accounts (“IRAs”) will be fiduciaries for purposes of the Employee Retirement Income Security Act of 1974 (“ERISA”) and the prohibited transaction provisions of the Internal Revenue Code (the “Code”). This detailed DOL proposal tackles the relationship between individuals who invest through IRAs, small plans and participant-directed plans and the investment professionals who provide advice and products to this growing segment of the market. It is being rolled out with considerable support from the White House, which signals that significant portions of the proposal may be adopted substantially as proposed.

Under the DOL's new paradigm, a broader array of advice and services will result in investment professionals being fiduciaries for purposes of ERISA. Most significantly, the proposal will expand the reach of ERISA's fiduciary duties and remedies by giving investment professionals the option, as a condition to relief from ERISA and the Code's prohibited transaction rules, to agree to have ERISA's fiduciary standards and remedies apply to them by contract in situations where they might not otherwise apply by statute.

The DOL's proposal will require financial institutions to rethink the way they and their investment professionals are compensated and will require a careful assessment of the costs and benefits of complying with the new requirements for prohibited transaction relief.

This client publication discusses the key aspects of the proposal and diagrams the key elements of each of the proposal's main components. Future client publications will analyze in greater detail key aspects of the proposal and suggest areas that may be appropriate for comment.

## The Key Components of the Proposal

The DOL's proposal consists of the following three components:

- A new proposed rule defining when persons providing investment advice to employee benefit plans and IRAs are so-called "advice fiduciaries" for purposes of ERISA and the Code.<sup>1</sup>
- Two new proposed prohibited transaction exemptions offering relief for certain fee and other commercial practices applicable to fiduciaries. The more important of the two is the proposed Best Interest Contract Exemption (the "BIC Exemption") that, among other things, conditions relief on an agreement to have ERISA's fiduciary standards apply by contract to advisers to IRAs and certain covered plans.<sup>2</sup>
- Amendments, revisions or the actual repeal of portions of existing prohibited transaction exemptions to conform to the impartial conduct standards in the BIC Exemption or to prior DOL regulatory initiatives.<sup>3</sup>

If adopted in their present form, the DOL's new proposed rule and proposed exemptions will expand the types of interactions with employee benefit plans and IRAs that result in fiduciary status. The expansion of fiduciary status will require the substantial alteration of common compensation and other commercial practices of the investment professionals who advise IRA, small plan and participant directed investors.

## The Paradigm Shift in the Proposal

The proposal embraces a major paradigm shift in the way that ERISA applies to investment professionals who advise and offer investment products to the retail employee benefit plan and IRA market. The key elements of this shift are the following:

- The proposed rule aims to have ERISA fiduciary rules apply broadly to those who advise IRAs, small employee benefit plans and participants in self-directed plans.
- The proposed rule enumerates specific types of advice to employee benefit plans and IRAs that will result in fiduciary status, in situations where the advice giver receives a fee or other direct or indirect compensation in connection with rendering the advice. The advice does not need to be on a regular basis, and there does not have to be an

<sup>1</sup> The proposed rule may be found at: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08831.pdf>.

<sup>2</sup> The proposed exemptions may be found at: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08832.pdf> (Best Interest Contract Exemption) and <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08833.pdf> (Principal Transaction Exemption).

<sup>3</sup> The amendments and revisions may be found at: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08836.pdf>; <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08837.pdf>; <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08839.pdf>; and <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08838.pdf>.

understanding that the advice will form the primary basis for the investment decision, as long as the advice is individualized or directed to the advice recipient for consideration in making investment decisions.<sup>4</sup>

- If advice givers acknowledge that they are fiduciaries, all categories of advice listed in the proposed rule will result in fiduciary status.
- Advice to take a plan distribution or to effect a rollover to an IRA is included in the categories of advice that will result in fiduciary status.
- The proposed rule will make it difficult, if not impossible, to continue compensation arrangements for advisers to IRAs and employee benefit plans where the amount of compensation or fee income, direct or indirect, varies based on security or product selection, unless the advisers and financial organizations comply with the BIC Exemption.
- The BIC Exemption is broad and principles-based. It has, at its core, “impartial conduct standards” that essentially condition relief from ERISA’s prohibited transaction rules on the agreement by individual advisers to IRAs or employee benefit plans (and the financial organizations that employ these advisers) to have ERISA fiduciary standards apply by contract to them.

## Effective Date and Comment Period

The DOL will accept written comments on or before July 6, 2015. The DOL plans to hold a public hearing during the 30-day period following the close of the comment period. Following the hearing, the DOL will accept additional written comments for a limited period of time.

The final DOL rule will be effective 60 days after its publication in the Federal Register, and the requirements of the final rule will generally become applicable eight months after publication in the Federal Register. The BIC Exemption will be available eight months after publication of the final rule and the other new and amended exemptions will be effective at that same time.

