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View From Sidley: Potential Impact of Proposed DOL Guidance on Definition of Fiduciary



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On April 14, 2015, the U.S. Department of Labor (“DOL”) issued a new proposed regulation defining “fiduciary,” which would expand the circumstances under which consultants, advisers, appraisers and others become fiduciaries for purposes of the Employee Retirement Income Security Act as a result of providing “investment advice.” In addition, the DOL issued a new proposed prohibited transaction class exemption, referred to as the “Best Interest Contract Exemption,” as well as other proposed guidance. In general, it appears that the DOL issued the proposed exemption and other proposed guidance in order to permit current business practices to continue even if certain parties who are not currently considered to be fiduciaries become fiduciaries as a result of the proposed regulation. However, the question is whether these pro-

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posals will really permit current business practices to continue.

Proposed New Definition

Under the proposal, a person is a fiduciary if that person provides, directly to a plan, plan fiduciary, plan participant or beneficiary, IRA, or IRA owner the type of advice or recommendations described in item 1 below in exchange for a fee or other compensation, whether direct or indirect, AND the person meets one of the conditions described in item 2 below:

1. Type of Advice or Recommendation:

■ *Recommendations as to Investments.* A recommendation as to the advisability of acquiring, holding, disposing or exchanging securities or other property, including a recommendation to take a distribution from a plan or IRA or a recommendation as to the investment of assets to be rolled over or otherwise distributed.

■ *Recommendations as to Management of Investments.* A recommendation as to the management of securities or other property, including recommendations as to the management of assets to be rolled over or otherwise distributed from the plan or IRA.

■ *Valuations of Assets.* An 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 involving the acquisition, disposition, or exchange, of such securities or other property by the plan or IRA.

■ *Recommendations of Advice Providers or Other Fiduciaries.* A recommendation of a person who will receive compensation for providing any of the types of advice described above.

2. Conditions. The person directly or indirectly:

■ represents or acknowledges that it is acting as a fiduciary within the meaning of ERISA with respect to providing advice or making recommendations described in item 1 above; or

■ renders the advice pursuant to a written or verbal agreement, arrangement or understanding that the advice is individualized to, or that such advice is specifi-

cally 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.

3. Exclusions From Fiduciary Status. The proposed regulation specifically excludes certain persons from being fiduciaries as long as they do not represent or acknowledge that they are acting as a fiduciary to a plan. Excluded persons include, among others:

- a *counterparty to a transaction* with a plan who is independent of the plan fiduciary, provided that certain conditions are satisfied including that either (A) the plan has 100 or more participants; or (B) the independent plan fiduciary has responsibility for managing at least \$100 million in plan assets. This exclusion is referred to as the “seller’s carve-out.”

- certain *swap dealers or major swap participants* acting as a swap or security-based swap counterparty to an employee benefit plan, provided certain conditions are satisfied.

- *providers of investment platforms* from which plan fiduciaries select and monitor investment alternatives for plan participants to direct investment of their plan accounts, provided certain conditions are satisfied.

- *employees* of any employer or employee organization sponsoring the plan if the employee is providing advice to a plan fiduciary and does not receive compensation for that advice beyond the employee’s normal compensation.

- *persons providing appraisals*, to: (A) an employee stock ownership plan, (B) a plan assets fund in which more than one plan invests, or (C) a plan, plan fiduciary, plan participant, IRA or IRA owner solely for purposes of satisfying reporting and disclosure requirements.

- *providers of investment education* that does not include recommendations with respect to specific investment products or recommendations on investment, management or the value of particular property.

Proposed Best Interest Contract Exemption

Relief. This new proposed exemption (the “BIC Exemption”) would permit “Financial Institutions” (i.e., registered investment advisers, banks or insurance companies), “Advisers” (i.e., persons or agents of a “Financial Institution” who provide investment advice), and their affiliates and related entities to receive compensation for services provided to “Retirement Investors” in connection with a purchase, sale or holding of an “Asset” by a Retirement Investor, as a result of the Adviser’s and Financial Institution’s advice.

“Retirement Investors” are defined as:

- a participant or beneficiary of a plan subject to ERISA with authority to direct the investment of assets in his or her plan account or to take a distribution;

- the beneficial owner of an IRA acting on behalf of the IRA; or

- a plan sponsor (or any employee, officer or director thereof) of a non-participant-directed plan subject to

ERISA with fewer than 100 participants, to the extent it acts as a fiduciary who has authority to make investment decisions for the plan.

“Asset” is defined as:

- bank deposits,
- CDs,
- shares or interests in registered investment companies (mutual funds),
- bank collective funds,
- insurance company separate accounts,
- exchange-traded REITs,
- exchange-traded funds,
- corporate bonds offered pursuant to a registration statement under the Securities Act of 1933,
- agency debt securities,
- U.S. Treasury securities,
- insurance and annuity contracts (both securities and non-securities),
- guaranteed investment contracts, and
- exchange-traded equity securities.

The definition specifically excludes from the term “Asset” a security future or a put, call, straddle, or any other option to buy an equity security from or sell an equity security to another without being bound to do so.

Conditions for Relief. The BIC Exemption contains many conditions in order for the relief to apply including, among others:

A. That the Adviser and Financial Institution enter into a written contract with the plan or IRA that, among other things, requires the Adviser and Financial Institution to comply with the “Impartial Conduct Standards” (described below).

The “*Impartial Conduct Standards*” require that the Adviser and Financial Institution:

- provide investment advice that is in the “Best Interest of the Retirement Investor” (discussed below),

- not make investment recommendations that would result in more than reasonable compensation being paid to the Adviser or Financial Institution, and

- provide certain disclosures that are not misleading.