## Next Steps

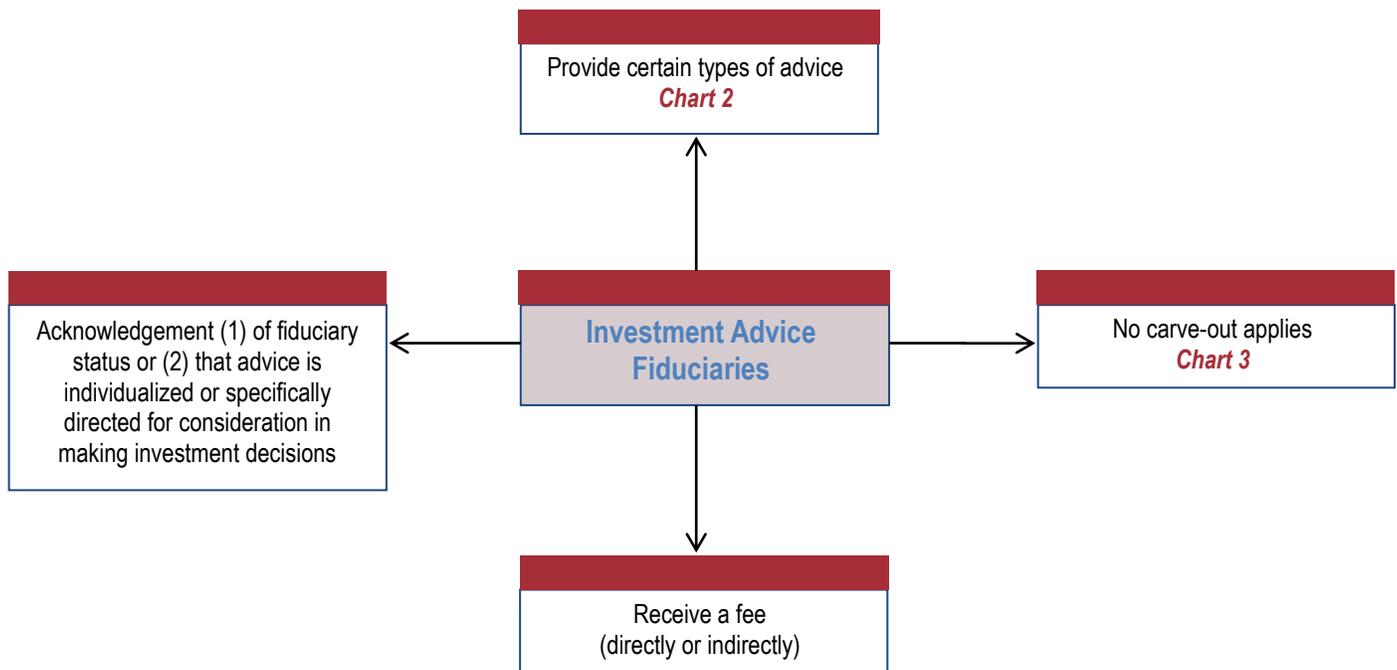
Now that the proposal has been published, you should consider how this new paradigm could affect your business. You may wish to submit a comment letter to the DOL or attend the public hearing. The following pages contain a set of charts designed to illustrate the application of the proposal.

- Charts 1-3: These charts explain the general application of the proposal, focusing on how one becomes an investment advice fiduciary, the four different types of advice that would qualify as fiduciary investment advice under the proposal, and the various carve-outs from the concept of fiduciary investment advice that could apply. They may be most useful for those seeking to understand the general scope of the proposal.

<sup>4</sup> Under the current DOL regulations, a person provides investment advice as a fiduciary if he (1) provides advice as to the value of securities or other property or makes investment recommendations, (2) on a regular basis, (3) pursuant to a mutual agreement, arrangement or understanding with a plan fiduciary that (4) the advice will serve as the 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.

- Charts 4-8: These charts describe the requirements for satisfying certain specific carve-outs. They should prove useful in ascertaining the impact of the proposal on individual businesses and persons.
- Charts 9-10: These charts explain the parameters of two new exemptions, the BIC Exemption and the Principal Transaction Exemption. They may be most useful to attorneys seeking to understand the application of these exemptions.
- Chart 11: This chart depicts the changes to existing prohibited transaction exemptions imposed by the proposal, and may be most useful to attorneys who are familiar with the existing exemptions.
- Note that, in the charts, outward-pointing arrows indicate conjunctive requirements, all of which must be established to satisfy the requirement in the center of the chart (see charts 1, 4-10). Inward-pointing arrows indicate alternative options (see charts 2-3).

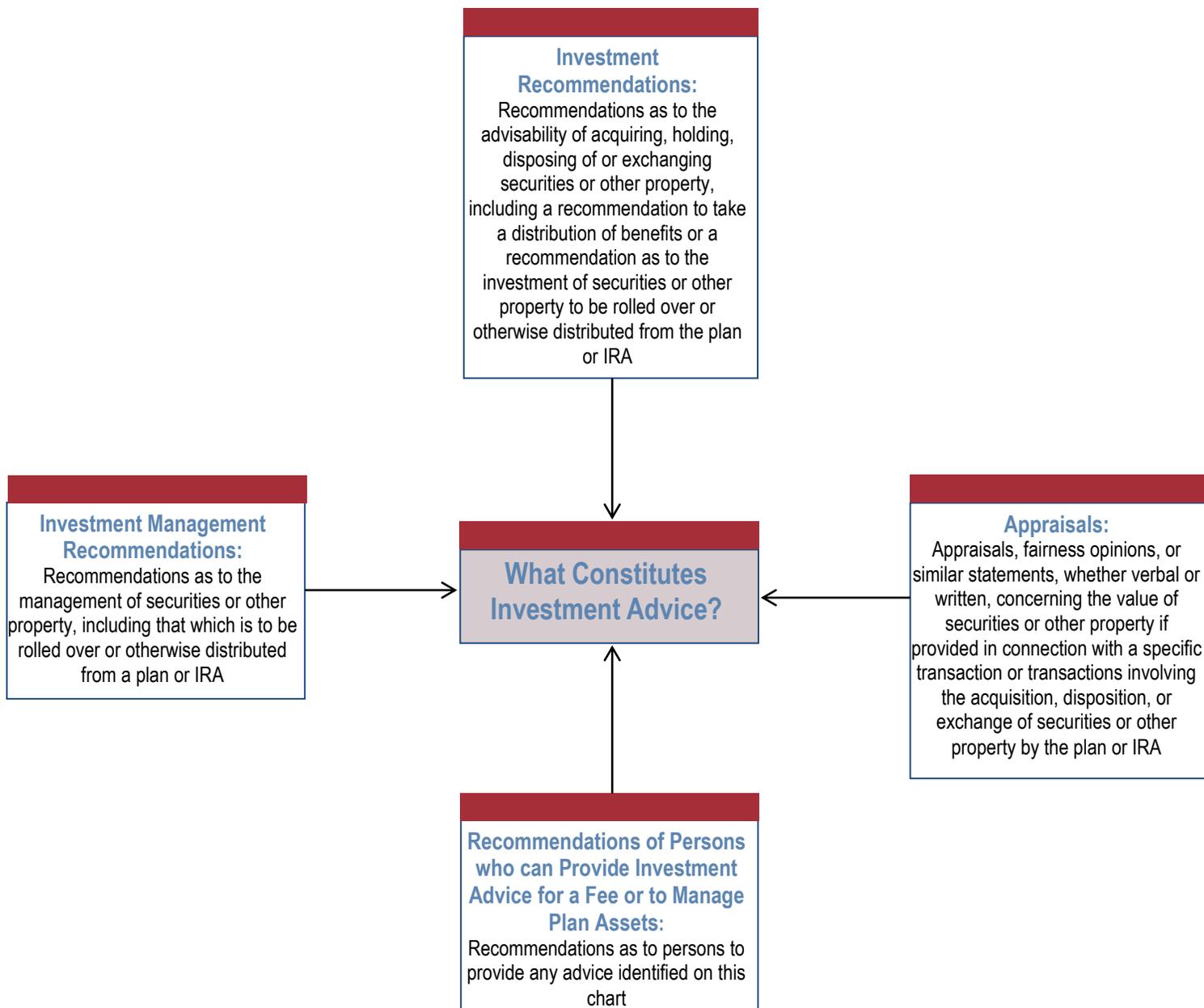
## Chart 1: Requirements to be an Investment Advice Fiduciary



Points to Consider:

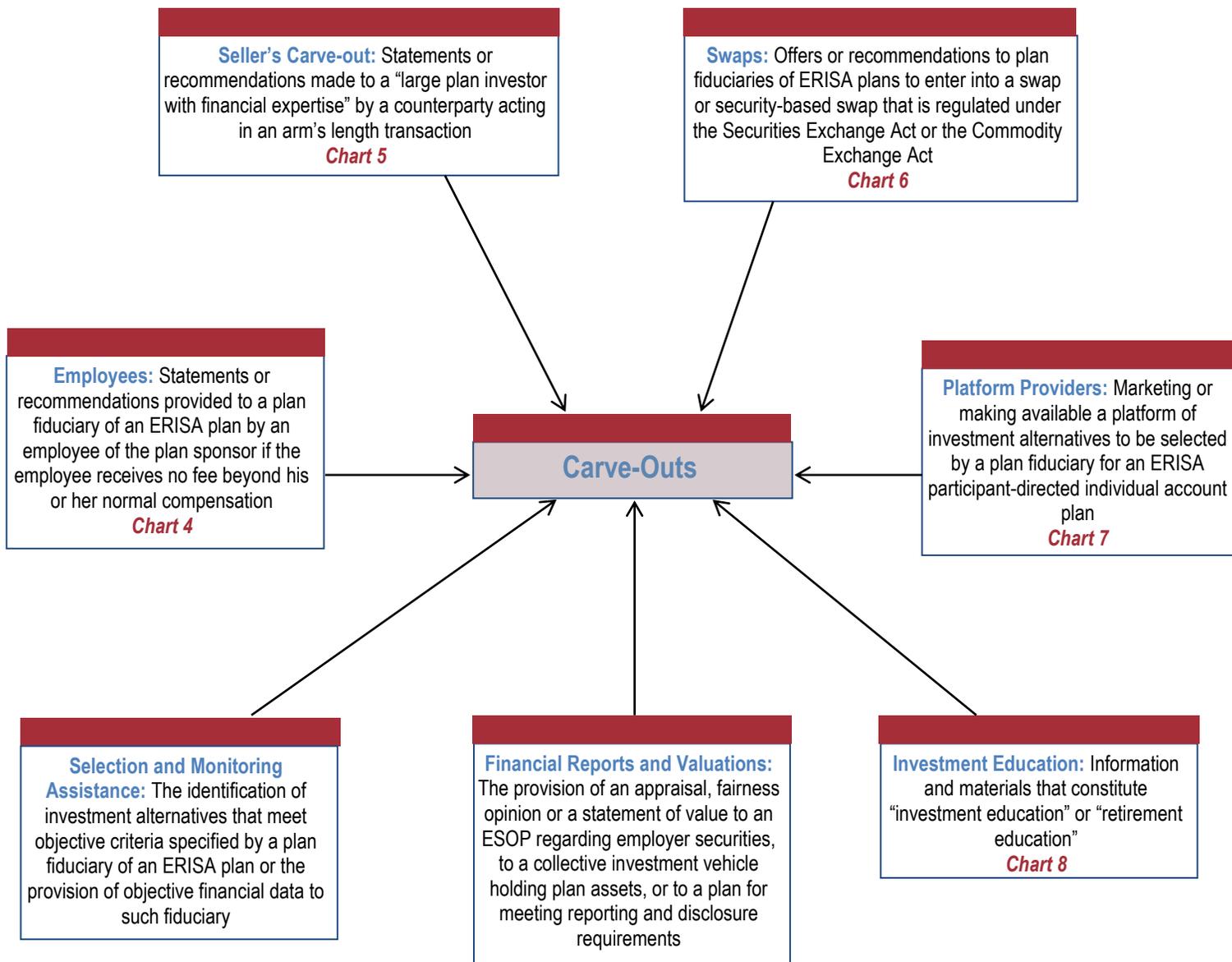
- Advice need not be provided on a continuous basis.
- Those who claim fiduciary status cannot later claim that the advice was not fiduciary in nature.
- Recommendations to the general public are not investment advice.

## Chart 2: Four Types of Investment Advice<sup>5</sup>



<sup>5</sup> More information regarding the definition of investment advice can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-19>.