The term “*Best Interest of the Retirement Investor*” means that the advice provided by the Adviser and Financial Institution “reflects the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person would exercise based on the investment objectives, risk tolerance, financial circumstances, and needs of the Retirement Investor, without regard to the financial or other interests of the Adviser, Financial Institution or any Affiliate, Related Entity, or other party.”

B. That the Financial Institution, *prior to the date on which the plan or IRA makes the recommended investment*, complies with substantial disclosure requirements, including disclosing, in the form of a chart with respect to each recommended investment, the “Total

Cost” of the investment for 1-, 5- and 10-year periods expressed as a dollar amount, assuming an investment of the dollar amount recommended by the Adviser and reasonable assumptions about investment performance that are disclosed. The Financial Institution also must maintain a public *webpage* that shows (1) the direct and indirect material compensation payable to the Adviser, Financial Institution and any affiliate for services provided in connection with the investments available through the Financial Institution, and (2) the source of the compensation, and how the compensation varies within and among investments. In addition, the Financial Institution must provide advance notice to the DOL that it will rely on the BIC Exemption and maintain certain records and provide information to the DOL upon its request.

Key Considerations for Practitioners

How Would the Proposed Regulation Impact Plan Sponsors? The proposed regulation should not change the determination of whether a plan sponsor is a plan fiduciary. If the plan sponsor has responsibility for selecting investment options or selecting other fiduciaries, the plan sponsor is a fiduciary. The proposed regulation would not change this result.

One question that arises is whether employees of a plan sponsor are considered to be fiduciaries. The proposed regulation makes clear that an employee of a plan sponsor will not become a fiduciary by reason of providing advice to a plan fiduciary, provided the employee does not receive compensation for that advice beyond the employee’s normal compensation. This carve-out provides relief from fiduciary status for employees of a plan sponsor that are required, as an incidental part of their jobs, to develop reports and recommendations for investment committees and other named fiduciaries of the plan sponsors’ plans without being paid for fiduciary advice. The proposed regulation does not specifically address whether employees whose primary job responsibilities are to provide investment advice to investment committees are plan fiduciaries. For example, many plan sponsors that maintain large defined benefit plans have a staff of investment professionals whose main job responsibilities are monitoring plan investments and providing investment recommendations with respect to assets of the plans. The proposed regulation leaves open the question of whether those employees are intended to be excepted from fiduciary status.

Should ‘Retirement Investors’ Be Limited in the Types of Investments They Can Make? It appears that many broker-dealers and other counterparties and advisers to Retirement Investors will have to rely on the BIC Exemption in order to receive compensation in connection with investments made by the Retirement Investors. If that is the case, the Retirement Investors will be limited in the types of transactions in which they may engage. Only transactions in “Assets” as defined above will be permitted. This means that Retirement Investors cannot invest in a private equity fund, a private real estate fund, a security future or a put, call, straddle, or any other option to buy an equity security. Neither ERISA nor the Internal Revenue Code prohibit Retirement Investors from investing in these types of assets so a question arises as to whether it is appropriate for the DOL to

prohibit these types of investments where the BIC Exemption is necessary to permit Retirement Investor to make an investment. Presumably, the DOL has concluded that Retirement Investors are not sufficiently sophisticated to be permitted to make these investments. This conclusion does not take into account the particular circumstances of each Retirement Investor. Some Retirement Investors are sophisticated investors that are more than capable of deciding to invest in any types of assets. For example, a hedge fund manager making investments on behalf of his or her IRA would appear to have the ability to determine whether a particular investment is appropriate for the IRA.

Does the BIC Exemption Apply to All Plan Fiduciaries?

Unfortunately, the BIC Exemption does not appear to apply to all Advisers or Financial Institutions that are fiduciaries as a result of the proposed regulation. One significant omission is fiduciaries of self-directed plans that have less than 100 participants and no special manager. This is because the BIC Exemption applies only to plans with less than 100 participants that are not self-directed. It is not clear whether the DOL intended to exclude fiduciaries for these types of plans from being able to rely on the BIC Exemption. If the BIC Exemption is not revised to cover these fiduciaries, many transactions currently undertaken by plans with less than 100 participants may be prohibited. For example, if the plan wants to adopt a platform but the platform exclusion does not apply, an issue arises as to whether that plan will be permitted by any Financial Adviser to adopt its platform. It does not appear that there is any policy supporting the exclusion of fiduciaries of these types of plans from being able to avail themselves of the relief provided by the BIC Exemption.

How Can an Adviser or a Financial Institution Avoid Being a Fiduciary?

As explained above, if an Adviser provides certain recommendations to a Retirement Investor, the Adviser and the Financial Institution may become a fiduciary to that Retirement Investor unless a carve-out applies. One carve-out applies where the Adviser provides investment education that does not include specific investment recommendations. Investment education includes:

- information and materials that describe the terms or operation of the plan or IRA and inform a plan fiduciary, participant, beneficiary, or IRA owner about the benefits of participation and the forms of distributions among other things;
- information and materials on financial, investment and retirement matters that do not address specific investment products, specific plan or IRA alternatives or specific distribution options;
- asset allocation models; and
- interactive investment materials.

An Adviser and Financial Institution could avoid being a fiduciary by reason of providing investment advice if the Adviser merely provides investment education without recommending any particular investments.

Should Your Client Submit a Comment to the DOL? Comments to the DOL are due by July 20, 2015. With the assistance of its lawyers, clients should determine whether the proposed guidance could negatively impact

the activities of its plans. For example, will the client's plan be prohibited from making certain investments? If

so, the client may want to consider submitting a comment to the DOL.