### Chart 3: The Seven Available Carve-Outs<sup>6</sup>

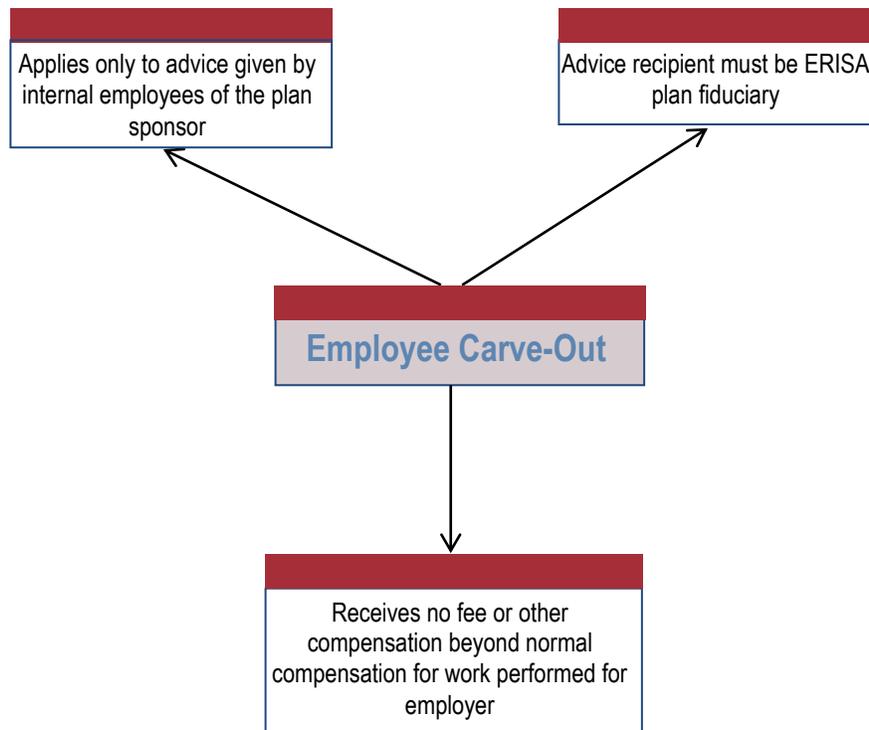


Points to Consider:

- The carve-outs exclude from the definition of investment advice recommendations that the DOL recognizes should not be treated as fiduciary advice.

<sup>6</sup> More information on the carve-outs may be found at: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-25>.

### Chart 4: Requirements of the Employee Carve-Out<sup>7</sup>

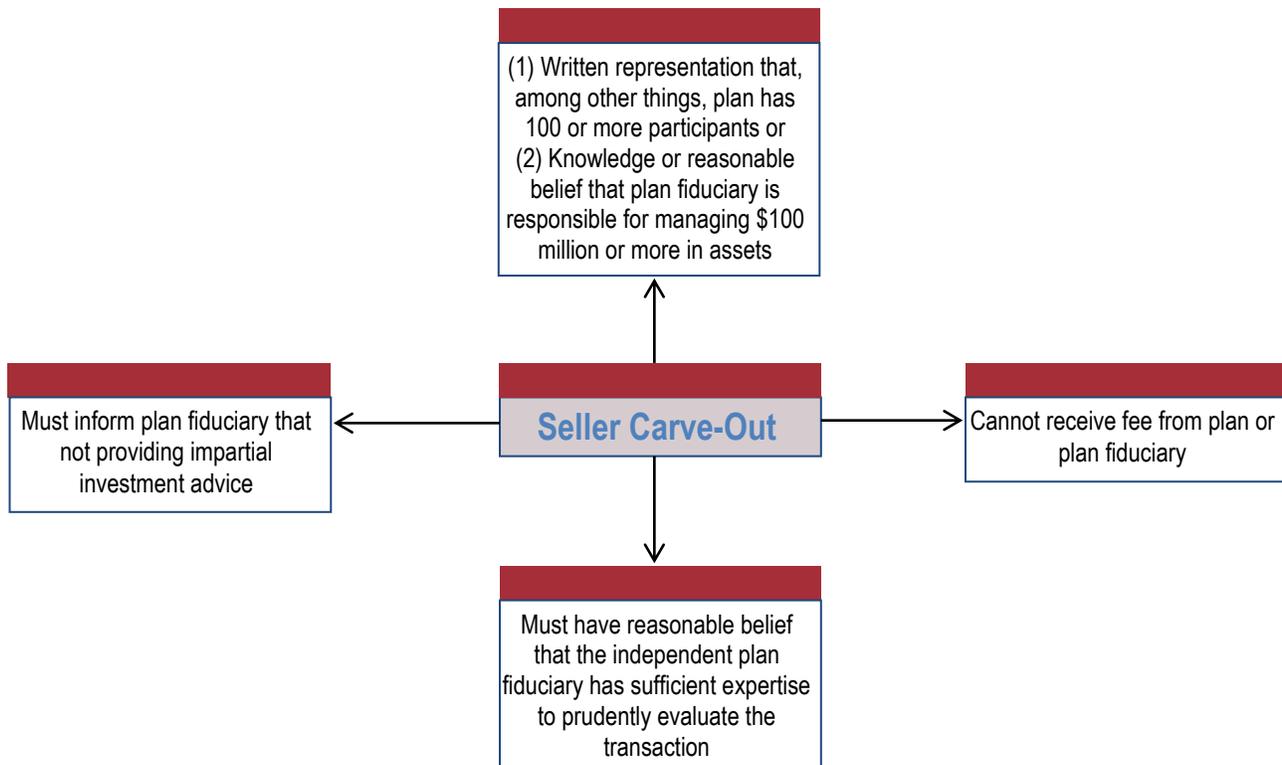


Points to Consider:

- Examples of this carve-out include a company's human resources employee communicating with the company's benefits committee.
- This carve-out is not applicable to communications to plan participants, beneficiaries or IRA owners.

<sup>7</sup> More information regarding the employees carve-out can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-29>.

### Chart 5: Requirements of the Seller’s Carve-Out<sup>8</sup>

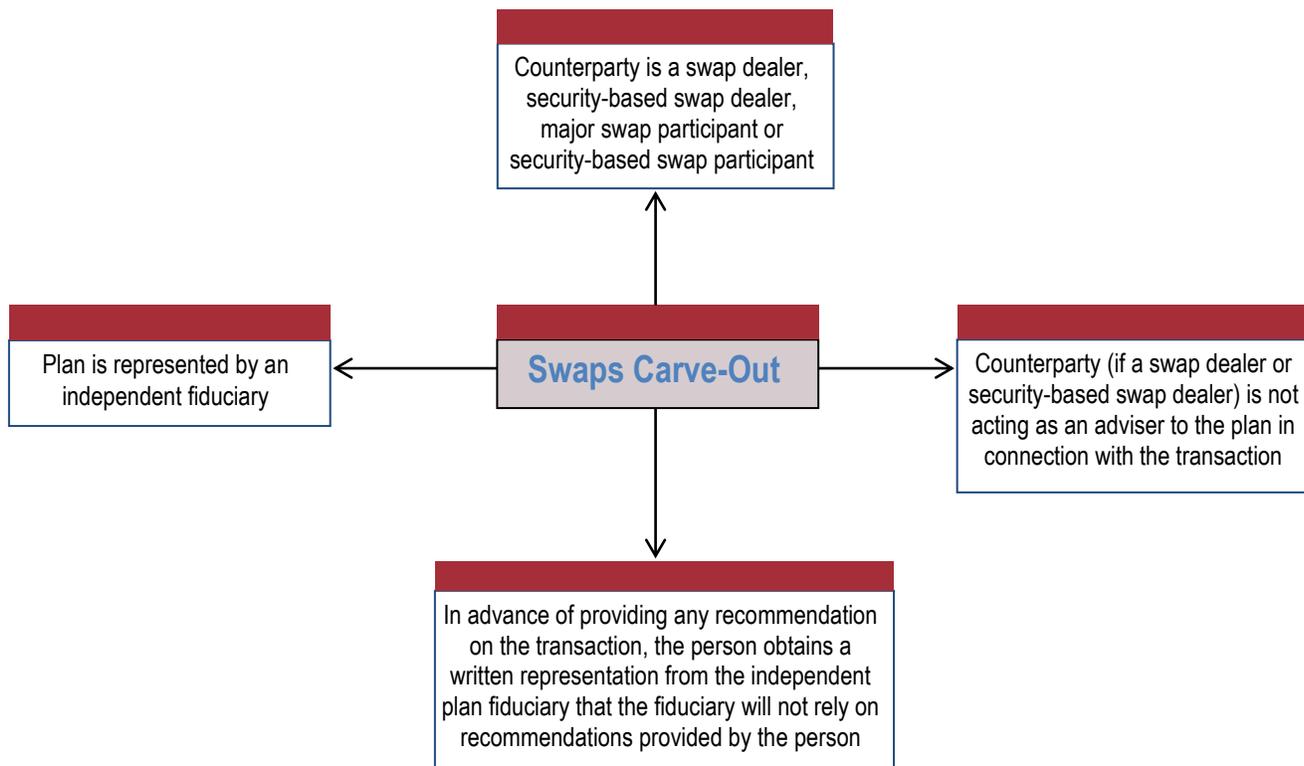


Points to Consider:

- Advice must be provided to an ERISA plan fiduciary; this carve-out is not applicable to smaller retail investors or IRA owners.
- The advice recipient must be independent of the advice giver and must exercise authority or control with respect to management or disposition of plan assets.
- The advice given must be with respect to arm’s length sale, purchase, loan or bilateral contract between plan and counterparty (or proposal to enter into such transaction).

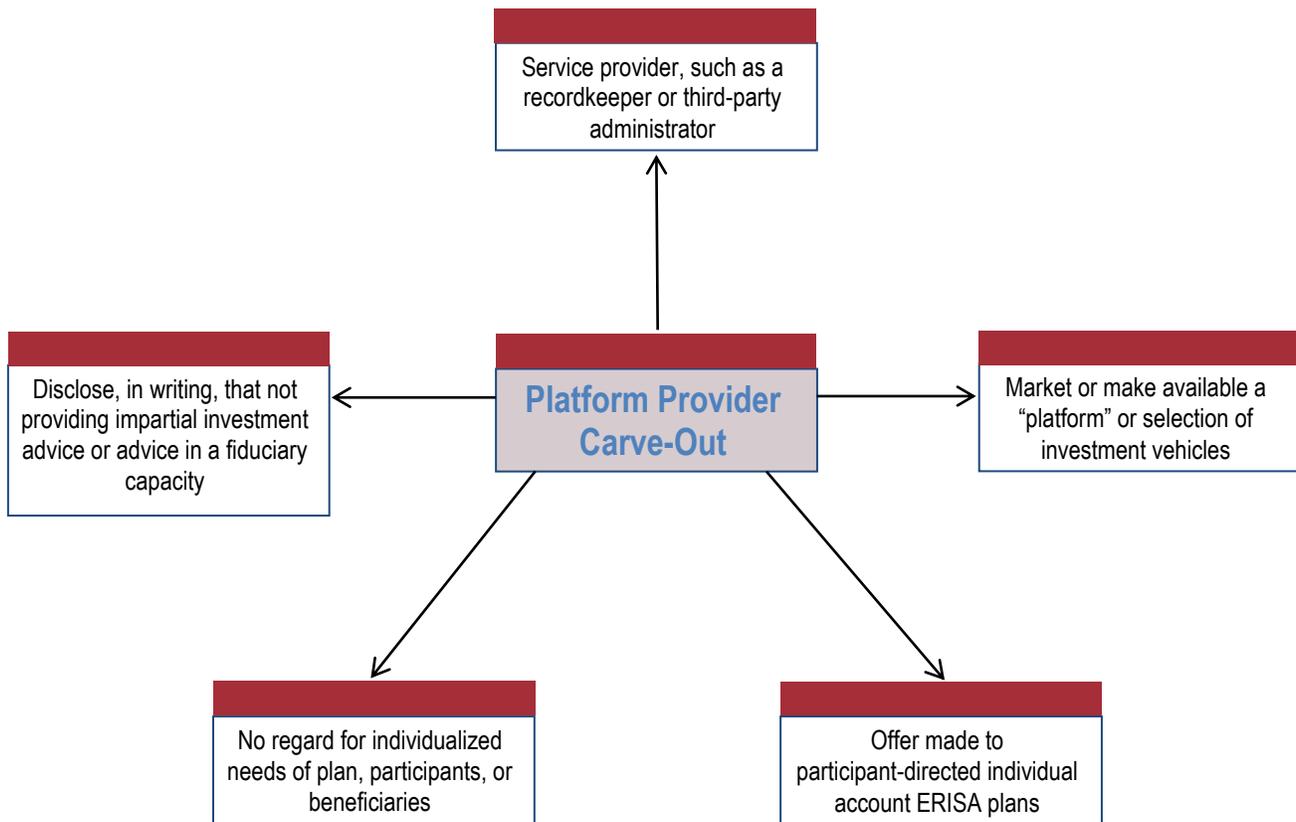
<sup>8</sup> More information regarding the seller’s carve-out can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-27>.

### Chart 6: Requirements of the Swaps Carve-Out<sup>9</sup>



<sup>9</sup> More information regarding the swaps carve-out can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-28>.

## Chart 7: Requirements of the Platform Provider Carve-Out<sup>10</sup>

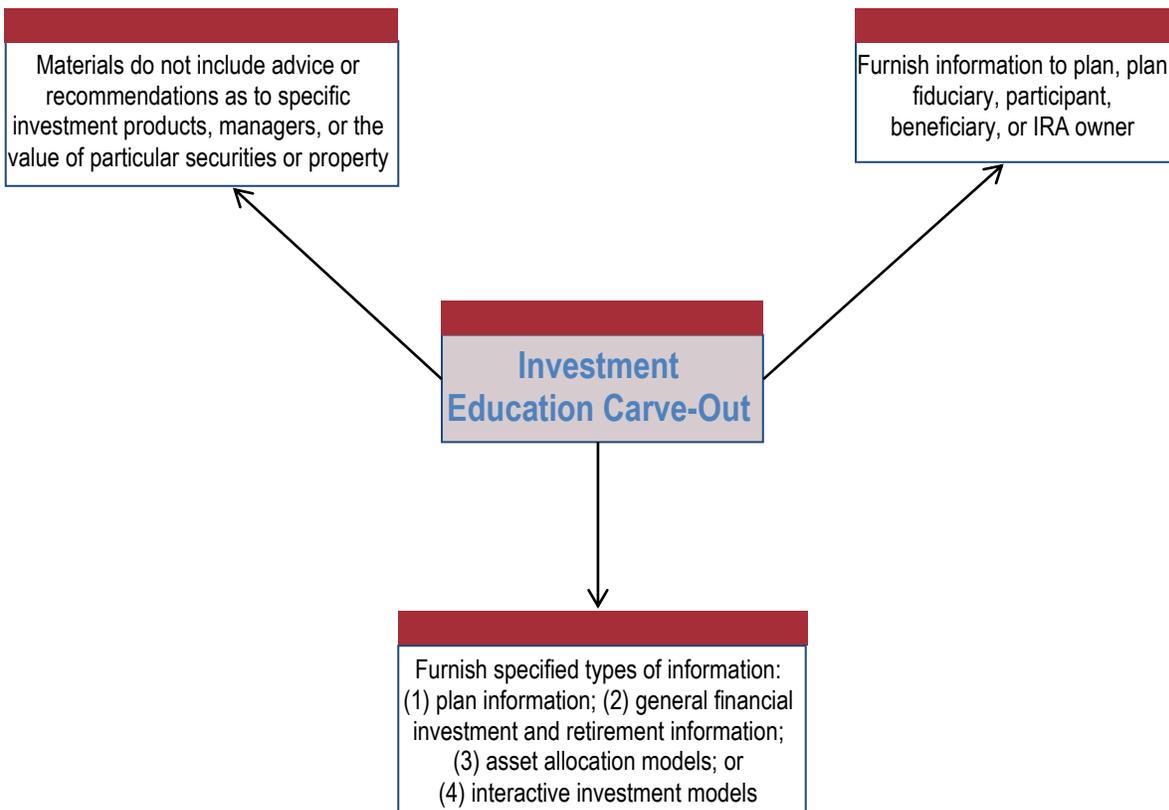


Points to Consider:

- This carve-out applies to 403(b) marketplace.
- It does not extend to IRAs and other non-ERISA plans.
- The proposal provides that merely identifying offered investment alternatives meeting objective criteria specified by the plan fiduciary or providing objective financial data regarding investment alternatives is not fiduciary advice.

<sup>10</sup> More information regarding the platform provider carve-out can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-30>.

### Chart 8: Requirements of the Investment Education Carve-Out<sup>11</sup>

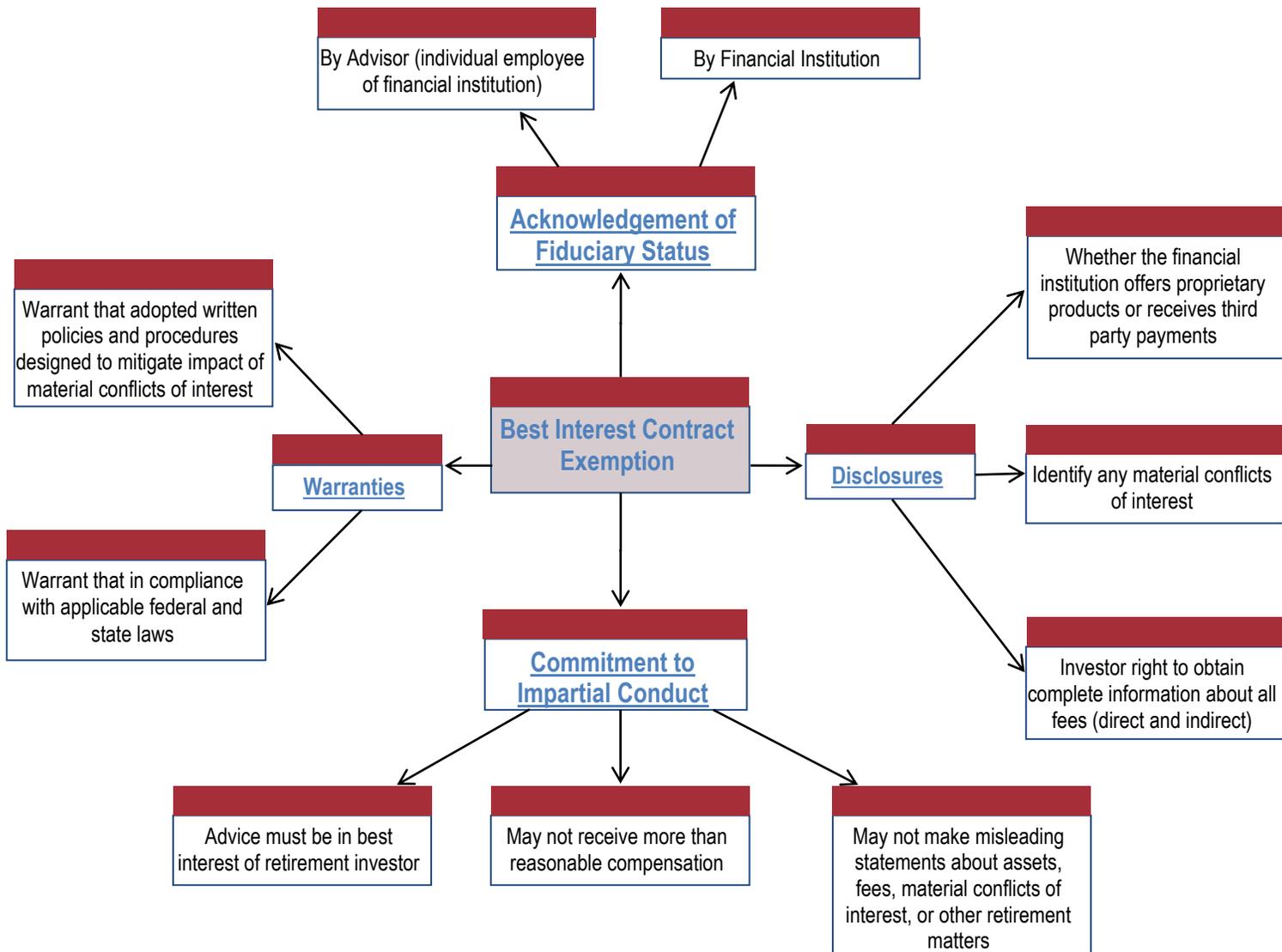


Points to Consider:

- This carve-out does not consider who provides the information, the frequency with which it is provided, or the form it is provided in.
- General information that helps one assess and understand retirement income needs or risks, or explains how to manage risks, is not fiduciary.
- Asset allocation models and interactive investment materials that refer to specific products available under a plan or IRA would now be considered individualized recommendations rather than investment education.

<sup>11</sup> More information regarding the investment education carve-out can be found here: <https://www.federalregister.gov/articles/2015/04/20/2015-08831/definition-of-the-term-fiduciary-conflict-of-interest-rule-retirement-investment-advice#h-31>.

**Chart 9: Requirements of the BIC Exemption<sup>12</sup>**

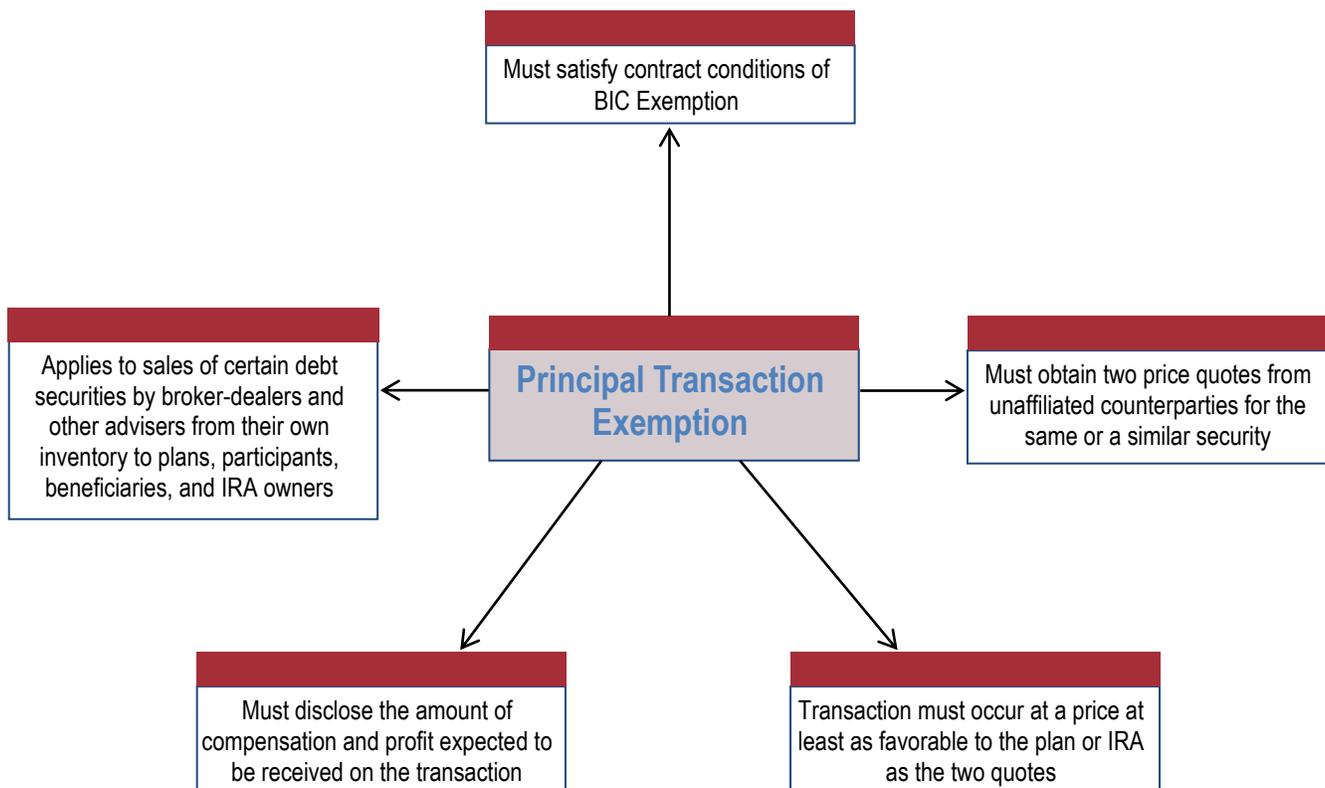


Points to Consider:

- This exemption applies a principles-based (flexible) approach rather than a prescriptive one.
- It applies only to investment advice given to plan participants and beneficiaries, IRA owners, and plan sponsors of non-participant directed plans with fewer than 100 participants; it would not apply to advice rendered to larger “institutional” investors.
- Assets that can be sold under the exemption are generally of the “plain vanilla” variety (e.g., bank deposits, CDs, corporate bonds, equity securities); derivatives such as puts, calls, straddles, and options, and investments in hedge funds and private equity funds are excluded.
- It affords IRA owners a private right of action (via contract) that was previously unavailable.
- Additional disclosure (point of sale and end of year), notice and record-keeping requirements apply.
- The contract must be in writing and cannot contain exculpatory provisions disclaiming or otherwise limiting liability of the adviser or financial institution for violation of the contract’s terms.

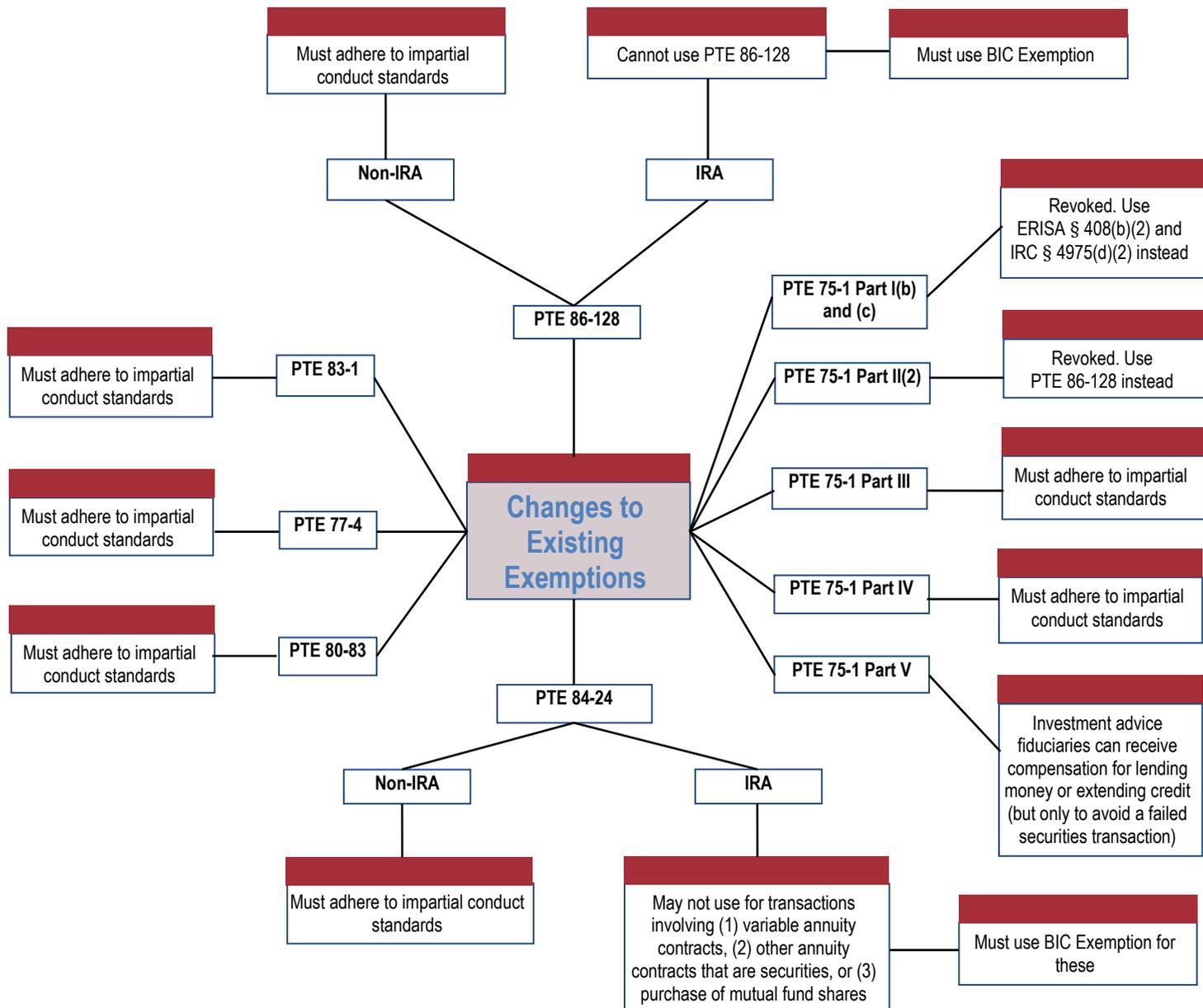
<sup>12</sup> More information regarding the BIC Exemption can be found here: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08832.pdf>.

**Chart 10: Requirements of the Principal Transaction Exemption<sup>13</sup>**



<sup>13</sup> More information on the Principal Transaction Exemption can be found here: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08833.pdf>.

**Chart 11: Roadmap of Changes to Existing Exemptions<sup>14</sup>**



Points to Consider:

- PTEs 75-1 Pt. III, 75-1 Pt. IV, 77-4, 80-83, and 83-1 remain available, but the impartial conduct standards would apply.
- PTE 86-128 now extends to a new covered transaction, allowing fiduciaries who sell mutual fund shares out of their own inventory to plans or IRAs to receive commissions for doing so.
- PTE 75-1 Pt. V now allows investment advice fiduciaries to receive compensation for lending money or extending credit (but only for the limited purpose of avoiding a failed securities transaction).

<sup>14</sup> For more information on these changes to existing prohibited transaction exemptions, please see the following: <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08836.pdf> (PTE 75-1 (V)); <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08837.pdf> (PTE 84-24); <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08839.pdf> (PTE 75-1 (III) and (IV)); PTE 77-4; PTE 80-83; PTE 83-1); <http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08838.pdf> (PTE 86-128; PTE 75-1 I(b)-(c), II(2)).

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